THE INTERPLAY BETWEEN FOREIGN DIRECT INVESTMENT, SECURITY AND EUROPEAN INTEGRATION BY COMPARING POLAND AND ROMANIA

by

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DECLARATION

I hereby certify that the work embodied in this thesis is the result of my own investigations except where reference has been made to published literature.

I declare that this work has not already been accepted in substance, nor is it currently being published in candidature for any other degree.

ABSTRACT

This work investigates the factors that have led to Poland and Romania's different evolutionary paths during the process of accession to the EU, placing an emphasis on security concerns, foreign direct investment and the interplay between the two. We identify two sets of determinants of the accession process, one in the political sphere and one in the economic sphere. Each set of determinants, be it in the political or economic sphere, has the potential to constitute a vicious or a virtuous circle which includes the prospect of EU membership itself. Furthermore, each of these circles is self reinforcing and can reinforce the corresponding circle in the other sphere. Finally, political and economic elements of the circles considered here can constitute security concerns for each of the countries analysed, while FDI represents a main element of the economic circle.

We find that until 1996 Romania has been trapped in a combination of two vicious circles in both the political and economic spheres, while Poland has benefited from a combination of two virtuous circles since 1993. We test the hypothesis that, by changing perceptions of security and enhancing FDI, the prospect of EU membership can break the vicious economic circle of high perceptions of insecurity, low FDI, slow reforms, poor prospects for EU integration and hence high perceptions of insecurity in which Romania has been trapped. This is achieved firstly by a qualitative comparative analysis between Poland and Romania with regard to the determinants of FDI and the nature of their security concerns. Secondly, an econometric model assesses the determinants of FDI in ten transition countries candidates for EU membership and in particular the role of security and European integration variables.

Our results support the hypothesis that, by creating positive perceptions of security of the candidate countries (especially of poor reformers), the prospect of EU membership may enhance FDI, thus speeding up economic reforms, leading to full membership of the Union and hence positive perceptions of security. It also appears that the prospect of EU membership can lead to a virtuous circle in the economic sphere through providing motivation for economic reforms and through financial aid and its impact on foreign direct investment and economic reforms.

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TABLE OF CONTENTS

LIST OF TABLES

Chapter seven

Chapter eight

LIST OF FIGURES

LIST OF DIAGRAMS

LIST OF APPENDICES

LIST OF ABBREVIATIONS

APAPS	Authority for Privatisation and Management of the State Ownership
AWS	Solidarity Electoral Action
BSEC	Black Sea Economic Co-operation
CDR	Democratic Convention of Romania
CEFTA	Central European Free Trade Agreement
CEECs	Central and Eastern European countries
CFSP	Common Foreign and Security Policy
CMEA	Council of Mutual Economic Assistance
CSCE	Conference for Security and Co-operation in Europe
DF	Domestic firm
EA	Europe Agreement
EBRD	European Bank of Reconstruction and Development
ECSC	European Coal and Steel Community
EU	European Union
EURATOM	European Atomic Energy Community
FDI	Foreign direct investment
FDSN	Democratic National Salvation Front
FOF	Foreign owned firm
FSN	National Salvation Front
FTA	Free trade agreement
GDP	Gross domestic product
IFIs	Institutional financial organisations
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Co-operation in Europe
LPR	League of Polish Families
MEBO	Management and Employees Buy Outs
NATO	North Atlantic Treaty Organisation
PAIZ	Polish Agency for Foreign Investment
PDSR	Party of Social Democracy in Romania
PPP	Purchasing power parity
PRM	Greater Romania Party
PSL	Polish Peasants' Party
PSM	Socialist Labour Party
PUNR	Party of Romanian National Unity

RAD	The Romanian Agency for Development
RASDAQ	Romanian over the Counter Security Market
S	Self Defence of the Polish Republic
SEZ	Special economic zone
SOE	State owned enterprises
SOF	State Ownership Fund
SLD	Democratic Left Alliance
TCA	Trade and Co-operation Agreement
UDMR	Democratic Alliance of the Hungarians in Romania
UGO	Urgency government ordinance
UW	Freedom Union
VAT	Value added tax
WEU	Western European Union
WIIW	Vienna Institute for International Economic Studies

CHAPTER ONE
INTRODUCTION

1. The background, purpose and main argument of the dissertation

Half a century since the end of World War II and over a decade since the dramatic fall of the Berlin Wall, the division of Europe between the East and the West appears to be over through the accession to the European Union (EU) of eight former communist countries. Poland, a great victim of the Second World War, an early reformer and a favourite of the enlargement process for most of the decade, will be one of ten countries to join the Union in May 2004. This will happen despite numerous doubts expressed by the EU in 2000 over Poland's capacity to keep pace with the frontrunners of accession. However, the era of the Ribbentrop Molotov Pact and of Yalta will not end for all former communist countries that since 1989 have embarked upon democratisation, marketisation and accession into the EU. Romania, another victim of Yalta and of a ruthless dictatorship until 1989, will not be part of the first round of the EU's enlargement. Romania is only likely to join the Union in 2007, provided that accession negotiations are concluded by the end of 2004 with marketisation and sufficient progress in economic reforms achieved.

The purpose of this study is to identify the factors that have led to Poland and Romania's different evolutionary paths during the process of accession to the EU and to draw lessons from the first decade of transition regarding these determinants. The dissertation argues that the different evolutions of Poland and Romania in their quest for EU membership have been largely determined by security concerns and foreign direct investment (FDI) as well as by the interplay of the factors with the process of EU enlargement itself. Thus, FDI appears to be an essential determinant of accession to the EU given its impact on transition to a market economy and on economic integration. Furthermore, security concerns have driven the European integration process since its early stages and even more so during the present enlargement, given the changed nature of security since the end of the Cold War. The present approach does not ignore the role economic transition has played in accelerating each country's accession to the EU membership as part of the Copenhagen criteria of membership. On the contrary, the progress to a market economy is analysed in order to clarify the determinants of the EU accession, and especially the role of FDI. Finally, security concerns include external threats as well as internal insecurity resulting from political and economic instability as will be discussed later on.

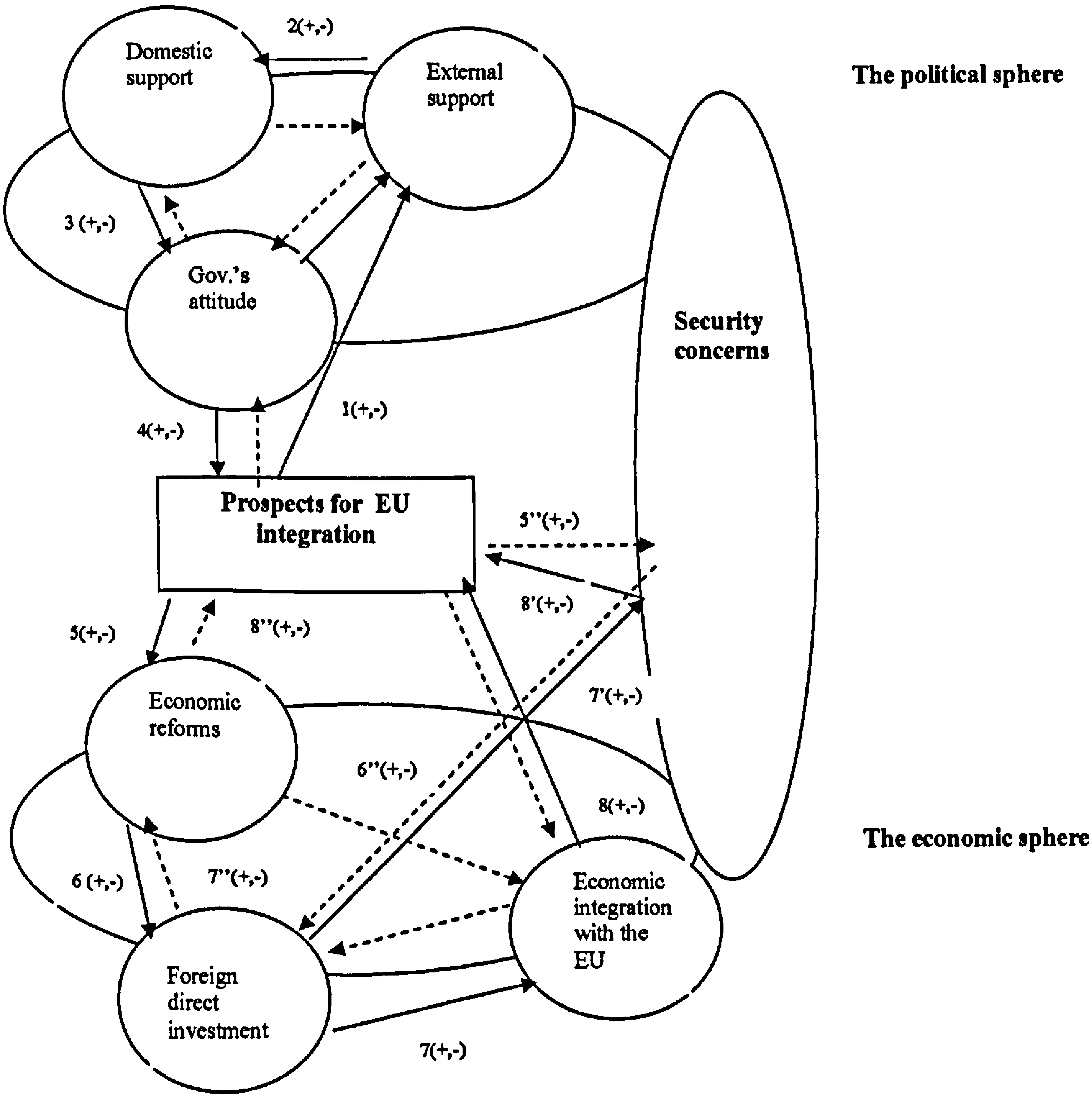
The main argument of the dissertation is that performance in the EU accession process is a result of the interaction between a political and an economic set of determinants. Each set of determinants, be it in the political or economic sphere, has the potential to constitute a vicious or a virtuous circle which includes the prospect of EU membership itself. Furthermore, each of these circles is self reinforcing and can reinforce the corresponding circle in the other sphere. Finally, political and economic elements of the circles considered here can constitute security concerns for each of the countries analysed, while FDI represents a main element of the economic circle. Until mid-1990s, Romania seems to have been trapped in vicious circles in both political and economic spheres while Poland appears to have enjoyed a combination of two virtuous circles for most of its transition. The two spheres, the security concerns realm and the elements of the model in each sphere are presented in diagram 1A. Prospects for EU membership become here both a dependent variable and an explanatory factor.

How do the economic and political circles work and interact? In the political sphere, governments risk losing popular support and willingness to reform unless international financial backing offsets some of the costs of transition and long run benefits are promised through the prospect of EU membership. This potential vicious political circle can create a vicious circle in the economic sphere by slowing down economic reforms and creating internal political instability as in diagram **1A(a, b)**.[1] Slow economic reforms and poor perceptions of security can in turn determine low prospects for EU integration, thus reinforcing the political vicious circle as in diagram **1A(c)**. Furthermore, insecurity resulting from slow reforms and internal political instability can deter FDI, thus slowing economic reforms and EU accession, thus reinforcing the economic vicious circle as in diagram **1A(d)**. Here the model draws a parallel between the concept of security as used by political science and risk as used in economic science. Overall, the two vicious circles have the potential to reinforce each other. Similarly, a political virtuous circle can determine an economic virtuous one and be reinforced by it. Thus, prospects of EU membership have the potential to create a virtuous political circle by enhancing popular support, governments' willingness to reform and internal political stability as in diagram **1A(e)**. In the economic sphere, perceptions of security resulting from internal political stability and progress in economic reforms can then attract the FDI necessary to enhance economic transition and accession to the EU. By maintaining the prospects of EU membership the virtuous economic circle can further enhance the virtuous political one as suggested in diagram **1B**.

[1] The letters a, b, c etcetera refer to the explanations given at the bottom of each diagram used throughout this dissertation.

Diagram 1A

Vicious and virtuous circles in the political and economic spheres in the quest for EU membership



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a) Arrows 1(-),2(-),3(-),4(-) indicate the vicious circle induced in the political sphere by poor prospects of EU membership for Romania for most of the first decade of transition.

b) Arrows 5(-),6(-),7(-),8(-) or 5(-),6(-),7'(-),8'(-) or 5"(-), 6"(-),7"(-),8"(-) indicate alternative vicious circles induced by poor prospects of EU membership either through their effect on economic reforms or through perceptions of insecurity and hence a negative impact on FDI.

c) Arrows 8"(-) and 8"(-) show that poor economic reforms and negative perceptions of security reinforce a vicious political circle.

d) Arrows 5"(-), 6"(-),7"(-),8"(-) show a vicious economic circle created by perceptions of insecurity.

e) Arrows 1(+),2(+),3(+),4(+) show a virtuous political circle induced by early prospects for EU integration.

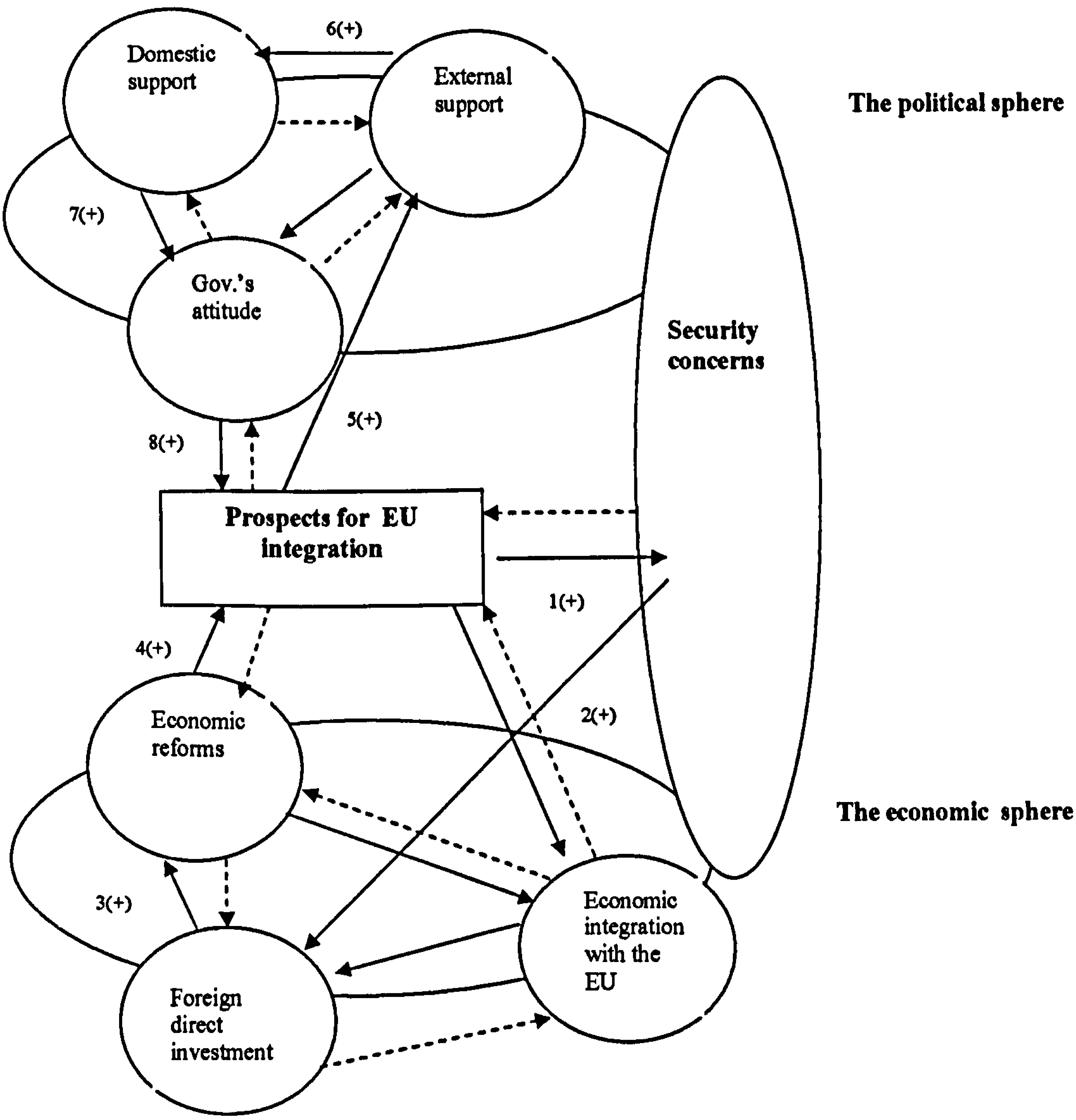
These two scenarios indicate that there is a certain potential for path dependency in attracting FDI, achieving economic transition and accession to the EU. This challenges findings by early studies of transition which conclude that the initial conditions can be overcome by using the right policy mix as will be discussed in more detail in chapter two. On the other hand, this confirms the assumptions of the path dependency theorists such as Stark and Grabher and raises the question over path shaping potential in transition countries.[2] The two scenarios bring up the question of whether a combination of vicious economic and political circles can be turned into a combination of two virtuous ones. The argument put forward by this dissertation is that unless security concerns are considered in the process of EU enlargement, there is a danger that the slow reformers are trapped in the vicious economic circle of perceptions of insecurity, low FDI, poor economic reforms, low prospects of EU membership and thus further insecurity as in diagram **1A(d)**. This vicious economic circle has then the potential to reinforce itself and to determine a vicious circle in the political sphere. This scenario would have potential negative effects on Europe as a whole by challenging the security of the continent. However, political decisions on EU enlargement, such as the one taken at the Helsinki European Council, appear to have the potential to break this vicious economic circle. By maintaining prospects of EU membership despite relatively poor records of economic reform, the EU can enhance prospects of security in the candidate countries, thus creating the conditions for a virtuous economic circle. Prospects of security can attract the necessary FDI for reforms and for EU integration. This virtuous economic circle can then reinforce itself and enhance a virtuous political circle of determinants of EU accession. By turning the vicious circle into a virtuous one, such a scenario appears to diminish the threat that instability in a candidate country poses to Europe as a whole as in diagram **1B(a)**.

The remaining part of this chapter is organised as follows: the significance of the study, the scope and methodology, explanations of the choice of comparison, definitions and finally the organisation of the dissertation.

[2] Grabner, G. and Stark, D. (eds.), *Restructuring Networks in Post Socialism: Legacies, Linkages and Localities*, OUP, Oxford, 1997.

Diagram 1B

The role of prospects of EU membership in enhancing virtuous circles in the economic and political spheres



a)Arrows 1(+),2(+),3(+),4(+), show how prospects of (early) EU membership can enhance positive perceptions of security in the candidate countries, thus creating a virtuous circle in the economic sphere. Furthermore, arrows 5(+),6(+),7(+),8(+) show that through its impact on the prospects of EU membership, this virtuous circle in the economic sphere can reinforce a virtuous circle in the political sphere

1.2 The significance of this study

Several arguments can be brought forward to justify the importance of this study. First, the study has an interdisciplinary nature and investigates the interplay between politics and economics in the process of the eastern enlargement of the EU. To my knowledge, this is the first study that puts forward a coherent model that explains the EU enlargement from this dual prospective while equally emphasising the role of security factors and of FDI. Thus, this project addresses Nelson's call in the early years of transition for studies which address the new nature of security and its interplay with the processes of democratisation, marketisation and Europeanisation.[3]

Second, the present research enriches the debate over path dependency and path shaping potential in transition and accession to the EU. Identifying the dynamics of the present enlargement process remains a useful exercise, given that in the absence of firm guarantees of EU membership by 2007, the accession of the remaining negotiating candidates Bulgaria and Romania may be influenced by the effects of the first phase of enlargement or by unexpected events. Furthermore, the lessons learned from such a comparison may be useful for the assessment of the relations between the EU on the one hand and Ukraine and Moldova on the other. By acknowledging the path dependency potential the project follows Ekiert's plea that post-communist studies take into consideration the particular nature of the legacy of the communist system in the countries considered.[4]

Third, as a comparative empirical study of Poland and Romania's quest to accede to the EU, accomplish economic transition and attract FDI, this research enhances our understanding of the post-1989 evolution of each of these two countries. To my knowledge, so far there has been no in depth comparative analysis of Poland and Romania with regard to the processes mentioned above. The merits of the comparison lie equally in the different paths that Poland and Romania have followed with regard to EU accession, economic transition, attracting FDI and eliminating security concerns, given that most comparisons are usually made between countries with roughly similar evolutions.

Finally, from a methodological point of view, the study demonstrates the advantages of adopting a multi-method approach. The qualitative assessment allows the establishment of causal relationships between the factors considered in the model, while the use of quantitative methods allows generalisations with regard to all ten transition countries candidates to EU membership and to possibly future candidates. The findings of the comparison are validated within the larger framework of the ten central and eastern European countries (CEECs) considered.

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[3] See Nelson, D., "The Comparative Politics of Eastern Europe", *Political Science and Politics*, Vol. 27, No. 1. 1994, p.51.

[4] Ekiert, G., "Peculiarities of Post- Communist Politics. The Case of Poland", *Studies in Comparative Communism*, Vol. 25, 1992, cited in Sakwa, R., "Postcommunist Studies: Once Again Through the Looking Glass (Darkly)?" in *Review of International Studies*, Vol.25, No.4, October 1999, p.716.

1.3 The scope and methodology

The analysis combines a qualitative and a quantitative approach. The hypothesis of the existence of vicious circles in the quest for EU membership is tested first qualitatively by comparing Poland and Romania in chapter three. In order to capture the complexity of the relations between the factors identified and the full nature of the potential vicious circles, the hypothesis is also tested with regard to the process of economic transition in chapter four and with regard to the determinants and the impact of FDI in chapter five. The connection between the political and the economic spheres considered in the overarching model of the dissertation is investigated in chapter six by using critically the concept of security concerns, drawing on the work of the Copenhagen School, as will be presented in chapter two.

The hypothesis is then tested quantitatively by using data for eleven years between 1990 and 2000 for the ten central and eastern European candidate countries for EU membership, i.e. Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. No references are made in the econometric model to the pre-1990 period given the fundamentally different economic and political systems of the CEECs before this date. The series end in 2000 but capture the main stages in the quest for EU membership. The econometric model assesses the determinants of FDI and of economic reforms using security and European integration variables as regressors and considering the interaction between them.

The analysis has drawn on a variety of both primary and secondary sources ranging from archives, interviews with academics and civil servants, statistical data, surveys and policy documents to newspaper articles, journal articles and books written by both local experts and international scholars. Statistics databases of the European Bank of Reconstruction and Development, the World Bank and the Vienna Institute for International Economic Studies (WIIW) were the main sources for the econometric model and for the empirical evidence throughout the dissertation.

1.4 Explaining the choice of comparison

Poland and Romania were chosen for this study for the following reasons. First, the two countries had different communist legacies which were reflected in their post-1989 evolution. The pre-1989 attempts at economic and political reforms in Poland gave the country a certain comparative advantage despite the serious economic crisis of 1989. Romania, on the other hand, lacked any real experience with democratisation and marketisation prior to 1989 and thus had a considerable disadvantage. Second, the early transition period saw a considerable gap open between the two in terms of their quest for EU membership, economic transition and attractiveness for FDI. This made Poland a frontrunner in the accession process and Romania a follow-up candidate, posing the question of path dependency.

Furthermore, security concerns acted as a brake for Romania's quest for EU accession while Poland appeared to turn its security concerns into an 'engine' for returning to Europe. The choice of the two countries was thus equally based on the differing influence of security concerns, especially in the light of the changing security concerns resulting from the 1999 Kosovo crisis. Third, Poland and Romania are comparable from a number of perspectives. They are respectively the largest and the second largest country amongst the CEECs in terms of area and population. They both have a large agricultural sector, although Poland's agriculture was hardly collectivised during communism and has now decreased its contribution to both GDP and employment. These large agricultural sectors provided similar concerns in the process of EU accession and with regard to the restructuring of the economy. Furthermore, both countries have important comparative advantages relative to the EU in the textile and steel industry and have a significant mining sector. These characteristics led to meaningful comparisons regarding the restructuring of the economy and the desirability of EU membership for both EU and the two candidate countries considered. Finally, Poland's geographical strategic position and Romania's more peripheral, albeit still strategic geographical position, made the comparison meaningful from the perspective of the EU's strategic interest in each of the two countries.

1.5 Definitions

The present section sets out the conceptual framework of the dissertation by offering working definitions of key concepts such as FDI, security, European integration and economic transition. According to Krugman, FDI represents international capital flows 'in which a firm in one country creates and expands a subsidiary in another with the distinctive feature that it involves not only a money transfer, but also the acquisition of control'.[5] The subsidiary becomes a part of the same organisational structure, as opposed to portfolio investment, where only a small share of stocks is purchased, therefore not allowing control.[6] The purpose of FDI is to allow the formation of multinational enterprises and the extension of control. By providing financial resources to their subsidiaries, FDI is an alternative way of accomplishing the same goals as international lending.[7] However, its effects on the host economy are potentially more complex and more lasting than international lending or portfolio investment, hence the interest in its role in the process of economic transition and accession to the EU. This 'superiority of FDI' is emphasised by defining FDI as a 'composite bundle of capital stocks, know-how and technology'.[8] The present study refers to FDI flows unless specified otherwise and draws on both working definitions provided above. Furthermore, the phrases FDI and foreign investment will be used interchangeably.

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[5] Krugman, P., *International Economics. Theory and Policy*, Longman, Harlow, 1997, p.16.
[6] Krugman, *International Economics. Theory and Policy*, p.16.
[7] Krugman, *International Economics. Theory and Policy*, p.16.
[8] de Mello Jr, L.. and Hussain, K., "International Capital Mobility in Developing Countries", *Journal of International Money and Finance*, January 1999.

A second notion which is included in the title and which will be defined here is the notion of security. Based on Buzan's concise definition of security as 'freedom from threat', this study adopts the broad view according to which security is not purely of military nature, but includes several sectors. This makes it possible to talk about political, economic, societal, environmental and military security.[9] Previously suppressed under the prevailing nuclear threat during the Cold War, in the post-Cold War period these non-military sectors of security became increasingly relevant, intrinsically related and self reinforcing. Thus, political security concerns the organisational stability of states, systems of government and the ideologies that give states legitimacy.[10] Therefore, political insecurity in the CEECs and subsequently in Poland and Romania is related to the more fluid and unpredictable political environment which has emerged during the democratisation process.[11] Economic security concerns access to resources, finance and markets necessary to sustain acceptable levels of welfare and state power. [12] In the case of the CEECs, economic decline and poor economic performance in general constitute security issues both at individual and at state level.[13] Societal security concerns the sustainability, within acceptable conditions of evolution, of traditional patterns of language, culture and both religious and national identity and custom.[14] Environmental security concerns the maintenance of the planetary biosphere as the essential support system on which all other human enterprises depend.[15] Finally, military security concerns the two-level interplay of the armed offensive and defensive capabilities of the states and state's perceptions of each other's intentions.[16] The present study refers mainly to political and economic security corresponding to the economic and political spheres investigated. Furthermore, it adopts the understanding of security as a self-referential notion as proposed by the Copenhagen School. From this point of view, security is subjective rather than objective and it has to be perceived as such by the observer.[17] Moreover, this study draws on the Copenhagen School's later concept of security as a speech act, as developed by Waever in 1995. It is

[9] The concept of sectors of security evolved with each new work of the Copenhagen School, including: Buzan, B. et al, *The European Security Recast: Scenarios for the post-Cold War Era*, Pinter, London, 1990; Waever, O., Buzan, B. et al, *Identity, Migration and the New Security Agenda in Europe*, Pinter, London, 1993; Buzan, B., Waever, O. and de Wilde, J., *Security: A New Framework of Analysis*, Lynne Rienner, London, 1998. For an analysis of the concept development see Huysmans, J., "Revisiting Copenhagen: Or, On the Creative Development of a Security Studies Agenda in Europe", *European Journal of International Relations*, Vol. 4, No. 4, 1998, pp. 488-490.

[10] Buzan, B., "Is International Security Possible?" in Booth, K. (ed.), *New Thinking about Strategy in International Security*, HarperCollins Academic, London, 1991.

[11] Dorman, A. M. and Treacher, A., *European Security. An Introduction to Security Issues in Post-Cold Europe*, Dartmouth Publishing Company, Dartmouth, 1995, p. 93, 139.

[12] Buzan, "Is International Security Possible?", pp. 34-35.

[13] Cable, V., "What Is International Security?", *International Affairs*, Vol. 71, No. 2, 1995, p.306.

[14] Buzan, "Is International Security Possible?", pp. 34-35.

[15] Buzan, "Is International Security Possible?", pp. 34-35.

[16] Buzan, "Is International Security Possible?", pp.34-35.

[17] Jahn et al distinguish between a threat and a perceived threat in a working paper cited in Huysmans, "Revisiting Copenhagen", p.491.

thus possible to 'securitise' some issues, bringing them from 'non-threats' into the political sector of security.[18] This is a social constructivist interpretation of security, as will be discussed later.[19]

Third, the term of European integration refers here to the process of the EU's eastern and central European enlargement from the preliminary stages of early 1990s to the Copenhagen European Council of December 2002.[20] Then, the EU committed itself to welcoming in May 2004 ten new members -eight former communist states and two Mediterranean countries- and acknowledged the target date 2007 set by the remaining candidates, Bulgaria and Romania. The more general term of European integration was also used in order to anchor the analysis in the general debate on European integration so far. Terms such as 'return to Europe', the 'accession process' or 'the quest for EU membership' will be used to refer to the present enlargement of the EU.[21] Drawing on a definition provided by Balassa, integration will mean here both 'the process and the state of affairs' i.e. the enlargement process and a certain state reached in this process by the two candidate countries discussed, Poland and Romania.[22] A further distinction used by this study is that between formal (or institutional) and economic integration. Thus, formal integration is a political stage of integration beyond a simple interdependence of economies. In the flexible terminology employed by Wallace and relied on in this study, formal integration includes 'those deliberative actions by authoritative policy makers to create and adjust rules to establish common institutions and to work through and with those institutions'.[23] In particular, formal integration refers in this study to different stages of the accession process represented *inter alia* by the signing of the Europe Agreements, the setting up of the Copenhagen criteria in June 1993, the publication of Agenda 2000 (including the Avis) in 1997 or the opening of accession negotiations in 1997 and in the aftermath of the Kosovo crisis and of the Helsinki European Council of December 1999. The study also uses elements of economic integration such as: convergence of economic welfare; increase of mutual trade and intra-industry trade; increase in factor (labour and capital) mobility; increase in policy co-ordination.[24]

Another key concept of the analysis is economic transition. This represents the process through which each CEEC aims to achieve the transformation from a centrally planned economy into a market economy. During this study, economic transition is also referred to as 'transition to a market economy',

[18] Waever, O., "Securitization and Desecuritization" in Lipschutz, R.D. (ed.), *On Security*, New York, Columbia University Press,1995, pp.46-86.
[19] Huysmans, "Revisiting Copenhagen", p.492.
[20] The author is aware that the process of European integration comprises in the broad sense organisations other than the EU, NATO included, but a discussion of these other components of the process of European integration is beyond the scope of this study.
[21] The author is aware of the discussion regarding the nature of 'return' to Europe as presented by Grabbe, H. and Hughes, K., *Eastward Enlargement of the EU*, Royal Institute of International Affairs, London, 1997.
[22] Balassa, B., "The Theory of Economic Integration: An introduction", in Nelsen, B. F., and Stubb, A. C. (eds.), *The EU. Readings on the Theory and Practice of European Integration*, Palgrave, New York, 1998, p.173.
[23] Wallace, W., *The Transformation of Western Europe*, London, 1990, p.54.
[24] Molle, W., *The Economics of European Integration. Theory, Practice, Policy*, Ashgate, Aldershot, 1997.

'marketisation' or simply 'transition'. As there is no uniform concept or form of market economy, this study adopts the criteria proposed at the Copenhagen Council and endorsed by the Agenda 2000 with the publication of the Avis. These criteria recommend that the level of functioning market economy and the capacity to deal with the competitive forces within the EU are assessed by: liberalisation of prices; liberalisation of trade; stabilisation of the economy; reform of the financial sector; patterns of ownership; quality of human and physical capital; quality of infrastructure; establishment of free trade.[25]

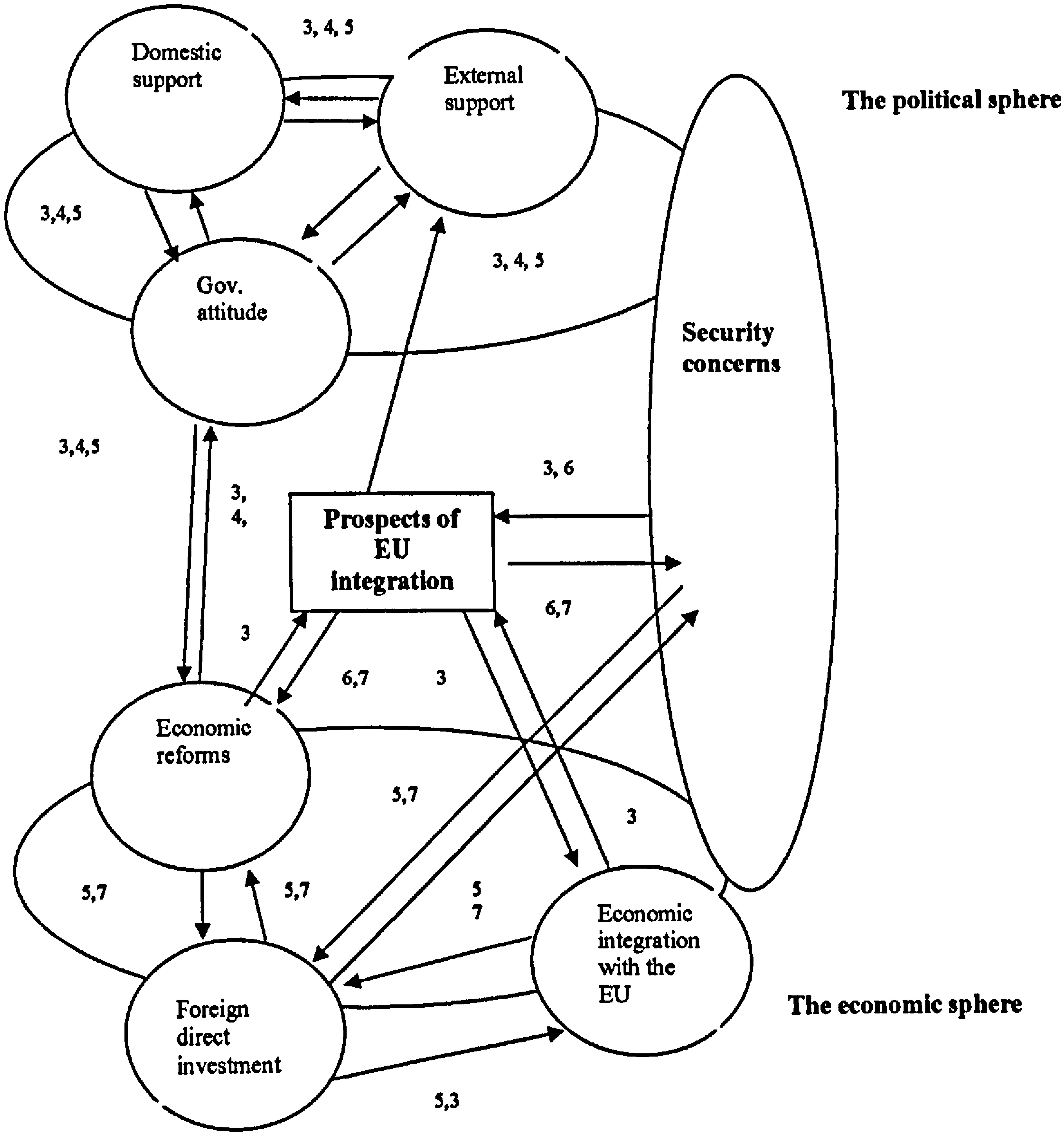
1.6 The organisation of the dissertation

The remainder of the dissertation is organised as follows. The second chapter provides a brief survey of the literature and sets out the theoretical framework of the dissertation. Chapter three discusses the relative importance of political and security factors and of compliance with the Copenhagen criteria in the process of Romania and Poland's accession to the EU. Amongst the Copenhagen criteria, the focus is on the economic criteria i.e. achievement of a market economy and the withstanding of competitive pressures. This chapter also provides evidence of economic integration between each of the two candidates and the EU, thus identifying FDI as an important element of economic integration. Chapter four analyses the factors responsible for each country's transition towards a market economy and demonstrates the interaction between the political and economic sphere in determining economic transition. It also suggests that attracting FDI represents an important policy during economic transition. Chapter five assesses qualitatively the main determinants of FDI in Poland and Romania with an emphasis on the investment climate of each country. The second part of the chapter provides evidence of the impact that FDI has had so far on Poland and Romania. The impact is analysed at the microeconomic level. FDI is seen as a way to speed up transition to a market economy, a means to enhance the host country's integration into the world economy and into the EU, a way to increase internal stability and to attract further FDI. Chapter six identifies the main security concerns of Poland and Romania since the fall of the Berlin Wall and analyses their impact on the EU accession process. The security concerns include the political and economic spheres and internal and external factors. This chapter also identifies the channels through which the EU can ensure the security of the candidate countries. Chapter seven tests the impact of the prospects of EU membership on foreign direct investment and economic reform. It assesses the role of security and European integration factors in enhancing FDI and the impact of FDI on economic reforms. It uses quantitative methods to test and confirm the inferences suggested by the qualitative analysis conducted so far. Finally, chapter eight presents the main conclusions of this study and their importance for the field of political economy. The diagram below shows which elements of the overall model are addressed in each chapter, as well as the relationships between these elements as they are discussed in the dissertation.

[25] Grabbe and Hughes, *Eastward Enlargement of the EU*, p.5

Diagram 1C

Chart flow of the chapters



The arrows indicate the bi-directional relationships investigated in this study. The numbers attached to these arrows represent the number of the chapters that deal with these relationships. Regarding the factors in the political sphere, chapters 3, 4 and 5 approach the bi-directional relationships from different perspectives i.e. from the point of view of the quest for membership of the EU (chapter three), of the economic transition (chapter four) and of attracting FDI (chapter five). When one relationship is addressed in two different chapters e.g. 5 and 7 or 6 and 7 the first one offers a qualitative assessment while the second one offers a quantitative one. Alternatively, one chapter may just identify the relationship while the other one addresses it in depth.

CHAPTER TWO
THE THEORETICAL FRAMEWORK

The aim of this chapter is to survey the literature and on this basis to develop the theoretical framework of this study. This chapter is organised as follows. First, it reviews the political theories which may explain European integration from a security perspective. Then it presents an account of the economic integration theories which assess the economic motives of European integration and of EU enlargement. The chapter continues with a review of the literature on the FDI determinants and on the impact of FDI in transition economies. It then examines the theoretical approaches to economic transition in the CEECs. Finally, the chapter presents the theoretical framework of this study. This study draws on theoretical approaches from political and economic theory, on transition and FDI literature, placing the analysis within the broad domain of political economy. These theoretical approaches correspond to the main elements of the model put forward in chapter one and represented in chapter one in diagram 1A.

2.1 Literature review

2.1.1 Explaining European integration and the present EU enlargement

Since its beginning, European integration has been driven by both security and economic motives. This interaction can be seen in the present process of the EU enlargement and is at the core of the present study, as will be detailed in the section dealing with the theoretical framework. The security externalities of economic integration are the focus of research by political theorists while economists are mostly interested in the impact of economic integration on welfare. The following pages will review several explanations for European integration offered by political, economic and political economy science with the aim of placing this study within the present debate.

Explaining European integration through security motives: theorising on European security

The 1989 Eastern European revolutions have led to an increased debate and an epistemological break in the study of European security.[1] While Mearsheimer was quick to predict a return to realism, Nye, Keohane and Hoffman argued that the *new world order* would be better explained by interdependence theory, international regimes and various patterns of co-operation.[2] Hyde-Price even suggested that what was needed was a new synthesis and a broader and richer conceptual framework.[3] The realist narrow understanding of security in military terms was challenged and security needed now to include

[1] Hyde- Price, A., *European Security beyond the Cold War. Four Scenarios for the year 2010*, The Royal Institute of International Affairs, London, 1991, p.16.

[2] Mearsheimer, J. J., "Back to the Future", *International Security*, Vol. 15, No. 1, 1990; Nye, J. cited in Hyde-Price, *European Security beyond the Cold War*, p.14; Keohane, R.O. and Hoffmann, S., "Conclusion: Structure, Strategy and International Roles" in Keohane, R.O., Nye, J. and Hoffmann, S. (eds.), *After the Cold War: International Institutions and State Strategies in Europe*, Harvard University, Cambridge, 1989-1991, p.401.

[3] Hyde-Price, *European Security beyond the Cold War*, p.14.

other dimensions such as political, economic, environmental and cultural. Furthermore, the realist assumption of states as rational utility maximisers was weakened by the 1989 dialectic between domestic and international behaviour.[4] The new paradigm was meant to explain the conditions of peace and not the causes of war. Indeed the recent years have seen the emergence of a new paradigm, Social constructivism, which suggests that the neo-neo debate is too narrow.[5] Furthermore, a blend between the social constructivist strand of Waever and the neo-realism of Buzan constituted the basis for the emergence of a school of European security studies, the Copenhagen school.[6] Neo-realism, neo-institutionalism, social constructivism and the Copenhagen school will form the basis for explaining the new security concerns since the end of the Cold War, the security motivations for the EU enlargement and the role of the EU in ensuring European security in chapters three and six.

A neo-realist view on security motives for European integration

Neo-realism represents the revival of realism in International Relations and is mostly associated with Waltz. He updates the realist analysis by emphasising the systemic level of analysis.[7] Hence, neo-realism is a theory of 'how the structural properties of anarchy provide particular sets of limitations upon possibilities for action in international politics'.[8] Five basic assumptions constitute the core of the neo-realist approach as synthesised by Mearsheimer, one of its most insistent advocates. First, in the absence of an overriding authority above states, the main principle of the international system is anarchy. Second, states' military capacities have an offensive nature. Third, states regard other states with uncertainty and thus suspicion. Fourth, the main driving force of states is their desire for survival or in other words the protection of their sovereignty. Finally, states are instrumentally rational, hence they act strategically to ensure their survival.[9]

Based on these assumptions, certain kinds of behaviour are anticipated to arise. Given the lack of an overriding authority, states act in the name of self-help. Fears of cheating and considerations regarding relative gains inhibit co-operation, thus obstructing the operation of international institutions.[10] Furthermore, as the concern for state sovereignty prohibits external institutions from interfering in the priorities of a state, institutions lack the ability to impose some collective interest or enforce rules of conduct. On the contrary, institutions aim to advance the particular interests of powerful states.[11] The

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[4] Hyde-Price, *European Security beyond the Cold War*, p.14.
[5] Croft, S. et al, *The Enlargement of Europe*, Manchester University Press, Manchester, 1999, p.13.
[6] Manners, I., "European [Security] Union: From Existential Threat to Ontological Security", *COPRI Working Paper No.5*, Copenhagen Peace Research Institute, Copenhagen, 2002, p. 17.
[7] Waltz, K., *Theory of International Politics*, Addison-Wesley, Reading, 1979, pp.88-93.
[8] Rosamond, B., *Theories of European Integration*, Palgrave, Basingstoke, 2000, p. 132.
[9] Mearsheimer, J.J., "The False Promise of International Institutions", *International Security*, Vol.19, No.3, 1994/1995, pp.8-9, p.10.
[10] Grieco, J.M., "Anarchy and the Limits of Co-operation: A Realist Critique of the Newest Liberal Institutionalism", *International Organisation*, Vol.42, No.3, 1988, p.499.
[11] Mearsheimer, "The False Promise of International Institutions", pp.8-9, p.13.

leading states create and shape institutions so that they can preserve their share of world power, or even add to it.[12] As a result, institutional outcomes reflect the balance of power between states.

At a first glance one would have difficulty in explaining the EU enlargement towards the east from a neo-realist perspective. First, neo-realists explain the initial steps of European economic integration through balance of power. Integration was a means of enhancing co-operation of partners amongst the common threat of the Soviet bloc. Once the common threat of Communism was gone, it seemed reasonable to authors such as Mearsheimer to anticipate that institutions such as NATO or the EU would lack justification and instead anarchy and violence would characterise the newly formed multi-polar world.[13] Second, the emergence of several civil wars in the Soviet successor states of Transcaucasia or in the former Yugoslavia and the impossibility of international institutions to deal effectively with them seemed to confirm the bleak anticipations of neo-realists.[14]

However, despite the Cold War being officially over, certain inertia in international relations justified some CEECs' fear of being drawn back in Russia's sphere of influence, thus increasing the appeal of membership of the EU, NATO and other international organisations. Neo-realist arguments seemed to apply here. Membership of the EU was driven by self-interest and by the CEECs' desire to balance the looming threat of a potential revival of Russian influence. The CEEC's motives for membership resembled Germany's fear of abandonment which was the driving force towards European integration in the 1950s. Thus, the balance of power principle acted as an 'engine' of the enlargement process rather than as a 'brake'. Moreover, initiatives such as the Stability Pact show that the EU has learned how to deal with conflicts that threaten the security of the continent. Furthermore, Germany's fervent support for early Polish membership of the EU can be interpreted as a means to enhance and maintain its influence in Poland that would be acceptable both bilaterally and internationally. Germany's success in lobbying for Poland within the EU, despite some divergent interests, is an example of how at times institutions are means to promote the interests of some influential member states. This was not the case with France's support for Romania in its quest for EU membership. Finally, another neo-realist security motivation for the EU enlargement appears to be the EU's desire to increase its international stand within the post-Cold War multi-polar world, consistent with EU's adoption of the Common Foreign and Security Policy. A different power balancing strategy was a security motivation for further integration in the early 1960s and continues to be so at the dusk of the third millennium.[15] However, Grieco admits that the realist theory collapses under the post-Cold War conditions, given that no

[12] Mearsheimer, "The False Promise of International Institutions"p.13.
[13] Mearsheimer, "The False Promise of International Institutions"pp. 4-56; See also Snyder, J., "Averting Anarchy in the New Europe", *International Security*, Vol.14, No.4, 1990, p. 9.
[14] van Ham, "Can Institutions Hold Europe Together?" in Miall, H. (ed.) *Redefining Europe. New Patterns of Conflict and Co-operation*, Royal Institute of International Affairs, London, 1996, pp.186-187.
[15] Moravcsik, A., *The Choice for Europe. Social Purpose and State Power from Messina to Maastricht*, UCL Press, London, 1999, p. 30.

hegemonic power seems to have emerged in the EU. On the contrary, EU member states bandwagon with Germany which, from a realism's own point of view 'would appear to be a serious empirical anomaly'.[16] Wallace also rejects the hegemonic stability argument as there is no single government that plays a hegemonic role in the EC.[17] The neo-realists' pessimism regarding the survival of European institutions in the absence of a common threat was counteracted by the neo-institutionalist view which is briefly reviewed below.

A neo-institutionalist view on security motives for European integration[18]

The neo-institutionalist approach to European integration consists of a number of studies influenced by refined versions of neo-functionalism, regime and interdependence theories. It was derived from Katzenstein and other political economists whose research shows that power is not everything in international relations.[19] It draws mainly on the claim that institutions matter.[20] Similarly to neo-realists, neo-institutionalists argue that self interest is the major incentive that motivates interstate co-operation in an interdependent world. For example, interdependent member states engage in institutionalised co-operative ventures such as those in the EC framework because they are not able to address their increasingly complicated problems alone.[21] Furthermore, following arguments derived from models such as the prisoners' dilemma, neo-institutionalists maintain that co-operation avoids outcomes that are sub-optimal, i.e. situations in which states will be worse off owing to their neglect of mutual agreement.[22]

Drawing on regime theory, neo-institutionalists claim that institutions, or 'regimes' as Krasner called them, minimise anarchy and make inter-state co-operation easier through various ways. They can mediate policies and conflicts.[23] They reduce the transactional costs of interstate relations. They also provide trust and facilitate the identification of common interests and the emergence of shared norms, rules and values.[24] They facilitate an environment of security among states which, according to

[16] Grieco, J., "Understanding the Problem of International Co-operation: The Limits of Neoliberal Institutionalism and the Future of Realist Theory" in Baldwin, D.A. (ed.), *Neorealism and Neoliberalism: The Contemporary Debate*, Columbia University Press, New York, 1993, p.330.
[17] Wallace, H., "Making Multilateral Negotiations Work", W. Wallace (ed.), *The Dynamics of European Integration*, Pinter for the Royal Institute of International Affairs, London, 1990, pp.224-225.
[18] Neo-institutionalism is also known as Neo-liberal institutionalism.
[19] Church, C. H., *European Integration Theory in the 1990s*, European Dossier No. 33, University of North London, 1996, p.32. For a thorough discussion on different types of Neo-institutionalism, see Rosamond, *Theories of European Integration*, pp. 113-123.
[20] Rosamond, *Theories of European Integration*, p.113.
[21] Keohane, R.O., *After Hegemony*, Princeton University Press, Princeton, 1984.
[22] Young, O.R., "International Regimes: Towards a New Theory of Institutions", *World Politics*, Vol. 39, No. 1, 1996, p.109; Keohane, R.O., "International Institutions: Two Approaches", *International Studies Quarterly*, Vol. 32, No. 4, 1988, p.386.
[23] Krasner, "Sovereignty. An Institutional Perspective", *Comparative Political Studies, Vol.21, p.66*, 1988; Baldwin, R. E., *Neo-Realism and Neo-Liberalism. The Contemporary Debate*, Columbia University Press, New York, 1993; Church, *European Integration Theory in the 1990s*, p.32.
[24] Sandholtz, W., "Membership Matters: Limits of the Functional Approach to European Institutions", *Journal of Common Market Studies*, Vol. 34, No. 3, 1996, p.406.

Keohane, allows government to emphasise absolute gains.[25] States co-operate even if they will not be the only or the greatest beneficiary.[26] Neo-institutionalists further argue that the member states remain the key actors with institutions facilitating co-operation and providing the rules for it.[27] However, institutional dynamics propels the process of integration beyond national wishes.[28] The role of institutions is thus seen as going beyond instrumentalism.[29] As Jachtenfuchs notes, 'institutions create theories about themselves which have, in turn, consequences for the interaction of actors'.[30] Furthermore, an institution can obtain an identity which is autonomous from the states that inhabit it, thus becoming an international actor in its own right which pursues the aggregated interests of its member states.[31] Finally, success in some areas of co-operation brings expectations of positive future relations, creating a virtuous circle. As a result, states get caught up in a continuing process through which the areas of co-operation are widened.[32] The argument that European integration has been necessary in order to prevent another Franco-German war is of neo-institutionalist nature. The deepening of integration as a result of widening though enlargement is also of neo-institutionalist nature. Neo-institutionalist arguments appear to explain the post-Kosovo crisis decision of the EU to safeguard security in Europe by maintaining the pace of the EU enlargement.

Despite its powerful explanations of the dynamics of the European integration, neo-institutionalism has certain limitations. First, institutions are only sometimes and not always capable of exerting significant effects. They have the potential to facilitate co-operation but they can neither transform interests that are fundamentally in conflict, nor foster altruism.[33] This is why the Copenhagen criteria of EU membership have aimed to ensure that candidate states share the same set of values with the Union, including democracy and market economy, prior to membership. Furthermore, the success of institutionalised co-operation is seen to depend on the number of participant member states, with fewer participants likely to prove more successful than larger numbers.[34] This argument justifies the initial

[25] Keohane, R.O., "The Diplomacy of Structural Change: Multilateral Institutions and State Strategies", in Haftendorn, H. and Tuschhoff, C. (eds.), *America and Europe in the Era of Change,* Westview, Boulder,1993, p. 53; Krasner, "Sovereignty. An Institutional Perspective", *p.66*; Baldwin, R. E., *Neo-Realism and Neo-Liberalism, The Contemporary Debate,* Columbia University Press, New York, 1993.
[26] Stein, A.A., *Why Nations Cooperate: Circumstance and Choice in International Relations,* Cornell University Press, Ithaca, 1990, 99.115-117; Keohane, R. and Martin, L., "The Promise of Institutionalist Theory", *International Security,* Vol.20, No.1, 1995, pp.44-45.
[27] R.O. Keohane, *After Hegemony,* 1984.
[28] Pierson P., "The Path to European Integration", *Comparative Political Studies,* Vol.29, No.2, 1996, pp. 123-163.
[29] Keohane, R.O. and Hoffmann, S., "Conclusion: Structure, Strategy and International Roles" in Keohane, R.O. and Hoffmann, S. (eds.), *After the Cold War: International Institutions and State Strategies in Europe, 1989-1991,* Harvard University Press, Cambridge, 1993, p.401.
[30] Jachtenfuchs, M., "Conceptualising European Governance", Jørgensen, K.-E, (ed.) in *Reflective Approaches to European Governance,* MacMillan, Basingstoke, 1997.
[31] Archer, C., *International Organisations,* George Allen and Unwin, London,1983, pp.141-149.
[32] Lyons cited in Archer, *International Organisations,* p.263.
[33] S. Croft at al, *The Enlargement of Europe,* p.14.
[34] Axelroad, R. and Keohane, R. O., "Achieving Co-operation under Anarchy: Strategies and Institutions", *World Politics,* Vol. 38, No. 1, 1985, pp. 234-46.

EU's reluctance to enlarge, the need for an institutional reform prior to enlargement and the fears within some of the CEECs over the EU's possible loss of enthusiasm for expansion.

Neo-institutionalism is relevant for the present study for several reasons. First, in the neo-institutionalist view, international organisations are entrusted a pivotal role in post-Cold War Europe. The dense institutionalisation of Western Europe was seen to help sustain co-operation, despite the absence of a common threat. Second, neo-institutionalism emphasises the gradual nature of integration as well as the potential for a virtuous circle of development induced by integration which will also be assumed by this dissertation. Finally, the neo-institutionalists acknowledge the role of institutions in enhancing the security of their member states and creating the conditions for superior gains. This present study assumes that the EU enlargement has been strongly driven by security motives as will be seen in the theoretical framework of the dissertation and discussed in chapter three.

A constructivist view on security motives for European integration

Social constructivism suggests that the neo-realist-neo-liberal institutionalist debate is too narrow.[35] Constructivists see both neo-schools as part of a positivist approach to International Relations that they reject. In contrast with Positivism, Social constructivism maintains that there is no objective truth in International Relations and that reliance on empiricism is therefore analytically dangerous. In their view, the observer and the observed cannot be separated.[36] Instead, knowledge is socially constructed, hence the real world is constructed by the values and the agents of that world.[37] Constructivists like Risse-Kappen reject the idea of an objective threat. They also argue that once functioning, the institutions are shaped by shared values. Finally, it is easier to adjust an already existent institution rather than to create new institutions of security co-operation.[38]

The constructivist approach was largely used to explain NATO's survival and metamorphosis since the end of the Cold War.[39] Constructivist arguments may also be used to explain EU enlargement. Thus, EU enlargement represents an attempt to broaden the basis of those who embrace the common values promoted by the Union. Democracy and market economy are amongst those values and can be enhanced through the process of EU enlargement, as will be argued in this study. Furthermore, by offering prospects of EU membership to the candidate countries their security concerns may be de-

[35] Croft et al, *The Enlargement of Europe*, p.14.
[36] Croft et al, *The Enlargement of Europe*, p.13.
[37] Neufeld, M., "Reflexivity and International Relations Theory" in Turenne Sjolander, C. and Cox, W.S. (eds.), Beyond Positivism: Critical Reflections on International Relations, Lynne Rienner, Boulder, 1994, p.15; Peterson, V.S., "Introduction" in Peterson, V.S. (ed.), *Gendered States: Feminist Re(Visions) of International Relations Theory*, Lynne Rienner, Boulder, 1992, p.12.
[38] Risse-Kappen, T., "Identity in a Democratic Security Community: The Case of NATO" in Katzenstein, P. (ed.), *The Culture of National Security*, Columbia University Press, New York, 1996, pp.359-399.
[39] Risse-Kappen, "Identity in a Democratic Security Community", pp.359-399.

securitised, i.e. moved out from the security realm, hence annulled. However, there are certain limitations to this constructivist approach to the EU enlargement. First, it is not implicit that the EU member states want to share their values with all the applicants.[40] Hence, there may be limitations to EU's predisposition to enlarge. This argument has loomed over Romania's quest for EU membership and justifies the interest in the factors that can contribute to Romania's successful accession. Neither does it necessarily follow that member states of an institution believe that all candidates can share those values and benefits.[41] This again has influenced the EU's openness towards enlargement. Third, it does not follow that all institutions are equally important in preserving and promoting these shared values or that all western organisations share the same values.[42] Institutions can collapse if they no longer represent shared values or states can withdraw as a result of internal changes.[43] This is why the focus of this study lies on the values promoted by the EU and acknowledges that there are not only benefits, but also challenges from the enlargement process. The present study maintains that the EU has a vast potential for complementing NATO in ensuring European security through broadening the basis of those who embrace democracy and market economy, as will be seen in chapter six.

<u>A view on European security by the Copenhagen school</u>

An important school that this study builds upon is the Copenhagen school of European security. The research conducted by its proponents represents 'possibly the most thorough and continuous exploration of the significance and the implications of a widening security agenda for security studies'.[44] The aim of the Copenhagen group has been to provide a fairly radical 'translation of a meta-theoretical stance into new conceptualisation and eventually theoretical innovation'.[45] They investigate how to move security beyond a narrow realist agenda, while 'avoiding ending up with an all embracing, inflated concept dealing with all kinds of threats to existence, well-being or development of individuals, social groups, nations and mankind'.[46] Their focus is on normative ideas and inter-subjective meaning.[47] The school has also developed concepts such as 'securitisation', 'societal security' and the 'regional security complex'. Although some of these concepts emerged before the setting up of the school, they have been subjected to a collective dynamic. As a result, the concepts introduced by the authors have changed dramatically and the concept of security is the most obvious one.[48] The

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[40] Croft et al, *The Enlargement of Europe*, p.16.
[41] Croft et al, *The Enlargement of Europe*,p.16.
[42] Croft et al, *The Enlargement of Europe*, p.16.
[43] Armstrong, D., *Revolution and World Order: The Revolutionary State in International Society*, Claredon Press, Oxford, 1993. Although Armstrong is a leading proponent of the English School, rather than Constructivism, his opinions are relevant here given the linkages between the two theoretical perspectives.
[44] Huysmans, J., "Revisiting Copenhagen: Or, On the Creative Development of a Security Studies Agenda in Europe", *European Journal of International Relations*, Vol. 4, No. 4, 1998, p.483.
[45] Iørgenson, K. E. (ed.), *Reflective Approaches to European Governance*, MacMillan, Basingstoke,1997.
[46] Huysmans, "Revisiting Copenhagen", p.482.
[47] Jachtenfuchs, M., et al, "Which Europe? Conflicting Models of Legitimate Political Order", *European Journal of International Relations*, Vol.4, No.4, 1998.
[48] Huysmans, "Revisiting Copenhagen", p.483.

definition of security according to the Copenhagen school was adopted by this study and was presented in chapter one. However, two points are worth making here. Among the five security sectors the political one is no longer considered the most important one as in the work of Jahn et al.[49] Instead, a special emphasis lies on the societal sector.[50] However, the Copenhagen group seem to underestimate the relevance of the economic sector of security and the present study will address this limit. Second, the group distinguished between a 'real threat' and a 'perceived' one. Since security is primarily a political issue, in order to be considered a security issue or concern, a threat has to be perceived as such. It can be perceived wrongly, but it has to be defined by actors to be of relevance to the political debate.[51] In recent works security changes, however, from a perception to a 'speech act.' Security is no longer a perception which refers to something real that exists independently of this perception. Calling something 'security' makes it into a security concern. It transforms an issue, for example an economic one, in a security concern. Security becomes a self-referential practice.[52] However, the construction of a security concern by means of the speech act of security is not in the power of an individual actor. Instead, it is an inter-subject act: 'Politics ultimately rests neither with the objects, nor with the subjects but among the subjects'.[53] Both the successful performance of the speech act and the logic of security are ultimately internal to the interplay of social practices.'[54] This study uses both perceptions of security and securitisation or de-securitisation as a speech act, as will be detailed in the theoretical framework.

A last concept proposed by the Copenhagen group which is of relevance for this study is the 'security complex'. [55] This was proposed by Buzan et al in order to introduce the regional level into security studies. The security complex approach assumes that a relatively autonomous security dynamic can exist between units of a region. It maintains that in certain regions the security interdependence can have such intensity, that it forms a sub-system security pattern which can be separated by its environment.[56] This can be considered a limitation of the Copenhagen approach, given that recent events have supported the opposite idea of European security being indivisible rather than divisible. Hence the need to expand the system to the whole of Europe. The present study draws on the conceptual framework proposed by the Copenhagen school as will be seen in the theoretical framework.

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[49] Jahn et al cited in Huysmans, "Revisiting Copenhagen", p.488.
[50] Buzan, B. et al, *Identity, Migration and the New Security Agenda in Europe*, Pinter, London, 1993.
[51] Jahn et al cited Huysmans, "Revisiting Copenhagen", p.491.
[52] Buzan, B. et al, *Security: A New Framework for Analysis*, Boulder, Lynne Rienner, 1998, p. 479.
[53] Buzan et al, *Security: A New Framework for Analysis*, p. 479.
[54] Huysmans, "Revisiting Copenhagen", p.493.
[55] Buzan, B. et al, *The European Security Order Recast. Scenarios for the Post Cold War Era*, Pinter, London, 1990, p.14.
[56] Buzan et al, *The European Security Order Recast.*, p.14.

To sum up, European integration and the present EU enlargement have been driven partially by security motives which can be explained through the lenses of neo-realism, neo-institutionalism, social constructivism and the Copenhagen school as in chapter three. However, security motives are not fully accountable for the process of European integration or for the CEECs' accession to the EU. Economic motives have played an equally important role in explaining European integration so far as will be shown in the following pages.

Explaining European integration through economic motives: economic theories of European integration

While political theorists of European integration are interested in the political results of integration i.e. the peaceful resolution of international conflict, economic theorists argue that economic gains are the chief motive for the continuation of the integration process. The economic literature distinguishes between degrees of economic integration corresponding to several institutional frameworks which vary from free trade areas to complete economic integration. Furthermore, the main interest of economists lies in the study of the welfare effects of such areas and of the conditions for their creation. The main stages of economic integration acknowledged by the economic literature and used in this study read as follows:

a) Free trade areas, where member countries agree on reducing intra-area restrictions to trade, while still keeping individual protection schemes against third countries;
b) Customs unions, where the members liberalise the intra-union trade and establish a common customs tariff against third countries;
c) Common markets, where the reduction of trade restrictions is also extended to factor movements;
d) Economic unions, where apart from reducing restrictions on trade and factor mobility there is also some harmonisation of national economic policies to cut remaining sources for discrimination;
e) Unification, which presupposes a supra-national authority with power to pursue unified policies in various areas, including monetary, fiscal and social policies. [57]

Studies dealing with the welfare effects of economic integration can be loosely divided into Orthodox and neo-classical theory. Although the discussion of the benefits of EU enlargement will be based on neo-classical theory, a brief reference will be made to the Orthodox literature below which forms the basis of the former. A review of other strands of economic literature is beyond the scope of this study.

[57] Balassa, B., "The Theory of Economic Integration: An introduction" in Nelsen , B.F. and Stubb, A.C-G. (eds.), *The European Union. Readings on the Theory and Practice of European Integration*, Palgrave, New York, 1998, p.175.

Orthodox v. neo-classical theory of European integration

The theory of integration of product markets is relatively recent, although classical economists such as Ricardo also investigated the problems of free trade and of preferential trade agreements.[58] The theory of economic integration stems from the seminal work of Viner who in 1950 examined the static effects of the establishment of a customs union between two countries. He concluded then that, depending on the size of the external tariff, the newly created customs union might lead to trade creation and trade diversion. The relative size of these two effects would determine whether the customs union would have an overall positive or negative effect on the participant countries. The creation of a customs union might therefore bring a once for all increase in the welfare and income of the member states.[59] Viner's concepts of trade creation and trade diversion are at the core of the classical theory of customs unions. The classical theory is not only concerned with the effects of the customs unions on the allocation of resources and international specialisation, but also with their impact on the exploitation of scales economies and on the terms of trade of the participating economies.[60] The theory assumes a perfectly competitive framework in which homogenous products are produced by firms that lack market power and incur no or few transaction costs. Another important major assumption that constitutes a limitation of the classical customs union theory is inter-country factor immobility.[61]

Additional explanations of the effects of European integration are offered by neo-classical theories. They address the inability of the Orthodox theory to explain intra-industry trade in similar products, even when scale economies are included. While not excluding the operation and the importance of comparative advantage based on factor endowments in certain sectors, new trade theories focus on situations in which the gains from trade stem purely from increased competition in the presence of scale economies and product differentiation.[62] In this new framework, one can note at least four sources of potential gains from regional integration, in addition to any that derive solely from increased specialisation according to comparative advantage. First, integration resulting from lower trade barriers increases effective market size, giving rise to more competition, a decrease in oligopolitistic mark-ups and reduced market segmentation. Second, longer production runs and lower costs are encouraged by larger market size. In this process, some higher cost firms may be eliminated and the demand met by imports. Furthermore, trade expansion is accompanied by increased market size that may enable more products to be produced more profitably, thus generating welfare gains from increased product diversity. Finally, integration may permit firms to engage in more plant specialisation, thus reducing

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[58] Molle, W., *The Economics of European Integration. Theory, Practice, Policy*, Ashgate, Aldershot, 1997, p.79.
[59] Robson, P., *The Economics of International Integration*, Georger Allen and Unwin, London,1984, p.82.
[60] Robson, *The Economics of International Integration*, p.17.
[61] Robson, *The Economics of International Integration*, p.82.
[62] Robson, *The Economics of International Integration*, p.83.

the number of products produced in a given plant and leading to cost reductions.[63] On the other hand, an increased market can lead to economies of scale and hence diminish competition, suggesting that the effects on competition may be ambiguous.

Given that EU membership will offer the CEECs all advantages stemming from joining the Single Market, special attention to the theory of common markets is required here. Furthermore, given that at present each CEEC is part of a partial free trade area with the EU, some references will be made to the impact of free trade areas on their members. As the theory of free trade areas and of single market are extensions of customs union theory, references to customs union theory will also be made here. So, is a common market a better option for the CEECs than a free trade area?

The literature agrees that customs unions are a second-best exercise which replace one distortion with another.[64] Thus, the same effects are produced by free trade areas, but in the case of free trade areas the extent of trade diversion is likely to be less. This makes free trade areas more appealing from a welfare point of view than customs unions.[65] Customs unions are also likely to be inferior to a policy of unilateral tariff reductions, and therefore need to be justified on other economic or non-economic grounds. Thus, de Mello, Panagaryia and Rodrik identify three channels through which regional integration could alter economic outcomes for the better. First, a regional trade agreement creates a larger polity which might discourage discretionary actions of particular governments. In particular, it would restrict the power of growth retarding political groups, unless powerful lobbies can form alliances across the countries. Second, when a regional agreement is set up *ab initio*, better choice may be made than at the national level, where policy makers have to contend with existing institutions that accommodate factional interests. Third, when participating countries have different economic institutions, policy-making at the regional level will entail a compromise between those institutions and may lead to a superior outcome for at least some of the countries.[66] Furthermore, membership of a preferential trade agreement such as the EU may act as a protection for the CEECs against the risk of more protectionist policies of the trading partners in the future. A customs union can also serve as a building block, rather than stumbling one for global free trade, with all positive advantages that come with increased trade liberalisation.[67] This is the case for the EU which expands free trade and its welfare benefits through the eastern enlargement.

[63] Robson, *The Economics of International Integration*, p.84
[64] Einer, W., "A New Look at Economic Integration" in Jacquemin and Sapir (eds), *The Internal Market*, p. 71
[65] Thirlwall, A.P., "Trade Agreements, Trade Liberalisation and Economic Growth: A Selective Survey", *Paper for the African Development Report*, 2000, p. 8
[66] de Mello, Panagaryia and Rodrik cited in Thirlwall, "Trade Agreements, Liberalisation and Growth", p. 9
[67] Gros, D. and Steinherr, A., *Winds of Change. Economic Transition in Central and Eastern Europe*, Longman, New York, 1995, p.496

By extending customs theory to common market, research has already acknowledged additional welfare gains. Good accounts of the theory of common market are given by Robson and Molle. Building on the neo-classical trade theory and on the theory of international production, Molle concludes that integration of labour and capital markets leads to net welfare gains for the participating countries.[68] This can act as a justification for the CEEC's desire to join the EU. Furthermore, integration of good markets should precede integration of capital markets as costs of protection of goods market are much higher under conditions of free capital flows, than under conditions of segmented markets.[69] This observation is consistent with the process of CEECs' accession to the EU, which started with the gradual liberalisation of the goods market. Moreover, Molle argues that the international movement of capital in the form of direct investment is a substitute for goods trade in the case of protection on goods market, but will create trade in the case of integrated good markets.[70] This finding emphasises the positive effects of trade liberalisation and of attracting foreign direct investment. Finally, Molle states that a common market may enhance the development of new sectors and extend the presence of existing ones.[71] Robson also finds that reducing barriers increases competition, reduces profit margins, reduces average costs of production and increases intra-EU market shares.[72] Factor mobility resulting from different marginal productivities leads to factor price equalisation. From the point of view of the candidate countries, this can be seen as an important factor leading towards economic convergence with the EU. However, this can also lead to an increase in the income gap between the CEECs that are joining in 2004 and the remaining candidates, Bulgaria and Romania, making catching up more difficult.[73] On the other hand, price equalisation may be an advantage for the latter two countries which are likely to benefit from low labour costs for a few additional years, thus remaining attractive for FDI.[74] This would happen if locational theory and path dependency arguments were disproved. Finally, as factor mobility may not necessarily benefit each member country, some intra-union redistribution may be required in order for all partners to share the advantages of the move towards a common market.[75] For the CEECs, the structural and the cohesion funds will be such means of welfare redistribution that would ensure additional benefits upon EU accession.

However, research also shows that extending a preferential trade area such as a free trade area or a customs union may have ambiguous effects and can lead to losses for both new comers and

[68] Molle, *The Economics of European Integration, Theory, Practice, Policy*, p.187.
[69] Molle, *The Economics of European Integration, Theory, Practice, Policy*, p.187.
[70] Molle, *The Economics of European Integration, Theory, Practice, Policy*, p.187.
[71] Molle, *The Economics of European Integration, Theory, Practice, Policy*, p.187.
[72] Robson, *The Economics of International Integration*, p.95.
[73] Smith, A., *The Return to Europe: The Reintegration of Eastern Europe into the European Economy*, MacMillan in association with the School of Slavonic and Eastern European Studies, Basingstoke, 2000, p.36.
[74] Bevan, A.A. and Estrin, S., "The Determinants of Foreign Direct Investment in Transition Economies", *Discussion Paper No. 2638*, CEPR, 2000, p.4.
[75] Robson, *The Economics of International Integration*, p.76.

incumbents.[76] Whether membership of a FTA renders losses or gains depends on several factors. First, the higher the initial tariff in a given sector, the larger the favourable effect and the smaller the unfavourable one. Second, the lower the post-FTA tariff on extra union countries, the less likely that the lower priced goods of the latter will be displaced. Third, the higher the tariffs in the outside world on the partner, the larger will be the gain or the smaller the loss. Fourth, the greater the complementarity in import demands of the countries forming the FTA, the larger the gains from the preferential trade agreement.[77] Fifth, the larger the union, the better the chance of including the least cost producer and thus minimising trade diversion.[78] Finally, the gain is greater, the greater the overlap between partners' production bundles, as in the absence of any overlap there would be no scope for trade creation. Given the degree of overlap, the greater the cost difference between the partners, the more significant the increase in the benefits of specialisation.[79]

Is then the EU expansion likely to be beneficial for both the EU and the candidate countries? In other words, are the conditions set above met? They are, according to Gros and Steinherr. Thus, the external tariffs of the EU are lower than those of most of the Eastern European countries. Furthermore, the EU is a very large trading area, so it is likely that it includes low cost producers, thus minimising the potential for trade diversion. However, the potential trade structure of the Central European countries once they have joined the EU is more difficult to assess. Gros and Steinherr find only that the structure of exports from Poland already differs from the average within the EU while Romania has a completely different structure. This finding might suggest that Poland and Romania do not meet the conditions for a beneficial membership of the Single Market. However, a comparison between EU correlation coefficients of export structures of Poland and Romania on the one hand, and Ireland, Portugal and Greece on the other, reveals certain similarities, counter-balancing the previous argument.[80]

All in all, both theory and empirical evidence point towards large potential gains for both the EU and the CEECs as a result of enlarging the EU to the east. Furthermore, a study by Baldwin et al anticipate that while all European regions gain from enlargement, the CEECs will gain more in relative terms.[81] Finally, the costs of enlargement are far offset by the benefits of enlargement and by the costs of non-enlargement.[82] Although the author is aware of these costs, they will not be addressed here, due to

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[76] de Mello, J. et al, "The New Regionalism: A Country Perspective" in de Mello, J. and Panagariya, A. (eds.), *New Dimensions in Regional Integration*, Cambridge University Press, Cambridge, 1993.
[77] de Mello et al, "The New Regionalism: A Country Perspective".
[78] For definitions of trade diversion and creation, see Molle, *The Economics of International Integration*, p.30.
[79] Winters, L. A., *International Economics*, Routledge, London, 1994, p.179.
[80] Gros and Steinherr, *Winds of Change. Economic Transition in Central and Eastern Europe*, pp. 497-500.
[81] Baldwin, R. E. et al, "The Costs and Benefits of Eastern Enlargement: The Impact on the EU and on Central Europe", *Economic Policy*, No. 24, 1997.
[82] For an assessment of the costs of the EU enlargement see Baldwin et al, "The Costs and Benefits of Eastern Enlargement "; Rollo, J., "Economic Aspects of EU Enlargement to the East" in Maresceau, M. (ed.), *Enlarging*

word and topic constraints. The paragraphs below will briefly review the economic benefits of EU enlargement, mainly from the candidate countries' point of view. This discussion is necessary in order to pinpoint both the motivation and the impact of EU membership. These elements will then pave the way towards answering why Poland and Romania have evolved so differently during the accession process and how prospects of EU membership affected the determinants of EU accession (in chapters three and six).

Assessing the benefits of enlarging the EU towards the East

Studies on the economic benefits of the present EU enlargement build mainly on the extension of customs union theory to free trade areas and common markets. Thus, while the Europe Agreements have initiated a hub-and-spoke type partially free trade area between the EU and each candidate country, EU membership will give the CEECs access to the benefits of the Single Market and of the economic and monetary union. As a result, the importance of full EU membership for countries such as Poland and Romania stems not only from the benefits of joining as such, but also from the limitations of the institutional framework provided initially by the Europe Agreements.

These limitations have been identified by several studies and read as follows. First, sensitive goods such as agricultural products, steel products, textiles and leather products remained protected in the EU until 1995. This protection was even more onerous for the CEECs and especially Poland and Romania, given that they have important comparative advantages in these sectors.[83] Second, by negotiating bilateral free trade agreements, the EU pursued a hub-and-spoke approach which biased competition in favour of the EU as long as the CEECs did not practice free trade amongst themselves.[84] The hub-and-spoke approach also had the potential of deterring investment in the East by discouraging investors from serving the entire region.[85] Moreover, this bilateralism had the potential of creating a permanent disadvantage for some countries through the dynamics of locational accumulation.[86] Being an incomplete liberalisation, the hub-and-spoke system had the potential of leading to an smaller increase in growth than in the case of complete liberalisation. Finally, the hub-and-spoke bilateralism had the potential of artificially discouraging trade between the CEECs, unless they liberalised their trade by setting a free trade area themselves.[87]

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the European Union. Relations between the EU and Central and Eastern Europe, Longman, London,1997; Păun, L., Dobrot, G., Pâslaru, D., "A adera sau a nu adera?". Un dialog cu doi actori: Uniunea Europeană şi România, *Paper Prepared for the Soros Foundation for an Open Society*, Bucharest, 2000.

[83] Gros and Steinherr, *Winds of Change. Economic Transition in Central and Eastern Europe*, p. 489.

[84] R. E. Baldwin, *Towards an Integrated Europe*, CEPR, London, 1994, pp. 131-132.

[85] Baldwin, *Towards an Integrated Europe*, pp.132-134.

[86] Baldwin, *Towards an Integrated Europe*, pp. 134-135; Krugman, P., "Increasing Returns and Economic Geography", *Journal of Political Economy*, June, 1991.

[87] Baldwin, *Towards an Integrated Europe*, p.137.

Although these negative effects of the hub-and-spoke approach were largely eliminated through the creation of the Central and Eastern European Free Trade Agreement (CEFTA) in 1993 and its expansion towards Bulgaria and Romania in 1997, one should not forget the enhanced positive effects that membership of the EU has in comparison with a free trade area. Thus, the EU offers more than free trade of goods. It offers the elimination of border controls and the legal provisions and institutional support necessary to ensure the durability of free trade. EU membership supposes the free movement of services, labour and capital, hence increased foreign direct investment. Joining the EU also supposes the co-ordination of economic policies and adherence to the treaty on the economic and monetary union. Through accession, the CEEC will also benefit from the financial support designed to accelerate convergence and enhance cohesion with the EU. They will equally take part in sectoral policies such as the common agricultural policy (CAP), scientific development, development aid and others.[88] An in-depth discussion of these benefits is, however, beyond the scope of this study.

The EU enlargement will bring to the CEECs (including Poland and Romania) six sources of economic growth. Three stem from the standard rendition of the neo-classical theory of international trade: efficiency gains due to rising import competition; economies of scales effects related to EU market access; gains from specialisation and a rise in the range of product varieties, which allow realisation of a higher level of consumption and utility.[89] Two further growth sources are suggested by recent additions to modern trade theory by Baldwin and Baldwin and Seghezza: growth induced by imports of intermediate products and technology-intensive machinery and equipment and their potential positive spillover effects and increasing FDI flows from the EU to the CEECs, particularly to those with prospects of earlier entry, as this tends to eliminate political risk for the EU and non EU investors.[90] Finally, the structural and cohesion funds are an additional means to enhance growth in the candidate countries upon EU membership.

By joining the EU, the CEECs will also benefit from the risk premium effect. The risk premium effect can be analysed at macroeconomic and at microeconomic level. Thus, on the microeconomic side, EU membership constraints arbitrary trade practices and indirect tax policy changes. It also locks in well defined property rights and codifies competition policy and state aids policy. Through convertibility, open capital markets and rights of establishment, EU membership also guarantees investors the free use of their investment. Finally, EU ensures that CEEC-produced products have access to the EU-15 market which accounts for 30% of world income.[91] On the macroeconomic side, EU membership

[88] Gros and Steinherr, *Winds of Change*, p.492; Rollo, "Economic Aspects of the EU Enlargement".
[89] Welfens, P.J.J, "Enlargement. Conflicts and Policy Options" in van Brabandt, J.M. (ed.), *Remaking Europe. The European Union and the Transition Countries*, Rowman and Littlefield Publishers, Oxford, 1999.
[90] Baldwin, R.E., "Measurable Dynamic Gains from Trade", *Journal of Political Economy*, Vol. 100, No. 1, 1992; Baldwin, R.E. and Seghezza,1996 cited in J.M. Brabandt, *Remaking Europe*, p173.
[91] Baldwin et al, "The Costs and Benefits of Eastern Enlargement", p.140; J. Rollo, "Economic Aspects of EU Enlargement to the East", p.259.

involves participation into the monetary union, thus providing a solid hedge against inflation spurts. These effects are likely to enhance investors' confidence and thus contribute to attracting the FDI necessary for the modernisation of the transition economies.[92]

EU enlargement brings economic benefits not only to the CEECs, but also to the EU present member states. For example, the given the abundance of labour in the CEECs compared with the EU current member states, and the existence of systematic trade barriers in labour intensive goods such as clothing, textile, shoes or agricultural goods, EU enlargement can stimulate production in labour intensive goods in the East and discourage them in the West. This can free resources in the West, thus allowing them to be used in more productive activities. By specialising in sectors in which each country has a comparative advantage, pan-European allocation of resources can improve and may lead to an increase in the GDP per capita throughout the region. [93] An enlarged EU will also have an increased importance in the world trade and in international relations in general.[94] It will entail more trade and investment opportunities. All these economic benefits are likely to be higher the more prepared the CEECs are to withstand the competitive forces within the EU, hence the need to comply with the economic criteria set at the June 1993 Copenhagen European Council, as discussed in chapter four. The relationship between FDI and economic integration justifies the choice of FDI as a explanatory factor of the accession process as analysed in chapters five and three.

The domino theory of regionalism and other negative motives for the EU enlargement

The domino theory of regionalism, proposed by Baldwin, lies at the cross-roads between political and economic theories of integration. This theory posits that the current wave of regionalism stems from 'idiosyncratic events' that are 'multiplied many times over by a domino effect'.[95] More precisely, Baldwin analyses the effect of the 1985 EU's decision to create a Single Market and thus renew the EU member states' drive towards unity. He argues that, whereas the primary motives for the creation of the Single Market were geopolitical and philosophical rather than purely commercial, the EU 1992 project created what might be called a 'political economy jealousy effect'.[96] Closer EU integration posed a threat to non-EU exporters who depended heavily on the EU market. Cheaper and easier intra-EU trade threatened to reduce the relative competitiveness of non-EU firms, thus harming their sales and profits. As a result, European non-EU exporters throughout the region called for their governments to counter the losses, thus pushing towards closer relations with the EU and eventually full membership.[97] Although this theory discards the economic motives which led to the 1992 Single Market project, it

[92] Baldwin et al, "The Costs and Benefits of Eastern Enlargement", p.140; J. Rollo, "Economic Aspects of EU Enlargement to the East" p.259.
[93] Baldwin, *Towards an Integrated Europe*, pp. 160-161.
[94] Baldwin, *Towards an Integrated Europe*, pp. 160-161.
[95] Baldwin, *Towards an Integrated Europe*, p.69.
[96] Baldwin, *Towards an Integrated Europe*, p.69.
[97] Baldwin, *Towards an Integrated Europe*, 1994, p.71.

gives a good account of the benefits of avoiding exclusion, hence the negative motives for enhancing the process of European integration.

The domino effect argument can be extended to the present EU enlargement. The present EU enlargement is largely driven by negative motives from both sides. On the one hand, the CEECs did not want to be deprived of access to the EU market, EU investment and of being perceived as EU members, hence European. Furthermore, EU membership was seen as a channel for pursuing domestic objectives. For example, EU has been used a 'scapegoat' for unpopular measures and will be, *inter alia*, a means to enhance growth and development through the structural funds and the price mechanisms. Finally, the CEECs saw no suitable alternative to EU membership. On the other hand, the EU member states themselves pursued further integration with the CEECs for negative reasons. They feared the loss of markets for trade and foreign direct investment. They also feared a rise in migration as a result of poverty or internal instability in the former communist countries. Finally, the EU feared increased social unrest in the area, should the Union have rejected the enlargement option.[98] This approach is relevant to the present study through its assumption that the EU enlargement is an inevitable process whose failure would be more costly than its accomplishment. Furthermore, this assumption supports the need to maintain the pace of Romania's integration into the EU and observe the target accession date recognised at the Copenhagen European Council in December 2002, as will be argued in chapter six.

2.1.2 Theorising on foreign direct investment

Having reviewed the theories on security and economic motives for European integration the following section offers a brief account of studies of FDI. The FDI literature can be loosely divided into two strands: studies dealing with the determinants of foreign investment and others dealing with the impact of FDI in the host economy. As both strands of literature are relevant to the present study, they will be briefly presented below.

Studies of foreign direct investment determinants

The determinants of foreign direct investment have been investigated by a vast theoretical literature. Most research has been conducted on developing countries, but the last decade has seen a considerable literature on the transition countries themselves. Reference will be made to both strands of literature, given that the first represented the basis for the latter. Six main approaches will be briefly reviewed here in order to justify the choice for Dunning's eclectic paradigm (OLI) for the theoretical framework of this study. A main approach to explaining international production is the survey approach.[99] This is

[98] Cameron, F., "The European Union and the Challenge of Enlargement" in Maresceau, M. (ed.), *Enlarging the European Union*, p.251; Saryusz-Wolski, J., "Towards a Single Perspective. Economics and Politics of Eastern Enlargement" in Maresceau, M. *(ed.), Enlarging the European Union*, p. 28.

[99] For a review of the survey approach, see Dunning, J. H., "The Determinants of International Production", *Oxford Economic Papers*, Vol.25, Issue 3, Nov.1973, p.294.

based on asking investors questions about their reasons for the initial decision to produce abroad. Given that usually the questions are formulated in very general terms, surveys have produced a wide range of answers which reflect as much the respondents' interpretation of the questions as the determinants of the investment decision.[100] For the purpose of this study such an approach was inappropriate given the complex methodology and its limitations.

The second approach to the study of FDI is capital theory. This theory focuses on capital or changes in capital and is essentially an extension of received capital theory. The main claim of the traditional theory of international capital movements is that such movements rise due to the differences in the levels of the interest rates between countries. Thus, capital flows across the exchanges if the margin by which the expected yield exceeds the cost of the capital is greater than that of projects at home.[101] However appropriate such an explanation is for portfolio investments, it is insufficient for FDI. At least two reasons can be invoked here. First, unlike portfolio investment, FDI does not imply change of ownership, hence invalidating the assumption of similar behavioural characteristics. Second, FDI is likely to be affected not only by potential returns of money capital, but also by the relative profitability of other inputs specific to FDI, such as entrepreneurship, technology and management expertise.[102] Although research on capital flows has provided useful insights with a direct bearing on the investment behaviour of multinationals, capital theory still remains somehow limited.[103] Thus, Dunning argues that the questions asked by capital theory do not get to the heart of the matter. The concern of this approach is not to explain foreign investment or capital formation *per se*, but to investigate how far profit rates and market growth influence capital allocation. Hence, it offers a limited explanation of foreign investment as such, ignoring other possible explanatory variables.[104] This constituted the major limitation of this approach which rendered it as inappropriate for the present study.

A third explanation of FDI is that of international economics and stems from the limitations of the received theory in explaining the recent level and composition level of trade. Thus, in the classical model of comparative advantage there is no room for multinational enterprises. With completely free movement of goods but immobility of factors of production within a price taking situation, there is low incentive for FDI.[105] However, these are no longer reasonable assumptions given the rise in FDI that has characterised the last twenty to forty or fifty years. The most powerful attempts to incorporate capital movements into trade theory have come from two directions. First, based on the Hekscher-Ohlin-Samuelson model, Mundell asserted that trade and capital movements are substitutes for each other and that the equalisation of factor-price ratios implies the equalisation of commodity price

[100] Dunning, "The Determinants of International Production", p.294.
[101] Dunning, "The Determinants of International Production", p.299.
[102] Stubenitsky, F. cited in Dunning, "The Determinants of International Production", pp.299-300.
[103] Spitaller, E., Stevens, Johnson cited in Dunning, "The Determinants of International Production", pp.299-300.
[104] Dunning, "The Determinants of International Production", p.303.

ratios.[106] Second, changes into technology or advances in knowledge have been taken into consideration in the analysis.[107] Thus, beginning with Posner, attempts were made to demonstrate how innovations in one country may affect the comparative advantage of countries, and how the trade initially generated might be gradually eliminated by the recognition and imitation of innovations elsewhere.[108] Within this strand of literature, the product cycle model of Vernon has maybe come the closest to explaining the role of multinationals in this process.[109] Overall, both approaches are micro-oriented and differ from the received theory in two major ways. First, they are concerned with the behaviour of firms rather than countries. Second, they are particular, rather than general models, as they tend to endow innovating firms and countries with certain characteristics and subsequently patterns of production and trade.[110] The value of the trade approach lies in placing FDI amongst other ways of exploiting a foreign market, insight which is adopted in this study.

A more strategic approach to FDI was offered by the game theoretic approach to industrial organisation.[111] In these models, comparative advantages are not considered as exogenously given. Multinationals are not only interested in exploiting them but rather in protecting and augmenting them.[112] Thus, the presence of specific assets gives rise to market imperfections which make FDI a credible strategy of controlling the market.[113] Hence, firms undertake FDI to improve or defend market shares by pre-empting competitors from doing likewise.[114] Given data restrictions this approach is not used by the present study.

More recently, location theory has focused on the importance of agglomeration economies as a rationale for FDI. Location theory suggests that regions that are the first to attract industrial concentrations can generate economies of scale external to the investing firm which are difficult to replicate by late comers.[115] The presence of technological and pecuniary externalities act as a centripetal force and the strong competition generated by the entry of other firms in the market act as a centrifugal force. Three sources of agglomeration economies were identified in empirical studies by

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[105] Kindleberger, C., *American Business Abroad*, Yale University Press, 1969.
[106] Mundell, R.A. cited in Dunning, "The Determinants of International Production", pp.299-300.
[107] Johnson, H.G. cited in Dunning, "The Determinants of International Production", pp.304.
[108] Posner, M. V., "International Trade and Technological Change", *Oxford Economic Papers*, Vol.13, 1961.
[109] Vernon, R., "International Investment and International Trade in the Product Cycle", *Quarterly Journal of Economics*, Vol.80, 1966.
[110] Dunning, "The Determinants of International Production", pp.304-308.
[111] Graham, E. M., "Market Structure and the Multinational Enterprise: A Theoretic Approach", *Journal of International Business Studies*, Vol.21, No.1, p.67.
[112] Horstmann and Markusen, "Endogenous Market Structure in International Trade", *Journal of International Economics*, Vol. 32, No. 1-2, 1992, p.109; Smith, A., "Strategic Investment, Multinational Corporations and Trade Policy", *CEPR Discussion Paper No. 37*, 1986.
[113] Jacquemin cited in Resmini, L.,"The Determinants of Foreign Direct Investment in the CEECs: New Evidence from Sectoral Patterns", *Economics of Transition*, Vol. 8, No.3, 2000, p.668.
[114] Resmini, L., The Determinants of Foreign Direct Investment in the CEECs, p.668.
[115] Porter, M., *The Competitive Advantage of the Nations*, Free Press, New York, 1990; Krugman, P., *Geography and Trade*, Leuven University Press and MIT University Press, Leuven and Cambridge, 1991.

Wheeler and Mody: infrastructure, the degree of industrialisation and the existing level of FDI.[116] The significance of previous foreign direct investment in attracting FDI was adopted by the present study for testing the path dependency hypothesis with regard to foreign direct investment.

Finally, another strand of literature links FDI determinants with the basic motivations for undertaking the investment. According to these theories, resource-seeking investors set their plants where the necessary resources are available while rent-seeking investors favour countries where factors of production, especially labour, are cheap. Market seeking firms choose countries that offer a large domestic market and access to regional (supranational) markets. Finally, firms acting strategically may link one of the above considerations with the need to follow the leader or gain additional advantages. From such a point of view, strategic FDI is quite similar to rent-seeking FDI.[117] Although the present study does not distinguish between different motives for FDI, it builds on the determinants suggested by this strand of literature.

Despite this significant theoretical research on FDI, there is no agreed model providing the basis for empirical work.[118] However, Dunning's eclectic OLI paradigm has offered a taxonomic framework for many empirical studies. The eclectic paradigm maintains that foreign direct investment can be explained by three categories of factors: ownership advantages (O) for firms to operate oversees, such as intangible assets; locational advantages (L) to invest in the host country rather than in the donor country; and benefits of internalisation (I).[119] The advantage of this theory is that it highlights the importance of locational advantages, including the role of the investment climate and of the government policies necessary to enhance FDI. The latter categories are of main interest for the present study, thus justifying the use of the OLI paradigm in the theoretical framework. Thus, the locational advantages included in the OLI paradigm refer to: spatial distribution of inputs and markets; input prices, quality and productivity of labour, energy, materials, components, semi-finished goods; transport and communication costs; control on imports, tax rates, incentives; climate for investment; political stability; legal, commercial and transport infrastructure; physical distance-language, culture, business customs; economics and R&D and marketing. [120] Furthermore, the OLI eclectic paradigm seems to synthesise findings of other previous theories, thus offering an all encompassing explanation of FDI.

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[116] Wheeler, D. and Mody, A., "International Investment Location Decisions. The Case of US Firms", *Journal of International Economics*, Vol.33, 1992, p.60.
[117] Dunning, J. H., "Location and Multinational Enterprise", *Journal of International Business Studies*, Vol. 29, No.1, p.50.
[118] Bevan and Estrin, "The Determinants of Foreign Direct Investment in Transition Economies", p.4.
[119] Dunning, J.H., *International Production and Multinational Enterprise*, London, George Allen and Unwin, 1981, p.49.
[120] Dunning, *International Production and Multinational Enterprise*, p.49.

Overall, the FDI literature has focused on developing countries and has identified the following determinants of FDI: the cost structures and market and institutional characteristics of the recipient economy;[121] openness of the host country, international agreements on trade and investment;[122] balance of payments constraints, restrictions on capital movements, macroeconomic performance in general in terms of inflation or fiscal and monetary policies;[123]non-financial incentives such as basic infrastructure provision;[124] size of the domestic market in conjunction with prospects of growth of the host country;[125] purely commercial considerations or social choice.[126] Since the fall of the Berlin Wall, a new strand of literature dealing with the FDI determinants in the CEECs has emerged, building on previous work.[127] The new strand of research was recognition of the specific needs and of the particular investment climate of the area.[128] The empirical work and the surveys conducted so far have led to a general consensus upon the main determinants of foreign direct investment in the CEECs. These factors include: domestic and potential market size, gravity factors, natural resources endowment, skills endowment, unit labour costs, progress in transition reforms, and economic and political stability.[129]

Within the general work on the determinants of FDI in transition economies some studies paid particular attention to the role of the investment climate. Research by Barrel and Holland, Meyer and Pind or Konings compared the good performance of advanced central European transition countries with the weak performance of Balkan and Soviet Union successor states which are less advanced in transition reforms. They concluded that the investment climate is an important determinant of FDI.[130]

[121] Lall, S., "Transnationals, Domestic Enterprises and the Industrial Structure in Host LDCs: A Survey", *Oxford Economic Papers*, No. 30, 1978.
[122] Morrisey, O. and Rai, Y., "The GATT Agreement on Trade-Related Investment and Their Relationship with Transnational Corporations", *Journal of Development Studies*, No. 31, 1995; de Mello Jr, L.., "Foreign Direct Investment in Developing Countries and Growth. A Selective Survey", *Studies in Economics*, No.1, 1997, University of Kent at Canterbury, Department of Economics.
[123] de Mello, Jr L.., p. 6.
[124] Chen, T. J., and Tang, D. P. cited in de Mello Jr, L. "Foreign Direct Investment in Developing Countries, p. 6.
[125] Bhasin, A., Jun, K., Economu, P., "Assessing the Sustainability of Foreign Investment Flows", World Bank, International Economics Department, 1994.
[126] Jasay, E.A., "The Social Choice Between Home and Overseas Investment", *Economic Journal*, Vol. 70, 1960, pp.105-113.
[127] Lucas, R., "On the Determinants of Direct Foreign Investment: Evidence from East and South East Asia", *World Development*, Vol. 21, No.3, 1993, pp. 391-406; Singh, H. and Jun, K. W., "Some New Evidence of Determinants of Foreign Direct Investment in Developing Countries", *Policy Research Working Paper No.1531*, World Bank.
[128] Bevan, A.A. et al, "Institution Building and the Integration of Eastern Europe in International Production", *Working Paper No. 16*, 2001, University of Sussex, ESRC, p. 1.
[129] Lankes, H. P. and Venables, A.J., "Foreign Direct Investment in Economic Transition. The Changing Pattern of Investment", *Economics of Transition*, Vol. 4, No. 2, 1996, pp. 331-347; Bevan and Estrin, "The Determinants of Foreign Direct Investment in Transition Economies"; Holland and Pain, "The Diffusions of Innovations in Central and Eastern Europe".
[130] Barrel, R. and Holland, D., "Foreign Direct Investment and Enterprise Restructuring in Central Europe", *The Economics of Transition*, Vol. 8, No. 2, 2000, pp. 477-504; Meyer, K. E. and Pind, C., "The Slow Growth of Foreign Direct Investment in the Soviet Union Successor States", *Economics of Transition*, Vol. 7, No. 1, pp. 201-214; Konings, J., "Effects of Foreign Direct Investment on Domestic Firms: Evidence from Panel Data in Emerging Economies", *WDI Working Paper No. 344*, 2000.

This approach will be used in this study in conducting a qualitative assessment of the investment climate in Poland and Romania in chapter five.

Other studies have focused on the role of the institutional framework, and of economic reforms in general, in enhancing FDI. In 1993 Svetličič et al. were asking whether there was a correlation between the magnitude of the political change and the inflows of FDI, noting the reforms already put into place by top FDI destinations in the CEECs at the time.[131] Later on, Scattaglia and Fischbach suggested that early FDI top destinations were the frontrunners of reforms.[132] Bevan at al. argued that institutions are providing advantages that are influencing the interactions between ownership and location advantages, thus enhancing FDI.[133] The EBRD Transition Report 2000 showed that there is a fairly strong correlation between FDI per capita and the average EBRD transition indicator with an R squared of 0.48.[134] Furthermore, by 2001, the EBRD expected FDI to flow to countries with the most comprehensive reforms.[135] Not only reform does open opportunities for profitable investment, but it diminishes risk, thus encouraging further investors. On the other hand, Buch et al. argue that at this stage future reforms in the candidate countries need to have substantial signalling effects in order to yield effects on FDI.[136] These findings have been the basis for the present study which assesses *inter alia* the impact of institutional reforms on FDI, thus enriching the debate in the literature.

A different strand of literature which constitutes the basis for this study investigates the impact of supranational trade agreements on FDI. Studies by Baldwin, Barrel and Pain or Balasubramanyam et al conclude that membership of supranational agreements enhances FDI.[137] In particular, several studies have analysed the impact of European economic integration on foreign direct investment from outside and inside the EEC. Research by Scaperlanda and Balough has provided the strongest empirical support so far for the hypothesis that the changes occurred in the 1960s in the location of foreign direct investment have been deeply influenced by the formation of the European Community.[138] Moreover, Franko and later Pelkmans argued that during the transitional period towards the customs union, the EEC has seen clear shifts in the locational patterns of the subsidiaries of transnational enterprises of

[131] Svetličič, M., Artisen, P. and Rojec, M., *FDI in Central and Eastern Europe*, St. Martin's Press, 1993.
[132] Fischbach, M. and Scattaglia, M., "Financial Flows to Eastern Europe: Determinants, Volatility and Sustainability Issues", *MOCT-MOST*, Vol. 7, 1997, p.76.
[133] Bevan A.A. et al, "Institution Building and the Integration of Eastern Europe in International Production",p. 2.
[134] EBRD, *Transition Report,* 1998, p.82.
[135] EBRD, *Transition Report,* 1998, p.82.
[136] Buch, C. M. et al, "Financial Flows to Transitional Economies into an Integrated Europe", *MOCT-MOST*, Vol. 9, 1999.
[137] Baldwin, *Towards an Integrated Europe*; Barrel, R. and Pain, N., "Domestic Institutions, Agglomerations and Foreign Direct Investment in Europe", *European Economic Review,* Vol. 43, 1999, pp. 928-934; Balasubramanyam et al, "Foreign Direct Investment and Growth: New Hypotheses and Evidence", *Lancaster University Economics Discussion Paper Series No. 7,* 1996.
[138] Scaperlanda, A. and Balough, R. S. cited in Yanoupoulis, G., "Foreign Direct Investment and European Integration: The Evidence from the Formative Years of the European Community", *Journal of Common Market Studies,* Vol. 28, 1990, p. 243.

EEC parentage.[139] Additionally, a study by Molle and Morsink concluded that there is evidence of a positive association between trade intensity, which is an indicator of the degree of economic integration, and intra-EC flows of FDI during the period 1975-1983.[140] Dunning also showed that during the period 1958-1985 there was a sizeable increase in intra-EEC FDI. He further showed that both extra and intra foreign direct investment was further stimulated by the creation of the Single Market within the EEC.[141] The positive effect of the creation of the Single Market on foreign direct investment from outside the EU was also confirmed by work by UNCTAD, Balasubramanyam and Greenway and Aristotelous and Fountas.[142] Finally, a study by Barrel and Pain asserted that there is clear evidence that the Single Market Programme has raised the level of intra-EU foreign direct investment significantly, with investment rising more sharply than one might have otherwise expected in those sectors that previously had the highest barriers to cross-border market entry.[143]

More recent studies have also shown evidence of correlation between FDI and EU membership, at least for poor entrants. O'Farrel showed that the Irish Republic had received a considerable boost in FDI from joining the EEC.[144] Martin and Velasquez confirmed the positive impact that accession to the EU had on attracting investment in Spain.[145] The boost to investment in Spain as a result of accession was also documented by Vinals et al and by Ortega et al.[146] For Portugal and Spain, Braga de Macedo and Torres specifically demonstrate the decline in country risk premium following accession.[147] Finally, previous enlargements have increased FDI in the new member countries, both before and in the aftermath of joining the EU.[148]

However, the role of the prospect of EU membership in attracting foreign direct investment in the CEECs has been investigated only by a few studies. Buch et al. argued that during the process of enlargement, capital account liberalisation and other elements of economic integration should

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[139] Franko, L. cited in Yanoupoulis, "Institution Building and the Integration of Eastern Europe", pp. 243-244; J. Pelkmans cited in Yanoupoulis, "Institution Building and the Integration of Eastern Europe", p. 244.
[140] Molle and Morsink cited in Robson, *The Economics of International Integration*, Routledge, London, 2000, p.120.
[141] Dunning, J. H., "The European Internal Market Programme and Inbound Foreign Direct Investment", *Journal of Common Market Studies*, Vol. 35, No. 2, 1997, p.208.
[142] UNCTAD cited in Robson, *The Economics of International Integration*, p.119; Balasubramanyam, V. and Greenway, D. cited in Robson, *The Economics of International Integration*, p.119; Aristoteleus, K. and Fountas, S. cited in Robson, *The Economics of International Integration*, p.119.
[143] Barrel, R. and Pain, N., "Foreign Direct Investment, Technological Change and Economic Growth within Europe", *The Economic Journal*, No. 107, 1997, p. 1775.
[144] O'Farrel cited in Yanoupoulis, "Institution Building and the Integration of Eastern Europe", p.246.
[145] Martin and Velasquez cited in Bevan and S. Estrin, "The Determinants of Foreign Direct Investment in Transition Economies".
[146] Vinas et al and Ortega et al cited in Baldwin et al, "The Costs and Benefits of Eastern Enlargement", p.141.
[147] Braga de Macedo and Torres cited in Baldwin et al, "The Costs and Benefits of Eastern Enlargement", pp. 141-142.
[148] Baldwin, E.R. and Haaparanta, P. (eds.), *Expanding Membership of the EU*, University Press, Cambridge, 1995.

contribute to higher investment into the candidate countries.[149] Baldwin anticipated in the early years of transition that FDI would increase at least in the CEECs that were likely to join the EU soon. He argued that early prospects of EU membership gave the investors some idea of the direction in which transition was going.[150] Investors also anticipated gains from EU membership. Finally, Bevan and Estrin suggested that third parties might invest in the candidate countries which form free trade areas with the EU to avoid tariffs on export. They also believed that enhanced growth and trade from economies of scale of integration provided a demand stimulant to FDI.[151] Their empirical results showed that some stages of the enlargement process impacted directly on FDI in the candidate countries and not through the risk perception of the country.[152] However, not all stages and elements of the accession process have been codified and used in previous empirical work, leaving a gap in the literature that this study aims to fill in chapter seven. Furthermore, the role of security factors on enhancing FDI has not been investigated and will be addressed in chapters five and seven.

Studies of foreign direct investment impact in the host economies

Considerable research has dealt with the impact of foreign direct investment on developed and developing countries and has constituted the basis for assessing the role of FDI in transition economies. A basic distinction between studies of FDI impact is between analysis at macroeconomic and at microeconomic level. As the present study deals with the effects of FDI at microeconomic level, only a brief reference will be made to the studies of FDI's impact at macroeconomic level.

At macroeconomic level, the main focus has been on the FDI impact on growth and on trade. Blomström et al and Balasubramanyam et al have given evidence that FDI has raised the growth rate of many developing countries.[153] Borensztein et al also fond a positive impact of FDI on the growth of transition countries.[154] Furthermore, research conducted by O' Sullivan on Ireland, Cabral on Portugal and Blake and Pain on the UK has shown that FDI enhances exports.[155] In the transition literature, Markusen and Repkine and Walsh found a strong relation between trade and foreign investment. They highlighted the reorientation of trade in the CEECs towards the EU which is their major source of

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149 Buch et al, "Financial Flows to Transitional Economies into an Integrated Europe", p.90.
150 Baldwin et al, "Institution Building and the Integration of Eastern Europe", p.139.
151 Bevan and Estrin, "The Determinants of Foreign Direct Investment in Transition Economies", p.6.
152 Bevan and Estrin, "The Determinants of Foreign Direct Investment in Transition Economies", p.23.
153 Blomström, M. et al and Balasubramanyam, V. et al cited in Barrel and Pain, "Domestic Institutions", p.1778.
154 Borensztein, E. et al, "How Does Foreign Direct Investment Affect Economic Growth?", *Journal of International Economics*, Vol. 45, 1998, pp. 115-135.
155 O' Sullivan, Cabral and Blake and Pain cited in Barrel and Pain, "Domestic Institutions", p.1782.

FDI.[156] FDI is thus seen as an avenue of CEECs' integration into the world economy and into the EU.[157]

A second strand of the FDI literature assesses the FDI impact at microeconomic level. In a study on developed countries, Barrel and Pain argued that foreign investors had higher propensity to undertake research and development (R&D) than domestic companies and hence they had higher productivity.[158] These results were confirmed by Hunya, Bornstein, Carlin et al, Barrel and Holland who suggested that FDI brings R&D, technology, management and skills in the CEECs.[159] The positive relationship between FDI and enterprise restructuring has also been shown in studies by the EBRD, Konings and Lizal and Svenjar.[160] However, the findings of some empirical studies on the FDI impact in transition are subject to certain criticisms. Thus, Hunya found that foreign direct investment enterprises had higher endowments of capital and higher labour productivity than domestic firms, suggesting the use of more recent technology. However, he could not rule out the possibility that this was related to FDI being concentrated in capital intensive industries.[161] Furthermore, Djankov and Hoeman found that FDI tends to flow to firms of above average size, initial profitability and initial labour productivity. These findings suggested that observed productivity improvements in the Czech Republic depend on the initial conditions of the firms, rather than on the transfer of new technologies and knowledge from investors or partner firms.[162] Furthermore, a study by Holland and Pain suggested that the FDI impact on total labour productivity in selected transition countries is due to more than just the initial conditions of the firms.[163]

The present study also acknowledges that FDI is responsible for several negative effects on the host country. Some of these have been identified by the literature as follows: the possibility of conflicting

[156] Markusen, J., "Trade versus Investment Liberalisation", *NBER Working Paper No. 6231*; Repkine, A. and Walsh, P., "European Trade and Foreign Investment U-Shaping Industrial Output in Central and Eastern Europe-Theory and Evidence", *IMF Working Paper No. 150*, 1998.
[157] Hunya, G., "International Competitiveness. Impacts on FDI in CEECs", *WIIW Research Reports No. 268*, August 2000, p7; Lipton, D. and Sachs, J. cited in Deichmann, J.I., "Distribution of Foreign Direct Investment among Transition Economies in Central and Eastern Europe", *Postsoviet Geography and Economics*, 2001, 42, No.2, p.144; Sachs, J. cited in J.I. Deichmann, "Distribution of Foreign Direct Investment", p.144.
[158] Barrel and Pain, "Domestic Institutions", p.1778.
[159] Hunya, G., "International Competitiveness. Impacts on FDI in CEECs", *WIIW Research Reports No. 268*, August 2000, p. 4; Bornstein, M., "Post-Privatisation Enterprise Restructuring", *Post-Communist Economies*, Vol. 13, No. 2, 2001,p. 197; Carlin, W., Estrin, S. and Schaffer, M., "Measuring Progress in Transition and towards EU Accession: a Comparison of Manufacturing Firms in Poland, Romania and Spain", *EBRD Working Paper No. 40*, 1999, p. 8; Barrell, R. and Holland, D. "Foreign Direct Investment and Enterprise Restructuring in Central Europe", *Economics of Transition*, Vol. 8, No. 2, 2000, p. 480.
[160] EBRD, Konings, Lizal and Svenjar cited in Krkoska, L., "Foreign Direct Investment Financing of Capital Formation in Central and Eastern Europe", *EBRD Working Paper No. 67*, 2001, p.3.
[161] Hunya cited in Barrell and Holland, "Foreign Direct Investment and Enterprise Restructuring in Central Europe", p. 479.
[162] Djankov, S. and Hoeman, B., "Avenues of Technology Transfer: Foreign Direct Investment and Productivity Change in the Czech Republic", *World Bank Economic Review*, Vol.14, No. 1, January 2000.
[163] Holland, D. and Pain, N., "The Diffusion of Innovation in Central and Eastern Europe: A Study of the Determinants and Impact of Foreign Direct Investment", *NIESR, Discussion Paper No. 137*, London, NIESR

aims between investors and the host country;[164] the lack of competitiveness of input and output markets, often induced by regulations within the host country;[165] the danger of over-dependency on FDI;[166] macroeconomic imbalances, including balance of payments and current account deficits.[167] However, an in depth discussion of the negative effects of FDI on the host country is beyond the scope of this study. Overall, FDI is seen as a crucial factor for regional development and convergence of the CEECs with Western standards of living.[168] FDI complements domestic investment which has been extremely low as compared to the needs of privatisation.[169] Through its package of attributes it can contribute to forming market-oriented institutions and behaviour.[170] However, this impact has not yet been analysed by empirical research and the present study aims to fill in this gap in the literature. The studies reviewed in this section constitute the basis for assessing comparatively the evidence of FDI determinants and impact in Poland and Romania so far in chapters five and seven.

3.1.3 Theorising on economic transition

Since the fall of Communism in 1989 research has attempted to analyse and explain the evolution of economic transition in Central and Eastern Europe. There has been a vivid discussion over the nature of transition, whether there is a triple or a quadruple one.[171] Bunce even questioned whether the CEECs face variations of the same process, i.e. democratisation, or totally different processes, i.e. democratisation v. post-communism.[172] However, up to the present there is no elaborated theory of transition to a market economy.[173] Furthermore, as in the early 1990s economic transition was seen as a process leading as quickly as possible to a market economy, there was a feeling that no theory of transition as such was actually needed. Instead, there was a great need for a policy approach that would define the strategies to establish the market in the shortest time possible and with the minimum cost.[174]

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[164] Družić, M., "Regional Dispersion of FDI in Eastern Europe", Sharma, S. (ed.), *Restructuring Eastern Europe. The Microeconomics of the Transition Process*, Edward Elgar, Cheltenham,1997, p. 103.
[165] World Bank, *Foreign Direct Investment Resilient in the Face of Financial Crisis*, World Bank, 1999, p.54
[166] Merrat, G., p. 118.
[167] Voinea, L., "Revisiting FDI Patterns in Transition. The Case of Romania", *Paper Prepared for EACES Conference*, May 2002, p.9.
[168] Hamilton, F. E. I. cited inDeichmann, J. I., "Distribution of Foreign Direct Investment", *Post-Soviet Geography and Economics*, Vol. 42, No. 2, 2001, p.144.
[169] EBRD, *Transition Report*, EBRD, London, 1998, p.88.
[170] EBRD, *Transition Report* ,1998, p.82.
[171] For a discussion on the triple transition see Linz, J. J. and Stepan, A., *Problems of Democratic Transition and Consolidation: Southern Europe, South America and Post-Communist Europe*, John Hopkins University Press, Baltimore, 1996, pp.401-433 and Offe, C., "Capitalism by Democratic Design? Democratic Theory Facing the Triple Transition in East Central Europe", *Social Research*, Vol.58, No.4, pp.865-892. For a discussion on the quadruple transition see Kuzio, T., "Transition in Post-Communist States: Triple or Quadruple?", *Politics*, Vol. 21, No. 3, 2001, pp. 168-177 and Rigby, T. H. cited in Sakwa, R., *Postcommunism*, Open University Press, Buckingham, 1999, p.39.
[172] Bunce, V., "Should Transitologists Be Grounded?", *Slavic Review*, Vol. 54, No. 1, 1995, p.119.
[173] Lavigne, M., *The Economics of Transition from Socialism to Market Economy*, MacMillan Press, London,1995; Bal, A., "Trăsături generale ale procesului de tranziţie la economia de piaţă în ţările foste comuniste" in Popa, I. (co-ord.), *Tranziţie si reformă*, Editura Economică, 2001.
[174] Lavigne, *The Economics of Transition*, p. 249

As a result, the debate focused on the speed and sequencing of such policies.[175] Furthermore, many studies have tried to account for what went wrong in transition in different countries. Thus, failures and delays in transition were attributed generally to a combination of factors as follows: the legacies of the past, a wrong evaluation of the reality due to imperfect statistics, the external constraint, technical errors in policies and finally, the inadequate assistance of the West.[176] This research constitutes the inspiration for the matrix of determinants of transition used in this study in order to identify the factors that led to different paths of transition and hence on different paths in the quest for EU membership by Poland and Romania.

Two main approaches to implementing economic transition emerged from this policy approach analysis. On the one hand, the neo-liberal or radical approach was proposed by economic advisors within the International Monetary Fund and the World Bank. On the other hand, a more gradual, transformatory view, was suggested by authors such as Hausner at al, Kovacs, Grabher and Stark, Offe and Amin and Hausner.[177] These two strands of literature are the pillars of the debate on transition and will be briefly reviewed below. However, some analysts argue that, given the complex nature of transition and the time consuming nature of some processes compared with others, the debate between gradualists and proponents of shock therapy has been a waste of time and energy.[178] Furthermore, practice has shown that a combination of the two approaches is the most likely approach to economic transition.

The neo-liberal approach

The neo-liberal approach was similar to an economic engineering exercise. It was based on the view that capitalism could be designed for the CEECs and imposed *by fiat*.[179] It contended that the institutions, regulations, practices and habits associated with market economy would emerge naturally and quite rapidly, once the power of capital was unleashed.[180] Through this emphasis on the power and

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[175] For a comprehensive overview see Balcerowicz, L., "Common Fallacies in the Debate on the Economic Transition in Central and Eastern Europe", *EBRD Working Paper No. 11*, EBRD, London, 1993; Bal, "Trăsături generale ale procesului de tranziție", pp.84-87; Lavigne, *The Economics of Transition*, pp.248-253.
[176] Aslund, A., "Lessons of the First Four Years of Systemic Change in Eastern Europe", *Journal of Comparative Economics*, Vol. 19, No. 1, 1994, pp. 22-38; Blacerowicz, L. and Gelb, A., "How to Stabilise-Policy Lessons from Early Reformers", *Transition*, Vol. 5, No. 6,1994, pp. 3-4; Sachs, J., "Russia's Struggle with Stabilisation, *Transition, Vol. 5*, No. 5,1994, pp. 7-10.
[177] Hausner, J. et al, *Strategic Choice and Path Dependency in Post-Socialism*, Edward Elgar, Aldershot, 1995; Grabher, G. and Stark, D. (eds.), *Restructuring Networks in Post Socialism: Legacies, Linkages and Localities*, OUP, Oxford, 1997; Offe, C., *Designing Institutions for East European Transitions* in Hausner, J. et al (eds.) *Strategic Choice and Path Dependency in Post-Socialism*; Amin, A. and Hausner, J. (eds.), *Beyond Markets and Hierarchies: Interactive Governance and Social Complexity*, Edward Elgar, Cheltenham, 1997.
[178] van Brabandt, *Remaking Europe*, p.179.
[179] Stark, D., "Not by Design: The Myth of Designer Capitalism in Eastern Europe" in Hausner, J. et al (eds.) *Beyond Markets and Hierarchies*; Hausner, J., "Imperative Versus Interactive Strategy of Systemic Change in Central and Eastern Europe", *Review of International Political Economy*, Vol. 2, No. 2, 1995, pp. 249-266.
[180] Smith, A. and Swain, A., "Regulating and Institutionalising Capitalisms", Pickles, J., Smith, A. (eds.), *Theorising Transition*, Routledge, London, 1998, p.26.

own life of institutions, this approach is related with the neo-liberal institutional approach in political science. It was also known as the Washington Consensus, a term coined by Williamson to describe the policies adopted by a number of Latin American countries in the mid 1980s with the support of the international financial organisations.[181] Friedman, Sachs and Lipton, the main proponents of this view, suggested a shock therapy economic programme that would include:

a) rapid price liberalisation in order to eliminate the excessive monetary base and to internalise the international prices;
b) rapid foreign trade liberalisation;
c) substantial devaluation of the national currency and internal convertibility in order to control inflation and stimulate exports;
d) hard budget constraints, including the eradication of subsidies;
e) rapid privatisation;
f) substantial external financing in order to cover some of the anticipated economic and social costs.[182]

The neo-liberal view was relatively popular amongst academics and politicians and contributed to the credibility of the Polish reforms at the beginning of transition. However, this approach displayed several important limitations. Thus, the legacy of the past and its potential impact on the success of any policies was largely ignored. The importance of adequate communication with the public in order to ensure its support for economic reforms was also underestimated. Furthermore, the technicist view of market institutions disregarded their complex social and political nature and the rather lengthy time needed for their setting. Finally, the economic and social cost of transition was underestimated greatly and so was the public disposition to bear this cost.[183] The shock therapy approach to transition and its limitations are relevant to this dissertation for the understanding of the early Polish transition and of the post-1996 economic reforms in Romania. The limitations of such an approach make the case for the need of a combination of approaches to economic transition as proposed by this study.

The gradual approach

The political economy of transition has challenged many of the axioms of neo-liberalism and an alternative policy approach to transition has emerged. The gradual or transformatory approach was based on the view that transition can only be a gradual process in which the market institutions would be introduced progressively or created through the transformation of the old ones. The gradual approach contended that the shocks of such a transition would be absorbed smoothly and borne easier by the population. This view also assumed the temporary coexistence of elements of both socialist and

[181] Williamson, J. cited in Sakwa, R *Postcommunism*, Open University Press, Buckingham, 1999, p.40
[182] cited in Bal, "Trăsături generale ale procesului de tranziție", p.85.
[183] Bal, "Trăsături generale ale procesului de tranziție", p.85.

market economy.[184] The gradual approach was exposed to certain criticism. Thus, a gradual introduction of reforms had the potential to consolidate the position of those opposing them, hence further delaying the transformation. Furthermore, by maintaining mechanisms of the former planned economy, this approach prolonged the inefficiency of the previous system. Two different strands can be identified within the gradual approach to transition to market economy or the transformatory view: the institutional (including the evolutionary) stand and the dual standpoint. The main propositions of these standpoints and their relevance for the present study will be briefly reviewed below.

The institutionalists

Proponents of the institutional standpoint include McKinnon, Stiglitz, Buchanan, Brabandt, R. Boyer and Jackson.[185] This strand of literature maintains that institutions are crucial in transition for their capacity to regularise conflicting accumulation strategies.[186] This again mirrors the neo-liberal approach on political science. By contributing to the setting of the rules of the game, institutions facilitate a long term approach to economic reforms.[187] Furthermore, socio-economic change is induced by people in negotiation with formal and informal institutions and change is the output of neither voluntarist design, nor structural determinism.[188] Transparency is a necessary condition for market efficiency and the state is called to intervene in case of market failure.[189] The relevance of this approach for the present study resides in its emphasis on the role of the state and the interaction between institutions and population, which makes the case for including public support amongst the determinants of economic transition in Poland and Romania.

The evolutionary approach

Within the institutional approach, the evolutionary theory appears the raise the most controversy because of its critics within the capitalist context and because of being wrongly confused with a standard gradualist approach.[190] This theory maintains that there is no need to destroy previous organisations and institutions because these can, in time, adapt to the new market conditions.[191] The evolutionary theory of transition towards market economy was explained by Murrel in various articles. He recommended a 'piecemeal approach to privatisation' and opposed it to radicalism. However, he did not criticise the stabilisation part of the radical programmes. Instead, he advocated strict direct controls on the non-market sphere, i.e. on state-owned enterprises, in order not to hinder the market response

[184] Bal, "Trăsături generale ale procesului de tranziţie", p.85.
[185] cited in Bal, "Trăsături generale ale procesului de tranziţie", p. 86; cited in Lavigne, *The Economics of Transition*, p.250.
[186] Smith and Swain, "Regulating and Institutionalising Capitalisms", p.27.
[187] Bal, "Trăsături generale ale procesului de tranziţie", p.86.
[188] Smith and Swain, "Regulating and Institutionalising Capitalisms", p.27.
[189] Bal, "Trăsături generale ale procesului de tranziţie", p.86.
[190] Lavigne, The Economics of Transition, p.250.
[191] Bal, "Trăsături generale ale procesului de tranziţie", p.87.

from the nascent private sector.[192] A similar standpoint was also adopted by Kornai.[193] The evolutionary approach was subject to certain criticism. Thus, Grosfeld argued that a new institutional and organisational order has to be established through a radical step such as privatisation through quick divestiture of the state. Only then could an evolutionary process be initiated.[194] Furthermore, this approach does not have predictive power regarding the operation of the set market structures or of the remaining state-owned enterprises.[195]

The path dependency approach

A particular strand of the evolutionary approach emphasises the existence of path dependency in transition. Stark and Grabher, its most forceful proponents, claimed that future forms of development arise out of particular trajectories or paths that have been followed in the past. In the case of transition economies, legacies of communism are a central component of our understanding of the possibilities and limitations of transition.[196] Furthermore, referring to Schumpeter, Stark argued that the innovation that takes place in transition at organisational level is based on a recombination and rearrangement of the existent institutional elements.[197] Additionally, Smith and Swain maintained that an understanding of the diversity of local responses to transition must arise from the way in which previous sets of social relations in place are reworked within the limits of these relations.[198] However, some studies suggested that path dependency constraints, but does not exclude strategic choice. Thus, change is not only path dependent but also path shaping.[199] Overall, the approach is related to the path dependency approach in political science proposed by Pierson. The path dependency and path shaping approach is adopted by the present study. This assumes that Romania and Poland's evolution in transition so far has been to a large extent path dependent but that there is a large potential of a path shaping evolution as will be discussed in chapter seven.

The dual (mixed) approach to transition to a market economy

Proponents of this approach such as Chavance, Kornai, Nuti or N. N. Constantinescu assume that the creation of market economy is a gradual process during which elements of the previous socialist economic and political system coexist with the newly created market institutions. This results in the

[192] Murrel, P. "Public Choice and the Transformation of Socialism", *Journal of Comparative Economics*, Vol. 15, No. 2, 1991, pp.203-210; Murrel, P., "Conservative Political Philosophy and the Strategy of Economic Transition", *Eastern European Politics and Societies, Vol. 6, No. 1, pp. 3-6.*

[193] Kornai, J. cited in Lavigne, *The Economics of Transition*, p.250.

[194] Grosfeld, I. cited in Lavigne, *The Economics of Transition*, p.250.

[195] Lavigne, *The Economics of Transition*, p.251.

[196] Grabher, G. and Stark, D. *Restructuring Networks in Post Socialism*; Stark, D., cited in Andreff, W., "Inerţiile economice ale tranziţiei", p.52; van Brabant, J. M., "Governance, Evolution and the Transformation of Eastern Europe" in Poznanski, K.Z. (ed.), *The Evolutionary Transition to Capitalism*, Westview Press, Oxford, 1995, p.158.

[197] Stark, D. cited in Andreff, W., "Inerţiile economice ale tranziţiei", p.52.

[198] Smith and Swain, "Regulating and Institutionalising Capitalisms", p.15.

[199] Smith and Swain, "Regulating and Institutionalising Capitalisms", p.27.

creation of a mixed economy.[200] The main difficulty is that the state maintains a significant role, sometimes unwanted. Although there is room for state desertion through the spontaneous privatisation of the state owned enterprises, the proponents of this approach do not offer a clear solution to how a mixed economy should be managed. Most of the proposals refer to the state as managing gradual bankruptcies, financial restructuring and solving the problem of bad debts.[201] Wijnbergen, for example, also suggests that the state organises training programmes, credits restructuring plans, finances public infrastructure investment and supports selectively different regions.[202]

This approach to transition has faced some important criticism. Thus, Chavance advances a 'grey scenario' in which a rather inert state sector leads to stagnant production, low modernisation and continuous disinvestment. As the government avoids bankruptcies for fear of social explosion, the private sector is burdened by the existence of public sector which crowds it out. Social expenditures decrease, except for unemployment benefits, while investment is low and deterred by high taxes. All in all, international competitiveness in the CEECs is weakened.[203]

Despite criticisms of the dual approach to transition to a market economy, an increasing number of authors have been calling for an increased role of the state in administering the transition.[204] After all, Chavance himself suggests a 'rosy scenario' of a mixed economy in which the state would have an active industrial and agricultural policy, a voluntarist employment and regional policy. The state should also actively deal with the remaining state sector.[205] This latter positive scenario of an active role of the state in managing transition is the basis for the assessment of the determinants of economic transition in Romania and Poland conducted in chapter four and in assessing the determinants of FDI in chapter five.

2.2 Combining the theoretical tools: the theoretical framework of the dissertation

The main argument of this dissertation is that performance in the EU accession process is a result of the interaction between a political and an economic set of determinants. Each set of determinants, be it in the political or economic sphere, has the potential to constitute a vicious or a virtuous circle. Furthermore, each of these circles is self reinforcing and can reinforce the one in the political sphere. Finally, political and economic elements of the circles considered here can constitute security concerns

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[200] Kornai, J. cited in Bal, "Trăsături generale ale procesului de tranziţie", p.87; Constantinescu, N.N., *Reformă şi redresare economică*, Editura Economică, Bucureşti, 1995; Nuti, D.M. 1993 cited in Lavigne, *The Economics of Transition*, p.251; Cheavance cited in Lavigne, *The Economics of Transition*, pp. 251-252.
[201] Lavigne, *The Economics of Transition*, p. 251.
[202] van Wijnbergen, S., "Enterprise Reform in Eastern Europe", *Economics of Transition, Vol. 1, No. 1,1993, pp. 21-59.*
[203] Cheavance cited in Lavigne, *The Economics of Transition*, pp. 251-252.
[204] Ellman, M., "Transformation, Depression and Economics: Some Lessons", *Journal of Comparative Economics*, Vol. 19, No. 1, 1994, pp. 1-21.
[205] Chavance cited in Lavigne, *The Economics of Transition*, p.251.

for each of the two countries analysed, as suggested in diagram 1A. Until 1997, Romania seems to have been trapped in vicious circles in both political and economic spheres, while Poland appears to have enjoyed a combination of two virtuous circles since 1993. The way these two circles work and interact was described in chapter one and in diagram 1A.

In order to suggest ways to break the two vicious circles, this study draws on insights from different theories and strands of literature as reviewed in the previous section. First, in chapter three the recognition of the role of security factors in enlarging the EU is based on neo-realist, neo-institutionalist and constructivist accounts of European integration, as well as on the Copenhagen school. Neo-realist balance of power arguments are called upon to justify the will of the EU to enlarge to the east and the support Germany has given to Poland in its quest for EU membership. These arguments are included in chapter six when discussing the security concerns. Self (national) interest and the fear of new spheres of influence are invoked to partially explain Romania and Poland's drive for EU membership. Neo-institutionalist insights are used to explain the importance of compliance with the Copenhagen criteria as a condition of accession to the EU. Membership of the organisation entails the consolidation of certain common values as a basis for avoiding future conflicts. Hence the Copenhagen criteria had the merit of synthesising these values and subjecting compliance with them to monitoring. In diagram 1A they are represented by transition to a market economy and/or economic reforms. The launch of the accession negotiations with Romania and other remaining candidates in the aftermath of the Kosovo crisis is explained through the lenses of Constructivism and of the Copenhagen school. In chapter six it is argued that by calling Romania a negotiating country rather than a second track candidate, the EU has diminished the security concerns with regard to Romania, thus de-securitising it, according to the Copenhagen school terminology. Furthermore, the decision taken at the Helsinki European Council can be interpreted as recognition that Europe as a whole represents a security complex- in the words of the Copenhagen school- and hence the security of each country is relevant to the security of the continent as a whole. The bi-directional relationship between prospects of EU membership and the security concerns in the political and economic spheres is presented in diagram 1A.

Second, the EU enlargement towards the East can be explained based on economic and political economy arguments. Drawing on the neo-classical theory of economic integration, Romania and Poland's accession to the EU can be justified through expectations of allocation, accumulation and growth effects for both the EU and the two candidate countries considered. The theories of free trade areas and of a single market are called upon to explain the welfare gains of the enlargement, including the investment opportunities in the CEECs and the role of FDI in enhancing economic integration. The assumption that EU membership will enhance FDI in Poland and Romania draws on previous research on the impact of the EEC and of its previous enlargements on FDI. Furthermore, this study adopts the argument that prospects of EU membership have a risk premium effect on the candidate countries, thus enhancing foreign investment by diminishing the security concerns, as in diagram **1A**. Finally, this study assumes the existence of a bi-directional relationship between formal (institutional or political) integration and economic integration, drawing on Balassa.[206]

Third, this study also draws on Baldwin's domino theory of regionalism in maintaining that for the candidate countries the drive for EU membership stems partially from the costs of being excluded from the EU. This is especially relevant for Romania, whose membership was postponed. This study adopts a similar negative motivation for EU membership which maintains that for the EU itself the costs of excluding some CEECs are higher than the costs of inclusion. In particular, the hypothesis of a vicious economic circle with potential negative effects on European security in the absence of firm prospects of EU membership stems from this negative motivation approach to the EU membership.

Throughout this study the analysis is conducted with reference to both the economic and political spheres. The interaction between politics and economics derives from studies of European integration and economic transition which acknowledge the relevance of political factors to the economic transformation of the CEECs. Drawing on the evolutionary approach to transition to a market economy, this study argues that there has been a strong element of path dependency in the economic transition so far, but that there is also a potential for a path shaping evolution. In particular, in chapter four, this study rejects the claim that policies are exogenous and suggests that the initial conditions had a strong impact on the choice of policies at the beginning of transition and hence on the path of economic transition. Furthermore, the assessment of the initial conditions themselves has to include both political and economic factors in order to capture the real magnitude of their impact. This study also proposes that the governments' choice of policies was affected by the internal and international support available as well as impeded upon them, as in diagram **1A**. Drawing on both the neo-liberal and gradual approach to transition, the present research maintains that transition entails a mix of the gradual and shock therapy types of measures, according to the nature and timing of economic reforms. The emphasis on privatisation as a crucial element of transition to a market economy stems from the institutionalist approach and raises the question of the role of capital and hence FDI in economic transition as discussed in chapters four and five.

The discussion of the role and impact of FDI in Poland and Romania in chapters five and seven draws on theoretical and empirical studies on FDI in developing and especially in transition economies. In particular, this study enriches the OLI paradigm by assessing the importance of institutional reforms, security factors and prospects of EU membership as a part of the locational factors that determine the decision to invest in a certain country. The assessment of the role of macroeconomic stability and of

[206] Balassa,"The Theory of Economic Integration: An introduction", p.175

fiscal and financial incentives in attracting FDI draws on locational factors, as suggested by the OLI paradigm of FDI determinants and on surveys of foreign investors. This research also contributes to the study of FDI impact at microeconomic level and enhances the discussion by assessing the effects of FDI on: a 'better life', hence internal political stability, transition to a market economy, integration into the EU and finally on attracting further foreign investment. In particular, this study emphasises the bi-directional relationships between FDI and institutional economic reform, FDI and internal stability, FDI and economic integration with the EU. These bi-directional relationships are part of the economic circle identified by this study. They also connect the economic circle with the political one through the impact on a better life and security concerns and indirectly on support for further reforms as suggested by diagram **1A.** In chapter seven location theory arguments are used to test the potential for path dependency in attracting FDI. Furthermore, the econometric model investigates the bi-directional relationship between FDI and institutional reforms in the CEECs, drawing on neo-institutionalist views.

Finally, in chapter six this study draws on the Copenhagen school of security in order to analyse the complex nature of security concerns in Poland and Romania in the aftermath of the fall of the Berlin Wall. It internalises the proposition that security entails several sectors, including a political and an economic one. Unlike the Copenhagen school, the present study emphasises the role of economic security amongst the five sectors proposed by Buzan et al. It also suggests that external and internal security concerns reinforce each other and that in the case of both Poland and especially Romania external security guarantees are crucial for the consolidation of internal security. EU offers such security guarantees not necessarily in the military sector as NATO does, but especially in the political and economic sector, hence EU has the potential to ensure a virtuous economic circle and a virtuous political one as shown in diagram **1A.**

CHAPTER THREE

THE QUEST FOR MEMBERSHIP OF THE EUROPEAN UNION

3.1 Part One: The quest for EU membership from an institutional perspective

Chapter two has presented a brief literature review and the theoretical framework of the study. This chapter aims to identify the main factors that have influenced Poland and Romania's different progress during their quests for EU membership. Explanations are sought in both the political and economic spheres and in the realm of security concerns. The economic and security factors identified will be analysed in more depth in subsequent chapters. The progress towards EU membership is analysed firstly from an institutional perspective and then from an economic point of view. The chapter also seeks to give evidence of how the institutional framework has impacted on economic integration, thus identifying ways in which the political circle and the economic circle of determinants of the EU enlargement influence each other, as in diagram **3A(a).**

The present part deals with the institutional side of the quest for EU membership and is organised as follows. It first presents the theoretical framework of the chapter. It then makes a brief overview of the way the different questions regarding the enlargement process were answered to. Later it analyses the political determinants of the enlargement process. This chapter then continues with an assessment of the trade off between economic and security factors during the progress towards new stages of institutional integration with the EU. These factors are represented in diagram **3A(b).** The analysis of the security concerns and their relationship with the accession process will be deepened in chapter six. The factors that have led to a certain path in transition will be discussed in chapter four. The first part of the present chapter ends with a brief account of the state of play in the accession process regarding the implementation of the *acquis communautaire*, the state of negotiations and compliance with the Copenhagen criteria by the time of the Copenhagen European Council of December 2002. An account of the way the accession process has answered the questions 'who'?, 'how'?, 'when'? is given earlier in the chapter.

3.1.1 The theoretical framework of the chapter

This chapter is based on the understanding that institutional and economic integration with the European Union have reinforced each other during the process of the EU enlargement. Furthermore, different stages in the institutional integration with the EU have been determined by factors of economic, political and security nature. The question to be investigated is what factors have affected Poland and Romania's quests for EU membership. In the political sphere, three main factors have been identified: the EU's attitude towards each candidate country considered here, also known as international support; each government's attitude towards accession and finally, the public support for EU membership. They are represented in diagram **3A.** The last two factors represent each country's attitude towards EU membership and will be analysed under the same heading. In the economic sphere, the main factor identified is compliance with the Copenhagen criteria in terms of transition to a market economy. This appears to be a crucial component, especially in the case of a 'wealthy' rather than 'healthy' approach to enlargement.[1] The chapter discusses the role of the progress in meeting the Copenhagen economic criteria in accelerating the accession process and sets the stage for the analysis of the determinants of economic transition in chapter four. Drawing on political theories on European integration, the chapter also assumes that progress in the institutional integration between Poland and Romania on the one hand and the EU on the other was determined greatly by security factors. Security refers here not to military threats, but mainly to threats of economic and political nature resulting from the complex process of transition to democracy and a market economy. It also comprises an internal and an external dimension which are interconnected. The chapter draws attention to the role of security concerns during the present enlargement process and sets the stage for a detailed analysis of these concerns and their interplay with EU membership in chapter six.

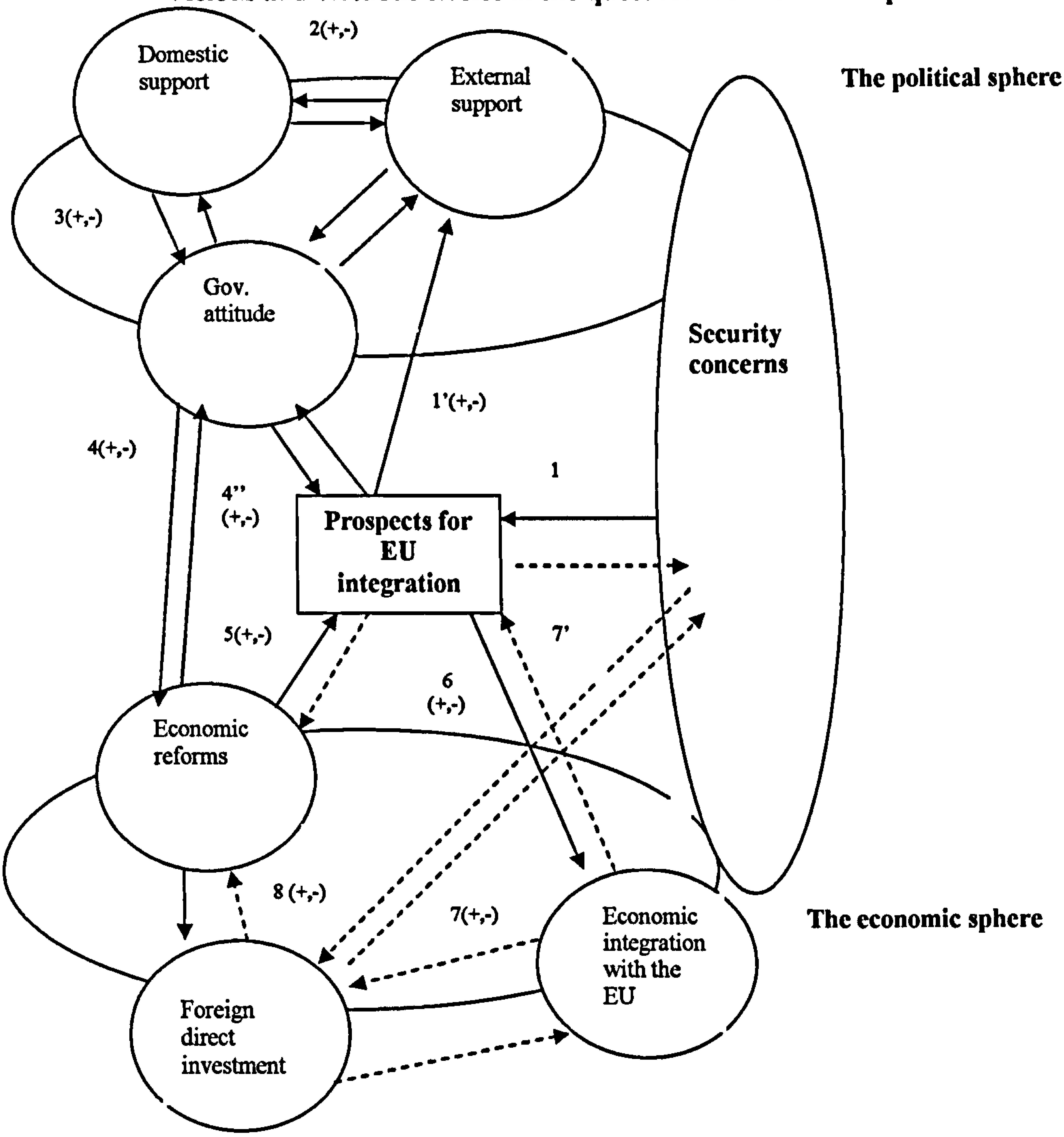
The second part of the chapter draws on economic integration theory as presented in chapter two. It seeks evidence of impact of the institutional framework on economic integration between Poland and Romania on the one hand and the EU on the other in terms of product markets and factor markets. Product integration corresponds to the present stage of integration between the EU and the candidate countries, i.e. a free (albeit imperfect) trade area. Factor markets integration corresponds to the stage of a common market which includes the four freedoms of movement and which will be achieved by the candidate member states upon full membership. However, the increasing level of FDI in the CEECs suggests that progress has been made in factor markets integration ahead of adherence to the common market. Hence, the assessment of factor integration and the assumption that integration in the economic sphere has the potential to enhance institutional integration. It is assumed that this bi-directional relationship is part of the interplay between the political and the economic sphere of the determinants of the EU enlargement, as in diagram **3A(a)**. An analysis of integration in terms of policies is beyond the scope of this study for reasons given in chapter two. Nevertheless, the study acknowledges that several steps have already been made in this direction, through the adoption and implementation of the *acquis communautaire*, the setting up of the accession partnerships and of joint institutions and through the efforts to meet the criteria for membership of the economic and monetary union upon accession.

Finally, this study supposes that trade and investment may enhance economic reforms and thus speed up transition to a market economy and institutional integration with the EU. Economic integration, FDI and transition to a market economy create the circle of economic determinants of the enlargement process as in the diagram **3A(c)**. The interaction with the political circle of the EU enlargement determinants appears to be ensured by the bi-directional relationships between

[1] A 'wealthy' approach to enlargement emphasises the need for strict compliance with the Copenhagen criteria whereas a 'healthy' approach to the enlargement process points towards the security motives of integration. For further discussion, see the following section.

economic and institutional integration, by security concerns which refer to both the economic and political sphere and by the impact of political factors on both transition and FDI. The latter two relationships are analysed in chapters four and five.

Diagram 3A[2]
Vicious and virtuous circles in the quest for EU membership



a) Arrows 6 and 7' indicate bi-directional relationship between institutional and economic integration with the EU.

b)Arrows 1 and 5 indicate the security and economic factors that have determined the enlargement process.

c)Arrows 6(+), 7(+), 8(+), 5(+) indicate a virtuous circle in the economic sphere induced by the prospect of EU membership and its effects on economic integration with the EU.

d)Arrows 1'(+), 2(+) and 3(+) indicate a virtuous circle in the political sphere induced by a favourable attitude of the EU and/or a positive attitude of the government towards economic reforms.

Legend:

——→ relationships that are addressed in chapter three

------→ relationships that are addressed in other chapters

3.1.2. The questions of enlargement: 'who'?, 'how'?, 'when'?

The main questions that the European Union had to answer regarding the Eastern enlargement process were 'who', 'how' and 'when' and the answers came gradually.[3] Thus, the signing of the association agreements gave partially the answer to the question 'who' by designating ten Central and Eastern European countries alongside Malta and Cyprus, while the Copenhagen European Council of June 1993 restricted the number of 'who' to those who met certain political and economic criteria. These criteria referred to the democratisation process, marketisation and the capacity to withstand competition within the EU, the adoption and the implementation of the *acquis communautaire,* as well as to the EU's readiness to enlarge. The December 1999 Helsinki European Council designated Turkey as a candidate and there is still room for future association agreements. By 2002, only twelve countries had started negotiations and thus were seriously considered for membership. These developments made some analysts -especially from the most advanced candidate countries-consider that there has been a widening of the process of enlargement rather than a deepening.[4] Moreover, the on going democratisation and economic reform in South Eastern Europe led to countries such as Croatia to aspire to membership. At the same time, the candidature of Turkey can still be considered a sensitive issue from the EU's perspective. Furthermore, despite reassurances given at the Copenhagen European Council, the present ten plus two strategy poses certain doubts on the accession of the remaining two countries Romania and Bulgaria. This is because target dates have been postponed before and because the impact that an enlargement of ten would have on the EU and on its capability and will to enlarge is still uncertain.

The question 'how' had a few answers from different perspectives. First, the cost of enlargement was initially estimated in the Agenda 2000 and then re-assessed at the Berlin Council. Second, the 'differentiation' approach was adopted initially through the 1997 Avis. Then, an 'all inclusive' approach was promoted at Luxembourg European Council in December 1997, followed by the launch of accession negotiations with the remaining 'pre-ins' candidates. Third, the 2000 Nice Council has actually suggested a 'ten plus two' approach, designing at the same time an institutional framework for a fifteen plus twelve enlarged EU. The question 'how' was also answered with some inconsistencies. Contradictions were noted, for example, in the approach towards the accession of Poland. A favourite of enlargement, Poland has been strongly supported by Germany and for most of the decade the Eastern enlargement without Poland was inconceivable. However, during 1997-1999, given the slow down in reforms, the hesitant rhythm of negotiations and the increase of unpopularity of EU membership within the Polish public, a first enlargement without Poland became for the first time a viable option. Warnings were given to Poland that a first enlargement

[2] This diagram is based on diagram 1A which was presented in chapter one.

[3] Phinnemore, D., "The Challenge of EU enlargement: EU and CEE perspectives" in Henderson, K. (ed.), *Back to Europe: Central and Eastern Europe and the European Union*, UCL Press, 1999, p. 72

without it might be possible, should Poland not make the necessary steps to speed up reform and negotiations.[5] Nevertheless, the renewed commitment for EU membership expressed by the Miller government regained EU's support for a fist phase of the enlargement that guarantees Poland's entry. Poland became again a pivotal country for the next wave of enlargement.[6] Verheugen even insisted that: 'It is absurd to discuss whether Poland would join the EU or not in a first wave.' [7] At the 2002 Copenhagen European Council Poland was invited to join the EU in May 2004.

Also regarding the question 'how', the discussion on the Eastern enlargement has been increasingly focused on not allowing a new division line to be drawn in Europe.[8] Thus, at the Lisbon European Council of June 1992 it was announced that it was 'neither possible, nor opportune to establish new frontiers of the EU, whose contours will be shaped over many years to come'.[9] In 2001, Prodi, the president of the European Commission, underlined that 'no new Iron Curtain' will be allowed.[10] Moreover, the enlargement commissioner Verheugen has increasingly emphasised that there is only one enlargement of which Romania is part, but in different phases.[11] Overall, the approach has switched from a 'wealthy' to a 'healthy' enlargement, from pure calculations as in the Opinions to taking into consideration security concerns, within 'proper perspectives', as at the Helsinki European Council in December 1999.[12] The shift in the debate has been also from the cost of the enlargement to the opportunities.[13] However, the present approach of ten plus two supports only partially this idea of a 'healthy' rather than 'wealthy' enlargement, as Romania, a country in a strategic position but implying rather a high cost, is not considered for the first phase.

The question 'when' waited for answers for long time and at times it seemed that the target date kept moving forward. Polish authorities even noted: 'Poland seems to be always five years short of accession'.[14] Since the 1993 Copenhagen Council switched the question from 'if' to 'when', there has been an increased pressure from the candidate countries for a firm date for accession, which

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[4] Balázs, P., "The Globalisation of the Eastern Enlargement of the European Union: Symptoms and Consequences" in Maresceau, M. (ed.), *Enlarging the European Union. Relations between the EU and Central and Eastern Europe*, Longman, Harlow, 1997, p. 369.
[5] *Eurobserver*, 27 June 2001; Central Europe, 8 March 2001.
[6] Preston, C., "Poland and EU Membership: Current Issues and Future" in Gower, J. and Redmond, J. (eds.), *Enlarging the European Union. They Way Forward*, Ashgate, Aldershot, 2000, p.40.
[7] *http://www.delpol.pl*, 3 September 2001.
[8] Garthon, T. Ash cited in Burant, S.R., "After NATO R. E. Baldwin et al, "The Costs and Benefits of Eastern Enlargement: The Impact on the EU and on Central Europe", *Economic Policy*, No. 24, 1997. Enlargement", *Problems of Post- Communism*, Vol. 48, Issue 2, 2001, p.1.
[9] de La Serre, F. and Lequesne, C., "Enlargement to the CEECs: Which Differentiation?", in Maresceau (ed.), *Enlarging the European Union*, p. 350.
[10] *Eurobserver*, 12 March 2001.
[11] Verheugen, G., News, 18 December 2001, *http://www.infoeuropa.ro.*
[12] Saryusz -Wolski, J., "Towards a Single Perspective. Economics and Politics of Eastern Enlargement" in Maresceau (ed.), *Enlarging the European Union*, p.278
[13] Gower and Redmond (eds.), *Enlarging the European Union*, p.188
[14] Gower and Redmond (eds.), *Enlarging the European Union*, p.179

was understandable.[15] A firm date was seen as a real commitment from the EU.[16] Although some indications were given at the Luxembourg Council in 1997, the question 'when' was answered only through the 2000 regular report and was confirmed at the Nice Council in December 2000. It was then anticipated that advanced countries could finish accession talks as soon as 2002 and thus join in 2004.[17] Until then it had been considered by the enlargement commissioner Verheugen that any unrealistic date would be a backfire and that: 'Nothing would be more dangerous than to raise countries' hope only to dash them'.[18]

On the other hand, not fixing a date meant for the candidate countries a lack of commitment. As a reassurance, at Nice it was envisaged that the first intake will be welcome in 2004, so that the new member states of the EU could take part in the parliamentary elections of the year. No specific deadline was advanced for Bulgaria and Romania. Up to then 2000 and 2002 had been promised repeatedly to the Polish government as membership dates, but it has been impossible to make this happen due to the lack of preparation from both sides. Furthermore, 2002 was rather optimistic, given that for previous accessions the negotiations lasted from one year in the case of Austria, Finland and Sweden, to seven years in the case of Spain and Portugal.[19] These hesitations led to continuous concerns from the Polish side over 'symptoms of a slowdown of the integration process in Europe'. In 2000 the Polish authorities even warned that 'delaying Poland's entry beyond 2003 would diminish Poles' readiness to endure painful market reforms and undermine their wish for membership'.[20] These warnings underlined the security implications of further delays in accession and can be extrapolated to the Romanian case at present.

Hesitations within the EU still remained regarding a commitment for 2007 as a date for accession of Romania and Bulgaria. Despite the enlargement commissioner Verheugen's recommendation, the Commission did not adopt 2007 as a target date for enlargement for Romania and Bulgaria, in its regular general report in October 2002. The Copenhagen Council also failed to provide a date, the Commission limiting itself to recognising that Romania has set itself a target date for accession. Lacking a firm commitment from the EU side, Romania needs to make sure that Romania meets all the necessary requirements in order to join the EU on the set date. This justifies the present study which looks at how

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[15] Cameron, F., "The European Union and the Challenge of Enlargement", p.248; J. Rollo, "Economic Aspects of EU Enlargement to the East", M. Maresceau (ed.), p. 253; G. Verheugen, Speeches, 21 September 2000, *http://www.europa.eu.int*
[16] Gower and Redmond (eds.), *Enlarging the European Union*, p.179
[17] *The Business Central Europe*, January 2001
[18] Verheugen ,G., "Speeches", 4 September 1999, *http://www.europa.eu.int*
[19] Cameron, F., "The Challenge of Enlargement: The View from Brussels. The Commission Perspective", p. 20; Gower, J. and Henderson, K., "Future Perspectives" in Henderson, (ed.), *Back to Europe*, p. 13; *Eurobserver*, 28 May 2002
[20] *The IPR Strategic Business Information Database*, 15 May 2000

different factors have affected the European enlargement so far and how they interact at present.

3.1.3 The quest for membership of the European Union: the 'star' and the 'underdog'

Since the early 1990s Poland and Romania have evolved differently in their quest for EU membership, due to both internal and external factors. Poland was part of the 'avant garde' Visegrad group who initiated new steps in the accession process, while Romania was part of the 'follow-up' group, who responded to external challenges and signals of the EU, avoiding exclusion rather than seeking inclusion.[21] Poland was for most of the period a favourite of the EU, a 'star' of the enlargement process, while Romania seems to be an underdog, 'stuck between Visegrad and Minsk'.[22] Poland will join in May 2004 while Romania is likely to join only in 2007.

The contrast between the present situation of the two countries with regard to the accession into the EU might lead to the wrong conclusion that Polish membership of the EU has been a 'safe bet' for the Union from the beginning. This has not been the case. Poland is the largest and most complex of all candidates.[23] It is both the biggest opportunity and the biggest headache for the EU.[24] Polish membership of the EU poses such challenges to the Union that Preston has concluded that: Poland's accession to the EU 'tests EU's methodology of enlargement'.[25] Poland is the most populous country with an important impact on the labour market and on the structural and cohesion funds. Its location is of traditional geopolitical sensitivity. It has a large agricultural sector and its industry has needed serious restructuring.[26] Nevertheless, the advocates of Polish membership of the EU have managed to turn some of these disadvantages into opportunities for the EU. Thus, the large population means a large market for EU products and increased investment opportunities. Its geographical position makes Poland a land in between Germany and Eastern Europe. Studies show that the threat of the agriculture and sensitive industries is less serious than it has been anticipated. The fear of massive immigration from the East rising from Poland's proximity to Ukraine has also been diluted as a result of strong border controls.[27] Overall, Polish EU membership seems to benefit not only Poland, but also the EU by increasing its size and weight in international affairs, stretching its boundaries towards east and offering new business opportunities. Poland brings a

[21] Balázs, P., "The Globalisation of the Eastern Enlargement of the European Union: Symptoms and Consequences" in Maresceau (ed.), *Enlarging the European Union*, p. 359; Phinnemore, D., "Stuck in the 'Grey Zone'? Fears and Frustrations in Romania's Quest for EU *Membership*", *Paper Presented at a UACES Conference*, April 2000.
[22] Verheijen, T., "The EU and Romania and Bulgaria: Stuck between Visegrad and Minsk" in Redmond, J. (ed.), *Prospective Europeans*, Harvester, London, 1994, p.151.
[23] Grabbe, H. and Hughes, K., "Central and Eastern European Views on EU Enlargement: Political Debates and Public Opinion" in Henderson (ed.), *Back to Europe*, p. 193.
[24] *The Financial Times*, 10 January 2002, p.18.
[25] Preston, "Poland and EU Membership", p.40.
[26] Preston, "Poland and EU Membership", p.40; *The Financial Times*, 10 January 2002, p.18; *The Economist*, 13 January 200.
[27] Wolczuk, K. and Wolczuk, R., "Poland's Relations with Ukraine: A Challenging 'Strategic Partnership'" in Smith, J. and Jenkins, C. (eds.), *Through the Paper Curtain. Insiders and Outsiders in the New Europe*, The Royal Institute of International Affairs, London, 2003.

large national and regional market, relatively skilled labour and raw materials. It offers a buffer zone for Germany and the Union, can enhance stability in the area and acts as 'gateway' to the East.[28]

On the other hand, Romania's generally poor economic performance has enhanced the potential costs for EU, as compared to the potential benefits. Romania has the lowest GDP per capita of the candidates, a relatively low level of restructuring and privatization which have placed it amongst the least favourites for EU enlargement. Furthermore, Romania's accession will lead to several costs for the EU, including the reallocation of the structural and cohesion funds from previous beneficiaries to Romania, the increase of the unemployment rate within the EU overall and increased costs under the *Common Agricultural Policy.*[29] Despite these costs, Romania offers large trade and investment opportunities, access to a large national and regional market, cheap but relatively skilled labour, raw materials, access to commercial roots through the Black Sea and a strategic position at the cross roads between Central Europe and the Balkans. This is why Romania represents an asset for the EU.

Poland's quest for integration into the European Union: the story of a 'star'

EU's attitude towards Poland's accession to the EU

EU's attitude towards Poland was very important for Poland's path in the accession process. It has changed from very supportive to demanding, even threatening, and back to supportive. Poland's perception within the EU also changed from the 'prodigy' of the East to the 'problem kid' who needs special attention and support.[30] At times, EU's commitment towards Poland went so far as not to conceive any further steps towards integration without Poland being amongst the first to become members, regardless of its poor readiness and the better performances of other candidates. Other times, Poland was almost warned that it would not be amongst the first CEECs to become members of the EU, unless real progress in negotiations, in restructuring of the agriculture and of the sensitive industries took place.[31] However, by 2001 Poland was again considered a *sine qua non* condition of the enlargement process, a pivotal country of the process.[32] Despite ranking tenth among the candidate countries in terms of negotiations progress, implementation of the *aquis communautaire* and progress in economic reforms, at the 2002 Copenhagen European Council, Poland was invited to join the EU in May 2004.

Why all this support for Poland? Leaving aside the benefits presented before, the large expatriate communities have contributed to an increased international awareness regarding the Polish political

[28] Cimoszewicz, W ., "Speech at the 9th Session of the Intergovernmental Conference of Accession of Poland to the European Union", Luxembourg, 10 June 2002.
http://home.btclick.com/polishembassy/wcimoszewicz160602.htm.
[29] Păun, L. et al, "A adera sau a nu adera? Un dialog cu doi actori: Uniunea Europeană şi România", *Paper Prepared for the Soros Foundation for an Open Society*, Bucharest, 2000, pp. 397-394.
[30] *Eurobserver*, 5 April 2001.
[31] *Central Europe*, 8 March 2001.

and economic transition. Second, the support must have been strongly embedded in the events of 1980s, when the Solidarity Movement challenged communist rule and the system, attracting the sympathy of the international community. It would be also easy to trace the roots of Western support for Poland even earlier, in the tragic events of World War Two.[33] Then, Poland was a victim of the Nazi occupation, despite the previous guarantees of protection given by France and Great Britain. It was partially this sense of guilt and the will to compensate Poland for its past sufferings that gave Poland a competitive advantage in comparison with the other CEECs looking for establishing relations with the EU. Fourth, the strategic geographical position bordering Germany made its case of EU membership more important as well.[34] Poland's most committed supporter for EU membership has been Germany who needed a buffer zone to the East. This issue will be addressed in more detail in chapter six.

However, much of the EU's support was a reaction to Polish demands or developments, rather than an own initiative of the Union. For example, the Phare programme was designed to offer financial support to Poland and Hungary as recognition of their efforts to reform their economies before 1989. The idea originated before the fall of the Berlin Wall and therefore Phare was an important political means to acknowledge the break up of the two countries with the Soviet Block. Poland was not only the first to be offered financial assistance- which was later extended to other CEECs- but was also amongst the first ex-communist countries to sign an association agreement with the EU and to mention membership of the EU as its goal. Ever since, Poland has constantly pushed for a firm date for accession. A firm date was seen by the Polish authorities as a guarantee of the EU's commitment and its pressure influenced greatly the EU's attitude towards Poland.

On the other hand, there are not only net supporters of Poland with the EU. Some EU members feel threatened by Poland joining the Union. Austria and Germany feared the impact on their labour markets and were determined to negotiate protective transition periods for free movement of labour.[35] France was protective towards its agriculture and the funds which would be redirected to Poland after accession. Furthermore, Spain, Greece, Portugal and Ireland will lose some of the cohesion and structural funds as a result of the Polish accession.[36] Despite these potential losers, Poland's accession into the EU has been generally recognised as a political imperative for the EU.[37]

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[32] Preston, "Poland and EU Membership", p. 40; *Eurobserver*, 12 March 2001.
[33] *Europe*, November 1996.
[34] *Europe*, November 1996; Freundstein, R., "Poland, Germany and the EU", *International Affairs*, Vol. 74, Issue 1, 1998, p.2.
[35] *The Financial Times*, 15 August 2001, p.3.
[36] *Eurobserver*, 28 May 2001.
[37] *IPR Strategic Business Information Database*, 13 November 2001.

Poland's attitude towards EU membership

EU membership has been a Polish foreign policy goal since 1989 which was pursued by all governments and with the support of the majority of society.[38] Poland has been at the 'avant garde' of the quest for returning to Europe and it actively pursued inclusion in the EU. Poland's approach to the EU enlargement evolved from a 'combination of myths, stereotypes, anxieties and hopes' towards a pragmatic attitude. Gradually not only the benefits, but also the costs of such a perspective were taken into consideration by the political class, interest groups and scholars. More specifically, once the negotiations started, the discourse changed from 'romantic declarations' to realist ones as trade-offs had to be done.[39] As Millard put it: 'The devil is in details'.[40] Furthermore, the strong support from the EU gave Poland plenty room for manoeuvre.[41] As a result of the good progress of the economic reforms which put Poland in the early years of transition in a position of superiority compared to other CEECs, Poland assumed that it would be part of the first phase of the enlargement 'no matter what'.[42] The Polish pursuit for European integration was thus generally characterised by a certain assertiveness and confidence.[43] A more flexible attitude was adopted only by the Miller government, once warnings were given by the EU that, unless Poland made enough effort to prepare itself for membership, it might not be considered for the first phase.[44]

EU membership was seen by the Polish authorities as a guarantee of security, a historical reconciliation with Germany, with a strong symbolical importance, and as a guarantee of Poland's returning to Europe'.[45] However, as a result of its more recent pragmatic approach to enlargement, several criticisms appeared. One criticism was directed towards the usefulness of rapid implementation of the *acquis communautaire*. Stawarka argued that there was a risk that too rapid implementation of the *acquis communautaire* as part of the Copenhagen criteria may lead to losing momentum of the Polish economy's dynamic growth.[46] In 1998 gelatine, milk, steel restructuring and borders were all sources of controversy.[47] Some right wing parties also pointed towards the dangers of agricultural decline, cheap imports, cultural and religious influences and the influence of Germany.[48] Disagreements also appeared over the free movement of labour, land acquisition, special economic zones and state subsidies.[49] Another bone of contention between Poland and the

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[38] Preston, "Poland and EU Membership",p. 53; Borowski, M., "Speech in Front of HM Parliament's Group for EU Enlargement", 1 July 2002, *http://home.btclick.com/polishembassy/borowski10702.htm*
[39] *The Economist*, 31 July 1999; *The Economist*, 13 January 2001.
[40] Millard, F., "Polish Domestic Politics and Accession to the European Union", p.203; *The Warsaw Voice*, 22 November 1998.
[41] Grabbe, H. and Hughes, K., *Enlarging the EU Eastwards*, The Royal Institute of International Affairs, London,1998, p.193.
[42] Preston, "Poland and EU Membership", p.40.
[43] Grabbe and Hughes, *Enlarging the EU Eastwards*, p.193.
[44] Preston, "Poland and EU Membership", p.40.
[45] Grabbe and Hughes, *Enlarging the EU Eastwards*, pp. 189-190; Preston, "Poland and EU Membership", p.40.
[46] Stawarska, R., "EU Enlargement from the Polish Perspective", *Journal of European Public Policy*, Vol. 6, No. 5, December 1999, p.822; Millard, "Polish Domestic Politics", p.208.
[47] Grabbe and Hughes, *Enlarging the EU Eastwards*, p. 193.
[48] Grabbe and Hughes, *Enlarging the EU Eastwards*, p.193.
[49] *The Warsaw Voice*, various numbers; Borowski, "Speech", p.2.

EU was the way the Phare funds were spent.[50] Finally, there has been a feeling in Poland that the EU did not have a clear strategy towards the country and that it 'has given too little and demanded too much'.[51] Warsaw complained a lot of 'foot dragging' and hostility from Brussels.[52] The Polish parliamentary Commission on Europe complained that relations often appeared a 'one way street': the EU was demanding very specific changes, while it remained always rather 'enigmatic' on the adaptations that the EU itself was ready to make.[53] These criticisms were part of the pragmatic approach to the EU accession. This intense debate on the prospect of EU membership almost threatened to turn the virtuous circle of the political determinants of accession into a vicious one, with potential negative effects on the economic sphere as well. The warnings given in 2000 by the EU were meant to avoid such a scenario and were followed by the expression of continuos support by the Miller government, a positive element of the desired virtuous political circle of determinants of accession.

Overall, Poland remained a 'star' of the accession process for most of the decade as a result of its assertive approach to membership and of the the EU's high economic and security interests in Poland's accession. The EU's attitude towards Poland, the Polish government's attitude towards accession and the public support constituted for almost of the decade a virtuous circle of political determinants of enlargement as presented in diagram 3A(d). When there was a danger that the political circle would turn into a vicious one as a result of a relaxation of the government policy and of a fall in public support, the EU acted as a 'stick' and maintained the virtuous circle.

Romania's quest for integration into the European Union: an 'underdog' or a 'rising star'?

<u>EU's attitude towards Romania</u>

The EU's attitude towards Romania evolved from reserved and reluctant to understanding and supportive, but still pragmatic. For reasons which will be reviewed below for most of the decade the EU seemed not to have a coherent strategy towards Romania. Instead, conjunctural events such as the Yugoslav wars or the Kosovo crisis led to changes in the EU's attitude.[54] These changes corresponded to the general move from a 'wealthy' towards a 'healthy' approach to the enlargement process. EU's changes of attitude have had an important impact on the political and economic spheres and on the security of each country, as will be discussed in chapter six.

Several factors can account for the EU's attitude towards Romania. First, the EU initially lacked information on Romania, maybe more than on other applicant countries.[55] Romania's geographical

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[50] Grabbe and Hughes, *Enlarging the EU Eastwards*, p.193.
[51] Millard, F., "Polish Domestic Politics and Accession to the European Union", *Soviet Studies*, Vol. 50, No. 5, 1998, p.208.
[52] *Central Europe*, 8 March 2001.
[53] Kancelaria Sejmu cited in Millard, "Polish Domestic Politics", p.209; Central Europe, 8 March 2001.
[54] Interview with Expert in World Economy and European Integration, Academy of Economic Studies, Bucharest, May 2000.
[55] Interview with Expert in World Economy and European Integration, Academy of Economic Studies, Bucharest, May 2000; Verheijen, "The EU and Romania and Bulgaria", p.151.

position far from the core countries of the EU and close to the Balkans, the 'powder keg' of Europe, further contributed to the initial lack of interest in its membership of the EU. Romania's large population and geographical area, large and backward agricultural sector and low GDP per capita made it a rather expensive candidate.[56] Slow reforms and early internal political instability also contributed to the reluctant attitude of the EU. Being treated as part of a group with Bulgaria, Romania was affected negatively by the Bulgarian economic crises in the early 1990s.[57] The wars in the former Yugoslavia accentuated the early perceptions of insecurity in the area and in Romania as will be discussed in chapter six. Additionally, Romania had insignificant lobby power with the members of the EU and lacked a committed supporter inside the EU comparable to what Germany has been for Poland.[58] The support given by France based on the shared Latin heritage and economic interests has not been able to counteract EU's reluctant attitude towards Romania resulting from internal political instability and poor compliance with the Copenhagen criteria. As an example, the French foreign affairs minister's proposition at the December 2000 Nice European Council to adopt one enlargement of twelve, rather than ten, was rejected as unrealistic by the enlargement commissioner Verheugen.[59] Romania was believed not to be able to get ready for membership by 2004 and it was argued that the Romanian and Bulgarian authorities themselves were not expecting their countries to join the EU in 2004.[60]

The EU's approach changed from a reluctant or hesitant to a supportive one, due to the security concerns raised in 1999 by the Kosovo crisis. It was feared that, by depriving the candidate countries of the prospect of EU membership, instability may spread in South-Eastern Europe, with governments and public loosing faith in reforms, democracy and a market economy. The decision to open accession negotiations was also prompted by the need to compensate Romania for its contribution to the NATO military campaign in Kosovo and for its losses as a result of the embargo over Yugoslavia.[61] After the Helsinki European Council, the EU's representative in Romania declared that: 'The EU would not spare any human or financial effort to help Romania in the European integration process'.[62] Although invited to open negotiations in 2000 as the other five remaining candidates, Romania's accession was delayed for pragmatic reasons, i.e. lack of compliance with the Copenhagen criteria and insufficient progress in the accession negotiations. At present, Romania aims to join the EU in 2007. By the end of 2004 Romania needs to achieve a functioning market economy, to adopt and implement the *acquis communautaire* and to finalise the accession negotiations. 2007 is the target date set unilaterally by the Romanian government in 2000 and acknowledged by the EU at the Copenhagen European Council of 2002. Although the EU

[56] *Europe*, November 1996.
[57] Verheijen, "The EU and Romania and Bulgaria", p.151.
[58] Verheijen, "The EU and Romania and Bulgaria", p.164.
[59] *European Report*, 21 November 2001, p.39; *Adevărul, 21 Noiembrie 2001.*
[60] *European Report*, 21 November 2001, p.39.
[61] Interview with Expert in Romania's Accession into the European Union, European Institute, May 2000; Interview with Expert in the European Commission Delegation, Bucharest, Romania, May 2000.
[62] Fotiadis, F., "Declaration at the European Commission Delegation Conference Press", Bucharest, 13 December 1999, *http://www.infoeuropa.ro.*

seems committed to welcoming Romania in 2007, the rising numbers of applicants for membership, previous postponements and the impact of the first phase of enlargement may raise fears of further postponements. This is why it is important that Romania is offered support and meets all the requirements for membership in 2007.

Romania's attitude towards the EU

For the first decade of transition Romania gave mixed messages with regard to its goal of integration into the EU.[63] Romania had no pro-active approach towards integration into the EU, on the contrary, it appeared to be passive, even defensive.[64] Romania sought to avoid exclusion rather than seek inclusion.[65] This attitude was largely responsible for its slow progress during the accession process. By being a follower rather than an 'avant garde', Romania was placed from the beginning amongst the slow candidate countries and faced the danger of path dependency. However, since the 1997 Avis, Romania's attitude has evolved from being hesitant to being more demanding and assertive, albeit still reactive till 2000. This change of attitude was based on a better understanding of the relative importance of economic and security factors in the accession process. Furthermore, this more focused outlook on the EU accession process has the potential of ensuring membership by the target date of 2007 through its interaction with the political and economic determinants of accession. Several factors can be held responsible for Romania's attitude to EU membership so far.

First, at the beginning of transition the political class and the public did not have enough understanding of the necessity of European integration. Hence, the early foreign policy was mainly oriented towards establishing good relationships with the neighbours, rather than towards actively pursuing integration into the EU, as the Visegrad Group did.[66] These developments proved to be useful later for the integration process itself, but they initially slowed down the effort towards accession. As the concept of sovereignty remained important for the political élite and the public opinion, EU membership was at the beginning seen as the only alternative to the Russian influence.[67] As a result, the debate in the media did not address enough the real gains and risks of EU membership, delaying the proper understanding of the process.[68]

Second, apart from the National Strategy from Snagov in the early 1990s, there was no coherent Romanian strategy for European integration until 2000.[69] Furthermore, the poor understanding of the relationship between integration into NATO and integration into the EU led to the poor success

[63] Interview with Expert in World Economy and European Integration, Academy of Economic Studies, Bucharest, May 2000.
[64] Interview with Expert in World Economy and European Integration, Academy of Economic Studies, Bucharest, May 2000.
[65] Phinnemore, "Stuck in the 'Grey Zone'?", p.10.
[66] Interview with Expert in Romania's Accession into the European Union, European Institute, May 2000.
[67] Verheijen, "The EU and Romania and Bulgaria", p.170.
[68] *Piaţa Financiară*, June 1998, p.5.
[69] Interview with Expert in Romania's Accession into the European Union, European Institute, May 2000.

of the 1997 campaign for Euro-Atlantic integration.[70] The hesitant attitude towards EU membership was also influenced by the lack of an early coherent strategy for economic development. As a result, the Avis published by the European Commission in 1997 stated that Romania was not yet ready to start accession negotiations.[71] The Medium Term Development Strategy drawn up in 2000 constituted the basis for a more focused approach to European integration, but it originated from demands expressed by the EU, and not from Romania's own initiative.[72] This had, however, the potential to ensure a virtuous circle in the economic sphere, with beneficial effects on the prospects for EU integration, as will be seen in chapter four.

Third, Romania relied excessively on the role of external security factors in speeding up its accession and neglected the importance of meeting the Copenhagen criteria. As a result, the qualification in a new stage of institutional integration was a 'blank cheque' most of the time. This was given so that the population would not lose interest and hope and therefore social strife would not transform the area in a zone of instability.[73] Furthermore, the poor understanding of the relationship between economic reforms and European integration led to low enthusiasm for reforms and hence slow progress towards EU membership.[74]

However, there are important positive factors which have characterised Romania's quest for integration into the EU. First, despite the slow evolution towards membership and the painful economic reforms, seventy six percent of the population still supported EU membership in 2002, the highest support among the CEECs.[75] Furthermore, European integration is endorsed by all political parties, including the nationalistic Greater Romania Party. Third, there has been a constant increase in the public awareness of the EU issues through the technical and financial assistance offered. Thus, specialists and the political élite have been trained in with a better understanding of the process of integration into the EU. Finally, Romania remains a pole of stability in an area that has been considered the 'new cock-pit' of Europe at the crossroads between Central Europe, Eastern Europe and South Eastern Europe, therefore making it a good asset for the EU.

All in all, Romania has been considered too big, too far, too poor, too slow in reforms and too passive, making it an 'underdog' of the enlargement process. The inconsistent attitude of the EU towards Romania had no power in creating a virtuous circle of political determinants, especially as the economic sphere was also trapped into a vicious circle. As economic reforms lagged behind, only security concerns have been able to increase Romania's prospects for EU integration so far.

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[70] Pipidi, A. M., *Politica Externă*, Societatea Academică Română,Bucureşti, 1997.

[71] European Commission, "Opinion on Romania's Application for Membership of the European Union", 15 July 1997.

[72] *Piaţa Financiară* May, 1998, p.5; Interview with Expert in Romania's Accession into the European Union, Romanian Foreign Affairs Ministry, Department of European Integration; Interview with Expert in the European Commission Delegation, Bucharest, Romania, May 2000.

[73] Interview with Expert in the European Commission Delegation, Bucharest, Romania, May 2000.

[74] Interview with Expert in Romania's Accession into the European Union, European Institute, May 2000.

[75] Opinion Poll conducted by IMAS, 16 July 2002, *http://www.europa.eu.int/comm/enlargement/romania*

Thus, the supportive attitude in the aftermath of the Kosovo crisis complemented by the government's willingness to reform had the potential to turn the vicious political circle into a virtuous one, with a positive impact on the economic sphere. This appears to justify Romania's claim to be ready to join the EU in 2007 on its own merits and possibly a status of a 'rising star'. Can accession on one's own merits be fostered by maintaining prospects of membership through considering security factors? This question will be investigated in chapter six. Furthermore, the impact of the prospect of EU membership on FDI and hence economic reforms will be assessed through the econometric model in chapter seven, in order to see the interaction with the economic sphere.

3.1.4 The quest for EU membership: the interplay between security and economic factors

This section presents chronologically how the interplay between security and economic factors has determined each new stage of the institutional integration of Poland and Romania with the EU. The initial conditions are important for signalling a possible path dependency. The 2002 situation is sketched in order to identify options for the future. The analysis is conducted for several stages corresponding to the main landmarks of the accession process relevant for this project: the association agreements, the Avis, the December 1999 Helsinki European Council and the December 2002 Copenhagen European Council.[76]

The initial conditions

Security concerns have had the main impact on how the economic and political relations prior to 1989 have influenced the post-1989 relations of Poland and Romania with the EU. Thus, in the 1980s Romania was the only country from the former Council of Mutual Economic Assistance (CMEA) to have established economic relations with the EU. Romania signed an agreement on textiles and steel in 1978 and one on trade in industrial production in 1980.[77] These were part of Romania's acting as a dissident within the Soviet Bloc.[78] Despite this apparent comparative advantage in relations with the EC, human rights violations determined the suspension of these agreements in early 1990s.[79] Moreover, the political instability in the early 1990s was conducive to an improvement in the EU's attitude towards Romania, making it unable to use the comparative advantage of prior economic and political relations with the EU.[80]

On the other hand, Poland's trade prior to 1989 was heavily dependent on CMEA. Only little trade and investment originated from the EC and it was mainly a result of the large Polish expatriate

[76] For a further discussion on the stages of the EU enlargement see Cameron, "The Challenge of Enlargement: The View from Brussels"; Gower and Redmond (eds.), *Enlarging the European Union*; Gower, J., "EU Policy to Central and Eastern Europe" in Henderson (ed.), *Back to Europe*; Gower and Henderson, "Future Perspectives" in Henderson (ed.), *Back to Europe*; Grabbe and Hughes, *Enlarging the EU Eastwards*, The Royal Institute of International Affairs, London,1998; Păun et al, "A adera sau a nu adera?".
[77] Verheijen, "The EU and Romania and Bulgaria", p.155.
[78] Verheijen, "The EU and Romania and Bulgaria", p.155.
[79] Verheijen, "The EU and Romania and Bulgaria", p.156.

community. However, for reasons presented earlier in the chapter, the late 1980s attracted a large interest in Poland's economic and political development. As part of this trend the Phare programme was initiated in 1989 to assist financially the economic restructuring of Poland and Hungary initially. The signing of EU association agreements followed shortly as a sign of the EC's interest in the area. All in all, security factors were responsible for Romania not being able to benefit from its prior economic relations with the EU and for Poland's success in attracting Western support for transition and for returning to Europe. The openness towards the West as of 1989 seemed to prevail and create a potential for path shaping rather than path dependency.

From the association agreements to the Avis

The signing of the association agreements had both a symbolical and a practical significance for all parties included. The symbolical value went so far as to the Hungarian foreign ministry to admit that there was a race for whom out of the Visegrad group would sign the agreement first, even at the detriment of quality. It was believed that the association agreements represented a new qualitative stage in relations with the EU and that an early start would ensure a positive external perception. From an economic point of view, the association agreements were a means to liberalise trade with the EU and foster economic co-operation. From a political point of view, they were a way to promote political dialogue and co-operation between the CEECs and the EC, as well as to enhance the Community's role in ensuring the stability of the continent.[81]

The agreements were a means to acknowledge the achievements of fast reformers like Poland and to encourage progress in slow reformers such as Romania. Thus, the association agreement with Poland recognised the 'significant achievements of the Polish people in the process of fast transition to a new political and economic order based on the rule of law and human rights, including the legal and economic framework for market economy and a multiparty system with free and democratic elections'.[82] On the other hand, the association agreement with Romania acknowledged 'the opportunity for a new relationship offered by the emergence of new democracy in Romania' and the 'need to continue and complete, with the assistance of the Community, Romania's transition towards a new political and economic system which respects the rule of law and human rights, including the rights of persons belonging to minorities, operates a multi-party system with free and democratic elections, and provides for economic liberalisation in order to establish a market economy.'[83] It was, in fact, the only agreement which included this political dimension, showing the problems of the Romanian society.[84] The EU recognised the role of the new agreement in 'establishing and enhancing in Europe a system of stability based on co-

[80] Verheijen, "The EU and Romania and Bulgaria", p.164.
[81] European Commission, *http://europa.eu.int/comm/enlargement/pas/europe_agr.htm*
[82] European Commission, *http://europa.eu.int/comm/enlargement/pas/europe_agr.htm*
[83] European Commission, *http://europa.eu.int/comm/enlargement/pas/europe_agr.htm*
[84] L. Păun et al, "A adera sau a nu adera?", p.382

operation, with the Community as one of the cornerstones'.[85] It further stated 'the Community's willingness to provide decisive support for the implementation of reform and to help Romania cope with the economic and social consequences of structural readjustment'.[86] These stipulations enforced the concern with the economic and political development in Romania and emphasised the fact that the association agreement was an expression of trust and support, mostly a political sign.[87]

While Poland was amongst the first CEECs to negotiate and sign an association agreement in December 1991, Romania only did so more than one year later, in February 1993. The late start of Romania's quest for EU integration can be attributed to several factors, some from the security realm: the political instability which characterised Romania in the early 1990s, the Yugoslavian and the Macedonian crises, internal problems of the EU over competencies in trade, the fear induced by the negotiations with the Visegrad group that the EU would have to give further concessions.[88] Given its progress in economic reforms and its assertiveness in its relations with the EU, Poland saw the Europe Agreement as a means to 'enshrine' its aim of EU membership. On the other hand, Romania perceived the agreement as a means to 'enter the sanctuary of the European Community after three years of isolation' and to bring Romania back in 'the new architecture of Europe which is constructed from the Community's initiative'.[89] It was considered to provide a 'better image of Romania's place within Europe and better perspectives'.[90] It was a sign that Romania 'got out of an interference and unstable area to join a system of alliances set up to safeguard democracy and to ensure prosperity of these peoples'.[91] This new step was considered by the foreign affairs minister of the time as rather late, but it was also believed that Romania had the potential to recuperate this delay.[92] This reception by the Romanian authorities was also a recognition of Romania's early economic and political problems which hindered its efforts to return to Europe. It equally acknowledged the economic and political benefits of the association agreement with the EU.

The association agreements had not only a symbolical and a political value, but were driven greatly by economic motives. They answered the need to exploit the new trade and investment opportunities which emerged with the fall of Communism and the dissolution of the CMEA. The trade part of the association agreements provided for the establishment of an industrial (imperfect) free trade area, the existing agricultural policy preventing liberalisation from fully extending to agricultural goods. The trade agreements were constructed on the two main premises of stand still and asymmetry in favour of Poland and Romania respectively. The latter meant that the EU would lower its customs duties faster, thus allowing faster access to its market. The principle mainly

[85] European Commission, *http://europa.eu.int/comm/enlargement/pas/europe_agr.htm.*
[86] European Commission, *http://europa.eu.int/comm/enlargement/pas/europe_agr.htm.*
[87] *Adevărul*, 2 February 1993, p.1.
[88] Verheijen, "The EU and Romania and Bulgaria", p. 164.
[89] *Adevărul*, 2 February 1993, p.1.
[90] *Adevărul*, 4 February 1993, p.1.
[91] *Adevărul*, 3 February 1993, pp.1-2.

concerned industrial goods and to sensitive products special rules were devised, combining quantitative restrictions and varying tariff rates.[93] Although the agreements had certain limitations that were already discussed in chapter two, they set the framework for trade liberalisation and economic co-operation, thus fostering trade, co-operation, economic growth and FDI. Despite the limitations acknowledged in chapter two, the association agreements created the conditions for a potential virtuous circle of development. Evidence of impact of the institutional framework on economic integration of Poland and respectively Romania will be given in the second part of this chapter and in chapter seven.

From the Avis to the Helsinki European Council

The next important stage in the enlargement process was the presentation of the Avis by the European Commission in July 1997.[94] Again Romania and Poland were strictly differentiated. While the Avis on Poland relied on accomplishments and facts, the one on Romania expressed trust in the future. While Poland was recommended to begin negotiations, Romania received an unfavourable Opinion reflecting its poor economic and political performance. As a result, Romania was not recommended to be part of the first wave of accession. The Avis was part of the 'wealthy' approach to the EU enlargement in which progress towards a new stage of the accession process was made on the basis of strict compliance with the Copenhagen criteria rather than on security concerns. It acted as a 'carrot' for Poland and as a 'stick' for Romania.

The Opinion stated that Poland was a democratic country with a stable institutional system acting in accordance with existing laws, respecting human rights and the rights of ethnic minorities.[95] Poland followed proper justice and home affairs policies, especially on international crime, drug trafficking, cross-border migrations and border controls.[96] Its market economy was perceived as working effectively, prices and trade being largely liberalised, and its economy successfully stabilised. However, major state-owned enterprises were perceived as still presenting a great problem. Agriculture still required a substantial overhaul. Overall, the Commission concluded: 'Poland can be regarded as a functioning market economy'.[97] It 'should be well able to cope with

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[92] *Adevărul*, 4 February 1993, p.1.
[93] Stawarska, "EU Enlargement from the Polish Perspective", p.824; Preston, "Poland and EU Membership", p.43.
[94] The Avis was a formal assessment of each candidate country's compliance with the Copenhagen criteria of EU membership. The document was issued by the European Commission, drawing on assessments by other international organisations and on a questionnaire designed by the European Commission and filled in by each candidate country. The Avis formed the basis for the recommendation given by the December 1997 European Council to open in 1998 accession negotiations with six of the candidate countries. The Avis is also knows as the Opinion, so the two terms will be used interchangeably.
[95] Stawarska, "EU Enlargement from the Polish Perspective", p.827.
[96] Stawarska, "EU Enlargement from the Polish Perspective", p.827.
[97] European Commission, "Opinion on Romania's Application for Membership of the European Union", 15 July 1997, *http://www.europa.eu.in/comm/enlargement/and/index.htm*; Stawarska, "EU Enlargement from the Polish Perspective", p.827.

competitive pressure and market forces within the Union in the medium term'.[98] Negotiations were started in 1998, showing that Poland was on the right track to membership of the EU. This positive attitude of the EU had the potential to reinforce the virtuous circle of political determinants of accession with a further positive impact on the economic sphere .

Although EU's attitude towards Poland was generally positive, the reaction towards the *Opinion* was moderate. The first reaction was of relief of Poland being considered as part of the 'better' rather than one of the 'worse' countries, as it was invited to open accession negotiations straight away.[99] However, academics argued that the areas where the EU had made specific demands were 'of greater benefits to Western Europe rather than to Poland'.[100] The Commission's Avis also appeared to set standards that not even the member states would actually meet, as in the case of freedom of the press.[101] Furthermore, it was argued that the criteria of membership were set too vaguely and that there was poor understanding about their weighting or relative priority.[102] These criticisms were part of the Polish bold attitude towards the EU described earlier. As a result, the Opinion sharpened the public debate within Poland. The more palpable the prospect of membership became, the more pragmatic the Polish approach towards EU membership was becoming with a potential to turn the virtuous circle of political determinants of accession into a vicious one.

On the other hand, the Commission was quite damning about Romania, despite expressing some trust in the new power. With regard to the political criteria, the Avis stated: 'Current improvements following the arrival in power of a new government make it possible to conclude that Romania is on the way to satisfying the political criteria set by the European Council at Copenhagen'.[103] Then, the Opinion stated that Romania 'has made progress recently towards improving the competitive capacity of its economy, notably by addressing major distortions such as low energy prices, by accelerating privatisation, and by beginning to liquidate loss-making state owned firms'.[104] The document concluded though that Romania was not a market economy and 'would face serious difficulties to cope with the competitive pressures and market forces within the Union in the medium-term'.[105] Progress in implementing the White Paper was also limited. In the Commission's opinion, the Romanian government had 'neither transposed, nor taken on the essential elements of the *acquis* as regards the internal market'.[106]

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[98] European Commission, "Opinion on Romania's Application for Membership of the European Union", 15 July 1997; Stawarska, "EU Enlargement from the Polish Perspective", p.827.
[99] Millard, "Polish Domestic Politics", p.209.
[100] Millard, "Polish Domestic Politics", p.209.
[101] Millard, "Polish Domestic Politics", p.209.
[102] Redmond, J. and G. G. Rosenthal, "Enlargement. Implicit Debates", J. Redmond, and G. G. Rosenthal (eds.), *The Expanding European Union. Past, Present, Future*, Lynne Rienner, London, 1998, p. 218.
[103] European Commission, "Opinion on Romania's Application for Membership of the European Union", 15 July 1997.
[104] European Commission, "Opinion on Romania's Application for Membership of the European Union", 15 July 1997.
[105] Phinnemore, "Stuck in the 'Grey Zone'?", p.10.
[106] Phinnemore, "Stuck in the 'Grey Zone'?", p.10.

All in all, the Opinion emphasised the primordial role of compliance with the Copenhagen criteria in progressing towards EU membership. However, aware of the potential negative security consequences of such a decision, the European Commission continued to express encouragement and support for the Romanian authorities. The head of the European Commission Delegation in Romania at the time argued that 'Romania was not rejected'. Romania was '[still] part of the enlargement process which comprised more stages' but 'had to recuperate a lot and prepare with regard to the next wave of negotiations'.[107] The enlargement commissioner also explained: 'The EU is waiting to see whether the Romanian government will accomplish what they have promised. If the economic promises are to be put into practice, Romania can be taken into consideration for negotiations'.[108] As further encouragement, the president of the European Commission emphasised that there was no connection between the countries with which the Union started negotiations and the number of countries which will eventually join the EU.[109] This may be a warning at present.

This 'wealthy' approach to the EU enlargement was received with strong criticism by the Romanian authorities and led to a more assertive attitude towards accession, driven by the fear of exclusion. The Avis acted as a 'carrot' for the Polish authorities and as a 'stick' for the Romanian government. The latter was forced to adopt a more committed attitude on both economic reforms and the process of European integration, in order to avoid maintaining a vicious circle of political determinants of accession in the absence of international support. Thus, unhappy with the Avis, the Romanian authorities lobbied the member states' governments before the December 1997 Luxembourg European Council with the aim to ensure that the EU would conduct an 'all inclusive' accession process.[110] In November 1997 the Romanian government circulated a paper to all EU governments in which they argued that differentiation in enlargement would distort trade. The report also claimed that the two wave approach would lead to discrimination in terms of financial transfers, so that the six countries of the first group would obtain much more from the European budget in the period 2000-2005 than the other six. Furthermore, it was argued that such a discrimination would cause a massive migration of foreign investment to the first wave countries. It was thus suggested that enlargement was made more inclusive by enhancing the importance of the European Conference, the accession partnerships and the annual review of progress for each candidate.[111]

Partially as a result of this more assertive attitude of Romania, at the Luxembourg European Council it was declared that the enlargement process would be 'all inclusive'. It was also decided that the progress of the candidate countries towards meeting the Copenhagen criteria would be assessed yearly though regular reports drawn by the European Commission. These were designed

[107] *Adevărul*, 17 July 1997.
[108] *Adevărul*, 17 July 1997, p.11.
[109] *Adevărul*, 17 July 1997, p.11.
[110] Phinnemore, "Stuck in the 'Grey Zone'?", p.8.
[111] Phinnemore, "Stuck in the 'Grey Zone'?", p.8.

to form the basis for the decision to start accession negotiations with the remaining candidates in the near future. However, in 1999 the regular reports formed only partially the basis for the decision to open accession negotiations with the remaining six candidates. The opening of negotiations recommended by the Helsinki European Council was driven greatly by security concerns raised by the Kosovo crisis which will be addressed below. Furthermore, the opening of accession negotiations appears to have impacted on the economic and political circle of determinants of Romania's accession into the EU and on perceptions of security, as will be seen in chapter six.

From Helsinki to Copenhagen

The Kosovo crisis emphasised once again the security dimension of the European integration process. It was again obvious that 'peace and stability across Europe are not yet a matter of fact but they must be maintained in some areas and achieved in others'.[112] It also became obvious that EU enlargement was the most effective means that the EU had of upholding its shared values across Europe.[113] Other means, such as the Stability Pact for South-Eastern Europe or the accession partnerships had already been deployed, but a more comprehensive and determined approach was needed. Moreover, the evolution of economic reforms adopted in most of the applicant countries and the social strife that followed in some of these countries drew attention towards the cost of delaying the new stages of the integration process. A new vision of enlargement was needed. In the words of Prodi, the president of the European Commission at the time: 'We need a political vision, not a technocratic one. We need to set a genuine enlargement strategy looking beyond accession to our life together in the enlarged family of European nations'.[114]

The security motives for the new stage in the institutional integration with the EU had been acknowledged since early 1999. The Romanian representatives to the EU-Romania Association Council in April 1999 had already pleaded in favour of opening accession negotiations with all CEE applicant states. Although Romania's ambassador to the EU had recognised that the country was not yet ready for accession and that it would not expect membership any time soon, it was believed that negotiations would send an important political message that Romania was not being left outside.[115] The Polish president Kwasniewski also warned that: 'If admission of new members would be considerably delayed, this could bring in the candidate countries social distrust and lack of support for the efforts towards membership'.[116] The European Commission made public its evaluation of the progress registered by the candidate countries and made recommendations to the Helsinki European Council to open negotiations with the countries that 'already fulfilled the

[112] *The Business Central Europe*, February 2000.
[113] *The Business Central Europe*, February 2000.
[114] Prodi, R., "Speech to the European Parliament Strasbourg", 14 September 1999, *http://www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.*
[115] O'Rourke, B., "Endnote: EU, East European Candidates Review Progress", RFE/RL Newsline, 6 May 1999.

political criteria and that proved themselves ready to take the measures to meet the economic criteria as well.'[117] The recommendation to open negotiations was 'a recognition of the widely recognised need to accelerate the enlargement process as a result of the changes in the European political arena, especially after Kosovo'.[118] A 'healthy' rather than 'wealthy' approach to enlargement was initiated.

Romania was recommended to start accession negotiations, despite the concern expressed in the Commission's Composite Report of October 1999, which noted that: 'All candidates except Slovakia, Lithuania, Bulgaria and Romania are considered to be functioning market economies... The economic situation in Romania is very worrying and sustained efforts will be needed to put a functioning market economy in place ... Romania [does] not meet either economic criterion. Regrettably, the situation in Romania has, at best, stabilised compared with last year. There are, however, exceptions. The situation of over 100,000 children in institutionalised care in Romania has seriously deteriorated, with the Government failing to act in time to ensure that adequate funding was provided for the children. This is an issue of human rights and the Romanian Government needs to continue to give it the political priority which it urgently requires. Romania has a mixed record in legislative approximation, with good progress in certain areas offset by delays in others... The capacities of the administration and the judiciary in Romania remain weak'.[119]

By being invited to open accession negotiations Romania was morally compensated for the losses incurred as a result of the embargo against Yugoslavia during the Kosovo crisis. Romania was also rewarded for its involvement in NATO's military campaign. It was equally believed that the opening of negotiations 'would consolidate the rhythm and the consistency of reforms'.[120] The Commission further hoped that the opening of negotiations would contribute to achieving national consensus, not only regarding the final goal of membership of the EU, but also with respect to the means to be followed to attain this objective.'[121] Moreover, the new stage in the integration process meant that new funds were provided by the EU, some of them invested in feasibility projects or in infrastructure which are an important means for attracting foreign investors.[122] Despite this political decision on the enlargement process, the economic criterion remained a priority for the EU. In its recommendation, the Commission suggested that the Romanian government 'should use this unique opportunity [given by the opening of accession negotiations] to progress on the line of a

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[116] Kwasniewski, A., "Press Conference in Paris at the French Institute of International Relations IFRI", cited by *Radio Romania Actualităţi*, 3 November 1999.
[117] Fotiadis, *http://www.infoeuropa.ro*, January 2000.
[118] Fotiadis, *http://www.infoeuropa.ro*, January 2000.
[119] European Commission, "Commission Sets out an Ambitious Accession Strategy and Proposes to Open Accession Negotiations with Six More Candidate Countries, Brussels, 13 October 1999
[120] Fotiadis, *http://www.infoeuropa.ro*, January 2000.
[121] Fotiadis, *http://www.infoeuropa.ro*, January 2000.
[122] *Piaţa Financiară*, March 2000, p.24; Interview with Expert in the European Commission Delegation, Bucharest, Romania, May 2000.

coherent and ambitious economic and structural reform.'[123] The EU representative to the EU also emphasised that bringing the economy to a stage with economic growth would contribute to attract FDI, create new jobs and improvement in the living standards. These would diminish the differences between Romania and the other candidate countries better situated in the race for integration.[124] Moreover, the enlargement commissioner Verheugen invited investors to Romania by saying that the country was a safe and good place to invest in.[125]

As a result of the recommendations made at the Helsinki Romania opened accession negotiations with the EU in five chapters in February 2000.[126] Some analysts argue that these fields were not of special importance with regard to reform and therefore the impact of the opening of negotiations on progress towards EU membership was relatively small.[127] Nevertheless, the opening of negotiations was an important political sign, a positive message which gave Romania an 'aim, a target to go towards.'[128] It underlined EU's trust in Romania's efforts to implement economic reforms and enhanced Romania's motivation for pursuing further economic reforms.[129]

Since Helsinki, each country's progress towards EU membership continued to be assessed by the regular reports drawn by the European Commission. The institutional framework of the enlargement process consisted of the accession partnership, accession conference, regular reports and the process of accession negotiations. The positive circles of political determinants of accession were threatened by developments in 2000, when criticisms towards both Poland and Romania were expressed. Thus, in a report drawn for the European Parliament, Baroness Nicholson threatened to ask for the cessation of accession negotiations as a result of poor conditions in the children care institutions, corruption and inadequate reform of public administration.[130] However, the tone of the regular report drawn by the European Commission was less threatening, albeit still critical. Romania was the only country not praised for its efforts and that was not even close to meeting the economic criteria.[131] This was partially a result of 2000 being an electoral year and of the previous democratic governments having been 'lost' in intra-coalition squabbling. The report signalled once again the danger of a vicious circle of political factors that could induce a vicious circle of economic determinants.

Poland also faced the possibility of a negative circle of political determinants of accession in 2000 when, for the first time, was warned of possible exclusion from a first phase of enlargement.

[123] Fotiadis, *http://www.infoeuropa.ro,* January 2000.
[124] Fotiadis, *http://www.infoeuropa.ro,* January 2000.
[125] News, *http://www.infoeuropa.ro,* January 2000.
[126] *Adevărul,* 10 March 1999.
[127] Interview with Expert in Romania's Accession into the European Union, European Institute, May 2000.
[128] Interview with Expert in Romania's Accession into the European Union, Romanian Foreign Affairs Ministry, Department of European Integration, Bucharest, May 2000.
[129] *Piaţa Financiară,* March 2000.
[130] *Eurobserver,* 15 May 2001.
[131] *The Business Central Europe,* November 2001.

Poland was placed amongst the second group of countries which had progressed the most in adjusting their national economies and law to European standards. Poland was criticised over agriculture, environmental protection and steel and fishing industries.[132] Worries were also expressed over a too high inflation, high current account deficit and growing unemployment.[133] Finally, concerns were articulated regarding a lasting paralysis of Polish courts, prison and customs services, the brutality of police and insufficient action against organised crime and corruption.[134] These warnings led to increased efforts by the post-2001 Miller government to ensure that Poland met the Copenhagen criteria and made the progress in accession negotiations necessary for early membership. A virtuous circle of political factors was reinforced with the potential to enforce an economic virtuous circle.

The Copenhagen European Council: back to a 'wealthy' approach to enlargement?

Almost ten years on from expressing its commitment to enlarge, at the 2002 Copenhagen European Council the EU invited ten candidate countries to join in May 2004. This ten plus two approach had already been adopted soon after Helsinki and had been confirmed at the 2000 Nice European Council. On that occasion, the proposition of an enlargement of twelve put forward by the French foreign affairs ministry was rejected by the enlargement commissioner Verheugen. The invitation addressed at Copenhagen was largely based on compliance with the Copenhagen criteria reflected in the regular reports, on progress in accession negotiations and on commitment to finalise them by the end of 2002. One can also argue that by 2002 the enlargement had become inevitable and hence to a certain extent security factors have once again influenced the timing of enlargement. As previously argued, perpetual postponement of the enlargement date posed the danger of governments loosing support for reforms and people turning against democracy and market reforms. These fears were enhanced by the results of the early 2000s elections in some CEECs which saw the rise of extremist parties and potentially brought closer the date of enlargement.

Nevertheless, the approach to enlargement remained largely 'wealthy' rather than 'healthy'. Bulgaria and Romania were delayed until they meet the Copenhagen criteria and conclude the accession negotiations. Furthermore, at Copenhagen the EU failed to commit itself to welcoming the two remaining countries by the proposed date of 2007 and only pledged to support them technically and financially in their aim to meet this target. The 'Road Map' was designed to guide Romania and Bulgaria in their preparations for membership by 2007 and increased financial assistance was offered under the framework of the partnership for accession. The state of the adoption and implementation of the *acquis*, of accession negotiations and compliance with the Copenhagen criteria are proof that security concerns still acted again as the engine of enlargement process, this time for Poland itself. Ranked the tenth in terms of overall preparations for membership, Poland was invited to join nevertheless. The invitation for membership was based on loose, rather than

[132] *The Warsaw Voice*, 19 November 2000.
[133] *The Warsaw Voice*, 19 November 2000.

strict compliance with the Copenhagen criteria. Its preparation for membership by December 2002 is presented comparatively with Romania in order to illustrate this point.

At the time of the Copenhagen European Council, Poland had closed twenty seven chapters out of thirty and was still negotiating the conditions for chapters on competition, agriculture and budgetary and financial conditions.[135] Furthermore, the European Commission's Report on 2002 noted that, although Poland generally met the commitments made in the negotiations, delays had occurred in the areas of agriculture, fisheries, environment, issues which had yet to be addressed.[136] Besides these, other problematic chapters had been the free movement of labour and the liberalisation of capital. By the Copenhagen European Council, Romania had opened all chapters of negotiations, except for three: free movement of services, agriculture and financial and budgetary provisions.[137] Romania had closed only thirteen: company law, fisheries, statistics, social policy, SMEs, education and training, science and research, external relations, CFSP and institutions.[138] Given the large number of the remaining chapters to be negotiated by Romania and the uncertainties implied by the first phase of accession, Romania pleaded towards the European Commission in October 2002 that the results of negotiations with Bulgaria and Romania would not be undermined by the first phase of enlargement.[139] Criticisms were also addressed with regard to the implementation of the *acquis communautaire* in Poland. Thus, the 2002 regular report stated that: 'Since the Opinion, Poland's progress has been characterised by a slow start and a subsequent acceleration in respect of the adoption of legislation. As a consequence, the vast majority of the *acquis* is now in place, although in some sectors there are considerable gaps in the necessary implementing legislation, for example, in the veterinary, environment and food safety areas. There has been a knock on effect in terms of administrative capacity which has progressed since the Opinion, but not to the same extent as legislative alignment'.[140] Similar conclusions were drawn for Romania. In the same 2002 Strategy Report, the European Commission noted that: 'Since the 1997 Opinion, Romania has made steady progress with the *acquis*. However, in many areas, there has been an increasing gap between progress in legal transposition and the limited ability of the Romanian administration to implement and enforce the newly adopted legislation.'

The limitations of Poland's preparation for EU membership presented in the 2002 regular report prior to the decision to invite it to join underline once again the fact that the Copenhagen criteria are just guidelines and their interpretation is very important. Thus, while the 2002 report acknowledged that Poland should be able to meet the obligations of a EU member state at the

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[134] *The Warsaw Voice*, 19 November 2000.
[135] Borowski, "Speech"; Cimoszewicz, "Speech.
[136] European Commission, "Strategy Paper 2002", *http://www.europa.eu.int/comm./enlargement/report 2002*, p. 69.
[137] European Commission, "Accession Negotiations: State of Play", *http://www.europa.eu.int/comm/enlargement.*
[138] *Adevărul*, 9 Octombrie 2002.
[139] *Adevărul*, 9 Octombrie 2002.
[140] European Commission, "Strategy Paper 2002", p.66.

beginning of 2004, corruption was identified as a cause for serious concern. It was suggested that efforts are needed to ensure concrete results for the comprehensive strategy to combat this problem. The Commission also recommended that Poland continued the present path of reforms in order to be able to cope with competitive forces inside the Union. Improvements were suggested to fiscal policy through the implementation of government's new expenditure norm at all levels of government as part of a more broadly based structural reform of public finances. Completion of restructuring and privatisation in heavy industry, the financial sector, energy distribution and agriculture are needed. The report also recommended that bankruptcy procedures and land registry should be improved and that Central Bank independence should be preserved in order to ensure macroeconomic stability and investor confidence.[141] Poland should also urgently deal with delays in preparations for membership, particularly in agriculture, fisheries and environmental protection.[142] Romania's lack of preparedness for EU membership by 2004 was also acknowledged in the 2002 report and constituted the basis for Romania not being considered for the first phase of enlargement. The European Commission noted that Romania fulfilled the political criteria and has continued to make significant progress towards being a functioning market economy, for which prospects have improved. Nevertheless, Romania remained the only candidate not yet a functioning market economy. [143]

Overall, to some extent, security factors continue to be the engine of the enlargement process rather than strict calculations and technical details. This approach should be further extended for supporting membership of Romania and Bulgaria so that the Eastern enlargement fulfils its aim of promoting stability and prosperity in Europe and of repairing the injustice of the Yalta agreement.

[141] European Commission, "Strategy Paper 2002", *p.66.*
[142] European Commission, "Strategy Paper 2002", *p.65.*
[143] European Commission, "Strategy Paper 2002", *p.70.*

3.2 Part Two: Evidence of economic integration with the European Union

The previous part has examined the factors underpinning Poland and Romania's evolutions towards institutional integration with the European Union. The present part gives evidence of economic integration achieved during their quests for full EU membership. Economic integration is assessed comparatively with the progress in institutional integration with the EU. The hypothesis tested is whether the institutional framework of EU enlargement has fostered economic integration between Poland and Romania on the one hand and the EU on the other. It is assumed that this increased economic integration will further enhance FDI and FDI would enhance economic reforms and lead to EU membership. This would complete the economic circle of determinants of the EU accession process introduced in chapter one. The latter two relationships will be assessed in chapters five and seven. A virtuous economic circle of determinants would enhance the political circle and would finally contribute to full membership. The time series range mainly from 1990 to 2001. Other periods of time are used for comparative reasons.

3.2.1 Methodological considerations and hypotheses

The present study is at the cross roads between ex-ante and ex-post studies. It is not an ex-post study because economic integration with the EU is not completed. Furthermore, the anti-monde (alternative path, way or reality) is difficult to construct because the time period before 1989 was structurally different from the present one and the economic relations between the two countries considered and the EU were scarce. Evidence of economic integration is given by trade and FDI flows between Poland and Romania on the one hand, and the EU on the other. Although migration has occurred and is an expression of the four freedoms of the Single Market to be acquired upon EU membership, the analysis of migration is beyond the scope of this study for several reasons. First, the Europe agreements do not provide for free movement of labour and hence limit the scope of migration. Second, a large amount of labour migration was not among the objectives of the EU in the first place'.[149] Third, the interest of this study is in the role and determinants of FDI in the context of the process of economic transition and enlargement of the European Union, hence the interest in FDI and in trade, which can be a determinant or a result of FDI. An in depth analysis of integration in terms of policy is also beyond the scope of this study. Furthermore, such an analysis would not be relevant, given that the CEECs only form an (imperfect) free trade area with the EU and are not yet part of the Single Market.

As stated in the theoretical framework of the chapter, economic integration is likely to be enhanced by the institutional integration with the European Union.[150] The institutional framework of the accession process has been gradually built through different European Council Councils as a result of changes within the Eastern European countries, within the EU or within the international arena.

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[149] Molle, W., *The Economics of European Integration: Theory, Practice, Policy*, Ashgate, Aldershot, 1997, p.6.

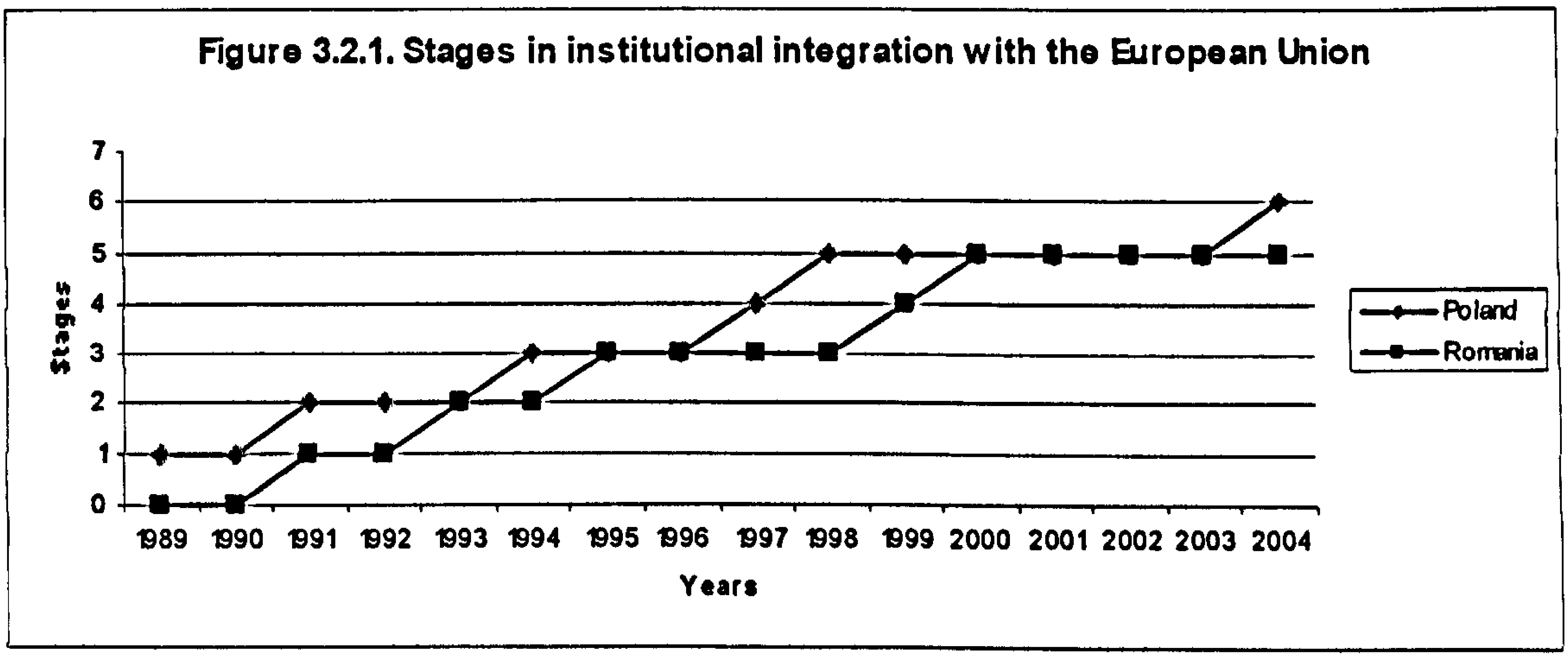
[150] Winters, A., "Britain in Europe: a Survey of Quantitative Trade Studies" in Jacquemin, A. and Sapir, A. (eds.), *The European Internal Market, Trade and Competition*, O.U.P., Oxford, 1991, p. 122.

This framework was reviewed in the first part of this chapter and is shown in brief in the table below. Each new stage in the institutional integration with the EU has represented a political sign for the candidate countries, with a potential impact on factor integration through the impact on the security concerns or the country image, an important FDI. This impact will be investigated in chapter seven through the econometric model. Trade, however, is likely to be less sensitive to political signs and more dependent on economic determinants, including the degree of liberalisation.[151] This is why changes in trade are assumed to be sensitive to the entering into force of the Europe agreements and to the expiry of the transition periods, rather than the start of accession negotiations, for example.

Table 3.2.1. Stages in institutional integration with the European Union

Stage in European Integration	Code	Poland	Romania	Hungary	Bulgaria
Signing of the TCA[152]	1	09/1989	05/1991	09/1988	05/1990
Signing of the EA[153]	2	12/1991	02/1993	12/1991	03/1993
Application for membership	3	04/1994	06/1995	03/1994	12/1995
Announcement of AN[154]	4	12/ 1997	12/1999	12/ 1997	12/1999
Starting of AN	5	03/ 1998	03/2000	03/ 1998	03/2000
Accession to be achieved by	6	05/2004	01/2007	05/2004	01/2007

Source: Piening, C., *The European Union in World Affairs*, Lynne Rienner Publishers, Boulder London, 1997, p.55; http://europa.eu.int/comm/enlargement/pas/europe_agr.



Source: As per Table 3.2. 1.

The comparisons between Poland and Romania are put into perspective by using Hungary and Bulgaria, countries which had a comparable track in the institutional accession process. Thus, before the 1999 Helsinki European Council, Hungary and Poland were fast track countries (as of the 1997 Avis), while Bulgaria and Romania have been part of the so called 'second wave' of enlargement. Then, the Helsinki European Council in December 1999 opened the prospect of

[151] For a more comprehensive account of models on trade determinants see Thirlwall, A. P., "International Agreements, Liberalisation and Economic Growth", *Paper for the African Development Report*, 2000
[152] The Trade and Co-operation Agreement
[153] Europe Agreement
[154] Accession negotiations

accession for all the candidates by starting negotiations regardless of the initial position in the first or second wave (appendix 3.1.A). This made it possible for the former 'laggards' to catch up with the other candidates in terms of preparation for membership in an attempt to avoid path dependency. At the 2002 Copenhagen European Council, Poland and Hungary were invited to join the EU in May 2004, while the EU also recognised that Romania and Bulgaria aimed for membership in 2007. There continues to be a lag of three years between the two countries, indicating different degrees of institutional integration with the EU.

As a proxy for the anti-monde (alternative path), comparisons are made with EU member states at present, or closely before and closely after achieving EU membership. All comparisons rely on the assumption that the participation of a country in international or regional trade depends on factors such as:

a) the size of the country- for large countries external trade counts for 20% of the GDP while for small countries the ratio is of 60% of the GDP;
b) the level of development of the country, including the structure of the economy.

Portugal and Spain have been chosen from the EU member states as being the closest to Romania and Poland in terms of size, level of development and structure of the economy. Thus, in 2001 Spain had a GDP at exchange rate prices of Euro bn 651 and Portugal had a GDP at exchange rate prices of Euro bn 122. Poland had a GDP of Euro bn 196.7 and Romania of Euro bn 44.4.[155] This makes Romania comparable with Portugal and Poland with Spain, but yet there are important differences in terms of the structure of the economy, which might be considered limitations of the comparison.

In order to give evidence of economic integration between Poland and Romania on the one hand and the EU on the other, the indicators mentioned below will be used with the following interpretations and hypotheses:

a) The balance of trade with the EU and the ratio of trade with the EU in GDP. The former indicates the direction of trade, while the latter reveals the openness towards the EU or the degree of economic integration. An improvement in the trade balance and an increased openness towards the EU are expected to correspond to improvements in the economic climate and to increasing institutional and economic integration with the EU.
b) The annual growth of total imports and exports and the annual growth of imports and exports with the EU for the period 1990-2000. It is expected that trade with the EU has grown faster than the total trade of the respective country, signifying an increasing economic integration.

[155] Eurostat, "Eurostat Yearbook. 2003", *http://europa.eu.int/comm/eurostat*.

c) The ratio of trade with the EU in total trade. It is anticipated that the ratio has increased and reached a level comparable with present EU member states of around 60% for countries with higher economic integration.[156]

d) The share of exports and imports to and from the candidate countries in total exports and imports of the EU. This shows how important trade partners the candidate countries are for the EU. It is expected that the ratio is similar to the one of Portugal and Spain prior to membership.

e) The FDI annual inflows and the stock for each year. It is expected that FDI originates mainly from the EU indicating an increased degree of factor markets integration.

The dates which may constitute structural breaks are 1992 for Poland and 1993 for Romania, corresponding to the entering into force of the interim agreements that accompanied the Europe agreements. Also, the expiry of the four and six years transition periods for sensitive exports to the EU can constitute important structural breaks for the levels of exports or total trade. This would be consistent with the hypothesis that the institutional framework has impacted upon the degree of integration in terms of trade between the EU, on the one hand, and Poland and Romania on the other. The remainder of the chapter is organised as follows. Evidence of trade integration is given from the candidate countries perspective and from the EU's stand. Second, evidence of factor markets integration is provided with data on FDI in Poland and Romania. Finally, the chapter presents the conclusions drawn from analysing the factors that have underpinned the EU enlargement process and from evidence of economic integration with the EU.

3.2.2 Product market integration from the candidate countries' perspective

Trade balance and total trade with the EU in GDP

Economic relations between the candidate countries and the EU are summarised in the trade balance and in the ratio of total trade with the EU in their GDP. The trade balance indicates the direction of trade while the trade ratio in the GDP assesses the openness of the economy towards the EU.

Table 3.2.2. Trade balance with the EU (bn euro)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	-0.39	-0.36	-0.28	-0.48	-0.33	-0.21	0	0.24	-0.1	-0.61	-0.39	Na
Romania	0.35	0.11	-0.48	-0.71	-0.1	-0.31	-0.85	-0.58	-1.3	-0.5	-1.1	-0.9
Poland	1	-1.79	-1.24	-2.65	-2.19	-3.04	-7.58	-10.85	-12	-11.4	-10.5	-8.9
Hungary	-0.02	-0.09	-0.36	-1.57	-2.01	-1.12	-1.18	-1.95	-2.2	-1.3	-1.1	0.5

Source: Eurostat, "External and Intra-European Union Trade, Monthly Statistics", No. 12, 1996, p.40-41; European Commission, Regular Reports, *http://www.europa.eu.int/comm/enlargement/candidate.htm.*

Table 3.2.2 shows that both countries have registered a negative trade balance with the EU, proving that they have represented markets for EU exports rather than source of EU imports. Liberalisation

[156] Genberg, H. and de Simone, F.N., "Regional Integration Agreements and Macroeconomic Discipline" in Anderson, K. and Blackhurst, R. (eds.) *Regional Integration and the Global Trading System*, Harvester Wheatsheaf, Hemel Hempstead, London,1993, (eds.), p.170.

indeed led in early 1990s to an increase in consumer goods imports and towards mid-1990s to increase in capital goods imports associated with FDI. The higher deficits of Poland are correlated with the size of the economy. The structural breaks in the early 1990s correspond roughly to the signing of the trade and co-operation agreement (1991 for Romania) and to the signing of the Europe agreements (1993 for Romania and 1991 for Poland). This indicates an anticipation effect which supports the idea that the prospect of EU membership has had a positive effect on the candidate countries. Since 1998 there has been an improvement in Poland's trade balance with the EU. This might be related to export growth as a result of FDI bringing new technology and know how in highly competitive and export oriented industries. Similar improvements are seen in Romania in 1999, 2000 and 2001, also possibly related to growth in FDI generated exports.

Table 3.2.3 shows that the ratio of trade with the EU in the GDP of three of the candidate countries considered has converged towards a ratio of circa 12%, except for Hungary. A similar trend was noticed in the trade of member states of the EU during the process of integration, thus confirming the increasing degree of integration with the EU displayed by the CEECs considered.[157] Data for 1994-2000 indicates different ratios for candidates and respectively the EU members. Only Hungary seems to have reached a comparable figure with Spain by 2000. The higher figure for Portugal is consistent with the smaller GDP, as compared to Spain, and the contrast with Romania suggests that there is still room for trade integration between Romania and the EU. Given that trade liberalisation between the candidate countries and the EU was asymmetrical, a better indication of its impact on trade is given by analysing imports and exports separately.

Table 3.2.3. Ratio of trade (exports +imports) with the EU in GDP

	1994	1995	1996	1997	1998	1999	2000
Bulgaria	0.07	0.06	0.08	0.09	0.08	0.09	0.10
Romania	0.06	0.04	0.07	0.08	0.08	0.11	0.12
Poland	0.11	0.08	0.13	0.14	0.14	0.14	0.15
Hungary	Na	0.12	0.21	0.27	0.32	0.33	0.35
Spain	0.21	0.24	0.25	0.25	0.30	0.28	0.32
Portugal	0.38	0.39	0.42	0.44	0.45	0.45	0.46

Source: Eurostat, *External and Intra-European Union Trade, Monthly Statistics*, No. 12, 1996, p.40-41; Eurostat, *External and Intra-European Union Trade, Monthly Statistics*, 6, Vol. 2, 1999, p.2; Eurostat, *Eurostat Yearbook 2002, p.5.*

Imports

The CEECs were from the beginning a potential market for EU products, given the non-saturated internal markets inherited from the Communist period and the structure of the economy, deficient in consumer goods industries. Romania was the most extreme case of deprivation of consumer goods, while Poland is the largest market in the region relative to both population and GDP. Hence, it is expected that there has been a substantial surge in imports from the EU and an increase of openness to the EU reflected in an increase of the ratio of EU imports in GDP. Imports will be

[157] Molle, W., *The Economics of European Integration, Theory, Practice, Policy.*

affected not only by trade liberalisation, but also by the GDP of importing countries and by the real exchange rate. An increase in the absolute volume of imports would be thus a reflection of positive economic growth in the candidate country considered and of cheaper foreign goods relative to domestic ones when expressed in domestic currency. An increase in the absolute volume of imports can suggest both trade creation and trade diversion but the data available makes difficult the measurement of these effects. A faster growth of imports from the EU than imports from the third parties could indicate trade reorientation from third parties towards the EU, hence increasing integration with the EU.

Table 3.2.4. Imports from the EU before 1990 (bn euro)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Bulgaria	0.81	1.00	1.05	1.14	1.25	1.63	1.47	1.45	1.40	1.47
Romania	1.77	1.76	1.10	0.91	1.05	1.15	0.99	0.65	0.61	0.69
Poland	2.89	2.33	2.09	2.11	2.43	2.73	2.39	2.33	2.76	3.95
Hungary	1.62	1.99	1.99	1.99	2.21	2.49	2.45	2.37	2.35	2.99

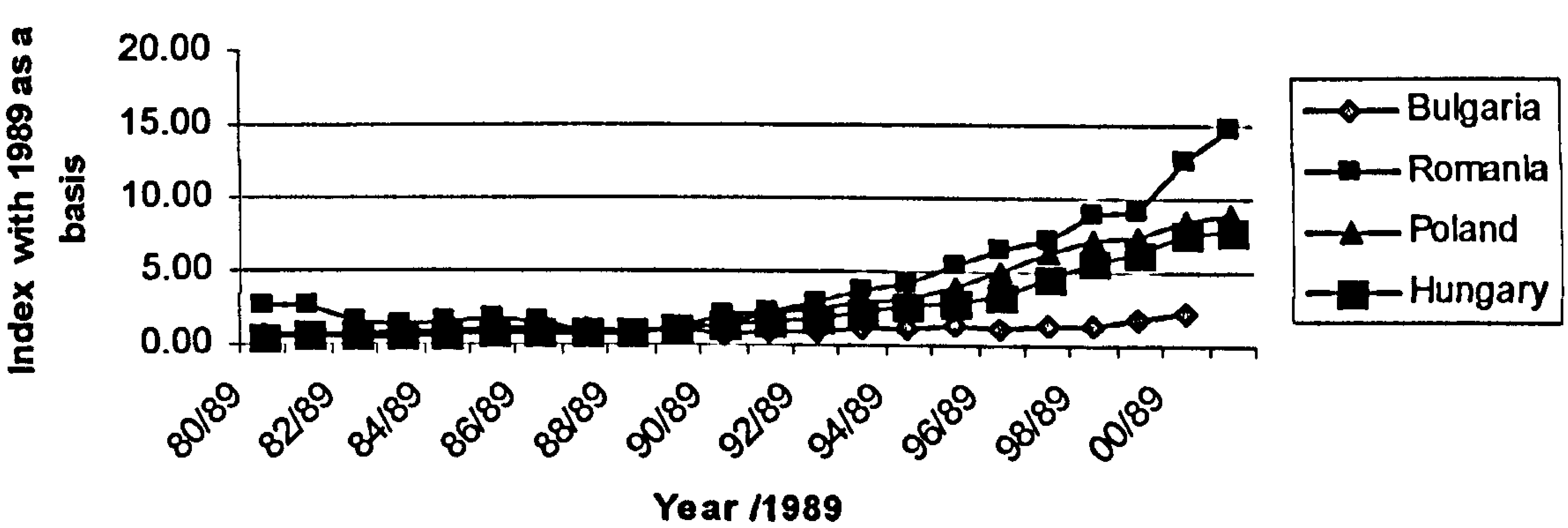
Source: Eurostat, *Statistical Yearbook. Recapitulation 1958-1989*, 1990, pp. 44-45.

Table 3.2.5. Imports from the EU (bn euro)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	1.03	1.17	1.26	1.49	1.75	2.05	1.70	1.85	1.98	2.51	3.12	Na
Romania	1.33	1.44	1.99	2.51	2.90	3.7	4.44	5.01	6.1	6.3	8.7	10.2
Poland	5.01	8.90	9.22	11.11	12.32	15.29	19.83	25.06	28.1	28.9	33.6	35.4
Hungary	3.76	4.69	5.28	6.45	8.07	8.73	9.99	13.58	16.7	18.6	23.0	23.6
Po/Ro	3.76	6.18	4.63	4.42	4.24	4.13	4.46	5.00	4.60	4.58	3.10	3.47

Source: Eurostat, *External and Intra-European Union Trade, Monthly Statistics*, No. 12, 1996, p.40-41; European Commission, Regular Reports, *http://www.europa.eu.int/comm/enlargement/candidate.htm.*

Figure 3.2.2 Imports from the EU before and after 1989



Source: As per Tables 3.2.4 and 3.2.5.

The tables and the graph above show that before 1989 Romanian imports from the EU were falling. The figure represents an index of imports from the EU with 1989 as a basis. This trend intensified towards the end of the period. This was a result of the efforts to pay off the foreign debt of the country by enhancing exports and decreasing imports. On the other hand, Poland's imports from the EU increased towards the end of the period, as a result of early attempts to restructure the economy through importing capital goods. The greater absolute imports for Poland are also a reflection of the Polish economy's larger size in terms of GDP. In 1990, Romania's imports from the EU doubled as a result of the relaxation of the government's policies in terms of imports and of the importance attached now to consumer goods imports especially. The figure above shows that after 1990 imports from the EU have been much higher in absolute terms in both countries. Moreover, there was an increase from 1980 to 2000 of almost nine times in Romania and more than ten times in Poland. There seems to be a limited relation between the absolute level of imports and the entering into force of the association agreements. In the case of Romania this might be a result of the increase in imports prior to liberalisation, which simply filled in the void left by the Communist regime, making the structural break earlier. This can be considered an anticipation effect of the agreement, rather than a direct consequence. Furthermore, in some products the liberalisation was only partial, hence the limited impact at the time.

In order to make more meaningful comparisons between the countries, the degree of economic integration between Romania and Poland on the one hand and the EU on the other is analysed by the ratio of imports from the EU in GDP, also known as the Vamvakidis index of integration.[158] The table below shows that in terms of openness towards the EU, the gap between Romania and Poland is closing. The ratio of imports from the EU to GDP was double for Poland in 1994 as compared to Romania, while in 2000 the respective ratios were 10% for Poland and 7% for Romania. This trend is consistent with patterns of trade with the EU by member states whose ratio of trade with the EU tends to converge during the integration process.[159] This suggests that the candidate countries considered here experience an increasing integration with the EU. The smaller size of Portugal is reflected in a higher ratio of imports from the EU in GDP, as compared to Spain. The differences between the candidate countries and the EU member states result from their different degrees of integration with the EU.

Table 3.2.6. Imports from the EU in GDP

	1994	1995	1996	1997	1998	1999	2000
Bulgaria	0.04	0.04	0.04	0.04	0.04	0.05	0.06
Romania	0.03	0.03	0.04	0.04	0.05	0.06	0.07
Poland	0.06	0.07	0.08	0.09	0.09	0.09	0.10
Hungary	Na	0.11	0.11	0.15	0.17	0.17	0.20
Spain	0.12	0.13	0.14	0.14	0.16	0.15	0.18
Portugal	0.22	0.22	0.24	0.25	0.26	0.27	0.28

Source: Eurostat, *External and Intra-European Union Trade, Monthly Statistics*, No. 12, 1996, p.40-41; Eurostat, *Statistics in Focus. External Trade*, 6-2/1999,p.2; Eurostat, *Statistics in Focus. External Trade*, 3/1998; p.2; European Commission, Regular Reports; Eurostat, *Eurostat Yearbook 2002*, p.5.

[158] Vamvakidis cited in Thirlwall, A. P., "International Agreements, Liberalisation and Economic Growth", p.19.

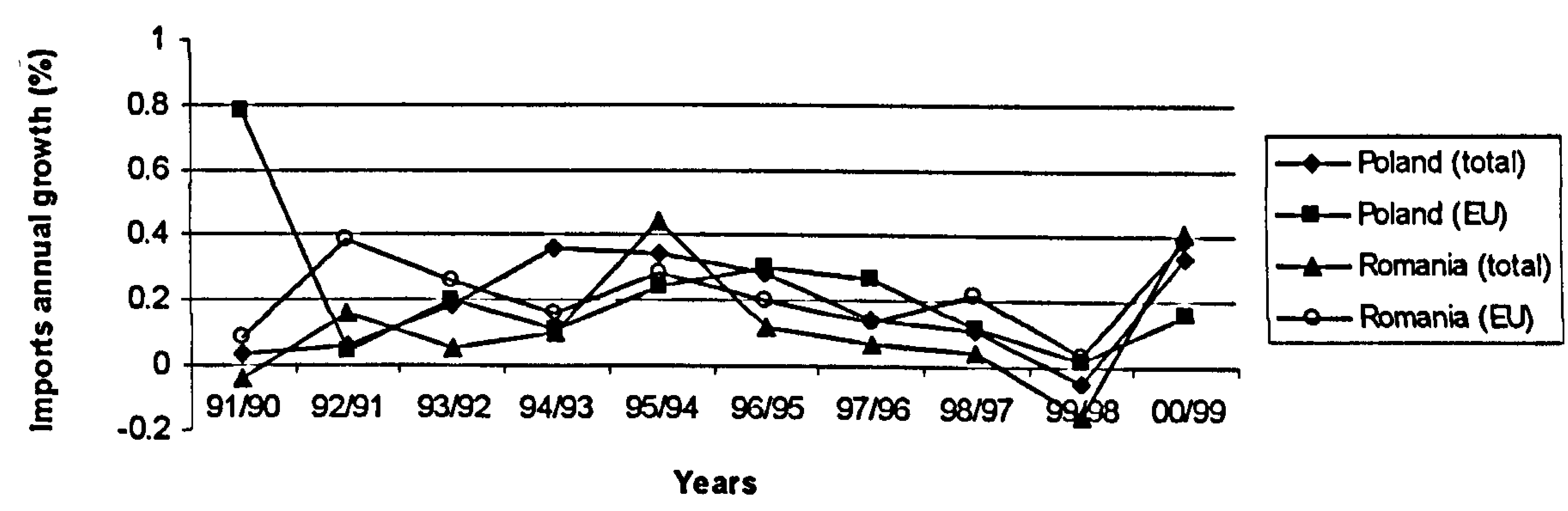
The question is now whether since 1989 imports from the EU have increased more rapidly than the total imports of the countries considered, thus indicating a reorientation of trade. Table 3.2.7 and figure 3.2.3 show that Poland's imports from the EU grew initially less than its total imports, as a sign of its initial relative dependence on the former Council of Mutual Economic Assistance (CMEA) market. However, since 1996 imports from the EU have grown faster than Poland's total imports. This suggests an increased economic integration with the Union and a reorientation of trade from non-EU sources. The increase may be related to the surge in FDI from the EU, thus indicating complementarity between trade and FDI. Romania's imports from the EU (expressed in Euro at market exchange rates) have increased more than its total imports, with the exception of 1995. In relative terms, Romania was more dependent on imports from the EU. This might be related to its relative independence from the CMEA, relatively little trade with the Black See Economic Co-operation Organisation (BSEC) and delayed membership of the Central Free Trade Association (CEFTA). Poland, on the other hand, achieved early membership of CEFTA and was relatively dependent on trade with former members of the CMEA. In both countries, towards the end of the period, imports from the EU increased slower than their total imports, pointing towards a possible diversification of imports from other markets or towards a EU market saturation.

Table 3.2.7. Evolution of annual growth of total imports v. imports from the EU

	91/90	92/91	93/92	94/93	95/94	96/95	97/96	98/97	99/98	00/99
Poland (total)	0.03	0.06	0.18	0.36	0.34	0.28	0.14	0.11	-0.05	0.33
Poland (EU)	0.78	0.04	0.20	0.11	0.24	0.30	0.27	0.12	0.02	0.16
Romania (total)	-0.04	0.16	0.05	0.1	0.44	0.12	0.07	0.04	-0.15	0.41
Romania (EU)	0.08	0.38	0.26	0.16	0.28	0.2	0.13	0.22	0.03	0.38

Source: Eurostat, *Eurostat Yearbook 2002*, p. 6.

Figure 3.2.3. Annual growth of imports from the EU v. total imports



Source: As per Table 3.2.7.

The annual growth rate of imports from the EU seems to be higher in the early years of transition. Indeed the EA (1991) led to a higher growth of imports from the EU than total imports in Poland.

[159] Molle, W., *The Economics of European Integration, Theory, Practice, Policy.*

In Romania the higher increase of imports from the EU than total imports appears to be a consequence of the TCA (signed in 1991 with effects showing in 1992) and in anticipation of the EA (signed in 1993). Overall, the data captures both an anticipation effect and a structural shift impact. This would explain why several years around the data of the implementation of the Europe agreements have seen high rates of annual growth of imports from the EU.

The analysis will now refer to the ratio of imports from the EU in the total imports of the candidate countries. The hypothesis is that the ratio of trade with the EU in the total trade of Romania and Poland increased towards meeting a similar size to the present comparable member states and that it has evolved similarly to former comparable candidate countries for EU membership, i.e. Spain and Portugal.

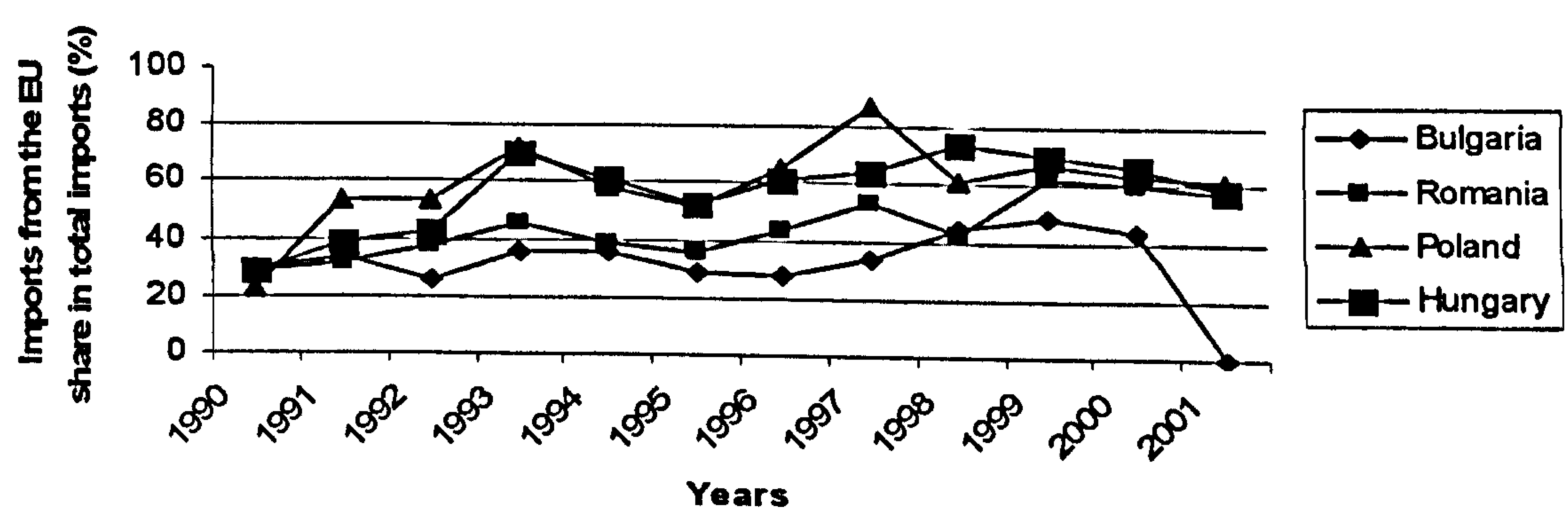
Table 3.2.8. Ratio of imports from the EU in total imports (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	30.07	33.33	25.40	35.64	35.86	29.20	27.76	34.01	44.9	48.6	44.0	Na
Romania	28.55	31.65	37.32	45.33	38.97	36.03	43.85	53.73	42.73	62.81	60.33	57.0
Poland	23.15	53.49	53.11	72.29	58.71	51.36	65.02	87.51	61.19	67.0	63.20	61.4
Hungary	28.89	38.79	42.58	70.47	61.82	52.06	61.01	64.05	73.8	70.77	66.03	58.0
Spain	62.3	62.8	63.3	65.0	66.4	68.5	69.3	66.0	70.7	68.7	66.4	67.0
Portugal	72.0	74.9	76.6	74.5	73.5	74.0	76.3	76.3	78.1	78.1	75.1	75.1

Source: Eurostat, *Eurostat Yearbook 2002, p.5;* Eurostat, *Eurostat Yearbook 2003*, p.188.

The table shows an anticipatory effect for Romania with a larger share of imports from the EU in the years prior to or corresponding to the signing of the TCA (1991) and of the EA (1993). For Poland one can see both an anticipatory effect of the EA and an increase in the ratio as a consequence of the EA (1991). Furthermore, there has been an overall increase of the ratio between 1990 and 2001 and a stabilisation at a level of approximately 60%. This level is similar to the share of imports from the EU in total imports of Spain. At this level, Poland and Romania are almost as integrated as present EU member states. The higher figure for Portugal is related to the smaller size of the economy and emphasises the comparatively lower degree of integration of Romania, also a smaller economy compared to Poland.

Figure 3.2.4. Imports from the EU share in total imports



Source: As per Table 3.2.8.

The ratios of trade with the EU in the early 1990s are different for Poland and Romania in comparison with Spain and Portugal, due to several factors: the sizes of the countries, their different economic development and the different degrees of integration with the EU. A more meaningful comparison can be drawn with Spain and Portugal prior to membership and closely after joining the Union. Both Spain and Portugal joined in 1986. There are, however, limitations to this comparison, due to different international conditions at the time, as well as particular features of each country.

Table 3.2.9. Ratio of imports from the EU in total imports of Spain and Portugal prior to or closely after EU membership (%)

Countries	1975	1980	1985	1990	1995
Spain	38.3	33.3	40.3	62.3	67.6
Portugal	48.6	48.7	48.9	72.0	73.9

Source: Eurostat, External and Intra-European Union Trade, Monthly Statistics, No. 12, 1996, p. 21; Eurostat, Eurostat Yearbook 2003, p.188.

The ratio of imports from the EU in total imports of Spain has increased prior to membership thus indicating an anticipatory effect. Furthermore, both countries have seen an increase in the ratio as a result of full membership, indicating that membership does indeed bring benefits in terms of increased bilateral trade. However, Poland and Romania have already reached a ratio higher than the one Spain had one year prior to joining the EU. This shows that along with developments in the institutional integration with the EU Poland and Romania have increased trade integration with the EU, thus having already benefited in economic terms from this process.

Exports

The Europe Agreements have provided that the EU would open its non-sensitive markets virtually immediately, but for sensitive industrial markets the abolition of tariffs and qualitative restrictions on imports would take from four to six years. The EU would offer concessions, but nothing like free trade in agriculture.[160] The structural break years are likely to be 1992, 1996 and 1998 for Poland and 1993, 1997 and 1999 for Romania, corresponding to the entering into force of the agreements and to the end of the transitory periods. Exports will also vary with the real exchange rate and the GDP of the importing countries. The higher the GDP, the higher are likely to be the exports. Furthermore, exports to the EU will be higher, the cheaper the Polish products are compared to the EU ones expressed in Euro. This would suggest that industries in the candidate countries have become competitive as a result of economic reforms. However, due to data availability and topic constraints, the focus lies here on the effects of institutional factors. The hypothesis is that exports to the EU increased in absolute terms compared with the pre-1989 period and faster than total exports. It is also expected that the ratio of the exports to the EU in GDP of Poland and Romania has increased and converged with values of other CEECs. It is equally

[160] Piening, C., *The European Union in World Affairs*, p.59.

anticipated that the ratio of exports to the EU in the total trade of each candidate country has reached values comparable to the EU member states during their quests for EU membership.

Table 3.2.10. Exports to the EU prior to 1990 (bn euro)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Bulgaria	0.51	0.58	0.63	0.58	0.56	0.59	0.55	0.52	0.46	0.53
Romania	1.83	1.97	1.90	1.90	3.06	2.91	2.48	2.43	2.23	2.54
Poland	2.80	2.12	2.36	2.53	3.46	3.57	2.95	2.90	3.36	3.86
Hungary	1.43	1.48	1.56	1.70	1.88	2.01	1.89	2.00	2.15	2.58

Source: Eurostat, *Statistical Yearbook. Recapitulation 1958-1989*, 1990, pp.44-45.

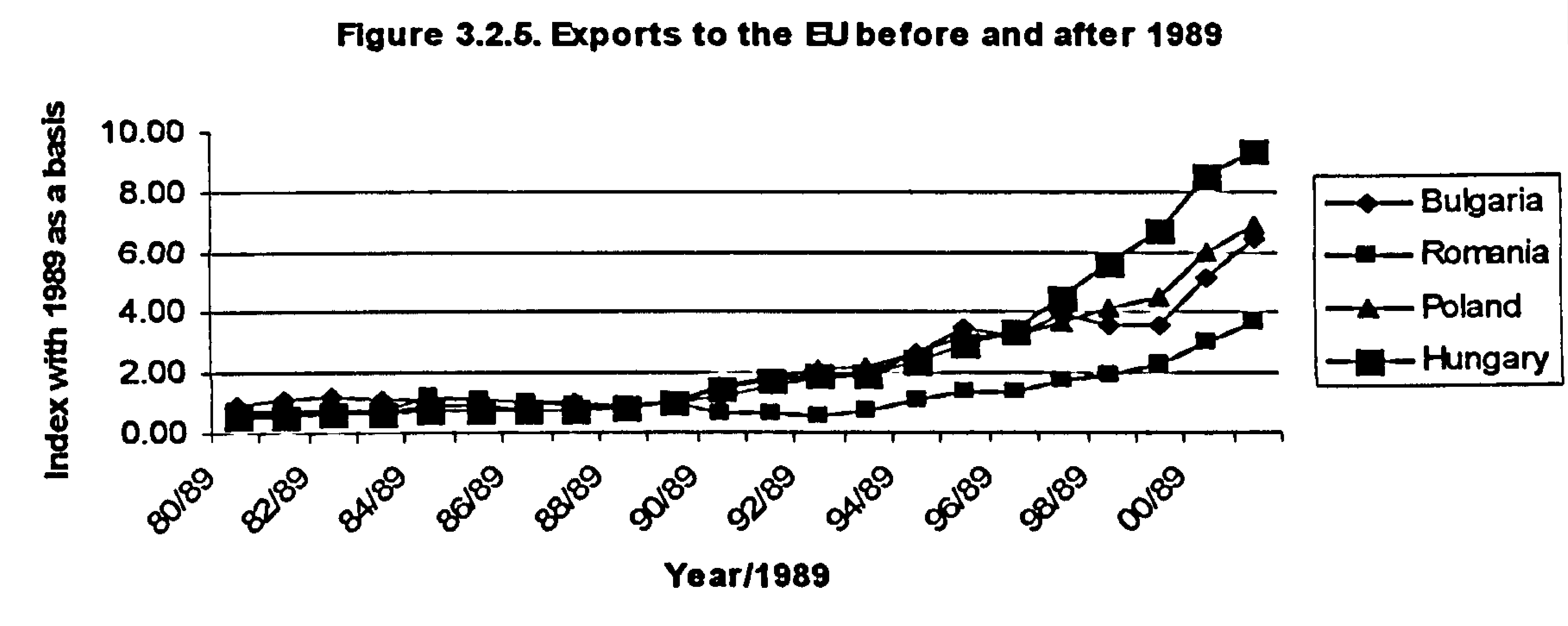
Table 3.2.11. Exports to the EU since 1990 (bn euro)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	0.64	0.81	0.98	1.01	1.42	1.84	1.70	2.09	1.88	1.90	2.73	3.4
Romania	1.68	1.55	1.51	1.80	2.80	3.39	3.59	4.43	4.8	5.8	7.6	9.3
Poland	6.01	7.11	7.98	8.46	10.13	12.25	12.25	14.21	16.1	17.5	23.1	26.5
Hungary	3.74	4.60	4.92	4.88	6.06	7.61	8.81	11.63	14.5	17.3	21.9	24.1
Po/ Ro	3.58	4.58	5.28	4.7	3.62	3.61	3.41	3.20	3.35	3.01	3.03	2.84

Source: Eurostat, *External and Intra-European Union Trade, Monthly Statistics*, No. 12, 1996, p.40-41; Eurostat, *Statistics in Focus. External Trade*, 6-2/1999, p.2; 3/1998, p.2; European Commission, Regular Reports.

Romania's exports to the EU decreased in 1990 as they were recalculated according to the needs of the internal market. Romanian exports overtook the level of 1989 only in 1994, shortly after the Europe Agreement came into force. On the contrary, Poland's exports have risen since 1986, its economy being exposed to economic reforms much earlier than the Romanian one. Polish exports continued to rise after 1990. The gap is closing, but Romania is still exporting to the EU less than one third than Poland. This suggests that there are different degrees of competitiveness of industry in Poland and Romania, as a result of different progress in economic reforms. The difference in competitiveness of the two economies can also be seen from the export structure as shown in chapter five.[161] Normalising the exports to GDP, similar ratios for Poland and Romania are found, with a slight improvement for Romania since 1999. The exports for 1999 must have captured the effects of the first large FDI inflows in Romania since 1998. The ratios for Portugal and Spain are, nevertheless, much higher than for Poland and Romania, consistent with their status of full EU members, as opposed to the one of candidates for EU membership. This may reflect the lower competitiveness of the candidate countries and the still limited access to the EU markets through exports.

[161] See also Smith, A., "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe" in Smith, J. and Jenkins, C. (eds.), *Through the Paper Curtain. Insiders and Outsiders in the New Europe*, The Royal Institute of International Affairs, London, 2003, pp.24-27.



Source: As per 2.s 3.10 and 3.2. 11.

Table 3.2.12. Exports to the EU in GDP

	1994	1995	1996	1997	1998	1999	2000
Bulgaria	0.03	0.02	0.04	0.05	0.04	0.04	0.04
Romania	0.03	0.01	0.03	0.04	0.04	0.05	0.05
Poland	0.05	0.01	0.05	0.05	0.05	0.05	0.05
Hungary	Na	0.01	0.10	0.12	0.15	0.16	0.15
Spain	0.10	0.11	0.12	0.12	0.13	0.12	0.14
Portugal	0.16	0.17	0.18	0.18	0.18	0.18	0.18

Source: Eurostat, *Eurostat Yearbook 2002, p.5;* Eurostat, *Eurostat Yearbook 2003*, p.188.

The question is now whether exports to the EU have increased faster than the total exports of the countries considered, thus indicating a reorientation towards the EU market. The following table and figure present data for annual growth of exports to the EU and the annual growth of total exports. Table 3.2.13 shows that since 1994, Romania's exports to the EU have increased more than its total exports, suggesting an increased economic integration with the EU. On the other hand, the same trend was registered in Poland only since 1997. In 2000, a diversification of export markets appears for both Poland and Romania, as suggested by the higher annual increase in total exports rather than exports to the EU. This could be also due to EU market saturation and to a deterioration of the real exchange rate.

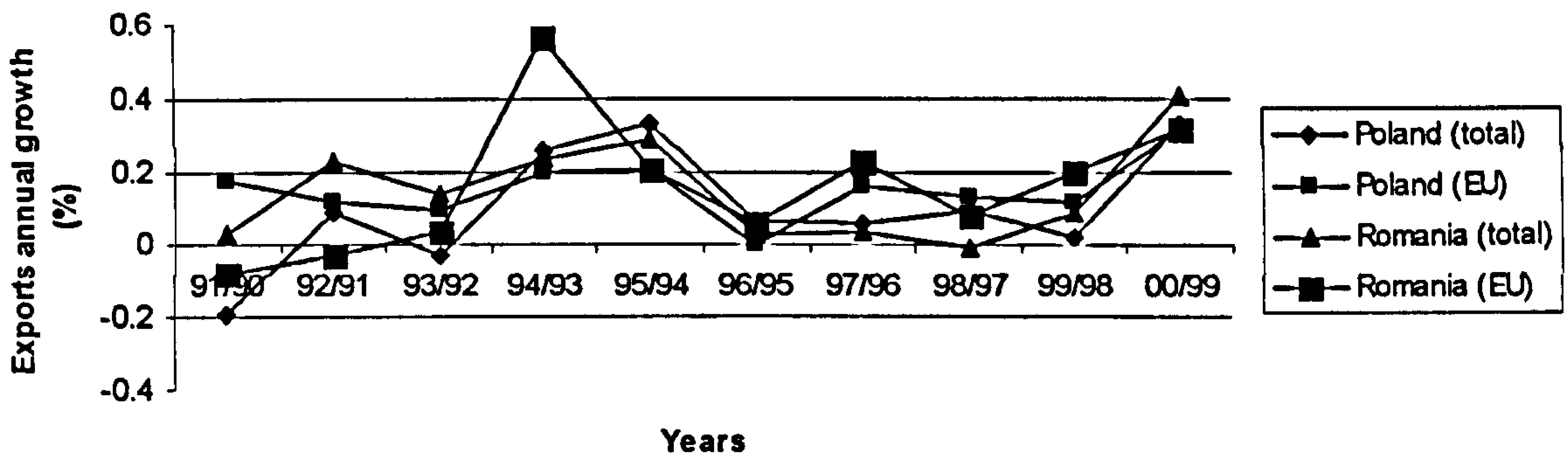
Table 3.2.13. Evolution of annual growth of total exports vs. exports to the EU

	91/90	92/91	93/92	94/93	95/94	96/95	97/96	98/97	99/98	00/99	01/00
Poland (total)	-0.19	0.09	-0.03	0.26	0.33	0.07	0.06	0.10	0.02	0.33	Na
Poland (EU)	0.18	0.12	0.10	0.20	0.21	0	0.16	0.13	0.12	0.32	0.21
Romania (total)	0.03	0.23	0.14	0.24	0.29	0.03	0.04	-0.01	0.09	0.41	Na
Romania (EU)	-0.08	-0.03	0.04	0.56	0.21	0.06	0.23	0.08	0.20	0.32	0.22

Source: Eurostat, *Eurostat Yearbook 2002*, p.5.

Table 3.2.13 also shows that the annual growth of exports to the EU of both Poland and Romania has been higher in years corresponding to the entering into force of the association agreements and to the expiry of the transitory periods. This suggests that economic integration in terms of exports has been affected *inter alia* by the institutional integration with the European Union. Hence, the EU association process has the potential to influence not only the political circle of determinants considered by this study, but also the economic sphere. This will be discussed in chapters six and seven.

Figure 3.2.6. Annual growth of exports to the EU v. total exports



Source: As per Table 3.2.13.

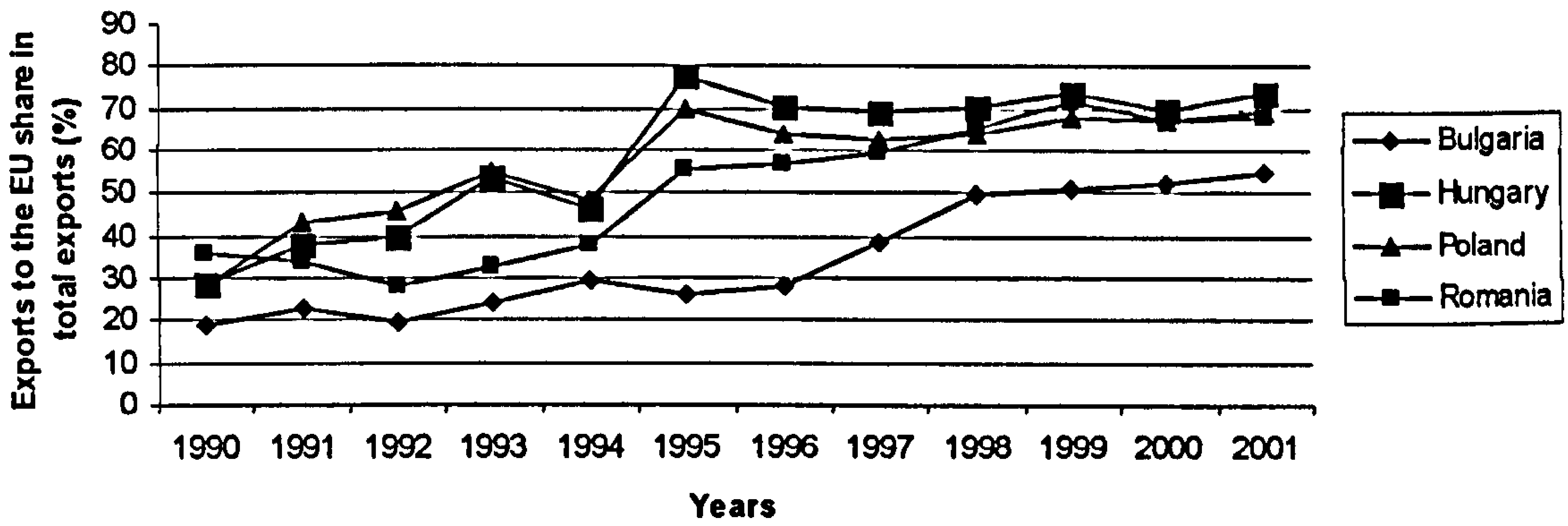
The degree of trade integration between the EU and the candidate countries can also be captured by the ratios of exports to the EU in total exports, data which is presented in the following table and figure. Since 1993 (the year of the signing of the EA) Romania has seen a continuous increase in the ratio of exports to the EU in its total exports, suggesting an increasing economic integration with the EU. For Poland there is a larger variation which suggests that, besides the EU market, Poland has had other important trading partners such as CEFTA. Both ratios have stabilised towards 70%, similar to Spain, indicating that the two candidate countries considered are as integrated in terms of product markets with the EU as present member states.

Table 3.2.14. Ratio of exports to the EU in total exports (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	18.69	23.08	19.76	24.16	29.10	26.21	27.76	38.43	49.6	50.1	52.1	54.8
Romania	36.07	34.07	28.32	32.51	37.62	55.66	56.44	59.22	65.04	72.04	66.90	68.0
Poland	27.76	42.73	45.97	55.05	48.27	69.96	63.70	62.51	63.96	68.04	67.15	69.2
Hungary	28.74	38.05	39.68	53.32	46.42	77.41	70.36	68.93	70.73	73.67	70.0	74.0
Spain	67.6	69.3	68.5	64.3	66.6	67.9	67.8	68.3	71.1	71.2	70.3	71.4
Portugal	81.2	82.4	81.4	79.9	80.0	80.1	80.6	80.8	82.0	83.2	80.3	80.1

Source: Eurostat, *Eurostat Yearbook 2003.*

Figure 3.2.7. Exports to the EU share in total exports



Source: As per Table 3.2.14.

Table 3.2.14 also shows that there was a large discrepancy between the ratios corresponding to the candidates and the ones corresponding to the member states at the beginning of the 1990s. This reflects the different levels of economic integration between the candidate countries and the EU, on the one hand, and between the EU member states on the other. However, the data regarding previous accessions shows a similar evolution of the candidate countries towards full integration with the EU. What about the degree of integration of Spain and Portugal prior to membership?

Table 3.2.15. Ratio of exports to the EU in total exports of Spain and Portugal prior to or closely after EU membership (%)

Countries	1975	1980	1985	1990	1995
Spain	50.8	54.1	55.3	67.6	67.3
Portugal	63.6	65.7	68.7	81.2	80.1

Source: Eurostat, *External and Intra-European Union Trade. Statistical Yearbook 1958-1996*, 1996, p.21; Eurostat, *Eurostat Yearbook 2003*, p.188.

Spain and Portugal joined the EU in 1986. Prior to accession and while preparing for accession, only approximately 50% of Spanish exports were directed towards the EU market. However, as a member of the EU, Spain exports circa 68% of its total exports to the European Union. This is comparable to the value for Poland and Romania at present. Portugal has seen a steeper increase in the ratio of exports to the EU in total exports after joining, suggesting a positive effect of membership. The higher figure for Portugal is consistent with it being a smaller economy than Spain. This data suggests that Poland and Romania are already integrated in terms of exports as Spain after joining the EU.

To sum up, from the candidates' perspective, the EU has become an increasingly important trade partner both in terms of exports and imports. This reflects a continuous process of economic integration similar or even more advanced than the one experienced by comparable previous candidate countries such as Spain and Portugal. Furthermore, at present, both Poland and Romania are almost as integrated with the EU in terms of trade as comparable member states, suggesting that they have already benefited from closer integration with the EU. This confirms the hypothesis that some of the added benefits of EU membership will be in security terms and factor markets integration.

3.2.3 Product market integration from the EU's perspective

It is useful to assess not only how important trade partner is the EU for the CEECs, but also how important trade partners for the EU these countries are becoming. This is because it is anticipated that the EU expansion will benefit both the CEECs and the EU. As stated in the theoretical framework, the higher the trade between future members of a customs union (here common market), the higher the likely benefits of joining for each party. The hypothesis is that the share of trade of Poland and Romania with the EU in the total trade of the EU increased towards meeting a similar size to the present comparable member states and that it evolved similarly to former comparable candidates for EU membership.

Table 3.2.16. Share of EU trade with the candidate countries in total EU trade (%)

Imports	1992	1993	1994	1995	1996	1997	1998	1999
Hungary	0.2	0.4	0.4	0.5	0.5	0.5	0.6	0.6
Poland	0.5	0.5	0.6	0.6	0.6	0.7	0.8	0.8
Romania	0.9	1.0	1.1	1.1	1.1	1.0	0.8	0.9
Exports								
Hungary	0.4	0.4	0.5	0.5	0.5	0.6	0.8	0.8
Poland	0.6	0.6	0.6	0.7	0.9	0.9	1.0	1.0
Romania	0.9	0.9	0.8	0.9	0.9	1.1	0.9	0.6

Source: Eurostat, *Eurostat Yearbook 2002*, p.10.

Table 3.2.17. Share of trade with Spain and Portugal in total EU trade prior to EU membership (%)

Imports	1980	1981	1982	1983	1984	1985
Spain	3.0	2.8	3.2	3.5	3.8	4.2
Portugal	0.7	0.7	0.8	0.9	1.1	1.2
Exports						
Spain	3.5	3.3	3.6	3.8	3.7	3.9
Portugal	1.3	1.4	1.4	1.2	1.0	1.1

Source: Eurostat, *External and Intra-European Union Trade. Statistical Yearbook 1986*, p. 5, 24.

Data on both imports and exports presented above shows that, from the EU's the point of view, Poland and Romania are not yet as integrated as Spain and Portugal prior to achieving EU membership. This confirms the findings of previous studies that the economic benefits of the EU enlargement are likely to be relatively higher for the candidate countries than for the EU. From this point of view, it is crucial that Romania meets the requirements of EU membership as soon as possible in order to use the momentum of the enlargement process and avoid further delays that might appear as a result of other applications for membership, external factors in general or internal factors of the European Union.

3.2.4 Factor integration. Foreign direct investment

The remaining section deals with factor integration. Since 1989 there has been an important surge in the FDI in the CEECs. Moreover, EU member states are the most important investors in terms of volume and number of businesses established. This is a result of economic determinants, as well as of geographic proximity, cultural ties or developments in the process of accession to the European Union by the candidate countries, as will be seen in chapter seven. FDI is important because it is a sign of factor markets integration, corresponding to the stage of a common market. Furthermore, FDI has a potential positive impact on economic reforms and progress in EU integration as illustrated in diagram 3A. This will be investigated in chapters five and seven. Evidence of factor integration between Poland and Romania on the one hand and the EU on the other is given here through FDI annual flows and stocks. Other indicators of FDI participation in the economy are offered in chapter five, part two.

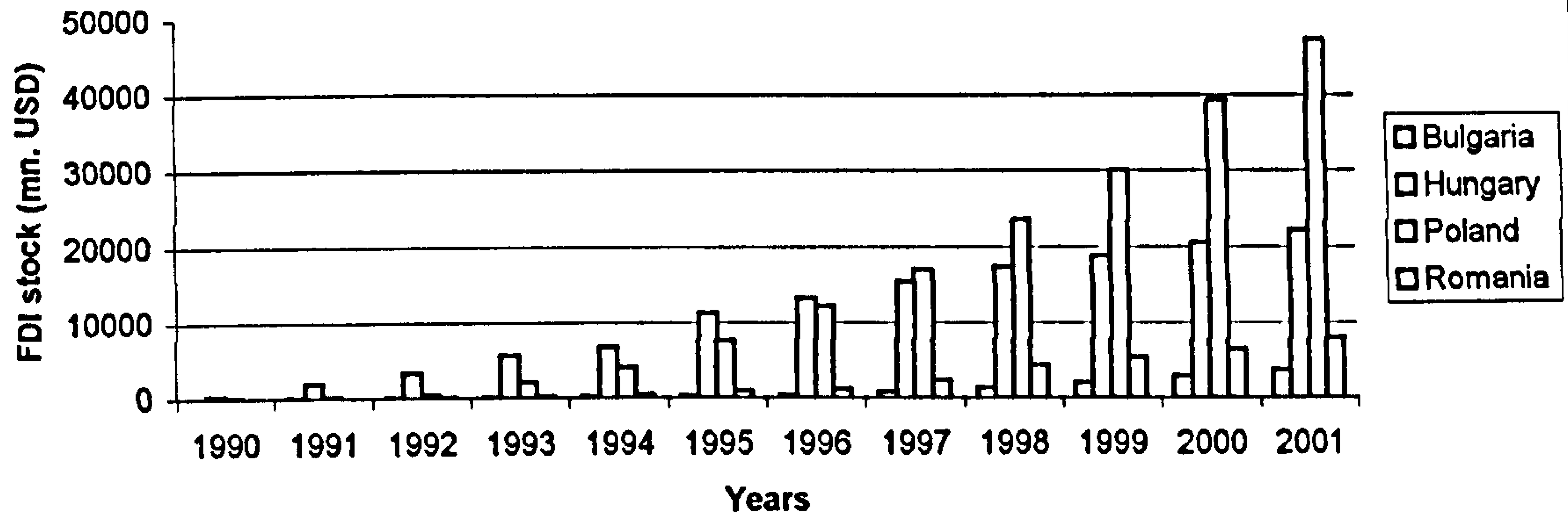
The table and the figure below show the difference between Poland and Romania in terms of FDI annual inflows. While in Poland there has been a constant increase in the annual inflows until the late 1990s, Romania had a downturn in 1996. This was a year in which the government was focused on the electoral campaign and investors adopted a 'wait-and-see' attitude. A significant surge in the FDI level was seen only as a result of increased confidence in the post-1996 democratic government. It was also due to decisive measures in privatisation and improving the investment climate in general, including macroeconomic stability. A consistent trend has been registered in Romania since 1996 and the post-2000 Năstase government is committed to further privatisation and economic reforms. The increased FDI annual inflows in Romania between 1998 and 2001 indicates that the country is catching up with other candidates regarding factor integration with the EU.

Table 3.2.18. Evolution of FDI flow in CEECs (mn. USD)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	13	56	42	40	105	90	109	505	401	700	975	800
Hungary	300	1,651	1,471	2,339	1,147	4,453	1,983	2,085	1,935	1,500	1,650	1,650
Poland	89	100	300	1,715	1,875	3,659	4,498	4,908	6,365	6,500	9,338	8,000
Romania	18	37	77	94	341	419	263	1,215	2,031	1,000	1,009	1,500

Source: EBRD, *Investment Profile. Poland,* EBRD, London, 2001, p.2; EBRD, *Investment Profile. Romania,* EBRD, London, 2001.

Figure 3.2.8. FDI stock in the candidate countries



Source: As per Table 3.2.18.

The higher level of FDI stock in Poland suggests a higher degree of economic integration with the EU. This is valid, despite a comparable ratio of FDI from the EU in the total FDI. Thus, in Poland 63.8% of the total FDI comes from the EU and in Romania 56.8% of total investors are from the EU.[162] The difference in the degree of economic integration in terms of FDI stock is consistent with Poland being invited to join in 2004 and Romania aiming for membership only in 2007. Furthermore, the discrepancy between FDI (both annual levels and stocks) suggests a difference in the FDI determinants and potentially a different impact of FDI, issues which will be assessed in chapters five and seven.

3.2.5 Conclusion

Chapter three has identified the factors that have contributed to the different evolutions of Poland and Romania in their quests for EU membership, by referring to the political and economic spheres and to the security concerns identified in chapter one. It also set the stage for an investigation of the determinants of economic transition and of the security concerns that seemed to have constituted the brakes on and respectively the engine of the present enlargement of the EU. The analysis distinguished between institutional and economic integration and gave evidence of integration in terms of product and factor markets between Poland and Romania, on the one hand, and the EU, on the other. It also tested whether the institutional framework of the enlargement process had an impact on the trade integration. The impact of the institutional integration on FDI and hence factor integration will be assessed quantitatively in chapter seven. The relationship between the elements of the economic circle will be also assessed in chapter seven. Several conclusions were drawn as follows.

Each country's progress in institutional integration with the EU was affected by factors in the political and economic spheres and by security concerns. In the political sphere, Poland's assertive attitude towards EU membership enhanced the EU's generally supportive attitude and the public support, creating a virtuous political circle of determinants of accession for most of the decade.

When public support was low and the governmental approach less enthusiastic, warnings from the EU had a 'stick' effect that recreated the virtuous political circle of the EU accession determinants. On the other hand, Romania's hesitant approach to EU membership was met with equal hesitance by the EU for most of the decade, creating a vicious circle of determinants, despite a very supportive attitude from the public at large. As a result of security concerns, the EU's more supportive attitude in the aftermath of the Kosovo crisis induced a virtuous political circle in conjunction with the new government's more active, rather than reactive attitude towards EU membership.

In the economic sphere, progress to a market economy and hence economic reforms remained the main determinants of progress of the institutional integration with the EU. This was the case especially when the European Union adopted a 'wealthy' rather than a 'healthy' approach to the enlargement process. Poland's status as a market economy was crucial for its early accession while Romania's failure to achieve a functioning market economy by 2000 and 2002 led to its accession being delayed till 2007. The importance of marketisation in the process of accession to the EU led to the investigation of the factors that have affected transition to a market economy in both Poland and Romania in chapter four.

The analysis further revealed that during the accession process there has been a trade off between economic criteria and security concerns. The relative importance of the two motives determined two different approaches also known as the 'wealthy' and the 'healthy' approach to the EU enlargement. When economic calculations prevailed the approach was considered 'wealthy', while security concerns became the engine of enlargement during the 'healthy' approach. Thus, immediately after the Kosovo crisis the EU's attitude towards enlargement changed from a 'wealthy' towards a 'healthy' one. However, prospects for more stability in South Eastern Europe as a result of democratisation have changed again the balance between security concerns and economic factors suggesting a possible return to the healthy approach, as defined at the beginning of the chapter. This is why, as long as the enlargement process is not yet completed, it is still important to investigate the factors that underpin this process and that are likely to ensure Romania's successful membership in 2007. An in-depth analysis of the security concerns is conducted in chapter six.

Finally, this chapter has given evidence of increased product and factor markets integration between Poland and the EU and Romania and the EU. The analysis has revealed that the ratio of trade with the EU in the total trade of the candidate countries considered has already reached figures comparable with present EU member states and with previous candidates for membership during their quests for accession. The ratio of trade with the EU in GDP has also converged in the candidate countries similar to developments in the member states during this integration process.

[162] WIIW, *Handbook of Statistics*, CDROM.

The same was true for imports and exports. The data also suggested that trade with the EU increased more in the years surrounding the dates of implementation of the association agreements and of expiry of the transitory periods. There is enough evidence to support the hypothesis that both Poland and Romania act like member states in terms of trade integration and hence EU enlargement will benefit both the EU and Poland and Romania. Given that their relative importance for the EU market is still lower than the importance of comparable former candidates such as Spain and Portugal it is important to emphasise that the benefits of this enlargement are registered not only in economic terms but also in security terms for both the EU and the candidates, as will be seen in chapter six.

The chapter has further provided evidence of increased factor integration with Poland having a higher degree of integration represented by a higher FDI annual inflows and a higher FDI stock. As the candidate countries still represent a free (imperfect) trade area with the EU, rather than a common market, the chapter has concluded that product market integration has been achieved ahead of the institutional integration with the EU. This suggests that factor integration is likely to foster further institutional integration, thus illustrating the bi-directional relationship between institutional and economic integration. This hypothesis is tested in chapter seven. Furthermore, the impact of institutional integration on factor integration is also tested through the econometric model on the FDI determinants constructed in chapter seven. Having identified progress to a market economy as a necessary condition for EU accession, chapter four investigates the factors that have led to Poland and Romania's different paths in transition to a market economy.

CHAPTER FOUR
THE DETERMINANTS OF ECONOMIC TRANSITION IN POLAND AND ROMANIA

Chapter three has identified the main political, economic and security factors leading to Poland and Romania's progress in formal integration with the Union. The chapter also presented evidence of product and factor integration and of the impact that institutional integration with the EU has had on product markets integration. This chapter focuses on the factors that have determined the process of transition to a market economy and draws lessons from the first decade of transition. Assessing the determinants of transition is important because achieving a market economy is a condition *sine qua non* of joining the European Union, as suggested in chapter three. Furthermore, progress in transition and economic reforms represent both a condition and a result of FDI, an element of economic integration identified in chapter three. This bi-directional relationship between economic reforms and FDI will be assessed in chapters five and seven. Furthermore, the success of economic reforms impacts upon the internal stability of the country and hence on security concerns and the prospects for EU integration, as will be seen in chapter six.

The first aim of this chapter is to identify the elements which led to the different paths and results of transition in Poland and Romania between 1990 and 2002. The comparison of economic transition is achieved by using determinants from both the economic and political spheres, which include: the initial conditions, governments' attitude towards reforms, the internal support for reforms, the role of international organisations and the policy mix (or economic reforms). The second aim of the chapter is to draw lessons from the experience of the two countries which could be used in the completion of the transition to a market economy in Romania.

The chapter is organised as follows. It first sets out the theoretical framework by referring to the theoretical framework of the dissertation. It then analyses comparatively the impact of each determinant considered on the path and results of transition. The chapter concludes with the lessons learned from the first decade of transition in Poland and Romania.

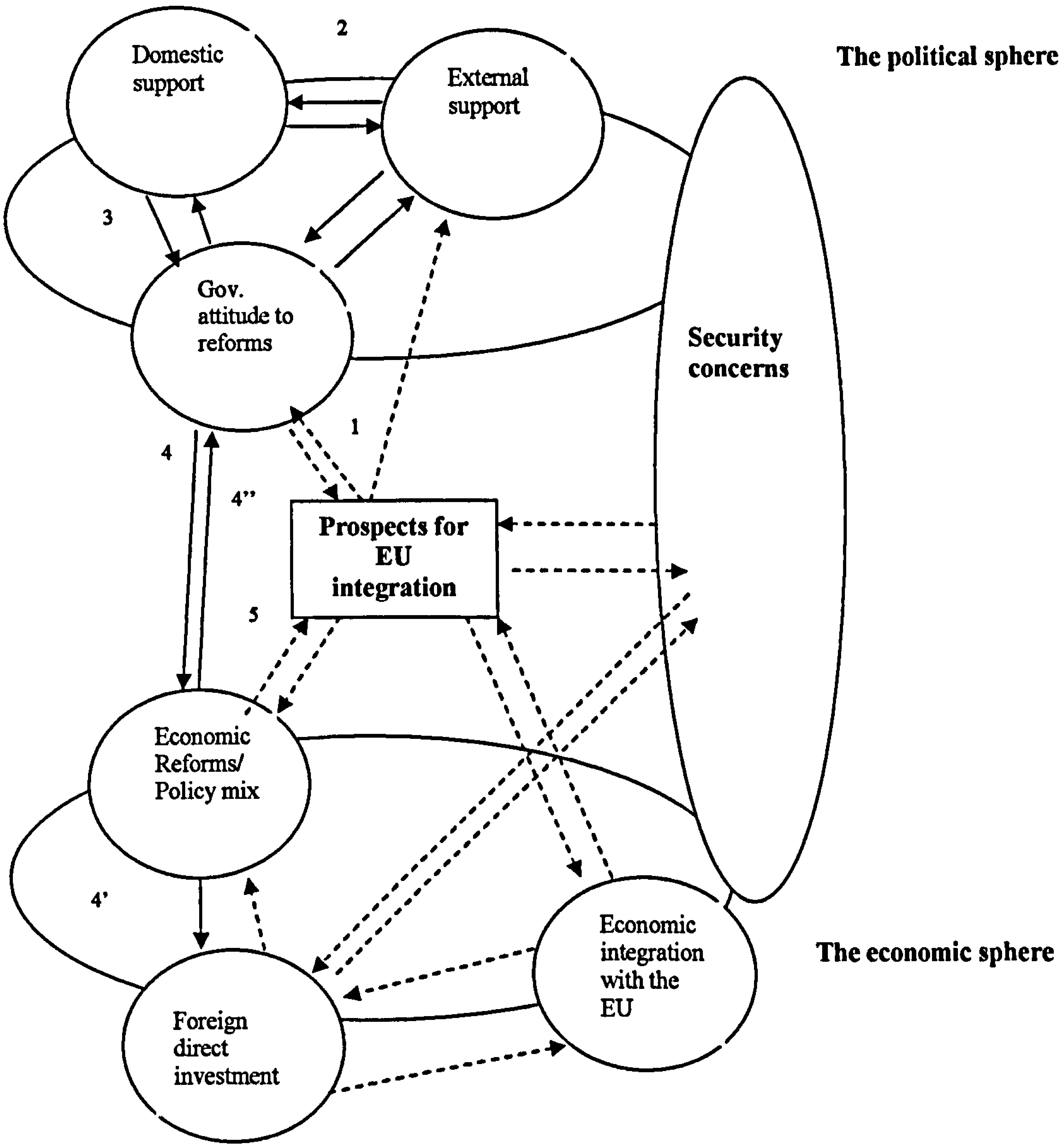
4.1 The theoretical framework of the chapter

This study builds on previous research which explains the path and results of transition in the CEECs through the impact of the initial conditions, the economic policy, domestic political developments, economic outcomes and external factors.[1] It distinguishes between factors in the economic and the political sphere and shows how they interact in determining the pace and results of transition. In the political sphere three factors similar to the ones affecting progress towards EU

[1] Aslund, A., "Lessons of the First Four Years of Systemic Change in Eastern Europe", *Journal of Comparative Economics*, Vol. 19, No. 1, 1994, pp. 22-38; Balcerowicz, L. and Gelb, A., "How to Stabilise-

membership are considered. These include: governments' attitude towards reform, the popular support for economic reforms and the international financial and technical assistance. In the economic sphere the main determinant of transition to a market economy is the policy mix adopted by the successive governments as suggested by the diagram below.

Diagram 4A
Vicious and virtuous circles in economic transition



a) Arrows 1, 2 and 3 indicate a virtuous circle in the political sphere induced by external support. Arrows 4 and 4'' indicate how a virtuous or vicious political circle can influence and be influenced by the economic circle through the policy mix (or economic reforms).

Legend:

⟶ relationships that are addressed in chapter four

- - - -▸ relationships that are addressed in other chapters

Policy Lessons from Early Reformers", *Transition*, Vol. 5, No. 6,1994, pp. 3-4; Sachs, J., "Russia's Struggle with Stabilisation, *Transition, Vol. 5*, No. 5,1994, pp. 7-10.

In order to test the hypothesis of path dependency in transition the study assesses the impact of the initial conditions on: the choice of policy, governments' attitude towards reform, internal and international support. This study challenges the previous findings that differences in performance in transition are a result of differences in structural reforms, rather than in the initial conditions and maintains that the initial conditions have led to path dependency in the early transition period.[2] This chapter also draws on studies which acknowledge that there is potential for both path dependency and path shaping.[3] It challenges the assumption that policies are totally controlled by the government and that international support is totally uncontrollable.[4] It is argued that international support is greatly affected by the governments' attitude towards reform and by the public support for reforms. The analysis agrees though with the assumption that the initial conditions are uncontrolled, and that they have influenced greatly the initial choice of economic policies.[5] The bi-directional relationships assumed in this study are part of the interplay between the political and economic spheres considered here. Furthermore, they suggest ways in which the political circle can reinforce itself or reinforce the circle in the economic sphere.

4.2 The initial conditions

There has been a continuous debate on the extent to which the initial conditions have been offset by other factors. Early studies of transition or of economic growth in the CEECs have shown that the impact of the initial conditions has been offset by the choice of economic policies. The policy mix seemed to be more important than the starting point.[6] However, the choice of policies depended on the initial conditions of transition, thus making difficult a total separation of the two and a fair assessment of the role of policies in determining transition. Moreover, countries like Romania and Bulgaria, which were amongst the less reformist in the Soviet block, remained the laggards of transition, being incapable of catching up with the leaders. This signalled the danger of path dependency in transition. A study by Falcetti et al which initially supported the decisive role of policies was later amended. It then concluded that in terms of achieving economic growth and economic reforms, it was probably safe to say that the CEECs have not yet defied the odds of initial conditions.[7]

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[2] See Berg, A. cited in Balcerowicz, L., *Post- Communist Transition: Some Lessons*, IEA, London, 2002, p. 43.

[3] Smith, A. and Swain, A., "Regulating and Institutionalising Capitalisms" in Pickles, J. and Smith, A. (eds.), *Theorising Transition* ,Routledge, London, 1998, p.27.

[4] Balcerowicz, L., *Transformation from Socialism to Capitalism*, CEU, London, 1995, p.169.

[5] See Havrylyshyn, O. and Wolf, T., "Growth in Transition Countries, 1990- 1998: Main Lessons" in Havrylyshyn, O.and Nsouli, S. (eds.), *A Decade of Transition: Achievements and Challenges*, IMF, 2001

[6] EBRD, *Transition Report*, EBRD, London, 1994, p.12; Camdessus, M., "Achievements and Prospects after Ten Years of Transition, Opening Remarks at a Conference on Transition", IMF, 1, February, 1999; Falcetti,E., Raisear, M. and Sanfey,P. "Defying the Odds: the Initial Conditions, Reforms and Growth in the First Decade of Transition", *EBRD Working Paper No. 55*, EBRD, London, 2000.

[7] Falcetti, E., Raisear, M. and Sanfey, P. "Defying the Odds: the Initial Conditions, Reforms and Growth in the First Decade of Transition"; Falcetti,E., Raisear, M. and Sanfey,P. "Defying the Odds?: The Initial Conditions, Reforms and Growth in the First Decade of Transition", *EBRD Working Paper 55*, EBRD, London, 2002, p.21.

The initial conditions of 1989 appear to have had an important impact on the path and results of transition in both Poland and Romania. Moreover, their interdependence with other determinants of transition makes them more influential than initially thought. This justifies an overview of the initial conditions as part of assessing the determinants of the path and of the results of transition to a market economy. Moreover, the assessment of initial conditions is a thread running throughout the entire dissertation. Their impact on progress towards EU membership was investigated in chapter three. Chapter five refers to the starting point regarding the investment climate, while chapter six acknowledges the importance of security concerns at the initial point of transition. Finally, chapter seven introduces the EBRD composite index of initial conditions in the econometric modelling of the determinants of FDI and of economic reforms, in order to test the hypothesis of path dependency.

In 1989 the common ground of the ex-communist CEECs was smaller then would appear at a first glance. The shared economic and political system was not identical, and Poland and Romania displayed considerable differences. These already gave a considerable comparative advantage to Poland, as will be seen below. The EBRD composite index of initial conditions –ranging from -0.4 to 3.5- reflects this difference, while a qualitative analysis reveals an even higher contrast between Poland and Romania The index is 1.7 for Romania and 1.9 for Poland, with values ranging from -0.4 to 3.2 and higher values representing a better situation.[8] The index is derived from a factor analysis and represents a weighted average of measures for: the level of development, trade dependence on CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market elements and state capacity.[9] However, several political and institutional factors are left aside and thus a more nuanced qualitative analysis of the initial conditions is required, as below. Moreover, a close analysis shows that the factors included in this index varied widely between the countries in transition and between Romania and Poland in particular.[10] It is then possible that, due to methodological limitations, the composite index has overlooked some of these differences.

The present study analyses the impact of initial conditions on transition by using two subcategories: the state of the economy and of the nation and the institutional framework. These are indicators of the preparedness of each country to embark on transition to a market economy. Thus, the state of the economy and nation are important prerequisites for the choice of policies, be they of a gradual or shock therapy type. Furthermore, the institutional framework can act as a catalyst for the

[8] Snoy, B., "How Successful Transition is Paving the Way for EU Enlargement. a View Based on EBRD Indicators", *Paper Presented at the Seventh Biennial International Conference organised by the European Community Studies Association (ESCA),* May 31-June 2001, Madison, Wisconsin, USA, p. 12.
[9] Snoy, "How Successful Transition is Paving the Way for EU Enlargement. a View Based on EBRD Indicators", p. 12.
[10] Camdessus, M., "Achievements and Prospects after Ten Years of Transition, Opening Remarks at a Conference on Transition", p.4; Dăianu, D., "Where Are Post-Communist Countries Heading to?", *CEROPE Working Paper, http://www.cerope.ro.*

adoption of a market economy. Using these two subcategories, the present chapter offers a brief overview of initial conditions in Poland and Romania which reveals a much better initial situation in Poland than in Romania. This appears to indicate that the better Polish performance in transition and accession to the EU is partially a result of path dependency, as defined in chapter two.

4.2.1 The state of the economy and of the nation

In 1989 Poland was in a deep economic crisis.[11] Poland had more difficult economic challenges than its neighbouring countries. Previous attempts to reform the system had not proven to be successful enough.[12] Hyper inflation, a high budget deficit, the discontinuation of repayment of foreign debt, the lack of a clear financial policy, decreasing economic output and falling domestic demand made Poland a country with a high economic instability. The increase in the index of consumer prices of 639.5% in 1989 was 1,000 times greater than in Romania.[13] In 1989, the external debt of USD 40.2 billion was a heavy burden compared with Romania, which had paid off all its debts and had managed to accumulate a net reserve of USD1.3 billion in the same year.[14] There was hidden unemployment in Poland, despite the official figure of 1% at the end of the year. Most companies were overstaffed and labour productivity was low.[15] A similar situation was faced by Romania.[16] The structure of capital investment in Poland was in many cases unsuitable for market needs and most of the firms lacked a market strategy. The dark situation of the economy was similar to a patient who needed a shock, an observation which gave the name to the reform programme adopted by Balcerowicz, the finance minister in 1989. The high inflation needed rapid stabilisation policies. The high external debt ensured the interest of the international financial organisations in a quick and successful transformation to a market economy, so that remaining debts could be repaid. International support was a major contributing factor to the early design of policies. The economic crisis also made it clear to the population that major reforms were needed.[17]

To a certain extent the population was ready to accept drastic reforms in order to see an overall improvement in the economy and in their standard of living. There were, however, signs that this support would not last long. The social structure was rather peculiar from the point of view of the transition towards a capitalist, market economy. The numerically largest social group, the workers, was the product of socialist industrialisation. Paradoxically, they were also the ones who had organised the strikes, supported and co-organised by intellectuals from the opposition, thus undermining socialism. This gave the workers a kind of 'romantic aura' and enshrined the various

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[11] Balcerowicz, *Transformation from Socialism to Capitalism*, p.293.
[12] De Broek, M. and Koen, V. *The 'Soaring Eagle': Anatomy of the Polish Take off in the 1990s*, International Monetary Fund, 2000, p. 4.
[13] EBRD, *Transition Report*, 1994, p.165-166.
[14] EBRD, *Transition Report*, 1994, p.165-166.
[15] EBRD, *Transition Report*, 1994, p.165-166.
[16] EBRD, *Transition Report*, 1994, p.165.
[17] For a discussion on the choice for shock therapy and on the internal debates in Poland in the early 1990s, see also Spiro, N., *The Politics of Economic transition: Shock Therapy in Poland, 1990-1991*, UKC Ph.D. Thesis, UKC, 1998.

forms of protest which later acted as brakes on reforms. When workers faced the negative consequences of transition, including actual or potential unemployment, they vociferously opposed reforms.[18] Similarly, the farmers had considered themselves the preservers of private property and thus a 'privileged' class of transition. On the other hand, they were amongst the ones negatively affected by the liberalisation of prices and the adjustment of tax rates at the beginning of transition, despite initial short run gains.[19] All in all, this social and economic structure had an important impact on the public support for transition and indirectly on the policy mix adopted by the Polish governments. The crisis called for radical reforms, but the volatile public support acted as a brake later on and induced a change of approach in 1993, when the election was won by post-communists.

On the other hand, the Romanian economy was the product of the most orthodox Communism in Europe. Resources were allocated almost exclusively on political criteria, through commands and party orders, through arbitrary and voluntary actions, totally disregarding the market and any potential entrepreneurial spirit.[20] Forty five years of semi-autarkic industrialisation placed emphasis on heavy industry that even by the standard of communist economics may be considered unusually strong.[21] The energy sector was overgrown and the tertiary one was neglected.[22] Industrialisation had been propelled by a high investment ratio, officially estimated at 24.3% in 1951-1953, 33.3% in 1976-1980 and 27.9% in 1981-1985.[23] However, the incapacity of the system to cope with increased complexity and its inability to assimilate and generate technological progress led to a fall in output in the late 1980s, reaching a growth rate of -5.3% in 1989 as opposed to only -1.4% in Poland the same year.[24] This was accompanied by a strong bias towards low value added industrial goods, which led to a deterioration of the terms of trade.[25] The effort to pay the foreign debt, actually a *suis generis* shock therapy, accentuated the decline in the competitiveness of the economy, exacerbated imbalances between sectors, increased shortages and generally lowered the welfare of the population.[26] The fixed capital of the Romanian industry was reduced by nearly 40%, leaving little room for fast recovery.[27] Although the government was trying to control inflation and unemployment, scarcities in all goods indicated the crisis.[28]

[18] Balcerowicz,*Transformation from Socialism to Capitalism*, p.294.
[19] Balcerowicz, *Transformation from Socialism to Capitalism*, p.295.
[20] Constantinescu, N.N., *Reformă şi redresare economică*, Editura Economică, Bucureşti, 1995, p. 60.
[21] Montias, J. M., "The Romanian Economy: A Survey of Current Problems", *European Economy*, No. 2, 1991, p.179.
[22] Constantinescu, *Reformă şi redresare economică*, p.61.
[23] Montias, "The Romanian Economy: A Survey of Current Problems", p.179.
[24] EBRD, 1994, p.165-166.
[25] Dăianu,"Where Are Post-Communist Countries Heading to?", p. 8 .
[26] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 9.
[27] Montias, "The Romanian Economy: A Survey of Current Problems", p.180.
[28] Montias, "The Romanian Economy: A Survey of Current Problems", p.180.

This disastrous state of the economy led to an equally disastrous state in the standard of living of the population.[29] Romanians had one of the lowest GDP per capita in the CEECs.[30] Furthermore, the communist legacy led to a large gap between demand and supply reflected by the fact that only 14 bani of 1 leu currency had corresponding goods and services on the market.[31] Electricity, heating, housing, food and consumer goods shortages brought the Romanian population to a situation of starvation and frustration. Thus, the burden of the past did not leave much room for a shock therapy economic programme. There was rather a need for a shock therapy for the population itself, so the choice made in the end by the post-1989 governments was to 'resuscitate' the Romanian people rather than the dying economy. The economy had still some resources for survival, as will be seen later on.[32] As a result, the first economic measures were directed towards increasing the standard of living, rather than to promoting reforms in the economy. This delay lessened the international support available and thus failed to ensure a virtuous political circle of determinants of transition and accession to the EU in the early years of transition.

4.2.2 The institutional framework

Further differences in the initial conditions of Poland and Romania occurred in the institutional framework.[33] By institutional framework one understands political and economic structures capable or not of supporting and maintaining the momentum for the transition to a market economy.

There were considerable differences in the institutional framework in both the political and economic spheres in Poland and Romania. In the political sphere, Poland has fully benefited from having preserved or created key institutions such as the family, the trade unions, the church and the press.[34] Furthermore, since the late 1970s 'democratic opposition' had been organised in Poland through the Committee for Defence of Workers (KOR). Moreover, civil society was created by intellectuals as an alternative to state power, with the aim of gradually promoting reform in the cultural and civic field.[35] Although challenging the leading role of the party or of the Soviet Union was out of question in the early 1980s, the civic society formed was a basis for a new political class and for the democratisation of Poland. The creation of the Solidarity Movement was also an important step towards political emancipation and democracy. Nine years later, Poland held semi-free elections in June 1989, and was the first eastern European country to embark on democratisation.

[29] Constantinescu, *Reformă şi redresare economică*, p.61.
[30] Dăianu, "Where Are Post-Communist Countries Heading to?", p.8.
[31] Dăianu, "Where Are Post-Communist Countries Heading to?", p.8.
[32] Stolojan, T., "Policy Making in Romania", *Paper at a World Bank Conference in Romania*, World Bank, Bucharest, 1999.
[33] Camdesus, "Achievements and Prospects after Ten Years of Transition, Opening Remarks at a Conference on Transition", p.5.
[34] Camdessus, "Achievements and Prospects after Ten Years of Transition, Opening Remarks at a Conference on Transition", p.6.
[35] Rie, "Post-Communist Polish Economic Reform: A Class Analysis", p. 4.

On the other hand, Romania experienced one of the most oppressive communist dictatorships. Civil society hardly existed and thus one of the main ingredients for the development of a capitalist system was missing. Moreover, church and religion were prosecuted and trade unions, which were the engine of change in Poland, were only 'puppets' in Romania. The regime did not allow alternatives to the power of the communist party. There had been only a few revolts expressing the unpopularity of the system but were quickly oppressed. Thus, revolt of the miners in the Jiu Valley in 1977 and that of the workers in the Tractorul Factory in Braşov in 1987 did not have any larger impact on society. Overall, the emerging leaders, the media and the population lacked knowledge about the principles of democracy and the market economy. This situation made change in Romanian society less radical and slower.[36] Romania ended Communism through a violent revolution in December 1989, with numerous human victims and proceeded into free elections in May 1990 and in May 1992. Until 1996 there was no real change of power, as will be discussed in more detail in chapter six. A more in-depth analysis of these institutional political factors is, however, beyond the scope of this dissertation.

The institutional framework in the economic sphere equally was different in the two countries. The Polish economy had certain elements of a market economy promoted through previous attempts at reform.[37] First, the workers' councils established in state-owned companies in 1981 were powerful and were able to decide on dividend distribution, profit sharing or director nomination.[38] Despite certain negative effects as a result of postponing the privatisation process, workers' councils induced a certain change in mentality through cultivating entrepreneurship which was vital for the new economic system.[39] Second, in 1989 78 % of the arable land was privately owned and private companies had already been accepted through law since 1987.[40] The share of the private sector in the GDP was 28.6% and by 1989 there were already 16,905 commercial companies in Poland, out of which 429 used foreign capital.[41] Also, the private sector share in employment was already 46.2% in 1989.[42] These elements of private ownership and entrepreneurship constituted a very good basis for transition to a market economy in Poland.

On the other hand, prior to 1989 policies in the Romanian economy were mainly politicised. The freedom allowed to state companies was minimal and the principles of self-financing and profit making were only marginal in the economy. The 'New Economic Mechanism' (NEM) introduced in 1978, which was supposed to give more decision making power to enterprises, had failed. During the 1980s NEM had become a huge bureaucracy, with institutionalised forms that gave a false

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36 Stolojan, "Policy Making in Romania", p. 4.
37 Balcerowicz, *Transformation from Socialism to Capitalism*, p. 316.
38 Balcerowicz, *Transformation from Socialism to Capitalism*, p. 273.
39 Balcerowicz, *Transformation from Socialism to Capitalism*, p. 294.
40 Balcerowicz, *Transformation from Socialism to Capitalism*, p. 316.
41 EBRD, 1994, p.165.
42 De Broek, and Koen, *The 'Soaring Eagle'*, p. 17.

image of enterprise and public participation in decision making.[43] Private property and entrepreneurship were hardly present. In Romania,under Ceauşescu the private non-agricultural sector was practically non-existent, and no data regarding the private sector share in GDP or employment is available for Romania.[44] The structure of industry had a strong bias towards gigantic units, with no regard for small and medium enterprises.[45] This initial economic situation considerably slowed down the process of transition to a market economy by providing a poor economic framework for economic reforms.

To sum up, different initial conditions have determined to a large extent the policies that the first post-1989 governments envisaged thus placing Romania and Poland on different transition paths. Society was more open, less oppressed and the standard of living was higher in Poland than in communist Romania. These, together with the deep crisis in the economy, elements of capitalism and democratisation and the international support, were good conditions for the implementation of the shock therapy in Poland. On the other hand, the initial conditions in Romania were more conducive to a gradual approach. The economic system was indeed in crisis but it seemed to have some resources for survival. The Romanian population, however, had no more energy for shock therapy reforms. In a way, they had already faced a shock therapy through Ceausescu's strategy to pay the external debt over the previous five years. As a result, the Romanian people were expecting a rapid improvement in their standard of living, rather than radical economic reforms with a further negative impact on their quality of life. This, together with the poor institutional framework, led to a gradual approach to reforms and to low external support, hence a vicious circle in the political sphere.

4.3 The governments' attitude towards reform

A second element which has influenced the path and results of transition was the governments' attitude towards reform. This is part of the political sphere of determinants of accession and was determined by several factors, as will be discussed below. First, the exposure to democratic procedures and market thinking prior to 1989 was different in the two countries. This constituted an important comparative advantage for Poland in giving a direction to the change envisaged, as discussed above. The previous attempts to reform the system in 1956, 1970 and the 1980s made Poland more open, more susceptible to change and gave a clearer image of what transition should be like.[46] This comparative advantage kept Poland at the forefront of reform for a few more years. On the other hand, the Romanian revolution was one against Communism, and was not specifically pro-Capitalism. Consequently, in 1989 there was no clear blueprint for the change needed in the Romanian economy and society and this slowed down reforms.

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[43] Stolojan, "Policy Making in Romania", p.4.
[44] Jeffries, I., *Socialist Economies and the Transition towards the Market. A Guide*, Routledge, London, 1993, p.455.
[45] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 8.
[46] Zukrowska, "Poland: The Short Cut to Reform Proved Possible", p. 2 and Ric, "Post-Communist Polish Economic Reform: A Class Analysis", p.9.

Second, reform in the political sphere interacted differently with reform in the economic sphere. Poland solved the dilemma of what should be transformed first, the political or the economic life of the country, by having the first push from the political sphere. The setting up of the Solidarity Movement in 1980 marked the birth of a new political class which was the engine of change in both the national and international aspects of the economy. Its accession to power in 1989 as a result of the Round Tables agreement, albeit limited, was the start of the shock therapy reforms.[47] Furthermore, the 1990 presidential election and the 1991 parliamentary election results were a good signal for the international community, a guarantee of the break with the past. Only political change could determine significant changes in the economic sphere. Moreover, only a government which is legitimate has the moral right to require sacrifices.[48] On the other hand, by 1989 there was no new political class in Romania which could promote the genuine spirit of democracy and of a market economy. Change within the ruling political class was slow. Until May 1990, when the first free elections were held, there was neither enough time, nor enough resources for the opposition groups to develop and win the elections. The accession to power of post-communists in both elections of 1990 and 1992 determined a gradual approach to economic reforms and decreased the external credibility of Romania's break with the past. All in all, economic reforms were slowed down by the lack of progress in democratisation, an interplay which will be further discussed in chapter six.

Third, there were different degrees to which the continuity of reforms was ensured in each country. In Poland policy making was relatively steady, despite the succession of unstable coalitions and minority governments which characterised the first decade of transition.[49] In the early years of transition the IMF almost requested that Balcerowicz remained in charge with reforms as a guarantee of their continuity. None of the Polish governments have turned its back on privatisation, deregulation or EU membership.[50] On the other hand, Romania suffered from stop-and-go policies and successive governments gave in to public pressure or to electoral interests.[51] Electoral cycles have typically been occasions for populist measures.[52] However, towards the late 1990s governments in both countries have learned to resist pressures and persevere with reforms, despite short term political interests. Thus, in 2000 the Isărescu government largely maintained the austerity measures necessary for macroeconomic stabilisation despite the electoral pressures.[53] The

[47] For a discussion on the choice for shock therapy and on the internal debates in Poland in the early 1990s, see also Spiro, N., *The Politics of Economic transition: Shcok Therapy in Poland, 1990-1991*, UKC Ph.D. Thesis, UKC, 1998.
[48] Winiecki, J., p.810.
[49] *The Economist*, 27 October 2001, p. 6.
[50] *The Economist*, 27 October 2001, p. 6.
[51] Dăianu, "Where Are Post-Communist Countries Heading to?", p.2; Jackson, M., "Political Incredibility and Bureaucratic Transition in Romania" in Hardt, P. and Kaufman, R.F. (eds.), *East-Central European Economies in Transition*, M.E. Sharpe, New York, 1995, p.199; Stolojan, "Policy Making in Romania", p.4.
[52] Cosea, M., "Panel Discussion: Structural Change and Macroeconomic Policies", *Romania 2000- 10 Years of Transition*, Bucharest, 2000.
[53] *Adevărul*, 20 Noiembrie 2000.

same dedication to reforms was shown by the group of liberals at the SLD's heart who managed to persuade the party to vote against a rise in teachers' salary, just before the Polish parliamentary election in 2001.[54]

Fourth, there were different degrees to which the countries applied 'exceptional politics' in the early stages of transition and consequently used the 'finite window of opportunity created by a populace that was longing for economic change in the aftermath of social and political upheaval'.[55] The 1989 window of opportunity was used fully by Balcerowicz. He introduced a rapid reform programme which inevitably had negative effects on the population but achieved a thorough improvement in the macroeconomic situation. The bold approach to reforms also earned international credibility for Poland. Although the shock therapy programme led to popular unrest and the return of the post-communists through the 1993 elections, it constituted a solid basis for the subsequent, gradual reforms such as privatisation.[56] The full use of the first window of opportunity set Poland on the path to achieving economic growth and to a certain extent it started a self fulfilling prophecy of success, setting Poland on a virtuous economic circle.

On the other hand, Romania lost two windows of opportunity: December 1989 and November 1996.[57] In 1989 there was a huge enthusiasm in the population for breaking with Communism. The revolution brought into the streets hundreds of people who wanted democracy and to see their standard of living improved as soon as possible. However, there had been so much suffering in the last years of the Ceauşescu regime, that the high short term costs of rapid reforms were not favoured. Moreover, the political power which emerged during the 1989 revolution under Iliescu, a former communist official, was supported by many ex-communist nomenklatura members. They were not ready to make a clear break from the communist economic and political methods and thinking. A gradual approach to reforms was adopted. Although Iliescu was part of a reformist movement of the party, a kind of Gorbachev, he was mainly perceived both internally and externally as a communist. This resulted in low international support for Romania and low credibility of reforms, reinforcing the vicious political and economic circles of Romania's post 1989 early evolution.

The second window of opportunity lost by Romania was in 1996. Then the democratic forces organised under the Democratic Convention of Romania won both the parliamentary and the presidential elections. This change of power secured important international credibility for

[54] *The Economist*, 27 October 2001, p. 7.
[55] Camdessus, "Achievements and Prospects after Ten Years of Transition, Opening Remarks at a Conference on Transition".
[56] Rie, "Post-Communist Polish Economic Reform: A Class Analysis".
[57] Dăianu, "Where Are Post-Communist Countries Heading to?", p.2; Jackson, "Political Incredibility and Bureaucratic Transition in Romania", p.553; Stolojan, "Policy Making in Romania", p. 4.

Romania.[58] However, the new Romanian government was not able to maintain this support and to answer to the optimism of the population through real reform. Instead, a struggle for political power and influence characterised the following years. Government reshuffles took place at least once a year thus inducing stop-and-go policies, undermining political stability, the credibility of the government and the pace of economic reforms.[59] A vicious political circle was maintained thus slowing the change of the economic vicious circle into a virtuous one, despite some progress in reforms and an increase in FDI. These developments prevented the creation of a full virtuous political circle in Romania in 1997.

Finally, a third window of opportunity appeared in 2000. Given the threat that Vadim Tudor, the leader of the nationalistic Greater Romania Party, would become the president of Romania, the 2000 victory of the post-communist Ion Iliescu can be considered a window of opportunity which this time was won. The threat of nationalism and of further slowdown in the process of EU integration enhanced the government's determination to implement real economic reforms. It was strongly believed that the future of transition relied on the measures promoted by the 2000 Năstase government. The importance of using the window of opportunity presented by the election was finally acknowledged by the ruling class in Romania. Moreover, the economic results achieved so far by the post 2000 governments' policies support the idea of a window of opportunity this time well utilised. Further success of the reforms will depend on whether the government continues to have the necessary public and external support, ensuring a virtuous political circle with a positive impact on the economic circle.

To sum up, the governments' attitude towards reform had a great impact upon the continuity, comprehensiveness and effectiveness of policies implemented in transition. The openness towards democracy and the market economy prior to 1989 has given a comparative advantage to Poland, placing it at the forefront of reforms. Electoral cycles have been occasions for populist measures and for changes of governments which led, especially in Romania at early stages, to policy changes. Finally, the way governments have used the early windows of opportunity such as the revolutions and the change of power was crucial in the results of reforms. Public and international support were also important in maintaining governments' attitude towards reform and international support, as will be discussed below.

4.4 The popular support for reform

Public support has influenced the initial and subsequent choices of policies, as well as the continuity, comprehensiveness, coherence and credibility of reforms. It has acted both as a catalyst

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[58] Phinnemore, D., "Stuck in the 'Grey Zone'?- Fears and Frustrations in Romania's Quest for EU membership", *Paper Presented at a UACES Conference*, April 2000.
[59] Dăianu, "Where Are Post-Communist Countries Heading to?", p.2; Cosea, "Panel Discussion: Structural Change and Macroeconomic Policies"; Jackson, "Political Incredibility and Bureaucratic Transition in Romania", p. 553.

for and a brake on reforms, by affecting governments' attitude towards reform, the international support and the policy mix. So, how did public support influence the path and results of transition?

First, the initial high public support for radical reforms was a catalyst for the implementation and early success of the Polish shock therapy programme. On the other hand, in 1989 the low enthusiasm of the Romanian population to bear the short term costs of transition led to the choice by the first post revolution government of making gradual reforms. The attempt of the Roman government to introduce a radical reform package in 1991 was stopped by the street protests of the miners. They feared the unemployment that would result from the closure of the mines and they demonstrated in Bucharest asking for the resignation of the PM. Giving in to the pressure from the public, the reshuffled Romanian government slowed down economic reforms.[60]

Second, public support for democracy or economic reforms has impacted upon the external credibility and support for the government. In the early 1990s public demonstrations were a test for the democratic maturity of the Romanian ruling class. The University Square protests against the return to power of the post-communists were severely suppressed by the authorities. Many of the participants were jailed, thus putting under question the respect of human rights in Romania. Similar doubts over democracy in Romania were raised by the miners' violence in Bucharest on 13-15 June 1991. Popular unrest and the non democratic measures taken by the government led to the stopping of international financial and diplomatic support for the Romanian authorities, on human rights grounds. The EEC stopped the negotiation of the association agreement and Phare funding. Other international financial institutions did the same.[61] This led to a further slowdown in the economic reforms initiated by the Romanian government. The frequent protests in Poland in the early 1990s also created an image of political instability. This was seen, however, as a by-product of the radical reforms implemented, and not as a sign of opposition to market economy or democracy. Hence, it did not have a negative effect on the international support offered to Poland.

Third, public support for reforms has been rather volatile in the first decade of transition, both in Romania and Poland, thus affecting governments' attitude towards reform. This was due to several factors. Reforms were seen as a guarantor of a better life, but the early results of transition were a fall in production, increased inflation, rising unemployment and an overall deterioration of the quality of life, regardless of the type of policies applied. The cost was borne unevenly by the population, creating losers and winners of transition.[62] This discrepancy between expectations and reality made public support for a certain government or type of policies short lived.[63] This led to several government reshuffles in both countries and to changes of power through elections. Between 1990 and 2002 the pendulum of power swung between right and left and Poland was ruled

[60] Stolojan, "Policy Making in Romania", p.10.
[61] *The Guardian*, 12 November 1991.
[62] Balcerowicz, *Transformation from Socialism to Capitalism*, p.263.
[63] Gomulka, p.91.

by nine prime ministers, one of whom served twice.[64] Up to the present Romania also changed seven prime ministers. However, popular unrest has affected to different extents the continuity and comprehensiveness of reforms. In Romania many policy changes were made as a result of pressure by trade unions, transforming the policies into stop-and-go policies.[65] On the other hand, successive governments in Poland have maintained a fairly unitary approach to reform, thus ensuring positive results.[66] The Polish authorities proved more resilient to strikes and popular unrest. Furthermore, the leaders were prepared to fall from power for adopting the right, but unpopular policies, rather than to sacrifice reforms for the sake of their own portfolio.[67]

Finally, public support for reforms was expressed through the mechanism of free elections and thus determined a change in the policy mix. It sanctioned reforms that were both too fast and too slow reforms. The negative results of the shock therapy on the standard of living of Poles led to the election of post-communists in 1993 and the adoption of more gradual policies with regard to privatisation. On the other hand, the disillusionment of the Romanian population with the results of the post-1996 democratic governments led to the rise of the nationalistic Greater Romania Party, the return of post-communists and the adoption of a more radical package of macroeconomic and microeconomic reforms. A similar trend was noticed in Polish politics at the 2001 election.[68] The return of post-communists in Poland also gave a new impetus to reforms and to preparations for EU membership, enhancing a political virtuous circle in Poland.

To sum up, popular support has had an important effect on the policy mix, the governments' attitude towards reform, external support and hence on the path and results of transition in general. Public support has influenced greatly the pace, the continuity, the comprehensiveness and credibility of economic reforms and more so in Romania than in Poland. Both rapid and gradual reforms create public discontent, but slow reforms, or no reforms at all, are bound to produce higher dissatisfaction or 'social fatigue', as in Romania. It is, thus, imperative that governments pursue measures to diminish social fatigue and to ensure public backing for their policies. International factors are equally important in creating and maintaining support for economic reforms as will be discussed below.

4.5 The role of international organisations

The path and results of transition depended to a great extent on support from the international organisations such as the European Union, the International Monetary Fund (IMF), the World Bank

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[64] *The Economist*, 27 October 2001, p.6.
[65] Dăianu, "Where Are Post-Communist Countries Heading to?", p.2; Jackson, "Political Incredibility and Bureaucratic Transition in Romania", p.553; Stolojan, "Policy Making in Romania", *Paper at a World Bank Conference in Romania*, p.4.
[66] *The Economist*, 27 October 2001, p.6; Balcerowicz, *Transformation from Socialism to Capitalism, p. 322;* European Commission, "2002 Regular Report on Poland's Progress towards Accession", p. 36-38
[67] Interview with Expert at the European Commission Delegation in Bucharest, Romania, 2000.
[68] Elections around the world, Elections in Poland, *http://www.electionworld.org/election/poland.htm.*

or the European Bank for Reconstruction and Development (EBRD). The present section will mainly refer to the impact of the international financial institutions (IFIs) mentioned above. The importance of the accession process in providing motivation and assistance for economic reforms will be discussed in chapter six.

The role of the IFIs in supporting economic reforms has been largely acknowledged by academics and practitioners and can be synthesised in three main points. First, the IFIs have provided financial means for the implementation of the macro-stabilisation and privatisation policies, as well as for easing the cost of transition.[69] Macroeconomic multilateral financing was offered, the lenders including the IMF. The IFIs provided Poland a stabilisation fund in 1990 to help establish currency convertibility.[70] This was a main element for the success of the shock therapy in increasing the number of private companies in the trade sector which became an engine of growth in the early 1990s in the Polish economy.[71] Furthermore, full currency convertibility was an important incentive for foreign investors in Poland and the lack thereof has constituted a deterrent to FDI in Romania.[72] For example, the IFIs also offered special balance of payments financing, which comprised debt write-offs, rescheduling and concessionary restructuring. Poland has benefited greatly from this type of assistance.[73] The IMF was essential for the resolution of Poland's debt restructuring talks with the commercial banks.[74] Debt restructuring was an important condition for fostering FDI. The World Bank and the EBRD also financed specific projects on concessionary terms and participated in privatisation in both countries.[75] Finally, the IFIs provided funds for the establishment of social safety nets necessary in order to attenuate the costs of transition.[76]

Second, the IMF and the World Bank have had an important structural impact in the Romanian and Polish economies. Training, consultancy and macro-economic policy advice were given to governments and civil servants.[77] For example, the shock therapy program applied in Poland was designed in co-operation with IMF representatives. IMF consultancy was also given for the 1991 and 1997 macroeconomic stabilisation programmes applied in Romania. The IMF consultancy has ensured a relative policy continuity in transition and the economic and political conditions set by the IFIs in the release the financial support acted as landmarks of the reform programmes.[78] The

[69] Lavigne, M., *The Economics of Transition from Socialist Economy to Market Economy*, MacMillan, London, 1995, p.234.
[70] Mohammed, A. A., "The Role of International Financial Institutions", Hardt, P. and Kaufman, R.F. (eds.), *East- Central European Economies in Transition*, M.E. Sharpe, New York, 1995, p.199.
[71] Balcerowicz, *Transformation from Socialism to Capitalism*, p. 239.
[72] European Commission, "Opinion on Poland's Application for Membership of the European Union", July 1997, p.27.
[73] Mohammed, "The Role of International Financial Institutions", p. 193.
[74] Balcerowicz, *Transformation from Socialism to Capitalism*, p. 235.
[75] Mohammed, "The Role of International Financial Institutions", p.201.
[76] Mohammed, "The Role of International Financial Institutions", p.201.
[77] Lavigne, *The Economics of Transition*, p.234; Mohammed, "The Role of International Financial Institutions", p.191.
[78] Stolojan, "Policy Making in Romania", p.7.

IMF support was equally a measure of the credibility of the reforms. As a result, more credibility was given to rapid than to gradual reforms.

Third, the IMF structural loans were a green light for credit from other financial institutions and for FDI.[79] The fact that Romania had not met the IMF requirements in the early 1990s was reflected in the low credibility for its reforms and low FDI inflows, at least up to 2000. On the other hand, the IMF initial support for economic reforms in Poland ensured high external credibility and further financial, technical and diplomatic support for transition and accession into the EU. Furthermore, the small number of standby agreements with Poland to the present is a strong sign of the early recovery of the Polish economy and of its capability of obtaining finance through other means. Moreover, the participation of the EBRD and the World Bank in privatisation can be seen as a guarantee of a good investment, thus attracting private foreign investors.[80]

Despite their generally positive impact on economic reforms, the technical and financial assistance from international organisations had certain limitations. A thorough assessment of these limitations is beyond the scope of this study but a few references will be made, nevertheless. First, the very concept of assistance has been rather ambiguous. For example, technical assistance was at times inadequate, provided by individuals or institutions who did not have enough knowledge of transition countries or just wanted to learn about business opportunities in the area.[81] Second, the financial means deployed for helping the CEECs were not sufficient, nor was the FDI induced by these.[82] The grant element in the assistance has been very low, there has been a huge gap between commitments and actual disbursements, and the credits offered generated further indebtedness. In Romania, the accumulation of foreign debts towards the late 1990s posed a threat in terms of inability to pay and this acted as a deterrent to FDI.[83] Third, assistance has been tied or conditional.[84] IMF conditionality is binding and shows a lack of flexibility. For example, in 1990 the IMF warned Poland of the withdrawal of support should inflation rise again.[85] In 1994 concerns were expressed by the Polish authorities that loans would be lost should privatisation be further delayed.[86] Between 1997 and 1999 the same conditionality led in Romania to an increased feeling that economic policy was devised outside the country.[87] The lack of flexibility of the IMF agreements combined with the incapability of several Romanian governments to fulfil the criteria

[79] Mohammed, "The Role of International Financial Institutions", p.193, p.197; *The Guardian*, 8 March 1993.
[80] Interview with Expert in Foreign Direct Investment in the CEECs, European Bank for Reconstruction and Development, London, 2002.
[81] Lavigne, *The Economics of Transition*, p. 238.
[82] Mohammed, "The Role of International Financial Institutions", p. 200.
[83] Isărescu, M., "Panel Discussion: Structural Change and Macroeconomic Policies", *Romania 2000- 10 Years of Transition*, 2000.
[84] Lavigne, *The Economics of Transition*, p.238 .
[85] The Guardian, 19 November 1990.
[86] *Keesing's World Record of Events*, No. 6, 1996.
[87] Stolojan, "Policy Making in Romania", p.2.

for obtaining financing led to several instalments being either annulled, or delayed.[88] This had an important negative impact on the course of macroeconomic stabilisation and structural reforms in Romania, as well as on the governments' external credibility. Fourth, there were shortcomings related to the administrative conditions and red tape required to release the funding, and there seemed to be a lack of an overall vision in the assistance offered to the CEECs.[89] Finally, the agreements with the international organisations did not address long run issues which had, however, a negative impact on people. Amongst such issues were the management of joint enterprises or the restructuring of the state-owned enterprises which could not be privatised.[90] Some of the limitations of the IFIs intervention were addressed towards the end of the decade *inter alia* through the promotion of measures aimed at economic growth rather than simply macroeconomic stabilisation.[91]

To sum up, despite certain limitations, the international financial organisations have had a largely positive impact on economic reforms. They have not only provided capital for government and investors and landmarks for reforms, but have equally increased the external credibility of the recipient countries. Poland has benefited greatly from the credibility given by the IMF at the beginning of transition whilst Romania's frequent failure to meet the criteria set by the IMF accentuated the negative perception of the country. External support for Poland contributed towards a virtuous political circle of determinants of transition and accession for most of the decade, while the lesser support for Romania and Romania's failure to meet the set criteria had a smaller potential for creating a virtuous political circle of determinants of transition and accession to the EU. As a result, Romania was in a vicious political circle until 1996.

4.6 The policy mix

Several studies of the determinants of transition to a market economy have concluded that the main differences between the transformation of the candidate countries were due to different policy measures as discussed in chapter two. However, this hypothesis seems to be contradicted by the successful transformation of both Hungary and Poland resulting from different policy mixes. Furthermore, the interplay between the policy mix, the initial conditions, the public support for reform and the international assistance seems to suggest that policy mixes alone cannot explain the variety of results in transition so far. The following section presents a brief analysis of the main policy mixes applied in Poland and Romania by various governments since 1989, aiming to capture the elements which have favoured Poland's early achievement of a market economy as defined by the Copenhagen criteria of 1993. These criteria included: liberalisation of prices, liberalisation of

[88] EBRD, *Investment Profile. Romania*, London, 2001, p.8.
[89] Lavigne, *The Economics of Transition*, p.238.
[90] Stolojan, "Policy Making in Romania", p.7.
[91] Bal, A., "Trăsături generale ale procesului de tranziție la economia de piață în țările foste comuniste" in Popa, I. (co-ord.), *Tranziție si reformă*, Editura Economică, București, 2001, p.31.

trade, stabilisation of the economy, reform of the financial sector, patterns of ownership, quality of human and physical capital, quality of infrastructure and establishment of free trade.[92]

Three periods are considered: 1990 to 1997, 1997 to 2000 and 2000 to 2002. These correspond roughly to the alternation in Romanian politics between the post-communists, the Christian democrats and the post-communists revamped as social democrats. With the exception of 1989-1993, when Solidarity formed the governments in Poland, the alternation between post-communists and democrats in Poland corresponded to the alternation in Romania. The Polish post-1989 transformation started with an impressive programme of shock therapy aimed at stabilising the economy. This approach adopted by the finance minister Balcerowicz set the tone and the pace of Polish transition but had to be abandoned due to loss of popular support. Between 1993 and 1997 the shock therapy was followed by a gradual approach to privatisation under post-communists. In 1997, the Solidarity Electoral Action (AWS), the heir of Solidarity, launched comprehensive reforms at the expense of some macroeconomic imbalances. The return of post-communists in 2001 led to emphasis on growth and job creation. For most of the transition period, Poland has been the 'Eastern European tiger', with impressive economic growth and increasing FDI annual inflows. However, towards 2000, Poland faced a slowdown and now Poland is making efforts to achieve economic recovery.

On the other hand, Romania started with a gradual approach and a search for macroeconomic stabilisation between 1990 and 1996. Between 1997 and 2000 the Romanian governments launched a shock therapy macroeconomic stabilisation programme and started the deep restructuring of the economy. Prudent macroeconomic policies, deep restructuring, economic growth and social protection have been promoted since 2000. Faced with the alternation of boom and bust for most of the decade, Romania is finally on an ascending path of economic growth and is making efforts to maintain the pace of restructuring in order to complete the transition to a market economy by 2004. So, what were the main policies which determined this economic performance in each country?

4.6.1 Two initial approaches to economic reforms: the Polish shock therapy and the Romanian gradual approach

The shock therapy initiated in Poland was formulated by the first post-1989 finance minister and deputy prime minister, Balcerowicz, with the support of the International Monetary Fund and the World Bank.[93] The package was also known as the 'Big Bang'. Its main policies were presented in chapter two and in appendix 4A.[94] The motivation of such a radical programme lay in several

[92] European Commission, "The Accession Criteria", *http://www.europa.eu.int*

[93] Bal, "Trăsături generale ale procesului de tranziţie", p.91; Balcerowicz, *Transformation from Socialism to Capitalism*, pp. 295-297.

[94] The main policies which formed the shock therapy applied by the Balcerowicz government in Poland in 1989 were: rapid price liberalisation in order to eliminate the excess of monetary supply and to internalise international prices; immediate openness towards foreign trade and FDI in order to eliminate the excess demand and to expose industries to foreign competition inducing a better allocation of resources;

factors. First, the previous gradual attempts to reform the system in 1980, 1981-1982 and 1988 had proven unsuccessful. The system could not be reformed, a radical transformation was needed. Second, the shortages and hyperinflation needed tough monetary and fiscal policies to stabilise the economy. Third, the structure of the system was the main cause of shortages and inflation through a vast misallocation of resources and thus a fundamental institutional transformation was needed. Fourth, the interplay between liberalisation, macroeconomic stabilisation and institutional change required a strong co-ordination of these policies. Fifth, psychological research also shows that people adapt better to radical changes rather than gradual ones, so a radical policy was preferred. Any delay or gradual approach would have accentuated the disequilibria and postponed indefinitely the deep restructuring of the economy, as happened in Romania. Finally, the period of extraordinary politics, when people tend to work for the common good in the aftermath of a change of such magnitude as the fall of Communism, tends to be short.[95]

However, experience has shown that this type of approach had several limitations. First, it ignored the inertia of the economic and political environment in transition. This was determined by the divergent interests of members of the ruling class and of the population, as well as by the lack of transparency of information. Second, the time frame was misperceived and it was wrongly supposed that social and economic processes can take place overnight. There was a huge gap between the expectations of the population in terms of increasing the standard of living and the early results of the shock therapy, which actually led to a worsening of living conditions. Third, the social and economic costs of such an approach had been seriously underestimated.[96] Thus, initially the shock therapy led to a fall in output and investment, a higher budget deficit, an increase in inflation and in unemployment and a drop in the standard of living.[97] Strikes and government reshuffles became common place and ultimately led to a change in power in 1993 and subsequently a more gradual approach to reforms.

convertibility of the national currency after a substantial devaluation to be used as an anti-inflationary anchor and instrument for stimulating exports; fiscal austerity, including subsidy cuts in order to balance the budget, diminish inflationary pressure and require enterprises to restructure; launch of rapid privatisation plans in order to determine a change in ownership and the creation of an entrepreneurial class conducive to increased efficiency, productivity and economic growth; financial and advisory support from the main international financial institutions to ensure the financial resources and the credibility necessary for reforms.(See Bal, "Trăsături generale ale procesului de tranziţie", p.85; Sachs, J. and Zinnes, E., "The Gains from Privatization in Transition Economies: Is 'Change of Ownership' Enough?", *CAER Discussion Paper No. 63*, February 2000, p.1.) To stop the inflationary spiral two anchors were used: fixed exchange rates and wage controls. The strategy also provided for the reduction and the restructuring of the foreign debt, as well as for a social safety net. A stabilisation fund of USD 2 billion was immediately made available by the IMF in support of the reform package. (See Balcerowicz, *Transformation from Socialism to Capitalism*, p. 296; Mohammed, "The Role of International Financial Institutions", p.199.)

[95] Balcerowicz, L., *Transformation from Socialism to Capitalism*, p.307 and p. 320.

[96] Bal, "Trăsături generale ale procesului de tranziţie la economia de piaţă în ţările foste comuniste", p. 85; Bunce, "Should Transitologists Be Grounded?", p. 61.

[97] European Commission, "Opinion on Poland's Application for Membership of the European Union", July 1997, *http://www.europa.eu.int/comm/enlargement/dwn/opinions/poland/po-op-en.pdf*, p. 24.

Despite its high short run cost in terms of the standard of living of the population, the shock therapy implemented in Poland has had several positive effects. This positive impact was accentuated by the fact that the main provisions of reforms were continued by the post-Balcerowicz governments until 1993.[98] For example, although the 1992 Olszewski government favoured a relaxation of the previous governments' stringent policies, they recognised the importance of retaining the confidence of the IMF and thus no other major alterations to previous reforms were made.[99] The 1992 Olszewski government only switched the emphasis from tightening inflation to halting recession through investment in state enterprises and encouraging exports. [100] the shock therapy programme eliminated the queues and shortages which had characterised the last years of communism. It achieved macroeconomic stabilisation, thus laying the foundations for attracting FDI and enhancing institution restructuring. It led to a huge improvement in the structure of relative prices and incentives for exports, input saving and quality enhancing innovations.[101] It encouraged the growth of the private sector which became an engine for economic growth in subsequent periods.[102] Furthermore, the debt restructuring and the macroeconomic stabilisation achieved under the program were part of the necessary conditions for attracting foreign direct investors. Finally, the program was accompanied by a prolific legislative programme which enhanced institution building, thus improving the investment climate.[103] Above all, the shock therapy program gained credibility and support for Poland by showing that the country was determined to break with the past and embark on irreversible reforms. This contributed to maintaining financial support from the international financial organisations and support by EU member states for Poland's integration into the European Union. It set the country on an irreversible path of transition, subsequent reforms benefiting from these early results. It created the conditions for a political virtuous circle which then enhanced the virtuous economic one. Furthermore, the shock therapy created the conditions for a full virtuous economic circle starting in 1993.

The anticipated elections of 1993 brought into power a coalition between the Democratic Left Alliance (SLD) and the Peasant Party (PSL). They were both pro-market economy but PSL was advocating more government intervention in the economy. The programme proposed by PM Pawlak aimed to achieve a reduction in unemployment, an increase in welfare spending, low interest rates to encourage investment and an increase in the debt relief to industry to accelerate restructuring of the economy.[104] Despite numerous governments reshuffles and regardless of an increased debate over privatisation between 1993 and 1997, the continuity of economic reforms

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[98] Balcerowicz, *Transformation from Socialism to Capitalism*, p. 322; *The Economist*, 27 October 2001, p.6; European Commission, "Opinion on Poland's Application for Membership of the European Union", p. 20
[99] *Keesing's World Record of Events*, No. 4, 1992.
[100] *Keesing's World Record of Events*, No. 4, 1992.
[101] Balcerowicz, *Transformation from Socialism to Capitalism*, p.322.
[102] Balcerowicz, *Transformation from Socialism to Capitalism*, p.322.
[103] Balcerowicz, *Transformation from Socialism to Capitalism*, p.322.
[104] *Keesing's World Record of Events*, No. 12, 1993.

was ensured through the 'Strategy for Poland' adopted in 1994. This strategy was aimed at export and investment led growth, continued disinflation and sound public finance. The comprehensive reforms envisaged ranged from reorganisation and decentralisation of public administration to the integration of the shadow economy into the official one.[105] The 'Package 2000' adopted thereafter focused on the requirements of EU accession and more specifically on the need for greater fiscal discipline and the channelling of national savings into investment.[106]

These policies were successful in bringing macroeconomic stabilisation and an end to recession. The Polish economy which started to grow in 1992 returned to its pre-transition output level in 1995 and by 1997 was still growing strongly.[107] Furthermore, the budget deficit had been reduced to just below 3% of nominal GDP. Thus, in its 'Opinion' on Poland's progress in preparing for EU membership, the European Commission considered that: 'In 1997 the policy framework for maintaining macroeconomic stability was largely into place'.[108] Furthermore, by 1997 privatisation was on its way. However, the main engine of privatisation and growth were the newly created enterprises, rather than the formal privatisation of state assets. This growth in new private enterprises was facilitated by the liberal rules on establishing a business, modest tax incentives, decentralised trade policy and currency convertibility.[109] Further discussion about the privatisation process will be included in chapter five in the larger context of the investment climate. All these achievements by the time of the 1997 elections set the stage for more comprehensive reforms in the Polish economy and society. They also placed Poland amongst the frontrunners of economic transition, a fact reflected in the 'Opinion' and in the recommendation by the European Commission that Poland would start accession negotiations as part of the then fast track candidates for EU enlargement.

On the other hand, given the initial conditions described previously, Romania adopted initially a gradual programme of reforms. Furthermore, the first measures taken by the post-1989 Romanian government were meant to improve the standard of living of the population. Not only did they not start any sort of economic reform, but they worsened the economic conditions of the country. First, the high demand for consumer goods which the Romanian population had been much deprived of during the last ten years led to a large increase in imports and a severe reduction of exports. This consumption boost was financed primarily by dis-saving and the depletion of foreign exchange reserves.[110] Furthermore, high imports spurred inflation and increased the budget deficit. Second, the government put an end to the rationing of electricity for households and continued to subsidise it. This was achieved at the expense of companies which saw cuts in their electricity supplies and

[105] European Commission, "Opinion on Poland's Application for Membership of the European Union", July 1997, p. 33.
[106] European Commission, "Opinion on Poland's Application for Membership of the European Union", p. 33.
[107] European Commission, "Opinion on Poland's Application for Membership of the European Union", p. 20.
[108] European Commission, "Opinion on Poland's Application for Membership of the European Union", p. 31.
[109] European Commission, "Opinion on Poland's Application for Membership of the European Union", p. 27.
[110] Dăianu, "Where Are Post-Communist Countries Heading to?", p.10.

thus had to cut their production. Furthermore, by subsiding electricity the waste of resources continued.[111] Third, the introduction of a five-day working week led to a further decrease in output.[112] Fourth, by accepting an increase in wages in the absence of an increase in output, inflation was fuelled, leading to macroeconomic instability and a further deterioration of the standard of living. Overall, while busy trying to improve the life of the population, the post-1989 Romanian governments achieved the opposite. These policies determined a vicious circle of economic development which then impacted on the political circle.

This rapid deterioration of the economy was the justification for a stabilisation plan supported by the IMF which was introduced at the start of 1991. This programme implied that liberalisation would take place in several phases and that stabilisation through monetary and fiscal policies would be moderate rather than strict. Price controls and trade restrictions were abolished gradually. The exchange rate was still not unified. Subsidies were gradually eliminated through a policy of hard budget constraints and monetary policy was directed towards positive interest rates. Privatisation was planned to take place in several phases, including large and small scale privatisation. The programme was meant to be supported through external sources of finance which would contribute to the modernisation of the economy. The programme also aimed to cover the social cost as soon as they occurred.[113]

The motivation for this gradual approach to reforms lay in several factors. First, given the poor state of the nation, the priority of the first post-1989 Romanian government was to increase the standard of living of the population rather than to take drastic measures regarding the economy. As a result, there were no serious attempts to deal with the macroeconomic imbalances before November 1990. Second, as Roman's attempt to introduce radical reforms filed, it was assumed that a transformation over a longer period of time would 'tame' the costs of the process and economic reforms would gain more supporters. Furthermore, there was no real change of power until the elections of 1996 and no political class with a genuine pro-market thinking. This made difficult the design and application of a revolutionary economic strategy such as the one suggested by Balcerowicz at the beginning of transition. The attempts of Roman to introduce radical reforms met popular protests. Moreover, the economy still had some reserves that would sustain populist measures in the short run. The crisis of the economy was still contained: inflation and unemployment were hidden, there was no foreign debt. Furthermore, foreign reserves and some 'soft' loans from international organisations could be used to create an impression of a better life, but only in the short run.[114] Additionally, the government gave in to the pressure of the population when more radical reforms were proposed. Finally, the two parliamentary and presidential elections

[111] Montias, "The Romanian Economy: A Survey of Current Problems", p. 183.
[112] Dăianu, "Where Are Post-Communist Countries Heading to?", p.10.
[113] Constantinescu, *Reformă şi redresare economică*, p.62.
[114] Stolojan, "Policy Making in Romania", p.4.

in May 1990 and May 1992 interfered with the course of reforms by increasing the bias towards populist measures.

Despite potential benefits, the gradualist approach ignored several factors. First, by disregarding the interaction between liberalisation, macroeconomic stabilisation and institutional change, this approach perpetuated the disequilibrium in the economy and failed to ensure superior economic mechanisms.[115] Second, the slow change consolidated the position of those who opposed it, making the pace of reforms even slower. The position of managers and employees in loss making companies was strengthened and their say in blocking the privatisation or the closing down of factories. A delay in the restructuring of the mining sector made worse the situation of the miners. This resulted in further protests such as the ones in 1991 which led to the fall of the Roman government.[116] Third, with no quick positive visible results, this approach perpetuated a negative image externally. This limited the support of international institutions available and thus lessened its impact on enhancing economic reforms and potentially creating a virtuous circle of economic development.

However, the IMF-based reform programme did not manage to stop inflation. It also brought to surface several growing tensions in the system. There were insufficient inflows of foreign capital to compensate for the low levels of domestic savings. The overvalued official exchange rate discouraged exports. The artificially low prices for energy and raw materials encouraged their over-consumption. Many exporters and importers found a way out by making barter deals, which introduced an implicit exchange rate into the functioning of the economy. Although this rate mitigated the pernicious effects of an overvaluation, it entailed considerable information and transaction costs. Moreover, capital flight and insufficient exports were becoming a matter of serious concern. Ameliorative measures were taken in the spring of 1992 through the increase of interest rates and of the refinancing rate of the National Bank. Furthermore, the exchange rate was devalued substantially and exporters were granted full retention rights, thus encouraging the repatriation of capital and trust in policy makers.[117] Moreover, the economy was confronted with a growing disequilibrium: increased inflation and budget deficit, the accumulation of foreign debt, a severe fall in output and a deterioration of the terms of trade.[118]

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[115] Bal, "Trăsături generale ale procesului de tranziţie la economia de piaţă în ţările foste comuniste", pp. 86-87.

[116] Stolojan, "Policy Making in Romania", p.10.

[117] Dăianu,"Where Are Post-Communist Countries Heading to?", p.10.

[118] The gradual price liberalisation spread the inflationary shocks over a longer period and postponed the need for restructuring. Furthermore, the lack of co-ordination in liberalisation increased the losses of enterprises which in some cases had to pay liberalised prices but were not yet paid liberalised ones. (See Constantinescu, N.N, *Reformă şi redresare economică*, p. 75.) The lack of full convertibility discouraged exports and thus affected negatively a very important source of economic growth. Furthermore, the basis for restructuring was feeble. By giving back to the workers their 'social parts' in the factories, a good basis for privatisation was wasted and a new inflationary push was created. (See Constantinescu, N. N., *Reformă şi redresare economică*, p. 75) The former state owned enterprises transformed into newly created commercial companies lacked capital for paying the wages. This led to recourse to expensive credits and thus

A change of policy was needed. A policy breakthrough was made in 1993-1994, when a more strict monetary and fiscal policy was adopted.[119] The results of these measures were much as expected. Inflation fell to an annual rate of 62% in 1994 (December on December) and there was a large reduction in the trade deficit.[120] Furthermore, the economy absorbed the shock of high positive real interest rates and of the exchange rate unification and there was no decline in output.[121] A major lapse of the strategy was, nevertheless, a more clear definition of property rights under privatisation. This could have had a very important impact on the size of capital inflows and the scope and intensity of restructuring.[122] The lack of deep restructuring led to only a fragile growth between 1995 and 1996 and to Romania relapsing into inflation. By the end of 1996 several worrying tendencies had emerged: a sharp rise in the trade and current account deficits, great distortions in relative prices, a continuous depreciation of the national currency, a rapidly increasing foreign debt, an increase in the unemployment rate and a consolidation of the grey economy.[123] By 1995, only little institutional change had appeared either through spontaneous processes such as massive land privatisation and the emergence of small private companies or through measures from above initiated by the government. These will be discussed in more detail in chapter five.

To sum up, by applying a shock therapy programme, Poland eliminated many of the distortions inherited from the previous system, achieving macroeconomic stabilisation and the start of restructuring of the economy. Rapid price liberalisation led to one inflationary shock rather than to several ones, full convertibility encouraged exports and hence economic growth, while the cut in subsidies forced firms to restructure and become increasingly competitive. A permissive legislative framework encouraged small private enterprises which became the engine of economic growth. Foreign investment contributed to privatisation and economic growth. On the other hand, the perpetual macroeconomic disequilibrium in the Romanian economy was largely induced by the incoherent policies, gradual liberalisation and the slow restructuring. As a result of the gradual price liberalisation, inflationary shocks spread over long periods, required high interest rates and hence discouraged investment. Lack of currency convertibility acted as a barrier to trade and slowed down the activity of the private sector. The persistence of subsidies maintained wasteful

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accumulation of debts. These, together with the arrears accumulated over time, constituted one of the most persistent brakes to the restructuring of the economy. (Ruhl, C., "Panel Discussion: Structural Change and Macroeconomic Policies", *Romania 2000. 10 Years of Transition*", 2000).

[119] This included a dramatic rise in the nominal interest rate which led to positive real interest rates; a substantial devaluation in several stages of the official inter bank market exchange rate which lowered it to more or less to the value prevailing on the grey market, thus considerably reducing the entry costs for those in need of foreign exchange; a strict control of the monetary base led to a reduced rate of money creation; Finally, a tighter fiscal stance aiming towards a lower budget deficit, when corrected for the removal of some explicit and implicit subsidies (See Dăianu, "Where Are Post-Communist Countries Heading to?", p. 12).

[120] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 12.

[121] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 12.

[122] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 12.

practices and budget deficits and delayed the restructuring of the enterprises. The gradual approach to reforms consolidated the inconsistencies inherited from the communist system and delayed the transition to a market a economy in Romania. It also induced low credibility and little international support for the government.

4.6.2 The democratic governments of 1997- 2000

Between 1997 and 2000 both countries were run by centre-right governments. The electoral victories of Solidarity Election Action and of the Democratic Convention of Romania were seen with much optimism, both externally and internally. Bold reforms were expected, as well as a new impetus in the quest for EU membership in Romania. However, in neither country did results meet expectations, as will be seen below.

The 1997 Polish elections brought to power a coalition of the Solidarity Election Action (AWS) and Freedom Union (UW) run by PM Buzek. With the macroeconomic policy framework in place, the Buzek government launched four giant reforms aimed at making the economy more efficient and more accountable. These reforms dealt with education, health care, local government and pensions. They were bold, but also caused short term economic pain and the public 'found them difficult to swallow in one gulp.'[124] Moreover, the record was mixed. The health care reform was considered a failure to the extent that a 'reform of the health reforms' was needed. The changes made in education and in the local government were a partial success whilst the most successful was the reform of the pension system.[125] These reforms were meant to ameliorate the budget deficit and to create conditions for sustainable endogenous economic growth by affecting supply side factors. The AWS government also imposed some restructuring on the sickest sectors of the economy, but not enough. The beginning of the reforms of the coal sector led to a fall in coal mining employment, from a peak of 420,000 to 145,000. However, experts thought that the industry should have lost another 70,000 before it could claim to be restructured.[126] Moreover, out of the forty mines resulting from mergers, only one was privatised.[127] In the steel sector the mergers of the least productive mills were postponed, thus keeping the mills inefficient.[128] Poland's failure to reform its steel mills caused rows with the EU. While a new Polish law had placed strict limitations on direct state aid, it had not yet stopped public sector companies from receiving help via tax and social-security write-offs.[129] This threatened to turn the political virtuous circle of determinants of transition and of EU accession into a vicious one.

[123] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 14; Constantinescu, *Reformă şi redresare economică*, p.79.
[124] *The Economist*, 27 October 2001, p. 10.
[125] *The Economist*, 27 October 2001, p. 10.
[126] *The Economist*, 27 October 2001, p. 13.
[127] *The Economist*, 27 October 2001, p. 13.
[128] *The Economist*, 27 October 2001, p. 13.
[129] *The Economist*, 27 October 2001, p. 14.

Some of the positive results of the AWS government were a rapid increase in exports and in FDI, a reduced trade deficit, increased competitiveness and productivity.[130] Poland continued to be the 'tiger' of Central Europe for the first years of the AWS government and to attract FDI, with a peak in 1998. However, a slow down in growth and increased disequilibria such as high unemployment and a high budget deficit characterised the end of the Buzek government.'[131] Already in 2000 the growth rate fell to 4% and a further fall to 2% was anticipated, the worst since Poland had emerged from the shock therapy. This slow down was partially due to cyclical factors, domestic and external, partially to economic policy mistakes.[132]

Poland was affected by the slowdown in the US and Europe, particularly in Germany which accounts for two thirds of her exports. Furthermore, Russia's financial meltdown caused also significant damage. Internally, the fall in consumer confidence reduced economic growth.[133] On the other hand, the consensus over monetary and fiscal policies had weakened.[134] Thus, the slowdown in investment was a result of high interest rates, a deep reduction in the preferential treatment for investors and a reduction in real depreciation write-offs. Another mistake was the policy of excessive limitations in domestic demand. Furthermore, the reduced competitiveness of the Polish manufacturing sector led to the appreciation of the zloty and restrictive credit rates in a situation when foreign entities relied on cheaper outside financing.[135] Finally, the Buzek government was accused of low efficiency of tax collection and the outflow of public funds to areas not controlled by the government or the parliament.[136]

The high budget deficit was partially a result of the AWS government and partially due to the left wing administration between 1993 and 1997.[137] Poland still had one of the most generous social benefits system, spread thickly and widely, a legacy of the communist system not dealt with well enough by former governments. Furthermore, the 2000 parliament had added recklessly to spending. All these had led to an awkward stand off with the Central Bank, whose governor, Balcerowicz, insisted that interest rates should stay high until politicians could demonstrate fiscally responsible behaviour.[138]

The third disequilibrium was growing unemployment, from 10% of the workforce in 1998 to 16 % in 2001.[139] The labour market was under pressure from two sides. As a result of firms trying to boost productivity and of job-protection clauses in privatisation contracts coming to expiry date,

[130] *The Warsaw Voice*, 13 January 2002.
[131] *The Warsaw Voice*, 13 January 2002.
[132] *The Warsaw Voice*, 13 January 2002.
[133] *The Economist*, 27 October 2001, p. 5.
[134] European Commission, "2002 Regular Report on Poland's Progress towards Accession",
, p.36, 38.
[135] *The Warsaw Voice*, 13 January 2002.
[136] *The Warsaw Voice*, 13 January 2002.
[137] *The Economist*, 27 October 2001, p. 5.
[138] *The Economist*, 27 October 2001, p. 5.

workers were laid off. Besides, some more job seekers were coming on to the market. These were the baby boomers of the early 1980s resulting from the imposition of the martial law. Increased unemployment was not only a social concern, a further strain on the budget and a sign of deterioration of the standard of living, but it was equally an alarming factor as regarded Poland's accession to the EU. Member states such as Germany and Austria were concerned that unemployed would flood their labour markets, thus making a strong argument for long periods of transition for the freedom of movement of labour.[140] This shows again how reforms affected EU membership and how the CEECs needed EU's support in order to ensure both political and an economic virtuous circle of development.

As a result, Poland was placed the tenth amongst the leading candidates for EU membership. Moreover, in 2000 there was for the first time talk of a possible first round of EU enlargement without Poland, as pointed out in chapter three. The 2000 Regular Report on Poland noted that 'a new momentum in reforms and in progress towards EU membership' was needed.[141] It was a signal that the virtuous economic circle needed a new impetus in order to remain a virtuous one, rather than to change into a vicious one. This new momentum appeared with the parliamentary elections of 2001 when the post-communists led by Miller won and formed the new government. The measures taken by the Miller government and the results so far will be discussed later.

How did the Romanian democratic governments of 1996-2000 deal with economic reforms? Given that the pre-1996 gradual policies had failed to ensure macroeconomic stability and institutional restructuring, in 1997 the Ciorbea government implemented a more radical reform program with the technical and financial support of the IMF and the World Bank. The most important challenge of the program was to pursue all policies in parallel and fully, a lesson learned from the previous attempts at reform. The main policies included: rapid privatisation of the former state owned enterprises; the liberalisation of the foreign exchange market and of other prices which were still administratively regulated; the cessation of subsidies, except for mining and agriculture; the creation of efficient markets, including the capital and land markets; macroeconomic stabilisation through a tight fiscal policy and a monetary policy which allowed a free flotation of the national currency; the provision of safety nets for those most affected by reforms. [142] Fifty enterprises per week were to be privatised. The restructuring of monopolies such as water and energy was a priority. Bank restructuring and privatisation was also crucial. The inter-enterprise arrears were to be eliminated.[143] By letting the currency float freely it was expected that exports would become more competitive and thus boost economic growth. Furthermore, by freeing the remaining

[139] *The Economist*, 27 October 2001, p. 5.
[140] *The Economist*, 27 October 2001, p. 5.
[141] European Commission, "2000 Regular Report on Poland's Progress towards Accession", p. 31.
[142] Gordon, L. (ed.), "Economic Policy Reform for Sustainable Development in Romania", *CAER II Discussion Paper No. 8*, 1998, p. 6; Constantinescu, *Reformă şi redresare economică*, p. 10.
[143] Gordon (ed.), "Economic Policy Reform for Sustainable Development in Romania", p. 6; Constantinescu, *Reformă şi redresare economică*, p. 10.

controlled prices a better reallocation of resources was anticipated and a push towards restructuring was envisaged. The cessation or reduction of subsidies was meant to diminish the budget deficit and to put pressure on firms to restructure. It was however, considered that agriculture and mining would still need protection for social reasons. The creation of efficient markets was a central point in accelerating transition to a market economy, with potential spillover effects. Both markets were necessary in fostering investment and especially FDI, with anticipated positive results on the institutional transformation. A 10% reduction of the government bureaucracy and a reduction of health and research and development budgets were accompanied by an increase in government revenues through the rise of certain taxes. The safety nets for those most affected by reforms were meant to eliminate the risk of social unrest that would lead to abandoning the reforms. Unfortunately, the government lacked a long term perspective in this matter.[144]

The results of the 1997 macroeconomic stabilisation shock programme were mixed and can be interpreted as the beginning of a second transformational recession.[145] On the positive side, the foreign exchange market began to function properly. The consolidated budget deficit was reduced to 3.7% of the GDP. The current account deficit shrank from 7.2% to 6.6% of GDP and the Central Bank's foreign exchange reserves soared to about USD 2 bn.[146] On the negative side, inflation did not fall, but reached a rate of 151%. GDP fell by -6.6%, much more than the expected -2%.[147] The large contraction of real credit considerably lowered the prospects for many small and medium-sized companies and it was a major factor in the fall of output. Finally, the high austerity led to a further expansion of the underground economy, which in turn led to demands for further fiscal relaxation.[148] All in all, the macroeconomic mix was not well balanced and the supply side response had been greatly overestimated. The loss of public support affected negatively the consistency and results of reforms, delaying the appearance of a strong virtuous circle in the political sphere.

Although the government pledged to privatise fifty enterprises per week, privatisation was delayed for several reasons. The post 1996 government was affected by internal squabbling and conflicts of interests which led to several reshuffles and thus impeded the continuity of reforms. The inter-enterprises arrears and the debts towards the state budget were deterrents to privatisation of the former state owned enterprises. The slow reforms in the banking system further delayed the improvement of payments. The fear of unemployment made privatisation contracts include clauses forbidding lay-offs, thus limiting the freedom of the new owners and the attractiveness of the sales in the first places. The privatisation of the energy sector, the hard-core of the economy, was politically sensitive and thus its delay maintained the resources misallocation within the economy.

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[144] L. Gordon, "Economic Policy Reform for Sustainable Development in Romania", p. 6; Constantinescu, N.N., *Reformă şi redresare economică*, p. 10.
[145] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 16.
[146] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 16.
[147] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 16.

Furthermore, the increased fiscal burden, corruption, bureaucracy and the expensive credits were not appropriate conditions for job creation by small and medium enterprises. Finally, the macroeconomic situation and the business climate in general were not conducive to FDI.[149] A break-through was made, however, in 1998. Following a more thorough understanding of the need to restructure in order to create the basis for lasting macroeconomic stabilisation and as a result of negative assessments by the EU, the Romanian government intensified the efforts to privatise large former state owned enterprises and achieved a few good deals with foreign investors. These included the sale of the national car manufacturer to Renault and the privatisation of the National Telecommunication Company.[150] Further discussion on the evolution of privatisation will be contained in chapter five, part one.

Economic recovery started during the Isărescu government.[151] Building on the results of the shock therapy applied in 1997 and on the new impetus in privatisation, this government focused primarily on promoting export led economic growth. The reforms proposed were part of the 'Medium Term Economic Strategy' which was in tune with the requirements of EU membership. Furthermore, the strategy was the subject of public debate and was endorsed by all political parties, thus promising a certain continuity of reforms, regardless of the results of the parliamentary elections of 2000. Strict financial discipline, an attractive business climate and appropriate rewards for work were the key directions of the programme.[152] For more details, see also appendix 4A. Overall, the investment climate began to improve under the Isărescu government.[153] Although the macroeconomic situation was still fragile and inflation had increased, there were signs of gradual improvement. The large reduction in the current account deficit, the full and timely repayment of all external obligations and the rebuilding of the official reserves were considered important achievements by the Regular Report of the European Commission.[154] Furthermore, the revival of exports and real GDP growth in the first half of 2000 were encouraging signs that recent policy efforts had a positive impact on the economy. However, the Report also noted that the authorities' ambitious plans to accelerate the privatisation and restructuring of the large loss-making public companies had proven difficult to implement. It was considered that the business investment climate was still affected by legal,

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[148] Dăianu, "Where Are Post-Communist Countries Heading to?", p. 16.
[149] Dăianu, "Where Are Post-Communist Countries Heading to?", p.16.
[150] EBRD, *Investment Profile. Romania*, EBRD, London, 2001, p.9.
[151] *Business Central Europe*, November, 2000.
[152] An important role in the achievement of growth and attracting FDI was attached to international financing and especially to the EU pre-accession funds. The reforms started with streamlining the state and a reform of fiscal policy designed to diminish the bureaucracy and corruption, as well as to create incentives to investment, both domestic and foreign. Corporation tax was reduced from 38% to 25% and VAT was unified at a rate of 19%, from 22% and 11% respectively. Furthermore, previous fiscal facilities granted to foreign investors were eliminated as will be seen in chapter five. While the simplification of the fiscal policy and the reduction of corporation tax were welcome, the renouncing of facilities was applied retroactive and harmed investors such as Renault. Moreover, the unification of VAT led to a temporary inflationary effect as it increased the price of goods previously taxed at a rate of 11%. (See *Adevărul*, 11 Ianuarie 2000).
[153] EBRD, *Investment Profile. Romania*, 2001, p.9.
[154] European Commission, "2000 Regular Report on Romania's Progress towards Accession", pp. 26-27.

political and economic uncertainty, a non-functioning financial system and unclear property rights, factors which had deterred foreign investors.[155]

To sum up, Poland and Romania's policies between 1997 and 2000 were determined greatly by the results of previous reform measures, by each governments' own agenda, as well as by public and international support. Having achieved macroeconomic stability, Poland was now ready for more comprehensive reforms, for enhancing exports and attracting FDI. Despite reshuffles and political bickering, Poland remained until 1998 the 'tiger' of Central and Eastern Europe and attracted in 1998 a record level of FDI. However, due to the poor co-ordination of reforms, several disequilibria resulted and compromised the virtuous economic of development towards the end of the period. Given its half way reforms at the beginning of transition, Romania still needed to stabilise the economy through a shock therapy type programme which led to a second transformational recession. By complementing the macroeconomic stabilisation programme with a bold privatisation programme, the government aimed to speed up marketisation and accession to the EU, thus creating the conditions for a future virtuous economic circle. The emergence of a full political circle was postponed partially due to the coalition infighting and the fall in support for radical reforms towards the end of the period. However, the Isărescu government managed to foster economic growth in 2000 by applying strict financial discipline, encouraging exports and improving the investment climate. This has formed the basis for a virtuous circle of economic development. FDI became an engine of privatisation and of economic development and attracting FDI became the main priority of the government as will be discussed in chapter five.

4.6.3 Post-communists back into power: 2001 onwards

The SLD government run by Miller came to power in Poland when the economy was slowing down. Already in 2000 the growth rate had fallen to 4% and a further fall to 2% was anticipated, the worst since Poland had emerged from the shock therapy.[156] Moreover, disequilibria such as a high budget deficit and high unemployment represented serious challenges. Thus, the objectives of the Miller government were to bring the budget under control and to create jobs. His programme called for the state to stimulate investment and the modernisation of the economy and could be summed up in four words: support, assistance, subsidies and guarantees.[157] The main way to reduce the budget deficit was by streamlining down the state, starting with the state agencies funded by the state but outside the control of government. Cutting social benefits was not favoured as that would drag down growth even further. Cutting taxes on businesses and increasing the flexibility of the labour markets were meant to spur economic growth. [158] The Miller government considered that a remedy for high unemployment was the use of public funds to protect and create new jobs. The introduction of tax breaks, of a system for the revaluation and depreciation of fixed assets and of

[155] European Commission, "2000 Regular Report on Romania's Progress towards Accession", pp. 26-27.
[156] *The Economist*, 27 October, 2001, p.5.
[157] *The Economist*, 27 October, 2001, p.7.
[158] *The Economist*, 27 October, 2001, p.7.

additional incentives were meant to guarantee a stable flow of foreign capital in the form of both direct and portfolio investments.[159] The SLD also vowed to concentrate its privatisation efforts on heavy industry. This was expected to boost the budget both by generating revenue and by removing the need for further subsidies. In the absence of strategic investors, stock market listing was considered an alternative for some companies.[160] Important conditions for overcoming the crisis were a better co-ordination of monetary and economic policies, further reductions of interest rates in line with European standard. A change was planned in privatisation by moving away from the practice whereby profitable companies were privatised and the loss making ones continued to be subsidised.[161] So, how did this programme work in practice?

The situation in 2002 was mixed. After the fall in economic growth experienced in 2001, 2002 can be considered a year of slow economic recovery characterised by an increase in industrial production, a low inflation and an improved balance of trade.[162] Data from the National Bank of Poland (NBP) shows that from June to September the GDP grew by 1.9% mainly as a result of increased domestic demand and exports.[163] However, much of the domestic consumption was based on previous savings, thus making the prospect of permanent recovery in Poland less likely.[164] Compared to 2001 revenues from privatisation dropped tremendously and so did the FDI inflow. This was partly because the privatisation process was close to completion. There were, nevertheless, prospects of a future increase to a level of USD 8 bn in 2005.[165] Entrepreneurs considered 2002 a positive year but an European economic survey noticed a deterioration of the investment climate. Furthermore on the positive side, export sales increased while unemployment decreased slightly. Finally, there were prospects for growth for 2003 and favourable forecasts for industrial production while exports showed that the economy was overcoming stagnation.[166] For a synthetic account of the policies pursued and their results, see also appendix 4A.

In Romania, the change of government through the 2000 elections did not lead to any fundamental modification of the ultimate goals of the economic policy. These were strongly restated through the approval of Romania's first pre-accession economic programme in mid-2001 and the conclusion of a new IMF agreement in October 2001.[167] Thus, the governmental economic program for 2001-2004 pledged to create conditions for securing economic growth, achieving macroeconomic stability and improving the investment climate. An average yearly growth rate of the GDP of 4.5-6% was envisaged during 2001-2004 by attracting foreign resources, especially FDI.[168] The

[159] See *The Warsaw Voice*, 13 January 2002.
[160] *The Economist*, 27 October 2001, p. 14.
[161] *The Warsaw Voice*, 13 January 2002.
[162] *The Warsaw Voice*, 19 December 2002.
[163] *The Warsaw Voice*, 19 December 2002.
[164] *The Warsaw Voice*, 19 December 2002.
[165] *The Warsaw Voice*, 19 December 2002.
[166] *The Warsaw Voice*, 19 December 2002.
[167] European Commission, "Strategy Paper 2002", *http://www.europa.eu.int*, p. 42.
[168] Guvernul Romaniei, "Programul de Guvernare", *http://www.gov.ro*,2000, *p.2.*

consolidation of macroeconomic stability was planned through structural reform and financial discipline. The aim was to diminish the budget deficit, to develop the domestic market, to encourage domestic production and speed up the privatization process. Efficiency and transparency were promoted in privatisation, as well as support for small and medium sized enterprises. The government also aimed for proper management of the public debt and of the current account deficit in order to gradually curb inflation to one digit by 2004. The improvement of the business climate was envisaged through providing a proper economic, financial and legal framework.[169] How did this work in practice?

A more balanced policy mix was adopted as a result of improved co-ordination among ministries and between the government and the Central Bank.[170] The Commission stated in its 2002 Report that: 'Some significant gains on macroeconomic stabilisation have been achieved over the last years. A more appropriate mix is decreasing inflation, while the growth has resumed and the external position remains sustainable. Considerable progress has been made on the creation of necessary market institutions. The ongoing overhaul of the banking sector, the successive improvements in the supervisory and regulatory framework for the financial markets and the advances in privatisation have progressively tightened enterprises financial discipline. Price and trade liberalisation, coupled with a significant adjustment of energy tariffs and important reforms of the tax system have set the stage for a more efficient allocation of resources. Restructuring is advancing in a number of sectors.'[171] The 2002 Commission report further noted that 'this progress, however, has not yet led to a significant acceleration in structural reforms, leading inter alia to delays in disbursements from the IMF'.[172]

To sum up, the 2000 slowdown of the Polish economy was a result of both cyclical internal and external factors and of certain policy mistakes. FDI fell due to privatisation being almost completed. A new commitment to a closer co-ordination of policies, financial discipline and job creation has the potential to foster economic growth, reinforcing the virtuous circle of economic development. Investment remains the engine of growth, be it private or public, foreign or domestic. The role of FDI and the policies to attract FDI will be discussed in chapter five. In Romania, a better co-ordination of policies, an emphasis on economic growth and on promoting investment though an attractive business climate, more determination to progress towards membership of the EU, a more supportive external environment and the knowledge that there is no more time to be wasted in transition have led to an improvement of prospects for the Romanian economy during the present Năstase government. This contributed towards placing Romania on a virtuous circle of economic development.

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[169] Guvernul Romaniei, "Programul de Guvernare", *http://www.gov.ro*, 2000, *p.2.*
[170] European Commission, "Strategy Paper 2002", p. 42.
[171] European Commission, "Strategy Paper 2002", p.70.
[172] European Commission, "Strategy Paper 2002", p.42.

4.7 Conclusion: Lessons from over a decade of economic transition

Chapter four has analysed the main determinants of the path and results of transition in Poland and Romania by referring to both the political and economic spheres identified in chapter one and represented graphically in diagram 4A. This assessment was needed because progress in economic transition has been a necessary condition for the progress in the EU accession process as shown in chapter three. In the political sphere, the governments' attitude towards reform, the public support and the international assistance are the main factors that have influenced the policy mix adopted and hence the economic outcomes. Furthermore, these factors interact with each other and have the potential to create either a virtuous or a vicious circle that impacts on the economic sphere through its influence on the policy mix, as shown in diagram 4A(a). A governments' positive attitude towards reform attracts international support which can contribute to ensuring public support as well, hence a radical policy mix. These political factors are similar to the ones identified in chapter three as political determinants of the accession process. In the economic sphere, economic reforms or the policy mix represent a condition for both transition and accession to the EU, as will be seen in chapters five and seven. They are affected and affect the political factors. They also interact with the factors in the economic sphere considered in this study: the level of FDI and of economic integration with the EU in general. These factors are shown in diagram 4A. A radical policy mix attracts international support but can shorten the public support. On the other hand, a credible programme of reforms can enhance FDI and trade, hence economic integration with the EU. Both political and economic factors depend greatly on the initial conditions that can create a strong potential for path dependency. Chapter four has also identified the need to attract FDI in order to complete privatisation and hence marketisation. The impact of the policy mix on attracting FDI is discussed in chapter five as part of the assessment of the investment climate in Poland and Romania. On the other hand, the impact of FDI on transition to a market economy and economic integration with the EU is discussed in chapter five, part two. Chapter three part two has also identified FDI as an element of economic integration with the EU while the impact of trade level integration with the EU on FDI will be assessed in chapter seven through the econometric model.

The comparison between the Polish and the Romanian experience during the first decade of economic transformation suggests certain possible conditions for successful transition to a market economy. Moreover, certain lessons can be learned by Romania in order to complete the transition to a market economy. First, the initial conditions have been more influential than initially thought and have created a certain potential for path dependency. They have greatly determined the initial public support for economic reforms, the governments' attitude towards reform, the external assistance and hence the policy mix adopted. Not only was the level of economic crisis in each country important, but also the state of the nation, the democratic experience prior to 1989 and the existence of an economic institutional framework that could foster a quick transition towards market economy. A realistic assessment of the initial conditions is crucial for the design of the most appropriate policies. Furthermore, the results of transition so far have to be interpreted relative to the initial conditions of each country, taking in consideration the path dependency and the path shaping potential of each country.

Each government's attitude towards reform has acted as the driving force of the transition process and has influenced the policy mix, the public and the international support for economic reforms. However, contrary to other opinions, governments' attitude towards reform has been subject to influence from the other political factors and from the initial conditions. Public support led to changes of governments and in each government's attitude towards reform. International support acted as a catalyst and thus enhanced governments' willingness to transform the economy. All in all, it was necessary that political class had a good understanding of the initial and final points of transition and a good vision of the aims of the process. It was important for governments to have a clear blueprint of the processes involved, their sequencing, interconnectedness and costs of transition.[173] Furthermore, policies needed to be credible, continuous and implemented by accountable and professional teams.[174] It was important that windows of opportunity such as revolutions or elections were used to apply the necessary reforms for the economy that could have high costs in the short run but high benefits in the long run.[175] Finally, the government should ensure the support of the public and of international organisations in order to maintain a virtuous political circle with a positive impact on the economic sphere.

Public support for economic reforms is a necessary condition for their continuity, success and credibility. However, popular support has been volatile and has acted at times as a brake rather than a catalyst for transition. It has also exacerbated the perceptions of internal insecurity with negative influence on the accession process as will be discussed in chapter six. Given this volatility, it was necessary for governments to use the windows of opportunity of elections to pursue firm reforms.[176] Furthermore, it was important that the authorities correctly informed the population about the timing and extent of the transition costs so that the gap between expectations and realities and the scope for protests could be diminished. Safety nets for the most affected segments of the population should ensure that the standard of living is not dropping below the acceptance level, thus decreasing the danger of popular unrest. Finally, the 'social fatigue' with reforms can be counteracted by providing strong long term rewards for high short terms costs. A main measure of these rewards is the prospect of EU membership. The role of the EU in providing a prize for the efforts of transition is discussed in chapter six and assessed quantitatively in chapter seven.

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[173] Constantinescu, *Reformă şi redresare economică*, p.246; Adumitrăcesei, D. and Niculescu, N.G., *Post-Socialist Romanian Economy. Where to? How? Why*, Editura Economică, Bucureşti, 1999, p. 87.
[174] Stolojan, "Policy Making in Romania", p. 12; Dăianu, "Where Are Post-Communist Countries Heading to?", p.13; Adumitrăcesei and Niculescu, *Post- Socialist Romanian Economy*. p. 88; Balcerowicz, *Post-Communist Transition: Some Lessons*, 2002, p.48.
[175] Balcerowicz, *Transformation from Socialism to Capitalism*, p.311.
[176] Balcerowicz, *Transformation from Socialism to Capitalism*, p. 312; Constantinescu, *Reformă şi redresare economică*, p.248.

The financial and technical support offered by the international organisations has played an important catalytic role in transition. The IMF's early support for the shock therapy programme in Poland enhanced the credibility of reforms and provided financing for macroeconomic stabilisation, a *sine qua non* condition for the success of the programme. The Polish debt rescheduling constituted an important condition for attracting FDI while financing by the World Bank, the EU and the EBRD has speeded up privatisation. For Romania, the IMF conditionality acted as a guarantee of a certain continuity in reforms but the inability of the Romanian authorities to meet the set requirements led to a loss of credibility of reforms and delays or annulments of IMF payments. The IFIs contribution to privatisation especially since 1997 has contributed towards the emergence of a virtuous circle in the political sphere. The EU's support and the prospect of EU membership have also affected positively the progress of transition by providing motivation for economic reforms, financial means and technical assistance. The role of the EU in enhancing security and FDI in Poland and Romania will be further investigated in chapters six and seven. More investment is needed and enhanced co-operation with the IFIs and their requirements. Loans should be geared towards the real needs of reforms, including ensuring social safety nets, funding human capital improvement and comprehensive reforms in areas such as pensions and education. Investments in infrastructure and in the privatisation of large enterprises should be complemented by credits and development funds for small and medium enterprises. The IFIs' assistance has to continue to contribute towards attracting FDI.

Finally, the policy mix has had a crucial influence on the pace of transition and has been greatly affected by the political factors considered here. The initial conditions, the public support, the governments' attitude towards reform and the international backing have led to the early adoption of a radical programme in Poland and of a gradual one in Romania. Furthermore, the results of these early policy mixes have impacted not only on the subsequent choices of policies, but also on public support, the governments' attitude towards reform and on international support. In Poland, the 1989 shock therapy programme lost popular support and led to the election of post-communists in 1993, hence a change in the governments' attitude towards reform and in the policy mix. In Romania, the failure of the post-communists to achieve credible results through the gradual approach to reforms led to the election in 1996 of the Democratic Convention of Romania, an increased international support and the adoption of a shock therapy type macroeconomic stabilisation programme accompanied by the start of a deep restructuring of the economy. These changes contributed towards changing the vicious circles in the political and economic spheres into ambiguous circles and later virtuous circles.

Regarding the policy mix, the analysis has concluded that despite short term negative effects on the standard of living of the population, a radical macroeconomic stabilisation was preferable to a gradual one which postponed both the stabilisation and the restructuring of the economy. It was important that macro-stabilisation and liberalisation were accompanied by restructuring and promotion of economic growth. Privatisation needed to be not be an aim in itself, but to encourage ownership forms that increased efficiency and encouraged the creation of a significant middle and managerial class.[177] Restructuring and closing the loss making former state owned enterprises needed to be a priority of the government. This has had the potential to decrease government expenditure through the cutting of subsidies and increase revenues through the privatisation price. Furthermore, restructuring leads to a more efficient reallocation of resources and to economic growth. A slow restructuring can compromise macroeconomic stability and hence deep restructuring is recommended with the contribution of FDI.[178]

It was necessary that the restructuring of industry and services was based on new technologies while FDI can be an important means for increasing efficiency and productivity.[179] Internal accumulation of capital was equally necessary and it was important that small and medium enterprises were supported and well promoted.[180] Simple, transparent and low taxation may ensure high rates of investment, domestic consumption and an incorporation of the grey economy into the official one. Furthermore, an increase in the tax basis can maintain the necessary revenues for the budget, thus diminishing fears of high budget deficits and increased inflation through lax monetary policies. Low interest rates may encourage credit expansion for both large investors and small and medium enterprises, provided that the economy is liberalised and stabilised. It was important that reform programmes catered not only for short run objectives, but equally included directions for long term development. It was necessary that strategies to enhance economic growth in the long run were designed, together with commercial policies and the development of strategic industries. Export competitiveness needed to be encouraged through specific industrial policies. The role of foreign direct investment in reforms had to be clearly defined and coherent measures designed in order to foster foreign direct investment. This issue will be addressed in chapter five.

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177 Constantinescu, *Reformă şi redresare economică*, p. 89.

178 Dăianu, "Where Are Post-Communist Countries Heading to?", p.22.

179 Bal, "Trăsături generale ale procesului de tranziţie", p.117; N. Stern, "The Future of Economic Transition", *EBRD Working Paper No. 30*, 1998, pp. 12-13.

180 Bal, "Trăsături generale ale procesului de tranziţie la economia de piaţă în ţările foste comuniste"; Constantinescu, *Reformă şi redresare economică*, p. 91; N. Stern, "The Future of Economic Transition", p.12.

Appendix 4A. Policies pursued by different governments in Poland and Romania

	Poland			Romania		
Period	**Policies**	**Achievements**	**Limitations**	**Policies**	**Achievements**	**Limitations**
1989-1992/1993	**Shock therapy**			**Gradual reforms**		
	*rapid price liberalisation *immediate openness towards foreign trade and FDI * convertibility of the national currency after a substantial devaluation *fiscal austerity, including subsidy cuts * launch of rapid privatisation *financial and advisory support from the IFIs	*elimination of queues and shortages *macroeconomic stabilisation *private sector growth *institution building * external credibility of reforms *external financial support for reforms	*initial fall in output and investment *initial high budget deficit *initial increase in inflation *increase in unemployment *political instability due to strikes and government reshuffles	*import liberalisation *end of energy rationalisation and increased energy subsidies for private consumption *reduced working week	*short term increase in the standard of living * unemployment kept under control	*high inflation *increased budget deficit *increased trade deficits *depletion of foreign currency reserves *fall in production
1991 1992	*relaxation of the stringent fiscal and monetary policies but no other major changes * investment led growth * export lewd growth			**IMF mid-of the road reform programme** * a tightening of fiscal and monetary policy, although real interest rates remained highly negative *a tax based income policy *currency devaluation *the introduction of a two-tier exchange rate system through the initiation of an inter-bank foreign exchange auction system.		*persistent inflation *discouraged exports *capital flight *increased budget deficit *postponement of restructuring *accumulation of inter-firms debts *lack of external credibility of reforms
1993-1996/1997	**Gradual reforms**			**Gradual reforms**		
1993	*increased welfare spending *reduction of unemployment			*strict monetary and fiscal policies	*fall in inflation *fall in the trade deficit	*lack of strategy for privatisation *unsustainable growth

1994	**low interest rates* *increased debt relief to industry **The Strategy for Poland** *continued disinflation *sound public finance *investment led growth * export led growth *integration of the shadow economy into the official one	**By 1996** * high economic growth *reduced budget deficit *framework for maintaining macroeconomic stability in place *privatisation on its way	**By 1996** *high unemployment *poor large scale privatisation			**By 1996** *increased foreign debt *distortion in relative prices *increased unemployment rate *consolidation of the grey economy *continuous depreciation of the national currency *poor privatisation
1997-2000/2001	**Gradual approach**			**Radical approach**		
1997	**Comprehensive structural reforms** *health reform *education reform *local government *pension reform *restructuring of the mining and steel sectors	*positive economic growth *increased FDI *increased exports *reduced trade deficit *increased competitiveness and productivity	*poor co-ordination of policies	**Radical IMF based macroeconomic stabilisation programme** * rapid privatisation of the former state owned enterprises. * liberalisation of the foreign exchange market and of other prices which were still administratively regulated * cessation of subsidies, except for mining and agriculture * creation of efficient markets, including the capital and land markets * macroeconomic stabilisation through a tight fiscal policy and a monetary policy which allowed a free flotation of	*proper functioning of the foreign exchange market *reduction in the budget deficit *reduction of the current account deficit	*persistent inflation *expansion of underground economy *fall of output *poor credits for small and medium enterprises

			By 2000 *reduced growth *high budget deficit *growing unemployment *increased trade deficit	the national currency *provision of safety nets for those most affected by reforms. **1998** *enhanced large scale privatisation **By 2000** *investment and FDI led growth *financing by the EU *streamlining of the state *reform of fiscal policy (corporate tax cut, unification of VAT) *fighting corruption	*positive economic growth *persistent FDI *reduction of the current account deficit *foreign debt timely repayment	**By 2000** *Still legal, economic and political uncertainly affecting the investment climate *uncertain property rights non-functioning financial system
2001-2002	**Growth promoting programme**			**Growth promoting programme**		
2001-2002	**Support, assistance, subsidies and guarantees** *investment led growth *streaming down the state *tax cuts and tax breaks *job creation through public funds *fiscal and financial incentives for FDI *privatisation of heavy industry * better co-ordination of fiscal and monetary policies *interest rates cuts	**By 2002** *increased domestic demand *increased production *low inflation *improved balance of trade	*fall in economic growth **By 2002** *fall in revenues from privatisation	**Growth promotion, macroeconomic stabilisation, improvements in the investment climate** * investment and FDI led growth *financial discipline and structural reforms *small budget deficits *transparency in privatisation *support for small and medium sized enterprises *one digit inflation by 2004 *control over the current account deficit and the public debt	**By 2002** *improved co-ordination of policies *gains on macroeconomic stabilisation *increasingly efficient allocation of resources *restructuring advanced in several sectors	**By 2002** *not significant enough acceleration in the structural reforms

CHAPTER FIVE
FOREIGN DIRECT INVESTMENT IN POLAND AND ROMANIA

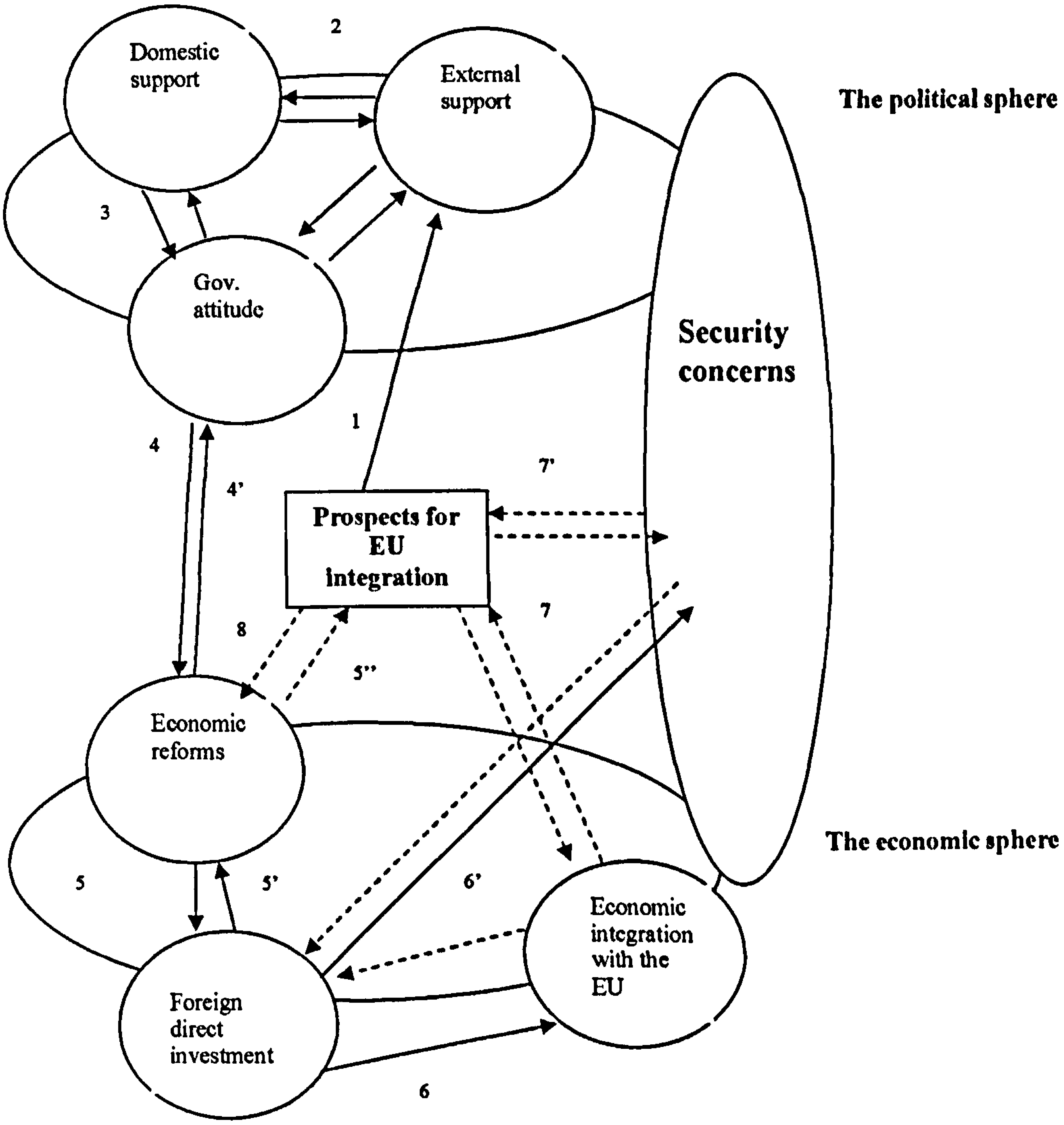
5.1 Part one: The investment climate

Chapter four has analysed comparatively the experience of economic transition in Poland and Romania by assessing the interplay between the initial conditions, governments' attitude towards economic reforms, the internal support for reforms, the assistance by international organisations and the policy mix. It has offered a comparative assessment of the main policies pursued in three different periods. Furthermore, it identified FDI as a necessary means of privatisation. Lessons for completing economic transition in Romania were drawn, and the need to encourage further FDI in both countries was emphasised.

This chapter is structured in two parts. Part one assesses comparatively the investment climate in Poland and Romania, while part two investigates the impact that FDI has had so far in each country. By assessing the FDI impact on transition to a market economy and economic integration with the EU, this chapter concludes the analysis of the determinants of economic transition in Poland and Romania. This chapter also investigates whether FDI can lead to a virtuous circle in the economic sphere as in diagram 5A(a). The first aim of this part is to assess the extent to which political factors have influenced FDI related policies in Poland and Romania, thus exemplifying the interplay between the political and the economic spheres assumed in this study. The second aim of this first part is to investigate the FDI related policies implemented in each country and their impact on the investment climate. While other locational factors such as geographical position or natural resources are given, policies are determined by governments and therefore include a certain scope for change. The policies analysed are: macroeconomic stabilisation, privatisation and FDI promotional policies (in a broad sense). A comprehensive quantitative assessment of the FDI determinants in the ten CEECs candidate for EU membership will be conducted in chapter seven.

The second part of this chapter aims to investigate the impact that FDI has had so far in Poland and Romania. The impact is assessed at four interdependent levels, each related to one element of the political or economic circle identified in this study: transition to a market economy or economic reforms, integration with the EU, standard of living and thus internal security concerns and finally, FDI. These elements are presented in diagram 5A. The FDI impact on enhancing further FDI is likely to give an indication of the extent to which a potential virtuous circle can become self-fulfilling. Lessons are drawn regarding the best ways to attract FDI and to enhance its impact in the host economy.

Diagram 5.A[1]
FDI determinants and impact in Poland and Romania



a) Arrows 6, 7, 8, 5 and 8 and 6', 7', 8, 5 show two alternative virtuous circles in the economic sphere induced by FDI.
b) Arrows 5 and 5' synthesise the bi-directional relationship between economic reforms and FDI which creates a strong potential for path dependency in attracting FDI, economic transition and in accession to the EU.
c) Arrows 1, 2, 3, 4 show how a virtuous political circle induces an economic virtuous circle by creating the necessary conditions for attracting FDI.

Legend:

——▶ relationships that are addressed in chapter five

------▶ relationships that are addressed in other chapters

[1] This diagram draws on diagram 1A as presented in chapter one.

5.1.1. The theoretical framework of the chapter

FDI is a necessary means for completing economic transition in Poland and Romania. Furthermore, through its impact on economic reforms and economic integration with the EU, FDI is likely to induce a virtuous circle of economic development, while the lack thereof is likely to determine a vicious circle, as identified by this study. That is why creating an attractive investment climate has become a major goal of governments of transition countries. The role of other factors aside, the scope and impact of FDI so far is to a certain degree an expression of the extent to which governments have applied the right mix of economic policies in general, and FDI specific policies in particular, to attract the right type of investors.

Investors tend to be motivated mainly by market-expansion, rent-seeking or a combination of the two. While aggregate level data cannot distinguish precisely between the two reasons for FDI, several surveys on investors in Poland and Romania identify both market size and low costs as prime motives for targeting these economies.[2] If both countries offer low costs and relatively large markets in terms of population, which are the other factors which determine FDI? These factors constitute the investment climate and are part of the locational advantages identified by Dunning's OLI paradigm which was introduced in chapter two. As ownership advantages do not depend on the host country, they are not part of this assessment. Location and internalisation incentives are considered in chapter seven which makes a quantitative analysis of the determinants of FDI in Poland and Romania within the framework of ten CEECs candidates for EU membership. The qualitative analysis conducted in this chapter is based on the role played by location factors within the OLI paradigm, and within these, on the role of government policies in creating an attractive investment climate.

There is no generally agreed definition of what actually constitutes the investment climate. The closest to giving a definition is the 1998 EBRD 'Transition Report' which states that: 'An investment climate conducive to FDI goes beyond macroeconomic stability and the non-discriminatory treatment to foreign investors. Foreign investment requires an ability to exercise corporate governance without arbitrary bureaucratic interference, a transparent regulatory and legal environment, effective markets and sound financial institutions.'[3] Policy papers and reports generally refer to several components as part of the investment climate. Thus, the EBRD 'Investment Profile' usually refers to investment policy and incentives, taxation, privatisation and restructuring, markets and trade.[4] Furthermore, the country image and the country risk capture the overall quality of the investment climate. The focus here will be

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[2] ECE, *East West Investment News*, No. 3, 1995, p.12; Denuţa, I., *Investiţiile străine directe*, Editura Economică, 1998, p.94; WIR, *Climatul investiţional din România*, Bucureşti, December 1996, p. 21; *The Warsaw Voice*, 8 April 2001.
[3] EBRD, *Transition Report*, EBRD, London, 1998, p.82.
[4] EBRD, *Investment Profile. Romania*, 2001, EBRD, London, p.2.

on macroeconomic stabilisation, privatisation, promotional policies and on the country image. Some of the remaining factors will be considered in chapter seven.

Why does this study emphasise the investment climate and policies to improve it? First, the investment climate is part of the locational factors from the OLI paradigm presented in chapter two. Second, the investment climate is a dynamic concept and thus there is enough scope for changes through specific policies which are country determined. It is this variability of policies which is likely to account for the differences in the volume and the impact of the FDI in Poland and Romania. It is also this policy flexibility which is likely to offer solutions for enhancing further FDI. Third, other locational factors are difficult to quantify very accurately or are results of changes within the main economic policies considered. Finally, the relationship between FDI and the policies considered is bi-directional, represented in diagram 5A(b). Thus, the assessment of the role of government policies in enhancing FDI is part of the analysis of the vicious circle identified by this study.

This study assumes that a 'visible' rather than an 'invisible hand' is needed in transition economics in general and in attracting FDI in particular. This assumption relies on several reasons. First, it is important that FDI contributes to the pursuit of the general economic policy of each country with a positive impact on economic transition, integration into the EU and achieving better standard of living. Specific policies can attract the investors most likely to generate a positive impact on the host economy. Second, the CEECs compete amongst each other in attracting foreign investors and therefore specific policies can contribute towards creating an increased attractiveness of the investment climate. Finally, the complexity of the transition process requires the setting of several priorities. This is the case, for example, with the need to attract FDI in infrastructure as a way to enhance the attractiveness of each country.

Three main types of government policies that can help create an attractive investment climate and thus enhance FDI and its potential impact on the economy, will be considered here: macroeconomic policies, institution building and promotional policies. The borders between these types of policies are blurred, but a distinction is necessary in order to identify the main effects of each of these policies. As an evaluation of the first two policy types has been the object of chapter four, the present chapter focuses on the role of these policies in creating a business climate conducive to FDI. First, the government has a leading role in ensuring the liberalisation of the economy in terms of prices, trade and investment and administers the results of this process though macroeconomic stabilisation policies. Second, the government has a significant say in defining the role of FDI in the economy through the institution building process.[5] Hence, the chosen path of privatisation influences the type and nature of

[5] UNCTAD, *World Investment Report*, UNCTAD, Geneva, 2000, p. 165; Kalotay, K., "The Contribution of FDI Revisited", *Journal of World Investment*, Vol. 2, No. 2, 2001, p.262.

potential FDI involvement and gives a sign of government's commitment to market economy.[6] Although institution building refers to more than privatisation, in this chapter the focus lies on the privatisation policy mixes. A broader definition of institution building is adopted in part two of the present chapter and in chapter seven.[7] For example, part two refers to bank reforms as part of the institution building, this time focusing on the FDI impact. In the econometric model in chapter seven institutional reforms encompass not only large and small scale privatisation, but also competition policy, banking reforms, enterprise restructuring and the development of stock markets as quantified by the EBRD transition indicators. Third, the state ensures the legislative framework for investment and can apply active policies for attracting and promoting FDI.[8] These polices include marketing the country as an attractive destination of FDI, creating institutions which support investors and granting financial, fiscal and other incentives which typically divert investment from other destinations.[9] Finally, as chapter four has argued with regard to policies in general, the FDI related policy mix is likely to have been influenced by factors in the political sphere such as the government's attitude towards reform, the public support and the international organisations. This study claims that there is a continuous interplay between the political and the economic spheres, so the impact of political factors on governmental policies, and hence the investment climate, will be assessed. This approach is justified equally by the fact that the public and the official attitudes towards FDI are part of the risk assessment and hence of the country image, an important determinant of FDI, as will be seen in the last section of this part.

5.1.2 Foreign direct investment determinants in the political sphere

Openness towards FDI is a positive signal for foreign investors and is a condition for pursuing policies which enhance the attractiveness of the investment climate. In Poland and Romania the government's attitude towards FDI has improved throughout the first decade of transition and has been subject to influences from both internal and external factors. Furthermore, the initial openness towards FDI has impacted upon the way FDI was perceived both by the public and officials. Elections, public perceptions and constraints by international organisations have affected the pace or the scope of the three main policies considered: macroeconomic stabilisation, privatisation and FDI promotion. This subsection aims to reveal how the official and the public attitude, the initial openness towards FDI and the international organisations have interacted and affected the mix of FDI related policies. A similar

[6] Barrell, R. and Holland, D., "FDI and Enterprise Restructuring in Central Europe", *Economics of Transition*, Vol. 8, No. 2, 2000, p. 484; Lavigne, M., *The Economics of Transition from Socialism to Market Economy*, MacMillan Press, London, 1995.

[7] The World Bank includes in institution building: legislation and its enforcement, financial institutions, governmental reforms, education and health and openness to trade and foreign investment. (cited in Grabbe, H. and Hughes, K., *Eastward Enlargement of the EU*, The Royal Institute of International Affairs, London, 1997).

[8] Mah, J. S. and Tamulaitis, D., "Investment Incentives in the Central and Eastern European Transition Economies", *Journal of World Investment*, Vol.1, No. 1, July 2000, p.1; Bonciu, *Atragerea şi monitorizarea investiţiilor străine directe*, Editura Ştiinţifică, Bucureşti,1997,p.25; Mazilu,A., *Transnaţionalele şi Competitivitatea. O perspectivă Est Europeană*, Editura Economică, Bucureşti, 1999, p.245.

matrix of determinants was used in chapters three and four and in the theoretical framework of the dissertation.

The initial conditions

Openness towards FDI was part of the Washington Consensus which made the blueprint of economic reforms, a 'mantra' of the donor community centred around Washington and presented in chapter two.[10] These policies were adopted initially by Poland and were implemented subsequently in different manners in other transition countries as pre-conditions for obtaining financing from the international organisations, as discussed in chapter four. Despite the international agreement over the CEECs's need for FDI, attracting foreign investment has been a relatively contested issue in both Poland and Romania. However, at the beginning of transition Poland seemed more open, while the Romanian officials seemed to be reluctant towards foreign investment. Thus, in 1990 the Polish government was already planning to encourage private investment by allowing for repatriation of profits, tax holidays and union-free work places. Moreover, the Polish authorities claimed support from the international community for the reduction of the foreign debt as a means of assisting the balance of payments and encouraging FDI. [11]

In Romania, the initial official attitude towards FDI involvement in the economy was negative. In 1990, officials said that the country would have no need of foreign capital if the next administration succeeded in modernising the economy and retraining the workforce. [12] This rhetoric showed very poor understanding of the needs of an economy with a poor financial system and scarce domestic capital. Some investment was welcome in small-scale private enterprise, but the state would retain its control on the levers of economic power and no foreign investor would have more than 49% of a Romanian enterprise. The government slogan was: 'We want control in Romania'.[13] This attitude was not conducive to active policies to promote and attract foreign investment that would have perhaps significant impact in the Romanian economy. Meanwhile, the positive Polish attitude towards FDI was a good start but was affected greatly by subsequent factors, as will be seen below.

The official attitude towards FDI

During elections, political interests clashed and the issue of FDI was used as a 'political weapon'. However, the official attitude towards foreign investment has improved over time in both countries. The fear of serving international capital interests, rather than domestic ones, was used by the opposition parties in the 1991 Polish elections. These accusations gained even more supporters after

[9] Bonciu, *Atragerea şi monitorizarea investiţiilor străine directe*, pp.25-26, 31, 54.
[10] Sachs, J., Zinnes, C., Y. Eliat, "Benchmarking Competitiveness in Transition Economics", *CAER II Discussion Paper 62*, February 2000, p. 1.
[11] *The Guardian*, 21 December 1990.
[12] *The Guardian*, 31 January 1990.

the 1993 elections, given that the radical reforms had already led to a fall in the standard of living. The new PM at the time accused the previous government of acting against the national interest by selling the 'family silver'.[14] This contributed to a serious slow down in the privatisation process so that the mass privatisation bill was only approved in 1995.[15] After the change of mood of 1995, the post-1997 democratic government with a pro-business coalition partner, Freedom Union, was then expected to increase the FDI inflows. Indeed in 1998 Poland became the main destination for FDI in Central Europe with USD 6.3 bn. inflow.[16] Furthermore, the Polish Government had already in 1998 a coherent plan for privatisation and attracting FDI up to 2001. The medium term economic strategy, designed by the ministry of economy in October 1999, mentioned FDI as one of the factors and conditions of development.[17] Finally, the post-2001 Miller government pledged to encourage FDI through improving the business climate.[18]

On the other hand, the first declaration on the desirability of FDI in Romania was made in the electoral year 1992.[19] Later, the need for FDI was emphasised by the Democratic Convention (CDR) in the electoral campaign in 1996. The Ciorbea government made specific reference to FDI as a means for pursuing privatisation and generating economic growth.[20] Finally, in the 2000 Romanian parliamentary elections the issues of the so called 'strategic privatisations' of the former government and of the need for a new start in privatisation were central.[21] These privatisations included enterprises from the hard-core of the economy i.e. the energy sector, the post services, the airlines, the railways, the insurance companies and the main banks, including the Commercial Romanian Bank, one of the most successful Romanian banks. It was considered that they were completed in haste and questions were raised regarding the suitability of investors and the quality of the privatisation deals.[22] In 2001, more concrete plans have been envisaged by the Năstase government to increase the supply able to meet an increasing demand for investment.[23] However, the post-election actions did not always keep up with the promises. Thus, Romania did not have a coherent policy for attracting FDI after the 1996 elections, despite the encouraging electoral campaign.[24]

[13] *The Guardian*, 31 January 1990.
[14] *The Economist*, 23 January 1993; *The Guardian*, 12 November 1993.
[15] EBRD, *Transition Report*, 2001, p.179.
[16] Paliwoda, S. J. et al, "Analysing Poland's 'Tiger' Status Economy", *European Business Journal*, 1998, vol. 10, p.21; WIIW, *Handbook of Statistics*, CDROM, p. 448.
[17] Ministry of Economy, "A Conception of the Medium Term Development of the Country Until the Year 2002", Warsaw, 13 October 1999, *http://www.cup.guv.plstruktur*.
[18] *The Warsaw Voice*, 13 January 2002.
[19] Interview with Expert in FDI in Romania, Romanian Development Agency, Bucharest, 2000.
[20] *Piața Financiară*, 3 March 2000, p.19; Sârbu, R., "Chestiunea Zilei", *ProTV*, May 2000; Radu Sârbu was at the time the director of the State Ownership Fund in Romania.
[21] *Adevărul*, 5 Noiembrie 2000.
[22] *Adevărul Economic*, 19-25 Ianuarie 2000.
[23] Guvernul României, "Programul de guvernare", 2000, *http://www.gov.ro*, p. 2.
[24] Interview with Expert in FDI in Romania, Romanian Development Agency, 2000.

The role of public opinion

The public mood was influenced by politicians, nationalistic feelings and by an increased gap in welfare.[25] In 1990 'We won't sell the country' was a popular slogan in Romania. Workers were demonstrating against returning expatriates wanting to take control over the country.[26] A similar attitude was seen later in Poland. A survey conducted in Poland in February 1992 found out that, for the first time, more than half of those questioned were against faster privatisation, opening domestic markets to domestic goods and welcoming foreign capital.[27] Moreover, letters were sent in 1992 by the general public to Balcerowicz, the finance minister of the time and the father of shock therapy, accusing him of 'serving everyone, from international capital to Satan'.[28] Nationalistic feelings were also responsible for the negative attitude in Poland surrounding the privatisation of the banks.[29] These nationalistic feelings led to the exclusion of foreign investors from the privatisation of the last four Polish state owned banks.[30]

Not only did public opinion influence policies and hence FDI, but FDI influenced public opinion. The more advanced the involvement of FDI in the economy, the more realistic became public opinion regarding the benefits, the limitations and the desirability of FDI. For example, in Poland, an opinion poll shows that there has been an increase in the percentage of those who oppose FDI from 17% in 1996 to 33% in 2001. FDI is no longer a 'rosy dream', but a reality.[31] Many Poles are present or former employees of foreign companies or have relatives who work for foreign investors. They have experienced both positive and negative situations related to FDI which made their judgement more 'realistic'. The scale of FDI in Poland today is also impressive. While in 1995 the annual FDI inflow was a mere USD 2.5 bn., in 1999 foreign investors brought USD 8 bn., increasing the annual flow more than three times.[32]

Overall, the results of public opinion polls in Poland show a generally positive but realistic attitude towards FDI. This appears to contribute to the increased attractiveness of the Polish market as a destination for FDI and to enhance the positive impact of investment in economy. The author is not aware of any similar polls conducted up to the present in the Romanian society. The main expectations and fears about FDI in Poland are presented in the table below.

[25] *The Economist*, 23 January 1993.
[26] *The Guardian*, 31 January 1990; Paliwoda et al, "Analysing Poland's 'Tiger' Status Economy", p.3.
[27] *The Guardian*, 6 February 1992, p.10.
[28] *The Guardian*, 6 February 1992, p.10.
[29] *The Banker*, November 1998, p.5.
[30] *The Warsaw Voice*, 23 June 2002.
[31] WIR, *Climatul investiţional din România*, p. 21
[32] *The Warsaw Voice*, 8 April 2001.

Table 5.1.1. FDI: expectations v. fears

Expectations about FDI	Fears about FDI
Upgrading of technology (56%)	Collapse of competing Polish companies (74%)
Creation of new jobs (49%)	Buying Polish land (66%)
Better supply	Buying national property (63%)
Improved quality of goods and services	Making Poland dependent on foreign capital (58 %)
Rise in qualifications of Polish employees	Taking over Polish enterprises (57%)
Eliminating the gap between Poland and developed countries	

Source: Opinion poll, *The Warsaw Voice*, 8 April 2001.[33]

It seems that the fears can explain partially the slow pace of privatisation of some of the former state owned companies and the reluctant liberalisation of the real estate regime. The table also identifies unemployment as one of the problems of transition and the role that FDI is expected to play in diminishing it. A mixed record of FDI, and economic transition in general, has been responsible for the mixed public feeling. Furthermore, this mixed record raises some concerns regarding the place FDI should be assigned in the economic transition and economic development of Poland and Romania. Over-reliance on FDI is, after all, dangerous and therefore encouragement of domestic savings and investment should be an equal concern of the government. The mixed but overall positive record of FDI impact in Poland and Romania so far will be assessed in part two of this chapter through quantitative and qualitative evidence. These fears about FDI in Poland can be partially explained by the public's false perception of foreign investors' motives. The table below shows that the public underestimates the role of prospects for economic growth, market size or quality of labour in foreign investors' decision to invest in Poland. Instead, the Polish public suspects investors of being drawn by rent seeking motives and thus being attracted mainly by low labour costs, easy profits, tax exemptions and tax breaks.

Table 5.1.2. Motives for FDI: public perception v. firms' motives

Public perception of motives for FDI	Motives for FDI
1. Labour costs	1. Prospects for economic growth
2. Easy profits	2. Labour costs
3. Tax exemptions and breaks	3. Size of the Polish market
...Access to a larger Eastern European market	4. Labour supply
11. Prospects for economic growth	5. Reduction in production costs

Source: Opinion Poll, *The Warsaw Voice*, 8 April 2001.

[33] The opinion polls were conducted by the CBOS polling centre and were commissioned by the PAIZ.

Table 5.1.3. FDI in different sectors: aspirations v. statistics

Where should FDI be directed to? (Poll-1999)	**Where is the largest FDI? (Statistics-1999)**
Automotive industry	Industry (50.8%)
Electronic industry	Financial intermediation (22.4%)
Roads construction	Wholesale, retail trade (9.7%)
Environmental protection	Construction (5.5%)
Health services	Transport and telecommunications (5.4 %)
Where should FDI be forbidden* or limited?**	Hotels and restaurants (1.2%)
Arms industry*	Real estate, renting and business activities (0.5%)
Services**	Agriculture (0.1%)
Agriculture**	

Source: *The Warsaw Voice*, 8 April 2001; WIIW, p. 451.

Table 5.1.3 shows that further differences arise between aspirations of FDI distribution across sectors and statistics. This table can be interpreted in several ways. First, there is a certain degree of agreement between public opinion and statistics. Indeed, industry attracts the most FDI. Then, agriculture attracted the lowest investment, consistent with the public's disliking of FDI in agriculture. On the other hand, participation in services e.g. financial intermediation has taken place despite negative opinions about it. This trend coincides with the earlier mentioned nationalist feelings regarding the acceptance of FDI in privatisation of the banks. Furthermore, the poll identifies very well a gap between the needs of the society and the interests of investors. Road construction is indeed a priority and this has been recently acknowledged by the Polish government and the EBRD as part of their strategies for development. However, this is less of a priority for private investors, which led to the high contribution of EBRD in this domain in both countries.[34] Overall, public opinion perception on FDI can partially explain the slow liberalisation of certain sectors of the economy and thus the slow inflow of FDI in these fields. Public opinion seems to have had an important impact on the government's attitude towards FDI and hence on the FDI related policies implemented. Furthermore, FDI seems to influence the official and the public opinion, thus enhancing the circle of political determinants of FDI, transition and accession to the EU.

The role of international organisations

The international financial institutions and the EU have increasingly referred to FDI as a necessity for economic transition. Encouraging FDI was one of the main aims included in the preamble of the association agreement signed by Romania and Poland with the EU and then reinforced by the accession partnerships drawn in 1999.[35] FDI was also included in the Medium Term Economic Strategy elaborated by the Romanian Government in 2000. FDI was considered one important source

[34] EBRD, "Poland. Strategy Overview"; EBRD, "Romania. Strategy Overview", *http://www.ebrd.com/country index.*

[35] European Commission, "Association Agreement. Poland"; European Commission, "Association Agreement. Romania"; European Commission, "Accession Partnership 1999. Poland ", p.4; European Commission, "Accession Partnership 1999.Romania ", p.4; *http://www.europa.eu.int/comm/enlargement/dwn* .

of economic growth and the strategy aimed at improving the business climate in order to attract increased investment.[36] Poland included FDI in its medium term development strategy in 1999 and in its governmental programmes ever since.[37] Furthermore, in a workshop organised by consultants of the Agency for International Development at Harvard, the representatives of the Romanian government were urged to focus more on FDI for the money it brings, technology, access to markets, ability to upgrade and restructuring of the enterprises.[38] These are only a few examples on how the international organisations have maintained the debate upon the role of FDI in the two countries. However, the role of international organisations in enhancing FDI in Poland and Romania goes beyond the rhetorical level as discussed in chapter four. The involvement of the IFIs in economic transition has been considered a green light for foreign investors and a sign of credibility of internal reforms, thus acting as a positive element within the investment climate. Furthermore, the involvement of the World Bank and the EBRD in the privatisation process has further fostered FDI contributing towards a virtuous circle in the economic sphere as in diagram **5A.**[39]

To sum up, the official and public attitude towards foreign investment has improved since the beginning of transition, but has also become more realistic. Elections, public debates and international organisations have been catalysts for the official attitude towards FDI and thus impacted upon the role FDI has been assigned in reforms and on the FDI related policies adopted. A reluctant official attitude towards FDI in Romania in the early years of transition has impacted upon the pace and scope of FDI related policies and hence on FDI. Although the initially positive attitude of the Polish government towards FDI was accompanied by some spells of negative public attitude, it formed the basis of effective policies able to attract foreign investment. The public attitude has also changed towards being more supportive but also more 'realistic'. Furthermore, the international support has played an important role in enhancing a potentially virtuous circle in the political sphere with a positive effect on the economic sphere, as in diagram **5A(c).** All these political factors have affected the policies pursued and hence each country's attractiveness to foreign investors.

5.1.3 Foreign direct investment determinants in the economic sphere

Macroeconomic stabilisation: a necessary condition for FDI

Three types of policies will be discussed as part of the FDI determinants in the economic sphere: macroeconomic stabilisation policies, privatisation and promotional policies. They are part of the investment climate as defined in an earlier section and imply an active role of the government. Thus, a

[36] *Adevărul Economic*, 9-15 Februarie 2000, p.2.
[37] Ministry of Economy, "A Conception of the Medium Term Development of the Country Until the Year 2002"
[38] Gordon, L. (ed), *Economic Policy Reform for Sustainable Development in Romania*, CAER II Discussion Paper No. 8, 1998, p. 9.
[39] Interview with Expert in FDI in Romania, European Bank for Reconstruction and Development, London, 2002.

stable macroeconomic situation constitutes a necessary condition for an attractive investment climate.[40] Macroeconomic stability can be judged from one criterion i.e. inflation rate, two criteria i.e. inflation rate and the budget deficit, or in broader terms. There are six conditions of macroeconomic stability which will be used to address the macroeconomic determinants of FDI in Poland and Romania: end of recession, a low inflation, a stable exchange rate, a low unemployment rate, a balanced state budget and a positive balance of the current account.[41] How do these affect FDI?

Any assessment of the FDI macroeconomic determinants has to acknowledge that the relationship is bi-directional. Part of the underlying assumption of this study is that FDI is determined and determines the level of economic reforms, as part of the circle of economic factors shown in diagram **5A(b).** For example, on the one hand, previous growth or prospects for growth of the host market represent an incentive for investors as part of the assessment of the market size and growth. On the other hand, potential positive effects of FDI on economic growth justify the choice of host countries to attract FDI by providing an attractive investment climate. Furthermore, macroeconomic stability cannot be maintained without restructuring, and thus contribution from FDI. Thus, FDI has been used to balance widening current account and budget deficits.[42] Moreover, through its contribution to enterprise restructuring, FDI leads to more efficient resource allocation and thus limits the scope of inflation. These are only a few examples of the bi-directional relationship between FDI and macroeconomic stability. The impact of macroeconomic stability on FDI is discussed in the following paragraphs. Data for these macroeconomic indicators is presented in table 5.1.4 for both Poland and Romania. Foreign debt, the presence of full convertibility and FDI are added to complete the survey of FDI and macroeconomic determinants of FDI.

Economic growth is an indicator of market growth and thus an important FDI determinant for market seeking investors, usually recognised by the literature and surveys.[43] Furthermore, economic growth can be a measure of the success of economic reforms and possibly of previous FDI impact on the economy. However, the evidence from the first decade of transition is ambivalent. First, early recessional transformations have deterred FDI in both Romania and Poland while later, increasing

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[40] de Mello L., Jr. and Hussain, K., "International Capital Mobility in Developing Countries", *Journal of International Money and Finance*, January 1999; Krkoska, L., "FDI Financing of Capital Formation in Central and Eastern Europe", *EBRD Working Paper No. 67*, December 2001, p.3.
[41] Kolodko, G.W. cited in Bal, A., "Trăsături generale ale procesului de tranziţie la economia de piaţă în ţările foste comuniste" in Popa, I. (co-ord.), *Tranziţie si reformă*, Editura Economică, 2001, p.107; Andreff, W. "Inerţiile economice ale tranziţiei" in Popa, I. (co-ord.), p.12.
[42] Calvo, G., "Capital Flows in Central and Eastern Europe: Evidence and Policy Options", *IMF Working Paper No. 57*, 1995, p.1.
[43] Bhasin, A. et al, "Assessing the Sustainability of FDI Flows", World Bank, *International Economics Department*, 1994; *The Warsaw Voice*, 8 April 2001; WIR, *Climatul investiţional din România.*

levels of FDI in Poland correspond to years of positive economic growth.[44] Second, positive growth between 1993 and 1996 did not attract considerable investment in Romania, despite a permissible legislation, as will be shown in a later section. This was partially due to the slow progress in privatisation and thus to few attractive investment opportunities. This lack of investment was also partially due to other macroeconomic imbalances and to a general lack of interest from investors greatly devoted to closer and more attractive destinations in Central Europe. Finally, negative growth did not discourage FDI in Romania between 1997 and 1999. The explanation for this phenomenon appears to be threefold. First, FDI was driven greatly by an attractive offer as a result of a boost in the privatisation programme by the newly formed government. Second, rent seeking investors might have been attracted by prospects for low wages during a recession.[45] Third, market seeking investors must have anticipated a rapid recovery after a short recessional transformation induced by the shock therapy type liberalisation and stabilisation programme applied by the Ciorbea government. Overall, economic growth is a necessary but insufficient condition for FDI. Its impact on FDI is ambivalent and has to be assessed in the context of other macrocoeconomic, microeconomic and political indicators, as shown in chapter seven.

High inflation or price instability generally deter FDI.[46] Table 5.1.4 suggests that the higher level of FDI in Poland is associated with an overall lower level of inflation than in Romania. Furthermore, Polish inflation has fallen up to 1999. However, in 1997 a high level of FDI was attracted in Romania despite an average annual increase in prices of 154.8%. This can be explained through the relative importance of other factors, such as privatisation and targeting, which have contributed to the surge in FDI in Romania in 1997 and afterwards. Furthermore, the high inflation of 1997 was a result of the completion of liberalisation of prices and inflation was expected to fall with the adjustment of the economy as a result of the stabilisation package. Finally, wage inflation can be an indication of the dynamism of an economy, thus accompanying economic growth.

Currency instability and currency inconvertibility affect negatively the investment climate by creating uncertainty regarding the profits or limiting the scope of profits repatriation.[47] Table 5.1.4 shows a steady depreciation of the nominal exchange rate correlated with a falling inflation in Poland. Romania, on the other hand, has faced relatively more abrupt changes in both the exchange rate and

[44] Hunya, G. , "The Role of FDI in Economic Recovery and Transformation", *Comment Prepared for the Joint LSE-WIIW Conference: Reconstruction and Integration in Southeast Europe: Economic Aspects*, Vienna, 12-13 November 1999, p.1.
[45] Voinea, L., "Revisiting FDI Patterns in Transition. The Case of Romania", *Paper Prepared for EACES Conference*, May 2002, p.6.
[46] Svetličič, M., Artisien, P. and Rojec, M., "FDI in Central and Eastern Europe: An Overview" in Svetličič, M., Artisien, P. and Rojec, M. (eds.), *FDI in Central and Eastern Europe*, Basingstoke, St. Martin's Press, 1993, p.5; Rogoff, K. and Reinhart, C., "FDI to Africa: The Role of Price Stability and Currency Instability", *IMF Working Paper No. 10, 2003*, p.10; Lim, E.-G., "Determinants of, and the Relationship between FDI and Growth: A Summary of the Recent Literature", *IMF Working Paper No. 175*, 2001, p.14.

inflation, suggesting higher currency instability, thus deterring foreign investors. Furthermore, full current account convertibility was achieved in Romania only in 1998, compared with June 1995 in Poland.[48] This data is consistent with Poland having attracted higher annual inflows of FDI, suggesting that currency convertibility is an important determinant of FDI. Currency convertibility is reflected by one of the EBRD indicators which is used in chapter seven in the construction of the stabilisation/liberalisation index. Data constraints limit the analysis of the trends in the real exchange rate which would have been more appropriate as part of the FDI determinants.

The influence of unemployment on FDI is more ambiguous. First, a high unemployment rate suggests possibly a low level of wages. This could be an attractive element of the investment climate in so far as it does not reflect a poor skills level. It may also indicate that there is labour force which awaits to take up employment or that wages have been maintained over the equilibrium level. Furthermore, an already high level of unemployment in Poland suggests that there might be concerns regarding further shedding off from former state owned enterprises acquired by foreign investors and subject to post-privatisation restructuring. Thus, in both Poland and Romania clauses regarding post-privatisation levels of unemployment have been common place, reducing to some extent the attractiveness of certain investment offers. Finally, a low level of unemployment in Romania is a sign of slow restructuring so far, putting thus the pressure of firing employees on the new owners. This would make a low rate of unemployment act as a deterrent to FDI.

Finally, the necessity of financing high current account deficits leads governments to adopt a more active policy to attract FDI.[49] In the absence of FDI, these high deficits can induce a vicious circle. Thus, Romania has faced an increase in the current account deficit since 1995 which, in the absence of substantial FDI, has led to a constant increase in foreign debt. This in turn limited the attractiveness for investors and the scope of the facilities the government could grant to foreign investors. After two years of high current account deficits, Romania attracted in 1997 a considerable amount of FDI for the first time since the beginning of transition. However, some FDI can be responsible for increased current account deficits by causing increased imports of raw materials and equipment. In Poland, high levels of FDI were accompanied by high current account deficits, especially since 1996. Furthermore, the high budget deficit in 1998 forced the Romanian authorities to cancel the fiscal facilities initially offered in order to attract large investors such as Renault, thus influencing negatively the business climate.[50]

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[47] Svetličič, Artisien and Rojec, *FDI in Central and Eastern Europe*, p.5.
[48] EBRD, *Transition Report*, 2001, p. 179, 183.
[49] Calvo, "Capital Flows in Central and Eastern Europe: Evidence and Policy Options", p.1.

Table 5.1.4. Selected macroeconomic indicators in Poland and Romania

Selected economic indicators	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP (% change)												
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1	4.1	4.5
Romania	-5.6	-12.9	-8.8	1.3	3.9	7.1	3.9	-6.1	-4.8	-2.3	1.6	4.1
Unemployment (% of labour force)												
Poland	6.1	11.8	13.6	15.7	16.0	14.9	13.2	10.3	10.4	13.1	15.0	14.0
Romania	Na	3.0	8.1	10.4	10.9	9.5	6.6	na	10.4	11.5	10.5	9.9
Consumer prices (annual average % change)												
Poland	585.8	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	6.8
Romania	5.1	174.5	210.9	256.1	136.7	62.3	38.8	154.8	59.1	45.8	45.7	32
General government balance (% GDP)												
Poland	3.1	-6.5	-6.6	-2.8	-2.7	-2.6	-3.1	-2.9	-2.6	-3.2	-3.3	-1.8
Romania	Na	Na	-1.7	-4.4	-2.2	-3.4	-4.8	-5.2	-5.5	-3.8	-3.7	-3.7
Current account (in USD billions)												
Poland	0.7	-2.2	-0.3	-2.9	0.7	5.3	-1.4	-4.3	-6.9	-11.6	-10	-12
Romania	-1.8	-1.3	-1.5	-1.2	-0.4	-1.8	-2.6	-2.1	-2.9	-1.3	-1.4	-1.5
Exchange rate, annual average												
Poland (Zl. Per USD)	0.9	1.1	1.4	1.8	2.3	2.4	2.7	3.3	3.5	4.0	4.3	4.6
Romania	22.4	76.3	308.0	760	1,655	2,033	3,083	7,168	8,875	15,333	21,693	28,550
Full convertibility												
Poland	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Romania	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes
External debt stock (USD billions)												
Poland	48.9	48.3	48.2	48.7	40.8	39.4	47.6	49.6	59.2	64.4	Na	Na
Romania	0.6	1.4	2.4	4.2	5.7	6.4	8.3	9.5	9.9	9.1	9.9	Na
FDI annual inflows (USD millions, net)												
Poland	10	117	290	580	542	1,134	2,741	3,041	4,966	6,348	7,528	5,397
Romania	Na	40	77	94	341	419	263	1,224	2,040	1,025	1,040	1,137

Source: EBRD, *Transition Report*, 1996, p.201, 203; EBRD, *Transition Report*, 2001, p.181,185; WIIW, *Handbook of Statistics*, CDROM, p.448

In 2001 both countries registered positive economic growth. Unemployment was more worrying in Poland, while a higher budget deficit in Romania indicated the need for attracting further FDI. A high current account deficit for Poland also suggests that exports should be enhanced, possibly through FDI. Inflation remained a relative concern for Romania which registered a consumer prices index of 32%.To sum up, macroeconomic stability is a necessary though not sufficient condition for attracting FDI. Data for Poland shows that early stabilisation of inflation has created the conditions for subsequent foreign investment inflows. Furthermore, the lower attractiveness of Romania was consistent with higher levels of inflation and higher economic instability in general, as shown by Munteanu.[51] However, additional factors are needed to explain the scope and the dynamics of FDI. Amongst these factors, the pace and method of privatisation play a central role, as will be discussed below. Moreover, the interaction between stabilisation and privatisation in determining FDI will be assessed quantitatively in chapter seven along with assessing the role of security and European integration factors.

Privatisation: an engine of FDI

The relationship between privatisation and FDI is complex. On the one hand, privatisation has become the main drive of FDI in transition countries.[52] Green field investment aside, FDI was mainly directed towards buying former state owned enterprises which were privatised. On the other hand, FDI has not always been the dominant form of privatisation. FDI prevailed only when sales to strategic investors prevailed in comparison with voucher privatisation.[53] In Poland and Romania changes within the mix of privatisation policies have impacted upon the timing and scope of FDI, as will be seen below.

The mix of privatisation methods was fairly similar in Poland and Romania and was subject to internal and external pressures. In both countries, motivation for privatisation has evolved from a rather idealistic and ethical approach to a more realistic and economics based approach, i.e. from social and distributional considerations, to increasing state revenues and improving corporate governance.[54] Poland started privatisation gradually, but once started it proceeded smoothly and successfully.[55] On the other hand, Romania suffered from inconsistency of policies and, when a bold privatisation programme was initiated in 1997, coalition infighting slowed down its application. Hence, the results of these similar privatisation mixes were very different. This was not only due to the pace and scope of privatisation, but also to the different investment demand. Some factors which might have affected the

[51] Munteanu, C., "On the Determinants of FDI", *Working Paper*, Academy of Economic Studies, Bucharest, 1991.
[52] Beyer, J., "Please Invest in Our Country. How Successful Were the Tax Incentives for Foreign Investment in Transition Countries?", *Communist and Post-Communist Studies*, Vol. 35, No.2, July 2002, p. 191; EBRD, *Transition Report*, 2000, p.63; Hunya, G., "International Competitiveness. Impacts on FDI in CEECs", *WIIW Research Reports No. 268*, August 2000; Hunya, G., "Recent FDI Trends, Policies and Challenges in South East European Countries", *WIIW Research Reports No. 273*, December 2000; Voinea, L., "Revisiting FDI Patterns in Transition. The Case of Romania", *Paper Prepared for EACES Conference*, May 2002.
[53] EBRD, *Transition Report*, 2000, p.64.
[54] Hunya, "Recent FDI Trends, Policies and Challenges in South Eastern European Countries", p.10.

investment demand include promotional policies in a broad sense and macroeconomic policies which are discussed in this chapter. Furthermore, the impact of security and European integration factors on enhancing FDI is assessed in chapter seven through the econometric model.

In both countries the early phase of transition was dominated by direct privatisation and attempts to achieve mass privatisation. Direct privatisation (in a broad sense) targeted ownership of small and medium-sized enterprises and had two main components in Poland: first, liquidation (in the narrow sense) through which the firm was dissolved, its assets sold to private entrepreneurs and the firm ceased to be a legal entity; second, direct privatisation (in a narrow sense) through which firms were converted into joint-stock companies whose ownership can be transferred in three ways: sale of assets; transfer of assets to a company so that a company with State Treasury and private person participation will result; and leasing of assets to an employee company.[56] According to the OECD, these two methods were practically reserved for insiders, hence foreign participation was minor. Furthermore, Jarosz found a total of only 61 enterprises privatised by the direct methods where foreign investors participated.[57] Wlodarczyk estimated the number at some 80 for the period 1990-1997, i.e. no more than 5% of all enterprises privatised in this way.[58]

Between 1993 and 1996 the prevailing privatisation method for small and medium-sized enterprises in Romania was Management and Employees Buy Outs (MEBO).[59] This gave priority to management and employees in acquiring the shares of their company and thus limited the potential involvement of outsiders, including FDI. Further limitations appeared when managers tried to prevent employees from trading their shares. Furthermore, when trading shares was possible, outsiders became reluctant to buy shares in companies with significant insider ownership and also operating in an environment with underdeveloped corporate law and disclosure rules.[60] Similar limitations were faced in Poland as a result of MEBO. Thus, as a consequence of a strong lobby by the trade unions and of strong powers of workers' councils, management and employee participation was encouraged by each privatisation route in Poland. MEBO was part of the direct privatisation method as shown above. Furthermore, the 1995 mass privatisation programme provided for an average 15% share to be given to the workers of the 512 state owned companies involved.[61] Moreover, in the capital privatisation method employees were first offered 20% of the equity at half price and finally 15% of the assets, free of charge.[62] Employees

[55] OECD, *Economic Surveys. Poland*, OECD, Paris, 2001, p. 81.
[56] Schöllmann, W., "Foreign Participation in Privatisation: What Does it Mean? Empirical Evidence from the Czech Republic, Hungary and Poland" *Post-Communist Economies*, Vol. 13, No. 3, 2001, pp. 379-380.
[57] Jarosz cited in Schöllmann, "Foreign Participation in Privatisation", p.384.
[58] Wlodarczyk cited in Schöllmann, "Foreign Participation in Privatisation", p.384.
[59] Voinea, "Revisiting FDI Patterns in Transition. The Case of Romania", p.5.
[60] Voinea, "Revisiting FDI Patterns in Transition. The Case of Romania", p. 5; OECD, *Economic Surveys. Romania*, 1998, p. 64.
[61] Schöllmann, "Foreign Participation in Privatisation", p.381.
[62] Schöllmann, "Foreign Participation in Privatisation", p.381.

tended to oppose further investments that could diminish their control over the enterprise. Hence, this important employee participation in privatisation constituted a continuous brake on further privatisation and on FDI.

Also in Poland, mass privatisation was only indirectly open to foreign investors' participation. In 1997 sizeable or even controlling stakes had been offered to outside strategic investors in 93 portfolio companies. Foreign investors participated in the privatisation of only 32 of these companies, a share of 34%.[63] This shows that emphasis on mass privatisation rather than capital privatisation has slowed FDI. It has, nevertheless, constituted the basis for more efficient privatisation methods. Romania also applied a comprehensive mass privatisation programme in 1995, after increased pressure for reforms by the World Bank and the IMF. The forthcoming 1996 elections constituted another important push factor.[64] This voucher-type assets distribution concerned nearly 4,000 companies whose shares were previously managed by the five private ownership funds established alongside the State Ownership Fund (SOF).[65] However, this scheme raised huge administrative problems and made privatisation even more difficult. By 1998, only 18.7% of the shares of the mass privatised companies were transferred, the state maintaining a majority stake in most of the companies included in the programme. Weighted by capital, only 7.8% of the companies were more than 50% privatised.[66] Furthermore, corporate governance problems appeared as a result of the high dispersion of capital and an unofficial capital market was created. Mass privatisation in Romania became, however, a necessary condition for the adoption of more effective methods of privatisation. Foreign investors participation was then encouraged in the privatisation of the remaining shares administered by the SOF, now the Authority for Privatisation and Management of the State Ownership (APAPS).[67]

By 1996, increasing budget and balance of payments deficits determined a switch towards sales to strategic investors in both Poland and Romania. Part of capital privatisation in Poland, this method concerned large enterprises which had been previously transformed into joint companies. It mainly consisted of public offers, tenders of public invitations to negotiations.[68] Although employee participation was equally encouraged, the emphasis this time was on strategic investors, including foreign ones. Capital privatisation has thus generated yearly more than 50% of total revenues from privatisation.[69] This bigger role of capital privatisation has at least a twofold explanation. First, this method concerns large enterprises and therefore can be expected to raise higher revenue per enterprise.

[63] Schöllmann, "Foreign Participation in Privatisation", p.382.
[64] *The Economist*, 10 June 1995.
[65] Earle, J.S. and Telegdy, A., "The Results of Mass Privatisation in Romania: A First Empirical Study", *Economics of Transition*, Volume 6, No.2, 1998, p. 318.
[66] Earle and Telegdy, "The Results of Mass Privatisation in Romania: A First Empirical Study", p.329.
[67] APAPS, *Privatisation Trends in Romania and Opportunities for Foreign Investors*, 2002, p.7.
[68] Schöllmann, "Foreign Participation in Privatisation", p. 384.
[69] Schöllmann, "Foreign Participation in Privatisation", p. 384.

Second, a strong position of company insiders in the direct privatisation was likely to impose lower prices and thus an overall lower level of investment.[70] The data below shows Polish privatisation revenues according to different methods applied. Statistical data on the last line of the table shows that foreign participation in capital privatisation has been substantial, generating more than 50% of the revenue. Furthermore, table 5.1.6 shows that capital privatisation has been the prevalent method in terms of number of companies privatised in Poland.

Table 5.1. 5. Polish privatisation revenue (PZL mn)

	1991	1992	1993	1994	1995	1996	1997	1998	91-98
Total	171	484	780	1,595	2,642	3,749	6,538	7,069	23,028
Lease, liquidation and rent	46	172	287	323	406	973	359	447	3,013
Capital privatisation	125	309	439	847	1,714	1,945	3,254	5,102	13,735
Privatisation of banks	0	4	54	425	521	831	2,925	1,518	6,278
Foreign capital in capital privatisation (percentage) [71]	85.9	98.2	77.0	66.0	77.3	65.8	An	Na	Na

Source: OECD, *Economic Surveys. Poland*, OECD, Paris, 2000, p.175.

Table 5.1.6. Evolution of the privatisation process in Poland

Number of companies privatised (totally or partially) during the year (total)	1991	1992	1993	1994	1995	1996	1997	1998	1999
Direct privatisation	182	293	232	238	109	189	181	149	151
Capital privatisation	28	23	47	36	26	24	44	16	87
Liquidation	19	67	100	117	93	167	114	75	57

Source: PAIZ, *The Polish Privatisation Process*, 28 June 2000.

In Poland there has been a considerable slow down in privatisation since 2001. This was partially due to remaining companies being the least competitive ones, in sensitive industries such as coal, steel, energy or chemical industry.[72] The slowdown was equally due to corruption and to the complicated privatisation process which includes substantial consultation with social partners.[73] Further slowdown in privatisation will possibly be determined by the need to restructure some of the remaining companies before privatising them.[74] Finally, limits to FDI participation in privatisation have been recently imposed in Poland by restricting bank privatisation to domestic investors.[75] This shows how political factors can negatively affect FDI related policies, thus potentially inducing a vicious economic circle. This is why international support and a positive government's attitude are very important. It is equally important that the policies implemented ensure high public support through a positive impact

[70] Schöllmann, "Foreign Participation in Privatisation", p. 381.
[71] Schöllmann, "Foreign Participation in Privatisation", p. 382.
[72] OECD, *Economic Surveys. Poland*, OECD, Paris, 2002, p.123.
[73] OECD, *Economic Surveys. Poland*, 2002, p.123.
[74] OECD, *Economic Surveys. Poland*, 2002, p.117-122.
[75] *The Warsaw Voice*, 23 June 2002.

on the standard of living of the population. FDI impact in this respect will be assessed in part two of this chapter.

In Romania, the poor results of previous privatisation methods and the pressure for reforms in order to progress towards EU membership led to direct sales being predominant in the period 1996-2000 as shown in table 5.1.7. The post-1996 Ciorbea government pledged to sell fifty enterprises per week in an attempt to increase the pace of privatisation.[76] Foreign investors were, however, constrained by pre-set prices which some times made the offers unattractive. Moreover, corruption, lack of transparency as well as high debts and arrears of the enterprises on offer led to a generally low interest from foreign investors and a low level of transactions. A change of strategy was needed. Direct sales negotiations were complemented by auctions and sales on the capital market in order to eliminate disputes over the privatisation price. Furthermore, the 2002 law for the acceleration of privatisation specifically allowed for privatisation at market price, rather than administered prices, and provided for the writing off of debts and arrears in order to make privatisations more attractive to foreign investors.[77] The government even introduced a programme of privatisation for 1 Euro. Despite certain criticism of such low prices, this method can boost the privatisation of very indebted and thus unattractive companies. The transaction is, however, subject to post-privatisation investment and/or job creation commitments.[78] This appears to be an acceptable compromise to break the vicious circle of high debts, lack of restructuring, higher debts and thus lower prospects for investment in these unattractive enterprises. The low transaction price aims to increase the attractiveness of such enterprises to foreign investors while the post-privatisation commitments aim to ensure that restructuring occurs with minimum costs for the employees. This policy is meant to ensure a virtuous political circle.

A summary of the privatisation methods used in Romania is given in table 5.1.7. This shows that privatisation in Romania picked up between 1996 and 2000. Although the two countries have applied a similar mix of privatisation methods, this has led to different results. These depended not only on the investment supply through the privatisation process, but also on the investment demand which was affected greatly by other factors, including the investment climate, geographical position, or the prospect of EU membership. Moreover, FDI was not only directed towards privatisation, but also took the form of green field investment. Thus, Poland has increasingly attracted green field investment in the special economic zones. On the other hand, Romania mainly attracted green field investment near the western border in processing industries.[79] In the event of completion or slow down in privatisation of former state owned enterprises, FDI should be increasingly directed towards green field investment.

[76] Gordon, (ed), *Economic Policy Reform for Sustainable Development in Romania*, p. 6.
[77] OECD, *Economic Surveys. Romania,* OECD, Paris, 2002, p.85.
[78] OECD, *Economic Surveys. Romania,* 2002, p.86.
[79] G. Hunya, "FDI in South Eastern Europe in Early 2000s", WIIW, *A study commissioned by the Austrian Ministry of Economy and Labour*, 2001, p.7.

In this way FDI impact in transition economies will continue beyond the end of the change of ownership of former state owned enterprises.

Table 5.1.7. Evolution of the privatisation process in Romania

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of companies privatised during the year (total)	265	604	648	1,388	1,304	1,267	1,854	1,341	127
MEBO	261	519	43	14					
Direct negotiations	4	85	605	1,007	1,064	244	1,337	1,235	19
Auctions				455	231	991			92
Sales on the capital market					9	32	64	106	16
Companies sold to foreign investors	1	1	5	4	44	96	83	38	na
Proceeds from sale to foreign investors- USD mn	2	3.9	15	15.5	403.8	608.1	57.1	7	na

Source: OECD, *Economic Surveys. Romania*, 2002, p.64.

The impact of privatisation on FDI can be assessed not only based on the mix of privatisation methods applied, but also from the point of view of economic sectors opened to FDI. Table 5.1.8 suggests late liberalisation for most of the infrastructure sectors, despite infrastructure being considered a key element of an attractive business location. The liberalisation in telecommunications or banking is consistent with high levels of FDI registered between 1998 and 1999, both in Poland and Romania. Furthermore, the late liberalisation of these sectors is consistent with the initial attitude of authorities in both countries that these sectors had strategic importance. The data in the following table refers to the years when some sectors were opened to FDI access, and not necessarily to the years when the first foreign investment occurred. For example, Telecomunikacja Polska was offered for privatisation in 1998, but France Telecom only invested in 1999. However, from the point of view of FDI determinants, the date of openness seems more relevant. The gap between this date and the first serious investment that occurred can be considered a measure of the country's attractiveness for investors or of the government's commitment for reforms. Thus, in Romania, the largest privatisation in the steel industry only occurred in 2000, with the sale of SIDEX to the Indian-UK ISPAT, despite an early liberalisation in 1997. Similarly, Petrom and Tarom have not been yet privatised. Finally, the most sensitive sectors in both economies are steel, mining and energy in general. In Poland, as a result of previous problems regarding the privatisation of the main companies in these fields, the government has now pledged to undertake the restructuring before privatisation would go further.[80] Although Romania seemed to have liberalised certain sectors earlier than Poland, this did not have a significant effect on the level of FDI, suggesting that other factors are also important.

[80] EBRD, *Investment Profile. Poland, 2001*, p.25.

Table 5.1.8. Openness towards FDI

Openness towards FDI in former state owned enterprises (SOEs)		Poland	Romania
Banking		1998: Pekao Group	1998:Romanian Development Bank
Insurance		1998: PZU	2000: Omniasig
Telecommunications		1998:Telecomunikacja Polska	1998: Romtelecom
Energy sector	Oil	2001: Rafineria Gdanska	1999: Petrom
	Coal	1998: two coal mines	
	Gas	2002: PGNIG	2000:Romgaz and SNP Petrom
Airlines		1998: LOT	2001: Tarom
Steel sector		1999: Huta Katowice	1997: Otelinox
Railways		2002	Strategic sector

Sources: EBRD, *Investment Profile. Poland*, 2001, pp. 25-30; EBRD, *Investment Profile. Romania*, 2001, pp.15-21

To sum up, privatisation has constituted a main engine for FDI in both Poland and Romania. However, despite similar mixes of privatisation methods the two countries have attracted considerably different volumes of foreign investment. This can be explained by the different pace and commitment to privatisation and by the internal and external political developments of each country. Furthermore, institution building in general, rather than privatisation alone, was different in the two countries and had a different effect, as will be shown in chapter seven. This also shows that policies alone are not able to explain the inflow of FDI. Furthermore, investment supply is not sufficient in explaining FDI. One has to analyse equally the investment demand and the factors which determine it. Some of these determinants of investment demand considered in this chapter are the macroeconomic factors and the policies to promote and attract FDI. While the former ones have already been discussed, the later will be addressed below. Furthermore, investment demand is likely to depend on factors specific to investing countries or firms or on the country image and implicitly on security concerns, as investigated in chapter seven.

Policies to attract and promote FDI: how effective?

In order to increase the FDI level, countries increasingly use FDI specific policies.[81] These promotional policies (in a broad sense) are part of the general economic policy of a country and can be classified as policies to attract and policies to promote FDI (in a narrow sense). While promoting FDI is mainly a marketing exercise, attracting FDI nowadays includes increasingly fiscal and financial incentives for investors in general or foreign investors in particular.[82] Financial benefits are usually preferred by developed countries and include subsidies for investment, training, development of the infrastructure,

[81] UNCTAD, *World Investment Report*, 2000, p. 6.

[82] Mazilu, *Transnaţionalele şi Competitivitatea*; Bonciu, *Atragerea şi monitorizarea investiţiilor străine directe*, p. 52.

and credits with preferential interest.[83] Fiscal benefits are especially used by developing countries in Asia, Africa or Eastern Europe. They include: tax holidays, tax exemptions, preferential taxes, low export or import taxes. Both types of incentives are more accepted in practice than in theory and their impact is difficult to assess, according to UNCTAD.[84] Moreover, the more recent trends of FDI diversion from Poland to Czech Republic support the possible effectiveness and attractiveness of such policies.[85] So, what is Poland and Romania's experience in attracting and promoting FDI so far and what lessons can be learned from these examples?

First, experience shows that fiscal and financial incentives are necessary but not sufficient for attracting FDI.[86] They have to be correlated with the general economic policy of the country, with privatisation and with macro-stabilisation measures.[87] Moreover, promoting FDI too early, before the environment is sufficiently reformed, is a mistake. Investors once disappointed are difficult to bring back.[88] Thus, Romania granted in 1991 important fiscal facilities, ranging from custom duties and value added tax (VAT) exemptions to tax on profit exemption for a period between two and five years depending on the activity.[89] However, balance of payment constraints and limited convertibility of the national currency did not allow, for example, for total repatriation of profit, a situation which deterred potential large investors.[90] Furthermore, these incentives encouraged disloyal investors. They created so called 'canned companies' which only operated until the period for fiscal facilities expired.[91] The same restriction to Romania's capability to grant incentives occurred in 1999. The large foreign debt accumulated by 1999 and the need to service it made the Romanian government suspend all the supplementary fiscal facilities introduced in 1998 in order to attract investors such as Renault.[92] This led to legislation in Romania being perceived as unpredictable, further deterring FDI. These developments also raised the question over the positive impact of incentives on economic growth and thus further measures were seen as necessary in order to increase the multiplier effect of foreign investment.[93] Furthermore, this initial negative experience with FDI led to targeting according to the size of investment.

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[84] UNCTAD cited in Bonciu, *Atragerea şi monitorizarea investiţiilor străine directe*, p.52; Subsequent research shows that breaks have limited impact.
[85] *The Financial Times*, 4 March 2002; *The Warsaw Voice*, 14 June 2002.
[86] Beyer, "Please Invest in Our Country", p.191.
[87] Bonciu, *Atragerea şi monitorizarea investiţiilor străine directe*, p.54; Wells, . cited in Gordon, L. (ed), *Economic Policy Reform for Sustainable Development in Romania*, p.34.
[88] Wells, L.cited in Gordon, L. (ed), *Economic Policy Reform for Sustainable Development in Romania*, p.34.
[89] RDA, *Romanian Investment Review*, September-October 1999, pp. 4-5.
[90] RDA, *Romanian Investment Review*, September -October 1999, pp. 4-5.
[91] RDA, *Romanian Investment Review*, September -October 1999, pp. 4-5.
[92] EBRD, *Romania. Investment Profile*, 2001.
[93] RDA, *Romanian Investment Review*, September -October 1999, pp. 4-5.

Second, the use of financial and fiscal incentives can reflect a certain role that the government assigns to FDI within the economic development of the country. In the literature this is called targeting.[94] The government draws certain priorities in terms of size of investment, sectors of the economy or geographical areas and uses financial or fiscal incentives packages to direct the investors accordingly. Poor, volatile or contradicting legislative framework can, however, have adverse effects as proved in Romania. Moreover, the credibility of the government is important in making investors consider the incentives.[95] The targeting method used by each country was a result of a learning by doing process. Previous patterns of FDI led both countries to adopting new targeting methods, as will be shown below.

Targeting according to the size of investment

Drawing on the experience of early years of transition when fiscal facilities mainly encouraged small and some times disloyal investors, the Romanian government has increasingly targeted according to the size of investment. The minimum contribution varied from large to small and medium investors. It also became more realistic in what was considered investment with a significant impact through the spill over effect on the rest of the economy.[96] The figure thus ranged from over USD 50 million in 1994 to USD 350,000 in 1997, to USD 50 million in 1999 and to only USD 1 million in 2001. The Law No. 332/2001 targeted investments over USD 1 mn which can contribute to the modernisation of the economic infrastructure, the creation of jobs and can have spill over effects on the economy.[97] It also provided that special conditions for investment of over USD 10 million may be subject to negotiations with the Department for Foreign Investors.[98] This provision for negotiations for further incentives prevented further legislation instability and left enough room for flexibility in dealing with large investors. However, in Poland, facilities granted previously on individual basis to investors such as General Motors have constituted indirectly barriers to other potential investors.[99] This shows that individual facilities can distort markets and thus have to be used cautiously, as they bear significant negative effects.

In recognition of its efficiency, a similar method of targeting has been recently adopted in Poland. The Polish version is, however, more comprehensive, aiming to encourage not only large investments, but also job creation, technology transfer and environmentally friendly technologies. This way of targeting can ensure the Polish economy high returns in exchange for the costs initially involved by fiscal and financial incentives. Thus, according to the Law on Financial Support for Investment of 2002, foreign

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[94] Mazilu, p.245.

[95] Interview with Expert in FDI in Romania, EBRD, London, 2002.

[96] Bonciu, *Atragerea şi monitorizarea investiţiilor străine directe*, "New Investment Law", *InvestRomania, http://www.investromania.ro/magazine/last issue.*

[97] Ministry of Development and Prognosis, *Romania. Executive Summary,* 2002, p.19.

[98] Bonciu, "New Investment Law."

investors in Poland may obtain different types of grants provided that they invest, employ, train their employees, develop the infrastructure and implement new, environment friendly technologies.[100] This type of targeting aims to ensure a high quality of investment with a visible positive impact on the economy. The time constraints put to investors are a means to diminish the risk of investment relocation, thus attempting to induce long lasting effects.

Overall, there are several advantages and downsides of targeting according to the size of investment. On the one hand, large investments have a potentially higher impact on the economy though the infusion of technology, know-how, employment opportunities, sales and integration in world economy. They are more resilient to crises and can induce reinvestment. Furthermore, targeting large investments is consistent with encouraging FDI participation in the privatisation of the former SOEs, often still large entities needing immediate restructuring. On the other hand, by granting large investors incentives such as tax holidays, the budget lacks important resources. This is why it is important that a stable macroeconomic situation is achieved prior to granting such facilities. Furthermore, by conditioning some facilities on performance, employment or financing criteria set for the foreign investors, authorities are likely to balance the initial loss resulting from facilities with future gains from the investment itself.

Targeting according to the field of activity

An alternative targeting method is encouraging investment in a certain field of activity. Governments can specifically grant incentives for investment in certain fields or exclude fields of activity from granting incentives. Such an attitude was adopted by the Romanian government in 1991 when it switched focus from trade and catering to industry and through the Urgency Government Ordinance No. 67/1999. This did not grant any incentives to companies from trade, banking and service sectors in an attempt to boost the privatisation of the hard-core of the economy i.e. steel, aluminium or energy producers.[101] The same discrimination was made through the Law No. 332/2001 which excluded from incentives the financial, banking and insurance sectors as well as those regulated by special provisions such as in ammunitions or drugs.[102] While such a decision is justified by the need to encourage restructuring of important sectors of the economy, financial and banking restructuring should to be top priorities of the governments due to the potential spill over effect on other sectors of activity.[103] Again, Poland has used a similar method of targeting, combined though with targeting according to geographical distribution as will be shown below.

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[99] Voinea, "Revisiting FDI Patterns in Transition. The Case of Romania", p.7.
[100] PAIZ, *http://www.paiz.pl.*
[101] RDA, *Romanian Investment Review*, November-December, 1999, Bucharest, p. 3.
[102] Bonciu, "New Investment Law".
[103] Bevan, A.A., Estrin, S. and Grabbe, H., "The Impact of EU Accession Prospects on FDI Inflows to Central and Eastern Europe", *Policy Paper No. 6*, 2001.

Targeting according to geographical distribution

In Poland, targeting was achieved through the creation of special economic zones (SEZs) which offer privileges to foreign companies. This type of targeting combined the need to help certain areas cope with the hardship of transition with the aim of improving the structure of the Polish economy and trade.[104] The SEZs were meant to create new jobs and encourage better use of industrial assets and infrastructure, to foster exports and trigger economic growth.[105] Moreover, some were located in areas close to the border so that they would enhance exports, or in the proximity of airports, European transport corridors or university centres, so that they made best use of infrastructure.[106] The basic law for the establishment and operation of SEZs in Poland was passed in 1994 when the economy was already stabilised. This timing was an important pre-requisite for success of the SEZs. The law called for preferential treatment and tax breaks for potential investors.[107] By the end of 2000 there were seventeen special economic zones in Poland of which fifteen were active.[108] These had an important impact on the regional development in Poland but a discussion on this topic is beyond the scope of this study.

How successful were the SEZs in attracting FDI? A thorough evaluation of the impact of the SEZs on FDI is beyond the scope of this study. However, several trends can be identified. Thus, despite early cautious perceptions on the possible success of the SEZs, experience has shown that incentives have initiated economic growth in these areas.[109] The SEZs also led to an improvement in the structure of the Polish economy. The techno-parks of Cracow and Mazovia are oriented towards the development of ultramodern technologies. The Moldin technopark is focused inter alia on electrical, chemical, precision machinery and motor industries as well as food processing.[110] Another positive impact of the SEZs was the incentive for green field projects, which makes foreign capital inflows less dependent on the progress of privatisation. Thus, by 1998 in the Euro-Park Mielec almost half of the thirty six projects were green field projects.[111]

Despite the generally acknowledged beneficial effect of the SEZs, there was a certain debate as to their desirability. First, the SEZs were accused of being 'a symptom of state interventionism', jeopardising

[104] *The Warsaw Voice*, 19 April 1998.
[105] *The Warsaw Voice*, 28 March 1999.
[106] *The Warsaw Voice*, 30 July 2000.
[107] The fiscal facilities granted to investors in the special economic zones in Poland through the 1994 law are: partial or complete exemption from income tax on business activities in the zones -for 10 years- a 50 % exemption for the next 10 years- and from corporate income tax; the possibility to classify some capital investment expenses as revenue; exemption from taxes and local fees for land, buildings and structures within the zone. (See EBRD, *Investment Profile. Poland*, EBRD, London, 2001, p. 10).
[108] EBRD, *Investment Profile. Poland*, 2001, p. 10.
[109] *The Warsaw Voice*, 19 April 1998.
[110] *The Warsaw Voice*, 26 October 1997.
[111] *The Warsaw Voice*, 28 March 1999.

the tax base and thus negatively affecting the budget.[112] Second, they did not comply with the EU regulation on public assistance. Progress towards EU membership and the necessity to adopt and apply the *acquis communautaire* made the existence of SEZs questionable. After a heated debate, in an attempt to comply with the EU recommendations, it was agreed in June 1999 to liquidate the zones such as Modlin which had been formally established but had not started operation yet. By 2002, further compromises had been made by Poland in order to comply with EU requirements regarding state assistance and competition.[113] These changes restricted the general incentives granted, but enabled the local governments to exempt, for example, real estate taxes or to impose them. Public assistance in forms of subsidies, tax relief and bonuses for creating new jobs were still part of the incentive packages for investment in the SEZs.[114] By 2002, investors, including the ones located in the special economic zones were eligible for fiscal and financial incentives as presented in the tables 5.1.9 and 5.1.10.

Romania attempted as early as 1992 to foster the role of free zones in attracting FDI. Some of them were active before 1989 and by December 1999 six free zones were active: Brăila, Constanța-Basarabi Sud, Curtici, Galați, Giurgiu, Sulina.[115] These zones provided several facilities to investors.[116] The relatively reduced size of these areas and their geographical position led to a modest impact on the economy.[117] The idea of stimulating FDI in certain geographical areas through financial and fiscal incentives was not, however, abandoned. The UGO 24/1998 established twenty two zones that have been declared 'disadvantaged' zones.[118] Companies established in these areas are granted a set of fiscal incentives.[119] These facilities led to the danger of fiscal evasion and therefore the government has increased its monitoring on these areas. Furthermore, the lack of appropriate infrastructure and means of communication makes investment in these areas relatively unattractive. Recently the necessary

[112] *The Warsaw Voice*, 26 October 1997; *The Warsaw Voice*, 19 April 1998.
[113] *PAIZ Newsletter*, 29 July 2002.
[114] *The Warsaw Voice*, 30 July 2000.
[115] RDA, *Romanian Investment Review*, November-December, 1999, Bucharest, p. 3.
[116] The fiscal facilities granted to investors in the free zones in Romania were: lease or rent of the land to Romanian or foreign natural or legal persons for a period of maximum 50 years; exemption of payment of customs duties or customs for means of transports, goods or other assets introduced or taken out of the zones; exemption from the payment of the VAT, excise and profit tax for the activities conducted in the free zones for the entire duration of their activity. (See RDA, *Romanian Investment Review*, November-December, 1999, p. 3)
[117] Interview, Expert in FDI in Romania, The European Bank of Reconstruction and Development, London, 2002.
[118] RDA, *Romanian Investment Review*, November-December, 1999, Bucharest, p. 3.
[119] The fiscal facilities granted to companies set up in the disadvantaged zones in Romania were: complete reimbursement of customs duties for machinery, equipment, installations, tools, means of transport (except for vehicles), know-how, other depreciable assets imported with the view of making and carrying investments in the zone; complete reimbursement of the customs duties for the imported materials, spare parts and/or constituent parts, necessary for the achievement of an own production in disadvantaged zone; exemption from the payment of the profit tax, for the duration of existence of the disadvantaged zone; exemption from the payment of the taxes levied for the change of the destination or for the exclusion from the agricultural circuit of land intended for the achievement of investment; ranting with priority of certain amounts from the Special Fund for Development placed at the disposal of Government of Romania, for the stimulation of export activity; guarantees for foreign credits; financing of special programs; financing of investment projects in which the state is a co-participant to the registered share capital. (See RDA, *Romanian Investment Review*, November -December, 1999, Bucharest, p. 3).

legislation framework was built in Romania for setting up industrial parks. They are aimed at developing the infrastructure and encouraging the production of software.[120] It is still too early to assess the success of these new forms of incentives. However, pressure from the EU regarding state assistance is threatening their existence in the Romanian economy, as has happened in Poland.

Romania seems to increasingly adopt similar policies to Poland with the aim to enhance its attractiveness for foreign investors. However, it appears that factors other than the incentives themselves have determined the main differences in each country's capability of attracting FDI. In order to investigate the importance of these other factors a quantitative analysis is conducted in chapter seven. A comparison among the general incentives given in Poland and Romania is provided in the following tables. The data shows a prevalence of fiscal incentives for Romania and an increased offer of financial incentives by the Polish government. In Poland, this targeting method signals a switch from simply attracting FDI to rewarding FDI. While fiscal measures diminish the local and central government revenues from the beginning, thus increasing the budget deficits, financial measures include budgetary contributions, provided that certain standard are met by investors. However, this increased government spending might not be consistent with the acute need to cut the increasing budget deficit. On the other hand, income and local tax exemptions seem to be the preferred fiscal incentives in the SEZ in Poland. Income tax relief is a positive measure in so far as it encourages enterprises to report their profits. Otherwise, they will be tempted to keep them down, so that paid income tax is reduced. Furthermore, local tax exemptions eliminate unfair competition between different areas based on fiscal policies.

Table 5.1.9. Fiscal and financial incentives in Poland and Romania as of 2002

Fiscal incentives	**Poland**	**Romania**
Exemptions from import duties and fees on imported capital	Yes	Yes
Delayed VAT for imports of components		Yes
Accelerated depreciation	Yes	Yes
Possibility to carry forward losses	Yes	Yes
Additional fiscal incentives in SEZs or free zones		
Corporate tax holidays	Yes	
Special deductions	Yes	Yes
Local tax exemptions	Yes	Yes
Financial incentives		
Grants for 25 % of investment outlays	Yes	
Grants for job creation (4,000 euro per job created)	Yes	
Grants for investment related to infrastructure development	Yes	
Grants for employee training (1,150 euro per employee)	Yes	
Grants for hiring unemployed	Yes	
Grants for hiring disabled people	Yes	

Source: PAIZ, *http://www.paiz.gov.pl;* Ministry of Development and Prognosis, *Romania. Executive Summary,* 2002, p.19; Mah and Tamulaitis, "Investment Incentives", p.233.

[120] Guvenul României. Ministerul Dezvoltării şi Prognozei, *Programul 'Parcuri Industriale'*, p.3.

Table 5.1.10. Other incentives in Poland and Romania as of 2002

Other incentives	Poland	Romania
Special institutional support	Yes	Yes
Programmes to support small and medium -sized firms	Yes	Yes
Priority investment projects	Yes	
Free trade areas and warehouses	Yes	Yes
Special economic zones	Yes	
Industrial parks	Yes	Yes
Disadvantaged Zones		Yes

Source: Mah and Tamulaitis, "Investment Incentives", p. 237, updated.

The relevance of the incentives offered by Romania is to a certain extent debatable. Thus, there is a vast legislation which encourages different types of investment by offering in the end very similar packages of incentives. This increases the legislative burden without producing qualitatively different results. Furthermore, the lack of transparency has encouraged corruption while the legislative instability has deterred investors during the first half of transition. Moreover, there is a strong emphasis on import duties exemptions. Then, the possibility to carry out losses is probably a way of avoiding paying income tax. Additionally, delayed payments of VAT are in the opinion of some investors just another legislative gimmick which creates more confusion and bureaucracy.[121] Finally, early incentives were not accompanied by enough efforts for economic reforms, thus making the focus on tax incentives insufficient for attracting FDI.[122]

Promotional policies and the country image

Attracting FDI through incentives should be complemented by a strong promotional effort. With the increasing competition between the CEECs in attracting FDI, country image is ever more important. So far Poland has benefited from an important international lobby and an incisive marketing strategy which helped it overcome the difficulties of early transition. When Poland was a politically unstable country in the early 1990s it lay behind Hungary and the Czech Republic in terms of FDI levels. However, when Poland became a frontrunner of the EU accession process or a 'tiger' of Eastern Europe with continuous high economic growth rates, Poland attracted increasing inflows of foreign investment. Furthermore, the country received a positive country risk assessment after the rescheduling and the cancelling of parts of its foreign debt, thus increasing its attractiveness for foreign investors. A generally positive country image has worked as an important factor attracting FDI in Poland, enhancing both a positive political circle and an economic one.

Romania, on the other hand, slipped into a vicious circle. The early political instability and the lack of consistent or serious economic reforms led to slow progress in the transition, the EU accession process

[121] *Adevărul Economic*, 4-10 October 2000, p. 25.

and in attracting foreign investment. Furthermore, after a peak in 1998, FDI fell again in 1999 as a result of mixed factors including the perception of high risk as a result of the Kosovo crisis. Guarantees for future EU membership given at the Helsinki Council and a bold new reform package have ensured stable levels of FDI since 2000, although much lower than the 1998 level. All in all, Romania has had poor lobby initiatives and its image outside the country has been poorly reflected.[123] This lack of accurate information and the relatively poor progress of Romania in transition has contributed to the low interest from investors for the Romanian enterprises offered for privatisation. This is why the present government has emphasised the role of promotional activities and has included them amongst the priorities in its economic and investment policy.[124] Furthermore, in 2001 the Romanian premier Năstase commissioned the two main agencies Moody's and Standard and Poor's to issue a new rating for Romania. This now reflects the recent progress made in reforms, thus creating a more accurate image of Romania as an increasingly attractive investment destination. The outlook on the country is now stable.

To sum up, an attractive offer of fiscal and financial incentives may complement the provision of a stable macroeconomic environment and of attractive privatisation opportunities. However, in the absence of these two preliminary conditions, incentives can have a negative effect in the economy and attract the wrong kind of investors. Furthermore, targeting ensures a certain control over the type and geographical spread of investment and on its potential impact in the economy. A mix of targeting methods is preferable, but its effects are still difficult to assess. Moreover, the impact of fiscal and financial incentives depends on the transparency, stability and enforcement of the laws and on the quality of assistance for investors. Finally, an adequate promotional campaign is important in ensuring foreign investors' interest in the destination country. Country image remains a crucial determinant of FDI but depends on factors other than just a promotional campaign. Successful economic reforms, internal and external political stability or the prospect of EU membership are elements of the country image that are likely to influence the investment climate and hence FDI. These will be further discussed in chapter seven.

5.1.4 An overall assessment of the investment climate in Poland and Romania

A comparison of the investment climate in Poland and Romania would be incomplete without referring to deterrents to investment identified by investors' surveys and studies of international organisations such as the EBRD and the World Bank. Thus, the table which follows suggests that in 2001 political instability was still a cause of concern for investment in Romania mentioned by 71% of the respondents. This is consistent with findings by Lucas and Ferris et al which maintain that political risk

[122] See also Ferris, S.P., Thomson, G.R. and Valsan, C., "FDI in an Emerging Market Economy. The Case of Romania", *Eastern European Economics*, Vol.32, No.4, July- August 1994, p.82.
[123] Alahdad, Z., *ProTV*, Aprilie 2000; Interview with Expert in Privatisation in Romania, Bucharest, 2000.

has a negative effect on the investment climate.[125] Furthermore, elements of economic instability such as national currency depreciation and inflation constituted the most important barriers for foreign investors, even more than political risk.[126] Shortcomings related to legislation instability, fiscal regulation, corruption and infrastructure in general are also high deterrents of FDI in Romania.[127] These seem to counter act to an extent the potential positive effect of attractive fiscal facilities. Moreover, this overview of deterrents to FDI in Poland and Romania seems to indicate the need to alter certain government policies in order to improve the investment climate and thus enhance FDI. In Poland the deterrents mentioned by investors are mainly of administrative nature, proving that the economic and political conditions for attracting FDI have been ensured through an adequate policy mix.

Table 5.1.11. Deterrents to FDI in Poland and Romania

Poland*	Romania**
1. Lack of system cohesion (44%)	1. National currency depreciation (91%)
2. Uneven application of laws by authorities (39.6%)	2. Inflation (90%)
3. Administration procedures for building permissions (36.7%)	3. Legislative instability (86%)
4. Real estate acquisition (34.5%)	4. Fiscal regulations (85%)
	5. Corruption (84%)
	6. Taxes (84%)
	7. Inappropriate infrastructure (75%)
	8. Ambiguous commercial legislation (74%)
	9. Political instability (71%)

Sources: PAIZ,1999 and World Bank,2001.

[124] Guvernul României, "Programul de guvernare", p. 5.
[125] Lucas, R., "Why Doesn't Capital Flow from Rich to Poor Countries?", *American Economic Review*, Vol.80, 1990, p.92; Ferris, Thomson and Valsan, "FDI in an Emerging Market Economy. The Case of Romania",p.81.
[126] See also Munteanu, "On the Determinants of FDI".
[127] See also Ferris, Thomson and Valsan, "FDI in an Emerging Market Economy. The Case of Romania", p.93.
* Data as in a poll conducted by PAIZ in 1999.
** Data as in a study conducted by the World Bank in 2001.

5.2 Part two: Evidence of the scope and impact of foreign direct investment in Poland and Romania

The previous part of the chapter has assessed the role of political factors and policies in improving the investment climate in Poland and Romania. This part of chapter five gives evidence of FDI impact at microeconomic level, i.e. on marketisation, integration into the world economy and with the EU, better standards of living for the population and on FDI itself. These types of impact are greatly interconnected and correspond to the elements of the vicious circles identified by this dissertation in the case of Romania in the early 1990s: poor economic reforms (hence slow marketisation), poor prospects for EU membership, internal instability, low FDI and thus slow economic reform. Here the analysis acknowledges that the relationship between FDI on the one hand and reforms on the other (policies or marketisation) is bi-directional, as represented in diagram 5A(b). The reverse of this relationship has already been assessed in part one. Moreover, FDI is both an indicator and a means of integration with the EU, as chapter three has identified. Additionally, by assessing the FDI impact on a better life, the chapter analyses the role of FDI in ensuring support for a market economy and EU integration and implicitly positive perceptions of security, as defined in chapter six. Finally, by assessing the FDI impact on FDI, this chapter tests the hypothesis of path dependency put forward in chapter one. This hypothesis will be tested quantitatively in chapter seven.

5.2.1 On foreign direct investment and transition to a market economy

FDI, a means of privatisation

The contribution of FDI to transition to a market economy will be analysed from three angles: as a sourcing factor, as a means of modernisation and as a means of structural change. FDI has been an important means of privatisation, thus contributing to marketisation.[1] However, the relationship between FDI and privatisation is bi-directional and relatively complex. On the one hand, progress of privatisation has acted as an incentive for foreign investors by showing that the host country is devoted to promoting and respecting private ownership and by offering complementing investment opportunities. This direction of the relationship between FDI and privatisation was analysed in part one of this chapter. On the other hand, FDI enhances privatisation by accelerating the sales of former SOEs for which there was not enough financing from other sources. Thus, foreign investment has complemented domestic savings which in periods of recession or high inflation were relatively low.[2] Studies reveal that in the CEECs foreign investment has contributed to a larger extent to capital formation compared to domestic credit and capital market financing.[3]

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[1] Hunya, "International Competitiveness. Impacts on FDI in CEECs", .4.

[2] Barrell and Holland,"Foreign Direct Investment and Enterprise Restructuring", p. 478; Mazilu, *Transnaționalele și Competitivitatea;* Ferris, Thomson and Valsan, "FDI in an Emerging Market Economy. The Case of Romania", pp.81-95; Kroska, L., "Foreign Direct Investment Financing of Capital Formation in Central and Eastern Europe"; Hunya, G., "International Competitiveness. Impacts on FDI in CEECs".

[3] Krkoska, "Foreign Direct Investment Financing of Capital Formation", p.18.

Nevertheless, FDI has not only contributed towards the privatisation of the former state owned enterprises. FDI has been also directed towards small and medium joint ventures or other forms of green field investment. This makes the total flow of foreign investment not correspond to the revenues from privatisation. Nevertheless, FDI, including green field investment, contributes towards marketisation.

In order to illustrate the scope of FDI in Poland and Romania and its role in privatisation, the following indicators will be used:

a) The annual inflows of FDI: They show the variability of foreign investment through time and suggest a certain trend for each country, possibly related to changes within the investment climate. High levels of FDI are likely to generate a higher impact on the economy, but the impact depends also on the FDI size relative to population and GDP.

b) FDI per capita: Through its magnitude, this indicator indicates the scope for potential FDI impact in each economy. The higher the FDI per capita, the higher the potential impact is likely to be.

c) FDI annual inflows as a percentage of GDP: This indicator suggests the contribution of FDI to the national domestic product. The higher the percentage, the higher the contribution of FDI is likely to be. However, similar figures for this indicator could result from a high level of FDI and a high GDP, as in the case of Poland, or low FDI and low GDP, as in the case of Romania, thus making the comparison difficult.

d) FDI as a percentage of gross capital formation: This indicator demonstrates the importance of FDI as a financing option. A high value would be consistent with the lack of domestic capital and the need for FDI in financing privatisation and marketisation in general.

e) The EBRD index of large scale privatisation: Although this is not a very accurate measurement of the FDI impact in the economy, a higher indicator can be a result of a higher contribution of foreign investment to the privatisation process.

f) The percentage of private sector in GDP and employment: Although the private sector includes companies other than foreign owned ones, these indicators give a measure of the role private property, including the one with foreign participation, plays in the economy as a whole.

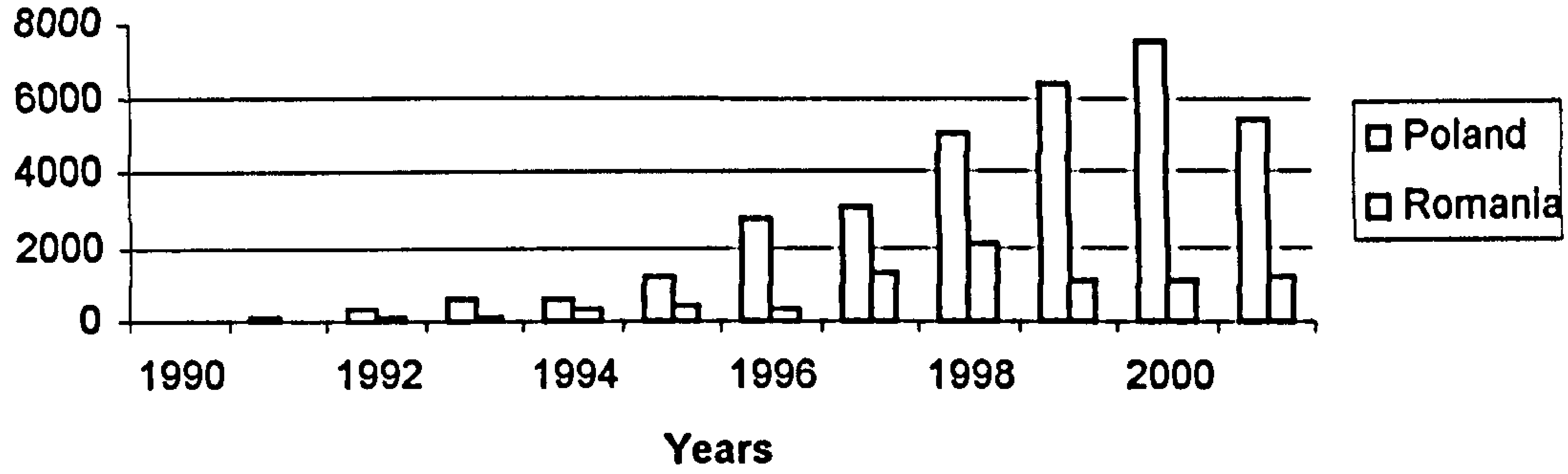
The annual inflows of FDI and the FDI per capita data for Poland and Romania indicate a potential higher impact in Poland. In terms of FDI per capita, the gap between the two countries has decreased since 1996, suggesting that Romania is in the process of catching up with Poland, but the difference is still striking.

Table 5.2.1. Foreign direct investment annual inflow (USD mn)

FDI annual inflows	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	10	117	290	580	542	1,134	2,741	3,041	4,966	6,348	7,528	5,397
Romania	Na[4]	40	77	94	341	419	263	1,224	2,040	1,025	1,040	1,137

Source: EBRD, *Investment Profile. Poland*, 2001, p.8; EBRD, *Investment Profile. Romania*, 2001, p. 11; WIIW, p.448.

Figure 5.2.1. FDI annual inflows in Poland and Romania (USD mn)



Source: As per table 5.2.1.

Table 5.2. 2. Scale of per capita foreign investment inflows (USD)

FDI /capita	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	2	8	18	44	49	96	117	127	165	194	258	221
Romania	Na	2	3.5	4	15	18	13	53	89	45	45	67

Source: EBRD, *Transition Report*, 2001.

Table 5.2.3. Evolution of FDI ratio of GDP (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	0.00	0.00	0.00	0.02	0.02	0.03	0.03	0.03	0.04	0.04	0.06	0.03
Romania	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.04	0.06	0.03	0.03	0.03

Source: Business Central Europe Statistics, *http://www.bcemag.com/_bcedb/history.idc*; EBRD, *Country Profile*, 2001; World Bank, *WDI Database*.

The evolution of FDI inflows since 1990 shows a significant late and slow start for Romania which by 1993 merely attained the level of Poland in 1991. Poland itself had a modest inflow compared with Hungary and the Czech Republic, due to its high foreign debt and internal political instability. However, Poland has faced a constant increase in the first years of transition, doubling the level each year till 1993. By then the 1993 elections brought in power a post-communist government which revived the nationalist debate over foreign investment and thus caused a slowdown in privatisation, as discussed in part one. The new boost at privatisation in 1995, combined with the

[4] Na stands for not available.

macro-economic stability achieved through the shock therapy programme, triggered increased FDI in Poland ever since.

For Romania, significant foreign investment inflows have only occurred since 1997, after the change of power through the 1996 elections. 1998 represented a peak with the sale of the Romanian National Telecommunications company and the Development Romanian Bank. A slowdown occurred in 1999 due to the negative risk ratings in view of the deadline for the repayment of the foreign debt and due to the Kosovo crisis as discussed in part one.[5] Although an electoral year in Romania, 2000 did not show a spectacular slowdown in privatisation and the beginning of accession negotiations with the EU must have been a significant signal for investors to keep their interest in the country, thus keeping the level of FDI similar to the previous year. Furthermore, some investments registered in 2000 resulted from deals concluded the previous year. This impact will be further assessed in chapter seven through the econometric modelling. A further increase in the FDI inflows was marked by the first year of the new government which made a serious pledge for vast privatisation and promotion of FDI, but whose credibility relied on keeping these promises. Poland has enjoyed a constant increase in FDI annual inflows, with almost spectacular rises between 1998 and 2000, but 2001 has already seen a slowdown. This was due to privatisation coming to a close and to tendencies of nationalisation. This points to the need for a strategy to attract more green field investment in order to maintain the level of foreign investment.[6] Data for FDI as a percentage of gross capital formation also suggests an increased role of foreign investment in Romania since 1998, with a peak in 1999. Poland, on the other hand, had already experienced a large FDI contribution to capital formation by 1996, which is consistent with the positive Opinion it received in 1997 from the EU and the invitation to open the accession negotiations.

Table 5.2.4. Foreign investment inflows as a percentage of Gross Fixed Capital formation (%)

FDI % in GFCF	1995	1996	1997	1998	1999	2000
Poland	5.2	15.5	15.1	14.5	15.9	17.8
Romania	2.7	5.5	3.3	16.3	19.0	16.6

Source: UNCTAD, *World Investment Report*, 2001.

The impact of FDI on ownership transformation can be captured by the EBRD index of large scale privatisation. The relationship between these indicators is bi-directional and the reverse relationship was considered indirectly in part one as part of the investment climate and will be used in chapter seven. The index ranks from 1 to 4.7 and shows again significant differences between Poland and Romania. Between 1996 and 1999 Romania was still in the band 2, i.e. comprehensive scheme

[5] EBRD, *Romania Investment Profile*, 2000, p. 10.
[6] EBRD, *Transition Report*, 2001, p.53.

almost ready for implementation with some sales completed.[7] On the other hand, Poland entered band 3 in 1994 with more than 25% of large scale enterprise assets in private hands or in the process of being privatised but possibly with major unresolved issues regarding corporate governance.[8] The post-1997 democratic governments in both countries seem to have had an important positive impact on the progress in large scale privatisation. Moreover, in Romania, stable FDI inflows since 1999 have led to further progress in privatisation reflected in a higher EBRD index, similar to Poland at present. A basic regression run by the author shows that FDI explains 53% of the progress in large scale privatisation in the CEECs, with a positive coefficient of 0.45. However, the scatter plots in appendix 5.2.A indicate only a feeble positive relationship between FDI and LSP.

Table 5.2.5. EBRD index of large scale privatisation (values from 1 to 4.70)

EBRD index of large scale privatization	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	2.0	2.0	2.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3	3.3
Romania	1.7	1.7	2.0	2.0	2.0	2.7	2.7	2.7	2.7	3.0	3.3

Source: EBRD, *Transition Report*, 2001, pp.180-184.

Finally, the FDI impact can be related to the evolution of the private sector in the economy. Indicators such as the share of the private sector in employment and production show the extent of transformation to a market economy, triggered partially by foreign investment. Thus, by 1999 the private sector share in GDP in Poland was 65% as opposed to 60% in Romania. However, the change since 1991 is more impressive in Romania. The share increased 2.4 times while in Poland the increase is only 1.62 times. This shows that initial conditions are very important in determining the outcome of policies and that Romania has the potential to catch up. The stagnation of the indicator for both countries for three years after 1997, in fact a turning point for both privatisation and foreign investment, can be explained through the slowdown of economic growth in the case of Poland and its already relatively large private sector and through the negative growth in the case of Romania. The share of private sector in employment shows a potentially higher FDI impact in Poland than in Romania. In Romania there seems to be an impact since 1999. One has to note though that Poland also has higher unemployment rates due to the lower share of state owned enterprises in employment.

Table 5.2.6. Private sector share of GDP (%)

Private sector share in GDP (%)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	30	40.0	45.0	50.0	55.0	60.0	60.0	65.0	65.0	65.0	70.0	Na
Romania	na	25.0	25.0	35.0	40.0	45.0	55.0	60.0	60.0	60.0	60.0	Na

Source: EBRD, *Transition Report*, 2001, pp.180-184.

[7] EBRD, *Transition Report*, 2001, pp.180-184.
[8] EBRD, *Transition Report*, 2001, pp.180-184.

Table 5.2.7. Private sector share of employment (%)

Private sector share in employment (%)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	Na	Na	54.0	57.0	59.0	61.4	63.0	66.7	69.2	70.9	72.0	Na
Romania	Na	Na	41.0	44.0	49.0	51.0	52.0	58.0	62.0	Na	Na	Na

Source: EBRD, *Transition Report*, 2001, pp.180-184.

To sum up, there is evidence of FDI contribution to marketisation as an element of privatisation in both Poland and Romania. Higher levels of FDI annual inflows and FDI per capita in Poland are likely to generate an overall higher impact in the economy. This is consistent with Poland being more advanced in large scale privatisation and with the private sector being responsible for a larger share of both GDP and employment than in Romania. Finally, FDI is not only participating in the privatisation of the former state owned enterprises, but is equally responsible for green field investment. The encouragement of green field investment is crucial for FDI levels to be maintained after privatisation is completed.

FDI, a means of modernisation

The traditional literature on foreign investment identifies its potential impact on economic modernisation through the input of research and development (R&D), technology, management techniques and skills.[9] Poland and Romania have inherited from the communist system industries with old technologies which needed updating in order to keep up with increased competition in international trade. Moreover, the race for EU membership and the need to resist to competitive pressures from inside the Union made modernisation an even more acute necessity.[10] Kalotay found a positive relationship between participation of FDI in privatisation and efficiency gains.[11] Moreover, FDI impact on restructuring is likely to be higher than the effects of other methods of privatisation which lead to dispersion of ownership and thus less incentives for improved governance and overall performance of the enterprise.[12] It is, however, likely that firms bought by foreign investors have already been subject to restructuring or had better performances in the first place, thus reinforcing a certain path dependency. Furthermore, the impact on restructuring depends greatly on the sector where the investment is made. For example, while an investment in the automotive industry is likely to induce a significant increase in labour productivity, investment

[9] Hunya, "International Competitiveness. Impacts on FDI in CEECs", p. 4; Borensztein, M.,"Post-Privatisation Enterprise Restructuring", *Post-Communist Economies*, Vol. 13, No. 2, 2001, p.197; Carlin, W., Estrin, S. and Schaffer, M., "Measuring Progress in Transition and towards EU Accession: A Comparison of Manufacturing Firms in Poland, Romania and Spain", *EBRD Working Paper No. 40*, 1999, p. 8; Barrell, R. and Holland, D., p. 480; Smith, A., "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe" in Smith, J. and Jenkins, C. (eds.), *Through the Paper Curtain. Insiders and Outsiders in the New Europe*, The Royal Institute of International Affairs, London, 2003, p.30.

[10] See Smith, "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe", p.28.

[11] Kalotay, "The Contribution of Foreign Direct Investment Revisited", p.261.

[12] Hunya, "Recent FDI Trends, Policies and Challenges in South East European Countries", p.11.

in banking has a less significant impact on labour productivity. Finally, this impact on restructuring is not restricted to the enterprises acquired or set up by foreign investors. It spills over into domestic firms through increased competition, thus accelerating economic reforms.[13]

Evidence of FDI impact on modernisation is given based on the indicators below, followed by some concrete examples:

a) R&D activities: Higher values of R&D activities are likely to be a result of foreign investors' activities, given the pressure on government expenditure during transition.

b) The EBRD index of enterprise reform: Although enterprise reform has not been exclusively determined by foreign investment, it is likely that higher FDI is associated with higher values of this indicator.

c) Shares of foreign investment enterprises in main indicators of manufacturing companies: A high share in investments, sales and export sales can indicate a positive impact on a firm's modernisation.

d) Labour productivity: An increase in overall productivity is likely to be associated with higher productivity of firms with foreign participation. The effect would also be seen as a result of spill over on domestic firms through competition, integration of production or better training of migratory employees.

An empirical study by Carlin et al finds that in Polish firms training and R&D activities are as significant as in Spanish ones and much more significant than in the Romanian ones.[14] This is consistent with aggregate data on R& D. This is also consistent with the higher FDI in Poland than in Romania and with the overall better economic performance of the Polish economy which allows the state and the private sector to spend more on R&D. In this context, one may assume that part of the variation of the EBRD enterprise restructuring index is due to foreign investment, as a sign of FDI impact on enterprise restructuring. However, the data below does not entirely support this hypothesis. The fact that no improvement in the index is seen in either country since 1993, despite a continuous rise in FDI, is intriguing. On the one hand, it defies expectations, on the other hand, it is consistent with the findings of Boscaiu et al on FDI impact on Romania. They found no significant difference between foreign owned and domestic owned private firms in terms of efficiency and labour productivity. They only confirmed that private firms had better performance than state owned ones, regardless of the provenance of their capital.[15] Similar results were reached by Konings with regard to Romania, although he found a significant impact of foreign ownership

[13] Barrell, R. and Pain, N., "Foreign investment, Technological Change and Economic Growth within Europe", *Economic Journal*, Vol. 107, 1997, p. 177.

[14] Carlin, Estrin and Schaffer, "Measuring Progress in Transition and towards EU Accession", p. 8.

[15] Boscaiu et al, "Impactul comerţului exterior şi investiţiilor străine directe asupra productivităţii în industria prelucrătoare. Cazul României", *Working Paper*, CEROPE, Bucharest, 2001, p.3.

on labour productivity in Poland.[16] Two explanations can be put forward for this. First, FDI is still too small and too new in Romania to have a significant impact. Second, in Romania the foreign owned sector has a bipolar structure, including the best performance firms and low performance ones.[17] This polarisation might be due to the targeting methods used by the Romanian government and the long period of unstable investment climate which must have attracted the wrong type of investors, as discussed in part one. A simple regression shows that FDI annual inflows explain only 36% of the variation of the index of enterprise reform with a low coefficient of 0.28. Furthermore, the scatter plots in appendix 5.2.A indicate a positive, yet feeble relationship between FDI and enterprise restructuring.

Table 5.2.8. EBRD index of enterprise reform (values from 1 to 4.70)

EBRD Index of enterprise reform	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Romania	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0

Source: EBRD, *Transition Report*, 2001, pp.180-184.

Furthermore, the lack of change of the EBRD enterprise restructuring index in both countries and the apparent lack of correlation with FDI can be explained in several ways. First, enterprise restructuring is not instantaneous. Time is needed for its effects to appear. Moreover, some foreign investors still have commitments for restructuring-related investment to be observed as part of post-privatisation contracts. Second, there are still large sectors, both in Poland and Romania, which have not yet been privatised, due to lack of restructuring. These include the coal and the steel sectors and pose the problem of path dependency. The situation of non-restructured companies keeps deteriorating as investors are not interested and thus not contributing to their restructuring. This concern has made the Miller government reconsider the strategy towards the steel and coal sector and propose state intervention, despite limitations by EU regulations on state aid.[18] Third, the FDI impact on enterprise reform depends partially on the level of integration of FDI related firms in the host economy. Finally, the EBRD index of enterprise restructuring has certain definitional limitations and thus is not able to capture the extent of the FDI impact. The broad definition of the indicator and the large spectrum of restructuring as such make quantifying the process rather difficult. Alternative indicators are suggested below to capture the impact of FDI on modernisation.

The effect of FDI on modernisation has to be assessed through more accurate measurements, such as the share of foreign investment enterprises in main indicators of manufacturing companies. The

[16] Konings, J., "Effects of Direct Foreign Investment on Domestic Firms: Evidence from Firm Level Panel Data in Emerging Economies", *WDI Working Paper No. 344*; UNCTAD, *World Investment Report*, 2000, p.5.
[17] Boscaiu et al, p.3.
[18] OECD, *Economic Surveys. Poland*, OECD, Paris, 2002, p.117-122.

following table shows the evolution of indicators such as the share in equity capital, employment, investments, sales and export sales in selected years between 1996 and 2000. In Poland all indicators rose between 1.5 times as, in the case of equity capital, and 2.33 times, as in the case of sales. On the other hand, the levels attained in Romania in 1998 at these indicators were only ¾ of Polish levels for 1996, suggesting an important gap.

Tables 5.2.9a and 5.2.9b. Share of foreign investment enterprises in main indicators of manufacturing companies, 1996- 2000 (%)

	Equity capital		Employment		Investments		Sales		Export sales	
	1996	1998	1996	1998	1996	1998	1996	1998	1996	1998
Poland	29.3	43.2	12.0	26.0	30.0	51.0	17.4	40.6	26.3	52.4
Romania	Na	Na	Na	7.8	Na	23.1	Na	14.1	Na	13.4

Source: Hunya, "Recent FDI Trends, Policies and Challenges in South East European Countries", p. 12.

	Equity capital		Employment		Investments		Sales		Export sales	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
Poland	50.5	Na	29.4	Na	63.1	Na	49.0	Na	59.8	Na
Romania	36.5	43.0	21.0	25.2	43.9	Na	33.9	38.6	33.4	43.9

Source: I. Dumitriu and G. Hunya, "Economic Restructuring through FDI in Romania", 7th *EACES Conference*, 6-8 June, Forli, Italy.

The data above suggests that in 1998 foreign companies in Poland were investing the same overall amount as domestic ones and were more export oriented. This suggests a higher impact on the economy as a whole compared with Romania. The lower share in employment is consistent with domestic firms still being the main employers in the economy. The lower figures for Romania are consistent with a lower FDI and thus a lower impact so far. Further data for 1999 and 2000 shows that in Romania there has been an increase in the participation of foreign owned firms in employment, investment, sales and exports sales, the figures reaching comparative levels with Poland in 1998. These evolutions indicate that the gap between the two countries is reducing. It is also consistent with a surge in FDI in Romania since 1998 and positive economic growth since 2000. This appears to imply that there is a scope for further improvements in foreign investment participation and its impact in the Romanian economy. Furthermore, the increased share in export sales in both countries appears to be a measurement of increased competitiveness on external markets as a result of modernisation. This is also a sign of increasing integration into the world economy.

Regarding the factor content of exports to the EU, Smith finds that there is an increasing gap between the candidate countries. He uses three categories developed by Wolfmayr-Schnitzer which divide manufacturing goods into: products that predominantly embody human-capital-intensive processes; products that embody resource-intensive processes; and products that embody labour-intensive processes.[19] Thus, Poland, and to a larger extent the other Central European economies, exports a higher share of human-capital intensive manufacturing products (34.5%) than, for example, Romania (with 16.6%) and a lower share of labour-intensive products (42.3% v.65.2%).[20] This suggests that Poland is more convergent with the EU, partially as a result of FDI, and can substantially benefit in terms of income and employment from trading with the EU. Its relatively lower convergence compared with Hungary or the Czech Republic is explained by a large domestic and regional market which did not put enough pressure on changing the structure of trade.[21] On the other hand, Romania may have problems in increasing its trade with the EU, should it maintain its dependence on labour-intensive products. Romania is likely to face pressures for protection from existing producers of labour-intensive goods, for which demand is increasing more slowly than for human-capital-intensive goods. [22]

An overall indicator of FDI impact on modernisation can be considered labour productivity.[23] An increase in labour productivity is either specific to the foreign owned firm or results from spill-over effects on domestic investors. The impact depends, however, on the sectoral distribution of FDI and on competitive pressures within the sectors most favoured by foreign investors. Thus, data for 1992-1999 shows that the change in labour productivity in manufacturing in Poland was 178.8 in 1999 (with 1992 as a basis), while in Romania the percentage was of 158.9.[24] The change in Romania was higher than in most other countries in transition, except for Hungary and Poland. This can be due partially to the initial conditions of the Romanian economy which was characterised by obsolete capital, hence a low productivity starting point in the first place. Furthermore, data on Poland shows that the productivity gap between foreign owned and domestic firms has increased from 1.5 to 1.9 in the 1994-1998 period.[25] A similar opinion was developed by Konings who found that foreign owned firms have better productivity than domestic or state owned ones. On the other hand, the aggregate level data above does not entirely contradict Konings' conclusion on the lack of such an ownership effect in the case of Romania.[26]

There are several concrete examples of how foreign investment impacts on modernisation in both Poland and Romania, including product improvement.[27] To take only a few cases, since

[19] Wolfmayr- Schnitzer, Y. cited in Smith, "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe"p.27.
[20] See Smith, "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe", p.27.
[21] Smith, "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe", p.31.
[22] See Smith, "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe", pp.25-26.
[23] EBRD, *Transition Report,* 2000, p.79.
[24] Kalotay, "The Contribution of Foreign Direct Investment Revisited", p.272.
[25] Hunya, "International Competitiveness. Impacts on FDI in CEECs", p.20.
[26] Konings, "The Effects of Direct Foreign Investment on Domestic Firms", p.5.
[27] Hunya, "Recent FDI Trends, Policies and Challenges in South East European Countries", p.14.

Rometelecom was taken over by OTE, the Greek telephony operator, there has been a significant expansion and improvement of the efficiency and quality of its services. During 2000 alone, Romtelecom successfully installed 420,000 new telephone lines and completed the digitalisation of 55% of the whole network. An important priority was the connection of isolated and economically underprivileged towns into the network.[28] This was, however, accompanied by higher tariffs and firings.[29] In Poland, the brewery sector has been largely modernised by foreign investors leading to a sales increase by 7% year-on-year in the first ten months of 2000.[30] Moreover, the presence of foreign investors has contributed to the strengthening of the banking sector. Thus, three banks from Poland figure among the ten major banks in Central and Eastern Europe in a ranking presented by British monthly *The Banker*. These banks are Pekao S.A., the largest in terms of own funds, PKO BP S.A., with the largest assets, and Bank Handlowy.[31] Similarly, in 2000, the Romanian Development Bank- the second largest commercial bank in Romania in which Société Générale has bought 51% of shares- was designated by *The Banker* as the best bank in Romania. This was an acknowledgement of the improvement in service quality and efficiency resulting through privatisation.[32] However, there have been cases in both Poland and Romania when foreign investors registered losses or acquired the companies to scrap and sell them, thus indicating a certain negative effect on modernisation.

To sum up, there is evidence of stronger impact on modernisation in Poland than in Romania with some indications of catching up potential for the latter. Furthermore, the impact of foreign investment on modernisation is subject to certain constraints. First, there is the danger that the companies chosen for privatisation were more competitive in the first place, thus making the assessment of FDI impact more difficult. Second, the overall impact of FDI on modernisation of the host economy depends to a large extent on the sectoral distribution and on the degree of integration with the economy as a whole. There is already evidence that some foreign firms are strongly integrated, thus impacting on other industries up or down stream. This was the case of Daewoo in Romania whose production was 58% integrated.[33] Third, the impact on domestic firms is ambiguous. On the one hand, FDI can induce spill over and healthy competition leading to modernisation in the domestic firms. On the other hand, increased competition can lead to bankruptcies in the domestic sector if there is not enough flexibility to adapt. Finally, the FDI impact on modernisation depends not only on the initial investment, but also on the post-privatisation commitments of investors and thus necessitates time to occur. In Romania, the still low level of FDI appears to be responsible for the insignificant difference between foreign

[28] EBRD, *Investment Profile. Romania*, 2001, p.17.
[29] Hunya, "Recent FDI Trends, Policies and Challenges in South East European Countries", p.15.
[30] EBRD, *Investment Profile. Poland*, 2001, p.17.
[31] EBRD, *Investment Profile. Poland*, 2001, p. 36.
[32] EBRD, *Investment Profile. Romania*, 2001, p. 27.
[33] EBRD, *Investment Profile. Romania 2001*, p. 17.

investors and domestic investors in terms of labour productivity and for the still modest contribution to employment, investment, sales and export sales.

FDI, a means of structural change

Foreign investment induces not only enterprise restructuring, but also restructuring of the entire economy.[34] Through technology inflow and market access, FDI can increase the ability of firms in the host country to adjust to market developments and technological change. Furthermore, the specialisation of foreign affiliates can differ from the domestic ones and thus FDI shifts the production structure.[35] Both countries have inherited from the communist system an economy with a high contribution of industry and agriculture to GDP and a relative low share of the tertiary sector. Furthermore, the requirements of transition to a market economy have included a deep restructuring of the tertiary sector. Thus, reforms in banking, transport and telecommunications infrastructure, whole trade and retail trade were crucial for the performance of the economy as a whole and for ensuring a positive investment climate. They needed, nevertheless, an important inflow of capital and FDI has partially contributed as a means of privatisation, a modernising factor and a factor of structural change. Given that once again the relationship between structural change and FDI is bi-directional, the analysis has to be taken with caution. Furthermore, the level of FDI in industry is still around 50% of all investment. The change in the GDP structure of the Polish and Romanian economy can be associated with foreign investment, especially judging from the statistics on the sectoral distribution of FDI. Moreover, evidence can be given for the improvement in the quality of services in both countries. The level of bank restructuring will be used to assess the impact of foreign investment on the tertiary sector.

The impact of foreign investment on structural change will be assessed starting from the following data:

a) The GDP structure: This is likely to show a switch from industry and agriculture to the tertiary sector and a correlation with the share of FDI in different sectors of the economy.

b) The FDI distribution in different sectors of the economy and the largest investors: FDI may be directed towards sectors with already proven comparative advantage as well as explore new sectors previously undeveloped. The bias towards new sectors is likely to create a structural change in the economy.

c) The number of foreign banks and the index of bank restructuring: They give an indication of the depth of structural change within the tertiary sector.

Data on structural change of the economy supports the idea of an increase in the role of the tertiary sector at the expense of industry and agriculture. Thus, in 2000 66% of GDP came from the tertiary

[34] Hunya, "Recent FDI Trends, Policies and Challenges in South East European Countries", p.14.

sector in Poland and 46.6% in Romania, at the expense of industry, whose contribution in Poland shrank from 40.2% in 1991 to 29% in 2000. The higher share of tertiary sector in Poland is consistent with relatively higher levels of FDI in the financial sector and a decline in the share of agriculture in GDP. Although high levels of FDI have been attracted into industry as a whole in both countries, large loss making enterprises not yet privatised have contributed to the fall of the share of industry in GDP. Finally, differences in the sector service between the two countries can be determined by differences between low value and high value added services.

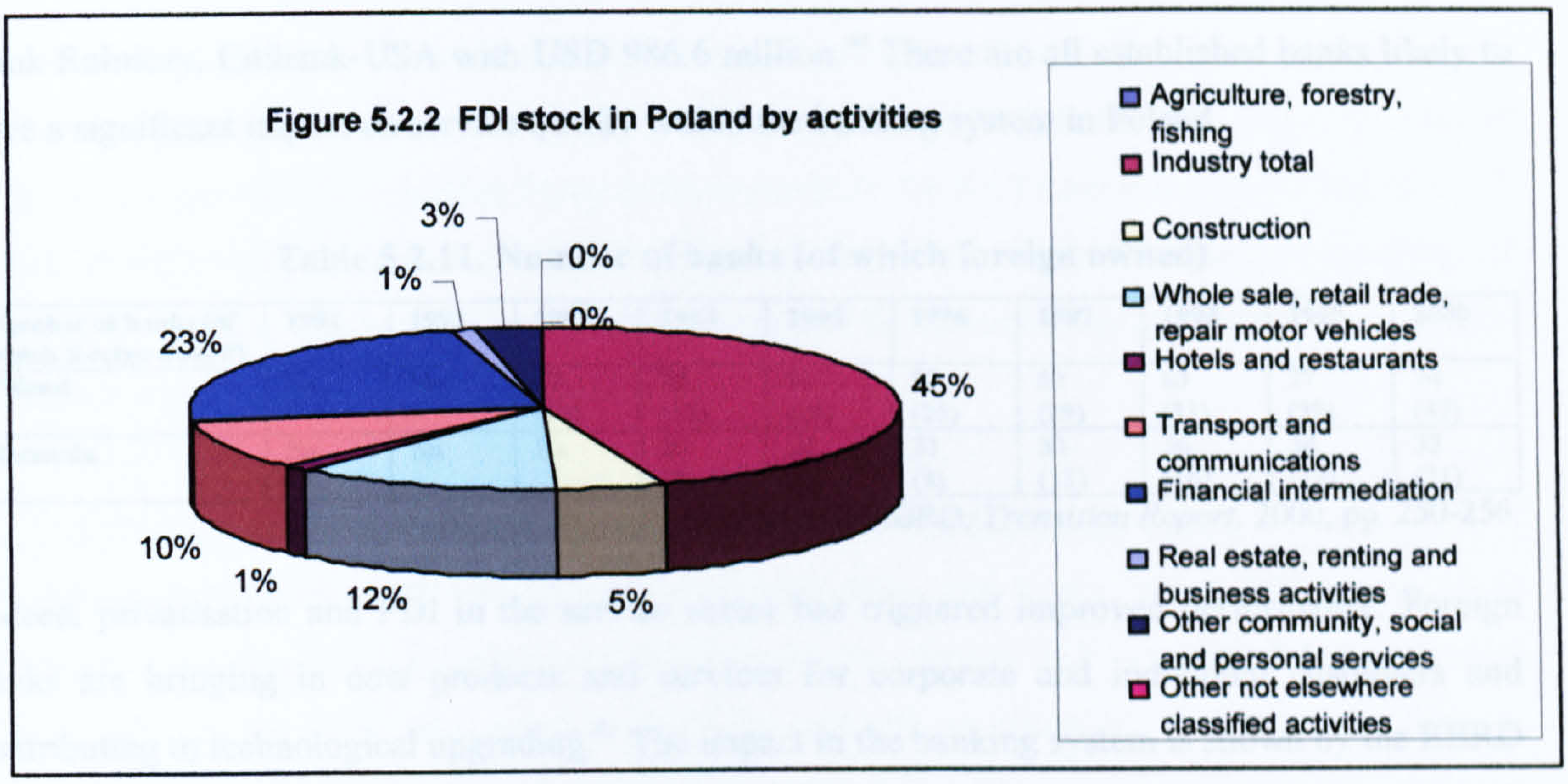
The data on sectoral distribution of foreign investment shows that the tertiary sector has attracted roughly half of the total investment in both Poland and Romania, thus supporting the hypothesis that FDI has been a means of structural economic change. In both countries FDI has been mainly directed to industry, especially automotive industry. The main difference resides though in the distribution of the remaining FDI. The second largest investment share is in the financial sector in Poland, i.e. 22.4 %, which is much larger than the investment in the same sector in Romania. In Romania, the second destination for FDI has been whole sale and retail trade. This indicates a lesser impact at microeconomic level in Romania than in Poland. In Poland, FDI directed towards the financial system has improved the quality of the business environment and the efficiency of enterprises, thus potentially attracting further FDI. Since 1999, privatisation-led investment has been attracted in Poland in telecommunications and banking. In Romania, telecommunications attracted the main investors in 1998 through the privatisation of Romtelecom and the investment by OTE-Greece, which bought 35% of the shares.[36] Data on FDI stock by activities in Poland and Romania and largest investors as of 2002 is provided in appendix **5.2.B.**

Table 5.2.10. GDP structure in Poland and Romania (%)

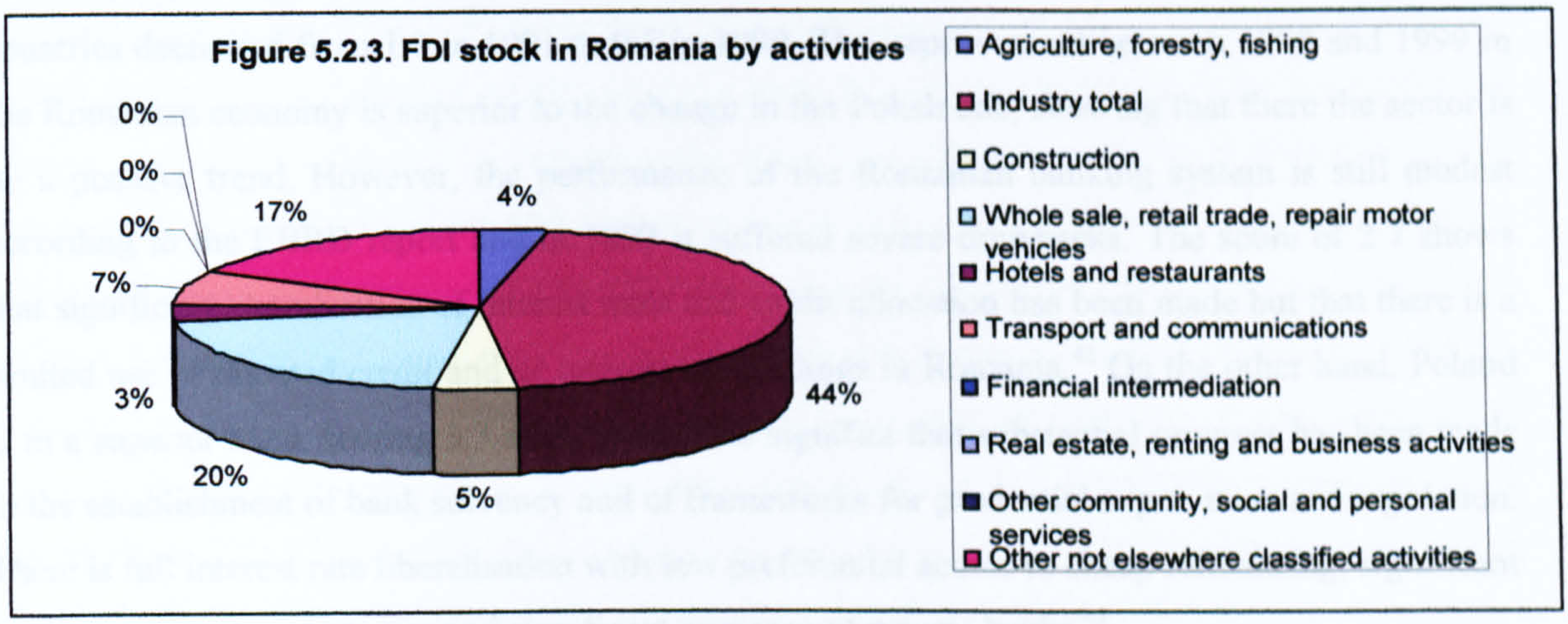
GDP structure in Poland	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Share of industry in GDP (%)	40.2	34.0	32.9	32.2	29.2	27.1	28.1	28.1	28.2	29.0
Share of agriculture in GDP (%)	6.8	6.7	6.6	6.2	6.4	6.0	5.7	5.5	5.2	5.0
Share of tertiary sector in GDP (%)	53.0	59.3	60.5	61.6	64.4	66.9	66.2	66.4	67.6	66.0
GDP structure in Romania										
Share of industry in GDP (%)	37.9	38.3	33.8	36.2	32.9	34.2	35.6	27.5	27.8	27.6
Share of agriculture in GDP (%)	18.9	19.0	21.0	19.9	19.8	19.1	18.8	14.5	13.9	11.4
Share of tertiary sector in GDP (%)	43.2	42.7	45.2	43.9	57.3	46.7	45.6	58.0	58.3	46.6

Source: EBRD, *Transition Report*, 2001, pp.180-184 and own calculations.[37]

[35] Hunya, "International Competitiveness. Impacts on FDI in CEECs", p.4.
[36] EBRD, *Investment Profile.Romania, 2001*, p.17.



Source: PAIZ[49]



Source: WIIW[50]

Statistics show further differences between foreign participation in banking privatisation in Poland and Romania. The higher number of banks in Poland suggests higher competition and thus higher positive impact on the economy as a whole. Moreover, in Poland the accumulated value of investments recorded in the financial sector by the end of June 2000 amounted to more than USD 9.2 billion, i.e. 23.7 % of the overall inflow of direct investments.[51] FDI accounts in Poland for 70% of the total assets in the domestic market banking sector as compared to only 52.6 % in Romania.[52] Amongst the investors in the banking sector in Poland one can note Unicredito Italiano with USD 1,042 million purchase of 50.09% of Pekao, Bayerishe Hypo-und Vereinsbank AG-Germany with USD 1,000 million stakes in Bank Przemyslowo-Handlowy and in Wielkopolski

[49] PAIZ, *FDI in Poland, http://www.paiz.pl*
[50] WIIW, p.450
[51] EBRD, *Investment Profile. Poland*, 2001, p.9
[52] EBRD, *Investment Profile. Poland*, 2001, p. 37; EBRD, *Investment Profile.Romania*, 2001, p. 26

Bank Rolniczy, Citibank-USA with USD 986.6 million.[40] These are all established banks likely to have a significant impact on service quality within the banking system in Poland.

Table 5.2.11. Number of banks (of which foreign owned)

Number of banks (of which foreign owned)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Poland	Na	Na	87 (10)	82 (11)	81 (18)	81 (25)	83 (29)	83 (31)	77 (39)	74 (47)
Romania	Na	Na	Na	20 (3)	24 (6)	31 (8)	33 (13)	36 (16)	34 (19)	33 (21)

Source: EBRD, *Transition Report,* 2000, pp. 250-256.

Indeed, privatisation and FDI in the service sector has triggered improved performance. Foreign banks are bringing in new products and services for corporate and individual customers and contributing to technological upgrading.[41] The impact in the banking system is shown by the EBRD index of banking restructuring. Poland has scored 3.3 since 1998 with however, a better starting point than Romania, i.e. 2.0 in 1991 in comparison with 1.0. Moreover, the gap between the two countries decreased from 1.0 in 1991 to 0.6 in 1999. The improvement between 1998 and 1999 in the Romanian economy is superior to the change in the Polish one, showing that there the sector is on a positive trend. However, the performance of the Romanian banking system is still modest according to the EBRD report and in 1997 it suffered severe drawbacks. The score of 2.7 shows that significant liberalisation of interest rates and credit allocation has been made but that there is a limited use of directed credit and or interest rate ceilings in Romania.[42] On the other hand, Poland is in a superior band, scoring 3.3 since 1998. This signifies that substantial progress has been made in the establishment of bank solvency and of frameworks for prudential supervision and regulation. There is full interest rate liberalisation with low preferential access to cheap refinancing, significant lending to private enterprises and significant presence of private banks.[43]

Table 5.2.12. EBRD index of banking sector reform (values from 1 to 4.70)

EBRD index of banking sector reform	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Romania	1.0	1.0	1.0	2.0	3.0	3.0	2.7	2.3	2.7	2.7	2.7

Source: EBRD, *Transition Report,* 2001, p.180-184.

To sum up, there is evidence of structural change of the Polish and Romanian economy in both quantitative and qualitative terms and FDI may be an explanatory factor. Thus, there has been a high increase in the share of the tertiary in GDP in both countries, which is consistent with almost half of foreign investment being attracted in this sector. However, this trend is likely to be counterbalanced by an increase in the role of industry. An investment climate improved by a

[40] EBRD, *Investment Profile. Poland 2001*, p. 37.
[41] *The Banker*, April, 2000, p.57.
[42] EBRD, *Transition Report,* 2001, p.180-184.
[43] EBRD, *Transition Report,* 2001, p.180-184.

restructured tertiary sector, combined with further privatisation of hard-core sectors of the economy such as steel, coal or energy can lead towards further investment in industry. The higher investment in the banking system in Poland is likely to be responsible for the higher share of tertiary in GDP, as well as for a better performance in banking, in attracting further investment and in improving the economy in general. The higher share of tertiary can still be sustained through further liberalisation of fields such as transport or telecommunications.

5.2.2 On foreign direct investment and integration with the European Union

The relationship between FDI and integration into the EU is also bi-directional. Thus, prospect of EU membership improves the investment climate and thus fosters FDI in the candidate countries. This hypothesis has been introduced in part one and will be tested in chapter seven through econometric modelling. Furthermore, levels of foreign investment are evidence of increased economic integration and represent means to enhance institutional integration, as suggested in chapter three part two. Finally, FDI can foster further integration with the EU as will be seen below and as represented in diagram 5A(a). So, how does FDI foster integration with the EU? First, foreign investment enhances privatisation and thus marketisation which is a condition of EU membership. This channel of the FDI impact on integration with the EU has been analysed earlier by considering FDI a means of privatisation and a modernisation factor. Second, increased investment from the EU contributes to a positive lobby for Romania's accession into the EU from business and political EU circles. The role of the EU's attitude in enhancing the prospect of EU membership has been assessed in chapter three and is represented graphically in diagram 3A in chapter three. Third, improvements in productivity and underlying services can increasingly lead to privatised firms being incorporated into regional and global networks of transnational corporations and thus enhance trade.[44] Evidence of integration with the EU as a whole has been given in chapter three, part two. This section gives evidence using firm level data.

Firm level data and studies suggest that foreign owned firms are increasingly trading with the EU and thus contribute to increased economic integration.[45] Thus, the FDI impact on trade has been proven by Markusen et al.[46] The contribution of FDI to Poland and Romania's integration into the world economy in general and into the European Union in particular will be assessed based on the following indicators:

a) Exports and imports by foreign owned firms: They show the propensity to import and export of foreign owned firms and thus their integration into the world economy.

[44] Kalotay, "The Contribution of Foreign Direct Investment Revisited", p. 262; UNCTAD, *World Investment Report*, 2000, p.53.
[45] Hunya, "International Competitiveness. Impacts on FDI in CEECs", p.7.
[46] Markusen et al cited in Krkoska, "Foreign Direct Investment Financing of Capital Formation", p.3.

b) The share of trade with non-transition countries: It shows the re-orientation of trade after the dismantlement of the former Council of Mutual Economic Assistance (CMEA), possibly correlated with the countries of origin of foreign investment.

c) The sources of foreign investment in both Poland and Romania: They show the level of integration with the EU member states through investment.

The level of the CEECs' integration into the global and the EU economy has increased since early 1990s. In a study on the Czech Republic, Poland, Hungary and Slovenia, Rojec showed that by mid-1990s integration was less than half completed. Only one third of the foreign firms were integrated in the investing network at that time.[47] However, a 2001 study by Kaminski and Smarzynska argued that Poland is increasingly taking part in global production and distribution networks through FDI inflows. Domanski found that FDI decreased the competitiveness gap between Poland and the EU.[48] Smith argues that there is a correlation between FDI and export performance of countries in transition.[49] Data for 1998 shows an increased export share of foreign firms in total exports in 1998 as compared to 1996.[50] Furthermore, table 5.2.13 shows that foreign owned firms (FOFs) have been more dynamic than domestic ones (DFs), both in exports and imports. Between 1994 and 1998 exports by foreign owned firms increased approximately 4 times, while exports by locally owned firms merely increased 1.07 times. FOFs increased their imports 3 times, while imports by DFs rose only approximately 1.5 times during the same period. Both local and foreign owned Polish firms are import oriented, but the ratio of exports to imports is higher in domestic firms, 67% v. 53.8%. These higher relative imports can be related to increased imports of capital goods by foreign firms as part of their contribution to the modernisation of economy or needed due to the standardisation of production. Boscaiu et al found that in Romania foreign ownership was associated with high export value, while state ownership was associated with a low export volume.[51] Furthermore, 38% of sales and 44% of exports originate from foreign affiliates.[52] The same study argued that frequency and intensity of export activities are maximal for foreign owned firms. However, a high propensity to import has been identified at the same time which is consistent with the assumption that foreign firms are responsible for increased imports of capital

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[47] Rojec, M. cited in Kalotay, "The Contribution of Foreign Direct Investment Revisited", p. 267.

[48] Domanski, B., "Industrial Change and FDI in the Postsocialist Economy. The Case of Poland", *European Urban and Regional Studies*, Vol. 10, No.2, April 2003, p.99.

[49] Smith, A., The *Return to Europe: The Reintegration of Eastern Europe into the European Economy*, MacMillan in association with the School of Slavonic and Eastern European Studies, Basingstoke, 2000, p.182.

[50] Kaminski, B. and Smarzynska, B., "Integration into Global Production and Distribution Networks through FDI: The Case of Poland", *Post-Communist Economies*, Vol. 13, No. 3, 2001, p. 282.

[51] Boscaiu et al, "Impactul comerţului exterior, p.12-13.

[52] Hunya, G., "FDI in South Eastern Europe in Early 2000s", WIIW, *A Study Commissioned by the Austrian Ministry of Economy and Labour*, 2001, p. 7.

goods and primary materials.[53] These are, nevertheless, signs of increased integration into the global economy.

Table 5.2.13. Exports and imports of foreign owned and locally owned firms (USD mn.), Poland

	1994	1995	1996	1997	1998
Exports					
Foreign owned firms	3,609	7,770	9,267	11,047	13,528
Locally owned firms	13,577	15,084	15,120	14,644	14,661
Imports					
Foreign owned firms	7,101	10,758	15,674	21,120	24,122
Locally owned firms	14,331	18,260	21,418	21,133	21,878
Foreign owned firms' share in total exports	21	34	38	43	48
Foreign owned firms' share in total imports	33	37	42	50	53
Ratio of exports to imports					
Foreign owned firms	50.8	72.2	59.1	52.3	53.8
Locally owned firms	94.7	82.6	70.6	69.3	67.0
All firms	80.2	78.8	65.7	60.8	60.0

Source: Foreign Trade Research Institute cited in Kaminski and Smarzynska, "Integration into Global Production", p. 275.

In terms of geographical distribution, Carlin et al found that in Poland the export activity of state enterprises did not appear to be dominated by a legacy of trade links with former Council of Mutual Economic Assistance (CMEA) countries.[54] In Poland, 1993 constituted a peak for non-transition trade partners, with a declining importance ever since until 1999, when the trend changed again. The decrease from 1993-1999 can be explained partially through the recession in some Western countries and through the increased trade within CEFTA, a regional integration scheme meant to enhance trade and co-operation and prepare the members for full integration into the EU, as in chapter six. Data on the trade distribution shows that in Romania the share of trade with non-transition countries in total trade has increased from 65.8% in 1991 to 89.5% in 1999, pointing to a decreasing importance of the former CMEA links. This trend in the geographical orientation of trade can be partially associated with increased levels of foreign investments from non-transitional countries which have either been complemented by imports, or have generated increased exports.

Table 5.2.14. Share of total trade with non-transition countries (%)

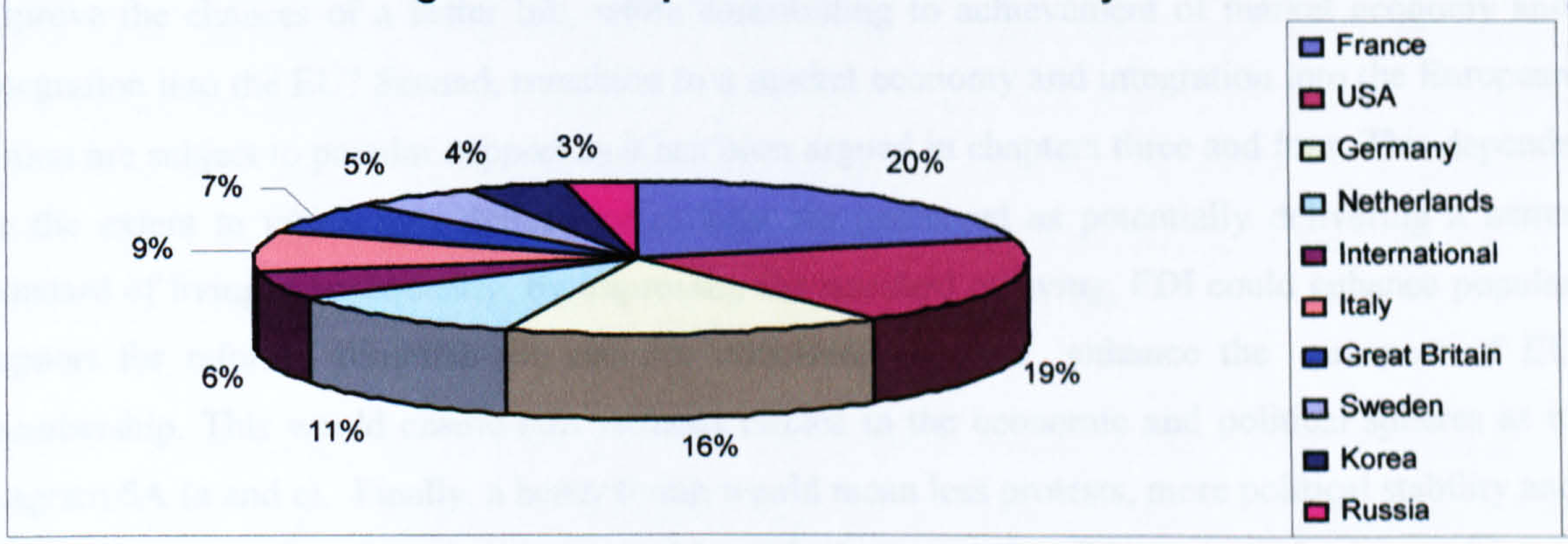
Share of total trade with non-transition countries (%)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Poland	83.2	84.4	87.7	86.3	82.3	79.3	75.5	74.7	79.3	81.1
Romania	65.8	74.8	84.4	86.2	88.8	88.9	86.5	88.0	89.5	87.5

Source: EBRD, *Transition Report*, 2001, p.180, 184.

[53] Boscaiu et al, pp.12-13.

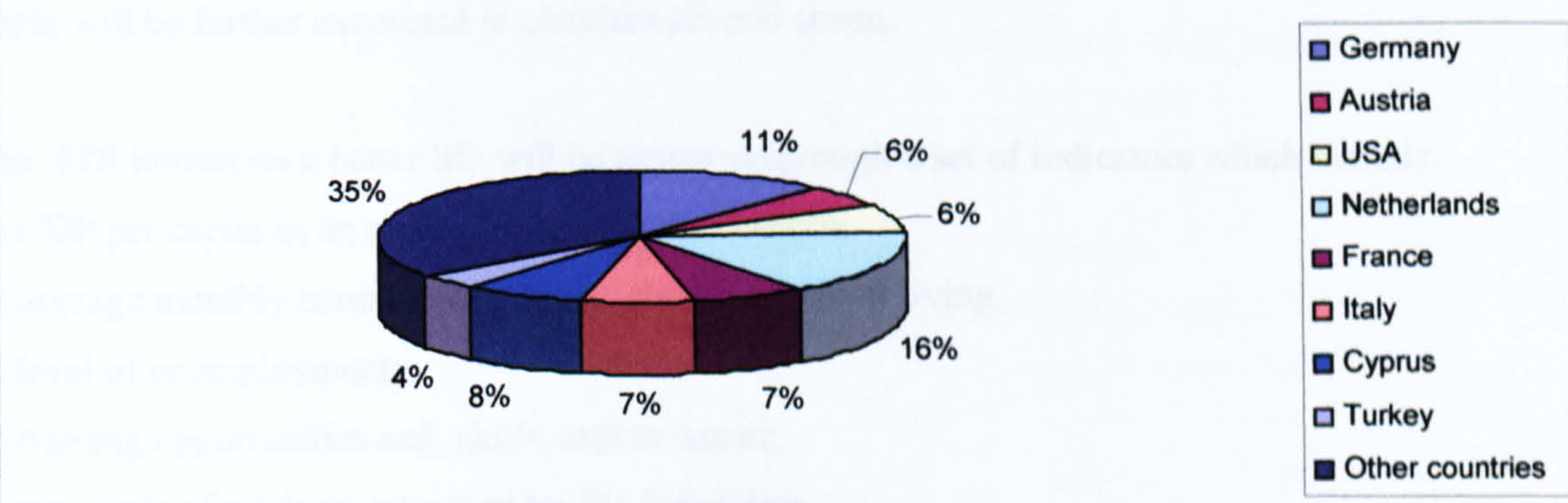
Data on the origin countries of FDI provided in appendix **5.2.B** and in the figures below shows that the majority of investment in both countries originates from EU member states, thus suggesting an increased integration with the EU. In both countries the main investors come from the EU, except for the US in Poland and Cyprus in Romania. The US investment in Poland can be explained through the large expatriate community in the US, the strong lobby and the traditional affiliation with the US. The Cypriot investment in Romania may have three possible explanations: a shared Balkan culture, geographical proximity and the use of the tax paradise in Cyprus by non-Cypriot investors.

Figure 5.2. 4. Capital invested in Poland by countries



Source: PAIZ[72]

Figure 5.2. 5. Capital invested in Romania by countries



Source: WIIW[73]

To sum up, there is strong evidence of increased integration of foreign owned firms in international trade and especially with the EU. The share of foreign owned firms in both exports and imports has increased in both Poland and Romania, showing a continuous integration into the world economy, with a higher level for Poland. Although it is difficult to dissociate integration in the world trade from integration into the EU, an increased share of trade with non-transitional countries and a high share of EU member states in investment suggests a trend towards higher integration into the EU than integration with other countries. This is consistent with both countries being candidates for EU

[72] PAIZ, Foreign investment in Poland, 2001

[73] WIIW cited in G. Hunya, *FDI in South Eastern Europe in Early 2000s*, p.14; PAIZ, http: //www.paiz.pl

membership and with the analysis conducted in chapter three. Furthermore, FDI triggers trade as suggested by firm level data, but the reverse causality is also possible, as part of the stages of a firm's production internationalisation. This relationship will be assessed quantitatively in chapter seven.

5.2.3 On foreign direct investment and a better life

Why assess the impact of FDI on a better life? Here are just a few reasons. First, the fall of Communism was driven by people's hope for freedom and a better standard of living. Market economy and EU membership were seen as means to achieve these goals. Can foreign investment improve the chances of a better life, while contributing to achievement of market economy and integration into the EU? Second, transition to a market economy and integration into the European Union are subject to popular support as it has been argued in chapters three and four. This depends on the extent to which they deliver, or at least are perceived as potentially delivering a better standard of living. Consequently, by improving the standard of living, FDI could enhance popular support for reforms, diminish the security concerns and thus enhance the prospect of EU membership. This would ensure two virtuous circles in the economic and political spheres as in diagram 5A (a and c). Finally, a better living would mean less protests, more political stability and thus an improved investment climate capable of further attracting FDI and reinforcing a virtuous circle of economic development. The role of internal stability in enhancing the virtuous political circle will be further examined in chapters six and seven.

The FDI impact on a better life will be assessed through a set of indicators which include:

a) GDP per capita as an aggregate indicator of wealth;

b) average monthly earnings, as a proxy for standards of living;

c) level of unemployment;

d) training opportunities and skills improvement;

e) standards of work as promoted by EU legislation;

f) consumer choice.

Data for GDP per capita at purchasing power parity (PPP) exchange rate between 1991 and 1999 in table 5.2.15 shows a significant improvement in Poland, with USD 3,987 in 1999, almost double that in 1991. This is a good measurement of the success of reforms and contributes to increasing convergence between Poland and the EU. In Romania, in 1995 the level of GDP per capita was the same as in 1991, while in 1999 it only increased by approximately USD 300. This reflects the stagnation of reforms in Romania and the fact that the population supports the cost of both transition and integration into the EU, with yet rather low benefits. The fact that there is still a high level of grey economy in Romania not captured in the official statistics of GDP does not change dramatically the gap between the two countries.

Table 5.2.15. GDP per capita at PPP exchange rate (USD)

GDP per capita (in USD dollars)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Poland	Na	2,037	2,197	2,234	2,399	3,085	3,483	3,511	4,066	3,987	4,108	4,736
Romania	Na	1,245	859	1,158	1,323	1,243	1,290	1,395	1,845	1,515	1,644	1,772

Source: EBRD, *Transition Report*, 2001, p. 180, 184.

A second impact in terms of an improved standard of living is the increase in wages for the employees of foreign owned enterprises and the spill over effect on wages in general.[55] Dochia found in a study on the performance of private enterprises in Romania that employees of private companies earned more than those working for the state ones.[56] However, this largely depends on the sector of activity and on the progress in privatisation. Comparable wages are in agriculture, construction and managerial or intellectual occupations while real estate employees, technicians and clerical staff earn more in the private sector than in the public one. However, the improvement in earnings in the private sector, including foreign firms, is still modest in comparison with the expectations and is still far from the EU average. [57]

Table 5.2.16 shows that the average salary per worker per economy and the GDP per capita levels have increased in both Poland and Romania since early 1990s. However, through setting high wages and increasing labour productivity foreign investors are likely to increase unemployment, thus affecting negatively the standards of living.[58] Furthermore, an increase in wages offered by foreign firms accentuated the inequality of Polish society in which the so called losers of transition are confronted with lower earnings.

Table 5.2.16. Average gross monthly wages

	Wages compared at current exchange rates (USD per month)			Wages compared at PPPs (USD per month)		
	1994	1995	1996	1994	1995	1996
Poland	241	300	331	502	534	518
Romania	86	104	104	255	285	305

Source: OECD, *Economic Surveys. Romania, 1998*, p.125.

The impact of FDI on unemployment is ambiguous. First, improved technology and increased productivity lead to increased unemployment. Furthermore, before many enterprises could be sold they had to be restructured, including firing of excess labour. Additionally, foreign owned enterprises usually proceed cautiously in shedding excess labour for at least two possible reasons. In some cases they were constrained by explicit or implicit employment guarantees in the

[55] Borensztein, "Post-Privatisation Enterprise Restructuring", p. 197.
[56] Dochia, A., "New Private Firm Contributions to the Structural Change in the Romanian Economy", CEROPE, *Working Paper No. 12*, 2000, p.10.
[57] OECD, *Economic Surveys. Romania*, February 1998, p.129.
[58] UNCTAD, *World Investment Report*, 2000, UNCTAD, Geneva, p.181.

privatisation contracts. In other cases they were concerned about hostile public opinion concerning foreigners' purchases of former state owned enterprises.[59] Finally, through the creation of green field enterprises foreign investment contributes to absorbing excess labour by creating new jobs while privatised and state-owned enterprises continue to contract.[60]

A study by Bilsen and Konings showed that job creation was disproportionately concentrated in green field enterprises, while job destruction is high in the state and privatised firms. Moreover, privatised firms have higher job destruction than the state owned ones.[61] These results can be extrapolated to foreign firms without, however, being able to make any inference on the difference between these and the domestic owned ones. Research shows that Polish state and privatised firms still stand out from their Romanian counterparts through their propensity to hoard labour. In Romania, there is still some labour hoarding in the state sector but not elsewhere.[62] This might be a result of the remaining relative high percentage of state sector in Romania and of the low share of green field enterprises in total private ownership.

However, these results are only indirectly related to the FDI impact on unemployment, as there is a large representation of domestic owned firms in both countries. The same restrictions apply to the aggregate data presented below, which suggests increased unemployment for the early stage of transition and restructuring in Romania. A steeper surge was registered in Poland in the period 1991-1994 and was the social price of the shock therapy which later led to a gradual approach to privatisation by subsequent governments. The effects of the Russian financial crisis and a second wave of restructuring of the hard-core of the economy, i.e. the energy sector, especially mining, are amongst the causes for the increasing unemployment in 1998 and 1999 in Poland. The recession and a second attempt to boost privatisation are responsible for the increase in unemployment in Romania in 1998 and 1999. The decrease in 2000 and 2001 can be considered a belated effect of FDI and of the social policies applied by the Năstase government in 2001. The high unemployment rate is a downside of economic transition and FDI in Poland. Furthermore, it emphasises the need to increase efforts to encourage job creation in small and medium enterprises and to foster further green field foreign investment as has been the aim of the Miller government.

[59] Borensztein, "Post-Privatisation Enterprise Restructuring", p.197; UNCTAD, *World Investment Report*, 2000, p. 197.
[60] Carlin, Estrin and Schaffer, "Measuring Progress in Transition and towards EU Accession", p. 8.
[61] Bilsen, V. and Konings, J., "Job Creation, Job Destruction and Growth of Newly Established, Privatised and State-Owned Enterprises in Transition Economies: Survey Evidence from Bulgaria, Hungary and Romania", *WDI Working Paper No. 106*, November, 1997, p.3, 9.

Table 5.2.17. Unemployment rate (% of labour force)

Unemployment (% of labour force)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 est.	2001
Poland	6.1	11.8	13.6	16.4	16.0	14.9	13.2	10.3	10.4	13.1	15.0	14.0
Romania	Na	3.0	8.2	10.4	10.9	9.5	6.6	7.4	10.4	11.5	10.5	9.9

Source: EBRD, *Investment Profile. Poland, 2001*, p. 8; EBRD, *Investment Profile. Romania, 2001*, p.10; EBRD, *Transition Report 1999*, pp. 252-257.

FDI is equally known for its positive impact on labour skills through increased training opportunities, superior management and the input of know-how. These skills transfer not only to employees of the foreign companies, but also spill over to domestic enterprises through labour mobility or through competition.[63] Furthermore, as seen in part one, Poland has increasingly used fiscal incentives for investors who are willing to train their employees, thus encouraging improvements of the labour force. In the long run, these improvements of the labour force are likely to increase the potential output of the economy.

Despite the opinion that some foreign investors tend to exploit their employees, FDI can indirectly ensure a better standard of living through the impact on labour legislation and compliance with the *acquis communautaire*. By upholding the *acquis communautaire*, Western investors tend to enhance its enforcement, also contributing to progress towards membership of the EU. Thus, Estrin et al found that compliance with the equal pay directive was uniformly high across Poland, Romania and Spain, comparing state-owned enterprises, green field and privatised companies. Compliance with the working time directive is high in Eastern European countries- with over three quarters of firms reporting compliance- but still lower than in Spain. Green field firms in Poland seem to comply less while in Romania, compliance levels are uniform across the three types of companies, but at a lower level than for Poland. In meeting the occupational safety directive, the Polish firms report the same level of compliance as Spanish ones, while Romanian firms have been well behind them. However, new start-ups in Romania show higher compliance levels than state owned enterprises.[64] These results are consistent with Romania being far more behind in the race for EU membership and in enforcing the *acquis communautaire*. They also suggest a higher positive impact in Poland.

Finally, the impact of FDI on a better life can be assessed through the increase in the quality, quantity and choice of consumer products. Given that prior to 1989 the market lacked even basic consumer products and trade related services were very poor, investment in the retail business is a sign of significant improvements in the standard of living of the population. Thus, statistical data on Poland shows that FDI in Poland has been rapid and extensive and that foreign retailers control now 10-12% of the total retail market in Poland. Poland has now 95 hyper-markets with at least

[62] Carlin, Estrin and Schaffer, "Measuring Progress in Transition and towards EU Accession", p.8.
[63] Borensztein, "Post-Privatisation Enterprise Restructuring", p. 197.

2,500 square meters of sales area, 730 supermarkets with over 400-2,499 square meters of sales area, and 936 discount retail outlets. Moreover, hypermarkets share about 22% of the total retail market.[65] Companies such as Nestlé, Coca Cola, McDonald's, Carrefour are common places in both countries ensuring improved service quality.[66]

To sum up, FDI has increasingly led to a better life in both countries, but the quantification of this effect is still difficult. On the one hand, there has been an increase in GDP per capita, monthly wages, equality of pay and labour force skills, but there has also been an increase in unemployment and regional disparities, partially related to the restructuring needed to attract investors. Green field investment should be promoted in order to offset the job destruction resulting at times from the privatisation led investment.

5.2.4 Foreign direct investment on foreign direct investment

The impact of FDI on attracting further FDI is important for assessing a possible path dependency in Poland and Romania. This hypothesis was put forward in chapter one. There are two main channels through which investment can induce further FDI and thus reinforce a virtuous circle of economic development, transition to a market economy, improved standard of living, internal and external stability and integration into the EU. First, FDI gives a positive signal to other investors about the investment climate of the host country as a positive element of the country image and the assessment of the country risk. Furthermore, figures of past levels of FDI can be used in FDI promotional campaigns, as in the case of Poland. Second, present investors can decide to reinvest their profits in an enterprise, sector or economy which have proven profitable.[67] Evidence of this possible impact will be given below. However, negative effects may occur when FDI crowds out domestic investment.[68]

So, is there evidence that FDI has determined further FDI so far? First, data shows that most of the CEECs have been successful so far, by international standards, in keeping an important share of the profits derived from foreign investments in the form of reinvested earnings. For the years 1993-1998, 48% of the profits made by foreign owned companies in Poland were retained as opposed to 61%, the Central and Eastern European average. [69] Similarly, a poll conducted in Romania in 2001 by the consultancy firm KPMG suggests that more than 60% of foreign investors wanted to reinvest their profits in Romania in 2002.[70] Second, foreign firms are generally more active in

[64] Carlin, Estrin and Schaffer, "Measuring Progress in Transition and towards EU Accession", p. 12.
[65] EBRD, *Investment Profile. Poland*, 2001, p. 15.
[66] EBRD, *Investment Profile. Poland*, 2001, p. 15; EBRD, *Investment Profile. Romania*, 2001.
[67] Hallam, "Poland's Tiger Economy", *European Business Journal*, Vol. 11, No. 2, 1999, p. 72.
[68] UNCTAD, *World Investment Report*, 2000, p.53.
[69] Kalotay, "The Contribution of Foreign Direct Investment Revisited", p. 276.
[70] *Adevărul Economic*, 2001.

investment than domestic ones.[71] However, a study by Carlin et al found that Romanian private enterprises, foreign owned included, had much lower investment rates than Polish ones which actually exceeded the investment rates in the Spanish companies. Thus, Polish enterprises appeared to be engaged in 'deep restructuring' whereas the Romanian ones were still in the earlier phase of 'reactive' low-investment restructuring.[72] These results are consistent with the macroeconomic stability being not yet perceived as lasting in the Romanian economy and thus investors being more reluctant to reinvest their profits.

To sum up, within a stable macroeconomic framework, FDI has the potential to attract further FDI, thus reinforcing a virtuous circle of economic development. Hence, it is important that efforts are made not only to attract foreign investment, but also to maintain and encourage post-privatisation investment and reinvestment of profits in general. The extent to which previous FDI determines present FDI will be further assessed in chapter seven.

5.2.5 Conclusion

Chapter five has analysed the FDI determinants in Poland and Romania by referring to the political and economic spheres identified in chapter one. It also provided evidence of FDI impact on transition to a market economy, integration with the EU, a better life and attracting further investment. These are elements of the economic and political circles whose interaction have influenced the accession process. This qualitative analysis set the background for a quantitative assessment of FDI determinants and impact in chapter seven. The aim of the analysis was to identify the role that FDI can play in the transition and the EU accession process and to define the conditions needed for attracting the necessary investment in Poland and Romania. Several conclusions were drawn.

First, the attractiveness of the investment climate in each country depended not only on the policies pursued by the government, but also on the extent to which these policies were influenced by the political sphere. A positive attitude of the Polish government towards FDI since the early 1990s contributed to the adoption of several FDI enhancing policies, hence the steady growth of FDI inflows since 1990. This positive attitude was enhanced by the support of international organisations and counterbalanced the temporary loss of public enthusiasm for FDI. Hence, a virtuous circle of political factors was ensured in the early years of transition. Although the 1993 elections saw a slow down in privatisation, this did not lead towards a negative circle given the reinforcing power of the economic sphere, now on a virtuous path. By 1997 the political virtuous circle was ensured by the government's renewed positive attitude towards FDI that enhanced the economic sphere through bold FDI related policies. In Romania on the other hand, the hesitant

[71] Hunya, "International Competitiveness. Impacts on FDI in CEECs", p.28.

governmental attitude towards FDI in the early transition was complemented by low public enthusiasm, thus creating a vicious political circle. This enhanced and was enhanced by the vicious circle in the economic sphere resulting from the hesitant reforms applied by the government. The vicious circles in the political and economic spheres were perpetuated until 1996 when elements of virtuous circles appeared: a more determined attitude from the government, a more enthusiastic public support, increased support from the international organisations and a new impetus in the FDI related policies. Although the positive elements in the political sphere were rather short lived, a virtuous economic circle was enhanced and maintained. Furthermore, in 2000 the political virtuous circle was enhanced through increased governmental commitment and through enhanced external support deriving from the opening of accession negotiations with the EU.

Second, the government plays a crucial role in enhancing the attractiveness of the investment climate through the macroeconomic policies conducted, the privatisation mix adopted and the promotional policies implemented. Macroeconomic stability represents a necessary condition for attracting FDI. Thus, the early stabilisation of the Polish economy contributed greatly to the steady increase in FDI while Romania's failure to stabilise the economy by 1996 constituted a constant deterrent for large investors. This also partially explains why a similar policy mix in privatisation led to different results in the Polish and Romanian economy. Privatisation represents the engine of investment flows and a change of focus towards direct sales to investors rather than MEBO or mass privatisation has led to increased inflows in both countries. However, the success of privatisation has depended not only on the investment supply but also on the investment demand. This was sensitive to factors other than progress in privatisation which will be further analysed in chapter seven. Fiscal and financial facilities can enhance the attractiveness of the investment climate, provided that the economy is stabilised. They can stimulate green field investment, thus ensuring investment flows after privatisation is completed. They are thus a complement and not a substitute for the other types of policies discussed. Furthermore, facilities can be used in order to enhance the positive impact of the FDI on the host economy.

Part two has presented evidence of the scope and impact of FDI on Poland and Romania so far. The impact was assessed at four interconnected levels, each of them related to the elements of the economic and political circles considered in this dissertation: progress of transition to a market economy or economic reforms, integration into the EU, better life or security concerns and further FDI. The analysis has noted that some of the relationships considered in order to assess the FDI impact were bi-directional. This was the case of privatisation or reforms and FDI or FDI and economic integration with the EU, to name just a couple. The way to deal with this reversed causality was to dissociate determinants from impact and to test the role of FDI in enhancing

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[72] Carlin, Estrin and Schaffer, "Measuring Progress in Transition and towards EU Accession", p. 8.

further FDI, as a way to reinforce a virtuous economic circle. The investigation has shown an overall positive impact of FDI in both countries, despite certain negative effects. The analysis has emphasised that earlier and more substantial investment in Poland has led to an enhanced impact at all levels considered. The impact has, nevertheless, depended on additional factors such as the sectoral distribution of FDI and the integration of foreign firms within the host economy.

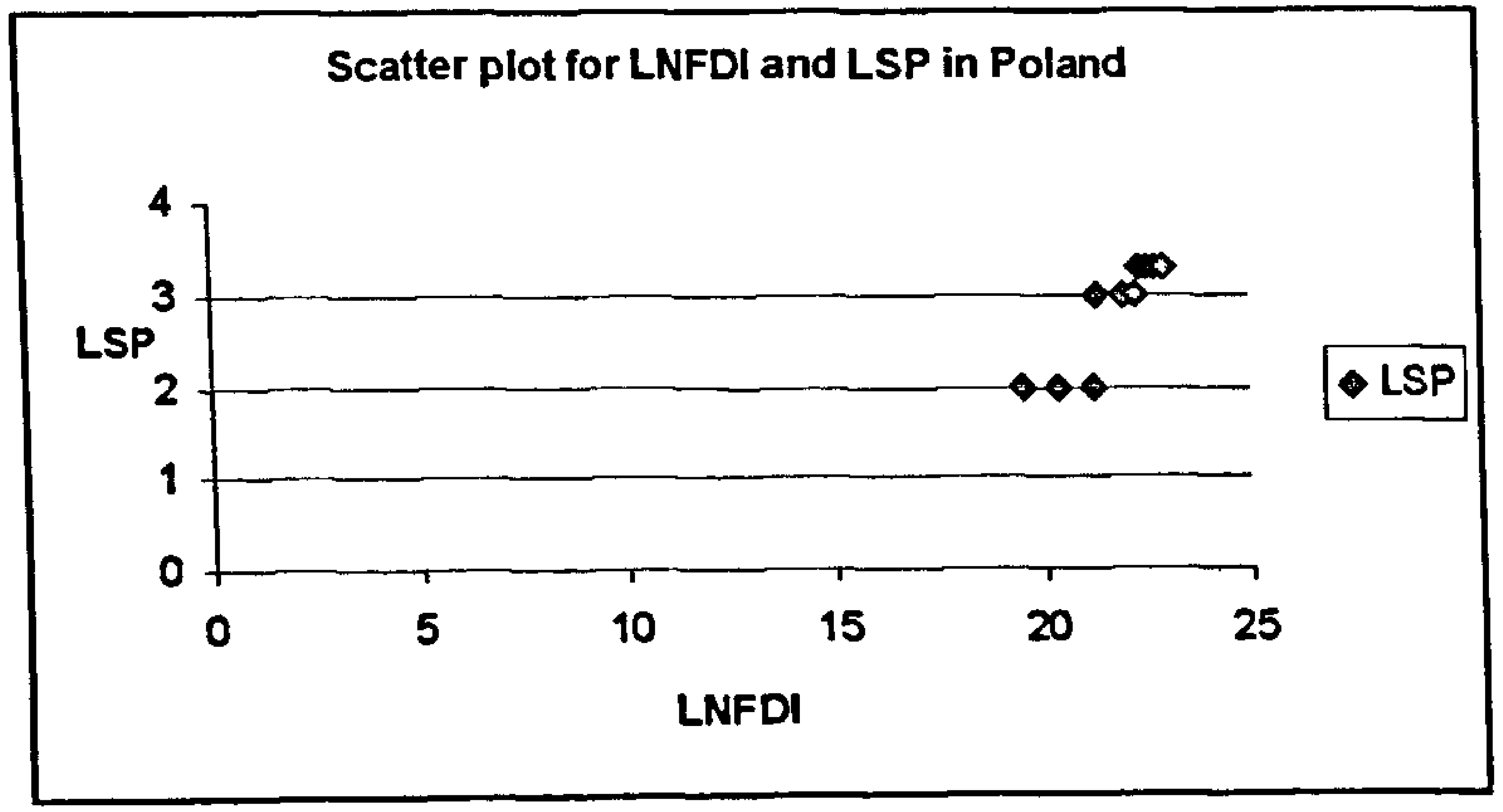
All these levels of impact are interdependent and the relations between them are bi-directional. Thus, by contributing to achieving market economy FDI has played an important role in Poland's quest for integration into the EU. Then, by improving standards of living FDI can maintain the support for FDI and reforms, thus enhancing prospects for achieving market economy in Romania in the very near future. By contributing to further investment, FDI can reinforce a virtuous circle of development in Romania, provided that other determinants of FDI are favourable. This is possible given that statistics on different indicators have already shown an important catching up potential for Romania. Thus, data regarding the performance of foreign firms in Romania had reached by 2000 the levels of 1998 in Poland, suggesting a reduction in the gap between the two countries.

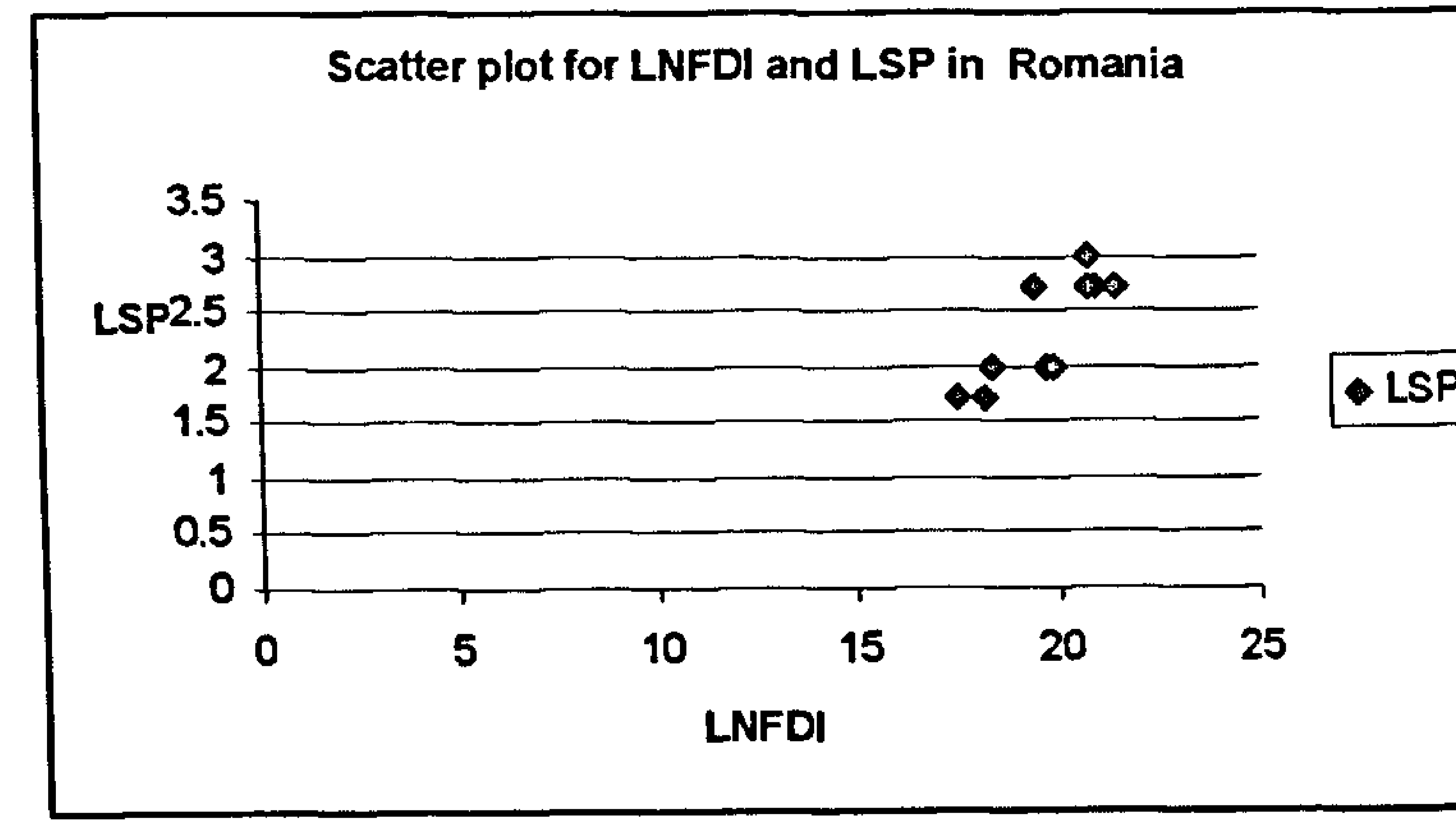
The following chapter will look at how security concerns have influenced the process of EU accession and consequently the country image. It will also assess the ways through which prospects for EU membership contribute towards enhancing positive perceptions of security in the candidate countries, thus equally affecting each country's image. The analysis of FDI determinants will be concluded through an econometric model in chapter seven. This model will also analyse the impact of FDI on economic reforms and will test the hypothesis of path dependency in a country's attractiveness for foreign investment and indirectly in economic transition and the EU accession process.

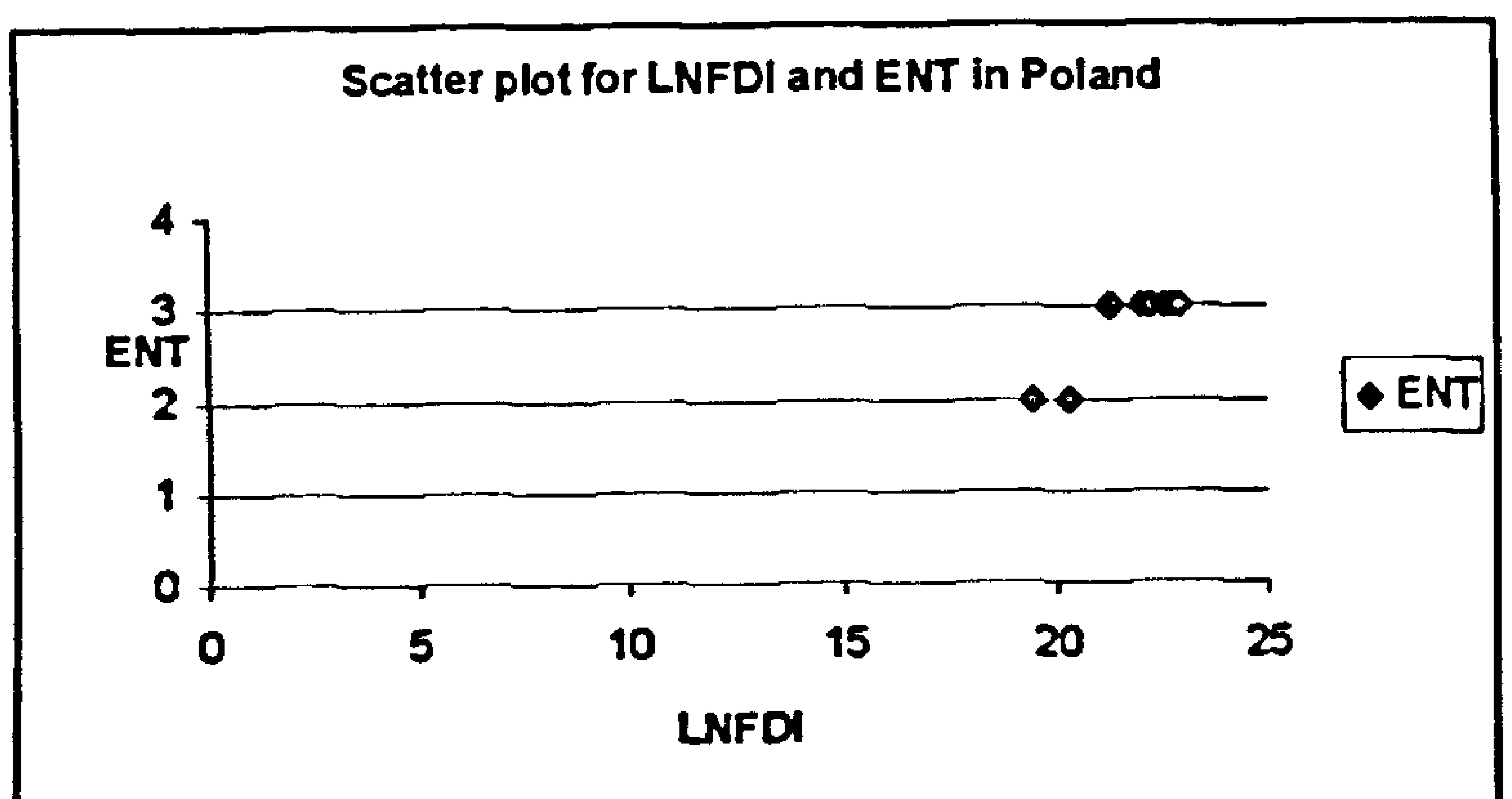
5.2.6 Appendices

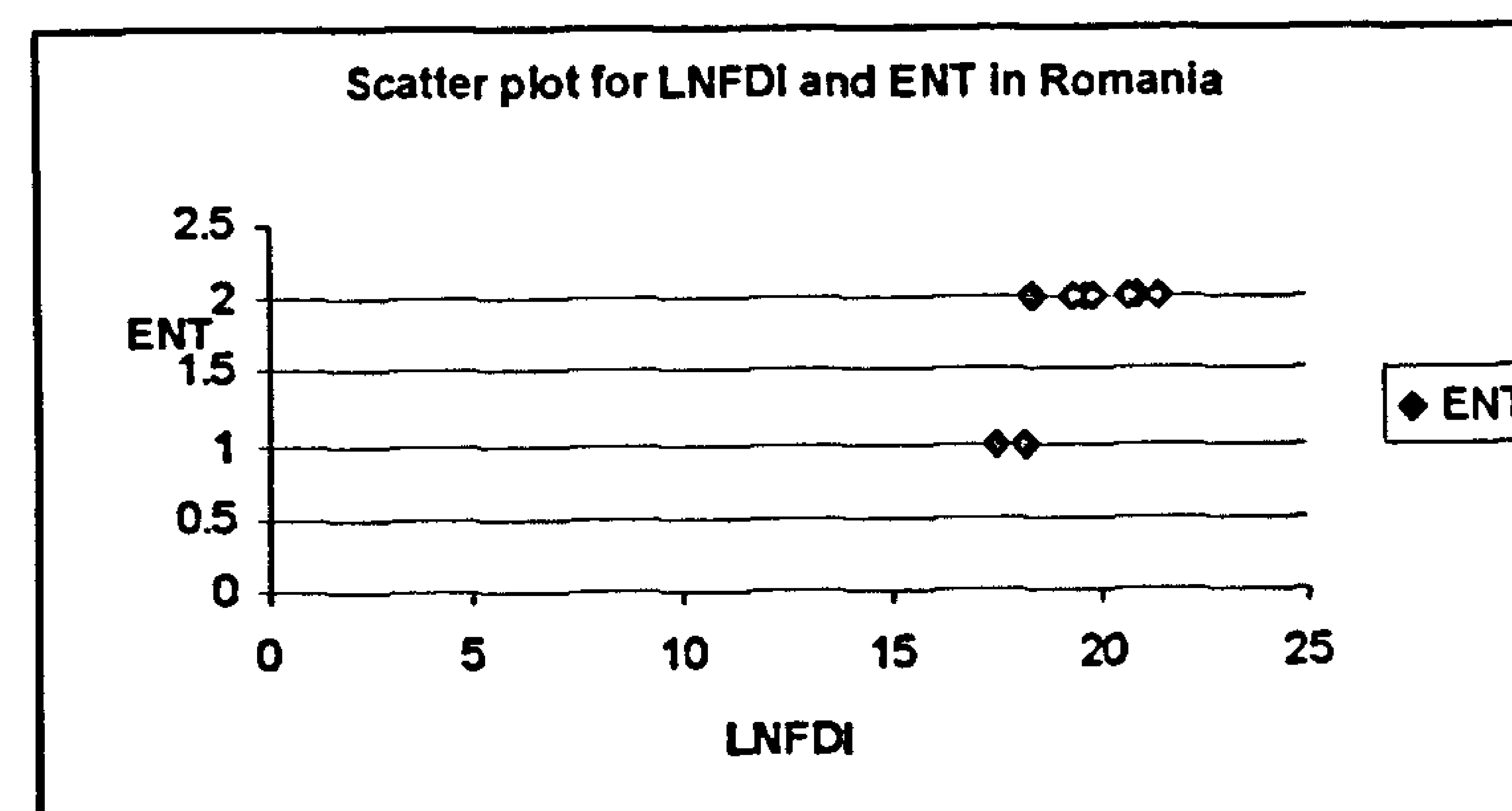
Annex 5.2.A

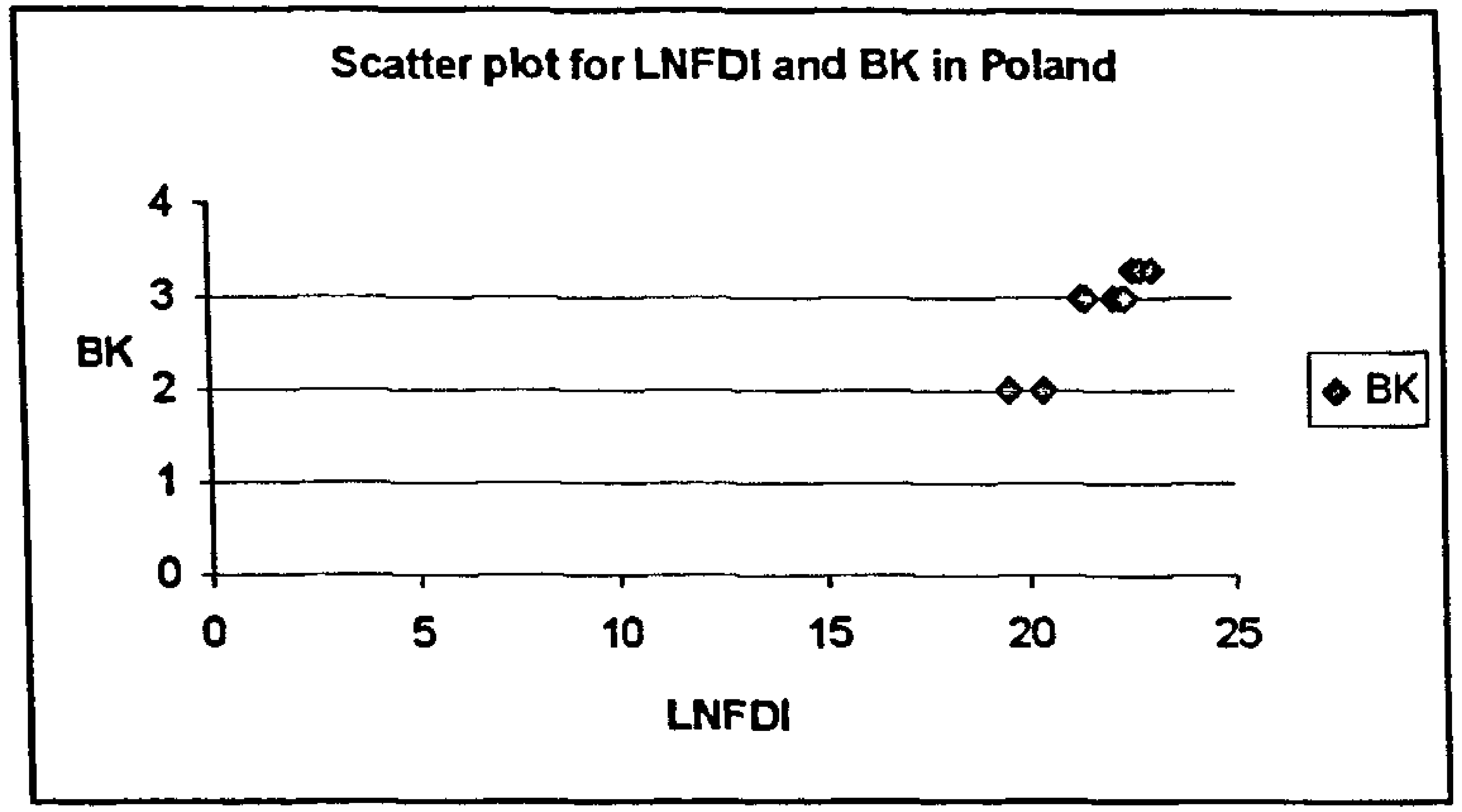
Scatter plots for foreign direct investment annual inflows and selected EBRD transition indicators in Poland and Romania










Scatter plot for LNFDI and BK in Poland
BK
4
3
2
1
0
0
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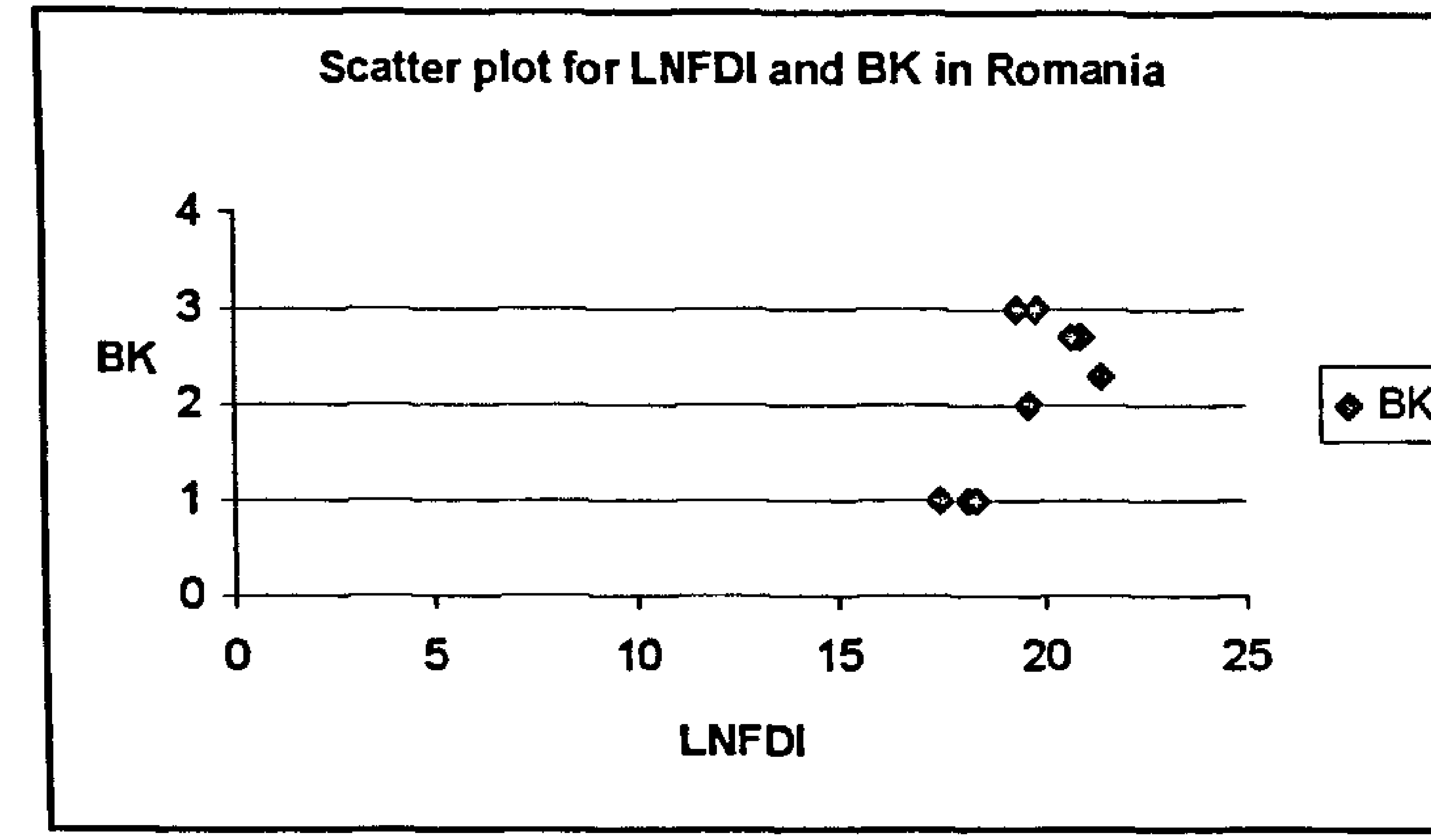
10
15
20
25
LNFDI
BK


Scatter plot for LNFDI and BK in Romania
BK
4
3
2
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0
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15
20
25
LNFDI
BK

Appendix 5.2.B

Foreign investment by activities, investors and countries in Poland and Romania

Foreign investment stock by activities in Poland and Romania (% in total)

Field of activity	Poland[1]	Romania[2]
Agriculture, forestry, fishing	0.1	3.6
Industry total	41.9	44.4
Mining and quarrying	0.4	Na
Manufacturing	37.8	Na
Electricity, gas, water supply	2.7	Na
Construction	4.6	4.5
Wholesale, retail trade, repair motor vehicles	11.6	20.1
Hotels and restaurants	1.0	3.1
Transport and communications	9.5	7.3
Financial intermediation	21.8	Na
Real estate, renting and business activities	1.1	Na
Public admin, defence	Na	Na
Education	Na	Na
Health and social work	Na	Na
Other community, social and personal services	2.9	Na
Other not elsewhere classified activities	Na	17.0

Source: WIIW and PAIZ[3]

Largest foreign investors in Romania 2002

No	Investor	Capital invested (USD million)	Country of origin	Activities
1.	LNM Holdings N.V	485.21	UK based Indian	Steel industry
2.	Clearwave Holdings B.V.	330.53	Canada	Mobile telephony
3.	The Rompetrol Group B.V.	309.01	Netherlands	Oil processing
4.	Renault	235.94	France	Automobile industry
5.	Raiffeisen Zentralbank Oesterreich AG	171.75	Austria	Banking
6.	Daewoo Motor Company Ltd	156.12	South Korea	Automobile industry
7.	Colgate-Palmolive(America) Inc	128.70	USA	
8.	Orange S.A.	103.31	UK	Mobile telephony
9.	Shell Overseas Holdings Ltd.	100.50	Netherlands and UK	Petrol distribution
10	Plasticos Tatay S.A.	98.21	Italy	Construction industry

Source: ARIS[4]

[1] By June 2002
[2] By December 2001
[3] WIIW, *Handbook of Statistics*, CDROM, p.450; PAIZ, *http://www.paiz.gov.pl/facts2_1.html*

Largest foreign investors in Poland by June 2002

No	Investor	Capital invested (USD million)	Country of origin	Activities
1.	KBC Bank	442.0	Belgium	Banking and insurance
2.	EBRD	239.6	International	Capital investments
3.	ITI Group NV	150.0	The Netherlands	Media and entertainment
4.	Credit Agricole	146.8	France	Banking
5.	Glaxo SmithKline	139.5	Great Britain	Pharmaceutical products
6.	GATX Rail Overseas Holding Corporation	114.8	USA	Transport
7.	Metro AG	100.0	Germany	Trade
8.	Guardian Industries Corporation	99.2	Spain	Glass manufacturing
9.	Carrefour	86.0	France	Trade
10.	Deutsche Bank Trust Company Americas	84.0	USA	Mining and quarrying

Source: PAIZ[5]

Investment in Poland and Romania by origin countries by 2001

(% in total investment)

Origin countries	Poland	Romania
Germany	16	11.3
Austria		5.9
USA	19	6.4
Netherlands	11	16.2
France	20	6.9
Italy	9	7.0
United Kingdom	7	
Korea	4	
Russia	3	
Cyprus		7.7
Turkey		4.0
Sweden	5	
Other countries	6	

Source: WIIW and PAIZ[6]

[4] ARIS, "Important Foreign Investors", *http://www.arisinvest.ro/investors.php*

[5] PAIZ, *http://www.paiz.gov.pl/facts2_1.html*

[6] WIIW in G. Hunya, *FDI in South Eastern Europe in Early 2000s*, p.14; PAIZ, *http: //www.paiz.pl*

CHAPTER SIX

Internal and external security concerns in Poland and Romania

Chapter five has analysed the determinants and the impact of FDI in Poland and Romania. Attracting FDI was identified as a necessary element of a successful transition to a market economy and of EU membership. An important determinant of FDI was considered the country image which was associated *inter alia* with internal political and economic stability. These two issues will be addressed in this chapter as part of the security concerns in Poland and Romania.

The present chapter aims to identify the internal and external security concerns in Poland and Romania and their impact on the EU accession process. It then aims to assess different ways in which EU membership can diminish the security concerns in Poland and Romania, thus addressing the bi-directional relationship between security and the EU integration process identified in chapter one and in diagram 1A. Furthermore, the chapter sets out the stage for the analysis of the role of EU membership prospect in enhancing FDI. By analysing EU's impact on security, the chapter aims to reveal whether prospects for EU integration can be a means to break the vicious circle of internal instability, hence high security concerns, low investment, poor reforms and thus poor progress in accession. This has been the case for Romania for the early period of transition as presented in diagram 6A(a). This assumption will be tested quantitatively in chapter seven.

This chapter is organised as follows. It first provides a theoretical framework by reviewing the new assumptions of the post-1989 order. Second, it analyses the internal and external security concerns in Poland and Romania and their impact on the EU accession process. Finally, the chapter identifies the main channels through which the EU appears to ensure security in Poland and Romania in parallel with membership of the North Atlantic Treaty Organisation (NATO).

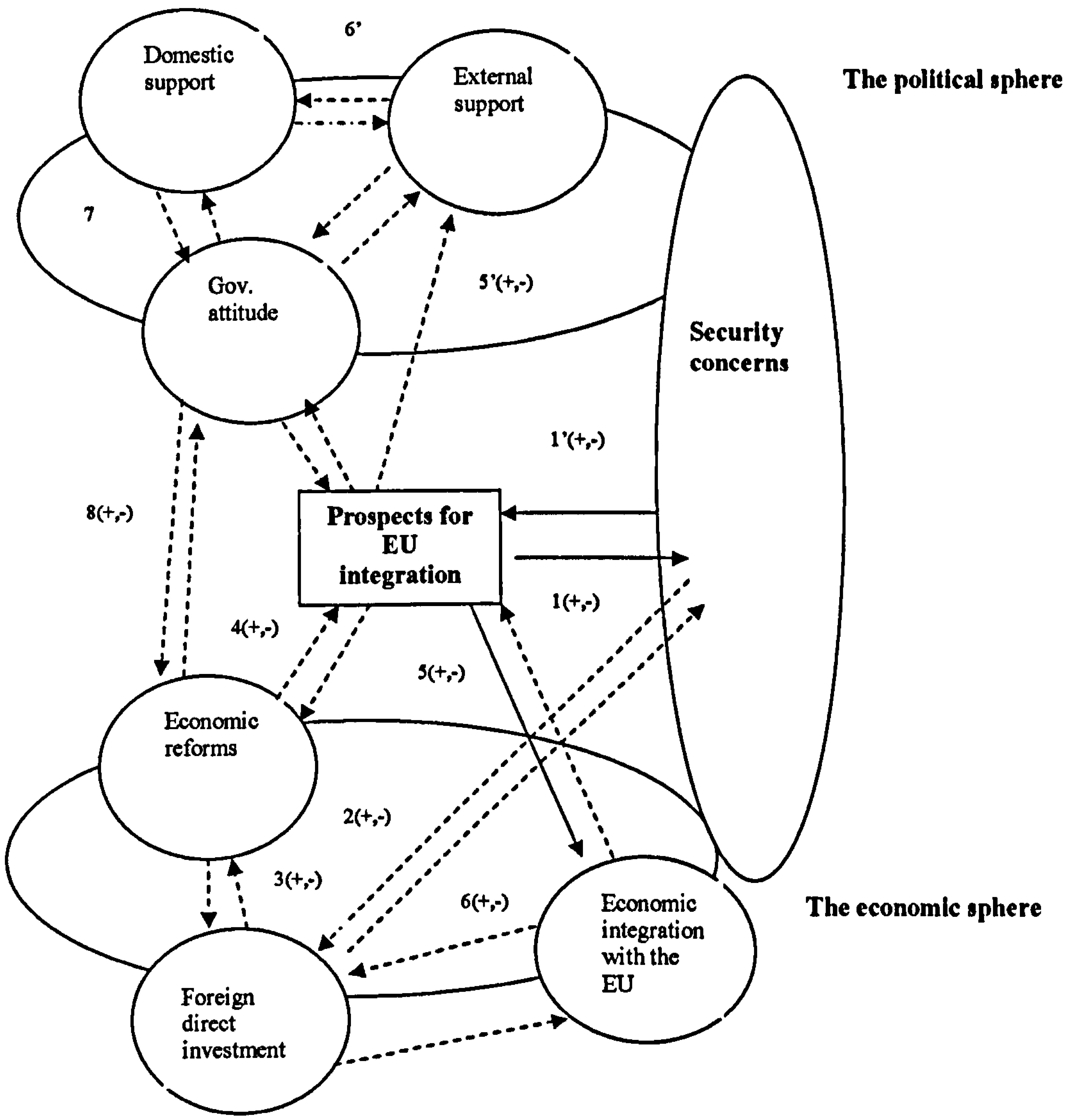
6.1 Theoretical framework of the chapter

The 1989 revolutions have changed irrevocably the international security system, bringing an irreversible end to the post-1945 'pax Sovietica'. However, this was not the 'end of history' as Fukuyama proclaimed, but rather an 'awakening of history', in the words of Hyde-Price. [1] Traditional patterns of co-operation reasserted themselves, older disputes resurfaced and new antagonisms started to develop.[2] Furthermore, security concerns were defined based on different assumptions from the ones valid during the Cold War.[3] These assumptions will be reviewed below and will constitute the

[1] Fukuyama, F., *The End of History and the Last Man*, Hamish Hamilton, London, 1992; Hyde-Price, A., *European Security beyond the Cold War. Four Scenarios for the Year 2010*, The Royal Institute of International Affairs, London, 1991, p. 49.
[2] Hyde-Price, *European Security beyond the Cold War*, p. 49.
[3] Hyde-Price, *European Security beyond the Cold War*, p.105.

theoretical framework of this chapter, drawing on the theoretical framework of the dissertation presented in chapter two.

Diagram 6A
The bi-directional relationship between security concerns and the quest for EU membership



a)Arrows 2(-), 3(-), 4(-), 5(-), 6(-) indicate a potential vicious circle in the economic sphere resulting from perceptions of insecurity.

b) Arrows 2(-), 3(-), 4(-), 1(-) indicate a potential vicious circle in the economic sphere which reinforces the perceptions of insecurity.

c) Arrows 1(+), 2(+), 3(+), 4(+), 1(+) indicate a potential virtuous circle in the economic sphere resulting from the prospect of EU membership. Arrows 5'(+), 6'(+), 7(+), 8(+) indicate a virtuous circle in the political sphere induced by prospects for EU integration and the interaction with the economic sphere.

Legend:

$\longrightarrow$ relationships that are addressed in chapter six

$\dashrightarrow$ relationships that are addressed in other chapters

First, the military threat of the Cold War gave way to diversified threats.[4] A whole 'Pandora's box' of new and old threats that had been contained or 'put on ice' during the Cold War was now opened.[5] Security, understood by Buzan as the 'freedom from threat', was reinforced as a contested and complex concept.[6] Security sectors included now: political, economic, societal, environmental and military security, as defined in chapter two.[7]

Second, the difficult experience of economic and political transition in the former CEECs emphasised the danger of economic and political instability and thus shed a new light on the importance of internal security.[8] The highest security concern for the CEECs became the continuous economic and political crisis to which these countries were subjected in the early years of the decade.[9] Furthermore, these crises reinforced each other. Economic crises led to protests, changes of government and thus political instability and security concerns. This in turn affected FDI and the continuity and scope of economic reforms, thus potentially reinforcing the economic crisis and the internal insecurity as in diagram 6A(b).

Third, a bi-directional relationship between security and transition has emerged. Security became the necessary condition for democratisation and marketisation to succeed. In the words of Nelson: 'Without security, the systems cannot devote resources to the arduous tasks of building a new polity and economy from the rubble of communist rule. Where there is no security, democracy and market economy will not survive.'[10] Furthermore, the success of democratisation and marketisation affected the perceptions of security of the candidate countries. All in all, internal transformations could not be dissociated from the concept of security.[11] Democratisation and marketisation became greatly dependent on external factors of security and the border between internal and external security became increasingly blurred.[12] International factors played a main rather than a marginal role in the internal

[4] Taracova, E. et al, "Public Attitudes in Four Central European Countries" in Smoke, R. (ed.), *Perceptions of Security. Public Opinion and Expert Assessments in Europe's New Democracies*, Manchester University Press, Manchester, 1996, p.39; A Hyde-Price, 1991, p.11.
[5] Hyde-Price, *European Security beyond the Cold War*, p.100.
[6] Buzan, B., "Is International Security Possible?" in K. Booth (ed.), *New Thinking about Strategy in International Security*, HarperCollins Academic, London, 1991, pp.34-35; Hyde-Price, *European Security beyond the Cold War*, p.11.
[7] Buzan, B. et al, *The European Security Recast: Scenarios for the post-Cold War Era*, Pinter, London, 1990.
[8] Stefanowicz, J., "Poland" in Smoke, R. (ed.), *Perceptions of Security. Public*, p.120.
[9] Taracova et al, "Public Attitudes in Four Central European Countries", p.34; Stefanowicz, "Poland", p.120.
[10] Nelson, D., "The Comparative Politics of Eastern Europe", *Political Science and Politics*, Vol. 27, No. 1. 1994, p.50.
[11] Smoke, R.,"The Security Situation of the Central European Countries: Historical Background", in Smoke (ed.), *Perceptions of Security*, p.15.
[12] Bigo, D. cited in Buzan et al, *The European Security Recast*, p. 182; Herring, E., "International Security and Democratisation in Eastern Europe" in Pridham, G., Herring, E. and Sanford, G. (eds.), *Building Democracy? The International Dimension of Democratisation in Eastern Europe*, Leicester University Press, London, 1994, p.89.

transformation of the CEECs.[13] For example, the revolutions were an international phenomenon from the start. They were influenced greatly by Gorbachev's economic and political reforms in the Soviet Union at the time and the abandonment of the Breshnev doctrine. Furthermore, the transition that started in Central and Eastern Europe at the same time enhanced a sense of cross-fertilisation and other transnational influences at the early stage.[14] Finally, the CEECs' search for security guarantees in an international or European framework further enhanced the external dimension of security and the interaction with the internal security concerns.

Fourth, perceptions of security became increasingly related to political geography. Four subsystems were identified in Europe, drawing upon common features from before and during the Cold War and blending them with geography.[15] The first region is Western Europe and includes the EU member states. This is seen as the 'kernel' of Europe, comprising states that have increased their economic and political integration over the past fifty years and have ensured the security and prosperity of the continent. The second region is Central Europe whose rebirth was acknowledged through the 1992 Petersbourg declaration. It comprises eight countries previously under Soviet influence: the three Baltic states, Poland, Czech Republic, Slovakia, Hungary, Romania and Bulgaria.[16] Attempts were made to restrict the concept to only Poland, Hungary, Czech Republic and Slovakia to support their strong claim of belonging to the European family and to enhance a positive image of the area. Belonging to Central Europe was seen as a guarantee of a fast accession to the EU.[17] The third group was the Balkans or South-Eastern Europe. This group of states was traditionally seen as an area of instability, leading to the spark for World War One and more recently to the conflict in the former Yugoslavia. Countries in the area include the former Yugoslavia, Albania, Bulgaria and, in the opinion of several analysts, Romania. The fourth group includes the successor states of the former Soviet Union who are still defining their identity. Geographically, these range from the more European Ukraine, Moldova and Georgia to the more distant Uzbekistan and Kazakhstan, which are still likely to incline towards authoritarian practices. Perceptions of security were different between these regions and especially between Central Europe and the Balkans. Furthermore, it has been difficult to define precisely the borders of these areas, countries such as Romania, Bulgaria and the Baltic states gravitating between such regions. Escaping the Balkan identity has been an aim of Romanian foreign policy, as will be discussed later on.

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[13] Agh, A., *Emerging Democracies in East Central Europe and the Balkans*, Edward Elgar, Cheltenham, 1998, p.303; Pridham, G., "The International Dimension of Democratisation: Theory, Practice and Inter-Regional Comparisons" in Pridham, Herring and Sanford (eds.), *Building Democracy?*, p.9; E. Herring, "International Security and Democratisation in Eastern Europe" in Pridham, Herring and Sanford (eds.), *Building Democracy?*, p.87; Kaldor, M. and Vejvoda,I., "Democratisation in Central and East European Countries", *International Affairs*, Vol. 73, No. 1, 1997, p.60.
[14] Pridham, "The International Dimension of Democratisation", p.8.
[15] Croft, S. et al, *The Enlargement of Europe*, Manchester University Press, Manchester, 1999, p.5.
[16] Meleşcanu, T, "The National Security of Romania. Priorities and Legitimate Concerns", *Central European Issues*, Vol. 1, No. 1, 1995, p. 14.

Fifth, rather than being sees as divisible as Park, Rees and Ullman suggested initially, European security has become indivisible, as acknowledged by Latawski and Dorman and Treacher.[18] Events such as the Yugoslav wars showed that nationalist unrest have a destructive effect, not only within the originating country, but also by bringing spells of insecurity to an entire area through increased migration, economic embargoes or fear of spread of conflict. Moreover, the 1999 Kosovo crisis led to the understanding by the EU that insecurity in countries in South-Eastern Europe was a threat to Europe as a whole. This resulted in an increased commitment of the EU to the security of the area through renewed assurance of EU membership for Bulgaria and Romania. The two countries were invited at the 1999 Helsinki European Council to open accession negotiations with the EU. Prodi, the President of the European Commission, admitted then that: 'Peace and stability across Europe are not yet a matter of fact. They must be maintained in some areas and achieved in others. This is the situation in which the Commission has chosen to act as initiator and guardian. [..] Enlargement is the most effective means we have of upholding our shared values across Europe.'[19] Furthermore, the Stability Pact for South-Eastern Europe was launched to support financially the post-war reconstruction of the area and to encourage investment in projects developed through regional co-operation. The aim was to foster economic growth in the area and thus avoid further instability that could spread to other areas, including the EU.

Finally, the dismantling of the Warsaw Treaty Organisation left the CEECs in a 'security vacuum'.[20] They looked for alternative institutional frameworks to fill in this vacuum and to 'return to Europe'.[21] The debate was between enlarging eastwards old organisations such as NATO, the EU and the Western European Union (WEU), relying on a pan European organisation such as the Organisation for Security and Co-operation in Europe (OSCE)[22] or even creating new regional security arrangements.[23] Scholars were divided over the survival chances of the old organisations. On the one hand, neo-realists like Mearsheimer believed that institutions such as NATO, the EU or the WEU were kept together during the Cold War period merely by the common threat of the Soviet Union and that the prospects for their role in ensuring the security of the continent were bleak.[24] On the other hand, neo-institutionalists like

[17] Sava, I.N. , *Zece ani de traziţie in Europa de Est*, Editura Fundaţiei Române, Bucureşti, 2000.
[18] Park, W. and Rees, G. W., *Rethinking Security in post Cold-War Europe*, Longman, London, 1998; R. Ullman, *Securing Europe*, Adamantine Press, Twickenham, 1991, p.28; Latawski, P., "NATO and East Central Europe: The Case of Poland", in Williams, A. J. (ed.), *Reorganising Eastern Europe: European Institutions and the Refashioning of Europe's Security Architecture*, Dartmouth Publishing Company, Dartmouth, 1994, p.86; Dorman, A. M. and Treacher, A., *European Security. An Introduction to Security Issues in Post-Cold Europe*, Dartmouth Publishing Company, Dartmouth, 1995, p. 86.
[19] *Business Central Europe*, February, 2000.
[20] Latawski, "NATO and East Central Europe: The Case of Poland", p.42.
[21] Smoke, "The Security Situation of the Central European Countries: Historical Background", p.99; Vukadinovic, R., "Challenges to Security in South-Eastern Europe", *COPRI Working Paper No. 35*, Copenhagen, 2000, p.4; Stefanowicz, "Poland", p.118.
[22] OSCE was until 1994 the Conference on Security and Co-operation in Europe (CSCE).
[23] Latawski, "NATO and East Central Europe: The Case of Poland", p.81.
[24] Mearsheimer, J. J., "Back to the Future", *International Security*, Vol. 15, No. 1,1990, pp. 4-56.

Rees considered that these institutions had 'a life of their own' and thus they could be adapted to 'export' security to the new democracies in Central and Eastern Europe.[25] So far, the reality has favoured the second point of view. Security has been ensured by an overlapping institutional framework which has both benefits and shortcomings.[26] On the positive side, the complementarity and specificity of each of these institutions makes co-operation useful in dealing with complex situations such as the wars in Yugoslavia. Each organisation offers a different degree of security and addresses certain sectors.[27] On the negative side, co-operation is sometimes hampered by practicalities, conflict of interests or lack of interest. The OSCE does not have enforcement power, the WEU is in a process of redefinition and NATO caters mainly for military and political security.

This chapter argues that the best guarantee of all sectors of internal and external security for Poland and Romania is EU membership. In the words of Hyde-Price: 'The European Union is the only reliable guarantee of democratic consolidation, economic wellbeing and national security.'[28] As stated earlier, military threats no longer play the major role in the security concerns.[29] The new emphasis should be on prevention of war.[30] While the wars in Yugoslavia have emphasised the need to create independent crisis management for the EU, they also demonstrated that creating conditions for durable peace are fundamental for the security of the continent. Moreover, economic security is increasingly important and can be seen a crucial sector of security. Economic hardship can create political and social unrest, endanger the environment and accentuate prospects for military or ethnic conflict, thus affecting other sectors of security. EU membership addresses all sectors of security and by providing prospects for economic development and prosperity addresses the very concern of economic insecurity. By its normative power exercised through the conditionality of the accession criteria the EU has already enhanced the process of democratisation and marketisation, thus contributing towards ensuring internal security of both Poland and Romania. The following discussion will address mainly security concerns in the political and economic sectors. Furthermore, the EU has a vast potential of de-securitising the candidate members by changing perceptions of security. This can then enhance foreign investment, foster economic reforms and prosperity, thus ensuring internal stability. Furthermore, the prospect of EU membership can reinforce a political virtuous circle with then a positive effect on the economic sphere, as in diagram 6A(c). This was one of the motivations for the EU pursuing an 'all inclusive'

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[25] Rees in Park and Rees, *Rethinking Security in post Cold-War Europe*, p.177.
[26] Ruhle, M. and Williams, N, "Managing Security in Europe", in Algieri, F. et al (eds.), *The European Union and the Challenge of Enlargement*, Bertelsmann Foundation, Gutersloh, 1996, p.89; See also Sakwa, R., "The Keystone in the Arch: Inclusion, Democracy and Universalism in Central and Eastern Europe", in Cottey, A. (ed.), *New Security Challenges in Postcommunist Europe*, Manchester University Press, Manchester, 2002, p.131.
[27] Park, W. "Introduction" in Park and Rees (eds.), *Rethinking Security in post Cold-War Europe*, p.14.
Hyde-Price, *European Security beyond the Cold War*, p.264.
[29] Stefanowicz, "Poland", p.120.
[30] Valki, L., "Security Problems and the New Europe: A Central European Viewpoint" in Williams, A.J. (ed.), *Reorganising Eastern Europe*, p. 112.

enlargement strategy since the 1997 Luxembourg European Council and especially since the Kosovo crisis, initiative from which Romania has benefited greatly.

However, the relationship between security and EU membership is bi-directional. Not only does EU offer security guarantees to its members, but security factors have affected Poland and Romania's institutional progress towards EU membership. Security factors have affected both countries' external image and the capacity to comply with the accession criteria. External security factors have acted either as catalysts for, or as brakes on, the progress towards EU membership as discussed in chapter three. Finally, security concerns have affected the level of FDI in the two countries, thus impacting upon the economic reforms and on both formal and economic integration with the EU. Security concerns appear to influence greatly the political and the economic circles identified by this project. Thus, the remainder of the chapter will identify the internal and external security concerns mainly in the economic and political sectors and their impact on Romania and Poland's progress towards EU membership. The last section will analyse the way EU membership addresses the internal and external threats identified in both Poland and Romania.

6.2 Security concerns in Poland and Romania and their impact on EU membership

6.2.1 Internal security concerns

In the absence of a strong military threat, the prime insecurity for both Poland and Romania became the internal political and economic crises which characterised the beginning of the 1990s. Furthermore, the political crisis reinforced and was reinforced by the economic one. However, the extent to which security concerns have affected Poland and Romania's quests for EU integration was different. Thus, previous Polish attempts at economic and political reforms gave Poland a relative comparative advantage over Romania, as already shown in chapter four. Furthermore, the international community's perceptions of security in Poland acted as a catalyst for positive change by de-securitising some of the internal and external threats.[31]

In the political security sector, the main security concerns, both at individual and state level, were related to the success of the democratisation process.[32] Democratisation represents the process of becoming democratic, while democracy is at its most crude 'popular or majority rule'.[33] Based on Doyle's famous assumption that 'democracies do not go to war with each other', the promise was that democratic states would provide 'a key building bloc for a less militarised and more co-operative security structure in Europe.'[34] Internally, democracy would ensure security at individual level through

[31] For a definition of the terms 'securitisation' and 'de-securitisation', see Chapter Two.
[32] Kaldor and Vejvoda, "Democratisation in Central and East European Countries", p.61; Pinder,J., "The European Community and Democracy in Central and Eastern Europe" in Pridham, Herring and Sanford (eds.), *Building Democracy?*, p.125.
[33] Herring, "International Security and Democratisation in Eastern Europe", p.88.
[34] Doyle, M., "Liberalisation and World Politics", *American Political Science Review*, Vol.80, No.4, 1986, pp.151-169; Hyde-Price, *European Security beyond the Cold War*, p.105.

inclusive citizenship, rule of law, respect of human and political rights, freedom of expression and alternative sources of information, separation of powers, elected power-holders, free and fair elections, associational autonomy and civilian control over the security forces.[35] Any abatement from the democratic behaviour was perceived as a potential security concern. This included threats to the system of government and its ideology, as well as secessionist or nationalist movements. Finally, political instability resulting from protests and frequent changes of government was also seen as a source of internal insecurity. This referred more to Buzan's definition of political security as organisational stability of the state.[36]

A first political security concern was the potential return to an authoritarian regime and the abandonment of democratic values.[37] This was more acute in Romania than in Poland. In Poland, the semi-free elections of 1989 were initially considered revolutionary. They had been initiated before the total fall of Communism in the Soviet Bloc.[38] Moreover, they led to the victory of Solidarity, the trade union which had challenged the communist rule since early 1980s. This regime change ensured external credibility for the Polish government and reflected commitment to reforms and democracy, thus de-securitising the partially free elections. However, soon they became 'too limited, too moderate and too rational' and new elections had to be held in 1990 for presidency and 1991 for parliament.[39] By coming second in elections, the Democratic Left Alliance (SLD) raised certain concerns regarding the return of the Left to the political life.[40] Furthermore, elements of authoritarian rule were preserved by president Walesa who 'wanted all the power for himself'.[41] Amendments to the Constitution finally diminished the presidential powers in 1995, thus eliminating the concerns over authoritarian rule in Poland.[42] The international community acted as a de-securitising agent with respect to the results of the 1993 elections. After an initial shock, the return to power of post-communists in 1993 was considered not as the negation of democracy, but as a sign of democratic rule. Almost applying double standards compared to Romania, the return of post-communists was interpreted as a peaceful double change of power rather than a regime change.[43] In time, this became in the eyes of the analysts the rule of thumb

[35] Kaldor and Vejvoda, "Democratisation in Central and East European Countries", p.63.
[36] Buzan, "Is International Security Possible", p.35.
[37] Hyde-Price, *European Security beyond the Cold War*, p. 57.
[38] Lewis, P. G., "East-Central Europe: The Czech Republic, Slovakia, Hungary and Poland" in White, S., Batt, J. and Lewis, P. G. (eds.), *Developments in Central and Eastern Europe*, Vol. 2, MacMillan Press, London, 1998, p.27.
[39] Tismăneanu, V., *Reinventing Politics. Eastern Europe from Stalin to Havel*, Free Press, New York, 1993, p.194
[40] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.258.
[41] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.64; Henderson, K. and Robinson, N., *Post-Communist Politics. An Introduction*, Prentice Hall, London, 1997.
[42] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.64; Henderson and Robinson, *Post-Communist Politics.*
[43] Linz and Stepan cited in Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.55.

when analysing the democratic status of a country, including Romania.[44] Poland was providing this example of democratic procedures and thus the elections' results did not affect negatively its prospects for returning to Europe. One has to remember though two important facts. First, Poland was the first country in Central Europe to vote post-communists back into power.[45] In initially the most radical reformer in Central and Eastern Europe, the electorate voted out of power the government whose shock therapy economic reforms led to a sharp decrease in its standard of living, thus pushing for a more gradual approach to economic transition. Second, Kwasniewski's Party of Social Democracy was the direct heir of the Polish United Workers party which had changed its name in 1990 and retained its members, two million as of 1986.[46] Although this might have constituted a serious security concern, it did not. Furthermore, in time, the return of post-communists was de-securitised. This was largely because post-communist parties in most of the CEECs embraced the general goals of achieving democracy, market economy and returning to Europe. Through conditionality, the quest for membership of NATO and of the EU ensured that democracy and market economy were pursued regardless of the ideological stand of the parties in power. At present, both Poland and Romania are ruled by post-communists, but this is not particularly considered a security concern. Ash believed that the real danger to democracy in Poland was not the victory of Kwasniewski, but the 'large right-wing extra-parliamentary movement of Walesa, supported by the Church and Solidarity.'[47] Furthermore, president Kwasniewski and his team want to be seen not as Eastern post-communists but as regular Western social democrats.[48] Similar efforts are made by the Romanian president Iliescu and PM Năstase and there are signs that the international community sees them as such. All in all, today the most important dangers to democracy are not the post-communists, but the emergence of extremist parties, as shown later.

The ascent to power of post-communists in Romania as a result of the 1989 revolution and of the 1990 and 1992 elections affected Romania's external credibility negatively and its progress towards EU membership. Romania was seen as a 'façade democracy' under which authoritarianism had survived.[49] Agh even used the phrase 'the revolution that never was' to refer to the Romanian revolution.[50] The National Salvation Front (FSN) which acceded to power in 1989 was seen as a 'nationalist party run by ex-communist apparatchiks' and so were its successors, the Democratic National Salvation Front

[44] Huntington, S., "How Countries Democratise", *Political Science Quarterly*, Volume 106, Number 4, 1991-1992.
[45] Lewis, P. G., "East-Central Europe: The Czech Republic, Slovakia, Hungary and Poland" in White, Batt, and Lewis (eds.), *Developments in Central and Eastern Europe*, p.35.
[46] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.46; Tismăneanu, *Reinventing Politics.*, p.195.
[47] Ash, T.G. cited in Agh, *Emerging Democracies in East Central Europe and the Balkans*,p.62.
[48] Linz and Stepan cited in Agh, *Emerging Democracies in East Central Europe and the Balkans*,p.62.
[49] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.258.
[50] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.259.

(FDSN) and the Party of Social Democracy in Romania (PDSR).[51] These doubts made the break with the past seem less radical in Romania than in other CEECs, including Poland.[52] One has to remember though that Romania had little democratic experience before 1945 and that any democratic manifestation had been impossible during Ceuşescu's dictatorship. Furthermore, apart from being a communist, Iliescu had dissociated himself from the Ceauşescu regime. Some suspicions over the fairness of the 1990 and 1992 elections in Romania led to further doubts over the country's commitment to democracy. Moreover, the participation of the Socialist Labour Party (PSM) and of the chauvinist Greater Romania Party (PRM) in the governing coalition in 1995 was perceived as a serious threat to democracy by the international community.[53] One has to take into consideration though that this coalition was forced by the other parties' refusal to form the government. Overall, it was only after the 1996 victory of the Democratic Convention of Romania (CDR) that the country's image improved and the international community intensified its interest in Romania and its accession to the EU and NATO.[54] The 1996 elections were seen as a 'historical turning point' in Romania's post-1989 history.[55] Closer to the present, the return of post-communists to power through the 2000 elections was not seen as a threat. Furthermore, some relatively recent internal accusations over the slightly authoritarian manner of the Năstase government in ruling the country have not constituted serious concerns externally. On the contrary, it was considered that the government was very determined in conducting economic reforms. This enhanced its external credibility, improved the country image and Romania's prospects for EU integration. The threat of authoritarianism was this time de-securitised, rather than securitised, as a result of the new approach of the EU.

A second security concern in the political and societal sectors was the rise of nationalism and of extremist parties. The potential for nationalist uprisings was lower in Poland as a result of its post-1945 ethnic homogeneity. Only 3% of the current 38.6 million population belongs to minorities such as the Ukrainian, Belarusian, German, Lithuanian communities or the smaller groups of Czechs, Slovaks, Armenians and Tatars. [56] However, the homogenous 'Polak- Katolik' majority in Poland has been accused of ethno-nationalism.[57] Furthermore, Poland's painful history, the repeated changes of borders and the legacy of the World War Two induced certain fears with regard to the status of its German minority. These were eliminated through the signing of the neighbourly relations treaty with Germany which will be discussed later as part of the external security concerns. Nowadays, the previously not acknowledged German minority in Poland has hundreds of associations and is represented in the Polish

[51] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.259.
[52] Weiner, R.., "Democratisation in Romania" in Stan, L. (ed.), *Romania in Transition*, Aldershot, Dartmouth, 1997, p.6.
[53] Weiner, "Democratisation in Romania", p.6
[54] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.276.
[55] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.258.
[56] Sanford, G., *Poland. The Conquest of History*, Harwood Academic Publishers, Amsterdam, 1999, p.109.
[57] Sanford, *Poland. The Conquest of History*, p.109.

parliament.[58] Some concerns have remained, nevertheless, regarding the issues of the Roma and Jewish minority.[59] Overall, Poland has done everything to meet the European standards of national minority treatment as acknowledged by the Opinion in 1997 and the regular reports produced ever since.[60] However, the long and difficult process of economic reforms and EU accession has imposed costs on the population that led to the rise of extremist parties, including anti-European ones. Thus, the Confederation for Independent Poland won several seats in the 1993 parliamentary elections but was successfully marginalised afterwards.[61] Nonetheless, the votes won at the Polish 2001 elections by extremist parties such as the League of Polish Families (LPR) and Self Defence of the Polish Republic (S) were a sign of the 'social fatigue' with transition. Additionally, the decreasing support for EU membership pointed to the need to finalise the EU enlargement within the very near future, thus rewarding the candidate countries for their human, social, economic and political efforts over the last decade and avoiding the danger of internal instability.

Given its ethnic composition and its highly oppressive post-1945 communist history, Romania was more exposed to the danger of nationalist uprisings than Poland. Thus, 11% of the Romanian population consists of ethnic minorities including German (0.5%), Roma (1.8%), other (1%) and Hungarian (7.1%), which is a dominant minority in Transylvania.[62] Several districts in Transylvania are predominantly inhabited by ethnic Hungarians and some of them constituted between the two world wars an autonomous region. This geographical distribution, the historical precedent and the legacy of an overt policy of suppression of ethnic minorities practised during the last decades of the communist regime generated a strong sense of identity in the Hungarian minority in Romania. Furthermore, once the communist oppression was removed and the democratic values endorsed, ethnic minorities started to assert their identity and claim increased rights.[63] The claims of the Hungarian minority were at times supported by the Hungarian authorities, making an internal security concern depend on external factors. Thus, in the early 1990s, the Hungarian PM Antall declared himself the prime minister of all fifteen million Hungarians, including the Diaspora.[64] Romanian politicians themselves exploited at times the anti-Hungarian sentiment as a means to gain votes. This appeared to be the case not only of Funar, the mayor of Cluj Napoca, an old Transylvanian city, but also of the

[58] Wallace, C. et al, "Old and New Security Issues in Post-Communist Eastern Europe: Results of an 11 Nation Study", *Europe-Asia Studies*, Volume 51, Issue 6, 1999, p.997.
[59] Sanford, *Poland. The Conquest of History*, Harwood Academic Publishers, Amsterdam, 1999, p.109.
[60] Sanford, *Poland. The Conquest of History*, p.109.
[61] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.57.
[62] European Commission, "Enlargement. Candidate Countries. Romania", *http://www.europa.eu.int/comm/enlargement/romania/index.htm.*
[63] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.261; Verderly, K., "Nationalism and National Sentiment in Post-Socialist Romania", *Slavic Review*, Vol. 52, 1993, p.179.
[64] Antall, J. cited in Nelson, D., "Poland, Czechoslovakia, and Hungary: The Triangle in Search for Europe" in Michta, A. A. and Prizel, I. (eds.), *Postcommunist Eastern Europe. Crisis and Reform*, St. Martin's Press, New York, 1992, p. 97.

Romanian president Iliescu in his early mandates.[65] Several events in the early 1990s contributed to nationalism being a security concern in Romania. The Council of Europe's *Recommendation No. 1201* regarding ethnic minorities' group rights was a bone of discontent between the government and the Democratic Alliance of the Hungarians in Romania (UDMR). Internally, this created unease between the government, UDMR and the civil society and perceptions of insecurity for both the Romanian majority and the Hungarian minority. Externally, this was seen as a hesitance from the Romanian authorities to comply with international legislation and shed further doubts on Romania's commitment to democracy, creating a perception of insecurity and impeding upon the country's prospects for returning to Europe. This negative perception was accentuated by the violent confrontation between ethnic Romanians and Hungarians at Târgu Mureş in 1991. This led to Romania's initial exclusion from the Phare Programme.[66] Furthermore, UDMR threatened in 1995 to unleash a programme of civil disobedience as a protest against the adoption of an education law by the Parliament, which was considered discriminatory.[67] However, ethnic violence remained just an unfortunate accident and peaceful co-habitation has remained the rule in Romanian society ever since the events of Târgu Mureş.[68]

Moreover, significant steps in avoiding extremism and promoting minority rights have been made in Romania. For example, the UDMR acceded to power in 1996 as a coalition partner of the Democratic Convention of Romania (CDR). This change led to considerable improvements in the observation of minority rights in Romania which were saluted by the international community.[69] Furthermore, the Romanian authorities have managed to solve diplomatically certain differences of opinion with the Hungarian government regarding the law on Hungarian status proposed in 2001 by the Hungarian authorities. The prospect of EU integration for both countries and the conditionality that came with it were partially responsible for the resolution of this difference of opinions. Furthermore, as part of a mutually agreeable solution, the Hungarian government offered its thorough support for Romania's membership of both NATO and the EU. This is an example of how a security threat can be de-securitised and how it affects and is affected by the process of return to Europe. Finally, despite winning a large number of seats in both chambers of the parliament and having a serious contestant for presidency in the 2000 elections, the nationalistic and xenophobic Greater Romania Party was isolated

[65] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.271; J.F. Brown, *Hopes and Shadows. Eastern Europe after Communism*, Longman, Harlow, 1994, p.97; Fati, S., "Romania-NATO după Madrid", *Politica Externă, Vol. 3, No. 4, 1997, p.39.*
[66] Severin, A., "Romania- Contribuitor si benficiar al integrării", *Politica Externă, Vol. 2, No. 2, 1997, p.86*
[67] Weiner, "Democratisation in Romania", p.13-17.
[68] Gallager, T., "The Balkans: Bulgaria, Romania, Albania and the Former Yugoslavia" in White, Batt and Lewis (eds.), *Developments in Central and Eastern Europe*, p.58.
[69] Phinnemore, D., "Romania and Euro-Atlantic Integration since 1989: A Decade of Frustration?", p.7; Partos, G., "Hungarian-Romanian and Romanian-Moldovan Relations" in Smith, J. and Jenkins, C., *Through the Paper Curtain. Insiders and Outsiders in the New Europe,* The Royal Institute of International Affairs, London, 2003, p.100.

by the political class and its impact on the legislative process was minimised. The results of the 2000 election in Romania were an indication that while threats to democracy by extremist parties are contained, they still exist and thus international support is important in anchoring some of the CEECs in democratic practices.

A third internal security concern in the political sector was internal instability resulting from political fragmentation. Political liberalisation in both countries led to the creation of numerous and diverse political parties that competed in the political arena. The party formation process was lengthy and complex and time was required for the political system to polarise. This wide variety of parties made coalitions necessary in order to form governments and carry out the legislative process. In Poland, the shock therapy affected the unity and credibility of Solidarity, eroded its membership and popular support and accentuated its disintegration starting in 1990.[70] This disintegration and the infighting, also known as the 'war at the top' created high political instability until 1993.[71] For example, the three party coalition 1991 government of Olszewski only survived six months, while the relative stable 1992 seven party coalition of Suchocka was brought down by economic crises and discontent.[72] Additionally, the electoral legislation in Poland did not initially address the issue of political fragmentation. By setting a low threshold for participation in the parliament, the Polish electoral law increased the number of parties in the legislature and thus negatively affected its cohesion.[73] Divergent interests of parties represented in parliament or in government led to deadlocks in legislative initiatives and in policy making, thus creating political instability, especially in the early 1990s.[74] The first year without a change of government was 1994.[75] Thereafter, lessons were learned regarding the negative effects of fragmentation and in preparation for the 1997 elections the opposition parties organised themselves in three large blocks. This strategy led to the victory of the Solidarity Electoral Action (AWS) of Krzaklewski which formed a coalition government with the Freedom Union (UW) of Balcerowicz.[76] Although the government was reshuffled several times, Buzek remained prime minister until the 2001 elections. Government stability was finally ensured in Poland and relatively maintained through the government of Miller, despite a few reshuffles.

In Romania, the political fragmentation of the democratic opposition before 1996 and in 2000 greatly contributed to the victories of post-communists in the 1990, 1992 and 2000 elections. Thus, in 1990

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[70] Agh, Emerging Democracies in East Central Europe and the Balkans, p.40; Agh, A., *The Politics of Central Europe*, Sage Publications, London, 1998, p.144.
[71] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.40.
[72] Brown, *Hopes and Shadows*, p.78; Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.50.
[73] Lewis, "East-Central Europe", p.23; Agh, *Emerging Democracies in East Central Europe and the Balkans*, p. 49.
[74] Lewis, "East-Central Europe", p.35.
[75] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p. 59.
[76] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.63.

there were more than eighty parties in the Romanian political arena.[77] Furthermore, the three parties that traced their roots back to the inter-war period had lost touch with the Romanian voters. The National Liberals, The National Peasants and the Social Democrats needed time to build their organisations and to reconnect with the electorate.[78] They recalled the pre-communist past, rather than pointing towards the post-communist future, thus failing to address contemporary issues.[79] Their leaders had been living mostly in exile and failed to attract enough support to win the elections. Although Văcăroiu remained PM for the full mandate between 1992 and 1996, several reshuffles took place as a result of non-confidence motions and street protests. Political fragmentation also led to the participation of the extremist Party of Romanian National Unity (PUNR) in government in 1994. Furthermore, this illicit 'liaison' became a 'legalised menage' with the signing in 1995 of the four party protocol which included alongside PUNR and PDSR the national communist Social Labour Party (PSM) and the chauvinist Greater Romania Party. Gallagher saw these developments as a 'reversed wave' of democratisation.[80] Indirectly, political fragmentation was a threat to democracy and thus a security concern, both internally and externally. The same political fragmentation and government infighting led to many changes of ministers during the democratic governance of 1996-2000 which slowed down the pace of economic reforms.[81] Being a collection of eighteen parties and organisations, the Democratic Convention of Romania that won the 1996 elections lacked cohesion and unity.[82] The differences of opinion were further exacerbated during the 1996-2000 governance to the extent that several parties left the alliance and presented their own candidates for the presidency and parliamentary elections. The votes were therefore spread and the two who qualified for the second round were Iliescu, the PDSR candidate, and Vadim Tudor, the candidate of the extremist Greater Romania Party. All in all, political fragmentation led to a high political and economic instability which were reflected in a negative image abroad until 1996 and only slightly improved afterwards. The 2001 victory of PSDR was not seen as a threat anymore and ensured relative political stability, contributing towards the creation of positive perceptions of security.

At the crossroads between political, societal and economic sectors of security lay the threats posed by street protests and strikes. These were connected with the pace, the depth and the success of political and economic reforms. As a sign of freedom, protests symbolised the tension between marketisation and democratisation.[83] They were securitised by the extent to which they were conducted in an undemocratic manner, triggered undemocratic behaviour from the authorities or led to numerous falls

[77] Tismăneanu, *Reinventing Politics*, p.268.
[78] Tismăneanu, *Reinventing Politics*, p.268; Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.263.
[79] Brown, *Hopes and Shadows*, p.101.
[80] Gallagher cited in Phinnemore, "Romania and Euro-Atlantic Integration since 1989", p.5.
[81] Phinnemore, "Romania and Euro-Atlantic Integration since 1989", p.7.
[82] Weiner, "Democratisation in Romania", p.17.
[83] Hyde-Price, *European Security beyond the Cold War*, p.57.

of governments with possible impact on the continuity of reforms. In Poland, the shock therapy economic reforms implemented by Balcerowicz led initially to a loss of output, high inflation, high unemployment and generally a fall in the standard of living of the population. This resulted in numerous protests and collapses of governments in the early 1990s leading to an overall perception of high internal instability, as shown in chapter four.[84] Although this country image deterred FDI, the governments' commitment to radical reforms ensured a high external credibility and thus external support, as has been discussed in chapter four. This external support has contributed greatly to the economic recovery and to reducing the internal instability of Poland, contributing towards full virtuous circles in the political and in the economic spheres.

This was not the case in Romania. In 1990 the Romanian government violently repressed the peaceful protests organised by students in the University Square against tendencies of an authoritarian rule. This repression was a gross infringement of human rights which alarmed the international community. It led to a stop of the international financing and to a pause in the negotiations for an association agreement with the EC.[85] Moreover, the violent protests of the miners in June 1991 were a strong threat to democracy and political stability. They violated any concept of rule of law, retarded democratic development and harmed Romania's reputation abroad.[86] Furthermore, they led to the fall of the reformist government of Roman and thus led to a slowing down of the economic reforms with a subsequent impact on the rate of progress towards accession into the EU.[87] Trying to ensure economic and social stability, pre-1996 governments postponed real reforms in economy.[88] The half hearted economic reforms in Romania in the early 1990s accentuated the economic crisis and made Romania fall further behind other CEECs in the quest for EU membership.[89] Furthermore, deep economic reforms became unavoidable by late 1996 and under international pressure a shock therapy was adopted by the democratic government of Ciorbea. This prolonged economic instability in Romania as it brought high inflation, unemployment, a further fall in the living standards of the population and protests by miners, hence political instability.[90] Security concerns came, as in early 1990s Poland, from the challenge to keep the balance between the speed of reforms and their social sustainability. Further fears were related to the possibility of ascent of non-democratic and extremist forces in case of failure of economic reforms.[91]

[84] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.40; Lewis, "East-Central Europe", p.35.
[85] Tismăneanu, *Reinventing Politics*, p.270; Gallager, "The Balkans".
[86] Brown, *Hopes and Shadows*, p.3.
[87] Tismăneanu, *Reinventing Politics*, p.271.
[88] Fati, "Romania-NATO după Madrid", p.39.
[89] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p.272.
[90] Phinnemore, "Romania and Euro-Atlantic Integration since 1989", p.7.
[91] Meleşcanu, "The National Security of Romania", p.14.

To sum up, economic and political instability were inevitable in the first decade of transition. Poland's perceptions of insecurity came from the pace and depth of economic reforms and their impact on the political sector while Romania's internal security concerns were mainly related to the drawbacks of the democratisation process. Deeply rooted in its lack of democratic experience, Romania's political instability was highly securitised by the international community, thus impacting negatively on its prospects for EU integration. Furthermore, the early attempts to maintain political stability through postponing economic reforms had the reverse results of spreading instability over a longer period and of damaging the external credibility of the government. Credibility was regained once the post-1996 and the post-2000 Năstase governments initiated deep reforms in economy. While Polish security concerns resulted initially from the high costs the shock therapy imposed on the population, they were de-securitised to a certain extent by the international community. The early radical reforms were seen as a real commitment to market economy and return to Europe. International credibility and reforms helped Poland create a virtuous economic and political circle as early as 1993. Nonetheless, reforms have led in both countries to an increased gap between winners and losers of transition and the rise of extremist parties which is now of more concern that the return of post-communists. This phenomenon emphasises the tension between marketisation and democratisation, certain limitations of the accession process and the need to ensure internal and external economic security. The external security concerns in Poland and Romania will be addressed below.

6.2.2 External security concerns

An analysis of the external threats faced by Poland and Romania in the post-Cold War era should be based on several observations. First, the end of the Cold War meant that two conditions were fulfilled. On the one hand, Soviet involvement in Central and Eastern Europe diminished considerably in importance. This occurred with the end of the Breshnev doctrine by Gorbachev. He made clear that the Soviet Union would no longer use coercion to maintain in power the communist regimes that Moscow had once imposed upon much of the region. On the other hand, the Federal Republic of Germany became a power committed to preserving Central Europe's *status quo* rather than revising it. The German reunification made unlikely a popular upheaval against the repressive government of the German Democratic Republic, an event that might have forced Bonn's intervention and possibly precipitated a larger war in the area.[92] However, these conditions do not necessarily imply that Russia and Germany stopped constituting threats, as will be shown later.

Second, Central Europe and South-Eastern Europe have been historically a buffer zone between different empires. French, German, Austrian, Russian or Soviet and Ottoman empires came and went and imposed different rules. Borders were changed many times, countries were created, destroyed or simply moved to a different place. Moreover, the population comprises a mix of different ethnic groups speaking many different languages and having distinct identities.[93] As a result, borders have always been disputed and the area has been troubled by ethnic tensions and nationalist irredentia. Moreover, unlike 'pax Americana' in Western Europe which at least tried to resolve some of these problems, the pax Sovietica in the East simply suppressed them. Thus, with the disintegration of the socialist community and the intensifying economic crisis in the region, the danger of resurgent nationalism became very real. Moreover, neighbours that could make historically justified claims to territory became potential threats. That is why recognition of the existing borders, however arbitrarily drawn, became the first security key issue of the post-1989 settlement.[94] Border recognition and minority rights also became the *sine qua non* of membership of NATO and implicitly of the EU.

Finally, the end of the Cold War led to the revival of political geography as discussed previously. Terms such as Central Europe and the Balkans were recalled to help identify sub-security systems. Perceptions of security in Central Europe differed from the ones in the Balkans and the two notions have greatly contributed to the de-securitisation of Poland and the securitisation of Romania. This is why discrimination by the international community became an important security concern of Romania as will be seen below.[95]

The following section looks at how external security concerns have impacted upon Poland and Romania's quest for EU integration by analysing the role of the great powers, the significance of neighbourly relations and the importance of 'Central Europeanness' for each country's image. Some of these issues affected first the prospects for NATO membership. However, as NATO enlargement was seen by some as a condition for the EU enlargement, these concerns affected indirectly EU membership. Furthermore, chapter three has shown that security motives have played a pivotal role within the 'healthy' approach to EU enlargement, while early security concerns have acted as brakes on the accession process. The discussion will show how Poland has transformed security concerns into opportunities while Romania failed to do so for most of the transition period.

Poland and Romania between the great powers

Russia

According to Park and Rees, European security will always be defined as opposed to Russia.[96] Russia not only remains a great nuclear power, but its resources, size, economic and political potential make it still a great power in international relations. Furthermore, its geographical position close to Central Europe means that it will potentially have an influence in this area. As an example, Russia has shown

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[92] Ullman, *Securing Europe*, p.138.
[93] Wallace et al, "Old and New Security Issues", pp. 995-996.
[94] Brzezinski, Z. ,"Post-Communism Nationalism", *Foreign Affairs*, Vol. 68, No. 5, Winter 1989/1990, pp.1-25; Wallace et al, "Old and New Security Issues", p. 998.
[95] Meleşcanu, "The National Security of Romania", p.17.

reluctance at times to fully acknowledge the loss of the empire.[97] Finally, a politically and economically unstable or undemocratic Russia would still constitute a threat for the CEECs.[98] Even more so, given that serious antidemocratic tendencies might lead to renewed neo-imperialism or to threats such as drugs, arms or human trafficking.[99]

Poland and Romania's fears towards Russia have been centred around two basic questions: the future economic and political shape of Russia and the possibility of future Russian imperialistic ambitions, regardless of the nature of the state. [100] Before August 1991, a conservative take-over in Moscow was considered a threat in Poland because the Soviet army was the only one in the region which had real invasion capability.[101] Furthermore, Russian troops continued to be stationed in Poland until 1992.[102] However, these fears of Soviet military intervention appear to have been overestimated. For the potentially conservative leaders, preserving order in the Soviet Union would have been a difficult enough task.[103] Second, according to many reports, the morale of the Soviet armed forces had weakened so that no rogue general would have dared to attempt a restoration of the borders of the former outer empire. Finally, the situation in 1991 was totally different from that of 1953, 1956, 1968 or 1979 when the Soviet Union had to face only one single enemy. In 1991 the Soviet 'revanchism' would have had to be directed against several nations simultaneously, which would have been impossible.[104] Closer to the present, although Russians themselves might be unwilling to recreate the military ambitions of the former Soviet Union, demagogic politicians such as Zhirinovsky still had the power to stir up popular feelings.[105]

The ambiguity of Russia's idea of 'near abroad' made Poland fear imperialistic tendencies over the former Warsaw Treaty Organisation member states. Thus, Russia's disguised reluctance to recognise

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[96] Park and Rees, *Rethinking Security in post Cold-War Europe*, p.10.
[97] Post-Soviet Russia has long continued to maintain military bases in former Soviet countries such as Moldova and Georgia, against the wishes of their governments. (See Cottey, A., "Return to Europe: The Transformation of Central and Eastern European Security", *Paper Presented at the BISA Conference*, University of Edinburgh, 17-19 December 2001, p. 5) Russia also exploited ethnic minority and border disputes in order to assert its influence in the Baltic States and Georgia. Additionally, Russia used states' dependence on oil and gas supply to apply political pressure in Ukraine or coerced states into membership of the Commonwealth of Independent States. (See Cottey, "Return to Europe", p. 5) Moreover, many of the conflicts of the post-Cold War Europe have taken place on the territory of the former Soviet Union, e.g. in Nagorno-Karabakh, Chechnya and Georgia. (See Park and Rees, *Rethinking Security in post Cold-War Europe*, p.178).
[98] Hyde-Price, *European Security beyond the Cold War*, p.56; Wallace et al, "Old and New Security Issues", p.996; Smoke, "The Security Situation of the Central European Countries: Historical Background", p.58.
[99] Cottey, "Return to Europe", p.5.
[100] Valki, "Security Problems", p.115; Carter, F.W. and Turnock, D., *The States of Eastern Europe*, Aldershot, Ashgate, 1999, p.177.
[101] Valki, "Security Problems", p.115.
[102] Dunay, P., p.125.
[103] The term of Soviet Union is used here in reference to events that took place before December 1991 when the Soviet Union was officially dismantled and the Commonwealth of Independent States was established.
[104] Valki, "Security Problems", p.115.
[105] Wallace et al, "Old and New Security Issues", p. 996.

the independence of Ukraine fuelled these concerns.[106] In effect, after the collapse of the Soviet Union, most elements in Moscow, even the most democratic reformers, wanted to perpetuate the *status quo* in Central Europe, i.e. a situation in which these countries belonged to no defence system or alliance, and definitely not to NATO.[107] Furthermore, Russia interpreted NATOs' expansion and intervention in Yugoslavia as attempts to exploit its weakness and threats to its security.[108] This is why Russia maintained for a long time a veto power over NATO's enlargement and president Yeltsin even warned over a 'cold peace', should Poland join NATO.[109] However, Russia's stand towards NATO's enlargement softened in time. With regard to Poland's accession, conflicting opinions had already started to appear in 1993. A declaration by President Yeltsin that Russia would not object to Poland's future participation in NATO was withdrawn and followed by many Russian demurrals.[110] In 1994, the Russian foreign minister Kozyrev declared that Russia would permit a NATO enlargement, on condition that it be done 'discretely' and 'without isolating Russia'.[111] Since then, bilateral relations have focused on Poland's role as a bridge to the East and on the Europeanisation of Russia.[112] Finally, the signing in May 1997 of the Founding Act on Mutual Relations, Cooperation and Security between NATO and the Russian Federation has contributed to facilitating NATO's first wave of expansion and to establishing a Joint Council between Russia and the Alliance.[113] Furthermore, the Kosovo crisis and the War on Terror necessitated co-operation between NATO and Russia and showed that a viable security arrangement has to consider Russia's participation.[114] While Poland has favoured Russia's close relationship with NATO, Poland's accession to NATO in 1999 appears to have eliminated Polish security concerns regarding Russia's proximity.

Until 1996, Romania's foreign policy shifted between East and West. Hence, its relations with Russia negatively affected Romania's return to Europe. Thus, the fear of a Soviet invasion appeared to be the motivation for the signature of a bilateral treaty in 1990 including a Soviet veto for Romania's participation in a security agreement. By being the only Central European country to sign such an agreement, Romania was perceived for a long time to be under Russian influence, although the initial bilateral treaty was never ratified and the Soviet Union was dismantled at the end of 1991.[115] Even in 1994 the Russian foreign affairs ministry declared that the Romanian partners were ready to develop military relations as strong as during the Warsaw Pact'. [116] However, for the Romanian part 'the

[106] Stefanowicz, "Poland", p.111.
[107] Smoke, "The Security Situation of the Central European Countries: Historical Background", p.101.
[108] Park and Rees, *Rethinking Security in post Cold-War Europe*, p.178.
[109] Stefanowicz, "Poland", p.115.
[110] Stefanowicz, "Poland", p.111.
[111] Stefanowicz, "Poland", p.111.
[112] Sanford, *Poland. The Conquest of History*, p.97.
[113] Park and Rees, *Rethinking Security in post Cold-War Europe*, p. 178.
[114] Rusi, A. M., "Europe's Changing Security Role" in Gärtner, H. et al (eds.), *Europe's New Security Challenges*, Lynne Rienner Publishers, London, 2001, p.122.
[115] Severin, "Romania- Contribuitor si benficiar al integrarii", p.31.
[116] Fati, "Romania- NATO după Madrid", p.40.

Romanian-Russian relations were cold' and diplomacy was already shifting towards the desire to become a part of NATO.[117] The delay in signing the treaty with Russia was amongst the reasons for Romania not being invited to join NATO at the 1997 Madrid Summit.[118] The resuming of negotiations for the bilateral treaty was important for Romania being invited to join NATO by 2004 within the larger context of the Russia-NATO co-operation in the War on Terror.

In the economic and political sectors of security Russia's influence on Poland and Romania has also been strong during the first decade of transition. Thus, the fall of the CMEA has been an important factor that led to the transitional recession in the early 1990s, thus enhancing the economic and political insecurity of both countries. The negative impact was higher in Poland, whose trade was greatly dependent on the organisation prior to 1989. Polish exports fell by 45% and imports by 33%.[119] On the positive side, Poland's strong need for new trade partners constituted a push factor for Poland's economic integration with the EU. Then, Russia's financial crisis in 1998 has affected FDI in Poland and Romania, albeit only to a little extent. Furthermore, a relatively economically sound Russia has become an important trade and investment partner for both Romania and Poland, thus contributing to their economic reforms and economic security. Despite a certain debate, there is no real fear of economic domination by Russia.

<u>Germany</u>

Although rarely admitted, Germany appeared to constitute a potential security concern for many Europeans after the end of the Cold War. Its history, overwhelming economic power and geographical position contributed to this perception. Some Europeans feared that Germany would leave NATO, ask the allied troops to leave its territory or acquire nuclear weapons.[120] However, these fears were counterbalanced quickly by Germany's commitment to remain anchored in NATO, to deepen the process of European integration through the adoption of the Euro and to widen both NATO and the EU by supporting the CEECs for membership.[121] Germany has not constituted a particular threat for Romania and therefore the analysis will be concentrated on the relationship between Poland and Germany.[122]

Poland's perception of Germany was characterised by mixed feelings.[123] On the one hand, Poland feared that a nationalist government might aggressively raise issues such as the borders, the German

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[117] Fati, "Romania- NATO după Madrid", p.40.
[118] Pop, A., "Un Triumfalism Păgubos", *Politica Externă, Vol. 3, No. 4, 1997*, p.12.
[119] Sanford, *Poland. The Conquest of History*, p.98.
[120] Hyde-Price, *European Security beyond the Cold War*, pp. 57-58.
[121] Cottey, "Return to Europe", p.5.
[122] Furthermore, although France has been known to support Romania, its influence has been relatively smaller than the one Germany had on Poland, hence only the limited reference.
[123] Smoke, "The Security Situation of the Central European Countries: Historical Background", p.46.

ethnic minorities or the rights of expellees.[124] This fear had deep roots in the troubled common history in which the German 'Drang nach Osten' had culminated with the partition of Poland in 1939 and the beginning of the World War Two. Furthermore, as a result of the 1945 peace treaties Poland was shifted westwards, now incorporating important former German territory. Future economic dominance over Poland was also feared. Poles feared that Germany would abuse its economic power to extort political concessions.[125] On the other hand, Germany became an inspiration for Poland through its concept of social market economy and, in the eyes of the Polish, 'the most desirable place to live in.'[126] It was also believed that German investment was good for the economy and that German economic and political influence could bring stability in the whole region.[127] Overall, the relations shifted from conflict to collaboration, a shift supported mostly by the young and within the Solidarity circles.[128] How did Poland diffuse these threats and how did they affect its prospects for EU integration?

First, the Federal Republic of Germany formally committed itself to respect the existing border by signing with Poland the reconciliation and neighbourly bilateral relations treaty in June 1991. Although the treaty eliminated the fear that Germany might again resort to military aggression, it was not sufficient in totally diffusing all shadows from the past and anxieties for the future. The best way to diffuse these anxieties was to make sure that Germany remained anchored in the Western structures of integration and security and that it supported Poland's return to Europe.[129] Thus, the legacy of past turbulent relations between Germany and Poland was a catalyst for Poland's quest for membership of both NATO and the EU. The existence of a bilateral treaty was *sine qua non* for pursuing NATO and EU membership. Moreover, the good bilateral relations were a condition for increased bilateral trade and German investment in Poland and thus increased integration with a main EU member state, as seen in chapter three. Furthermore, the recognition of minority rights has contributed towards meeting the Copenhagen political criteria of accession to the EU. However, memories of border changes made land acquisition by foreigners impossible, constituting a negative element of the investment climate in Poland for a long time. Furthermore, the fear of economic invasion by Germans once the EU enlarged made accession negotiations stumble over the land acquisition transition periods and hence affected Poland's quest for EU membership. Second, Germany became the most committed and influential supporter of Poland's integration into NATO and the EU. Statesmen in both countries used repeatedly the cliché that Germany's road to the East lay through Poland while Poland's road to Europe lay

[124] Hyde-Price, *European Security beyond the Cold War*, pp. 57-58.
[125] Taracova et al, "Public Attitudes in Four Central European Countries", p.46; Hyde-Price, *European Security beyond the Cold War*, pp. 57-58; Wallace et al, "Old and New Security Issues", p.996; Sanford, *Poland. The Conquest of History*, p.96.
[126] Smoke, "The Security Situation of the Central European Countries: Historical Background", p.46; A. Hyde-Price, *International Politics of East Central Europe*, p.208.
[127] Starzynski, P., "Poland" in Smoke (ed.), *Perceptions of Security*, p.55.
[128] Sanford, *Poland. The Conquest of History*, p.94.
[129] Stefanowicz, "Poland", p.109.

though Germany.[130] While this did not eliminate the fear of German economic domination, German support helped speed up the process of obtaining firm security guarantees through NATO membership. Furthermore, German support for early Polish EU membership succeeded even when Poland was lagging behind in meeting the accession criteria or conducting the accession negotiations, as already shown in chapter three.

For Poland, the initial threat posed by Germany became a catalyst for EU integration. While Poland cultivated co-operation with Germany, Romania failed to acknowledge in the early 1990s the benefits that Germany's support might bring. Thus, when Kinkel, the German foreign affairs minister, offered in 1990 to visit Romania ahead of the French diplomacy, the Romanian authorities declined the offer, in an attempt to emphasise the traditional links with France. This diplomatic signal downsized the support Germany was ready to give Romania in the early 1990s.[131] Although Germany became by 1998 one of the largest investors and main trade partner of Romania, it hesitated in supporting Romania's bid for NATO membership in 1997. Since then, Romania's efforts to ensure Germany's diplomatic support and economic interest have intensified. France, on the other hand, has proven a rather feeble advocate of Romania's return to Europe. France's limited involvement with NATO diminished its power in supporting Romania's candidacy for NATO in 1997. Furthermore, the recommendation of the French foreign minister addressed at the Nice European Council of December 2000 to start accession negotiations with all twelve CEE candidates was rejected by the European Council. However, the United Kingdom has become an active supporter of Romania's candidacy for EU membership. This increased support appears to be motivated by economic and military interests, as well as by the British stand over EU which favours widening over the deepening of the Union. A more in depth analysis is, nevertheless, beyond the scope of this study.

Neighbouring relations

Borders have always been disputed and the area has been troubled by ethnic tensions and nationalist irredentia. Furthermore, with the experience of the Yugoslav wars, relations between neighbouring states and the issue of national minorities became increasingly a security concern not only for the states in the area, but also for the EU. There was a fear that further nationalist conflicts could become a challenge to the territorial or political *status quo* in the region which could draw in other major powers, 'spill into contiguous geographical areas such as NATO's southern region' or 'degenerate' into a 'Lebanon-type' situation of incessant conflict. '[132] This led to the initiation of the Balladur Pact which made NATO, and implicitly EU membership, conditional on signing neighbourhood treaties with all

130 Sanford, *Poland. The Conquest of History*, p.95.
131 Pop, "Un Triumfalism Păgubos", p.12.
132 Hyde-Price, *European Security beyond the Cold War*, p.57.

neighbours and on respecting the rights of minorities.[133] Instability in South-Eastern Europe has also led to the revival of the terms 'Balkans' and 'Balkanisation' with negative perceptions of security in the area as will be discussed later on. How did Poland and Romania deal with the issues of borders and political geography?

Poland: a pole of stability and a gateway to the East

Borders have been a sensitive issue for Poland, a relatively new state which suffered numerous transfigurations in history, including the dismantling during the World War Two and the westwards territorial shift institutionalised at the end of the conflict.[134] Thus, since 1989 the Polish overriding political objective was to supersede the legacy of hostility with its neighbours.[135] Soon after the end of the Cold War, Poland found itself amidst seven new neighbours which had replaced the three previous ones. Thus, the German Democratic Republic had vanished into the Federal Germany, Czechoslovakia had given way to the Czech Republic and Slovakia, while the Soviet Union had been replaced by Lithuania, Russia (through its district of Kaliningrad), Belarus and Ukraine. To minimise the possible threats that might arise from these new states, Poland signed treaties of reconciliation and good neighbourly relations with every one of the seven within only four years. These treaties contained clauses that frontiers would remain unchanged and inviolate and that the rights of minorities would be observed.[136] They constituted an important condition for NATO membership and a signal of Polish security which enhanced Poland's prospects for EU integration.

Poland has also met all requirements regarding minority rights as recognised by the Opinion and the regular reports. Furthermore, Poland's good relations with its eastern neighbours made Poland an important gateway towards the East, a pillar of stability in the area. Poland became the advocate of Ukraine's quest to join the EU and Poland tried to ensure that no 'paper curtain' will cross between the two countries.[137] It has good relations with Lithuania which has joined the race for EU membership and was invited to join in May 2004. Poland's relationship with Belarus aimed to minimise the threats that might appear from a closer relationship between Russia and Belarus. Furthermore, Poland's increased control of its eastern borders has aimed to minimise the danger of illegal immigration, drugs, human and arms trafficking. It raised, however, the question of a new division line between the East and the West, of a 'paper curtain' rather than an iron one.[138] As a result of its strategic geographical position

[133] Molnar, G., "The Geopolitics of NATO Enlargement", *International Studies*, Vol. 3 No. 3,1997, p.5.
[134] Stefanowicz, "Poland", p. 108.
[135] Michta, "Poland, Czechoslovakia, and Hungary", p.70.
[136] Stefanowicz, "Poland", p. 107.
[137] Sakwa, "The Keystone in the Arch: Inclusion, Democracy and Universalism in Central and Eastern Europe", p.132.
[138] For a further discussion on Poland's relationship with its eastern neighbours, see: Wallace et al, "Old and New Security Issues"; Stefanowicz, "Poland"; Michta, "Poland, Czechoslovakia, and Hungary"; Sanford, *Poland. The Conquest of History;* Glenny, *The Rebirth of History*; Wolczuk, K. and Wolczuk, R., "Poland's Relations

and of its good relations with its neighbours, Poland's membership of the EU and NATO became a valuable asset for both organisations and Germany in particular. Poland's appeal to the EU was further enhanced by its co-operation with Hungary, Czech Republic and Slovakia and with the rebirth of Central Europe as a political concept. The role of 'Central Europeanness' in creating positive perceptions of security will be discussed in a later section.

Romania's neighbourly relations: between challenges and opportunities

Romania's borders have changed since 1918 when the country incorporated all its historic provinces. The country suffered in 1940 huge territorial losses which Romania only partially recovered at the end of the World War Two. Transylvania was reincorporated into Romania but Bessarabia became the state of Moldova within the Soviet Union. South Dobrudja became Bulgarian territory and Bucovina, a north eastern Romanian territory, was annexed by Ukraine. With this legacy, borders have been contested and an important security concern for Romania. Furthermore, their recognition was a key condition for Romania's membership of NATO and implicitly of the EU. Given the contested history, the negotiation of the treaties has suffered several delays. These delays have negatively affected Romania's prospects for both NATO and EU integration. Most of the treaties were signed under the pressure of the Madrid Summit of 1997 when the decision over NATO's enlargement was planned.

In the absence of a proper institutional framework, Romania's relations with its neighbours have constituted important security concerns until mid-1990s. Thus, the most sensitive relations were with Hungary and Moldova. Bilateral relations between Romania and Hungary have been largely affected by suspicions over the treatment of the Hungarian minority in Romania and over the intentions of the Hungarian authorities to interfere in Romania's internal affairs on this basis. These suspicions and developments presented earlier on as part of the internal security concerns were partially the cause of the failure of the two parties to sign a bilateral treaty ahead of the Conference on Stability. The 1995 Conference on Stability was initiated by the Balladur Pact as a condition for the CEECs' return to Europe. The neighbourly and friendship treaty was signed in 1996 ahead of the 1997 Madrid Summit which was to decide over NATO's enlargement. This was, nevertheless, not enough for Romania to be invited to join NATO, further affecting the prospects for EU membership. By 2002 the relations between Romania and Hungary did not constitute special security concerns given changes in the attitude of both of the Romanian and Hungarian authorities. Romania has improved its attitude towards its Hungarian minority and, despite several incidents, Hungary has become an advocate of Romania's integration into NATO and the EU.[139]

with Ukraine: A Challenging 'Strategic Partnership'" in Smith and Jenkins (eds.), *Through the Paper Curtain. Insiders and Outsiders in the New Europe.*

Romania's relations with Moldova were affected by Romania's early nationalistic stand in its foreign policy and Moldova's own search for identity in the aftermath of its independence. Early attempts to build a special relationship between the two countries were then affected negatively by the separatist conflict in Transnistria and by an increasingly pro-Russian approach by the Moldovan authorities since mid 1990s. They accused at times the Romanian party of interfering in Moldova's internal affairs and led to a further delay in signing the bilateral agreement. The lack of such an agreement by 1997 contributed to Romania's delayed NATO membership and to maintaining perceptions of external insecurity. The 2000 bilateral treaty paved to a certain extent the way to the 2002 invitation of joining NATO. As NATO membership was considered a pre-condition for EU membership, this treaty contributed indirectly to progress in Romania's quest for EU integration.[140]

Yugoslavia's proximity negatively affected Romania's efforts to be seen as a Central European state rather than a Balkan one. Developments in Yugoslavia have given rise to security concerns for Romania while representing the most serious challenge to the security of the whole area. In the early 1990s, by trying to have amiable relations with the Milosevic regime, by being reluctant to condemn human rights violations in Yugoslavia and by expressing concern for Yugoslavia's exclusion from the CSCE, the Romanian government appeared as a tacit supporter of what was seen by the EU and NATO as a 'pariah regime'. This did not enhance Romania's prospects for returning to Europe.[141] Later, the Yugoslav wars created instability in South-Eastern Europe which led again to a low interest in Romania's integration into the EU. Furthermore, economic embargoes against Yugoslavia and the blockage of traffic on the Danube also affected Romania's trade, economic growth and prospects for prosperity. These concerns made the Romanian government reluctant to participate in the UN sanctions, an attitude which had a negative effect on Romania's prospects for EU integration.[142] Yugoslavia's negative impact on Romania has diminished since the signing of the bilateral agreement in 1996. By distancing Romania from the Milosevic regime, the post-1996 leadership improved the Romania's image abroad and facilitated more positive assessments of country's suitability for integration into the EU.[143] The previous Yugoslav threat became the catalyst for Romania's integration in the EU in the aftermath of the Kosovo crisis as was seen in chapter three.

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[139] See also Partos, "Hungarian-Romanian and Romanian-Moldovan Relations"; Vukadinovic, R., "Challenges to Security in South-Eastern Europe", *COPRI Working Paper No. 35, Copenhagen*, 2000.
[140] For further references to the Romanian-Moldovan relations, see J. Bugajski, *Nations in Turmoil. Conflict and Co-operation in Eastern Europe*, Westview Press, Oxford, 1995; Valki, "Security Problems"; Vukadinovic, "Challenges to Security in South-Eastern Europe"; Partos, "Hungarian-Romanian and Romanian-Moldovan Relations".
[141] Phinnemore, "Romania and Euro-Atlantic Integration since 1989", p.4; Severin, "Romania- Contribuitor si benficiar al integrarii", p.16.
[142] Phinnemore, "Romania and Euro-Atlantic Integration since 1989", p.4.
[143] Phinnemore, "Romania and Euro-Atlantic Integration since 1989", p.5.

Some analysts argue that a democratic Serbia and Montenegro is no longer a threat to the stability of the area and will not retain EU's interest for integration in South-Eastern Europe.[144] However, the country still has a lot of problems on all sides. Montenegro is on a brink of separation, Kosovo can practically be written off for Serbia, Sandzak is demanding autonomy and Hungarians have been supported in their aspirations for a full secession from Yugoslavia by nationalistic political forces from Hungary.[145] Furthermore, stability depends on economic security which can be enhanced through international financial assistance and FDI, as has been envisaged through the Stability Pact. Romania's internal stability, good relations with Yugoslavia and its active participation in the Stability Pact appear to be good conditions for Romania's membership of the EU. Romania can maintain stability in an area which is still likely to pose threats to the security of Europe as a whole. However, a thorough investigation of the bilateral relations between Romania and its neighbours is beyond the scope of this study.

To be or not to be Central European?

Poland's relations with the Visegrad Group and the 'privilege' of Central Europeanness

Poland has searched to create a network of political, economic and even security ties with Hungary and Czechoslovakia by setting up the Visegrad Triangle in 1990, renamed as the Visegrad Group after the split of Czechoslovakia in 1993. This was an institutionalisation of the revival of Central Europe as a political concept and had initially an exclusive nature. Thus, Romania's attempt to become a member in 1992 was unsuccessful.[146] From a Polish point of view, the organisation was meant to be valuable in its own right. From the other members' point of view, the group was just an integration exercise useful in enhancing their prospects for EU integration.[147] Regional co-operation was seen as a stability factor, increasing members' credibility through their ability to work together.[148] However, it was also feared that anything that would resemble an alliance might hinder the members' entrance to the EU, NATO or other organisations.[149] Regardless of the motives for membership, this collaboration had the merit of projecting outside, and especially to the EU, a positive image of its members. The Visegrad Group came to symbolise a keen drive for EU membership, successful democratic transition and advanced economic reforms. Doubts loomed over Slovakia's performances, but the general image was extremely positive. Foreign investors were attracted by the stability and prosperity of the area, and the EU's intention to enlarge was also channelled onto Central Europe. Furthermore, the concept of Central Europe was the opposite of the Balkans which were associated with instability, ethnic hatred and violence, so well symbolised by the Yugoslav wars in the early 1990s and the 1999 Kosovo crisis.

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144 Interview with Expert in foreign direct investment in transition countries, EBRD, London, 2002.
145 Vukadinovic, "Challenges to Security in South-Eastern Europe", p.28.
146 Pop, "Un Triumfalism Păgubos", p. 11.
147 Stefanowicz, "Poland", p.116.
148 Millard, F., *The Anatomy of the New Poland*, Edward Elgar, Aldershot, 1994, p.217.

Eventually, competition between the Visegrad Group's members led to a lessening of the importance of the group in enhancing EU accession.[150] In 1993 the economic ties took the form of the Central European Free Trade Association (CEFTA) which in 1997 enlarged towards Romania and Bulgaria. The Central Europeanness of Romania was slowly accepted by Central Europeans themselves, despite having been recognised at EU level as early as 1992. This was proof of the constant redefinition of the political geography in the area, very well captured by Agh who refers to the past: Central Europe was 'like a ferry boat moving back and forth between West and East' with 'successful and unsuccessful stories'.[151] Nevertheless, the early years of the Visegrad Group created positive perceptions of security for Poland, creating the conditions for a political virtuous circle.

Romania: from Central Europe to the Balkans and back

In 1992 the Petersburg Declaration clearly recognised Romania's Central European status amongst the other eight countries as follows: the three Baltic states, Poland, the Czech Republic, Slovakia, Hungary, Romania and Bulgaria.[152] Nevertheless, soon afterwards, perceptions of Romania seemed to disregard its official Central European identity. Academics, officials and international organisations such as the EBRD referred to Romania as a part of the Balkans. This was partly due to Yugoslavia's proximity which has largely perpetuated an image of instability in the area, as discussed earlier on. The Balkan label was also partly justified in the early 1990s by the internal political instability of Romania and by its failure to guarantee all its borders through signing bilateral relations agreements. The slow progress in economic reforms contrasted with the good economic record of countries such as Poland, Hungary or the Czech Republic, thus further distancing Romania from Central Europe. While Central Europe was perceived positively, the Balkans had a negative perception. Moreover, 'Balkanisation' became a negative term to suggest instability, lack of rule of law, danger and violence. Mearsheimer even used it to warn against the consequences of the end of the Cold War on security in Europe.[153] Not only was this image fuelled from inside, but it was equally constructed from outside, in order to enhance the superiority of Central Europe.[154] Within a highly competitive EU accession process, such a dichotomy was useful in speeding up the accession of Central European countries at the expense of the Balkan ones, to the extent that a Romanian scholar stated: 'Who enters Central Europe, enters Europe.'[155]This discrimination was seen as an important security concern by the Romanian

[149] Smoke, "The Security Situation of the Central European Countries", p. 101.
[150] Stefanowicz, "Poland", p.116.
[151] Agh, *Emerging Democracies in East Central Europe and the Balkans*, p. 3.
[152] Meleşcanu, "The National Security of Romania", p. 14.
[153] Mearsheimer, "Back to the Future", p.31.
[154] Todorova, M., "The Balkans: From Discovery to Invention", *Slavic Review*, Volume 53, Issue 2, 1994, p.455.
[155] Sava, *Zece ani de trazitie in Europa de Est.*

authorities.[156] It had the potential of enhancing a negative circle of instability and underdevelopment in which the countries in the area seemed to be trapped in the early transition.

On this basis, the Romanian authorities have intensified their efforts to promote Romania as a Central European country. The attempts in 1992 to join the Visegrad Group were unsuccessful, but membership of CEFTA was finally achieved in 1997. This affiliation to a Central European organisation was paralleled by a stronger commitment to economic reforms, NATO and EU membership by the newly elected centre-right government and thus gave more substance to Romania's 'Central Europeanness'. This appears to have been reflected in a positive external image which, correlated with progress in privatisation, has led to an increased level of FDI in Romania. Romania remained at the same time deeply anchored in South-Eastern Europe. Its participation in the Black Sea Economic Co-operation initiated in 1992 was enhanced as a proof of Romania's capability to co-operate on a regional scale. Furthermore, Romania became part of the Stability Pact on South-Eastern Europe initiated in 1999 by the EU as a result of the Kosovo crisis. This pact marked the beginning of the de-securitisation of the area. By replacing the notion of 'Balkans' with 'South-Eastern Europe', an attempt was made to improve the external image of the area and prospects for stability. Moreover, in 2000 the launch of the EU accession negotiations with all remaining candidate countries seemed to contribute to a reconciliation of political geography and the de-securitisation of the Balkans. Romania remains a pole of relative stability in South-Eastern Europe, an area which can be still threatened by instability. This has been a major argument put forward by Romania in its quest for both NATO and EU membership.

To sum up, Poland has transformed most of its external security concerns into opportunities through an active policy of integration into NATO and the EU, ensuring good neighbourly relations towards the East from the first years of transition and promoting regional co-operation in a Central European framework. Furthermore, Germany's support enhanced the Polish prospects for returning to Europe, while the proximity of Russia's near abroad has constituted an important push factor for a rapid integration into the Euro-Atlantic structures. On the other hand, Romania's external security concerns emerged from the delay in signing bilateral treaties with its neighbours and from political developments both within Romania and within its neighbours. Furthermore, this delay and Romania's shifting foreign policy in the early 1990s have contributed to the postponement of NATO and hence EU membership and the perpetuation of the security vacuum brought by the end of the Cold War. Finally, it has been shown that perceptions of security are as important as security concerns themselves. The fear of discrimination as a result of a perceived Balkan identity represented an important external security concern. Thus, by being perceived as a Balkan country, Romania has been

[156] Năstase, A., "Politics in Transition", *Central European Issues*, Vol. 1, No. 1, 1995, p.7; Meleşcanu, "The National Security of Romania", p. 14.

lagging behind in both EU integration and attracting FDI for most of the transition period. However, a change of perception since 1996 and increasingly since 1999 with the Helsinki European Council has contributed to Romania entering a virtuous circle of development. Overall, the international community and especially the EU have contributed greatly to the securitisation or de-securitisation of some of these security concerns. The role of EU in enhancing security of Poland and Romania will be assessed in the following section.

6.3. Is EU membership the best way to ensure security in Poland and Romania?

Given its internal challenges, its history and its geographical position, the stability of Central and South-Eastern Europe is contingent on security arrangements at European wide level.[157] Furthermore, for Poland and Romania EU and NATO membership are not only pragmatic projects, but also very symbolical ones.[158] They are an insurance against a new Yalta, the symbol of the real end of the Cold War.[159] As an investigation of NATO's role in providing security is beyond the scope of this study, the following pages will refer only to the EU. Thus, the EU itself does not want to see the CEECs going back to communist economies and authoritarian rule as this would have a 'seriously destabilising effect on the security of the continent as a whole'.[160] The majority of EU members placed emphasis on further economic and political integration as a means of reinforcing the CEECs economic and societal security and ultimately military security.[161] This is because in addition to its economic and political substance, the EU is a security mechanism, the significance of which, even though indirect in its operation, should not be underestimated.[162]

Thus, EU membership appears to be the best way to guarantee security for Poland and Romania in conjunction with NATO membership.[163] Several arguments will be put forward to support this claim. First, the EU has provided security through its initiation, previous enlargements and through launching the Stability Pact in South-Eastern Europe. Second, EU membership addresses all sectors of security, be it economic, political, societal, environmental or military. Finally, Europe has increasingly become a security complex in which an indivisible security makes co-operation *sine qua non* for maintaining peace and stability. By security complex one means a 'set of states whose major security concerns and perceptions are so interlinked that their national security problems cannot reasonably be analysed or

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157 Gow, J. cited in Smith, M. A., "The NATO Factor: A Spanner in the Works of EU and WEU Enlargement?" in Henderson, *Back to Europe*, p.170; Latawski, "NATO and East Central Europe: The Case of Poland", p.191; R. Vukadinovic, "Challenges to Security in South-Eastern Europe", p. 25.
158 Stefanowicz, "Poland", p.120.
159 Stefanowicz, "Poland", p.120; Taracova et al, "Public Attitudes in Four Central European Countries", p.46.
160 Dorman and Treacher, *European Security*, p.150, 156.
161 Dorman and Treacher, *European Security*, p.150, 156.
162 Tiersky, R., *Europe Today*, Rowman and Littlefield Publishers, Oxford, 1999, p.429.
163 Murphy, A., "Securing Europe's Future: The Role of the European Community" in Williams (ed.), *Reorganising Eastern Europe*, p.33.

resolved apart from one another.'[164] Furthermore, security interdependence between states inside this complex is higher than among states outside them.[165] This interdependence makes co-operation in security terms necessary for all members of the security complex and thus co-operation in Europe the *sine qua non* for the security of the continent.

Previous experience shows that the EU can de-securitise the countries from Central and Eastern Europe through economic integration.[166] For more than fifty years the EU has ensured prosperity and peace for its members and now once again the EU is called upon to ensure security in the face of new threats. Thus, economic security and avoidance of another world conflict were the main motivation for the setting up of the EU's predecessors. By pooling together the economic resources of the six founding economies, the EEC, the European Coal and Steel Community (ECSC) and later the EURATOM made war between France and Germany inconceivable.[167] Furthermore, the EU has contributed greatly to democratic consolidation in Greece, Spain and Portugal by granting them membership soon after they abandoned totalitarian regimes.[168] The present hopes for security in the continent rely once again on the EU's potential to ensure reconciliations such as the French-German one, now in the case of Poland and Germany, or Romania and Hungary, or to consolidate democracy in the former communist countries of Central and Eastern Europe. In the words of Hyde-Price at the beginning of the 1990s: 'One of the best ways to ensure that the disintegration of the Soviet bloc does not produce a zone of chronic instability and authoritarian nationalism in the eastern bloc of Europe is by enmeshing these newly democratising states in a web of ever deepening interdependencies. In this way, it might be possible to create a favourable and supportive international environment for the reform process in the East. By providing positive incentives and an institutional framework of pan-European co-operation it may be possible to give practical encouragement to liberal and reforming coalitions in the East and prevent the emergence of autarchic and excessive nationalistic policies in these fragile politics.'[169]

Potentially, EU membership addresses all sectors of security, including military. An in depth discussion of the EU's potential role in ensuring military security is beyond the scope of this study. A few remarks will be made, nevertheless. Thus, the continuous interest in increasing the security of the continent has included the initiation of the Common Foreign and Security Policy as a distinct pillar of the European Union through the Maastricht Treaty in 1991. Furthermore, following the Maastricht agreement, the increased powers given to the Western European Union were meant to give substance to EU's ambition to become an actor in military terms and to decrease the reliance on NATO in self-

[164] Buzan et al, *The European Security Recast*, p.11.
[165] Buzan et al, *The European Security Recast*, p.11.
[166] Manners, I.J., "European [Security] Union: From Existential Threat to Ontological Security", *COPRI Working Paper No.5*, Copenhagen, 2002, p.26.
[167] Smoke, "The Security Situation of the Central European Countries", p.99; Tiersky, *Europe Today*, p.429
[168] Croft et al, *The Enlargement of Europe*, p.58.
[169] Hyde-Price, *European Security beyond the Cold War*, p.151.

guarding the security of the continent.[170] Although the Yugoslav wars, the Gulf war and the Kosovo crisis have exposed numerous limitations to the EU's military capability, they pointed towards the need to further develop the military capabilities of the EU. These would enable the EU to respond effectively to crises in which NATO might have no interest in intervention. This is, nevertheless, still a project.

Although there is a certain potential for further development of a military capability of the EU independent of NATO, at present the best way that the EU can ensure the security of the continent is through addressing non-military threats. Thus, the EU's role in Central and Eastern European security consists of establishing long term conditions for peace and stabilisation through economic and political co-operation.[171] By addressing the political and economic sectors of security, the EU makes a major contribution to the stability of the continent, given that economic and political security are interdependent and impact greatly upon the other sectors of security, including military security. The section below will look at the ways the EU has addressed the internal and external security concerns in Poland and Romania which were defined earlier in the chapter. The indivisibility of security of the continent makes security of Poland and Romania important not only for themselves, but for the EU and for the continent as a whole. There are several channels through which the EU has contributed to enhancing security of Poland and Romania: by providing the incentive for membership and the accession criteria; by offering funds, enhancing trade and investment, thus reducing the potential for economic and political instability; by changing external perceptions of each country with regard to their security concerns; by addressing the external threats to each country. These will be discussed below.

First, by offering the 'carrot' of membership and setting up the accession criteria, the EU imposed certain standards of democratisation and marketisation.[172] By exercising its normative power on the candidate countries and creating incentives for adherence to democracy and market economy, the EU aimed to minimise the danger of return to authoritarian regimes and centrally planned economies.[173] Although achieving democracy and market economy were genuine goals of Poland and Romania regardless of the prospect of EU membership, by offering a 'prize' for successful transition and anchoring these countries in an international framework, a stronger commitment by the local authorities and population was ensured. This was especially important given a certain tension between marketisation and democratisation and the large cost borne by both population and the political elite as

[170] Smoke, "The Security Situation of the Central European Countries", p.15.
[171] Murphy, "Securing Europe's Future", p. 33.
[172] Murphy, "Securing Europe's Future", p.118.
[173] For a discussion of the normative power of the European Union, see Manners, I.J., "Normative Power Europe: A Contradiction in Terms", *COPRI Working Paper No. 38*, Copenhagen, 2000.

shown in chapter four.[174] With the prospect of EU membership, the population was encouraged to cope with the hardships induced by economic reforms and the political elites were pushed to apply unpopular reforms with positive results in the long term.[175] The motivational impact of the EU membership prospect was especially acknowledged in the aftermath of the Kosovo crisis when the Commission invited the previously second track candidates to start accession negotiations. Partially justifying this decision, Prodi, the president of the European Commission, said: 'We risk losing some countries along the way by depriving their reforms of a tangible, credible objective and as the political consequences of such an exclusion cannot be measured, no risk should be taken.'[176]

The prospect of EU membership also encouraged the political forces in both countries to minimise the impact of extremist parties on the political arena, thus defending the democratic rule. The extremist Greater Romania Party was marginalised in Romania after the 2000 elections, despite obtaining 20 percent of the seats in parliament. Furthermore, in the context of the EU accession process, not only was the threat of extremism in Romania contained, but contributed to the mobilisation of the political class in ensuring a faster rhythm of reforms and of preparation for EU membership after the 2000 elections. Through EU conditionality a security concern was transformed into a catalyst for change and progress towards EU accession. Furthermore, through the imposition of the economic criteria, governments in both countries were encouraged to promote reforms for transition to a market economy. The criteria constituted landmarks in conducting economic transition. They also included important conditions for attracting FDI, completing privatisation, enhancing economic growth and prosperity. Although the pace of economic reforms depended also on the internal conditions of each country, the EU's support had an important catalytic role which will be assessed quantitatively in chapter seven. This role emergsed despite several limitations which will be discussed below.

At times compliance with these standards induced internal debates or protests. In Romania, human rights observation led to differences of opinion regarding the interpretation and the limitations of such rights. The 1201 Recommendation of the Council of Europe created an intense debate between the government and the UDMR as was already discussed. A similar debate was provoked by the law on Hungarian status proposed by the Hungarian government in an attempt to ensure the financial prosperity of its nationals outside Hungary. However, on this occasion it was the normative power of the EU which tempered Hungary's claims to apply the Hungarian Status law in a discriminatory way towards Romanian nationals. Furthermore, the 'carrot' of EU membership was not able to stop the emergence of extremist parties in either of the countries and their election in parliament. Thus, disillusioned with some of the results of economic and political transition, voters in Romania turned in

[174] Cernat, L, "Lungul drum al integrării europene", *Politica Externă*, Vol.2, No.2, 1997, p.77.
[175] Cameron, F., "The European Union and the Challenge of Enlargement" in Maresceau, M. (ed.), *Enlarging the European Union. Relations between the EU and Central and Eastern Europe*, Longman, Harlow, 1997, p. 251.

2000 to the extremist PRM in Romania and in Poland to the League of Polish Families (LPR) and to the Self Defence of the Polish Republic (S). These results pointed towards a 'fatigue' with transition and towards the need to support externally the democratic consolidation in both countries.

The assessment of progress towards EU membership according to compliance with the economic criteria also had several negative side effects. Thus, the closing of sensitive sectors such as mining led to important protests in both Poland and Romania. The prospect of implementation of the common agricultural policy upon accession to the EU have led to frequent protests by the Polish farmers ahead of closing the accession negotiations on agriculture. Similarly, capital market liberalisation requirements met increased resistance and protests from citizens wary of foreigners buying Polish land. Indirectly, these EU requirements increased political instability in both countries. Furthermore, some argue that the rapid transposition and implementation of the *acquis communautaire* required an enormous financial, human and administrative effort thus using resources which could have been used in more productive areas of economic and political reforms.[177] This might have been the case of Romania which lagged behind regarding the accession target date. Additionally, the market economy is associated with greater risk and thus it is difficult to dissociate it from economic insecurity. Companies can go bankrupt and thus lead to increased unemployment, a source of increased insecurity at individual level but a common occurrence in a market economy framework. Furthermore, increased competition has led to a polarisation of society, an increasing gap between poor and rich, another potential source of corruption and political instability in both Poland and Romania. Despite these limitations, the prospect of EU membership has provided the prospect of a long term benefit to counteract the short term losses. The prospect of EU membership also signifies the real end of the order imposed by the Yalta agreement at the end of World War Two.

Second, by providing pre-accession funds, liberalising trade and encouraging FDI, the EU contributed to the progress of economic reforms and the economic development of both Romania and Poland. Economic development can minimise political and economic instability and thus increase internal security. By being directed towards ensuring safety nets for the people most affected by the economic transition, some of the pre-accession funds have contributed towards reducing political instability and societal insecurity. Furthermore, funds have been used to ensure the institution building of both Poland and Romania, thus creating a strong basis for political and economic stability. Additionally, any funds directed towards building the civil society are an investment in the process of democratisation, thus eliminating the threat of return to authoritarian regimes.[178] Then, trade and FDI are important determinants of economic growth, thus enhancing economic convergence with the EU, the prospect of

[176] *Business Central Europe*, February, 2000.
[177] Bevan, A.A., Estrin, S. and Grabbe, H., "The Impact of EU Accession Prospects on FDI Inflows to Central and Eastern Europe", *Policy Paper No. 6*, December 2001.

accession and of increased welfare. Furthermore, access to markets and investment represents an important condition for achieving economic security, as defined by Buzan et al.[179] However, there are several limitations to EU's impact on Poland and Romania's internal security through funding, trade and FDI.

Thus, suspicions appeared over the misuse of some of the pre-accession funds and thus increased perception of corruption in both Poland and Romania. Then, trade liberalisation has increased the dependence on the EU market which accounts for almost two thirds of both imports and exports in both countries. Moreover, for most of the decade access to the EU markets was imperfect as it did not incorporate areas such as steel, textile and agriculture in which both Romania and Poland have a comparative advantage over the EU. The limited access diminished the contribution trade liberalisation might have had to enhancing economic growth and economic security in the two countries. Furthermore, as a result of the significant trade and foreign investment by German businesses, concerns of German economic domination over Poland have increased. Finally, FDI did not always measure up to expectations and closure of plants in both Poland and in Romania has led to increased unemployment, thus fostering economic insecurity.

Third, the prospect of early or belated EU membership affected each country's image and acted as a signal for investors. Based on the assumption that security threats are constructed by the observer, by offering early prospects for EU integration to Poland, the EU reinforced the positive perceptions of the country, thus enhancing FDI and its impact on the economic and political spheres as in diagram 6A(c). On the other hand, by initially labelling Romania as a second wave country in the process of accession, the EU risked further discouragement to foreign investors and thus enhancing the vicious circle in which the country had been trapped for the first years of transition. The subjective nature of security was partially the reason why the EU enhanced the all inclusive character of the enlargement process in the aftermath of the 1999 Kosovo crisis. By inviting Romania and the other remaining candidate countries to open accession negotiations, the EU showed its commitment to their development, positively affecting their external image. This had the potential to enhance Romania's attractiveness for foreign investors, thus boosting reforms and reinforcing the positive image of the country. This will be further discussed in chapter seven. Finally, the Stability Pact for South-Eastern Europe also contributed to de-securitisation by committing the international community to the economic development and security of the area and by enhancing regional co-operation.

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178 Sakwa, "The Keystone in the Arch", p.142.

179 Buzan et al, *The European Security Recast*, Pinter, London, 1990, p.14.

Finally, the EU is addressing the external threats that Poland and Romania have perceived since the end of the Cold War and which have been discussed earlier on. Thus, by extending the area of prosperity towards east, the EU complements NATO in filling the security vacuum resulting from the dismantling of the Soviet empire. By contributing to the CEECs' political and economic reforms, the EU minimises the influence that Russia can exert through economic or political means on either Poland or Romania. Furthermore, the EU's co-operation with Russia and financial support are likely to enhance further Russia's own democratisation and marketisation, thus reducing the risks of future instability or imperialist policies in the 'near abroad'. Moreover, by contributing to securing the eastern borders as part of the preparations for membership of the Schengen agreement, the EU can minimise the inflow of migration, drugs, arms and prostitution trafficking which have constituted an important security concern for Poland, Romania and the EU itself. EU membership also offers a solution to Poland's fears of German economic dominance. By expanding the EU, the eastern candidates have reinforced the Union's members' commitment to integration, including Germany. Thus, by being well anchored in the EU, Germany constitutes less of a threat for Poland. Furthermore, by joining the EU, Poland becomes an equal partner in an organisation whose decisions Poland can now influence. Poland has taken part in the Convention on the future of Europe thus contributing to shaping the role that Germany will play in the organisation. EU membership is also likely to benefit from and enhance Romania's role as a pole of stability in South-Eastern Europe. As it is inconceivable to see EU member states going to war with each other, EU membership is the natural answer to the normalisation of relations not only between Poland and Germany but also between Romania and Hungary. Furthermore, through its participation in the Stability Pact and the Black Sec Economic Co-operation, Romania is likely to continue to enhance co-operation and development in the area. Overall, the EU enlargement to the east removes the fear of fragmentation which appears to be a crucial security concern for Europe while the further development of the Common Foreign and Security Policy (CFSP) is likely to increase the EU's say in ensuring the security of the continent.[180]

However, EU membership brings fears as well. To note just a few, EU membership implies surrendering some sovereignty, thus replacing the Soviet influence with the European one.[181] While this is true to a certain extent, the process of Europeanisation has been a voluntary project of both Poland and Romania and is likely to bring more benefits that costs.[182] Furthermore, in a world of high economic interdependence total sovereignty has become an obsolete concept. However, a deeper discussion on this issue is beyond the scope of this study. Second, EU membership is likely to create new division lines of the continent and to replace the Iron Curtain with a so called 'Paper Curtain' or a 'Golden Paper'. The accession of Poland and Romania will enhance discussions over the likelihood of

[180] Waever, O., "European Security Identities", *Journal of Common Market Studies*, Vol. 34, No.1, 1996, p.129.
[181] Buzan et al, *The European Security Recast*, p.153.
[182] Starzynski, "Poland" p.55; Croft et al, *The Enlargement of Europe*, p.10.

membership by Ukraine and Moldova, thus restating the question of 'Where does Europe end?' Increased security measures at the Polish and Romanian eastern borders will limit the freedom of movement of citizens from Belarus, Ukraine and Kaliningrad in the case of Poland and from Moldova and Ukraine in the case of Romania, thus possibly creating a new sense of exclusion. Third, Polish people have expressed fears that in an enlarged Europe they would become 'second class citizens' and Poland would be a source of manpower and cheap and low quality goods.[183] Although the EU authorities have made efforts to diffuse the fears over second class citizenship, the results of the European Convention might bring back these fears by confirming an option for increased integration of the initial six and a Europe of variable geometry. Then, foreign investment has indeed been attracted by cheap labour but has aimed towards providing good quality products. Finally, in terms of ensuring military security, the CFSP has still considerable limitations.[184] While the early 1990s wars in Yugoslavia have indicated the need for EU independent crisis management capabilities, the Kosovo crisis has revealed shortages in the capabilities of EU acting alone militarily and the need to co-operate with NATO and Russia. These flaws led analysts to conclude that 'the EU is unlikely to achieve a truly autonomous defence capability in the next 10-15 years which would allow it to carry out medium-sized combat operations such as Kosovo without the United States.'[185] Additionally, the recent war on Iraq has shown that the EU is not prepared to act with a single voice and can be in disagreement with some members of NATO. Furthermore, the candidate countries themselves disagreed with important members of the EU such as Germany and France, thus emphasising the division of the continent in matters of external security. While the EU is likely to eliminate the security concerns between its members, it still lacks the capability of ensuring full guarantees against outside threats. The EU's co-operation with NATO is still essential in ensuring the security of the continent. However, a more in depth discussion of the EU's role in ensuring the military security of the continent is beyond the scope of this study.

6.4 Conclusion

This chapter has identified the main internal and external security concerns in Poland and Romania in the aftermath of the Cold War and their impact on the EU accession process. A political and an economic sector of security were identified corresponding to the two sets of factors analysed by this study as in diagram 6A. Security was seen as both a condition and a result of the EU integration process. While the border between internal and external security concerns has become blurred, a distinction between these two categories was useful for analytical purposes. Acknowledging the bi-directional relationship between EU integration and security, the chapter presented several channels

[183] Starzynski, "Poland", p.55.
[184] Rusi, "Europe's Changing Security Role", p.114.
[185] Rusi, "Europe's Changing Security Role", p.119.

through which EU membership consolidates security of Poland and Romania, thus ensuring the security of the continent in parallel with NATO membership.

Several conclusions were drawn. Security concerns have acted initially as brakes on the accession process and increasingly as an engine since the Kosovo crisis. Furthermore, security concerns were as important as the perceptions of security themselves. The prospect of EU membership has played an important role in de-securitising the two countries. The analysis has shown that the main internal security concerns for both Poland and Romania were related to the political and economic crises that characterised the early years of transition and to the extent to which these crises were securitised or de-securitised by the international community. Given the magnitude and the tension between marketisation and democratisation, economic and political crises were inevitable during transition. However, their causes were most important in the way they affected EU integration. Thus, Romania's internal instability was mainly due to the imperfections of the democratisation process resulting from the legacy of the authoritarian regime of Ceauşescu. Romania was in a vicious political circle until 1996. It was through the ascent to power of the Democratic Convention of Romania in 1996 that security concerns related to the democratisation process were eliminated.[186] Episodes of political and economic instability occurred as a result of the fragmentation of the political class and of the more radical reforms initiated, but they were inevitable and political change finally led Romania towards a virtuous political circle and a virtuous economic one. External security concerns such as the Kosovo crisis became catalysts rather than brakes on Romania's integration with the EU. A strong commitment to reforms by the post-communist government of Năstase elected in 2000 contributed to the de-securitsation of the country, despite the rise of extremist parties and accidental popular unrest. These elements created the preconditions for the creation of a virtuous political circle.

On the other hand, Poland's high internal instability in early 1990s was a direct result of the shock therapy economic reforms initiated by the Balcerowicz government. They imposed high costs on the population, led to increased protests, falls of governments and the disintegration of Solidarity, thus accentuating political instability and political fragmentation. However, the reform programme showed a high commitment to the market economy and ensured international support for reforms and EU integration, thus creating a virtuous political circle by 1993. Furthermore, the high commitment to a market economy contributed to the de-securitisation of the 1993 return to power of post-communists and to maintaining a generally positive country image with positive effects on its return to Europe. The authoritarian tendencies of President Walesa were also overlooked and the three major changes of government between 1993 and 1997 or the reshuffles between 1997 and 2001 were not seen as

[186] Grabbe, H. and Hughes, K., *Eastward Enlargement of the European Union*, The Royal Institute of International Affairs, London, 1997, p.17.

particular security concerns. Poland had already entered a virtuous circle of economic and political stability in 1993 as a result of the reforms and the credibility brought by them.

The analysis has also shown that external security concerns have affected to a considerable extent Poland and Romania's quests for integration into the EU. Their impact depended greatly on the extent to which threats were transformed into opportunities through a successful foreign policy. Thus, Poland has succeeded in turning most of its external threats into catalysts of EU integration while Romania was slow in doing so. Poland's fear of Russia determined an important turn in its foreign policy after the 1991 coup and an active commitment to NATO and EU membership. On the other hand, Romania's foreign policy was still shifting between East and West by 1994. Poland's concerns over German domination led to the early signing of the bilateral treaty, the intensification of economic and political collaboration and to Germany becoming the strongest advocate of Polish return to Europe. On the other hand, Romania's hesitance in searching for Germany's support diminished its prospects for early integration in both NATO and the EU. Poland has also built strong relations with its eastern neighbours, the former Soviet Union republics, aiming to become a key factor in the stability of the region and a gateway towards the East. Good neighbourly relations constituted a condition for NATO, and implicitly, EU membership and made Poland a good asset for both organisations. NATO membership achieved in 1999 gave Poland the security guarantees necessary to focus on further economic reforms.

On the other hand, Romania has postponed the recognition of its borders with most of its neighbours and suspicions over territorial claims expressed by Ukraine and Moldova did not comply with the image of a 'pole of stability' that Romania wanted to promote. This led to the delay in both NATO and subsequently EU membership. It was only since 1996 that Romania has tried to turn the external security concerns into opportunities. By signing bilateral treaties with Hungary and Ukraine, inviting the Hungarian Democratic Alliance of Romania to take part in the government, by initiating negotiations with Moldova and Russia and by distancing themselves from the Milosevic regime of Yugoslavia the Romanian authorities have reduced the external security concerns of Romania. Furthermore, by supporting NATO's military campaign in Kosovo, Romania turned the Yugoslav threat from a brake into a catalyst for its return to Europe. The Helsinki European Council rewarded Romania's commitment to NATO and the EU by inviting it to open accession negotiations in 2000. The analysis has also shown that perceptions of security in Poland and Romania appear to have been influenced by the revival of Central Europe and the Balkans with their respective positive and negative connotations. Poland's Central European status has maintained a positive image and the Visegrad Group was initially a means of enhancing Poland's chances for early integration into the EU. On the other hand, the negative image associated with the Balkans and Romania's proximity with this area have enhanced perceptions of insecurity that slowed down Romania's return to Europe. Nevertheless, by initiating the Stability Pact for South-Eastern Europe the EU has contributed greatly to the de-securitisation of the Balkans, thus appearing to enhance a virtuous economic circle in the area, including Romania.

Finally, the chapter has argued that European security is indivisible and thus security in Central and South-Eastern Europe is crucial for the stability of the continent. Furthermore, despite several limitations, EU membership appears to be the best way to consolidate the security of Poland and Romania, by complementing the security guarantees given by NATO. Furthermore, both countries are important assets for both the EU and NATO through their role as pillars of stability and gateways to the East and South-East. The EU's normative power and the incentive of membership have enhanced democratisation and marketisation, thus eliminating the danger of return to authoritarian rule and a centralised economy. Financial support, trade and investment from the EU have enhanced reforms and thus increased economic security of the two countries. Additionally, the EU accession process has changed perceptions of security in each country, acting as a signal for potential investors. This impact will be tested through the econometric model in chapter seven. Last but not least, EU membership addresses the external security concerns of both Poland and Romania and the issue of fragmentation in Europe which is a threat in itself.

Overall, the bi-directional relationship between security and EU integration has been proven. The following chapter will complement this analysis through a quantitative assessment of the impact security factors, EU integration and economic reforms have had on FDI. Furthermore, the impact of FDI and EU integration on economic reforms will be analysed in order to capture the remaining facets of the vicious or virtuous circle identified by this study.

CHAPTER SEVEN

THE INTERPLAY BETWEEN FOREIGN DIRECT INVESTMENT, SECURITY, AND EUROPEAN INTEGRATION

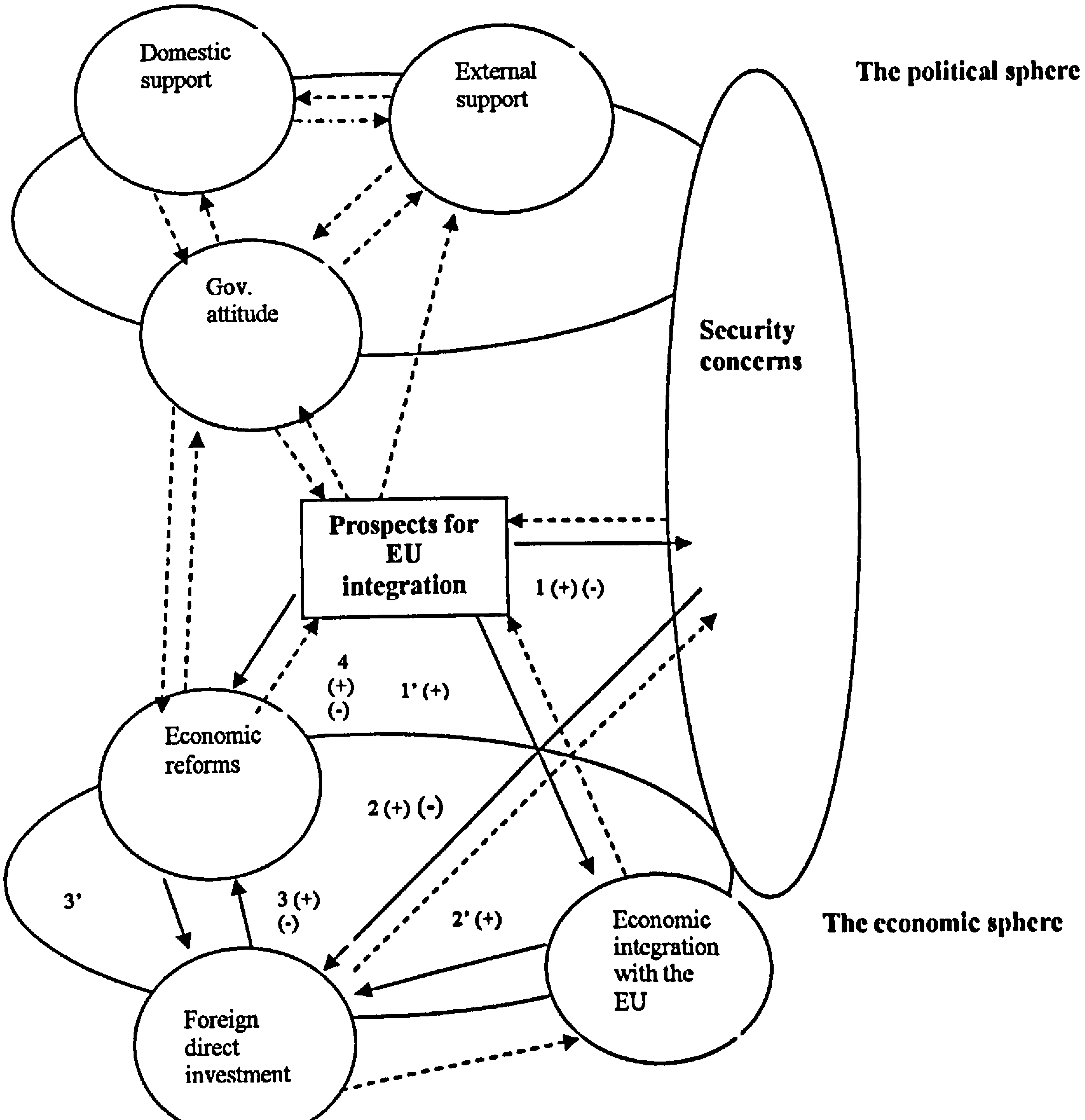
Chapter six has discussed the complex nature of security since the end of the Cold War. The success of internal economic reforms and the fear of return to an authoritarian regime were identified as some of the main security concerns of both Poland and Romania. The qualitative analysis has also shown that internal and external security concerns have affected Romania and Poland in their quests to integrate into the European Union. Furthermore, the discussion suggested several ways in which the prospect of EU membership can address the security concerns of each candidate country and thus increase security in the area. This risk diminishing effect of the prospect of EU membership and its impact on FDI and economic reforms are assessed in the present chapter.

The first aim of this chapter is to test quantitatively the hypothesis put forward in chapter one of the dissertation that countries such as Romania have been trapped in a vicious circle of high security concerns, low FDI, poor economic reforms, poor prospects for EU integration and thus high security concerns as in diagram 7A(a). Economic reforms represent a component of security concerns and appear both as a determinant and a result of FDI as represented in diagram 7A(b). This bi-directional relationship appears to be at the core of the vicious circle in the economic sphere and is examined quantitatively. Furthermore, the hypothesis of path dependency is tested by assessing the impact that the initial conditions and previous investment have had on present FDI.

The second aim of the chapter is to suggest ways of turning the vicious circle in the economic sphere into a virtuous one. This is achieved by testing the role European integration and security factors other than economic reforms play in enhancing FDI in the CEECs. The assumption is that poor security resulting from slow reforms could be overcome through prospects for EU integration, hence bringing about positive perceptions of security, economic integration or government determination for future reforms. This may create the necessary conditions for fostering FDI and implicitly economic transition and EU membership. The chapter is structured as follows: theoretical framework; description and motivation of variables; empirical analysis and results; conclusion, tables and appendixes.

Diagram 7A[1]

The role of security and EU integration factors in enhancing a virtuous circle in the economic sphere



a) Arrows 2(-), 3(-), 4(-) and 1(-) indicate the vicious circle in which Romania was trapped till late 1990s as a result of negative perceptions of security.

b) Arrows 3 and 3' capture the bi-directional relationship between FDI and economic reforms which enhances the danger of path dependency.

c) Arrows 3(+), 4(+) 1(+), 2(+) indicate a potential virtuous circle induced by FDI.

d) Arrows 2(+), 3(+), 4(+) 1(+), 2(+) indicate the virtuous circle induced by positive perceptions of security from which Poland benefited since 1992/1993.

e) Arrows 1(+), 2(+), 3(+), 4(+) indicate a virtuous circle induced by the prospect of EU membership (and its impact on security concerns) from which Romania has benefited since the Helsinki European Council.

f) Arrows 1'(+), 2'(+), 3(+), 4(+) indicate a virtuous circle induced by the impact of the prospect of EU membership and economic integration with the EU on attracting FDI in a candidate country.

Legend:

⟶ relationships that are addressed in chapter seven

- - - -▸ relationships that are addressed in other chapters

[1] Diagram 7A is based on diagram 1A.

7.1. Theoretical framework of the chapter

Since the fall of the Berlin Wall, marketisation, democratisation and integration into the EU have been the main goals of the CEECs, including Poland and Romania. FDI appears to be intrinsically bound up with economic reforms and EU accession. As shown in chapter five, FDI contributes to privatisation and modernisation, thus influencing the success of transition to a market a economy. Furthermore, by enhancing economic reforms FDI can accelerate the process of integration into the European Union as in diagram 7A(c). Moreover, investment flows are a measure of economic integration with the EU and are associated with increased bilateral trade with the Union. They may also boost the support of the business and political community for the host's country economic development and EU membership. Given these potentially positive effects, attracting FDI seems to be vital for countries such as Romania or Bulgaria which are less advanced in economic reforms and in the EU accession process. However, the experience so far has shown that the bulk of FDI has been directed especially towards the frontrunners in reforms and European integration. These countries were considered less risky by investors and thus attracted large financial flows. Furthermore, investment induced by perceptions of security appears to have enhanced economic reforms, prospects for EU integration and perceptions of security, thus creating a virtuous circle of economic development as in diagram 7A(d). Poland's case seems to illustrate this virtuous circle, despite some elements of internal insecurity in the early 1990s. On the other hand, countries such as Romania seem at the beginning of transition to have entered a vicious circle as presented below and in diagram 7A(a).

The chapter seeks to illustrate the vicious circle by establishing the impact FDI has on economic reforms and the impact economic reforms, other security variables and European integration variables have on FDI. The model also tests whether prospects of EU integration foster economic reforms. However, the main focus lies on the assessment of FDI determinants for a panel data of the ten CEECs candidates to the EU over ten years, between 1990 and 2000. The main question investigated here is whether security factors and European integration are capable of enhancing FDI in the candidate countries, thus breaking the path dependency induced by poor previous economic reforms.

The framework for the empirical model is provided by Dunning's OLI paradigm for reasons explained in chapter two. This maintains that FDI can be explained by three categories of factors: ownership advantages for firms to operate oversees (O), such as intangible assets; locational advantages to investment in the host rather than in the donor country (L) and the benefits of internalisation (I). Studies on FDI in transition economies have focused mainly on locational advantages of the region and so will this study. The literature suggests that the key locational FDI determinants are demand, cost factors and the risk of investment, in terms of both political and economic environment. Lucas, Jun and Singh put particular stress on indicators of economic and political risk, including macroeconomic stability, institutional stability and political stability.[2] Holland and Pain used principal components analysis across macro-economic and institutional variables, Garibaldi et al used a variety of World Bank and EBRD indicators. Resmini used a synthetic indicator of risk, the operation risk index, while Bevan and Estrin used the credit rating to account for the country risk.[3] Risk assessment has been especially important for the transition countries which have confronted themselves with internal economic and political crises, or with the danger of external instability posed by events such as the Yugoslav wars and the Kosovo crisis. These factors have been referred to earlier on in the dissertation as security concerns and will be captured by the security variables used in the model. Consistent with the definition of security proposed in chapter six, security variables considered here refer to macroeconomic stabilisation, institutional reforms, the ideological orientation of the government, participation in free trade arrangements and discrimination on political geography grounds. The choice of these variables will be motivated in the following section.

The literature also refers to trade openness and participation in free trade areas as important FDI determinants as discussed in chapter two. Furthermore, EU membership is seen as a particular case of regional integration, with positive effects on attracting investment in the candidate countries. Not only does EU membership offer access to the single market, but the prospect of EU membership can enhance the security of the candidate countries as seen in chapter six. By improving the country image and diminishing the perceptions of a country' risk, the prospect of EU membership can thus increase FDI. Furthermore, the prospect of EU accession can also foster economic reforms, thus creating conditions for further FDI. Hence, the econometric analysis in this chapter tests the impact of European integration on both FDI and economic reforms. Further references to the literature will be made when motivating and describing the variables.

Overall, three categories of variables are used in assessing the FDI determinants: economic (demand and cost) variables, security variables and European integration variables. FDI and European integration variables are used to assess the determinants of economic reforms. The choice of variables is motivated and the variables are described below. For a description of variables also see appendix 7A.

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[2] Lucas, R., "On the Determinants of Direct Foreign Investment: Evidence from East and Southeast Asia", *World Development,* Vol. 21, No. 3,1993, p. 391; Singh, H. and Jun, K.W., "Some New Evidence on Determinants of FDI in Developing Countries", *Policy Research Working Paper No. 1531,* World Bank, 1995.

[3] Holland, D. and Pain, N., "The Diffusions of Innovations in Central and Eastern Europe: A Study of the Determinants and Impact of FDI", *NIESR Discussion Paper No. 137,* National Institute of Economic Research, London, 1998, p.1; Garibaldi, P. et al, "What Moves Capital to Transition Economies?", *IMF Conference "A Decade of Transition",* Washington, DC, February, 2000; Resmini, L., "The Determinants of

7.2. Description and motivation of variables

7.2.1 Foreign direct investment

Foreign direct investment is the dependent variable. As a vicious circle was identified, the model tests *inter alia* the dependence of FDI on the lagged FDI. This addresses the question of path dependency, i.e. of FDI being its main determinant. Furthermore, in order to assess the impact of previous investment on present reforms, lagged FDI is an independent variable in the regression on the determinants of economic reforms. FDI is also an endogenous variable in the system of simultaneous equations. The FDI variable is expressed in natural logarithm. In the system of simultaneous equations and in the panel data regressions on the determinants of economic reforms, when FDI is an independent variable, its coefficient can be interpreted as elasticity. FDI represents aggregate yearly inflows as generally employed by studies of investment in transition economics. Several specifications were tried with standardised measures of FDI such as FDI per capita and FDI as a percentage of GDP, but the results were inconclusive and thus were not reported.

The question of path dependency for the CEECs was raised by the transition literature and the post-1989 reality might also indicate such an evolution.[4] The fast reformers attracted higher levels of FDI and it was feared that this would enhance the gap between the CEECs.[5] Moreover, the initial two-track approach to the EU enlargement was abandoned in 1999 *inter alia* based on path dependency arguments. However, the path dependency theory can be challenged. Thus, Bulgaria, which was the last in the quest for EU membership as assessed by the regular report in 1997 made improvements by the 2001 regular report, leaving Romania the least advanced country in the accession process.[6] Moreover, it is highly possible that by delaying their accession into the EU, Romania and Bulgaria will continue to attract FDI as a result of maintaining comparatively lower production costs with the new EU member states. This is likely to be the case if the ten new EU member states will be price convergent with the EU upon accession. All these contradictory opinions regarding the possibility of path dependency justify the investigation of FDI being its own determinant. Path dependency will be also tested by assessing the impact of initial conditions on FDI and on economic reforms.

Several data problems must be noted with regard to the FDI variable. Distortions limiting the comparability of the data may come from differences in the minimum stake necessary for an investment to qualify as direct investment rather than portfolio investment or from currency translation adjustments.[7] Furthermore, the aggregate nature of the variable limits the use of certain

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FDI into the CEECs: New Evidence from Sectorial Patterns", 2000; Bevan, A. A. and. Estrin, S, "The Determinants of FDI in Transition Economies", *CEPR Discussion Paper No. 2638*, December 2000, p.5.

[4] Falcetti, E. et al, "Defying the Odds: the Initial Conditions, Reforms and Growth in the First Decade of Transition ", *EBRD Working Paper No. 55*, 2000, p.5.

[5] See also Smith, A., *The Return to Europe:The Reintegration of Eastern Europe into the European Economy*, MacMillan in association with the School of Slavonic and Eastern European Studies, Basingstoke, 2000, p.177.

[6] *http://www.europa.eu.int/comm/enlargement/index.htm.*

[7] EBRD, *Transition Report*, EBRD, London, 1998, p. 82.

regressors when assessing the FDI determinants. For example, independent variables capturing the geographical proximity between source and host countries or characteristics of the source countries such as GDP and interest rates are either irrelevant or cannot be used, thus explaining the specification of the models used in this study.

7.2.2 Economic (demand and cost) variables

Market size

The size of the domestic market is a generally recognised determinant of FDI and empirical work by Lankes and Venables, Resimini, Deichmann and Bevan and Estrin suggests that most of the investors in the CEECs are market-seeking.[8] Not only the national market, but also regional (supranational) markets are important for the decision to invest. Thus, the host's country's membership of free trade agreements offers access to a larger market than the domestic one. Furthermore, if the host country has free trade agreements with countries with which the source country does not practice free trade, then the advantages of a free trade area membership are even higher for investors. Overall, membership of free trade agreements is a measure of market openness and thus a determinant of FDI. However, under the title 'Market size' only the domestic market is considered, leaving the regional market to be represented by variables under the title 'Security' relating to membership of free trade areas such as the Central European Free Trade Association (CEFTA) and the Black Sea Economic Co-operation (BSEC). The choice of treating CEFTA and BSEC membership as security variables was based on the assumptions that economic integration increases security. The use of these variables also stems from the assumption that the two organisations were meant to enhance prospects for EU membership by providing experience of economic and political co-operation.

There are several indices for market size used in empirical work. Deichmann argued that GDP growth represents an excellent yardstick for the extent and direction of change in economy. Like Culem and Landsbury at al., he concluded that market growth is an important determinant of FDI.[9] Resmini used GDP per capita and population as proxies for actual demand and absolute size, respectively. She found that investors prefer large markets with high growth prospects.[10] Bevan et al. used the host country GDP in current prices- to reflect the attraction of the host country as a market and location of complementary resources- and the GDP for the source country- to reflect

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[8] Lankes, H.P. and Venables, A.J., "FDI in Economic Transition: The Changing Patterns of Investments", *Economics of Transition*, Vol.4, No. 2 , 1996, p.331; Resmini, "The Determinants of FDI into the CEECs", p.675; Deichmann, J.I., "Distribution of FDI among Transition Economics in Central and Eastern Europe", *Post Soviet Geography and Economics*, 2001, Vol. 42, No.2, p.145; Bevan and Estrin, "The Determinants of FDI", p.13.

[9] Deichmann, "Distribution of FDI among Transition Economics", p.145; Culem, C.G., "The Locational Determinants of FDI among Industrialised Countries", *European Economic Review*, Vol. 32, No. 2,1998 , p.885; Lansbury, M. et al, "FDI in Central Europe since 1990: An econometric Study", *National Institute Economic Review*, No. 156, p.107.

[10] Resmini, "The Determinants of FDI into the CEECs", p.678.

the economic power of the source country to generate multinational firms and outward FDI. They also found a significant and positive relationship between the GDP in the host country and FDI.[11]

Given that in this study FDI flows are not analysed with respect to source countries, only a variable for the host country will be used as an estimate of market size, i.e. GDP. This is the GDP of the host country in current prices at exchange rate in US dollars (USD). LNGDP is the logarithm of GDP so that the coefficient can be interpreted as elasticity. It is expected that there is a positive relationship between LNGDP and LNFDI. The results might be, however, affected by the imperfect quality of the data which relies on different statistic systems in the CEECs. This data might not be totally comparable. Furthermore, due to a still significant share of the hidden economy in the transition economies, the data may not cover entirely the extent of the economic activity. On the positive side, by including transport costs, the GDP in current prices comprises implicitly information on the location of the countries considered, which relates to market potential. This helps overcome the limitations of the absence of an accurate variable on distance comparable with some used in other studies.

Labour cost

Labour cost advantages are generally recognised as one of the FDI determinants.[12] Given the high wage differentials between the EU and the CEECs and the industrial restructuring in Western Europe, foreign investors were expected to use factor cost differences and to build export oriented production in the CEECs.[13] Thus, manufacturing businesses experience simultaneously a cost push in the West and a cost pull in the East. Furthermore, this quest for lower costs is justified as a pay-off for the lower productivity obtainable in the host countries.[14] Empirical studies generally support the affirmations above. Resmini used wage differentials and found that this difference affects FDI positively, especially in traditional sectors.[15] Bevan and Estrin found that wages are not significant but that relative unit labour costs are an important determinant of FDI.[16] However, Deichmann concluded that labour costs are not a statistically significant determinant of FDI in Central and Eastern Europe because the gradual wage variation within the region, as opposed to the large gap between the average CEE wage and that of the West, does not offer additional information beside the one conveyed by more influential variables.[17]

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[11] Bevan, A.A. et al, "Institution Building and the Integration of Eastern Europe in International Production", *Working Paper No. 16*, 2001, University of Sussex, ESRC, p. 13.
[12] Culem, "The Locational Determinants of FDI among Industrialised Countries",p.885; Deichmann, "Distribution of FDI among Transition Economies", p. 146; Lansbury et al, "FDI in Central Europe since 1990", *National Institute Economic Review*, No. 156, p.107; Resmini, "The Determinants of FDI into the CEECs", p. 675.
[13] Falcetti et al, "Defying the Odds", p.5; Business Central Europe, *http://www.bcemag.com/statsdb.*
[14] Ozawa, T., "FDI and Economic Development", *Transnational Corporations*, Vol. 1, p.28, 2000.
[15] Resmini, "The Determinants of FDI into the CEECs", p.675.
[16] Bevan and Estrin, "The Determinants of FDI", p.15.
[17] Deichmann, "Distribution of FDI among Transition Economies", p.150.

For the purpose of this study AVER is defined as the annual mean of the monthly wage in USD at market prices at official exchange rate. The anticipated sign is positive, given that a higher wage is still lower than in the EU but represents a higher potential market. The data has to be taken with caution for several reasons. First, total labour costs should include also day training and benefits not customarily provided in the West.[18] Second, there are differences in wages according to the sector of activity, i.e. public v. private or manufacture v. services, and these are not captured by the variable chosen. However, in absence of a comparative data for labour costs that would take into consideration the facts above, average earnings can be considered satisfactory. Furthermore, as FDI is neither country, nor industry specific, a narrower definition of labour cost was irrelevant.

7.2.3 Security variables

The variables under this title can be seen as components of a general concept of security. As discussed in chapter six, security concerns include *inter alia* the success of economic reforms, the type of government in power and membership of regional organisations, be they regional free trade organisations or the EU. Variables such as REF, STAB, GOV, CEFTA and BSEC were introduced to test the importance of these factors in determining FDI and will be briefly presented below. Furthermore, chapter six has noted that for the Romanian authorities the potential discrimination against Romania as a result of its externally constructed Balkan identity constituted an important security concern, especially at the beginning of transition. This is why dummies such as VISE and BALK were constructed and tested in several specifications of the model. Although EU integration has a significant security component as it was shown in chapter six, EU integration variables will be discussed separately. Finally, a variable capturing the initial conditions in the CEEC is used in order to assess the hypothesis of path dependency. This variable is included under this title because it is part of each country's image and thus relates to a certain extent to the security concerns as defined in chapter six.

Initial conditions

Theoretical studies have emphasised the impact of initial conditions on the pace and results of economic transition in the CEECs, as has been shown in chapter four. Furthermore, the EBRD has produced an index which reflects the initial conditions in each of the ten candidates to EU membership. This index is derived from factor analysis. The index of initial conditions represents a weighted average of measures of the level of development, trade dependence on CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, elements of market economy and state capacity.[19] For the purpose of this analysis the index computed by the EBRD was inverted so that higher values of the index relate to more favourable starting conditions. The

[18] Deichmann, "Distribution of FDI among Transition Economics", p. 146.
[19] Snoy, B., "How Successful Transition is Paving the Way for EU Enlargement. a View Based on EBRD Indicators", *Paper Presented at the Seventh Biennial International Conference Organised by the European Community Studies Association (ESCA)*, May 31-June 2001, Madison, Wisconsin, USA, p.12.

index takes a value of 1.9 for Poland and 1.7 for Romania.[20] Not previously used in studies of FDI determinants, the EBRD transition index of initial conditions was found significant in a study of economic growth in the CEECs conducted by Falcetti et al.[21] It is expected that better initial conditions led to a higher FDI inflows and thus INIT has a positive sign. It is also possible that difficult initial conditions were seen by investors as potentially triggering deeper economic reforms, thus actually enhancing FDI. This would be represented by a negative sign displayed by INIT.

Economic transition

The experience of the most advanced countries in transition has proven that FDI depends on prospects of macroeconomic stability and on the institutional framework of the host countries. These aspects have been quantified through eight different transition indicators by the EBRD and have been used by Bevan et al to explain FDI in the CEECs.[22] Chapter six has argued that the success of economic reforms has been considered an important security concern in both Poland and Romania. Furthermore, Lankes and Venables found that risk perception of a country is closely correlated with the EBRD ranking of national transition level.[23] Hence, the inclusion of economic transition amongst security variables appears to be justified.

A mean of the eight EBRD transition indicators was used in a study by Bevan et al to identify the FDI determinants and was found significant.[24] However, most of the studies have assessed the impact of individual elements of the transition process on FDI and amongst these, of privatisation. Lansbury et al. found that private sector share has a positive effect on inwards FDI in the Visegrad countries, a result which was not confirmed by Holland and Pain though.[25] The latter found, nevertheless, that the method of privatisation, measured on a four-point scale, accelerates FDI inflows.[26] Moreover, Bevan et al. concluded in a panel data analysis of the institutional determinants of FDI that private sector development, reform of the banking sector, price, foreign exchange and trade liberalisation along with legal development have a positive impact on foreign investment.[27] Furthermore, Resmini concluded in an analysis of FDI determinants across sectors that the pace and depth of structural reforms are crucial for attracting the FDI and consequently the type of investor, the technology transferred and the level of industrial restructuring.[28]

[20] For values for all CEECs, see Snoy, "How Successful Transition is Paving the Way for EU Enlargement", p. 12.
[21] Falcetti et al, "Defying the Odds", p.5.
[22] Bevan et al, "Institution Building and the Integration of Eastern Europe in International Production", *EBRD Working Paper No. 16*, January 2001, p.2.
[23] Lankes and Venables, "Foreign Direct Investment in Economic Transition", p.331.
[24] Bevan et al, "Institution Building", p. 2.
[25] Lansbury et al, "FDI in Central Europe since 1990"; Holland and Pain, "The Diffusions of Innovations in Central and Eastern Europe", p.1.
[26] Holland and Pain, "The Diffusions of Innovations in Central and Eastern Europe", p.1.
[27] Bevan et al, "Institution Building", p. 2.
[28] Resmini, "The Determinants of FDI into the CEECs", p.683.

This chapter builds upon the findings of previous research and enriches them by considering economic reforms as both a determinant and a result of FDI. Thus, FDI is a major means of restructuring while a certain degree of reforms, privatisation included, are expected in order to foster FDI.[29] This bi-directional relationship between FDI and reforms seems to be at the centre of the vicious or virtuous circles identified in this study. Unlike previous studies, this chapter identifies two main components of the economic transformation, liberalisation/stabilisation and institutional reform which conform with the main policy elements analysed in chapter five. Furthermore, these two components are part of the assessment of the investment climate conducted in chapter five. They are quantified on the basis of the EBRD transition indicators in order to assess the impact of liberalisation/stabilisation and institutional reforms on foreign direct investment.

The macroeconomic stabilisation/liberalisation variable STAB is defined as the mean of the two indicators computed by the EBRD with regard to stabilisation, i.e. PR (price liberalisation) and FOREX (trade and foreign exchange system). These are part of the investment climate and of the locational advantages in the OLI paradigm and thus are important conditions for FDI, as already discussed in chapter five. On the other hand, the composite index REF reflects the institutional reform and it is a mean of six indices computed by the EBRD: LSP (large scale privatisation), SSP (small scale privatisation), ENT (governance and enterprise restructuring), COM (competition policy), BK (banking reform and interest rate liberalisation), SEC (securities markets and non-bank financial institutions). These are elements of the investment climate, some of which were addressed in chapter five from a qualitative point of view. This specification of these two composite indices was justified by the roughly similar trends in time displayed by their components, as suggested in appendix 7B. Thus, the mean is an appropriate estimate for the general trend in the case of REF and for the main two components in the case of STAB. REF was constructed in order to investigate the bi-directional relationship between FDI and institutional reforms. Its components are likely to be influenced by FDI, and to influence FDI. An equal weighting was given to all factors in order to create an overall indicator of the level of reforms in which all components are equally important. Several specifications have been tried with different weights of the components of REF. However, the overall significance of the model is not sensitive to these different weights, thus justifying the choice of equal weighting. The expected sign for both REF and STAB is positive.

The EBRD indices take discrete values between 1 and 4.3 (corresponding to 4+), higher values indicating better progress towards achieving market economy.[30] REF and STAB were preferred to an investment climate rating such as the one produced by the Heritage Foundation, which only takes values from 1 to 3 with little variation across countries or for each country.[31] However,

[29] Svetličič, M., Artisen, P. and Rojec, M., "FDI in Central and Eastern Europe: An Overview" in Svetličič, M., Artisen, P. and Rojec, M. *(eds.), FDI in Central and Eastern Europe*, St. Martin's Press, New York, 1993.

[30] For a comprehensive description of the scale used in computing the EBRD transition indicators, see EBRD, *Transition Report*, 2000, EBRD, London, p.25.

[31] The Heritage Foundation, *www.heritage.org/research/features/index*

certain caution is necessary about the data regarding the progress of transition. In fact, measures of reform are highly imperfect as the EBRD relied partially on subjective indices rather than on directly observable variables. Furthermore, the low variability of the EBRD indicators may transfer the weight of impact onto other variables. Finally, the transition indicators are categorical variables and their combination with numerical ones such as the average monthly wages or aid per capita can pose questions of estimation and interpretation. In fact, only the coefficients of numerical variables expressed in logarithm can be interpreted as elasticities.[32] Furthermore, differences in the magnitude of the variables can influence their significance in determining the dependent variable.

Governance

Despite several references in policy documents, no FDI empirical literature has included the ideological orientation of the host country government among the independent variables. As discussed in chapter six, the return to power of post-communists constituted one of the main security concerns in the CEECs. This not only posed the threat of return to authoritarianism, but was partially perceived as a factor that would slow down economic reforms. Thus, Snoy pointed out that there is a correlation between institutional performance and initial government turnover.[33] Then, the EBRD, Balcerowicz and Camdessus emphasised the role of the government orientation in affecting the pace and the depth of economic reforms.[34] Potentially, a post-communist government would also affect the country's attractiveness for FDI. In the early 1990s, post-communists in Romania promoted slogans such as 'We do not sell our country', thus deterring FDI. The variable GOV included in this study addresses the external perception of security, based on the assumption that a post-communist government would be seen outside as less reformist than a democratic one.

The dummy variable GOV was computed to account for the different ideological orientation of the host country's governments. GOV takes value 0 for a post-communist government and 1 otherwise. Problems might occur for countries such as Latvia, for example, in which the governments in power were not radically different in terms of ideological orientation. It is expected that a democratic government (as opposed to post-communist) would have a positive effect on FDI and thus the sign of GOV would be positive. This has to be interpreted with caution though in the present conditions when post-communist governments took over in many of the CEECs, including Romania and Poland. By being anchored in the process of accession to the EU and by pursuing deep economic reforms, including policies meant to foster FDI, the post-communist nature of these governments may be of less importance and thus have a less impact on the country image and on FDI.

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[32] The coefficient of a dummy variable has to be transformed in antilog to base e, then subtract 1 and then be interpreted as an elasticity. For details, see D.N. Gujarati, *Basic Econometrics*, McGraw-Hill International Editions, London, 1995, p.526.
[33] Snoy, "How Successful Transition is Paving the Way for EU Enlargement", pp. 11-12.
[34] EBRD, *Transition Report*, EBRD, London, 1994, p.47; Camdessus, L. M., *Achievements and Prospects after Ten Years of Transition. Opening Remarks at a Conference on Transition*, IMF, 1 February 1999.

Geography and political geography

Physical and psychological proximity are important FDI determinants. Both theory and empirical evidence generally suggest that contiguity or proximity to the countries of origin is a relevant determinant of FDI.[35] Martin and Velasquez found a significantly negative effect of distance on FDI in the OECD countries and a positive significant effect if the host countries share a common border.[36] Bevan at al. concluded that the existence of a common border is an important determinant for FDI in the context of the Central and Eastern Europe, where borders have moved enormously in the past century, reflecting the intertwined history and culture of the region.[37] Wei found a negative effect of distance and a positive one for language tie.[38] However, Sölvell and Nordström concluded that the importance of geographical distance has declined since the 1970s and economic conditions are becoming more important.[39]

Remini used the average distance from the each host country to the EU and showed that this affects FDI negatively. The closer a country is to Western Europe, the higher its FDI attraction capacity.[40] Another way to account for proximity is to use dummies for different geographical regions. While they are not entirely accurate in terms of physical distance, they can capture to a certain extent a psychological distance reflected in the connotations of political geography terms. Thus, dummies for Central Europe, Southern Europe and CIS were used in an assessment of transition by Gros and Suhrcke and they proved significant. This shows that there is a common element of countries within these regions, possible related to risk perception as well.[41] The present study favours such an approach, given that areas such as the Balkans appear to have a negative meaning that could deter FDI.

Given the aggregate nature of the FDI data, it is only possible to use proxies for geographical distance. The emphasis in this study lies on assessing the relevance of political geography notions of Balkans and Visegrad. BALK is a dummy variable with value 1 for Romania and Bulgaria and 0 otherwise and VISE is a dummy with value 1 for Poland, Hungary, Czech Republic and Slovakia and 0 otherwise (the remaining countries are the Baltic states and Slovenia). BALK is expected to have negative value capturing the negative connotation of the Balkans as a political geography term, whereas VISE is expected to have a positive one. The Visegrad Group was meant to ensure a quick integration of its member states in the EU through political and economic co-operation and

[35] EBRD, *Transition Report*, 1998, p.82; M. Družić, Regional Dispersion of FDI in Eastern Europe, in S. Sharma (ed.), *Restructuring Eastern Europe. The Microeconomics of the Transition Process*, Edward Elgar, Cheltenham, 1997, p. 103; Resmini, "The Determinants of FDI into the CEECs", p.675.
[36] cited in Bevan et al, "Institution Building", p.20.
[37] cited in Bevan et al, "Institution Building", p.20.
[38] cited in Bevan et al, "Institution Building", p.20.
[39] Sölvell, Ö., *Entry Barriers and Foreign Penetration. Emerging Patterns of International Co-operation in Two Electrical Industries*, Institute of International Business, Stockholm Institute of Economics, Stockholm.
[40] Resmini, "The Determinants of FDI into the CEECs", p.676.
[41] Gros, D. and Suhrcke, M., "Ten Years After: What Is Special about Transition Countries?", *EBRD Working Paper No. 56*, August 2000.

through maintaining a determined pace of internal reforms. VISE and BALK are an expression of a country's image which is an important determinant of FDI, as discussed in chapter five.

Regional free trade organisations

Chapter six has argued that integration in regional organisations such as the Central Free Trade Area (CEFTA) and the Black Sea Economic Co-operation (BSEC) has been a means for both Poland and Romania to diminish the external security concerns and to promote and enhance a positive country image. As country image is an important FDI determinant, this chapter tests the relevance of CEFTA and BSEC membership for FDI. Furthermore, membership of free trade organisations is a sign of market openness and can encourage FDI through access to a larger market, as already mentioned. Dummies for membership of each of these organisations are computed, 1 for membership, 0 otherwise. A positive effect on FDI is expected, equivalent to a shift. Nevertheless, several limitations regarding the use of these dummy variables can be noted. First, membership of CEFTA and BSEC are not powerful enough proxies for the market size, as they do not differentiate between the size of the two markets or their geographical position. Furthermore, the BSEC dummy does not capture the fact that some of the countries which form this organisation do not have preferential trade agreements with the EU and thus Romania appears to be a bridge between them and EU investors. Despite these limitations, a positive sign is expected for both CEFTA and BSEC.

7.2.4 European integration variables

The last category of independent variables used to assess the FDI determinants in the CEECs comprises European integration variables. Chapter three has distinguished between institutional and economic integration and has shown how these components of European integration reinforce one another. Furthermore, chapter six has argued that prospects for EU integration can enhance the positive image of a candidate country through security guarantees both in the economic and political spheres.[42] Thus, by diminishing perceptions of risk, the prospect of EU membership or steps in the institutional integration with the EU may have a positive impact on attracting FDI. Furthermore, chapter six has shown that economic integration through increased bilateral trade and aid from the EU can enhance security in the candidate countries. This may affect positively the level of annual FDI. The European integration variables used in this study comprise two subcategories consistent with the previous analysis conducted in chapter three: institutional integration variables and economic integration variables.

Institutional integration variables

As shown in chapter three, the signing of the association agreements has led to an increase in the trade with the EU through the setting up of an imperfect free trade area with each candidate country. Although the first real commitment for enlargement from the EU's part only came at the

June 1993 Copenhagen European Council, it is likely that the accession agreements have impacted on FDI through their effects on trade and possibly through the anticipation of future closer relations with the EU. Furthermore, a study by Bevan and Estrin shows that the Essen announcement of EU's commitment for enlargement has had a positive impact on FDI in the Visegrad countries. These were not only geographically closer to the EU, but also more advanced in economic reforms.[43] Moreover, the same study showed that the publication of the Opinion has increased FDI in the then first track countries faster than in the second track ones, thus increasing the gap between the frontrunners and the laggards of accession.[44] Additionally, the progress towards membership acknowledged by the regular reports since 1997, or through the opening of negotiations, have influenced the external image of the candidates, their credibility and possibly the foreign companies' decision to invest. Thus, Verheugen, the commissioner for enlargement, mentioned at the 1999 Helsinki European Council that the opening of the accession negotiations by Romania was equally a signal for investors that the country was worth investing in.[45] On the other hand, an expert in Romania's process of accession to the EU argued that negotiations themselves are not enough for investors. They need real commitment in the form of reform.[46] To a certain extent, though, the opening of negotiations has accelerated economic reform in Romania. The Helsinki European Council decision was conditioned upon further progress in economic reform and, following the European Council, president Constantinescu appointed a new prime minister. During his mandate, the country has reached positive economic growth for the first time after three years of recession, proving that economic reforms have worked.[47] These facts justify an assessment of the effects the prospect of EU membership have had so far on FDI in the CEECs.

Several dummies representing the progress towards EU membership are defined. ASOC is a dummy that reflects the impact of the existence of an association agreement between the respective country and the EU. ASOC takes a value of 1 starting with the year after the signing of the association agreement and 0 otherwise. It is assumed that increased FDI is a consequence of the signing of the agreement, and of the anticipation regarding the trade liberalisation effects. NEG is a dummy which reflects the beginning of the accession negotiations with the ten central and eastern European candidate countries for EU membership. It takes a value of 1 for the years when accession negotiations took place. So, NEG is one from 1998 onwards for the first five CEECs to start negotiations as a result of the 1997 Opinion of the European Commission, and from 2000 onwards, for the remaining five countries, which benefited from the Kosovo crisis and were invited

[42] The Copenhagen School refers to sectors of security but for consistency with the model proposed in this dissertation the term of spheres is preferred.
[43] Bevan and Estrin, "The Determinants of FDI", p.12.
[44] Bevan and Estrin, "The Determinants of FDI", p.19.
[45] Verheugen, G., *http://www. infoeuropa.ro*, December 1999.
[46] Interviews, Expert on Romania's Accession to the European Union, European Institute, Romania, 2000 and 2001.
[47] *Adevărul*, January, 2001.

at the 1999 Helsinki European Council.[48] Otherwise, NEG is 0. However, as the decision to open accession negotiations was motivated by different factors in 1999 as compared to 1997, the use of two different dummies was also considered. These dummies are meant to capture the different nature of the two decisions regarding the launch of negotiations, as well as their potential different impact on the countries concerned. The difference of the two events stems, on the one hand, from the fact that the Avis recommended negotiations based mainly on a rather strict assessment of the candidate countries' compliance with the economic Copenhagen criteria for membership. On the other hand, at Helsinki, the recommendation for opening of accession negotiations made was made largely on security considerations, at the expense of strict conformity with the economic criteria. As argued in chapter six, it is likely that the decision taken at Helsinki has greatly affected perceptions of security in the five remaining candidate countries, with a potential beneficial effect on attracting FDI.

AVIS reflects the impact of the decision taken in 1997 to open negotiations with the then six first track countries (1 for 1998 onwards for the six fast track countries, 0 otherwise) and HELSINKI is a dummy for the decision taken in 1999 to open negotiations with the remaining six candidates (1 for 2000 onwards for the six former second track countries, 0 otherwise). A positive relationship between each of these variables and FDI is expected. A positive sign of HELSINKI would suggest that the vicious circle identified for Romania in the economic sphere has been broken. The results might however be affected by the few number of observations since 2000 included in the panel. It is also likely that the results will be affected by the correlation between the institutional integration variables and REF which is shown in appendix 7C. The correlation between REF on one hand and AVIS or ASOC on the other confirms that these stages of institutional integration reflected the success in the economic reforms. Finally, the lack of correlation between REF and HELSINKI is consistent with the fact that this new stage occurred regardless of the economic performance of the candidate countries.

Economic integration variables

<u>Trade with the EU</u>

Chapter three has given evidence of economic integration through trade and FDI between Poland and Romania on the one hand and the EU on the other. Furthermore, chapter six has suggested that the EU has contributed to enhancing security of the candidate countries through providing financial aid. These elements constitute the basis for analysing the impact of economic integration on FDI. Thus, trade openness is generally recognised as a determinant of FDI.[49] However, the positive relationship between FDI and trade is debatable, the two being seen in the literature as either

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[48] The first five countries to start accession negotiations in 1998 include: the Czech Republic, Estonia, Hungary, Poland and Slovenia. The second track five CEECs, who started accession negotiations in 2000, include: Bulgaria, Latvia, Lithuania, Romania and Slovakia.

[49] Caves, R. E., *Multinational Enterprise and Economic Analysis*, Cambridge University Press, Cambridge, 1996; Singh, H. and Jun, K. W., "Some New Evidence on Determinants of FDI in Developing Countries", *Policy Research Working Paper No. 1531*, The World Bank, 1995.

complementary or competitive in nature.[50] Thus, Hakansson's model of transnational corporations sees trade as an arms-length precursor to foreign direct presence in the form of FDI, as a first step of internalisation.[51] On the other hand, the positive relationship between the two was pointed out by both theoretical and empirical studies such as those by Caves, Singh and Jun, Balasubramanyam et al, Resmini, Deichmann, Bevan et al.[52]

This study seeks to identify the impact trade with the EU, and thus economic integration with the EU, has had on FDI. Two thirds of trade is conducted with the EU and it is thus possible that FDI would follow the same geographical pattern. Furthermore, it is likely that non-EU investors would aim to have access to the EU market through investment. Thus, trade with the EU would affect the level of FDI, as well as the other way round. A similar approach was adopted by Bevan and Estrin who found a negative but not significant relationship between the imports from the EU relative to total imports and FDI.[53] The negative sign appeared to suggest a substitution effect between imports and FDI which was, nevertheless, not significant. In this study three variables reflect the trade between the CEECs and the EU. TRADEU is the most commonly used indicator of economic integration with the EU and reflects the percentage of trade with the EU in the total trade of the candidate country. IMPEU is the share of imports from the EU in total imports and EXPEU is the share of exports to the EU in total exports. It is expected that a higher trade openness enhances foreign investment and thus the sign of TRADEU is positive. Furthermore, the study assumes a complementary relationship between imports and FDI and equally a positive relationship between exports and FDI. It is expected that higher imports of capital goods enhance investment, or imports of raw materials are associated with reinvested profits by the foreign investors. On the other hand, export driven industries are likely to have attracted foreign investors or to have determined the reinvestment of profits by initial investing companies. It is, however, likely that the trade variables capture some of the effects of the new institutional stages in the integration process represented by ASOC, AVIS or HELSINKI, as shown by the correlation matrix presented in appendix 7C.

Financial aid

In the 1970s it was believed that governmental aid should be replaced by private foreign investment.[54] However, the post-1989 developments showed that the economic and political transformation in the CEECs required that aid was directed towards areas which did not meet efficiency requirements for private investment, but which were absolutely necessary for the

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[50] See Deichmann, "Distribution of FDI among Transition Economics", p.145.
[51] Hakansson cited in Deichmann, "Distribution of FDI among Transition Economics", p.145.
[52] Caves, *Multinational Enterprise and Economic Analysis*; Singh and Jun, "Some New Evidence on Determinants of FDI in Developing Countries"; Balasubramanyam, V.N. et al, "FDI and Growth: New Hypotheses and Evidence", *Lancaster University Economics Discussion Papers Series EC7*, 1996; Resmini, "The Determinants of FDI into the CEECs", p.677; Deichmann, "Distribution of FDI among Transition Economies", p.145; Bevan, A.A., Estrin, S. and Grabbe, H., "The Impact of EU Accession Prospects on FDI Inflows to Central and Eastern Europe", *Policy Paper No. 6*, December 2001, p.5.
[53] Bevan and Estrin, "The Determinants of FDI", p.25.
[54] Meier, J. M., "Private Foreign Investment" in Dunning, J.H.(ed.), *International Production and Multinational Enterprise*, George Allen and Unwin, London,1981, p.412.

success of the transition process. Furthermore, as shown in chapter four, the contribution of international financial institutions to the launching of economic reform programs acts as a sign of credibility of the country and affects FDI positively. Moreover, if aid is directed towards modernising the infrastructure and improving the human resources, the impact of aid on FDI becomes even more relevant and direct. However, due to data restrictions it was not yet possible to distinguish between aid in general and aid in infrastructure as such. Finally, general aid affects indirectly FDI through easing the cost of transition and consequently encouraging both population and governments to support deep economic reforms.

No empirical study that the author is aware of has included aid amongst the FDI determinants in the CEECs. Here AIDCAP is aid per capita and is used to assess the impact of international aid on FDI in the ten Central and Eastern European candidates for EU membership. This assessment is increasingly relevant, given that the CEECs have received substantial pre-accession aid from the EU in support for their preparation for EU membership. A positive relationship is expected, showing that keeping up the momentum for EU membership through financial assistance both from the EU and international financial institutions can foster FDI and economic reforms. The EU's decision to increase substantially the financial assistance given to the remaining two candidates that are not joining the EU in 2004 appears to confirm this assumption and the role that aid can play in the quest of the eastern European countries for membership of the European Union.

7.3 Data, empirical analysis and results

Earlier in the chapter a potential economic vicious circle has been identified between perceptions of insecurity, low FDI, poor economic reforms, low prospects for European integration and consequently further perceptions of insecurity. In order to illustrate this vicious circle and to assess ways to turn it into a virtuous one, two main panel data regression were drawn. The choice for panel data had a twofold motivation. First, the focus of this dissertation is on comparing the evolution of Poland and Romania throughout time, hence neither cross-sectional data, nor times series were adequate. Second, a panel of ten countries and eleven years comprises enough observations and variation, both across time and individuals, to allow for meaningful comparisons. The single panel data equations are testing the determinants of economic reforms (REF) and of foreign direct investment (LNFDI). For the FDI determinants, a basic model was considered and gradually security and integration variables were added to test their significance. The existence of individual random or fixed effects was tested. For all specifications the Lagrange multiplier favoured the existence of individual effects over the classical model and the Hausman test indicated the presence of random effects which are shown in tables 7.1, 7.2, and 7.3. Additionally, in order to capture the bi-directional relationship between economic reform and FDI assumed by this study, a system of simultaneous equations has been drawn. REF and LNFDI are endogenous variables and institutional integration variables are included in each equation as exogenous variables. The system is just identified and was estimated through three stage least squares (3SLS), a specific method for systems of simultaneous equations.

The analysis proceeds in three parts, as follows. First, the reform equation assesses the relevance of FDI for economic reforms which are a necessary condition for EU integration. Once this causality is established, the focus changes to the FDI determinants. As discussed in more detail in chapter five, the assumption here is that FDI contributes to privatisation, enterprise restructuring, increased competition, banking restructuring and the development of securities market which are all comprised in the REF variable. To capture the time lag between FDI and its potential effects on economic reforms, REF is regressed on LNLAGFDI. The equation also tests the importance of the prospect of EU integration in fostering economic reforms which was discussed in qualitative terms in chapter six. The inverse relationship is also assumed in building the vicious circle in the economic sphere, but it is not tested statistically. Thus, reforms remain a main determinant of progress towards EU membership complemented by the increasing importance played in the accession process by security factors, as shown in chapter three. The importance of economic reforms in accession was shown by the delay of Romania and Bulgaria's accession which is likely to take place in 2007. Second, the FDI equation tests the role security and European integration variables have in determining FDI. The variable REF is part of the security variables considered and it is assumed that FDI is attracted by countries more advanced in economic reforms. This bi-directional relationship between economic reforms and FDI appears to be at the core of the vicious economic circle identified in this study. It is thus reasonable to look for other factors that can impact on one of these variables and create a leap forward, regardless of what happens with the other variable. So, are European integration and security variables other than economic reforms capable of breaking the vicious circle by enhancing FDI? This question is addressed by the panel data regressions on the FDI determinants. Finally, the hypothesis of a vicious circle is tested through the system of simultaneous equations in which LNFDI and REF are endogenous variables. The results are compared with the estimations of the single equations panel data regressions to check their consistency.

The data ranges from 1990 to 2000 and includes the ten CEECs candidates to EU membership: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. The main series are provided by the EBRD Transition Reports and by the WIIW statistics data base. A certain precautionary note regarding the results is due from the outset for several reasons. There are some missing variables which make the number of observations differ from one specification to the other. Furthermore, it is likely that results have been affected by a certain degree of correlation between the main reggressors as suggested by the correlation matrix in appendix 7C. This correlation gives, nevertheless, a strong evidence of the interdependence of the factors considered and supports the assumption of a vicious circle. Moreover, the combination of categorical, numerical and dummy variables might make interpretation of coefficients rather difficult. Finally, the fact that only random effects were identified is to a certain extent a limitation of the study, as it is rather improbable that in reality FDI and reform are caused by random rather than individual fixed effects. However, the existence of random effects makes it possible to generalise the results and partially dismisses the assumption of path dependency. If the determinants are not necessarily country specific, then path dependency can be avoided. Other limitations related to the availability and quality of the data were identified when discussing and motivating the variables. Despite all these precautionary notes, the coefficients of the basic model are robust to all specification changes. Furthermore, there are enough observations to allow generalisations to be inferred from these results. Finally, the high R squared and the joint significance of the variables used in different specifications give the estimations an important explanatory power.

7.3.1 Panel data regressions for the determinants of the economic reforms

REF=(STAB, LNLAGFDI, ASOC, NEG) + ε (Model 1)

REF=(STAB, LNLAGFDI, ASOC, AVIS, HELSINKI) + ε (Model 2)

The regressions above test the hypothesis of a vicious circle between security factors, European integration variables and FDI by considering the determinants of economic reform. Can FDI enhance economic reforms and thus integration into the European Union, as in diagram 7A(c)? Can the prospect of EU membership maintain the momentum for economic reforms, as suggested in chapter six? Some limitations are expected, given that the bi-directional relationship between economic reforms and FDI could be also explained by a simultaneous equations system, as presented later on in the chapter. A specification with the LNFDI was tried but the results were not significantly different. The lagged variable was preferred in order to account for the time necessary for FDI to have an impact on economic reforms. Furthermore, a specification with the initial conditions was also tried, but INIT was found to be not significant and thus was not reported. This does not necessarily contradict the assumption made in chapter four that economic reforms depended on the initial conditions, which seems to be supported by the 0.20 correlation shown in appendix 7C. This only shows that any index of initial conditions has to take into consideration other factors, including political and institutional ones, as suggested in chapter four. Furthermore, appendix 7D shows that REF displays a positive trend towards reaching a ceiling at the end of the period. It is thus likely that HELSINKI has a lower impact as a result of both this ceiling and the small number of observations for this variable.

The results of the estimations are presented in table 7.1. They suggest that STAB is not significant, but LNLAGFDI is. This is consistent with the hypothesis that FDI has contributed towards economic reforms. Model 1, both ASOC and NEG are significant, showing that early economic and political ties with the EU and prospects for EU membership have urged governments to promote economic reforms. However, the results may also pick up the reverse relationship between reforms and accession, i.e. that the association agreements and the launching of negotiations have depended on a certain level of economic reforms, especially in the case of the first five to start negotiations in 1998. However, NEG does not capture the different high symbolical value of the negotiations started in 2000 which were meant *inter alia* to speed up reforms and to create different perceptions of security. Thus, in order to distinguish between the impact of the AVIS and of HELSINKI on economic reforms, model 2 is drawn.

In model 2, two of the EU institutional integration variables, ASOC and AVIS, appear to have had a significant positive impact on economic reforms through the so called 'carrot effect'. As explained earlier and in chapter six, economic reforms have been anchored in the process of accession into the European Union and EU membership was regarded either as the 'stick' or as the 'carrot', 'the prize' for the sacrifices needed during transition, the 'light at the end of the tunnel'. The accession agreement was a first step towards closer relations with the EU and it appears to have given momentum to the internal reforms in which the CEECs were embarking in early 1990s. Hence, it appears that early ties with the EU have greatly affected the economic performance of the candidate countries, thus potentially placing them in a virtuous or a vicious circle of economic transition. Furthermore, the publication of the Avis in 1997 appears to have contributed towards maintaining the pace of economic reforms in the countries then recognised as the more advanced in economic and political transition and thus in the accession into the EU. However, it is also possible that the regressions only capture the inverse relationship between reforms and EU integration, i.e. the fact that the faster reformers concluded association agreements earlier and that they were recommended through the Avis to open accession negotiations in 1998. The lack of significance of the Helsinki European Council may be due to the little number of observations from 2000 onwards and to the fact that REF itself had already reached a ceiling by that time. The lack of significance of HELSINKI may also suggest that reforms in the second track candidates had already picked up before 2000, as a result of the 'stick' effect of the Avis. By not being invited to open accession negotiations, the then second wave countries feared exclusion, hence needed to reform quickly to be maintained in the race for membership. This was the case of Romania who has speeded up reforms since 1997.

Furthermore, the coefficients of the three European integration variables appear to indicate that the impact of progress towards EU membership on reforms diminishes though in time, from a coefficient of 0.33 to 0.18 and then 0.10. These decreasing coefficients appear to indicate a possible 'social fatigue' with regard to two processes which took longer than expected at the beginning of the 1990s. It is known that the target date for the EU enlargement has been postponed several times and that the positive results of economic reforms took longer to appear in the laggard countries. It is thus possible that using EU membership as an excuse for implementing unpopular reforms has become more and more difficult in time, given the delays mentioned.

Overall, the results of the panel data regression above are consistent with the argument that FDI has a positive and significant impact on future reforms and that the prospect of EU membership has constituted a strong motivation for sustained economic reforms in the candidate countries, especially in the early stages. Once the role of FDI in enhancing economic reforms has been established, the reverse of this bi-directional relationship will be analysed below. Furthermore, the analysis seeks to suggest FDI determinants other than economic reforms that can keep up the momentum for investment and hence economic reforms and economic integration into the EU, thus enhancing a virtuous economic circle as in diagram 7A(d).

7.3.2 Panel data regressions for the determinants of foreign direct investment

The basic model

LNFDI= (REF, LNGDP, GOV) + ε (Model 1)

The results of the regressions for the FDI determinants are presented in tables 7.2 and 7.3. A basic model was built through the combination of REF, LNGDP and GOV. The results obtained through different specifications proved to be robust, and the variables jointly significant, with an R squared between 0.75 and 0.89. LNAVER was also introduced in this model but it was found insignificant and therefore it was dropped from the basic model specification. There are several clarifications to be made regarding this main model. First, LNGDP is both an indicator for the market size and a normalisor for FDI. Several specifications were run with a dependent variable expressing FDI as a percentage of GDP but the results proved not significant, hence the choice for FDI and GDP levels. This was probably due to the small values that such a variable takes in the case of the CEECs. Furthermore, several specifications were run with economic growth as a regressor but it was found not significant and therefore the results were not reported. This might be related to the ambivalent effect of growth on FDI presented in chapter five, part one. Second, GOV is slightly correlated with REF and it is mostly important from the point of view of investors' perception. Thus, at early stages of transition the turnover of ex-communist governments signified high determination of the new rulers to reform the economy. Investors might have been attracted by bold reforms initiated by democratic governments early in the decade. However, towards the late stages of transition some democratic governments proved feeble in advancing reforms while post-communist ones were almost forced to be reformist by the race for FDI or for EU membership. The results have also to be taken with caution as at the present most of the CEECs governments are post-communist and reformist at the same time. Then, REF is not only a measure of the present economic reforms, but also an indication of potential future reforms, thus determining certain expectations from investors. REF also reflects the initial conditions the country faced at the beginning of transition, as was argued in chapter four. The correlation between REF and INIT shown in appendix 7C supports this argument. Finally, the fact that LNAVER is not significant does not necessarily contradict the hypothesis that FDI is attracted by lower labour costs. Regardless of the average wage in each of the candidate countries, they will be much lower than in the EU member states and thus will represent a reduction in the production costs.

Model 1 validates the choice of variables and has an important explanatory power with an R squared of 0.75. It shows that economic reforms are a very important determinant of FDI, consistent with the fact that FDI is directed towards countries advanced in transition. It potentially signals the path dependency of poor reforms, low FDI, hence poor reforms as suggested in diagram 7A(b). As anticipated, the perception of the host country's government is also significant, with a positive coefficient of 0.35, indicating that a democratic government of the host country appeals to investors. This has been the case of Poland and Romania whose post-1997 and post-1996 democratic governments saw indeed the highest surge in FDI during the whole transition. Additionally, the model suggests that FDI in the CEECs is market-seeking as LNGDP is significant and has a very high coefficient of 0.92. Finally, the positive sign of LNAVER shown in model 2 indicates that, given that wages in the CEECs are already significantly lower than in the EU, foreign investors are interested in relatively high wages that represent a potentially larger market. Higher wages may also indicate a higher productivity which could be associated with lower rather than higher labour costs. However, the data available is not sufficient to draw definite conclusions regarding the market-seeking or rent-seeking nature of investment in the ten CEECs considered.

Overall, the results of both the basic model of FDI determinants and of the regressions on the determinants of economic reforms are consistent with the hypothesis of a bi-directional relationship between FDI and reforms, or FDI and security, as economic reforms are part of security concerns in the CEECs. These results indicate a potential path dependency and the potential danger that slow reformers attract low FDI with little impact on economic reforms, EU integration, and thus security, as represented in diagram 7A(a). To what extent are the initial economic conditions and previous FDI able to reinforce this path dependency?

Path dependency

LNFDI= (REF, LNGDP, GOV, INIT) + ε (Model 3)

LNFDI= (REF, LNGDP, GOV, LNLAGFDI) + ε (Model 4)

Model 3 assesses the importance of initial conditions in determining FDI. INIT is not significant but REF is, thus showing that economic reforms rather than initial conditions have affected FDI in the ten CEECs. However, this does not eliminate entirely the possibility of path dependency, as REF itself is correlated with INIT, as shown in appendix 7C. Thus, chapter four has shown that the pace and results of economic reforms have been determined to a certain extent by the economic and political initial conditions of each country considered. Additionally, INIT may not be significant because this variable does not take into consideration political factors that have shaped the initial conditions in the transition countries, as suggested in chapter four. Finally, the negative sign of INIT appears to suggest that harsher initial conditions created expectations of radical reforms and of improved economic prospects, thus fostering FDI. Overall, the lack of significance of INIT can be interpreted as an indication that the danger of path dependency can be eliminated by considering other variables, including security and European integration variables, as will be seen later.

Model 4 tests the significance of LNLAGFDI for LNFDI. It is arguable whether this regression alone may prove path dependency, rather than simply the fact that previous investment affects, indeed, the present one. However, in the absence of data which could allow for the estimation of different types of lagged variables and/or different equation forms, this specification may be considered consistent with the argument of path dependency. LNLAGFDI is significant. Its coefficient of 0.51 is the largest of this specification and supports the hypothesis that FDI is to an extent its own determinant. This is also suggested by the correlation of 0.67 between LNFDI and LNLAGFDI shown in appendix 7C. It appears that investors will reinvest their profits, provided that a certain amount of economic reform has been achieved and that there is a market for their products, as anticipated in chapter five. In this context, perception of the government becomes insignificant and first hand experience of the country through investment is the most relevant. The results can be also interpreted as FDI acting as a country risk assessment for new investors, which are encouraged by the existence of previous investment. This specification requires a further observation with regard to the REF variable. The small coefficient can be explained in several ways. Investment could be resilient to a slow down in economic reforms, provided that previous investment has already been attracted by previous reforms. This might be the case of Poland in the late years of transition. Then, this low coefficient might be a reflection of the bi-directional relationship between FDI and reforms, thus allowing for FDI to impact on further reforms, rather than being greatly affected by them. This might be the case of the surge in FDI in Romania since 1998. Overall, the low coefficient of REF might be induced by the correlation between REF and LAGLNFDI presented in appendix 7C. Not surprisingly, this model has the second largest R squared of 0.84, emphasising the danger of path dependency unless security and European integration variables are considered.

The security determinants of FDI

LNFDI= (REF, LNGDP, GOV, CEFTA) + ε (Model 5)

LNFDI= (REF, LNGDP, GOV, BSEC) + ε (Model 6)

LNFDI= (REF, LNGDP, GOV, BALK) + ε (Model 7)

The security variables considered by this study are REF, STAB, GOV, CEFTA, BSEC and BALK as was discussed earlier on. REF and GOV are part of the basic model and they are significant for FDI in all specifications with a positive sign as expected. STAB was tried and proved insignificant and was thus dropped from the basic model and not reported here. A certain parallelism between stabilisation/liberalisation and institutional reforms might explain why STAB is not significant. Furthermore, the effects of stabilisation might actually be captured in the variation of the GDP itself, thus compensating for the lack of a specific variable for the stabilisation/liberalisation process.

Models 5 and 6 show that CEFTA and BSEC are not significant, but they have positive coefficients, as expected. The fact that these results are not consistent with the hypothesis of regional integration being a signal for foreign investors, might suggest that EU integration is perceived by investors as a more important process than the set up of free trade areas such as CEFTA and the BSEC. The results might also be affected by the fact that membership of these agreements is represented through a dummy variable. In model 7 BALK is also not significant and it has a sign contrary to the expected one. This result contradicts the hypothesis that FDI has been deterred by perceptions of insecurity related to the political geography concept of Balkans. However, the results might have been affected by the high correlation with other variables such as economic reforms. (See appendix 7C.) Furthermore, as argued in chapter six, it is possible that BALK has actually affected the prospects for European integration and thus indirectly FDI. VISE and COMBRD were also tested, but there was high collinearity and thus they had to be dropped. The collinearity may result from the fact that VISE and COMBRD refer to countries which have been faster in reforms, hence in attracting FDI.

The European integration determinants of FDI

Institutional integration with the European Union

LNFDI= (REF, LNGDP, GOV, ASOC, NEG) + ε (Model 8)

Models 8 to 13 test the significance of European integration variables from an institutional and an economic perspective. In model 8, ASOC is significant but NEG is not. This is only partially consistent with the hypothesis that institutional integration with the EU enhances foreign direct investment in the candidate countries. By initiating a gradual increase in the bilateral free trade with the EU, the agreements increased the openness of the CEECs and thus appear to have fostered FDI. It is also possible that some investors saw the agreements as a stepping stone for the CEEC's closer relationship with the EU and thus a promise for economic reforms and political stability, necessary conditions for both EU integration and FDI. This is consistent with the fact that, although the EU confirmed its commitment for enlargement only in 1993 at the Copenhagen European Council, the Polish association agreement of 1991 already mentioned EU membership as a goal of the Polish foreign policy. The results of model 8 suggest that early differentiation through the different timing of the association agreements had an important positive impact on investors, thus potentially already deepening the gap between the frontrunners and the laggards of transition and enhancing the vicious or the virtuous circles of their economic development. As at the time of the signing of the accession agreements the experience with reforms was still minimal, it is likely that anticipation still played an important role in influencing FDI. These findings partially contradict the results by Bevan and Estrin which found that the accession agreements did not have a significant impact on FDI, but complement their conclusion that the Essen announcement had a positive effect on foreign investment, especially in the Visegrad countries.[55] However, the lack of significance of NEG suggests that, over the whole sample, there is no systematic relationship between foreign

[55] Bevan and Estrin, "The Determinants of FDI", p.12.

direct investment and the beginning of the accession negotiations with the EU. This does not necessarily contradict the hypothesis that new stages of European integration represent signals for investors, but points to the need to use different variables, reflecting the different motivations behind launching the negotiations in 1998 and in 2000 respectively and thus their potentially very different impact on FDI. The impact of AVIS and HELSINKI is investigated in model 9.

LNFDI= (REF, LNGDP, GOV, ASOC, AVIS, HELSINKI) + ε (Model 9)

In model 9 the signing of the association agreements appears to be a significant signal for foreign investors with a high coefficient of 0.52, with an interpretation as above. Model 9 also finds that the publication of the Avis did not have a significant impact on the level of the FDI in the candidate countries that were recommended to start accession negotiations in 1998. By differentiating between the frontrunners and the laggards of transition, the Avis did not communicate something new to potential investors. It merely recognised the *status quo* and confirmed the old perceptions of the attractiveness of the different countries. The high correlation between AVIS and REF seems to support this argumentation, which also conforms with Bevan and Estrin. They found no impact on the level of FDI attracted by the then so called first track candidates.[56] The lack of significance of AVIS can also be attributed to the impact of the 1997 Russian financial crisis. These results do not contradict, however, the fears expressed by the Romanian authorities at the time, that the differentiation created in the EU accession process would decrease the FDI attracted by the less advanced countries. In fact, the regression refers to levels of FDI and not to the rate of growth of FDI. Empirical evidence and the study by Bevan and Estrin show that after 1997 FDI has grown faster in the 'first track' candidates than in the second track ones, thus potentially creating a vicious circle in the second track CEECs.[57]

In model 8 HELSINKI is significant and has a positive sign, showing that maintained prospects for EU integration are important signal for investors, especially for the countries with weaker results in terms of economic reform. Whereas recognising the *status quo* of the frontrunners through the AVIS appeared to have no significant impact on increasing FDI levels, enhancing the prospects for integration for the laggards in the aftermath of the Kosovo crisis appears to have been able to give further guarantees to investors, thus increasing the attractiveness of these countries. Institutional progress towards EU membership appears, therefore, to be more significant when economic reforms are limited. By improving substantially the perceptions of security of the remaining five candidate countries, the Helsinki European Council gave new signals to potential investors and enhanced FDI. Maintaining prospects for EU integration appears to be a way to enhance FDI and thus lead to further economic reforms- potentially a way to break the vicious circle captured in this model. It is, therefore, possible that since the Helsinki European Council Romania has entered a virtuous circle of development as suggested in diagram 7A(e). On the other hand, the results might be affected by the fact that the frontrunners in economic reforms had already approached the end of

[56] Bevan and Estrin, "The Determinants of FDI", p.18.

their privatisation programmes and saw increasing cost convergence with the EU, thus facing a relative fall in their FDI inflows leading to a diversion towards countries less advanced in economic reforms and EU accession.

Economic integration with the European Union

LNFDI= (REF, LNGDP, GOV, AIDCAP) + ε (Model 10)

LNFDI= (REF, LNGDP, GOV, TRADEU) + ε (Model 11)

LNFDI= (REF, LNGDP, GOV, IMPDEU) + ε (Model 12)

LNFDI= (REF, LNGDP, GOV, EXPEU) + ε (Model 13)

Models 10 to 13 assess the importance of economic integration with the EU in enhancing FDI by considering variables such as: aid per capita, trade with the EU percentage of total trade, percentage of imports from the EU in total imports and finally percentage of exports to the EU in total exports. Model 9 tests the role of financial aid in enhancing FDI. Financial aid is here a result and a sign of further integration with the EU. Thus, the pre-accession programmes provide for important funds to be directed towards institution building or investment feasibility projects, conditions that can foster FDI into the candidate countries. The results show that aid per capita is indeed significant, but the low coefficient shows a relatively low impact. This can be due to aid being so limited in the first place, needing time to show effects, or being used with not enough efficiency to deliver the results expected. Nevertheless, aid remains an important component of the pre-accession strategy and can be a catalyst for improving conditions for FDI, including investment in human resources, and the model recognises its significance.

Models 11 to 13 investigate the impact on FDI induced by integration with the EU in terms of trade. The models consider the trade with the EU percentage of total trade (TRADEU), the percentage of imports from the EU in total imports (IMPEU) and finally the percentage of exports to the EU in total exports (EXPEU). The positive coefficients of each of these three variables suggest complementarity between FDI and trade rather than substitution. Furthermore, TRADEU and EXPEU are significant and suggest that higher economic integration with the EU attracts higher investment. The high coefficient of EXPEU and its significance appear to suggest that FDI is attracted in industries which are export oriented. While this appears to imply a potential positive effect on economic growth in the host countries, it is also possible that FDI is attracted by already competitive industries, thus diminishing its role on modernisation in the recipient country. On the other hand, the positive coefficient of IMPEU suggests a move from imports towards a superior stage of internationalisation, i.e. foreign investment. The introduction of the European integration variables suggests that institutional and economic integration with the EU can represent a way to break the vicious economic circle presented in this study.

[57] Bevan and Estrin, "The Determinants of FDI", p.19.

To sum up, the panel data regressions have shown that FDI in the CEECs is market driven and is determined by security and European integration factors, including economic reforms, democratic governments, prospects for EU integration and economic integration with the EU. Furthermore, there is a certain danger of path dependency, with slower reformers attracting lower FDI, progressing slower in economic reforms and in the EU accession process and thus attracting again lower investment. However, difficult initial conditions appear to have been overcome. Furthermore, the positive impact of the prospect of EU membership on the slower reformers may suggest that institutional integration with the EU can diminish the risk of path dependency and thus break the vicious circle in the economic sphere. Overall, the result of different specifications of regressions on both FDI and REF are consistent with the hypothesis of a bi-directional relationship between these two variables. Furthermore, the results have reinforced the need for considering a system of simultaneous equations as below.

7.3.3 A system of simultaneous equations on the determinants of foreign direct investment and of economic reforms

In order to capture the vicious circle and the bi-directional relationship between the variables considered here, a system of simultaneous equations was drawn having as endogenous variables foreign direct investment (LNFDI) and respectively the economic reform (REF). A system of simultaneous equations is also more appropriate given the endogeneity in the single equation estimations. Furthermore, it is assumed that the relationship between FDI and REF is simultaneous, hence it is more difficult to break the vicious circle. The question is whether institutional integration variables affect directly economic reforms by providing further motivation, the 'light at the end of the tunnel', or through FDI, acting as a signal for investors that the candidate countries are desirable locations for investment.

The three stage least squares method used here addresses the limitations of testing the bi-directional relationship between FDI and economic reforms through single equation estimation methods, as in the panel regressions drawn earlier. The results of the system of simultaneous equations estimations reveal once again the complex relationship between the factors considered. Furthermore, they are consistent with some of the previous findings and provide complementary explanations as well. The three stage least squares results are explained below and presented in table 7.4.

The accession negotiations variable

REF=(LNFDI, STAB,ASOC, NEG) + ε

LNFDI=(REF,LNGDP,GOV,ASOC,NEG) + ε (Model 1)

The results of model 1 are consistent with the results of the single equation estimation of the determinants of economic reforms. FDI is found a significant determinant, emphasising the need for attracting FDI in transition countries in order to speed up economic transition. Furthermore, progress of institutional integration with the EU appears to be a motivational factor for governments to pursue economic reforms, consistent with the analysis in chapter six. The estimations also suggest that the impact of FDI on reforms is instantaneous, hence the strong advantages of attracting FDI. The results regarding the FDI determinants are only partially consistent with the ones of the single equation estimations. Only the domestic market is significant. At a first glance, the lack of significance of REF could be seen as a limitation. However, this could indicate a way to break the economic vicious circle, by affecting FDI through other factors than reforms. Furthermore, a higher GDP could be associated with more advanced reforms resulting in economic growth, hence counterbalancing the lack of significance of REF. Finally, neither ASOC, nor NEG are significant determinants of FDI. The lack of significance of ASOC may again be counterbalanced by the significance of LNGDP, with a higher GDP resulting partially from higher exports due to trade liberalisation with the EU. The lack of significance of NEG suggests the need to differentiate between the AVIS and HELSINKI.

The role of the Avis and of the Helsinki European Council

REF=(LNFDI, STAB,ASOC, AVIS, HELSINKI) + ε

LNFDI=(REF,LNGDP,GOV,ASOC,AVIS,HELSINKI) + ε (Model 2)

Model 2 suggests the same interpretation for the determinants of foreign direct investment. ASOC and AVIS are significant for economic reforms, but it is possible that the results capture the reverse relationship, i.e. that faster reformers have concluded association agreements sooner and have also been invited to negotiate sooner. The lack of significance of HELSINKI may be due to the little number of observations. The main limitation of this model is that it does not capture the significance of FDI for economic reforms. This might be due to the correlation between FDI and AVIS presented in appendix 7C. However, if the institutional integration variables are defined as to account for anticipation effects rather than consequences, then LNFDI, ASOC, AVIS and HELSINKI are all significant determinants of foreign direct investment.[58] This is consistent with the nature of the system of equations which captures simultaneous effects. The results of model 3 are consistent with the hypothesis that the prospect of EU integration has been an important motivational factor for economic reforms in the candidate countries.

Overall, the three stage least squares results are consistent with the hypothesis of complex relationships between the variables considered in this study. They are also consistent with the existence of a vicious and respectively virtuous circle of economic development in which certain countries in transition may have been locked in for some periods of time. Some lack of consistency between the findings of the single equations estimations and of the system of simultaneous equations estimations was predictable from the start, given the endogeneity in the single equations regressions, and can only support the hypothesis of complex relationships between the variables assessed. The main limitations are the lack of significance displayed by REF and European integration variables for FDI. However, one can argue that the GDP level is correlated with

[58] See new definition of variables in table 4.

economic reforms and thus its significance for FDI implicitly suggests the importance of REF. Furthermore, following the same reasoning, REF seems to be affected by European integration variables which thus affect FDI, at least indirectly. Finally, the simultaneous relationship examined through the three stage least squares seems to overlook the fact that there is a certain gap between FDI and their impact on economic reforms, hence the advantages of using lagged FDI when assessing the determinants of economic reforms, as in the single equation models.

7.4 Conclusion

This chapter has investigated the interplay between security, FDI and European integration in the CEECs during the first ten years of transition and has arrived at two main conclusions. First, it has been demonstrated the existence of a potential vicious circle of insecurity, low FDI, poor economic reforms and thus poor prospects for EU integration as in diagram 7(a). This vicious circle may account for Romania's relatively poor evolution during the first decade of transition in terms of attracting FDI and progressing towards EU membership. Security here included concerns regarding the success of economic reforms, the ideological orientation of the government, membership of regional free trade agreements and discrimination on political geography grounds, consistent with the analysis conducted in chapter six. Second, it has been shown that the prospect of EU membership enhanced by security motives can create a virtuous circle in the economic sphere by improving perceptions of security, fostering integration with the EU, FDI, economic reforms and finally full EU membership.

The results of the panel data regressions are consistent with the hypothesis of a bi-directional relationship between FDI and economic reforms which appears to be at the centre of the vicious circle in the economic sphere. Furthermore, the estimation of the system of simultaneous equations pointed, indirectly, to the existence of a bi-directional relationship between FDI and economic reforms. The analysis has also shown that FDI is to a high extent its own determinant and thus there is the danger that countries with initial high investment will continue to attract investors at the expense of the lower FDI recipients. This potential path dependency seemed to be enhanced by the sensitivity of FDI to early ties with the EU through the signing of association agreements. Early commitments to EU integration appear to have been important for FDI, thus potentially creating a virtuous path or circle of development.

Second, the empirical analysis has investigated ways to break the path dependency and the vicious circle in the economic sphere. The analysis suggested that the prospect of EU membership and economic integration with the EU can lead to path shaping by transforming the economic vicious circle into a virtuous one. Thus, the panel data regressions have shown that the initial conditions are not a significant determinant of FDI, despite the correlation between the two variables. This finding appears to suggest that in terms of attracting FDI, the legacy of the past has been overcome to a certain extent, thus reducing the scope for path dependency. The same conclusion can be inferred from the lack of significance of the initial conditions in determining economic reforms. The insignificance of political geography (BALK) in determining FDI in countries such as Romania and Bulgaria can also be seen as a sign that the vicious circle of development considered here can be broken. Perceptions of insecurity related to an externally constructed Balkan identity appear to have been overcome by progress in economic reforms and by prospects for EU integration. A further indication that the vicious circle can be broken is given by the lack of significance of the AVIS in enhancing FDI in the frontrunners of transition and EU accession. Furthermore, the negative sign of this variable appears to be consistent with the increased FDI attracted by Romania since 1997. This increase was a result of Romania's speeding up its privatisation programme and of FDI diversion from countries such as Poland, where privatisation was closer to completion. Nevertheless, the real potential of breaking the vicious circle seems to be displayed by the Helsinki European Council variable. At Helsinki, prospects for EU integration were renewed for countries previously considered the laggards of accession, as they were invited to open accession negotiations with the EU. This has greatly changed perceptions of security of the five candidate countries invited to negotiate, thus giving new signals to foreign investors. This new momentum for EU integration appears to have fostered FDI in the five CEEC candidate countries previously considered second track candidates. It had the potential to turn the previous vicious circle of development into a virtuous one as in diagram 7A(e.) The high coefficient of HELSINKI emphasises this conclusion. Institutional integration variables have also been shown to have enhanced economic reforms, consistent with the analysis in chapter six.

The single equation regressions have also shown that economic integration with the EU has enhanced FDI in the CEECs. Thus, financial aid, percentage of trade with the EU and of exports to the EU were found to be significant FDI determinants. The findings regarding the role of financial aid reinforce the justification for substantial pre-accession funding being allocated to countries such as Romania and Bulgaria, whose EU accession was delayed until most likely 2007. They make the case for continued financial support for these countries in order to maintain the pace of reforms and continue to attract FDI. Pre-accession financial assistance will potentially temper the widening of the gap between them and the new members of the EU that might result from increasing funding for the ten CEECs that are likely to join in 2004.[59] Furthermore, the results suggest that competitive, export oriented sectors are likely to attract FDI, thus reinforcing a virtuous circle of development. This suggests that industrial policies should continue to encourage sectors in which candidate countries have comparative advantages in terms of quality/price ratio.

Overall, the empirical analysis is consistent with the argument that FDI is market-seeking and has proven that security and European integration variables are important FDI determinants. The lack of significance of BSEC and CEFTA appears to suggest that accession to the EU is more

[59] See also Smith, A., "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe", in Smith, J. and Jenkins, C. (eds.), *Through the Paper Curtain. Insiders and Outsiders in the New Europe*, The Royal Institute of International Affairs, London, 2003, p.34.

important for investors that any exercise of regional co-operation which were meant in the first place to enhance prospects for EU integration. Trade liberalisation represented by the association agreement and changes in perceptions of security by the Helsinki European Council have had a strong positive effect on FDI and on economic reforms in the initially second wave candidates. However, the decreasing impact that each new stage of institutional European integration has had on economic reforms warns about the danger of a certain 'fatigue' with transition. This 'fatigue' might reduce even further the motivational and risk diminishing impact of the prospects of EU membership. It is thus important that in the case of Romania and Bulgaria prospects for EU accession are maintained and complemented by further economic integration and internal economic reforms. All these elements appear to be able to enhance FDI, complete transition to a market economy and finally bring EU membership as per diagram 7A(f). The attractiveness of the two countries will also consist in the persistence of relatively low production costs given that EU membership was delayed until most likely 2007. It is likely that FDI will be diverted from the new EU members which will be price convergent with the EU towards the remaining candidates, not yet aligned to the EU price levels. [60]

7.5 Tables and appendices

[60] See also Grabbe, H. and Hughes, K., *Eastward Enlargement of the European Union*, The Royal Institute of International Affairs, London, 1997, p.34.

Table 7.1
Panel data estimations of the determinants of economic reforms

Models on REF	Model 1	Model 2
STAB	-.00 (.00)	.-00 (.00)
LNLAG FDI	.17* (.44)	.19* (.03)
ASOC	.52* (.09)	.33* (.08)
NEG	(.20)* (.09)	
AVIS		.18* (.08)
HELSINKI		.10 (.10)
Constant	-1.06	-1.28* (.63)
R Squared	.57	.58
Individual Effects	R.effects	R. Effects

Note:
a) The coefficients and the standard errors are provided in the columns.
b) The coefficients marked with * and ** are significant at 5 and respectively 10 percent.

Table 7.2
Panel data estimations of the determinants of FDI

LNFDI	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
REF	1.07* (.14)	.89* (.17)	1.04* (.14)	.38* (.18)	1.06* (.18)	1.07* (.14)	1.10* (.15)
LNGDP	.92* (.16)	.93* (.15)	1.07* (.21)	.41* (11)	.91* (.17)	.93* (.17)	.92* (.17)
GOV	.35* (.15)	.53* (.15)	.35* (.15)	.05 (.13)	.35* (.16)	.35* (.16)	.35* (.15)
LNAVER		.09 (.19)					
INIT			-.16 (.15)				
LNLAGFDI				.51** (.09)			
CEFTA					.02 (.26)		
BSEC						.38 (.33)	
BALK							.27 (.45)
Constant	-5.25 (3.74)	-5.60 (3.52)	-8.36* (4.84)	-1.10 (2.15)	-4.91* (3.97)	-5.47 (3.98)	-5.31 (3.99)
R squared	.75	.78	.89	.84	.75	.75	.75
Individual effects	Random Effects	Random effects	Random Effects	Random Effects	Random Effects	Random Effects	Random Effects

Note:
a) The coefficients and the standard errors are provided in the columns.
b) The coefficients marked with * and ** are significant at 5 and respectively 10 percent.

Table 7.3
Panel data estimations of the determinants of FDI

LNFDI	Model 8	Model 9	Model 10	Model 11	Model 12	Model 13
REF	.66* (.20)	.70* (.20)	1.04* (.14)	.89* (.16)	.99* (.15)	.87* (.17)
LNGDP	.85* (.15)	.91* (.17)	.94* (.17)	.91* (.16)	.89* (.18)	.96* (.17)
GOV	.34* (.15)	.37* (.15)	.39* (.15)	.42* (.16)	.46* (.16)	.44* (.16)
ASOC	.55* (.22)	.52* (.22)				
NEG	.23 (.18)					
AVIS		-.07 (.21)				
HELSINKI		.61* (.27)				
AIDCAP			.01* (.005)			
TRADEU				.78** (.47)		
IMPEU					.83 (.84)	
EXPEU						1.16** (.72)
Constant	-2.77 (3.67)	-4.24 (4.06)	-5.99 (3.87)	-5.40 (3.79)	-4.88 (4.11)	-6.36 (4.04)
R squared	.77	.78	.77	.77	.76	.77
Individual effects	Random Effects	Random Effects	Random Effects	Random Effects	Random effects	Random Effects

Note:
a) The coefficients and the standard errors are provided in the columns.
b) The coefficients marked with * and ** are significant at 5 and respectively 10 percent.

Table 7.4
Estimations of the system of simultaneous equations

	Model 1		Model 2		Model 3***	
EQUATIONS REGRESSORS	**LNFDI 3SLS**	**REF 3SLS**	**LNFDI 3SLS**	**REF 3SLS**	**LNFDI 3SLS**	**REF 3SLS**
REF	.03 (1.23)		.12 (1.30)		.28 (1.27)	
LNFDI		.10* (.05)		.07 (.05)		.10** (.05)
STAB		-.00** (.00)		-.00 (.00)		
LNGDP	.87* (.10)		.88 (.10)		.93* (.11)	
GOV	.40 (.34)		.41 (.32)		.36 (.27)	
ASOC	1.03 (.86)	.59* (.13)	.96 (.92)	.62* (.13)	.57a (.72)	.50*a (.13)
NEG	.53 .(54)	.34* (.11)				
AVIS			.37 (.57)	.45* (.13)	.37b (.80)	.55*b (.12)
HELSINKI			.60 (.38)	.10 (.17)	.63c (.43)	.24**c (.12)
CONSTANT	-1.89 (2.17)	.39 (1.00)	-2.50 (2.41)	.77 (.17)	-3.84 (2.24)	.57 (.96)
R Squared	.73	.55	.74	.56	.72	.56

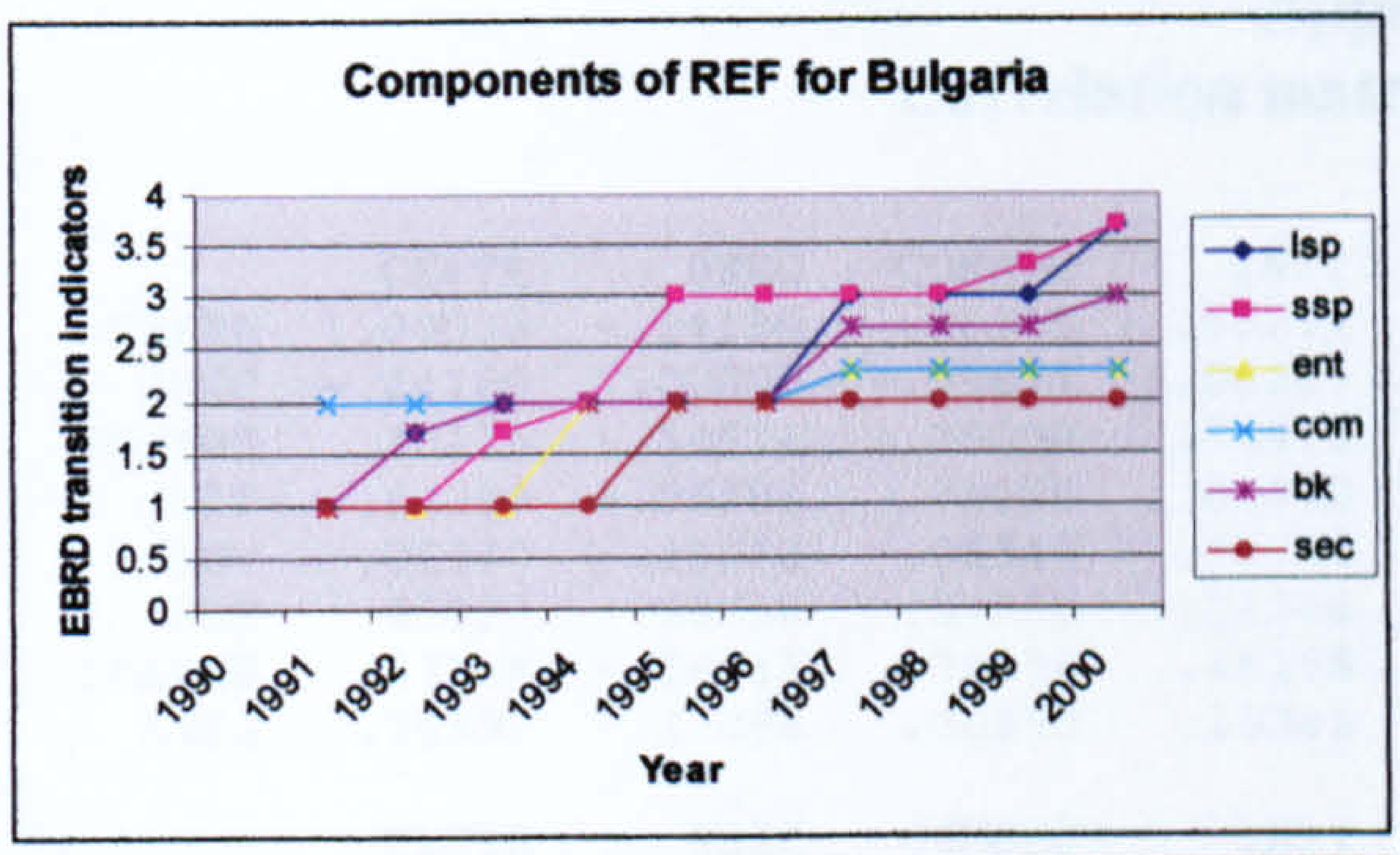
Note:
a) The coefficients and the standard errors are provided in the columns.
b) The coefficients marked with * and ** are significant at 5 and respectively 10 percent.
***) For this model the specification of the institutional integration variables has changed to account for anticipation effects, rather than causal ones. ASOC takes value one since the year of signing the association agreement. AVIS takes value 1 since 1997, when the recommendation to start accession negotiations was made for five CEECs. Helsinki takes value 1 since 1999, when the recommendation to start accession negotiations was made for five CEECs.

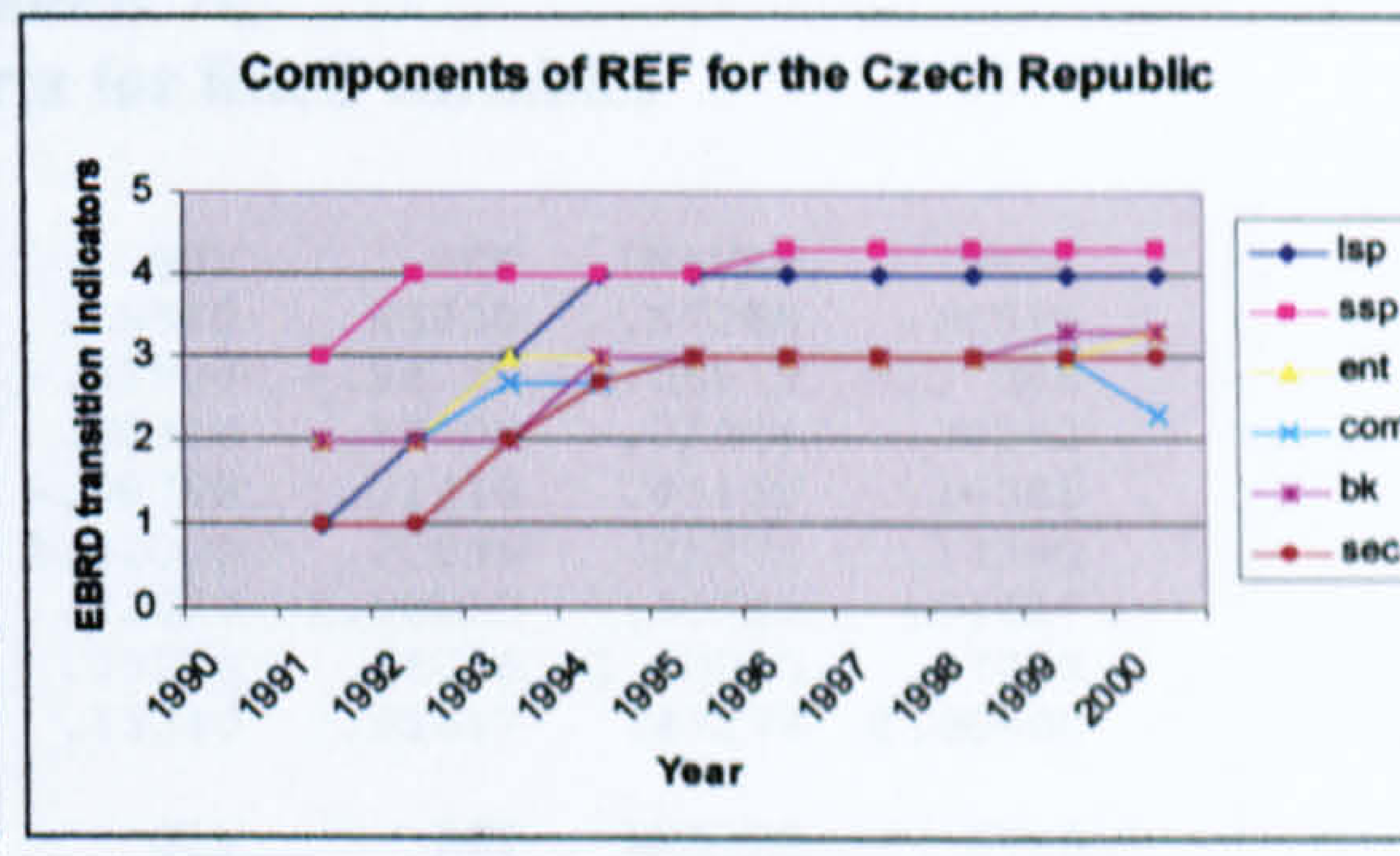
Appendix 7A

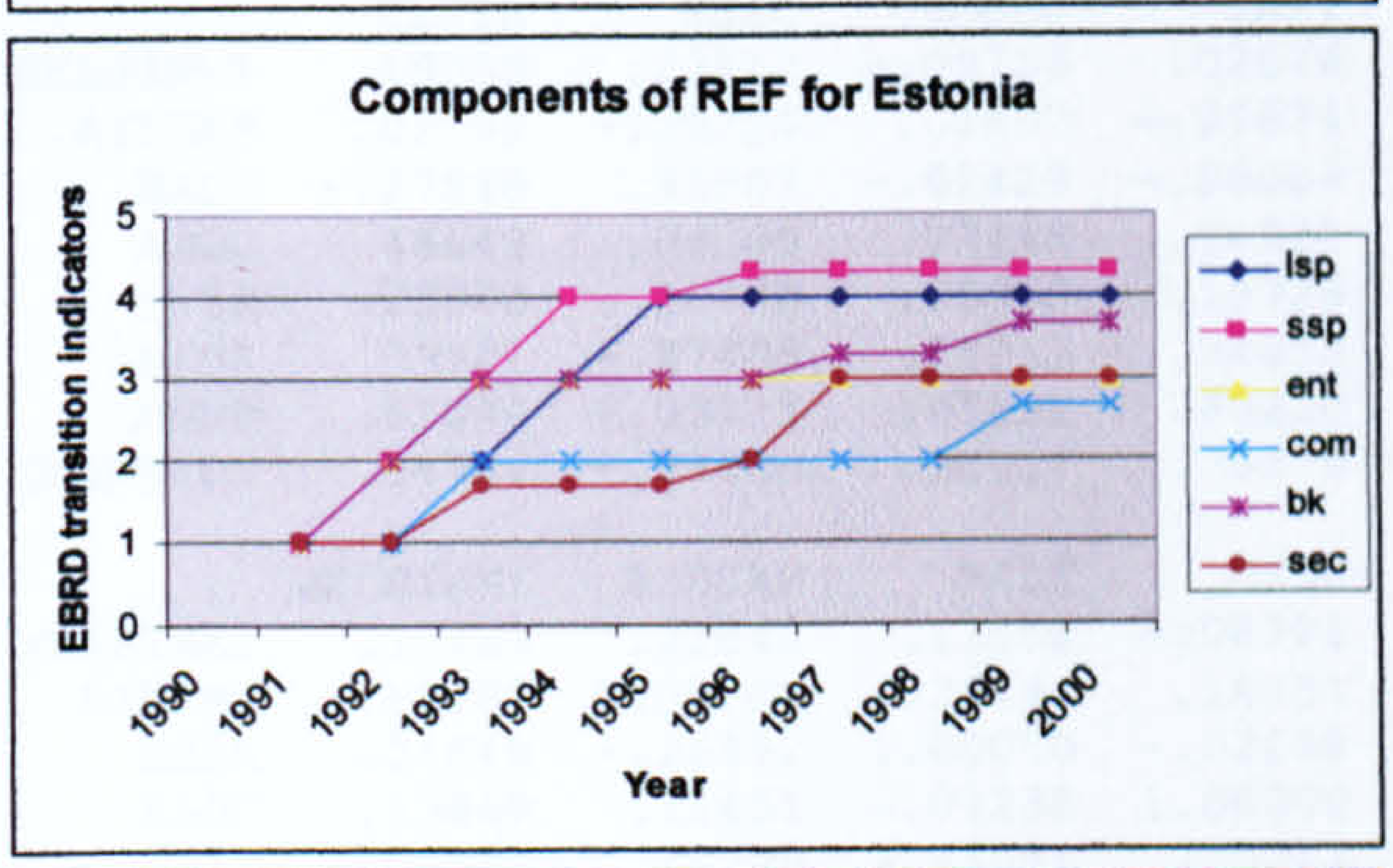
List of variables

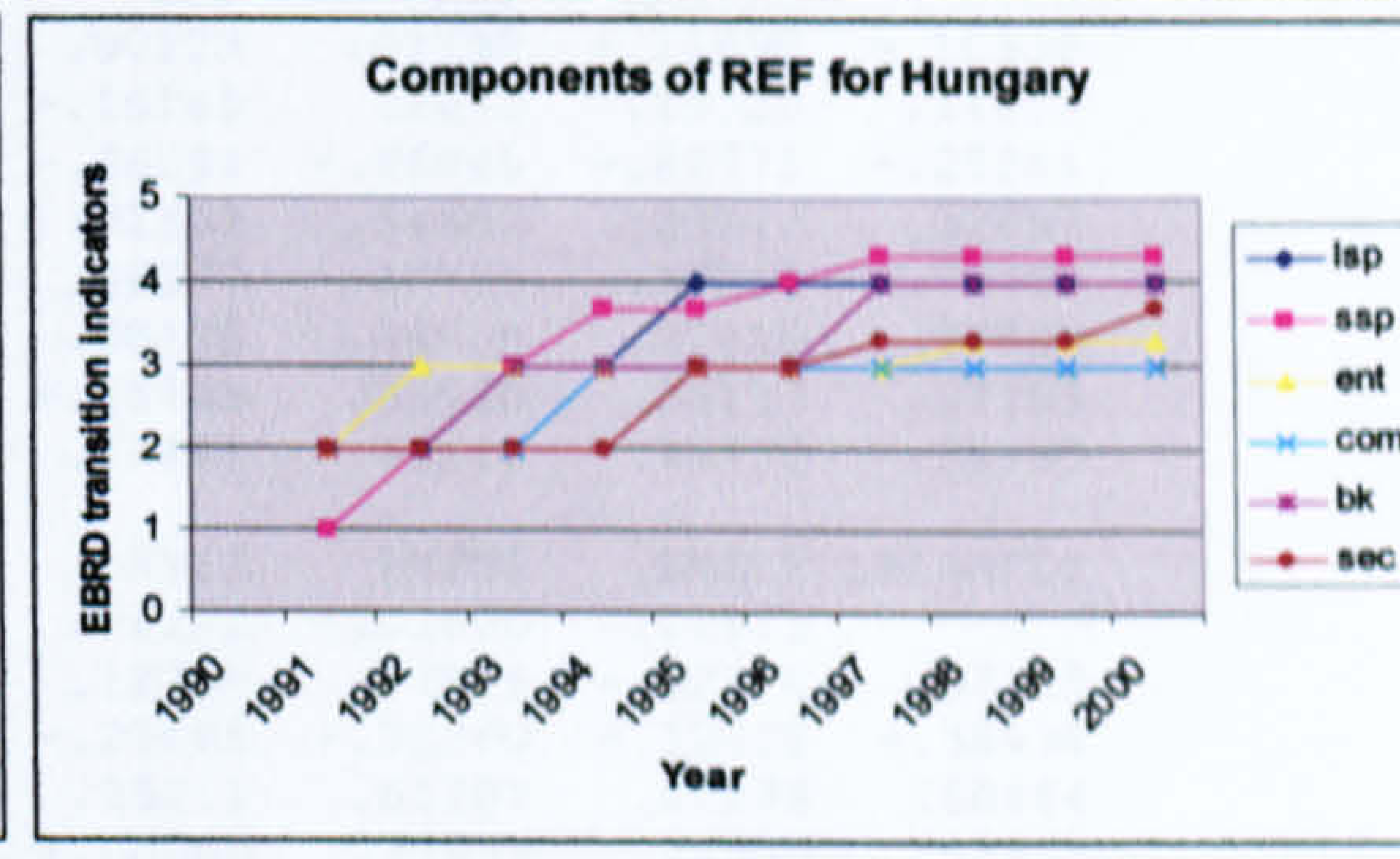
Abbreviations	Full description	Source
FDI **LNFDI= ln (FDI)** **LAGFDI** **LNLAGFDI= ln(LAGFDI)**	FDI, aggregate annual inflows, current USD	World Bank, *World Development Indicators*, CDROM
REF	Reform composite indicator: mean of six reform indicators by the EBRD (LSP, SSP, COM, SEC, ENT, BK)	EBRD, *Transition Report*, 1999
STAB	Stabilisation composite indicator: mean of two stabilisation indicators of EBRD (TREX and PR)	EBRD, *Transition Report*, 1999
GDP **LNGDP= ln (GDP)**	GDP at market prices, current USD	World Bank, *World Development Indicators*, CDROM
AVER **LNAVER =ln (AVER)**	Average monthly earnings USD, PPP	Central Business Europe, *http://www.bcemag.com*
GOV	Government dummy (0 for leftist, 1otherwise)	Computed by the author
INIT	Initial conditions categorical variable	EBRD, *Transition Report*, 1999
ASOC	Impact of the association agreement dummy (1 starting with the first year after the signing of the agreement, 0 otherwise)	Computed by the author
NEG	Impact of the launching of accession negotiations (1 for each year when a country negotiated with the EU, 0 otherwise)	Computed by the author
AVIS	Impact of the Avis dummy: recommendation for opening negotiations by the six first track countries (1 for 1998 for the six first track countries, 0 otherwise)	Computed by the author
HELSINKI	Impact of the Helsinki Council dummy: recommendation for opening negotiations by the six second track countries (1 for 2000 for the six second track countries)	Computed by the author
CEFTA	Membership of CEFTA dummy (1 for years of membership, 0 otherwise)	Computed by the author
BSEC	Membership of BSEC dummy (1 for years of membership, 0 other wise)	Computed by the author
VISE and BALK	Visegrad v. Balkans v. others dummies (VISE: 1 for the Czech Republic, Hungary, Poland and Slovakia, 0 otherwise; BALK:1 for Bulgaria and Romania, 0 otherwise)	Computed by the author
COMBRD	Common border dummy (1 for common border with the EU, 0 for otherwise)	Computed by the author
AIDCAP	Aid per capita	World Bank, *World Development Indicators*
TRADEU	Trade with EU % in total trade (openness towards EU)	WIIW and *World Development Indicators*
IMPEU	Imports from the EU % in total imports	WIIW and *World Development Indicators*
EXPEU	Exports to the EU % in total exports	WIIW and *World Development Indicators*

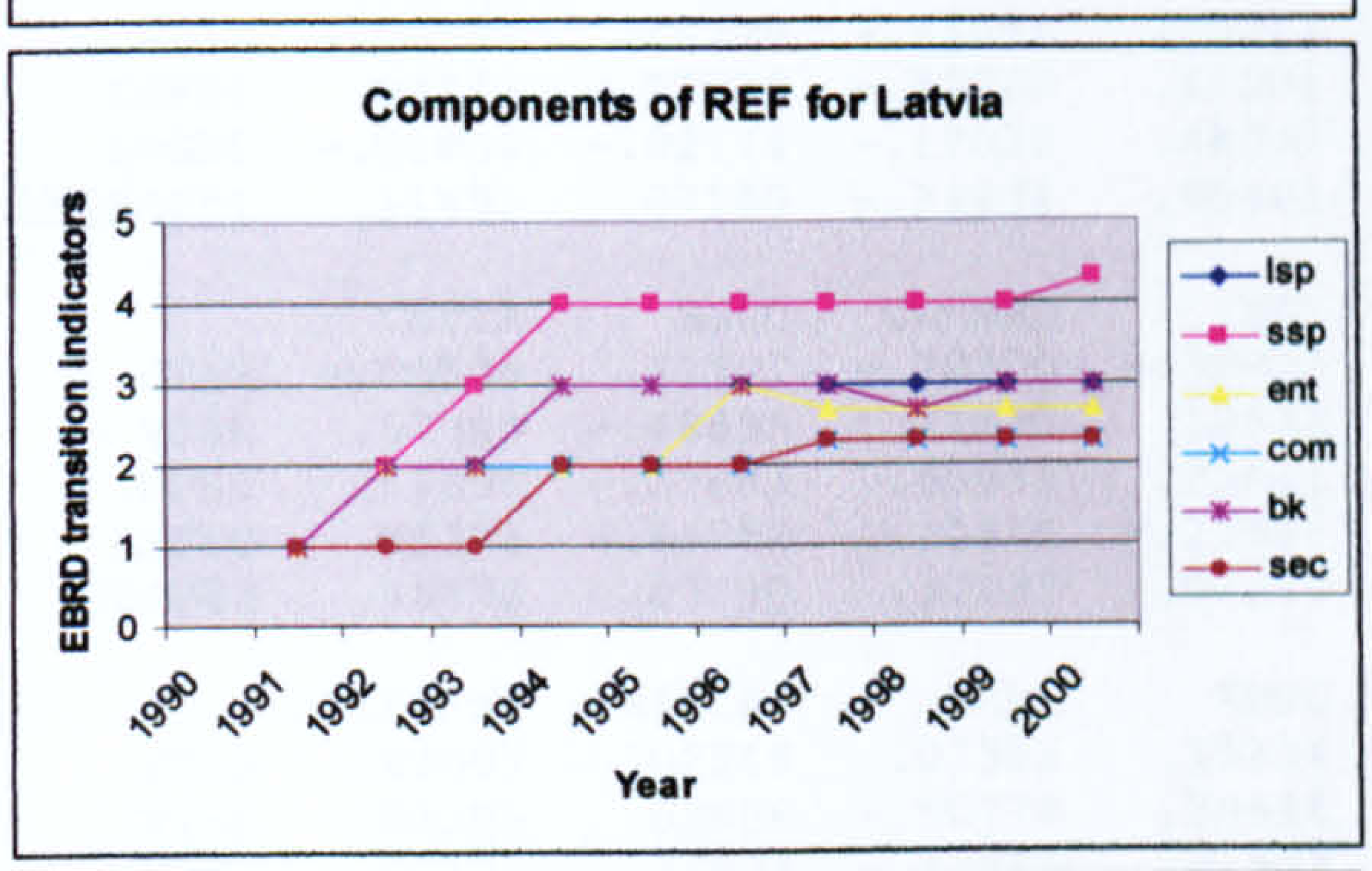
Annex 7B
Trends in the components of REF

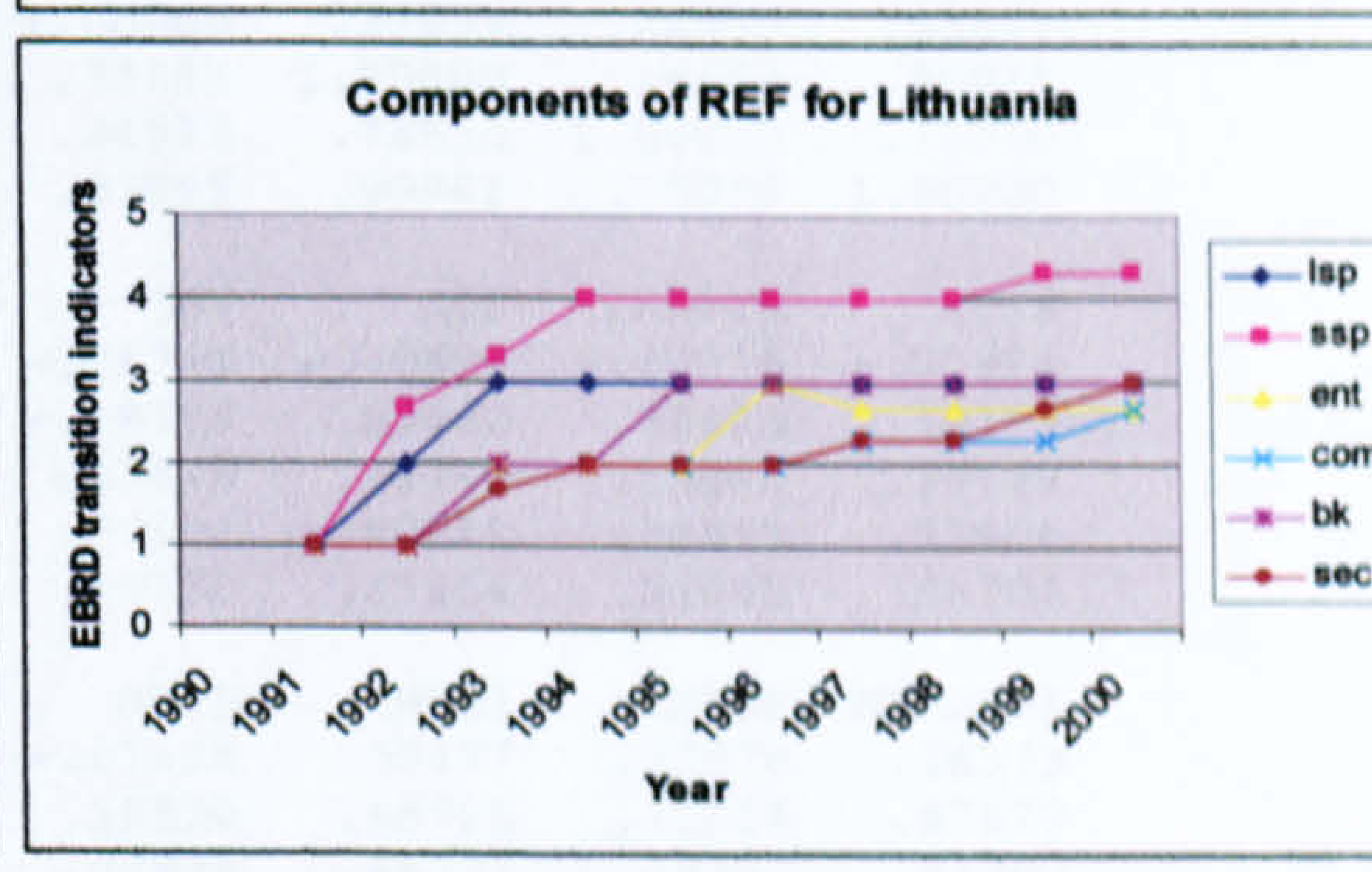


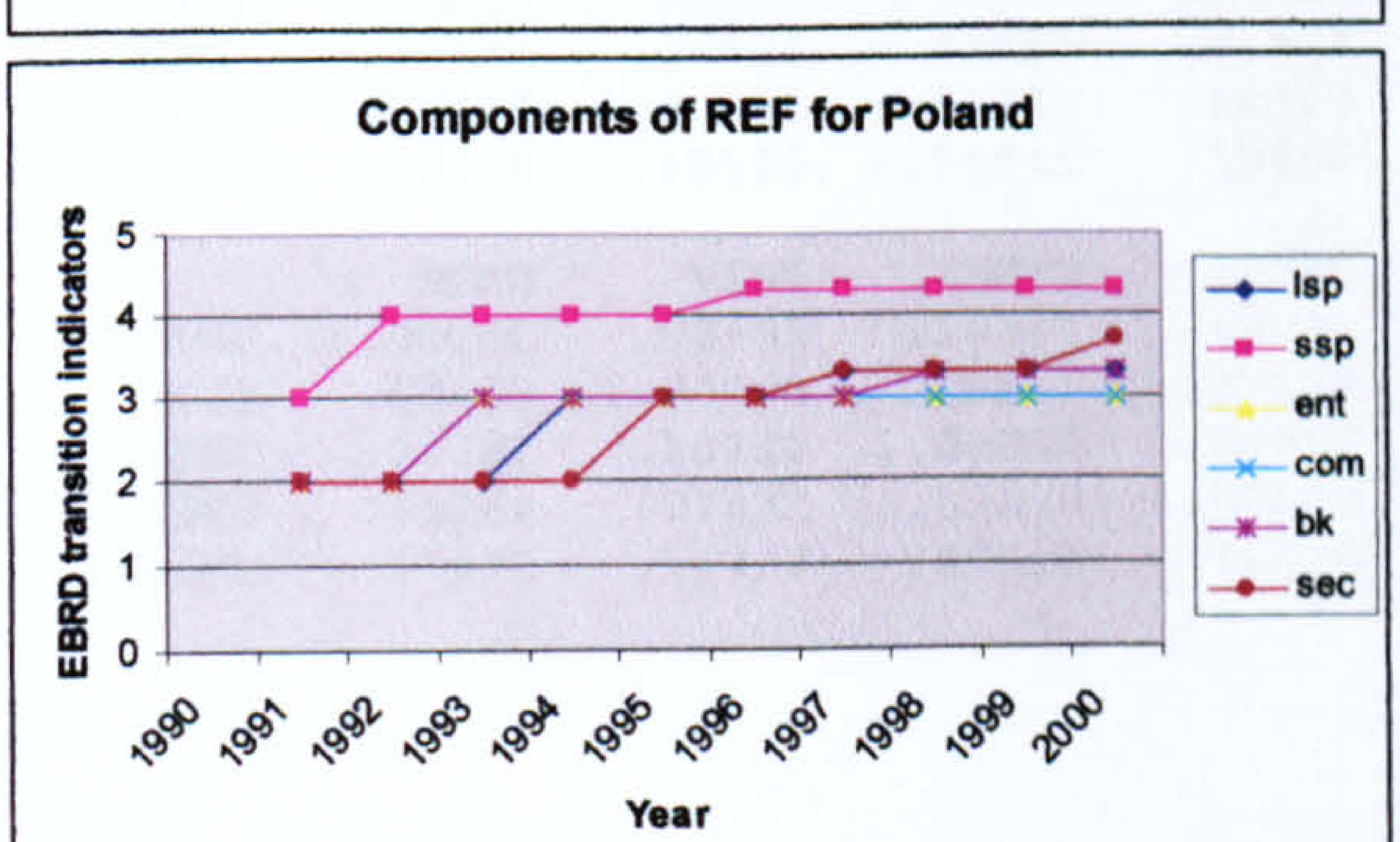


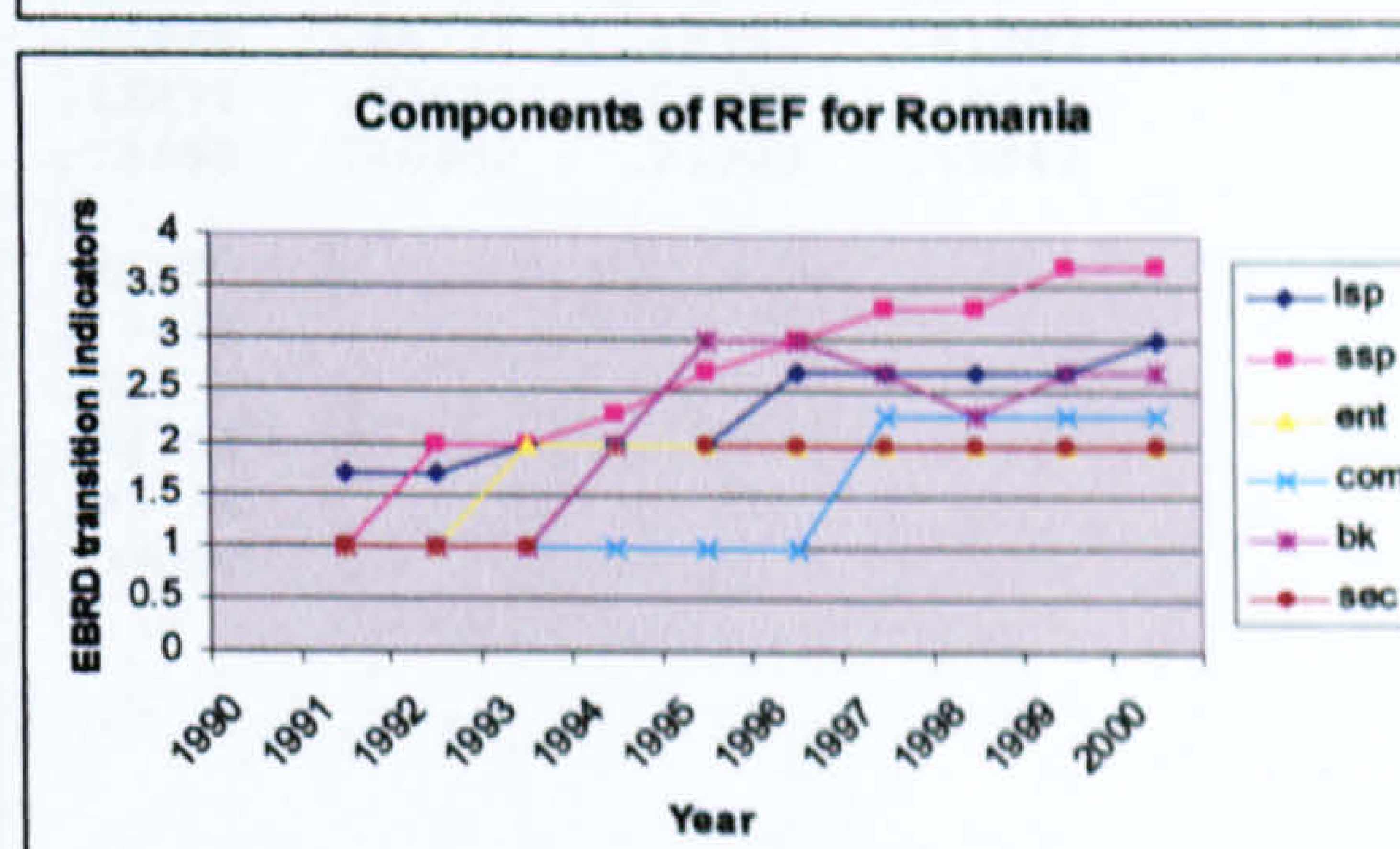


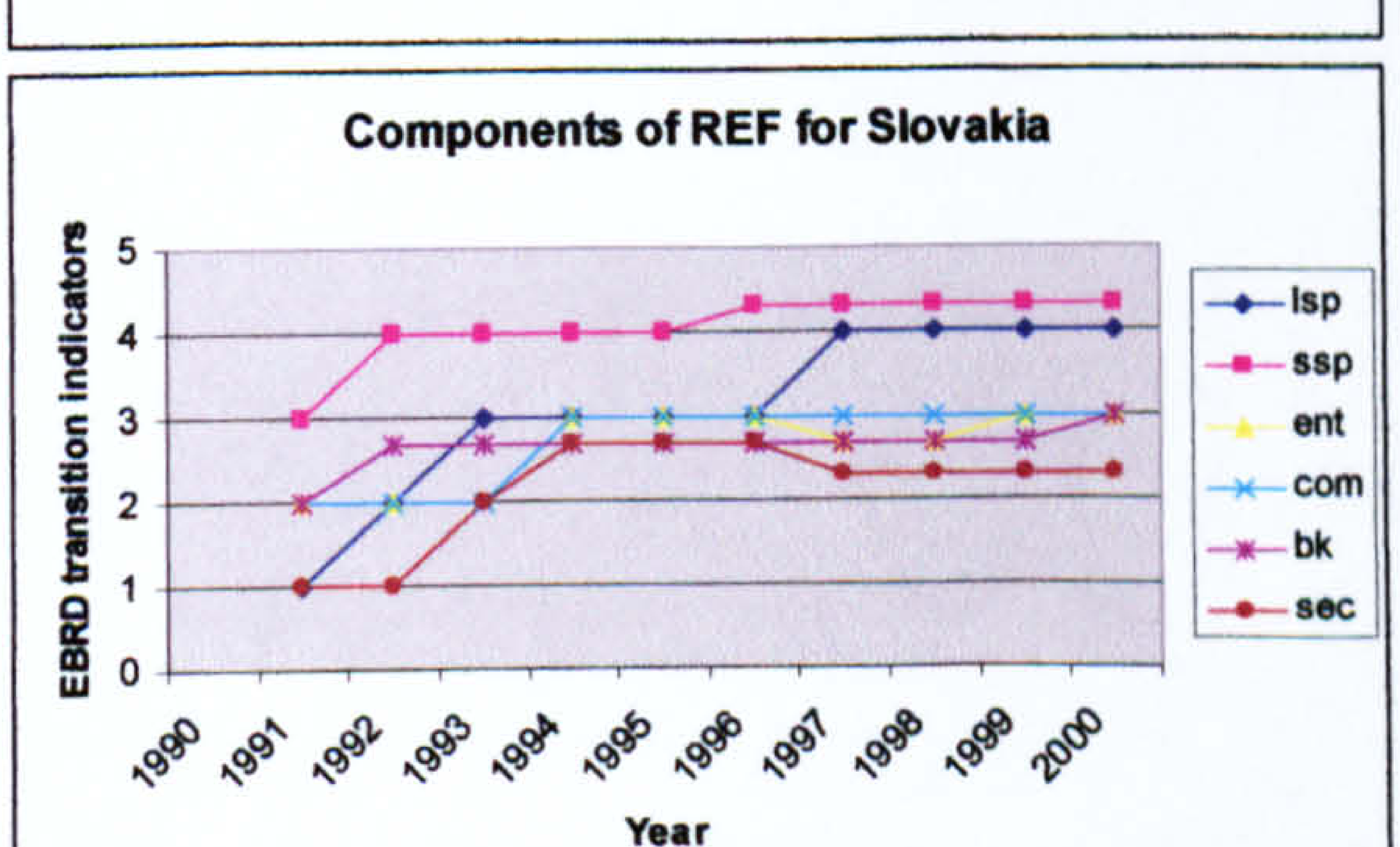


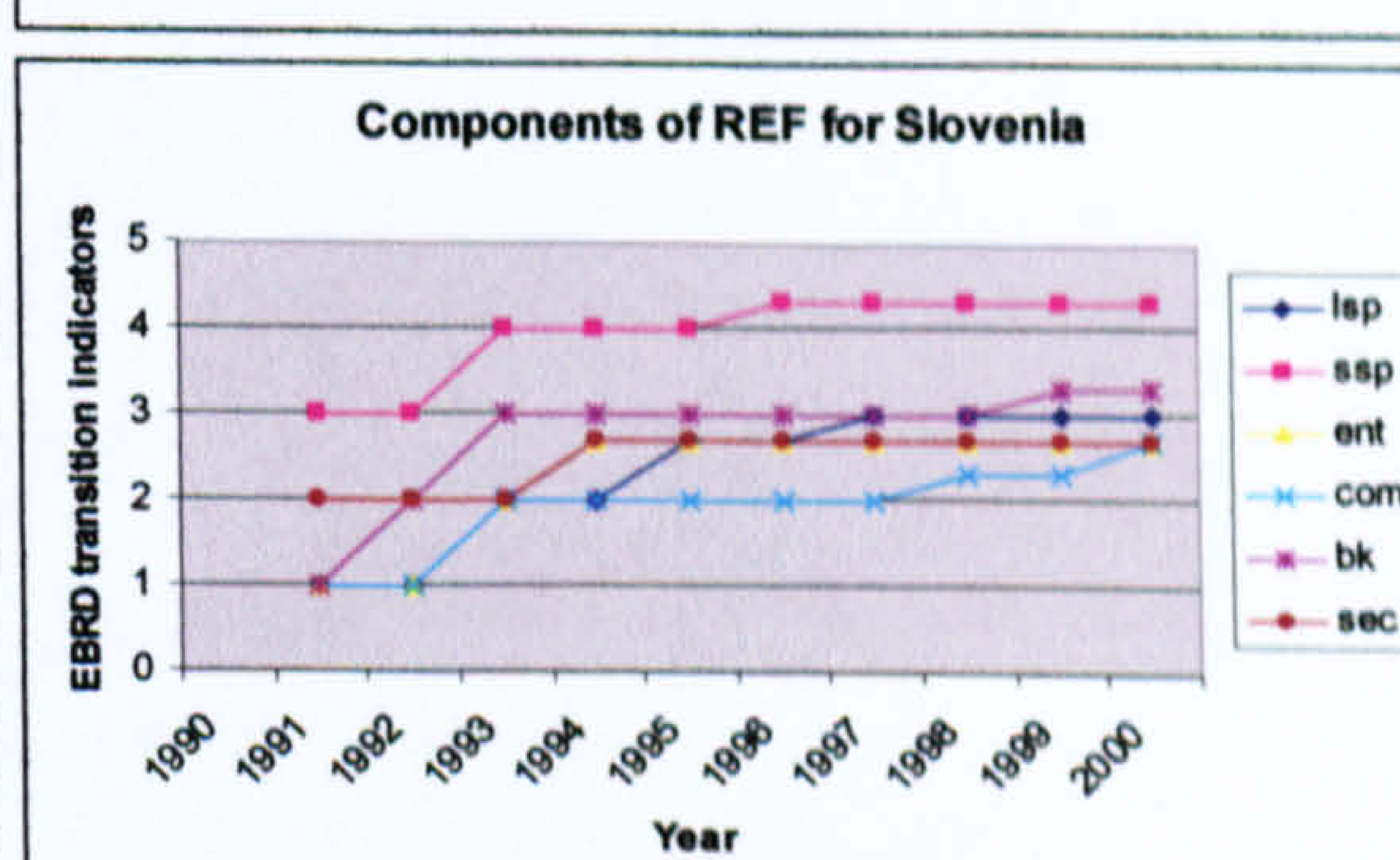












Appendix 7C
Correlation matrix for listed variables

	CEFTA	BSEC	COMBRD	INIT	GOV	REF	LNAVER	AVIS
CEFTA	1.00000	-.24160	.70175	.63294	.05340	.65920	.57286	.30592
BSEC	-.24160	1.00000	-.59874	-.06286	-.21938	-.58758	-.56915	-.27088
COMBRD	.70175	-.59874	1.00000	.76998	.05340	.57505	.72354	.30592
INIT	.63294	-.06286	.76998	1.00000	-.08748	.21248	.45158	.16366
GOV	.05340	-.21938	.05340	-.08748	1.00000	.22236	.25278	.13340
REF	.65920	-.58758	.57505	.21248	.22236	1.00000	.65736	.51617
LNAVER	.57286	-.56915	.72354	.45158	.25278	.65736	1.00000	.47278
AVIS	.30592	-.27088	.30592	.16366	.13340	.51617	.47278	1.00000

	CEFTA	BSEC	COMBRD	INIT	GOV	REF	LNAVER	AVIS
HELSINKI	.19089	.23112	-.09756	.02676	.00223	.01798	-.11698	-.10939
AIDCAP	.02798	-.29724	.01697	-.27674	-.16165	.26673	.15320	.14436
BALK	-.27518	.95907	-.62429	-.06064	-.26294	-.66865	-.62771	-.28244
ASOC	.46648	.03205	.27148	.24928	.01605	.54652	.25212	.32867
AVIS	.25963	-.20778	.25963	.15728	.09577	.40759	.39101	.76706
LNFDI	.59941	-.27405	.54213	.34853	.08175	.64608	.37316	.37889
LNGDP	.63570	-.09775	.67622	.60220	-.15445	.35920	.36137	.27293
LNLAGFDI	.64744	-.24682	.58117	.39279	.11445	.69142	.46173	.38190

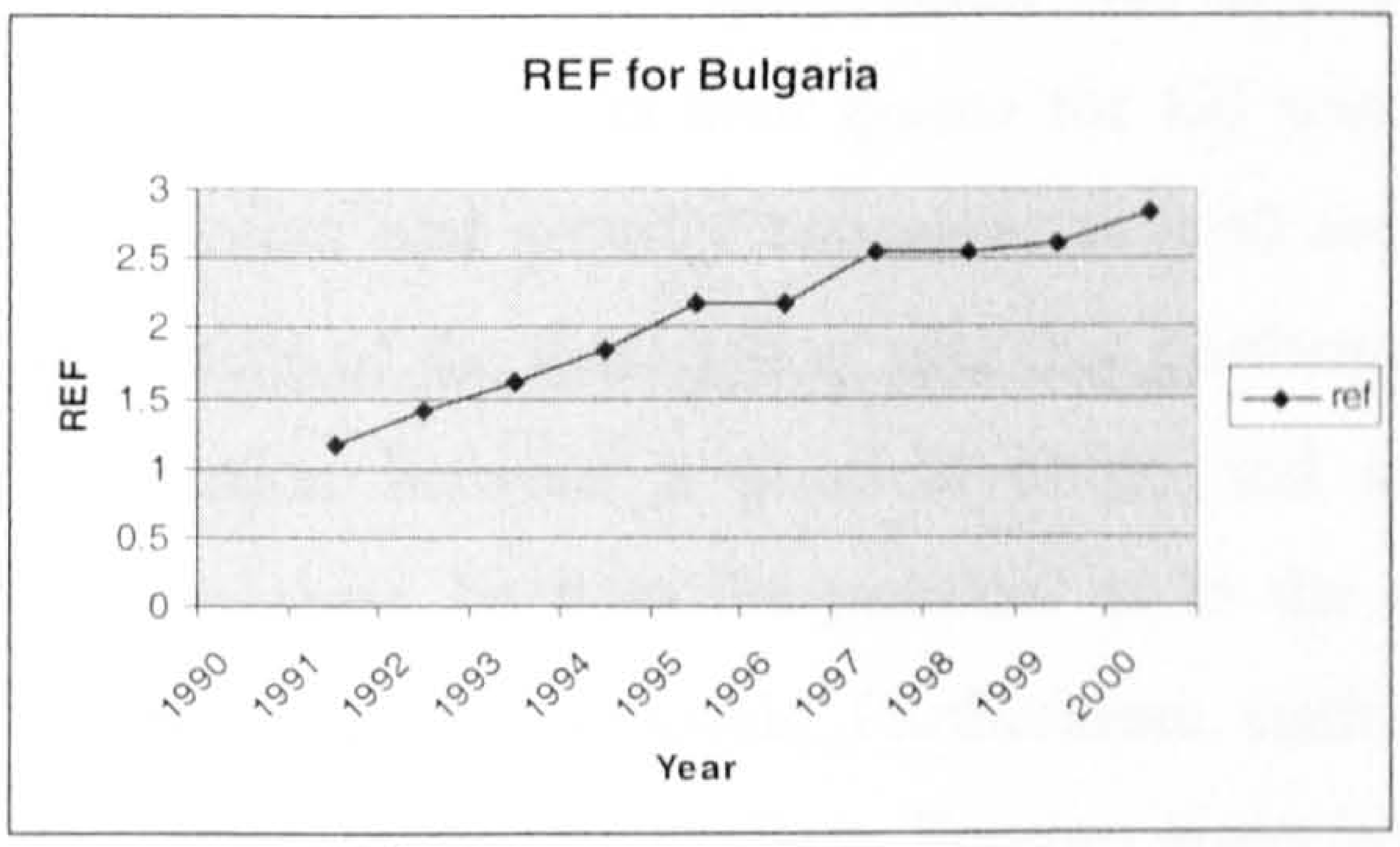
	HELSINKI	AIDCAP	BALK	ASOC	AVIS	LNFDI	LNGDP	LNLAGFDI
HELSINKI	.15485	.21848	.13868	-.08391	.04222	-.01606	.11851	
AIDCAP	.15485	1.00000	-.26492	.14451	.12799	.17816	-.02174	.07189
BALK	.21848	-.26492	1.00000	-.02238	-.21665	-.32260	-.12022	-.34434
ASOC	.13868	.14451	-.02238	1.00000	.25211	.61201	.46239	.60464
AVIS	-.08391	.12799	-.21665	.25211	1.00000	.33693	.24939	.33695
LNFDI	.04222	.17816	-.32260	.61201	.33693	1.00000	.76653	.90941
LNGDP	-.01606	-.02174	-.12022	.46239	.24939	.76653	1.00000	.75050
LNLAGFDI	.11851	.07189	-.34434	.60464	.33695	.90941	.75050	1.00000

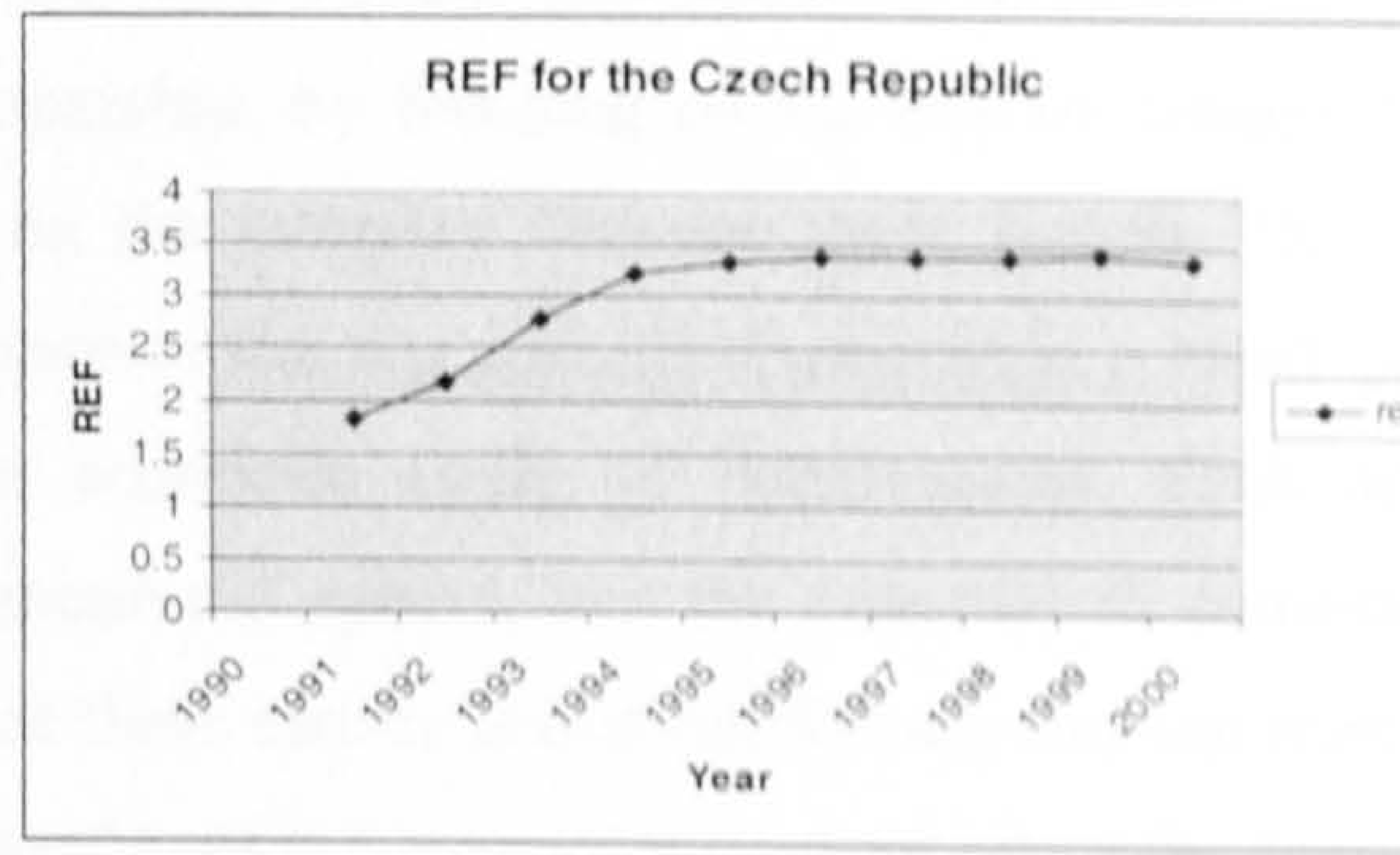
	CEFTA	BSEC	COMBRD	INIT	GOV	REF	LNAVER	AVIS
STAB	-.06506	.11302	-.20200	-.39023	-.05740	-.00694	-.20126	-.02923
VISE	.57543	-.48695	.81330	.59033	-.09453	.53452	.30423	.19115
IMPEU	.41396	-.37883	.50985	.23641	.17469	.40759	.55543	.29429
EXPEU	.08324	-.44786	.11375	-.23992	.33931	.48241	.36695	.31406
TRADEU	.25572	-.47790	.32233	-.04257	.30750	.51454	.51060	.34904

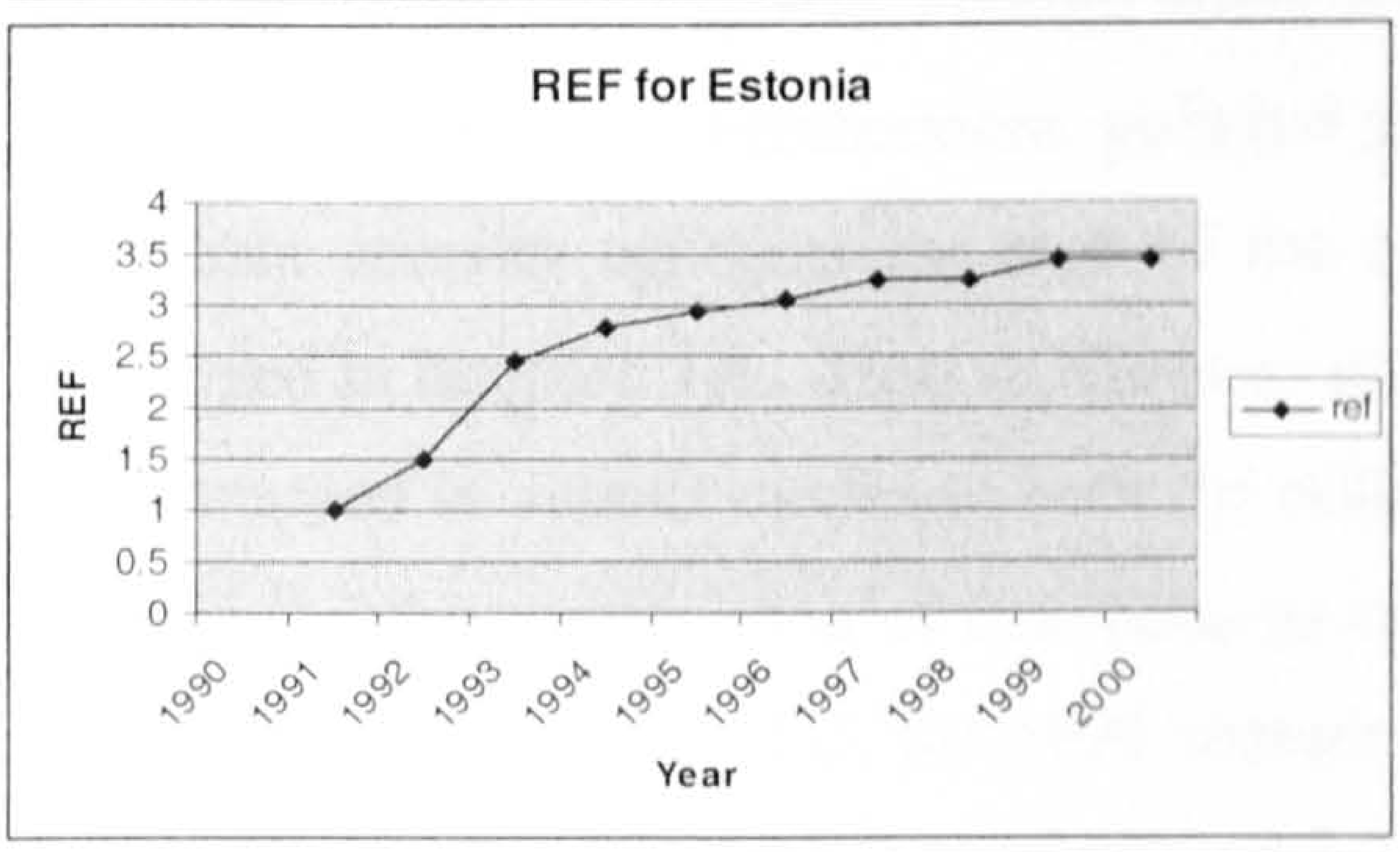
	HELSINKI	AIDCAP	BALK	ASOC	AVIS	LNFDI	LNGDP	LNLAGFDI
STAB	-.03007	.02218	.07383	.15124	-.01428	.30477	.32578	.26573
VISE	-.05286	.02856	-.50774	.39644	.16530	.68725	.72524	.67979
IMPEU	-.02435	.06824	-.43215	.01533	.27974	.46731	.45327	.51260
EXPEU	-.03096	.23181	-.51280	.14849	.22874	.37004	.02564	.38009
TRADEU	-.03214	.18525	-.54641	.10488	.28598	.46982	.23703	.49842

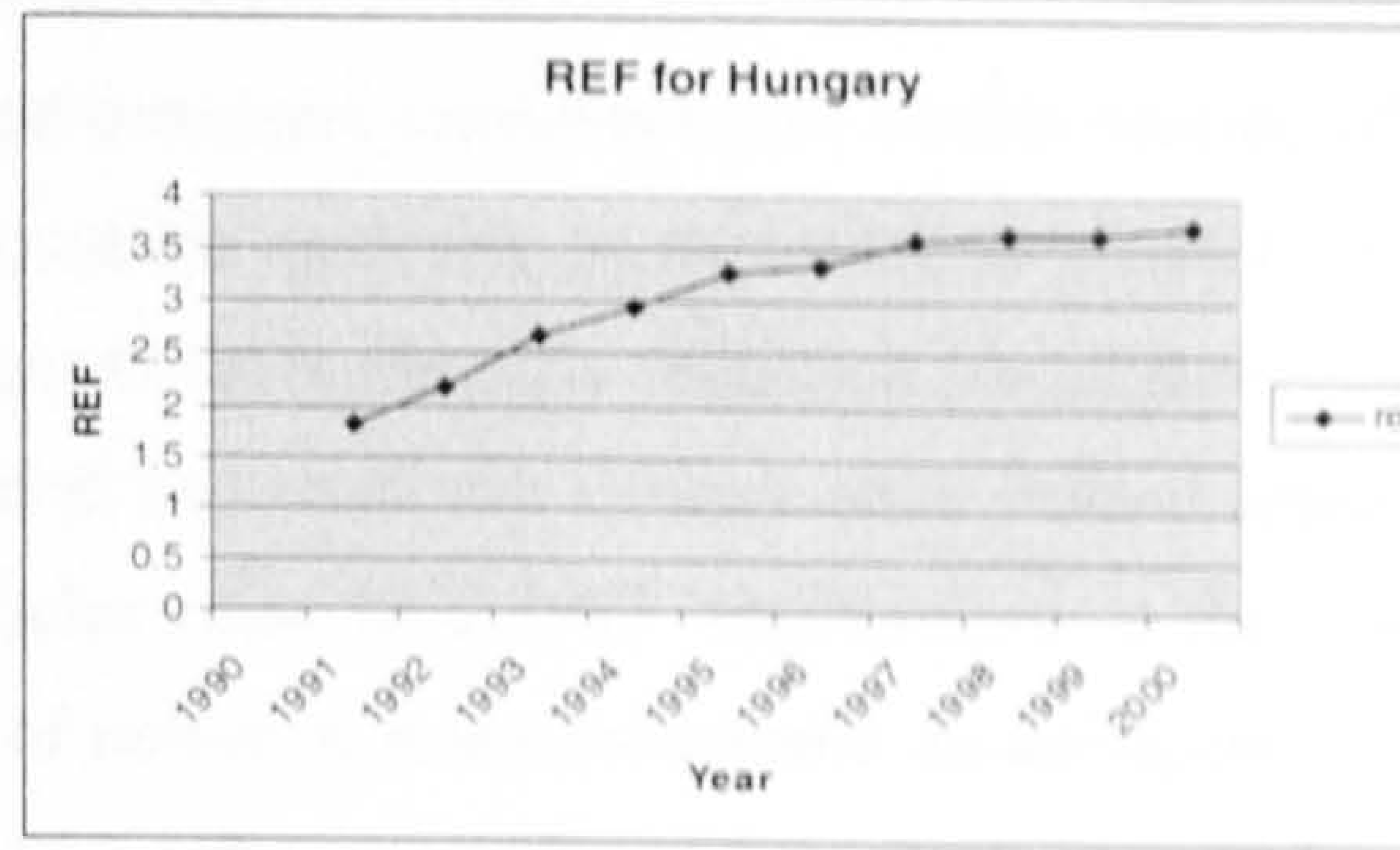
	STAB	VISE	IMPEU	EXPEU	TRADEU
STAB	1.00000	.03405	.10361	.19261	.17672
VISE	.03405	1.00000	.28241	.07632	.18727
IMPEU	.10361	.28241	1.00000	.52310	.82903
EXPEU	.19261	.07632	.52310	1.00000	.91026
TRADEU	.17672	.18727	.82903	.91026	1.00000

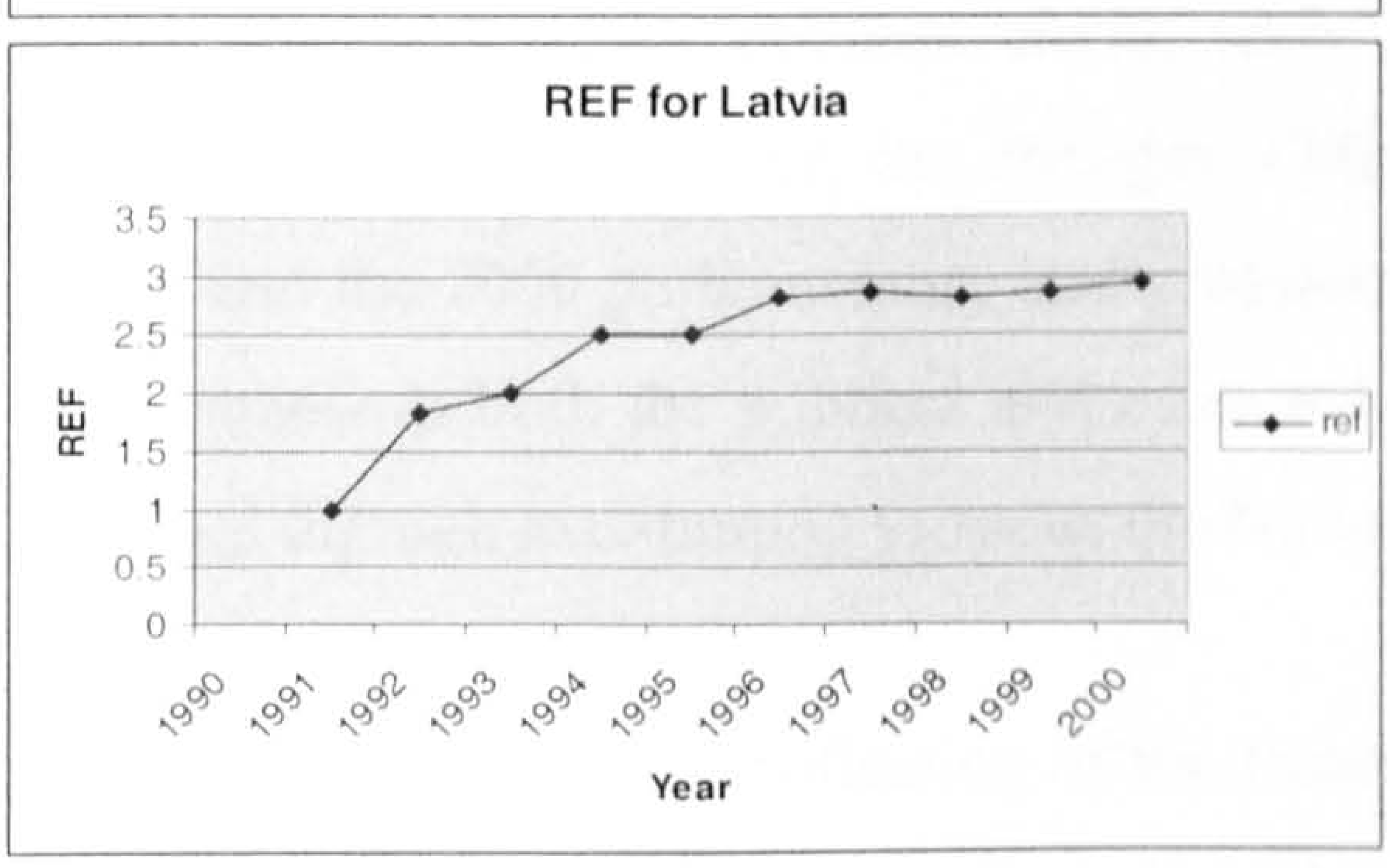
Appendix 7D
Trends in the economic reform indicator (REF)

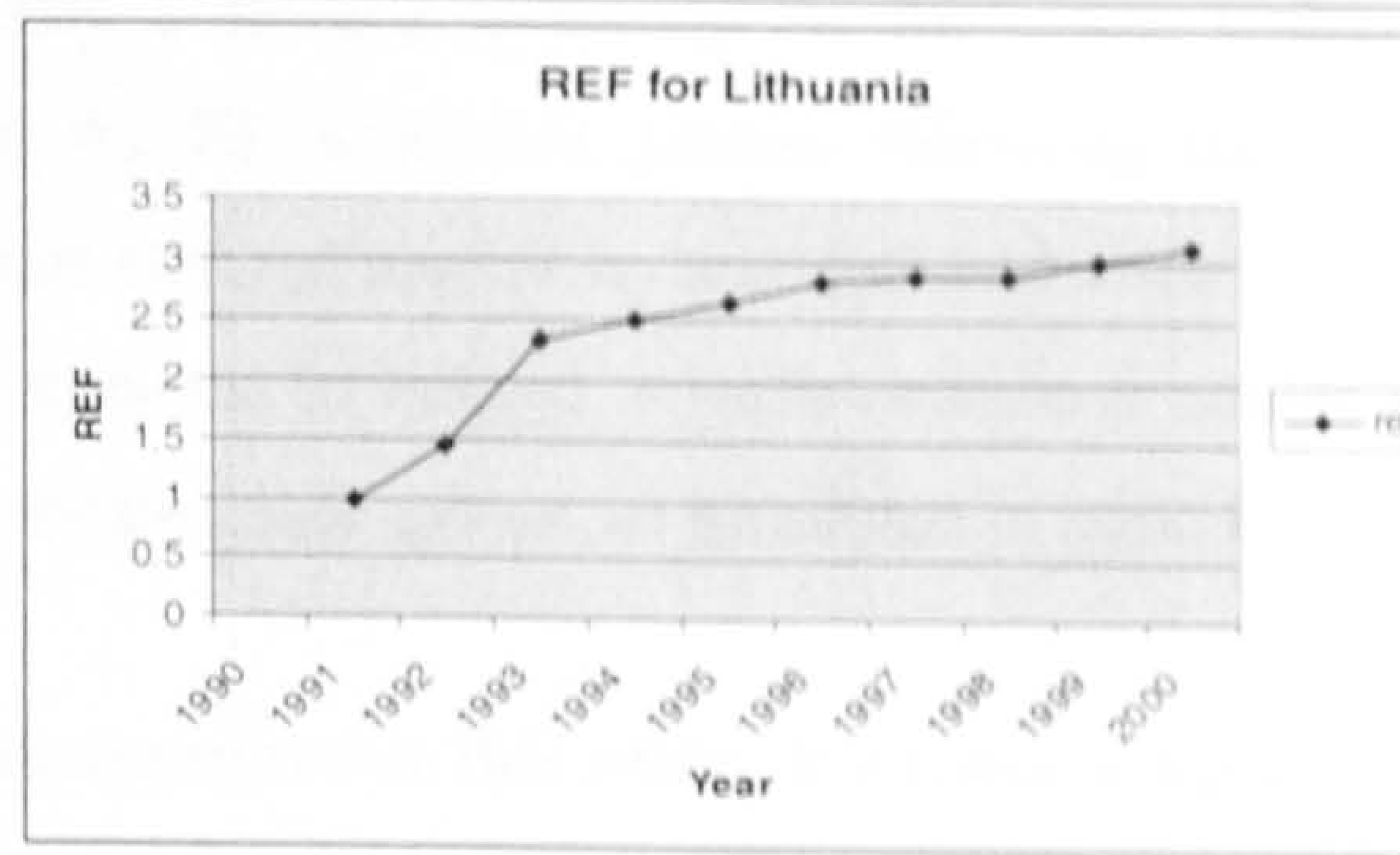


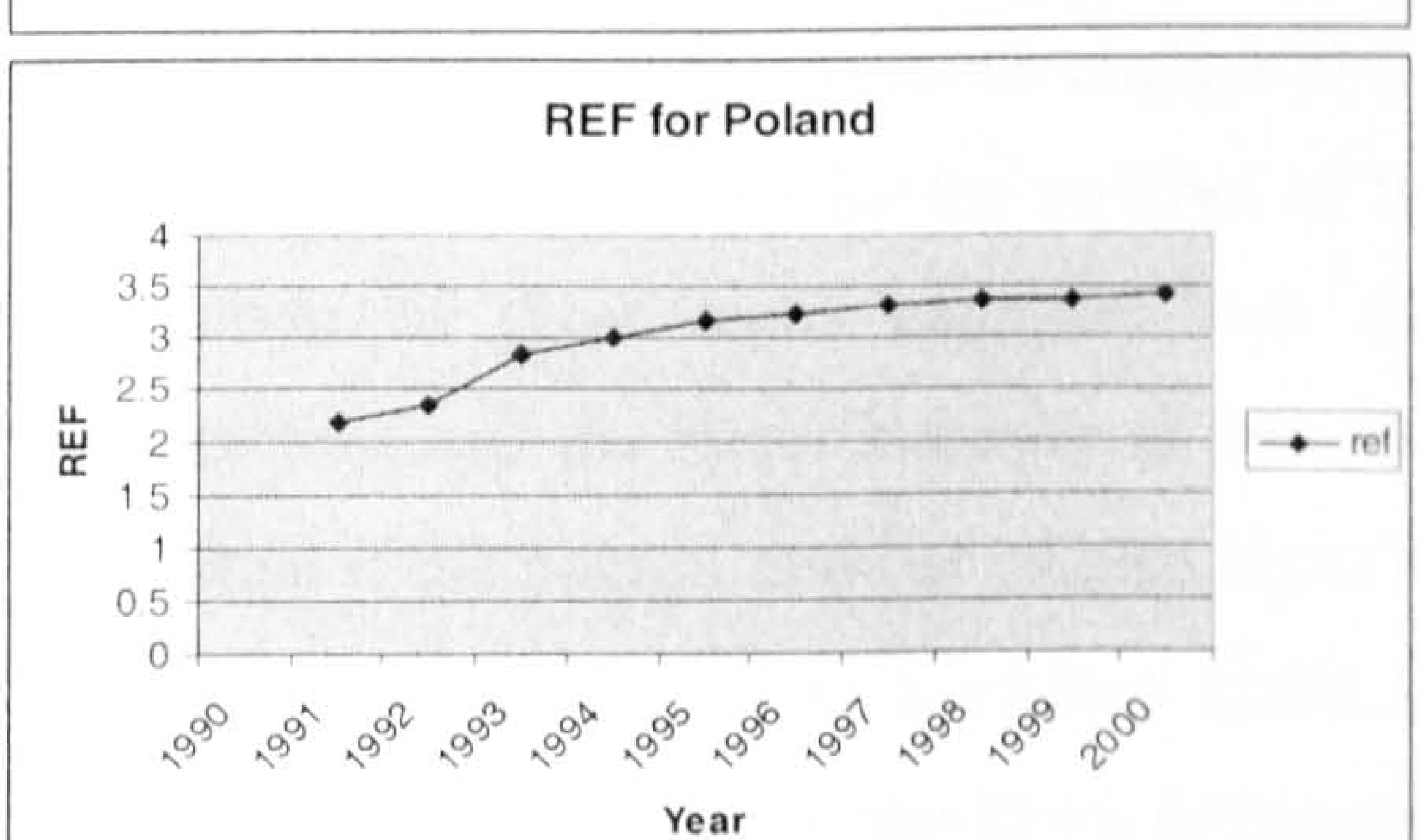


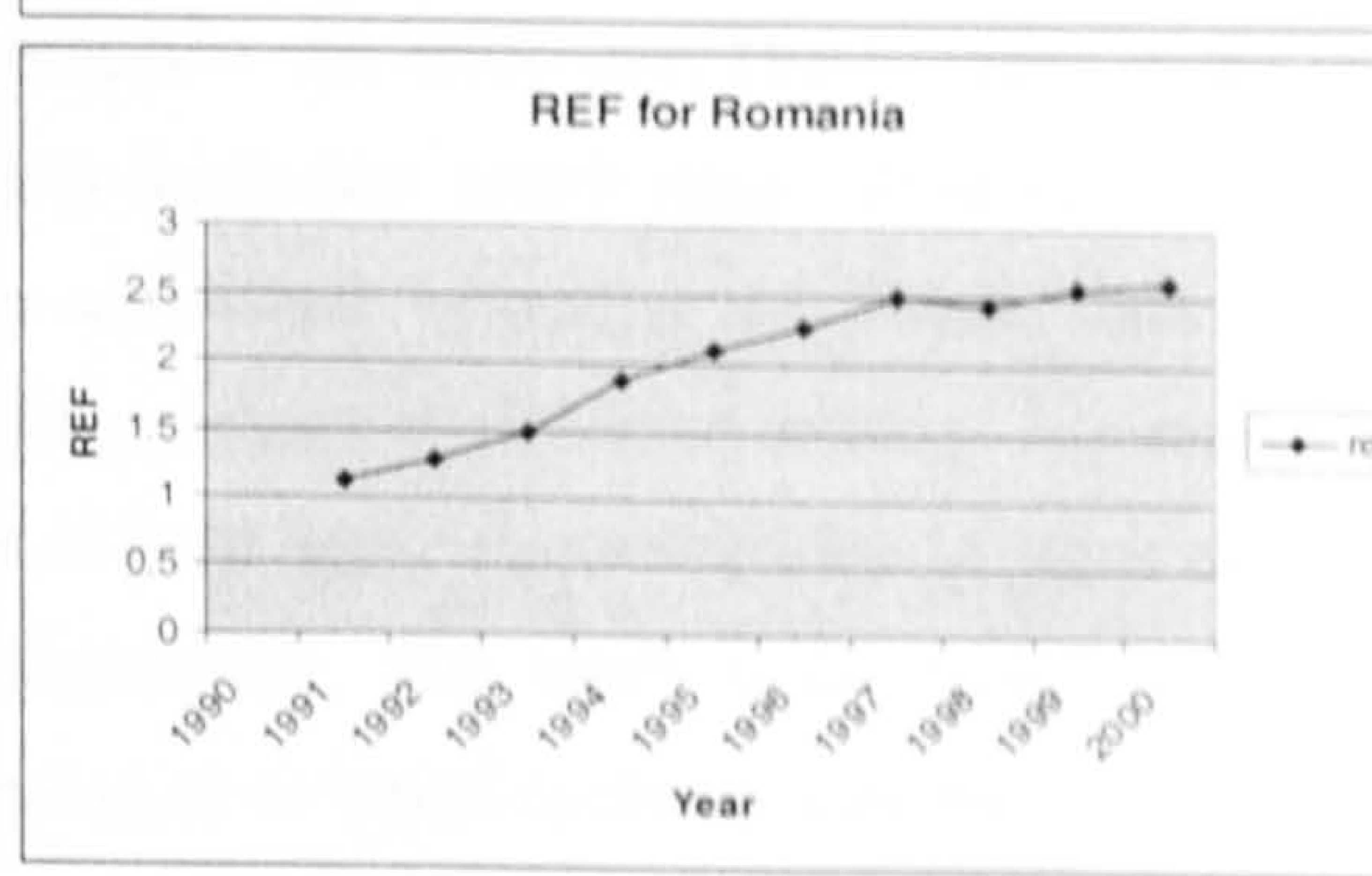


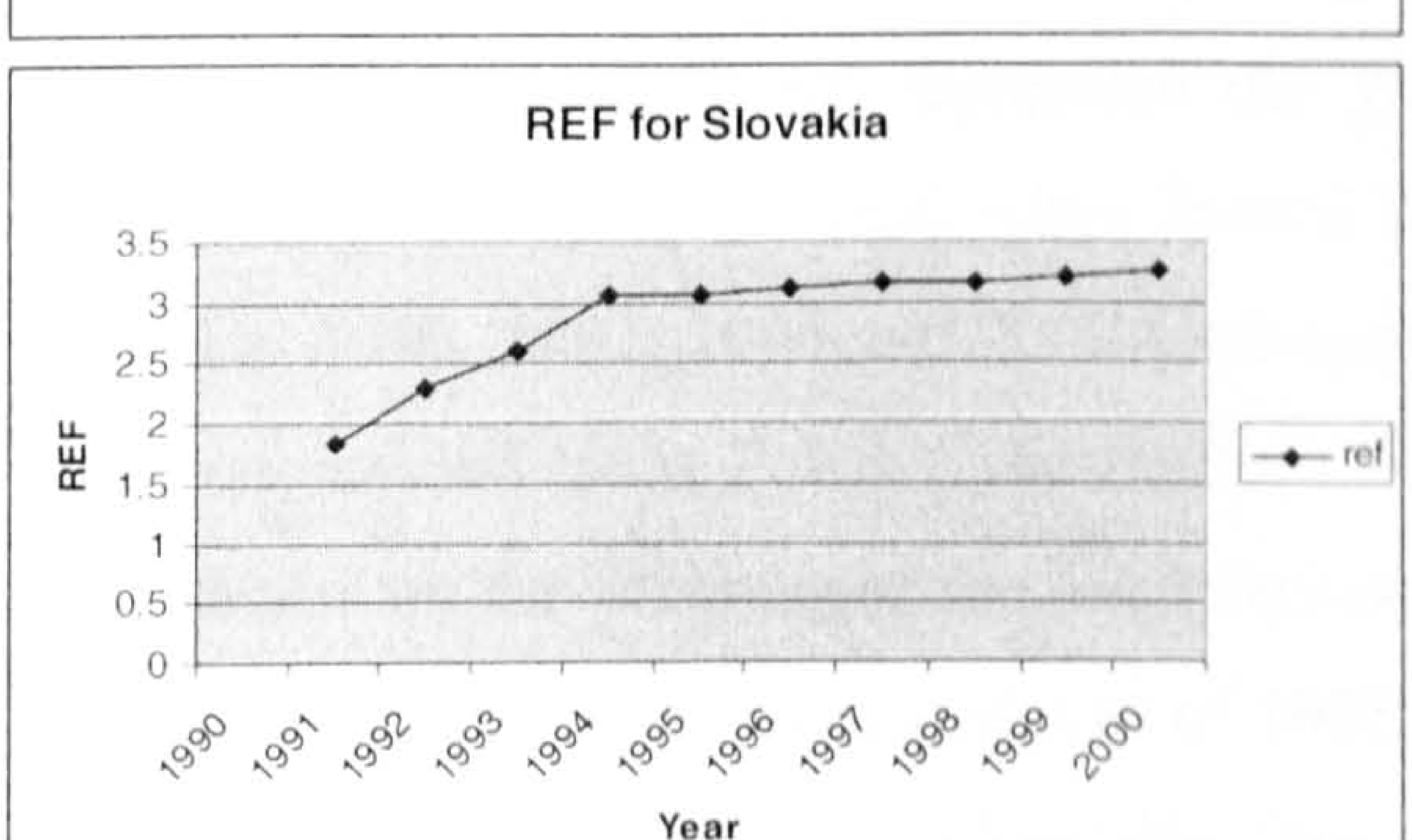


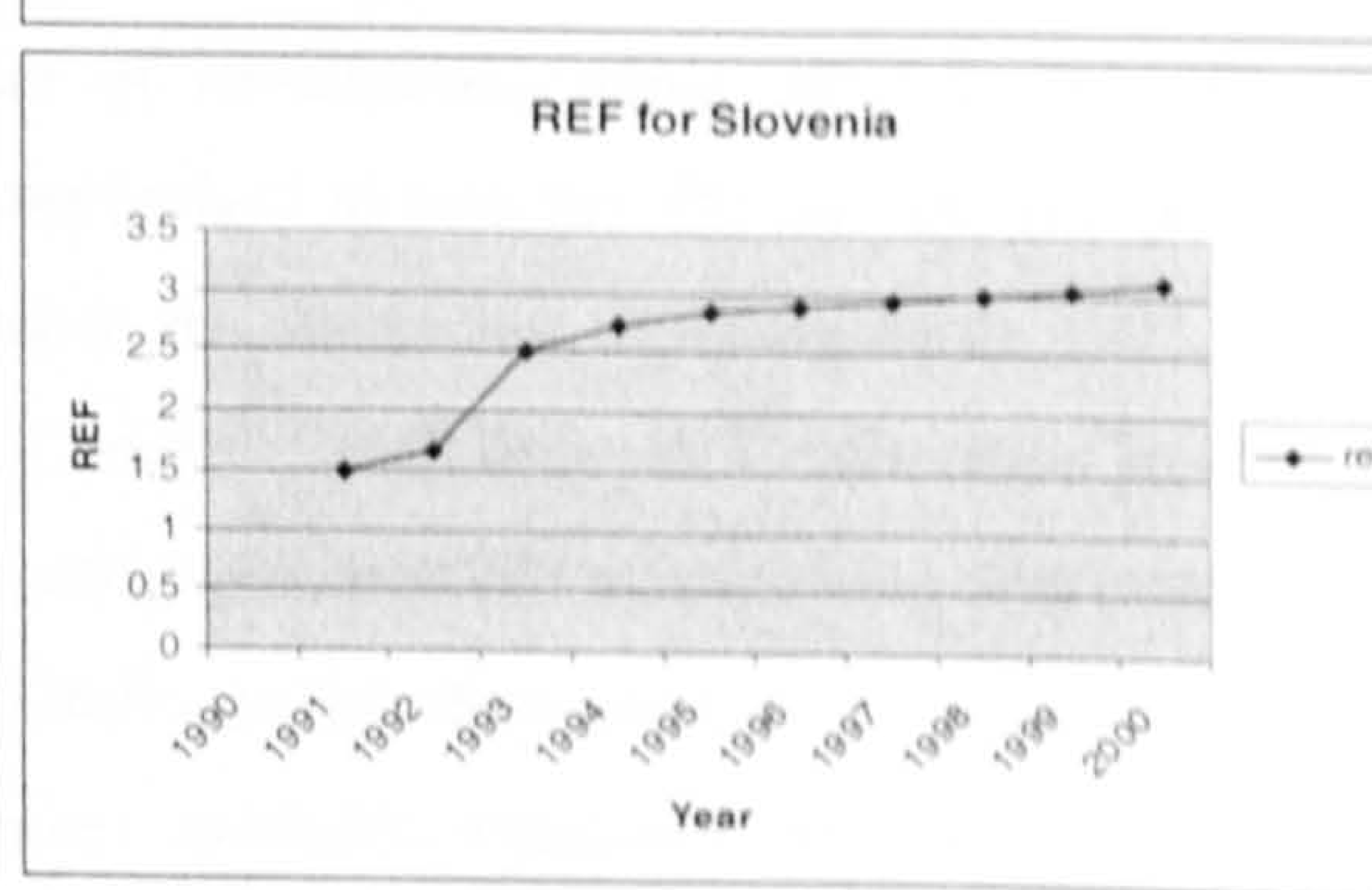












8. Conclusion

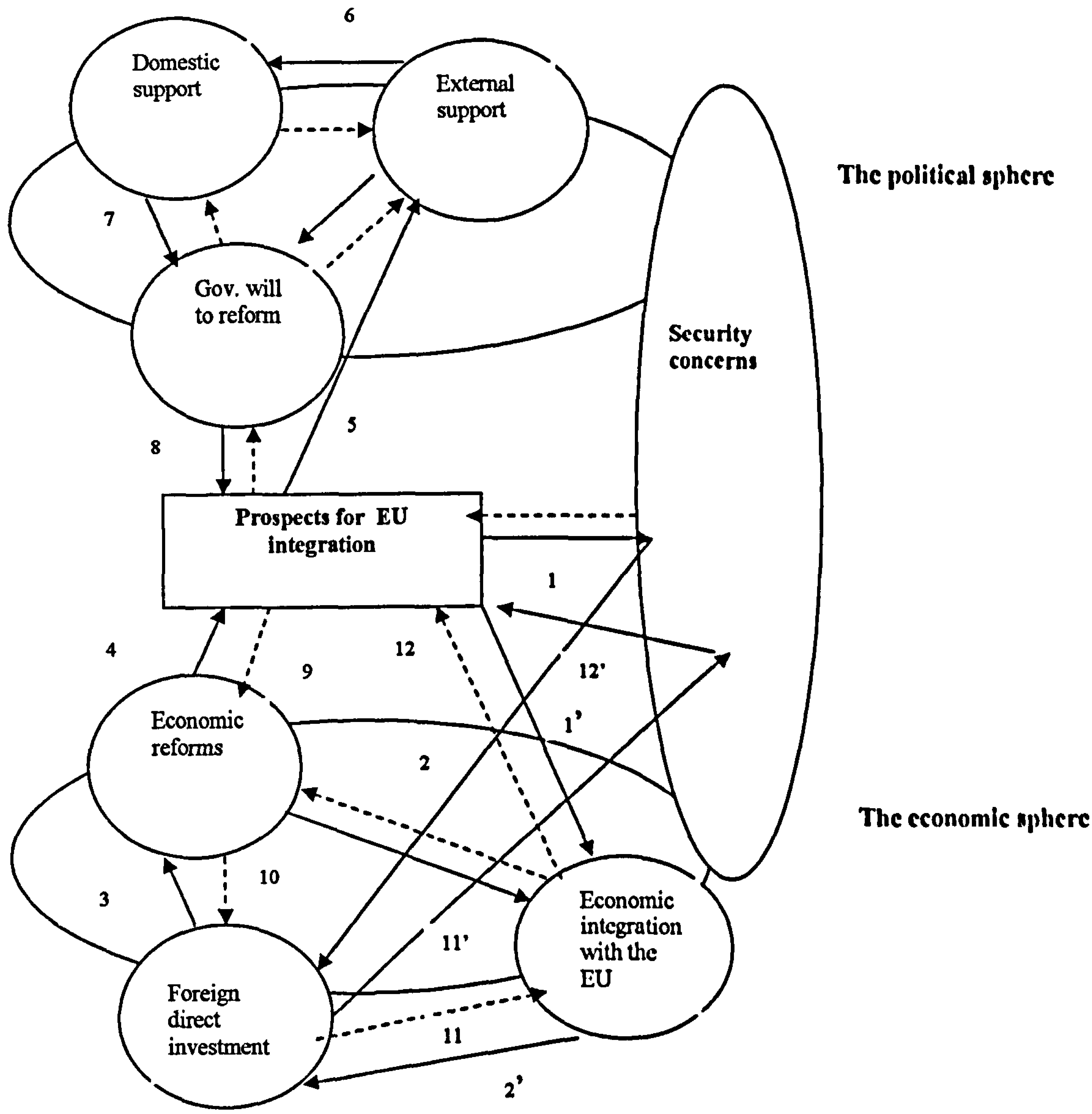
The main aim of this dissertation was to explain why Poland and Romania have had different evolutionary paths in their quests for EU membership, by focusing on the role of foreign direct investment and security concerns, as well as on the interplay between these factors. The main argument of the dissertation was that performance in the EU accession process is a result of the interaction between a political circle and an economic circle of determinants. Each set of determinants, be it in the political or in the economic sphere, has the potential to constitute a vicious or a virtuous circle. Furthermore, each of these circles is self-reinforcing and can reinforce the circle in the other sphere. Foreign direct investment is a necessary component of the economic circle of determinants. Furthermore, political and economic elements of the circles considered can constitute security concerns for each of the countries analysed, as discussed in chapter six and suggested in diagram 1A. Thus, it has been argued that in the early transition period Romania has been trapped in vicious circles in both the political and economic spheres while Poland appears to have enjoyed a combination of two virtuous circles since 1992/1993. Furthermore, in the absence of full support from the EU, the 1996 change of power in Romania created an ambiguous circle, rather than a virtuous political circle, with only a limited influence on the circle within the economic sphere. However, the changes within the EU accession process following the Kosovo crisis and the 2000 parliamentary and presidential election appear to have induced virtuous circles in Romania in both the political and economic spheres. In Poland, vicious economic circles were avoided through maintaining virtuous circles in the political sphere, as presented in table 8.1.

Table 8.1 presents a quantification of the factors examined in this study. It attributes a plus sign if they contribute towards a virtuous circle and a negative one otherwise. The intensity of the impact of each factor is reflected by the number of signs attributed, which ranges from one to five. The attribution of these signs captures both the individual evolution of Poland and Romania respectively, and the factor intensity in one country relative to the other country. A virtuous circle is created if the overall number of plus signs is at least eight. A combination of signs can lead to either an ambiguous, or to a vicious circle respectively. The years in the tables represent the beginning of four periods considered, corresponding to electoral cycles and events in the accession process. The starting point represents the year of revolutions, while 2002 is the year of the Copenhagen European Council when Poland was invited to join the EU and the end point of this analysis. 1990, 1992, 1996 and 2000 correspond to the Romanian elections while 1993, 1997 and 2001 correspond to the Polish ones. Furthermore, in 1997 the European Commission has presented its Opinion on the progress of the candidate countries towards EU membership and invited five of them to start accession negotiations as of 1998. 2000, on the other hand, is the year when Romania started accession negotiations alongside four other candidate countries, previously known as the 'second wave' countries. The assessments within each column of the table refer to the trends initiated by the events of the beginning of each period.

Insert table 8.1

Diagram 8A[1]

The role of security and EU integration factors in enhancing virtuous circles in the economic and political spheres



a) Arrows 1,2,3,4 and 1,2,11,12 indicate two alternative virtuous circles in the economic sphere induced by prospects of EU membership.

b) Arrows 1 to 4 and 5 to 8 show how through political decisions on the enlargement process, prospects of EU membership can create a virtuous economic circle that induces in turn a virtuous political circle as well.

c) Arrows 9 to 12 indicate a virtuous economic circle induced by a virtuous political circle through its impact on prospects of EU membership.

d) Arrows 1',2',3 and 4 show a virtuous circle in the economic sphere induced by the effects of the prospect of EU membership on economic integration with the EU.

[1] This diagram is based on diagram 1B presented in chapter one.

The hypothesis of reinforcing political and economic circles was tested empirically with respect to foreign direct investment in order to suggest a means of turning a pair of vicious circles into a pair of virtuous ones. Several questions have directed the inquiry:

a) What were the general factors that have affected Poland and Romania's accession to the European Union? Is there evidence of increasing economic integration between Poland and the EU and Romania and the EU? Can institutional integration enhance economic integration?

b) Which factors have determined the path towards, and the results of, transition to a market economy in Poland and Romania?

c) What are the main determinants of foreign direct investment in Poland and Romania? Is there evidence of impact of foreign direct investment in Poland and Romania ?

d) What are the main security concerns for Poland and Romania and how did they affect the prospects of EU membership? And how did prospects of EU membership affect security concerns in Poland and Romania?

e) What is the impact of security and European integration factors on FDI? S it possible for the prospects for EU membership and economic integration with the EU break the vicious economic circle in which Romania has been trapped for most of the transition period?

Using the tools presented in chapter one for analysing the object of the empirical inquiry, a number of conclusions have been drawn relating to each of the above questions. These findings are presented below with reference to diagram 8A and table 8.1. Furthermore, policy recommendations are offered while reviewing these findings.

8.1 The quest for EU membership: an institutional and an economic perspective

When discussing the factors that have influenced Romania's and Poland's quests for EU membership, it is important to distinguish between institutional and economic integration and to acknowledge the bi-directional relationship between them. It has been argued that institutional integration between Poland and Romania, on the one hand, and the EU, on the other, appears to depend on several factors and their interaction: the EU's attitude towards enlargement, Poland and Romania's attitude towards EU accession, progress of transition to a market economy and finally, internal and external security concerns. The first two factors are part of the political circle of determinants analysed in detail in chapter three. The remaining two factors were analysed in depth in chapters four and six. Furthermore, it has been shown that this bi-directional relationship is one of the ways through which the two circles considered in this study interact with each other. Thus, evidence has been given that institutional integration with the EU has led to increasing economic integration in terms of both trade (chapter three) and foreign investment (chapter seven.) Furthermore, it has been argued that economic integration enhances the prospects for EU membership, hence institutional integration with the EU. Thus, it has been shown that foreign direct investment- an element of factor markets integration identified in chapter three- is a necessary means of privatisation (chapter five) and contributes to economic reforms in general (chapter seven). In turn, economic reforms are a necessary prerequisite for institutional integration with the EU, as shown in chapter three.

The analysis of the factors which have influenced Poland and Romania's institutional integration with the EU has identified several vicious and virtuous political circles during the first decade of transition. These have depended on the relative influence of each of these factors, as well as on the interaction between them. Regarding the first factor in the political sphere, the EU's early discriminatory attitude towards Romania created the conditions for vicious circles in both the political and economic sphere. Furthermore, the EU's early positive attitude towards Poland, a member of the Visegrad group, contributed towards creating both political and economic virtuous circles of determinants of the accession process. However, as the focus switched from economic determinants of expansion towards security determinants, creating what a Polish analyst has called a 'healthy', rather than a 'wealthy' approach to enlargement, Romania's prospects of EU membership have been enhanced. Security concerns have increasingly constituted the 'engine' of enlargement, despite poor internal reforms acting as 'brakes'. Thus, security concerns raised by the Kosovo crisis triggered the launch of accession negotiations with Romania and with other remaining candidates, previously considered not yet ready from an economic point of view for this new phase of institutional integration with the EU. By launching the accession negotiations and by creating positive perceptions of security in Romania, the Helsinki European Council has contributed towards the creation of virtuous circles in Romania in both the economic and the political sphere. The quantitative analysis conducted in chapter seven was consistent with this argument. Furthermore, in 2000 the EU's warnings for Poland regarding the slowness of reforms, accession negotiations and implementation of the *acquis communautaire* prevented virtuous economic and political circles from turning into vicious ones, as represented in table 8.1.

Second, a main distinguishing factor in Poland and Romania's progress in accession was each country's governments' attitude towards EU membership. Poland adopted a proactive attitude from the beginning and, despite some loss of momentum during the 1997-2000 governments, Poland projected a strong will to join the EU as soon as possible. The bold Polish attitude was based not only on an early radical approach to economic reforms and on the external credibility gained, but also with the knowledge that Poland's accession to the EU was strongly supported by Germany, for both economic and security reasons. Romania, on the other hand, lacked a coherent strategy for accession for most of the transition period and has had a reactive attitude, avoiding exclusion rather than seeking inclusion. This attitude was accompanied by a hesitant approach to economic reforms, which resulted in low external credibility and in an inability to use fully the diplomatic support given by members of the EU such as France. Overall, a pro-active official attitude, a coherent accession strategy and efforts to enhance the lobby within the EU member states are crucial elements of a positive attitude of a candidate state able to contribute towards the creation of a virtuous political circle.

A crucial determinant of EU accession has been each country's compliance with the Copenhagen criteria and especially the progress of transition to a market economy. Poland's compliance with the Copenhagen criteria, including a good record of economic reforms, was the basis for the Commission's recommendation to open accession negotiations in 1998, as with other 'first wave' candidates. Success in economic reforms became part of a virtuous circle in the economic sphere since 1993, as represented in table 8.1. On the other hand, Romania's poor record of economic reforms by 1997 was reflected in the Avis and in the European Commission's decision to place it amongst the 'second wave' candidates, which would not open accession negotiations at that stage. This poor record of economic reforms was part of the vicious circle in the economic sphere until 1996, as represented in table 8.1. Reforms implemented by the post-1996 governments created conditions for improving the prospects in the economic sphere and the achievement of a full virtuous economic circle starting in 2000. Failure to become a market economy so far has delayed Romania's accession until most likely 2007, while Poland's market economy status has contributed to Poland's accession to the EU in May 2004. The factors leading to the different paths in transition towards market economy were investigated in chapter four and the conclusions drawn will be presented in the following section of this chapter. All in all, no candidate country should underestimate the importance of meeting the Copenhagen criteria for a successful accession to the EU.

Finally, security concerns have played an increasing role within the 'healthy' approach to enlargement. When economics acted as a brake, security acted as the engine of the enlargement process, as discussed in chapter three. Thus, Germany's strategic interest in Poland's accession to the EU was the drive of a generally positive EU attitude towards Poland for most of the decade, thus contributing towards creating a virtuous political circle. Enlargement without Poland in the first wave seemed inconceivable. When by 2000 Poland fell behind other candidate countries in terms of internal reforms and accession negotiations, the EU was ready to postpone the entire enlargement process to allow Poland to catch up. This virtuous political circle avoided the creation of a vicious circle in the economic sphere for Poland. On the other hand, Romania's closeness to the Balkans, the 'powder keg' of Europe, appears to have affected negatively its prospects of EU membership by leading to a hesitant attitude of the EU, especially in the early 1990s. Negative perceptions of security in the early 1990s reinforced the vicious circles in the political and economic spheres. While the support offered by France did not have the substance of Germany's backing of Poland, the Kosovo crisis became a catalyst for Romania's accession to the EU through the security concerns posed. The Helsinki European Council de-securitised these concerns and created positive perceptions of security for Romania by launching the accession negotiations. The focus has changed from security, as a condition for the enlargement process, to security as a result of it, as discussed in chapter six. This point is consistent with the evidence that Poland and

Romania have already benefited largely from the accession process in terms of trade, hence the additional benefits of EU membership in security terms and further foreign direct investment, *inter alia*, as discussed in chapter three.

8.2 Transition to a market economy: the interplay between the political and economic spheres

Given that the achievement of a market economy is a necessary condition for EU membership, it is necessary to investigate the main factors that have determined the path and results of economic transition in Poland and Romania. It has been argued that performance in economic transition was dependent on the interaction between governments' attitude towards reform, domestic support, international backing for reforms, policy mix (or the economic reforms implemented) and initial conditions of transition. The first three factors represent the political circle of determinants of transition and accession to the EU, while the fourth is part of the economic circle. The initial conditions have been included in order to test the hypothesis of path dependency and of self-reinforcing circles in both the economic and the political spheres.

The analysis has shown that the initial conditions of transition were more influential than initially expected. Although purely economic conditions have proven not to be significant for either reforms or FDI (chapter seven), a simple economic account of the initial conditions is not sufficient, as shown in chapter four. Instead, differences in the state of the economy and of the nation, as well as differences in the institutional framework should be considered. It has been shown that the interplay between the initial conditions and other elements of the political and economic circles has created the premise for a faster economic transition in Poland than in Romania. In Poland these interactions led to a economic virtuous circle as soon as 1993, while Romania only entered one in 2000, as shown in table 8.1. Not only did they create a certain gap between the two countries, but they had a strong impact on the scope and pace of the early economic reforms. These accentuated even further the differences, thus enhancing the path dependency. Furthermore, the initial conditions determined largely the level of domestic support for economic reforms and the governments' attitude towards embarking on either a bold or a gradual reform programme. In addition, the choice of a particular approach to economic reforms influenced the degree of international backing which had in turn the potential to sustain the pace and scope of economic reforms. All in all, any assessment of economic transition in the CEECs has to be aware of the potential for path dependency and hence take into consideration the initial conditions of the transition.

Second, governments' attitude towards reforms was a crucial determinant of the path and results of the economic transition. It affected greatly not only the policy mix, but also the international support for a successful economic transition of the country. Governments' attitude towards reforms depended on previous exposure to democratic procedures and market thinking, on prior attempts to reform the system and on the emergence of a new political class devoted to promoting democracy and market economy. Domestic and international support also impacted upon governments' readiness to reform. Prior experience of both economic and political reforms made the Polish society more open, more susceptible to change and gave the newly emerged 1989 democratic government a relatively clearer understanding of the aims and means of economic transition. Furthermore, the change of power at the beginning of transition facilitated the implementation of an IMF supported reform package which ensured external credibility of both government and economic reforms. Poland therefore made full use of the early window of opportunity of 1989 by showing strong commitment to a market economy, regardless of the cost for the population or the governments in power. Early commitment to bold reforms created a virtuous political circle which was able to influence the economic sphere, contributing to the creation of a full virtuous economic circle by 1993. The economic circle then reinforced the political cirlce, despite the post-communists' election into power in 1993. In 1997, the AWS' election reinforced the commitment to reforms and the virtuous political circle that had been created was able to enhance a virtuous economic circle of development. Slowness in FDI and in economic reforms in 2000 did not create vicious economic and political circles, given the 'carrot and stick' role of the EU accession process, as shown in table 8.1.

On the other hand, Romania's lack of political and economic reforms prior to 1989 led to a relatively poor vision of the priorities and aims of economic transition. It also led to a very slow formation of a new political class that could commit firmly to radical changes. As a result, the 1989 window of opportunity was lost through the rise of post-communists to power, thus further diminishing internal and international support for economic reforms. These developments contributed towards the creation of a vicious political circle which set Romania on a vicious economic circle as well. The two vicious circles have persisted until 1996, when a new window of opportunity was partially lost. Despite international and domestic support for reforms, the government infighting affected the scope and pace of economic reforms, thus negatively influencing Romania's prospects for EU membership. Elements of virtuous circles emerged, however, without the power to create a full virtuous political circle or a full virtuous economic circle. Increased foreign direct investment induced by FDI related policies since 1998 and economic reforms applied in 2000 by the newly elected government, following the EU's renewed commitment for Romania's accession, appear to have been part of a virtuous circle in the economic sphere. These were discussed in chapters four and seven and represented in table 8.1. All in all, it proved best for governments needed to and should use windows of opportunity such as elections to apply necessary, but potential unpopular policies. Continuity of economic reforms should also be ensured by maintaining the cohesion of the government.

The analysis has also shown that popular support for economic reforms has been rather volatile and has acted both as a catalyst for as well as a brake on change. Popular support has impacted upon the external credibility and international support for the government (chapter four), as well as on perceptions of security of each candidate country, as discussed in chapter six. Furthermore, the high cost imposed by economic reforms on population in general, and on some categories in particular, have led towards a certain 'fatigue' with transition. This can have a negative impact on future election results and hence on future governments' readiness to reform. This is consistent with the quantitative analysis conducted in chapter seven. Furthermore, the increasing support for extremist parties shown in the 2000/2001 election in both Poland and Romania warned of the limitations of applying economic reforms at any cost. It also suggested that governments should ensure higher popular support through growth promoting policies, ensuring safety nets for the population and by providing prospects of long terms benefits associated with EU membership. This may diminish the danger of internal instability and contribute to enhancing the political circle of determinants of transition and integration into the EU. The danger of loss of support for a market economy as a result of economic reforms suggests, *inter alia,* the need for an assessment of the impact that foreign direct investment has had on the standards of living, as in chapter five.

Fourth, the path and results of economic transition in both Poland and Romania have depended greatly on the support given by international organisations, and especially on the process of accession to the EU. The international financial institutions offered humanitarian aid, macroeconomic multilateral financing, financial and technical assistance for privatisation or for the establishment of safety nets necessary in order to attenuate the cost of transition. Furthermore, through the conditions set, the IMF standby agreements provided landmarks for economic reforms, ensured the continuity and credibility of the policy mix and triggered assistance from other IFIs. Landmarks for the economic reforms, technical and financial assistance were also offered through the EU accession process. Moreover, EU membership acted both as a 'carrot' and as a 'stick'. Progress in institutional integration with the EU encouraged governments in the candidate countries to apply at times unpopular reforms and rewarded the countries who did so. On the other hand, delays in accession resulted from hesitance to embark on bold reforms. Hence, fear of further delays determined some governments to implement real reforms. This contributed to the de-securitisation of the country, as discussed in chapter six. However, the effectiveness of the international support depended on each country's ability to meet the requirements set by the international organisations or to make full use of the assistance offered. Thus, by complying with the conditions set in the 1989 IMF standby agreement, Poland has ensured credibility of its reforms and further financial assistance leading to positive effects on performance in economic transition. Moreover, early compliance with the Copenhagen criteria enhanced the prospects for integration into the EU, which in turn constituted motivation for further economic reforms, as discussed in chapter seven. On the other hand, Romania's consistent failure to comply with the conditions set by the IMF standby agreements had a negative impact on the government's credibility, on the financial assistance offered and on the economic reforms as such (chapter four). Although difficulties in complying with the Copenhagen criteria led to delays in the accession process (chapter three), the financial assistance provided within the general framework of accession has the potential to contribute positively to the success of economic reforms, either directly, or by enhancing FDI, as seen in chapter seven.

Fifth, the path and the results of the economic transition have greatly depended on the reform measures applied. These were affected greatly by the determinants in the political sphere, as discussed in chapter four. Successful transition needs continuity, credibility and co-ordination of economic reforms. Contrary to the early opinions, transition supposes a combination of gradual and shock therapy reforms, rather than an exclusive option for one or the other. While liberalisation and stabilisation seem to benefit from a bold approach, privatisation is more likely to profit from a gradual approach, consistent with its large scope and significant social implications. It is also more likely that highly legitimised governments choose to implement bold reform programmes, based on high internal and international support. Furthermore, the state needs to redefine its role, rather than roll back completely. The governments should elaborate economic reform programmes based on the specifics of the country and consistent with the goals of achieving a market economy and integration into the EU, thus contributing towards a virtuous economic circle. Macroeconomic stabilisation and liberalisation measures have to be accompanied by deep restructuring, economic growth promotion and the provision of safety nets for the population, in order to ensure continuous support. Furthermore, industrial policies should enhance the comparative advantages of each economy in order to ensure its competitiveness and its successful integration into the world market, including the Single Market. Finally, the analysis has concluded that attracting foreign direct investment appears to be a prime necessity for the completion of privatisation and marketisation and subsequently for the accession into the EU, a key element of the Polish success in the quest for EU membership. Creating conditions for foreign investment needs to be continue to be a priority of the economic policies pursued by governments, as discussed in chapter five.

8.3 Foreign direct investment: the missing link in economic transition and accession to the EU

Given the need for attracting FDI in order to enhance privatisation, marketisation and EU membership, it is important to assess the main determinants of foreign direct investment both in the political and economic spheres. It is also necessary to provide evidence of the impact foreign direct investment has had in transition in both Poland and Romania. This supports the identification of FDI's place within the economic circle and the interplay with the other factors considered. The analysis has shown that factors from the political sphere have had a great impact on FDI related policies (or reforms in general), thus illustrating the interaction between the political and the economic sphere. The reluctant attitude of the government and public opinion in the early transition period has delayed the adoption of appropriate FDI related policies in Romania. On the other hand, Poland's relatively greater openness towards FDI has contributed towards adopting FDI related policies with a positive impact on FDI. Furthermore, several bi-directional relationships have been acknowledged between FDI and elements of both the political and economic spheres considered here, signalling the potential for vicious or virtuous circles.

The first bi-directional relationship is between foreign direct investment and economic reforms. It has been shown that FDI was affected greatly by the pace and methods of privatisation (chapter five) and by progress in institutional reforms in general (chapter seven). Macroeconomic stabilisation was proven to be a necessary (chapter five), however, not significant (chapter seven) condition. Evidence was provided regarding the FDI involvement in large scale privatisation (chapter five) and FDI has been found to be a significant determinant of institutional economic reforms (chapter seven).

The second bi-directional relationship identified is between foreign direct investment and the EU integration process, the latter being seen from both an institutional and an economic perspective. Thus, it has been shown that new stages in institutional integration with the EU enhance foreign direct investment (chapter seven). This is either due to trade liberalisation, as in the case of the signing of the association agreements, or due to improvements in perceptions of security, as in the case of the starting of the accession negotiations with the initial 'second wave' CEECs, in the aftermath of the Kosovo crisis and of the Helsinki European Council. Furthermore, foreign direct investment enhances economic reforms (chapters five and seven), which in turn lead to progress of institutional integration with the EU (chapter three). Moreover, it has been shown that foreign owned firms participate largely in foreign trade, hence enhancing the integration of both Poland and Romania into the world economy in general, and with the EU in particular (chapter five). Additionally, FDI appears to be enhanced by a high openness to the EU in terms of exports, as well as by financial aid, some of which has been granted by the EU (chapter seven). This reflects the impact of economic integration with the EU on FDI. Finally, FDI by EU member states represents a measure of increased integration with the EU, with a higher degree for Poland. This is consistent with Poland being invited to join the Union in May 2004 and Romania aiming to do so in 2007. This evidence also emphasises the need to attract further FDI in Romania, in order to benefit from its potentially positive impact in economy.

The third bi-directional relationship singled out in the analysis is between FDI and security concerns. First, it has been shown that FDI has contributed to a general improvement of the standard of living (chapter five). This improvement may increase public support for market economy and hence diminish the security concerns related to internal instability, as defined in chapter six. However, FDI may also be associated with negative phenomena, such as high unemployment in Poland and increased income disparities within both Poland and Romania, thus enhancing the need for attracting investment with potentially a net positive impact (chapter five). Second, it has been shown that foreign investors are sensitive to the country image and that country image reflects, to a certain extent, security concerns (chapter five). The Balkan identity of Romania appears not to have had a direct effect on foreign direct investment (chapter seven), Instead, it appears to have had an indirect effect through its impact on the quest for EU membership (chapters six and seven). Furthermore, the renewed prospects for EU integration, resulting from the start of the accession negotiations in 2000, have provided positive signals to investors in the five CEECs concerned, consequently enhancing FDI (chapter seven).

Finally, the analysis has shown that there is potential for path dependency in attracting foreign direct investment. FDI can attract further FDI through either reinvested profits, or through improvements in economic reforms, the country image and perceptions of security concerns in general (chapters five and seven). So far FDI directed to Poland has contributed greatly to the transition to a market economy, economic integration with the EU and attracting further FDI through an improved investment climate, thus maintaining a virtuous economic circle of development. This virtuous economic circle had in turn the potential to enhance the political circle through increased support for the market economy resulting from prospects of a better of life, as discussed in chapter five. While FDI has been relatively low in Romania and with a more modest impact on transition and EU integration, there is the possibility that once attracted, FDI will determine future investment, and thus contribute towards a virtuous circle of economic development. The question remains how to attract foreign direct investment despite poor previous investment or despite a poor record of economic reforms. One way to avoid the consequences of this path dependency appears to be to enhance FDI through expectations about the future, rather than simply through observations of the present situation. Perceptions of security seem to be important here and were addressed in chapter six

8.4 European integration and security concerns in Poland and Romania

Given that security has been an important determinant of both EU accession and FDI, it is imperative to assess closely the nature of security concerns in Poland and Romania. Internal and external security concerns have been identified in both the political and economic spheres in chapter six. It has been argued that changes in security concerns (or perceptions of security) appear to influence both the economic and the political circles, eventually contributing towards turning a vicious (or ambiguous) circle into a virtuous one. It is also necessary to investigate ways in which perceptions of security in one country may be changed, and in particular, the role of prospects for EU membership in doing so. In other words, can the EU enhance security in the candidate countries, thus potentially creating an economic virtuous circle of positive perceptions of security, high FDI, economic reforms, economic integration with the EU and high prospects of EU membership as in diagram **8A(a)**? This virtuous economic circle would have in turn the potential to enhance a virtuous political circle of support for reforms, a positive government attitude to reforms and firm international backing. This would further impact positively on the EU accession process.

The analysis has shown that during the first decade of transition the main internal security concerns in both Poland and Romania were related to the political and economic crises and the extent to which they were securitised or de-securitised by the international community (chapter six).

Although these crises were inevitable, given the magnitude of transformation and the tension between democratisation and marketisation, their individual causes were responsible for their different impact on EU accession. Thus, Romania's main sources of internal political instability and external perceptions of insecurity were the imperfections of the democratisation process, deeply rooted in the legacy of the communist system. Furthermore, the attempts of early governments to limit popular unrest through postponing economic reforms only spread the public discontent over longer periods and securitised the country even more, creating negative perceptions of security up to 1996, as illustrated in table 8.1. This had a negative impact on Romania's prospects for EU integration. Political instability persisted in Romania throughout the 1996-2000 governments, given the lack of political experience of these democratic governments and in particular the cost of the shock therapy implemented by the Ciorbea government. Added to other security concerns, this created uncertain, rather than positive perceptions of security regarding Romania, as shown in table 8.1. On the other hand, Poland's early strong commitment to both democracy and a market economy ensured international credibility and support. It also contributed to de-securitising to a certain extent the internal political and economic instability resulting from the shock therapy reforms implemented by Balcerowicz or the return to power of the post-communists in 1993. International support contributed towards turning the circle of economic instability into a virtuous one. It also contributed towards avoiding a negative political circle that could have emerged from the low support for radical reforms already displayed by 1993. Hence, since 1993 Poland has enjoyed positive perceptions of security, as demonstrated in table 8.1. The 2000 election in both countries showed that increasing poverty represents an additional challenge to security, by triggering the rise of extremist parties. However, the prospects of EU membership de-securitised these events, contributing towards positive perceptions of security in both countries. Hence, governments and international organisations should ensure that prospects of poverty are minimised through successful economic reforms and through offering long term gains, including prospects of EU membership.

The analysis has also shown that external security concerns have greatly affected the progress of integration into the EU. Their impact depended on the extent to which each country transformed threats into opportunities through a successful foreign policy. Thus, Poland has been largely successful in turning most of its external threats into catalysts for NATO and EU membership, while Romania has been slow in doing so. Poland's fear of Russia determined an important change in its foreign policy since the 1991 Moscow coup and an active commitment to both NATO and EU membership ever since. On the other hand, Romania's close relationship with Russia until 1994 gave the impression of Romania still being in Russia's sphere of influence. This maintained a negative perception of external security and slowed down Romania's return to Europe. Polish concerns over Germany were the catalyst for close bilateral economic relations and triggered strong German support for Poland's integration into the EU. As Germany did not constitute a particular concern for Romania, Romania was hesitant to seek its support for EU membership, thus lacking an important lobby necessary to EU accession. Furthermore, Poland's commitment to build good neighbourly relations led to early bilateral agreements with both Eastern and Western neighbours. These developments justified Poland's claim to be a pole of stability in the region and a 'gate' towards the East, thus leading to early membership of both NATO and the EU. On the other hand, Romania postponed border recognition with its neighbours. Suspicions over territorial claims expressed by Moldova and Ukraine in the early 1990s did not fit the image of a pole of stability that Romania wanted to promote. Up to 1996, negative perceptions of security accentuated the vicious political and economic circles in which Romania had been trapped. Improvements since 1996 have not been sufficient to ensure early membership of either NATO or the EU, creating only ambiguous circles in both the economic and the political spheres. Only security concerns posed by the Kosovo crisis and the War on Terrorism have been able to speed up Romania's return to Europe through the opening of accession negotiations with the EU in 2000 and through NATO's invitation in 2002 for membership by 2004. These contributed towards positive perceptions of security and the creation of a virtuous political circle, as shown in table 8.1. All in all, governments should not underestimate the impact that external security concerns have on internal security and on the process of accession into the EU. Enough support from influential members of the EU should be sought, in order to ensure a successful accession.

The study has further shown that perceptions of security in Poland and Romania appear to have been influenced by the revival of the political geography notions of Central Europe and the Balkans with their positive and negative connotations respectively. Thus, Poland's recognised Central European status has maintained a positive image and the Visegrad Group was a means to enhance Poland's chances for early integration into the EU. In the early 1990s, internal political instability and the lack of economic reforms underlined Romania's Balkan identity. This was despite Romania being classified in 1992 as a Central European country. Romania's proximity to the Balkans accentuated perceptions of insecurity, thus slowing Romania's return to Europe. However, the launch of the accession negotiations and the Stability Pact for South-Eastern Europe in the aftermath of the Kosovo crisis appears to have contributed to the de-securitisation of the Balkans, thus leading to virtuous circles in both the economic and the political spheres (chapter six).

Finally, it has been argued that, despite several limitations, EU membership appears to be the best way to consolidate the internal and external security of Poland and Romania by complementing the military security guarantees given by NATO. Through its normative power and incentive of membership, the EU has enhanced democratisation and marketisation in both Poland and Romania. This diminished the danger of return to authoritarian rule and a centralised economy, thus enhancing their internal economic and political security. Financial support, trade and investment from the EU have also increased the economic security of each country. Moreover, EU membership addresses the external security concerns of both Poland and Romania and the issue of fragmentation in Europe, which is a threat in itself. By enhancing a virtuous circle in the political sphere, prospects for EU membership appear to affect the economic sphere as well. Finally, the impact of prospects for EU membership on FDI has been proven in chapter seven, as will be discussed below.

8.5 The interplay between foreign direct investment, security and European integration: Can the prospect of EU membership break the vicious circle in the economic sphere?

It is important, finally, to test the existence of a vicious circle in the economic sphere and to investigate ways to break it. The vicious circle in the economic sphere has been illustrated through the quantitative analysis conducted in chapter seven. The econometric models have confirmed the bi-directional relationship between economic reforms and FDI which are seen to be at the centre of the vicious economic circle. Foreign direct investment also appears to be highly influenced by previous investment, thus pointing towards the danger that countries with a high initial investment would continue to attract investors at the expense of recipients of lower FDI. This potential for path dependency seems to be enhanced by FDI's sensitivity to early ties with the European Union in the form of association agreements. By liberalising trade through anticipating closer relations with the EU, early commitments to EU integration appear to have been important for FDI, thus potentially creating a virtuous circle or path of development for countries such as Poland.

However, the analysis has also suggested that this path dependency may be broken. Thus, the initial conditions have been shown not to be significant either for FDI, or for economic reforms. Furthermore, FDI appears not to be sensitive to political geography identity such as the Balkans, suggesting that perceptions of security are dynamic, rather than static. Progress of EU accession and of economic reform appears to have been more important for investors than simply identification with a geopolitical area. It is thus likely that the vicious circle can be broken through security or European integration factors.

Thus, it has been found that progress in European integration can turn a vicious economic circle into a virtuous one through its impact on FDI and on economic reforms. In particular, by renewing the prospects of EU membership for the slower reformers, and thus improving perceptions of security in these countries, the 1999 Helsinki European Council has enhanced foreign direct investment in countries previously considered second wave candidates (chapters six and seven). This has created the conditions to turn a vicious economic circle into a virtuous one. This finding is particularly important given that the launching of accession negotiations with the frontrunners of transition (as a result of the 1997 Avis) has not been shown to be significant. This signifies that prospects for EU membership are effective in creating positive perceptions, especially when there are flaws in economic reforms. This is particularly important for Romania (and Bulgaria), whose accession to the EU has been delayed until 2007, and where there is a need for further FDI in order to complete privatisation and modernisation of the economy.

Furthermore, it has been shown that economic integration with the EU in terms of financial aid, percentage of trade with the EU and exports to the EU have all had a positive effect on foreign direct investment. The finding regarding the role of financial aid makes the case for maintaining and enhancing the financial support offered to Romania and Bulgaria as a means of continuing to attract investors. This would also minimise the widening of the income gap between the remaining candidate countries and the EU or the CEECs joining in 2004, and the potential effects this increased inequality would have on European security. The significance of openness in terms of exports for FDI suggests that competitive, export oriented sectors, are likely to attract foreign direct investment, thus potentially reinforcing a virtuous circle of economic development. This appears to indicate that industrial policies in general, and policies to attract FDI, in particular, should be directed towards sectors in which the candidate countries already have comparative advantages. Given that Poland and Romania's main competitive advantages are in sectors considered sensitive by the EU, complete trade liberalisation is essential for the impact on FDI to be at its maximum.

The econometric analysis has also shown that progress in institutional integration with the EU has accelerated reforms in the candidate countries. However, the lack of significance of Helsinki for economic reforms and the decreasing impact that each new stage of institutional European integration has had on both FDI and economic reforms, signals the danger of a certain 'fatigue' with transition. This 'fatigue' might reduce even further the impact that prospects of EU membership have had on FDI and economic reforms, directly or indirectly. Thus, in the case of Romania and Bulgaria it is important not only that prospects of EU membership are maintained, but that they are also complemented by economic integration through aid and trade and by further internal economic reforms, including the improvement of the business climate. All these appear to be able to enhance FDI, complete transition to a market economy in Romania and finally bring full EU membership. The attractiveness of the two countries will also consist in the persistence of relatively low production costs, given that EU membership has been delayed most likely until 2007. It is also likely that FDI will be diverted from the new EU members, which will be price convergent with the EU, towards the remaining candidates not yet aligned at the EU price levels.

8. Final conclusions, their significance and further research

The main argument of this dissertation has been that, unless security concerns are considered in the process of EU enlargement, there is a danger that the slow reformers are trapped in the vicious economic circle of high perceptions of insecurity, low foreign direct investment, poor economic reforms, low prospects of EU membership and thus further insecurity. This scenario would have potential negative effects on Europe as a whole through challenging the security of the continent. However, political decisions on EU enlargement, such as the one taken at the Helsinki European Council, appear to have the potential to break this vicious economic circle.

First, by maintaining prospects of EU membership despite poor records of economic reforms, the EU can enhance prospects of security in the candidate countries, thus creating the conditions for a virtuous economic circle. Prospects of security can attract the necessary FDI for reforms and for EU integration. This virtuous economic circle can then reinforce itself and enhance a virtuous political circle of determinants of EU accession as shown in diagram 7A(c). Such a scenario appears to diminish the threat that instability in a candidate country poses to Europe as a whole.

Second, by maintaining prospects of EU membership, the EU may encourage governments in the candidate countries to adopt bold economic reforms that attract further FDI, enhancing economic integration and finally leading to full EU membership, as in diagram 8A(c). Fatigue with transition appears to indicate though that the motivational impact of the prospect of EU membership is decreasing, indicating serious limitations of this scenario.

Finally, the prospect of EU membership may enhance trade with the EU, leading to increased FDI, progress of economic reforms and hence full membership, as in diagram 8A(d). However, given that trade liberalisation is almost complete and the candidate countries are as integrated as full member states in terms of trade, the effects of these scenario appear to be rather limited. It is most likely that the combined effects of all three scenarios may contribute to full EU membership by candidates such as Romania.

These findings are important for several reasons. First, contrary to some opinions, European security is indivisible and thus stability in South Eastern Europe is necessary for the stability of the continent as a whole. While Romania does constitute a pole of stability and security in the area, EU membership can offer supplementary guarantees that could further strengthen its security and its de-securitising role in the area. Second, like in many candidate countries, the last general election in Romania have shown that there is a certain 'fatigue' with both transition and accession to the EU and a danger of extremism or return to totalitarianism, should the EU accession be delayed even further. Third, despite the EU's acknowledgement of Romania and Bulgaria's aim to join the EU in 2007, there are yet no firm guarantees from the EU, as the two countries have to conclude the accession negotiations and fulfil the Copenhagen criteria. Furthermore, Romania's prospects of EU membership are likely to be affected by the impact the first phase of enlargement will have both on the EU and on the CEECs that will join in 2004.[2] Thus, by emphasising the importance of prospects of EU membership for the political and economic development of Romania, this dissertation argues that the remaining two candidates are granted increased financial assistance and that the target date is observed. Loose target dates have been previously modified, postponing accession and risking a loss of support for reforms and for EU membership as such. Fourth, as FDI

[2] See also Smith, A., "Economic and Trade Relations Between the European Former Communist States and the States of Western Europe" in Smith and, Jenkins, J. C. (eds.), *Through the Paper Curtain. Insiders and Outsiders in the New Europe*, The Royal Institute of International Affairs, London, 2003, p.2.

appears to be necessary for economic reforms, integration into the EU and prospects of a better life in the candidate countries, finding the factors that foster investment seems to offer solutions for both transition to a market economy and accession into the European Union. This is important not only for the candidate countries considered, but also from the point of view of investors who may exploit business opportunities in the area.[3] Finally, the findings can be applied and tested in comparisons between Ukraine and Moldova. The general findings of this dissertation can also help in assessing the progress towards EU membership made by candidate countries such as Croatia or Turkey, as well as other potential candidates for EU membership.

The contribution of this dissertation can be seen from several perspectives. First, the study has an interdisciplinary nature and investigates the interplay between politics and economics in the process of the eastern enlargement of the EU. To my knowledge, this is the first study that puts forward a coherent model that explains EU enlargement based on the bi-directional interaction between the economic and the political sphere, while equally emphasising the role of security factors, of FDI and their interplay. This project answers Nelson's call in the early years of transition for studies which address the new nature of security and its interplay with the processes of democratisation, marketisation and Europeanisation.[4]

Second, the present research enhances the debate over path dependency and path shaping potential in transition and accession to the EU. Identifying the dynamics of the present enlargement process remains a useful exercise, given that in the absence of firm guarantees of EU membership by 2007, the accession of the remaining negotiating candidates, Bulgaria and Romania may be influenced by the effects of the first phase of enlargement or by unexpected events. The conclusions drawn from the comparative analysis of Romania and Poland can thus be extrapolated to Bulgaria or potential candidates for EU membership. By acknowledging the path dependency potential the study follows Ekiert's plea that post-communist studies take into consideration the particular nature of the legacy of the communist system in the countries considered.[5]

Third, as a comparative empirical study of Poland and Romania's quest to accede to the EU, accomplish economic transition and attract FDI, this research enhances our understanding of the post-1989 evolution of each of these two countries. To my knowledge, there has been so far no in-depth comparative analysis of Poland and Romania with regard to the processes mentioned above. The merits of the comparison lie equally in the different paths that Poland and Romania have

[3] See also Sakwa, R., "Postcommunist Studies: Once Again Through the Looking Glass (Darkly)?", *Review of International Studies*, Vol.25, No.4, 1999, p.712.
[4] See Nelson, D., "The Comparative Politics of Eastern Europe", *Political Science and Politics*, Vol. 27, No. 1. 1994, p.51.
[5] Ekiert, G., "Peculiarities of Post-Communist Politics. The Case of Poland", *Studies in Comparative Communism*, Vol. 25, 1992, cited in Sakwa, R., "Postcommunist Studies: Once Again Through the Looking Glass (Darkly)?" in *Review of International Studies*, Vol.25, No.4, October 1999, p.716.

followed with regard to EU accession, economic transition, attracting FDI and eliminating security concerns, given that most comparisons are usually made between countries with roughly similar evolutions.

Fourth, from a methodological point of view, the study demonstrates the advantages of adopting a mixed-method approach. The qualitative assessment allows the establishment of causal relationships between the factors considered in the model, while the use of quantitative methods allows generalisations with regard to all ten transition countries candidate for EU membership as well as future candidates. The findings of the comparison are validated within the larger framework of the ten central and eastern European countries considered. To my knowledge, this is the first study which investigates the bi-directional relationship between FDI and economic reforms in the candidate countries. The role of security and European integration variables in attracting FDI has also been under-studied.

Finally, this study points towards several areas of further investigation. First, it will be important to evaluate the extent to which Romania's quest for EU membership will be affected by the 2004 enlargement of the European Union. Second, an analysis of economic convergence with the EU may follow the examination of the evidence of economic integration between Poland and Romania, on the one hand, and the EU, on the other. Third, although a detailed analysis of the determinants of FDI has been offered, both qualitatively and quantitatively, it will be useful to assess the determinants of green field investment, as a means to maintain FDI levels beyond the completion of privatisation. Furthermore, with firm level data, a more systematic examination of the FDI impact at microeconomic level may be conducted. Finally, the discussion of security concerns may be enriched by looking at ways of accommodating the Common Foreign and Security Policy by Poland, upon accession in 2004.

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