ant Croatoslavia, politically, economically and culturally attractive to all Southern Slavs, including those still under Ottoman sovereignty. All of this was to have been sanctioned under a direct arrangement with the Austrian Crown without Hungarian co-tutelage.

7 - Josip Juraj Strossmayer (1815-1905), bishop, patron of the arts, chief donator of the Yugoslav (today Croatian) Academy of Sciences and Arts ; advocated federalism within the Monarchy, the strengthening of ecumenism, and closer ties between all, especially the South, Slavs.

8 - Frano Supilo (1870-1917), publicist and politician, member of the Yugoslav Committee formed abroad during World War I; advocated a broadly federalist Yugoslavia.

- Stjepan Radić (1871-1928), leader of the Croatian Peasant Party, the most important political grouping between the two world wars; died of wounds sustained in an assassination attempt in the Belgrade parliament.

9 The foreign policy of Dubrovnik aimed at maintaining good and peaceful relations with all neighbours, and with more distant protectors of its free trade, such as Venice and Istanbul.

10 Count Petar Zrinski (1621-1671), Ban, military leader in the Thirty-Year War against the Turks, disappointed with the terms of the Vasvár Peace, which did not provide for the restitution of Croatian and Hungarian lands, considered a more direct settlement with Turkey, on more favourable terms for Croatia.

11 See note 6.

12 See note 8.

13 - Vlatko Maček (1879-1964), succeeded Stjepan Radić at the head of the Croatian Peasant Party; negotiated an agreement with the government in Belgrade on the creation of a large autonomous Banate of Croatia, with parts of Bosnia and Herzegovina.

- Josip Broz Tito (1892-1980), communist fighter against the German and Italian occupation, military leader, statesman; severed the ties with Stalin; co-founder of the non-aligned bloc.

Economic and Social Cohesion Policy and Enlargement of the EU

Jorgen Mortensen

INCOME DIFFERENTIALS IN THE EU IN THE PAST AND IN THE FUTURE

At the time of the first enlargement of the European Community, in 1973, the original six member states constituted a relatively closely knit and homogeneous trading zone. GDP per head of population (in purchasing power standards) in Italy stood only some 20% below that of the Federal Republic of Germany, with Belgium, France and the Netherlands within this range and only Luxembourg substantially above the FRG.

The 1973 enlargement entailed the entry of two new member states (Denmark and the United Kingdom) with per capita GDP close to the median of the founding members and one new member state (Ireland) with a per capita GDP only about 50% of that of Germany and 60% of that of Italy.

In 1981 the then nine EC member states were joined by Greece with a per capita GDP close to that of Ireland and in 1986 by Spain and Portugal with a GDP level respectively somewhat higher than and somewhat lower than that of Greece. The two latter enlargements, involving three countries with a total population of 58 million, consequently resulted in a significant shift of the geographical and economic balance in the EC in favour of low-income Mediterranean countries.

The German unification, furthermore, brought into the EC East Germany with a population of some 16 million and a per capita GDP some 30% of that of West Germany or 60% of that of the level of Portugal.

The 1995 enlargement, involving the entry of Austria, Sweden and Finland, on the contrary entailed the addition of high-income countries of Northern "obedience" and thus, to some extent, re-established the North-South equilibrium existing among the original Six.

In 1994 the level of GDP per capita within the EU, converted at current rates of exchange, ranged from about 7,000 ECU in Greece and Portugal to some 25,000 in Denmark (and even more in Luxembourg), corresponding to a spread of about 1:3.5. Enlargement of the EU to include the ten CEECs would, first and foremost, entail a pronounced rise in income differentials within the Union.

Among the candidate countries only Slovenia has an income level comparable to that of Greece and Portugal. In fact, at some 6,000

Graph 1: GDP per capita, ECU, 1994
Market rates of exchange
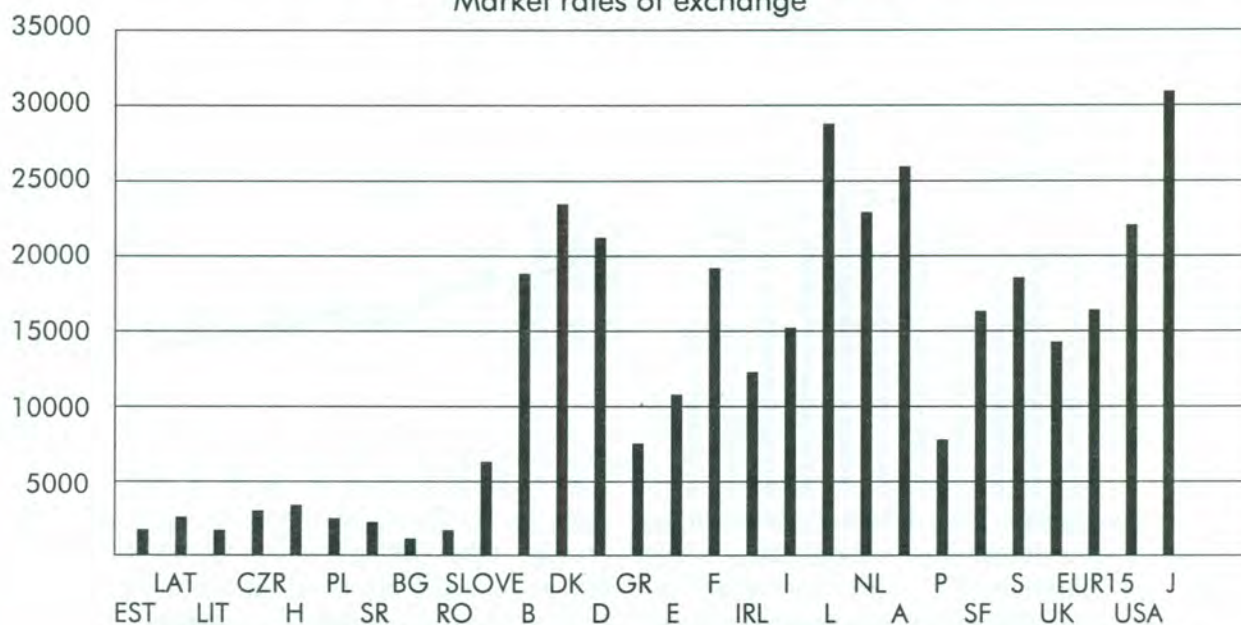
Source: EBRD, OECD, European Commission

ECU, the level of GDP per head of population in Slovenia in 1994 was only some 15% below that of Greece and rising fast.

In a ranking of the CEECs according to nominal income per capita, Hungary would come second, followed closely by the Czech Republic. In these two countries the level of per capita GDP in 1994 amounted to some 3,500 ECU, or about 50% of the level in Greece and Portugal.

Further down the scale, Poland and Slovakia in 1994 recorded a per capita GDP of some 2,000 ECU, or less than a third of the level of Greece and Portugal. As for the remaining group of countries, that is the Baltics, Bulgaria and Romania, the level of their per capita GDP was around 1,000 ECU, or only one seventh of the level in Greece and Portugal.

Enlargement of the EU towards the east, could thus, if the five CEECs with the lowest per capita income were included in the first wave, result in an increase in income differentials among member states from 1:3.5 as indicated above to some 1:25 in the enlarged EU.

The data on per capita income presented above are obtained by converting national accounts data using the current market rate of exchange between the ECU and the national currency. However, as frequently underlined by analysts, international income comparisons using market rates of exchange take account only of the international purchasing power of the currencies concerned. However, in low-income countries the prices of domestically produced goods and ser-

vices are almost always lower, relative to the prices of internationally traded goods and services than in high-income countries.

As an example let it be assumed that for the price of a camera one may get, say, ten hair cuts in Germany and fifty hair cuts in Romania. Barbers' services cannot be exported and therefore do not influence the exchange rate (at least not directly). On the other hand, since the number of hair cuts which can be consumed is limited, the relatively low price for hair cuts is a direct benefit for Romanian consumers which must be taken into account in international real income comparisons. In order to provide data on price differences, international organizations undertake surveys of prices for comparable goods and services and produce an aggregate index for the overall price level in a country, using the weights (the basket) of a reference country, normally (but not exclusively) the United States or the European Community. The ratio between the two price levels thus can be interpreted as a pseudo-exchange rate and is therefore termed "purchasing power parity".

The difference (or ratio) between the market rate of exchange and a measure of purchasing power parity is frequently taken to be a crude measure of over, respectively under, valuation of the currency in question.

However, as indicated above and underlined by the leading researchers in the field of international comparisons of real income (notably

Graph 2: Income and PPP/EXCH ratio
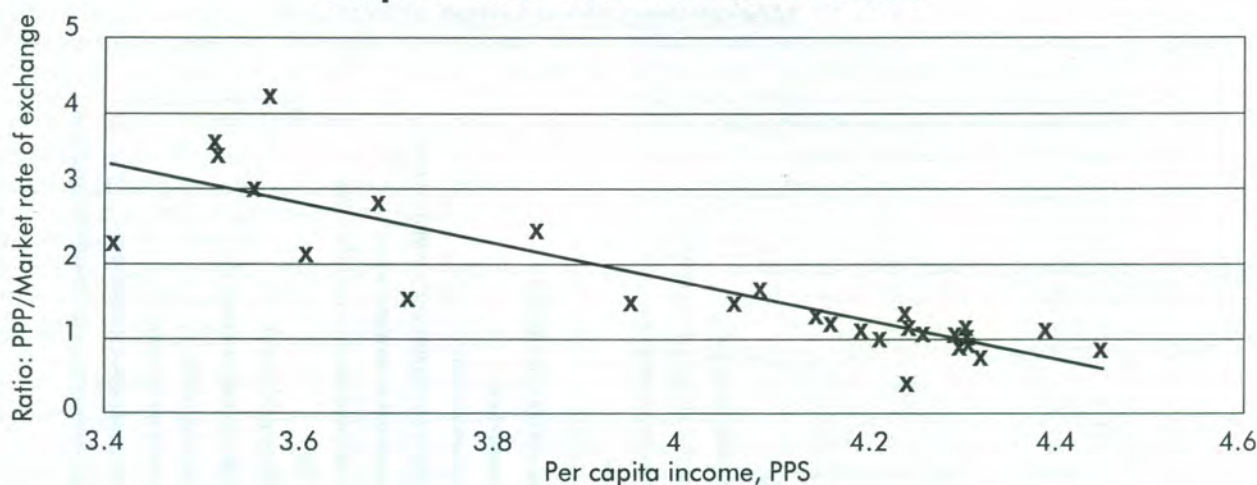
Summers and Heston), the difference between the two measures is determined not only by possible over/under valuation of the currency but also by the relative price differences between internationally traded and domestically traded goods and services.

As a consequence of this difference with respect to relative prices, income levels in low-income economies expressed in purchasing power standards (converted at purchasing power parity) are normally substantially higher relative to those of high-income economies than income levels expressed in common currency terms (converted at market rates of exchange).

As corollary of this, the difference (ratio) between the market rate of exchange and the purchasing power parity is determined not just by possible over/under valuation of the currency but also by the income level of the country concerned.

This feature is illustrated in graph 2 covering the ten CEECs, the fifteen EU member states, United States and Japan.

As seen, there is a clear negative correlation between the figures on the x-axis indicating the income level, as measured by the log of data on ECU per capita, and the figures on the y-axis, indicating the ratio between the market rate of exchange and the purchasing power parity. (Data are obtained partly from the OECD as far as CEECs are concerned and partly from the Commission's (DGII) data base as far as the EU, US and Japan are concerned.) In fact, the lower the level of income, the higher is the market rate of exchange relative to the purchasing power parity. To take an example: while for the UK the market rate of exchange (£ per ECU) in 1994 was quite close to the purchasing power parity, for Romania the market rate of exchange was about three times the purchasing power parity. Conse-

quently, the Romanian per capita income expressed at purchasing power parity was three times higher than the per capita income expressed in ECU at the current rate of exchange.

The line drawn in the graph results from a regression with the level of income in purchasing power standards as the independent and the ratio between the rate of exchange and the purchasing power parity as the dependent variable. As suggested the correlation is quite convincing with an $R2$ of 0.78. Observations lying above the line indicate a higher level of the ECU/PPP ratio than the one corresponding to the level of income, suggesting therefore a possible undervaluation of the currency. Observations lying below the regression line, on the contrary, could be interpreted as indicating an overvaluation of the currency.

Due to the systematic difference between the purchasing power parity and the market rate of exchange, there is also an equally systematic difference between the income per capita calculated in nominal ECU (or USD) terms and the income per capita calculated in terms of purchasing power parity. As illustrated in Graph 3, the real income of the various countries considered here when expressed in Purchasing Power Standards (PPS) shows substantially smaller discrepancies between low- and high-income countries than when expressed in ECU terms. However, it should, once again be stressed that income data based on PPS provide a more appropriate indicator for the *domestic* purchasing power of the currency of the country but not for the *international* purchasing power. Moreover, contributions to the EU's budget and other transactions between a member state and the Union are always based on the nominal national accounts data and converted at the market rate of exchange for the ECU. This aspect, though technical in nature, is highly rel-

Graph 3: Per capita income
Purchasing power standards, 1994
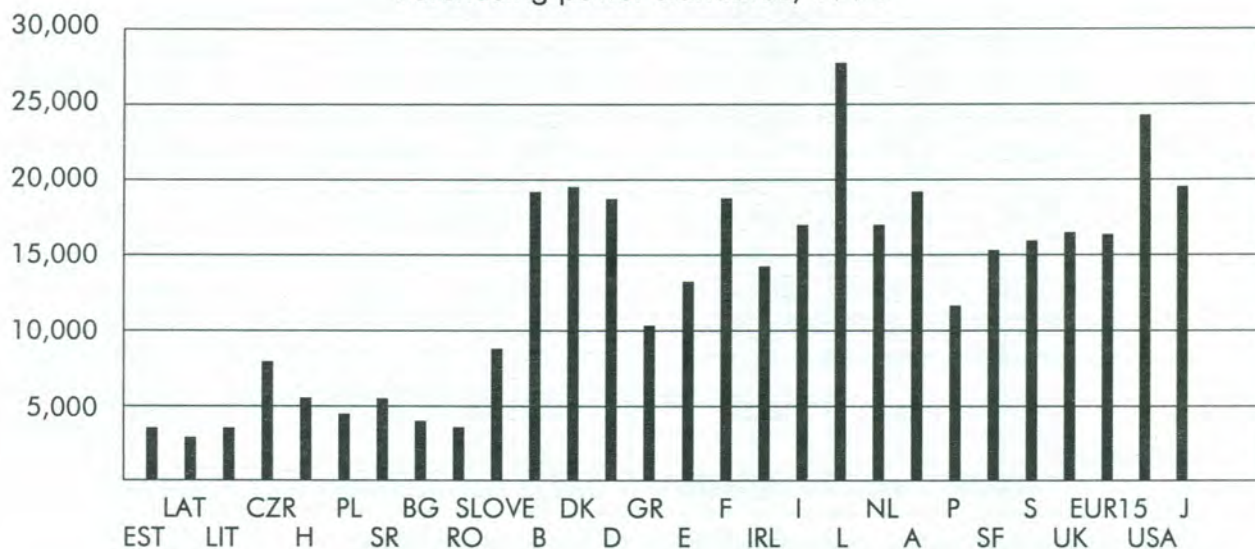
evant for calculating both the contributions from the member state to and the domestic currency value of transfers and subsidies received from the EU's budget and well as the domestic currency value of loans from abroad, etc.

IMPLICATIONS OF ENLARGEMENT FOR THE EU'S STRUCTURAL FUNDS AND THE NEW MEMBER STATES

At its Madrid 1995 meeting the European Council established the following principles for the application of structural and cohesion funds in the perspective of enlargement:

"1. The objective of strengthening the economic and social cohesion, as laid down in article B of the Common Provisions of the Treaty on European Union, continues to be a fundamental element of EU policy.

2. There must be a guarantee for the poorer member states on the continuation of solidarity, although its application should take account of the success achieved in economic and social cohesion. The general application of the cohesion policy throughout the Union should be maintained, even if there is a need to concentrate funding on specific regions or policy priorities.

3. Improvement and a revision of cohesion policy is necessary, as it needs to become more effective. The Cohesion Report, which the Commission will establish in 1996, in accordance with article 130B of the Treaty, will provide a basis for the review. The reform of cohesion policy within the 15 member states, which is to follow, should, however, take place in an acceptable time period.

4. During a time when most member states are going through a period of rigorous budget management in order to maintain or fulfil the Maastricht criteria, the Union should also provide a clear signal that it shapes its policies in a way that the principle of budget discipline is concretely respected.

5. While the objective should be full application of cohesion policy to new member states, transitional arrangements after accession will be necessary to integrate them gradually into the policy and its financial aspects.

6. While implementing the structural funds in the CEECs, the economic effectiveness of transfers must be assured. Experience suggests that volumes of assistance which are high in relation to the recipients' GDP are difficult to use effectively, and can even distort their economic structure. In other words, high volumes of assistance might pose big problems for the new member states, as their administrative systems, their absorptive capacity and their ability for co-financing the aid might be overwhelmed by the influx of funds." (Quoted from press release IP/95/1325 from the Spokesman' Service)

These general guidelines from the European Council, thus, state two basic, complementary principles: first that the principle of economic and social cohesion should continue to be applied after enlargement but that, second, this application must take account both of these countries' capacity to translate assistance from the structural funds into a genuine improvement of their growth potential and of their capacity to re-allocate domestic economic and financial (budgetary) resources in order to be able to provide the required national co-financing of projects receiving Community assistance.

Table 1: Financial allocations, Structural Funds, Objective 1

COUNTRY	Objective 1 population		Objective 1	Allocation per
	000	% nat. pop.	allocation	head, ECU '94
Belgium	1279	12,7	730,0	570,8
Germany	15960	19,7	13640,0	854,6
Greece	10209	100,0	13980,0	1369,4
Spain	23269	59,4	26300,0	1130,3
France	2546	4,4	2190,0	860,2
Ireland	3503	100,0	5620,0	1604,3
Italy	21134	36,4	14860,0	703,1
Netherlands	217	1,4	150,0	691,2
Portugal	9868	100,0	13980,0	1416,7
United Kingdom	3310	5,7	2360,0	713,0
TOTAL EU	91295	26,2	93810,0	1027,5

Source: European Commission (Sixth Annual Report on the Structural Funds)

The Community's Structural Funds (the Regional Fund, the Social Fund, the Agricultural Fund and the Cohesion Fund) according to the conclusions of the Edinburgh European Council of December 1992 would for the period 1994 to 1999 (six years) receive budget allocations amounting to a total of 141 billion ECU, corresponding to some 31% of the total commitment appropriations for this period.

About 70% of the total appropriations of the Structural Funds would be allocated to "Objective 1", i.e. allocated to the programmes aiming at providing assistance to regions with a low level of income (normally less than 75% of the Community average). The remaining 30% are allocated to Objectives 2-5: old industrial areas, long-term unemployment, agriculture and fisheries.

As shown in Table 1, within the EU regions with about 91 million inhabitants, corresponding to 26% of the EU's total population, will, during the 1994-1999 period, qualify for Objective 1 assistance. However, only three EU member states, Greece, Ireland and Portugal, qualify fully for aid under Objective 1 under the present financial programming. In other member states the share of population covered by these regional aid programmes range from zero in Denmark to 59% in Spain (making the Spanish programme the largest in absolute terms). The highest per capita allocation is observed for Ireland (1604 ECU per capita for the six years included). For Greece and Portugal per capita allocations are somewhat lower, respectively 1,369 and 1,417 ECU, presumably due mainly to administrative delays in implementing programmes,

Apart from some financial support through special Community initiatives (such as for example the special programmes for isolated islands) the three member states where all regions qualify for objective 1 assistance do not receive aid under the other objectives. By contrast, even high income countries such as France and the United Kingdom receive comprehensive financial support through the schemes in favour of the old industrial areas and/or long-term unemployment (objectives 2, 3 and 4). Furthermore, due to the existence even in rich member states of regions with a comparatively low level in income, Belgium, Germany, France, Spain, Italy and the United Kingdom in addition to aid under objectives 2-5, receive substantial amounts under objective 1.

As illustrated above, the next enlargement, if it were to take place within a foreseeable future, would involve the incorporation of a number of new countries with a level of income significantly lower than even the poorest regions in the existing EC. The implications of applying the existing rules for the Structural Funds would, on the basis of the above figures, entail the granting of aid amounting to approximately 1,500 ECU per inhabitant of the CEEC countries over a five-year period, that is some 300 ECU per year. At the present level of income per capita, ranging from some 1,000 to some 3,000 ECU, the aid from the Structural Funds would, thus, other things being equal, amount to 10-30% of income. Even if such an amount of aid could be sustained by the EC<Ž146>s budget, transfers from the Structural Funds of this order magnitude would most certainly exceed, by a large margin, the absorptive capacity of the receiving country. Firstly, there would be a limit to the volume of investment and/or current expenditure of the kind which is supported by the Funds (investment in infrastructure,

equipment, environmental clean-ups, education, etc.). Secondly, few, if any, of the CEECs would appear to be in a position to provide the domestic financial resources required to respect the (additionality principle), that is, the principle that the EC support will normally provide only 50% of the financing of the elected projects while the recipient country must provide the remaining 50%, either via the general government budget or via borrowing (see box). Thirdly, a massive in-flow of money would be likely to create serious economic and monetary instability, leading to in-flation, loss of competitiveness and the risk of in-stallation of a permanent dependency upon EC aid.

The risk of serious economic and monetary instability resulting from an unrestricted applica-tion of the rules of the EC's Structural Funds would, furthermore, be aggravated by the simul-taneous application of the common agricultural policy (the CAP). Introduction of the present market arrangements for agricultural products, even as modified in recent years and in the near future, could be expected to lead to substantial increases in prices of agricultural products at the level of the consumers, resulting in abrupt and massive changes in relative prices, manifold rise in land prices, boosting of costs and general price inflation, etc.

ADDITIONALITY AND CONDITIONALITY AND THE EU'S STRUCTURAL FUNDS

The Principle of Additionality constitutes a basic feature of the functioning of the EC's Struc-tural Funds. According to this principle, the aid received from the Structural Funds is assumed to come in addition to the financing from local sources. The aid is, thus, assumed to be granted to projects which would not have been carried out without the aid from the EC's budget. Typically the aid from the Structural Funds will cover 50% of the total cost of the project. However, in the case of particularly poor regions and/or socially justified projects the EC's contribution may be as high as 75%. In other cases, where the social justification is less obvious, the EC's share may be as low as 25%.

The aid is normally granted on the condition that the EC's rules of competition and free access to the market of public procurement are respected. Consequently, the projects implemented with aid from the structural funds are subject to an open and rigorous tendering procedure allow-ing firms from all EC member states to tender for such projects. Since local firms frequently do not possess the know-how and the human and financial resources to undertake, say, the construction of a bridge, a tunnel, to deliver an up-to-date digital switching equipment or install modern sewage treatment facilities, a high proportion of the aid from the Structural Funds (according to some estimates up to 60%) is in reality channelled back to the most advanced member states in the form of procurement contracts.

Access to aid from EC's Structural Funds under "Objective 1" (the Regional Fund) is open with a few exceptions of a temporary nature for regions with a GDP per capita, in purchasing powers standards, is below 75% of the EC's average.

The Cohesion Fund, established by the Maastricht Treaty, provides grants to Member States with a per capita GDP of less than 90% of the Community average (Spain, Greece, Portugal and Ireland) which have a programme leading to the fulfillment of the conditions of economic conver-gence as set out in Article 104c of the Treaty and aiming at avoiding excessive government deficits. The Cohesion Fund finances two types of projects: environmental projects and projects of com-mon interest in the area of transport infrastructure. The rate of Community assistance is between 80 and 85% of public or equivalent expenditure. In the event of the Council deciding that an excessive government deficit exists in a Member State, no new projects or, in the case of large multi-stage projects, no new stages of a project shall be financed from the Fund for that Member State.

A simple continuation of the economic and social cohesion according to the lines and prin-ciples followed in the past, therefore, cannot be taken for granted. Some of the very basic features of these policies may, in fact, need to be recon-sidered in the light both of the budgetary con-straints of the EU and of the absorptive capacity of the new member states.

However, assessments of the costs and ben-efits of EU membership for the CEECs should also take account of the delay which would be re-quired for the candidate countries to reach the

level of 75% of the EU's average income (at PPS). This question will be addressed in the following section.

THE SCOPE FOR AND THE MECHANISMS OF CLOSING THE INCOME GAP

As shown in section 1, the difference between the Purchasing Power Parity and the market rate of exchange shows a pronounced tendency to decline as a function of the real income level (Graph 2). This feature is mainly due to the fact that prices of internationally traded goods and services tend to increase to the level prevailing in the world market while the prices of goods and services traded only domestically remain determined by the general level of income and productivity in the economy.

The splitting-up of the CEEC economy in a sector which is exposed to competition in foreign markets (or to competition from imported products) and a sector which, due to the very nature of the goods and services it produces, has taken place at a rapid pace after the break-down of the communist regimes. It has entailed huge, and in some cases chaotic, changes in relative prices between the two main sectors and notably in countries which have been in the forefront in the opening up of frontiers and in liberalizing capital movements such as Estonia, the Czech Republic and Slovakia. It has been less pronounced in countries where the opening up has been more timed such as, notably, Hungary, Bulgaria and Romania.

During the subsequent course of economic integration and reduction of the degree of real income divergence, the price relations can be expected to change again in favour of the (sheltered) sectors, that is, the prices of domestically traded goods and services can be expected to rise relative to the internationally traded goods and services. This, in fact, constitutes a mechanism whereby the domestic (sheltered) sectors are provided a share in the benefits from trade integration engineered by the sectors exposed to (and benefitting from) foreign competition. The detailed implementation of this process will vary from one country to another depending upon the capacity to adjustment of the various sectors of the economy, the influence of monetary and fiscal policy, etc. It is, therefore, hardly possible to predict with a high degree of exactitude the path of this process.

Nevertheless, an illustration of the link between real income catching up and the change in relative prices can be found in the performance of the Greek and Portuguese economies during the process of adjustment of their economies to the EC's internal market. As far as Portugal is concerned, its GDP per capita in 1985, just before joining the EC, in ECU terms amounted to only 29% of the EC average (excl. ex-GDR). However, in PPS terms Portugal's per capita GDP amounted to 53.1% of the EC average; implying a PPP/exchange rate ratio of 1.82. Ten years later, in 1995, Portugal's per capita GDP in ECU terms had increased to 46.9% of the EC average while in PPP terms it had increased to 67.9. The PPP/exchange rate ratio had, thus fallen from 1.82 in 1985 to 1.45 in 1995.

Short-term fluctuations of the PPP/market rate of exchange ratio may be due to other factors and these figures quoted for Portugal do not serve as a model but only as an illustration of the mechanism whereby all sectors in the economy obtain a share in the benefits from integration. In practice, however, due to this mechanism prices and costs in the sheltered sectors tend to increase faster than the prices in the exposed sectors. The mechanism could also be reversed in phases where sectors which hitherto did not participate in the economic integration are abruptly being exposed to foreign competition or, alternatively, obtain access to the world market. The latter could be the case for agriculture in some of the CEECs such as, notably, Poland and Romania. Typically, however, the catching up process for most of the CEECs can be expected to involve a substantially faster rise in nominal incomes expressed in ECU terms than expressed in PPP terms. The corollary of this, then, would be a faster rise in the GDP deflator than in the prices of exports and imports of goods and services. and this process could take place, it must be stressed, without distorting the monetary and economic stability of the economy.

(As pointed out by the economists of the (Scandinavian School) in the 1960s this process can be expected to continue as long as the productivity increases in the exposed sectors are faster than the productivity increases in the sheltered sectors. Since the scope for productivity increases in are likely to be particularly large when hitherto protected industries are exposed to foreign competition, the mechanism may be particularly powerful in the CEECs with relatively large potential for income increases through growth in the volume of exports of goods and services.)

This aspect is likely to be of considerable importance when tracing the route for integration of the CEECs in the European economy. As a general rule of thumb, the speed of catching up of per capita income in ECU terms will be deter-

Table 2: Feature of the catching up process

Portugal	1985	1995	Change %
Real effective exchange rate 1938 = 100			
A: Based on GDP deflator	100	137.2	37.2
B: Based on deflator of exports of goods and services	100	116.5	16.5
C: GDP Deflator/Deflator of exports of goods and services	100	117.8	17.8
GDP per head of population, EUR 15=100			
A: ECU terms	29.1	46.9	61.2
B: PPS terms	53.1	67.9	27.9
C: Ratio PPS/ECU	1.82	1.45	- 20.7

Source: Commission services (DG II)

mined by the future productivity increases in the *exposed* sectors only, rather than in the economy as a whole. Using again the illustration of this mechanism, during the course of the catching up process the price of a hair cut in Romania will increase in proportion to the price of most manufactured goods. This change in *relative* prices will show up as an increase in the consumer price index over and above the rate of inflation in the most developed countries. However, it is a result of a change in relative prices between traded and non-traded goods and services and will therefore not, as such, entail a deterioration of the competitiveness of the Romanian economy.

In practice, this process of change in the relative prices will be superimposed on other aspects of economic performance, such as monetary policy, cost developments in the *exposed* sectors, etc. The actual economic development and performance of a country will therefore not necessarily correspond to the theoretical pattern outlined above. For example, in contrast to the classical cases of successful catching up, such as Ireland and Portugal, the development of Greece since accession to the EC has, in fact, mainly due to economic mismanagement by the Papandreou-regime, entailed both stagnation of the real per capita income and a decline in nominal (ECU) income relative to the EC average.

The economic development of Portugal during the last decades may, as already indicated, provide a good indication of the potential evolution of the CEECs, now that they are in the process of implementing the free trade arrangements contained in the Europe Agreements. Since joining the EC, as a reflection of the relative price changes mentioned above, the Portuguese GDP deflator, in fact, rose by almost 3 percentage points faster per annum than the GDP deflator for the fifteen EC member states on average. Over this

period, however, the deflator of exports and goods and services rose by about one percentage point per year more than the EC average, resulting thus in a certain loss of price competitiveness of Portuguese exports. Adjusting for this effect, nevertheless, the Portuguese GDP deflator could probably have increased by some two percentage points more than the EC average, simply due to the change in relative prices and costs between the exposed and sheltered sectors and, thus, without any loss in external competitiveness.

In sharp contrast to Portugal, Ireland, at the time of joining the EC, had an income per capita in ECU terms approximately the same as the level in PPS terms. This may have been due to the fact that, due to the de facto monetary union with the UK and to the free movement of labour between Ireland and the UK, Irish domestic costs and prices had already moved closer to the UK level. Consequently, the concept of a (sheltered) sector had less relevance in the Irish case and the scope for changes in relative prices between the exposed and sheltered sectors was more limited. This is also illustrated by the fact that the Irish GDP deflator and deflator of exports and goods and services between 1983 and 1995 rose at about the same rate relative to the EC average.

Using the conceptual framework illustrated above, it now become possible to establish a scenario for the evolution of the economic performance of the CEECs during the period of catching up to, say the present EC average.

Taking, first, Romania as an example, the level of per capita GDP in PPS terms in 1995 was only some 21.5% of the EC average of 17482 ECU or 3758 ECU. In order to attain the 1995 level of per capita GDP in the EC, per capita GDP of Romania in real terms would thus need to increase some 360%, corresponding to an annual rate of increase of 5% per annum for 32 years (or, alter-

natively, 6% per annum for 26 years). During this process of increase in real GDP, however, the ratio between the market rate of exchange and the purchasing power parity would be reduced as a result of changes in the relative prices between the sheltered and the exposed sectors. Consequently, the rate of growth of nominal GDP (without any change in competitiveness of the Romanian exposed sector!) could be some 1.4 points higher than the real rate of growth if the catching up to the EC average would be obtained over 32 years and 1.7 points if the catching up would be brought about over 26 years. The speed of catching up of *nominal* income would thus be considerably faster than the catching up of real income. During the course of the period, furthermore, the rate of catching up would be particularly fast in the early phase of the process and slow down in response to a reduction of the income gap.

The catching up scenarios outlined above, although apparently both highly technical and highly speculative, have serious implications both for macro-economic stability, notably the sustainability of government budget balance and an external deficit, and for the politics of the enlargement process in general.

During the next two decades the potential for expansion of per capita output in the CEECs, which have a relatively well educated work force and a culture of production, will be considerable, probably at least some 5% per annum (The Japanese economy, during the first two decades of opening up of foreign trade through, notably, gaining access to the US market, experienced an average rate of growth of labour productivity of some 10% per year on average. An assumption of a 5% productivity growth in the CEECs over the next two decades would, in comparison with the experience of Japan and other Asian countries, appear to be on the low side.) Furthermore, the expansion of output will be accompanied by an additional 1-2% increase in the GDP deflator due to a shift in relative prices between the exposed and sheltered sectors. This category of price increases should, thus, not be interpreted as being equivalent to general inflation and would in fact correspond to zero inflation in the most developed EC countries (where the GDP deflator and the deflator of exports of goods and services tend to develop in parallel). The Maastricht criteria would, thus, as far as the rate of inflation in low-income countries is concerned (The rate of inflation should not exceed by more than 1.5 points the average of the three EMU countries with the lowest rate.), appear to be overly strict

and would need to be adjusted as far as these countries are concerned.

Also the criteria concerning the general government budget balance and gross debt would need to be reconsidered in order to allow the CEECs to integrate harmoniously into the EMU. In fact, with prospects for an increase in nominal GDP in ECU terms considerably above the scope for (non-inflationary) increase in the EC average, the CEECs would be in a position to sustain both a higher budget deficit and a higher external deficit than a high-income member state. (The higher the growth of nominal GDP, the higher the budget deficit or the external current deficit compatible with a constant level of public and/or external debt in proportion to GDP. For example at a rate of growth of nominal GDP of say 8% per annum, a deficit of 4.5% would be compatible with a public debt amounting to 60% of GDP. However, at a rate of growth of nominal GDP of only 4% per annum the level of deficit compatible with a constant debt/GDP ratio would be only 3%, etc.)

Due to the prospective fast increase in GDP in ECU terms during the process of integration, the contributions from the CEECs, once inside the EC, would also rise considerably faster than the contributions from the high-income member states. In fact, since the EC's own resources and supplementary contributions are based on nominal data, such as VAT receipts and GDP expressed in ECU terms, these items would, on the assumption that the quality of national accounts statistics and the efficiency of tax collection are enhanced in line with the growth of incomes, rise in line with the nominal GDP and expenditure of the CEECs.

There would, thus, be not only costs but also considerable gains for the EC in a rapid integration of the CEECs through the implementation of the Europe Agreements already in force and an early membership opening the opportunity for these countries to participate fully in all aspects of EC policies, including the common agricultural policy. The essential condition for a successful completion of this process over the coming decades would be for these countries to adopt a policy aimed at a strict maintenance of macro-economic stability and to allow only such budget and external deficits as would be sustainable in the long run and, in the case of external deficits, covered by long-term capital imports. Again, the implementation of such policies would, beyond doubt, be considerably facilitated by the prospect of early and full admission into the EC rather than a long waiting period in the corridors.   ∎