Globalisation and regional integration; a view from Eastern Europe and the FSU[*][**]

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Globalisation and regional integration have transformed the world economy in the past half century. Nowhere have these two processes been more significant and more dramatic in their scope and speed, than in the 27 countries of Eastern Europe and the former Soviet Union (FSU) that constitute the area of operations of the European Bank for Reconstruction and Development (EBRD). On balance, these processes have been and will continue to be beneficial to those affected by them. Where there have been losers – and where there may be more in the future – the response should be not to raise the drawbridge, but to create institutions and mechanisms to safeguard losers from deprivation and hardship and, where possible, to create the opportunities for losers to join the winners.

Before we can make an assessment of the impact of globalisation and regional integration on Eastern Europe and the Commonwealth of Independent States (CIS) countries, some key concepts need to be defined, clarified and put into context.[1]

Globalisation: a definition

Globalisation is the steady decline in importance of national boundaries and geographical distance as constraints on mobility. A new phase of this process began following the end of World War II. People, goods and services, factors of production and their owners, financial capital, enterprises, technology, brand names, knowledge, ideas, culture and values all move more easily across national frontiers than at any time since the beginning of World War I. This process is known as globalisation. It affects virtually every nation or region in the world. The phenomenon is driven, first, by technological advances reducing the cost of transportation, mobility and communication, and second, by deliberate political decisions to reduce or even to eliminate man-made barriers to international mobility.

The first of these two driving forces is irreversible, barring a catastrophe on the scale of the fall of the Roman empire that causes major technical regress. Setbacks to the processes reducing the cost of transportation, mobility and communication can occur. An example is the global increase in the cost of air travel and in other costs of engaging in international trade resulting from the recent terrorist attack on the US.

[1] The FSU contains all fifteen former Soviet Republics. The CIS is the FSU minus the three Baltic States.

The political forces driving the lowering of man-made obstacles to international trade and mobility cannot be taken for granted. They have been reversed in the past. They can be reversed again. Between 1870 and 1914, international trade in goods and services was as free as it is today. International lending and borrowing were also highly developed and subject to few official restrictions. The range of financial instruments traded internationally was of course much more restricted than it is today. However, mobility of people, including international migration, was less restricted during the Gold Standard days than it is today.

Governments can attempt, with varying degrees of success, to build firewalls around their countries to control the content of information accessed and transmitted through the Internet. A few countries have succeeded in cutting of their populations from virtually any form of contact with the rest of the world. Current examples of such nations are North Korea and Myanmar. It is interesting to observe, though, that even for these countries, noticeable and gradually widening cracks are appearing in the walls of these 'isolation ward' nations.

The reality and ubiquity of the globalisation process is undeniable. Its most vocal critics, the loose post-Seattle coalition spanning greens, blue collar trades union members from the industrial countries, drop-the-debt groups and violent anarchists and nihilists, brought together by cheap air travel and the internet, constitute a *global* movement against globalisation.

Globalisation is a Janus with two aspects: one positive and one negative. It means the diminishing importance of national frontiers and geographical distance as obstacles to the mobility and movement of just about everything: good, bad, and ugly. Examples of the unambiguously negative dimensions of globalisation, or *pathological globalisation* include the following:

Pathological globalisation

- The international spread of contagious diseases affecting humans has accompanied the increased mobility of humans and animals. Historically, smallpox and measles have destroyed societies. Today, TB, HIV-AIDS, Ebola virus, Nile virus and flu virus can spread with alarming speed. So can BSE and foot and mouth disease.

- The threat of international contagion in financial markets, manias and panics, irrational euphoria and despondency is but a phone call, news flash or e-mail message away.

- Crime (the drugs trade, money laundering, tax evasion) has become a global industry.

- Terrorism has become a global threat perpetrated by loose global networks of terrorists and those who support them.

- Threats to national or regional cultures and identities are (perceived to be) posed by a global culture of consumerism that spreads rapidly through the media.

Note that, except possibly for the last example, these pathological forms of globalisation can only be tackled effectively through global action, that is, through world-wide co-ordinated actions by governments, international organisations and civil society. Safety and security through withdrawal, exclusion or isolation is not an option.

Two cheers for globalisation

Apart from these pathologies, globalisation is, potentially, a blessing. It is first and foremost about increasing opportunity, choice and freedom. The simple but fundamental proposition that is the cornerstone of this positive judgement, is that trade – voluntary exchange – is not a zero-sum but a positive-sum game. Globalisation brings enhanced scope for mutually beneficial trade, through specialisation, division of labour, diversification of risk. It boosts learning opportunities, through emulation and imitation at first, and then through synergistic investment in new knowledge and skills. While it is not yet true that people from anywhere can move to opportunities everywhere, the obstacles to international movement of people, as tourists, consumers, investors and economic immigrants have been falling for these past 50 years. Concerns about global terrorism have set this process back, but once the lessons have been learnt and the proper private and public measures have been implemented, the process of globalisation will resume.

Thanks to globalisation, regions and nations can safely and productively specialise in the production of far fewer goods and services than they wish to consume, because a specialised and restricted national production basket can be traded internationally for a richer and more diverse consumption basket. Access to global financial markets and international portfolio diversification makes it possible, in principle, to insure the residents of a nation against the risks (e.g. terms of trade shocks) associated with specialising in the production of a relatively narrow bundle of goods and services in an uncertain global environment. Young workers can move from countries with a predominantly young population and limited physical capital to countries that have a greying population and a 'youth deficit', but ample physical capital. If disease travels internationally, so do cures and the means of administering them and of paying for them. The international community of scholars is more than the sum of its constituent national parts. Knowledge, once produced, is the ultimate global public good. The problem of striking the right balance between the costly production of new knowledge and the (virtually) costless dissemination of existing knowledge will have to be resolved through global co-operation, legislation, rule making and enforcement. Access to the aesthetic and artistic 'acquis' and the cultural achievements of the rest of the world can enrich every nation.

The key political issue of our time is to ensure that institutions are created, at all levels, local, national, regional and global, to ensure that these *potential aggregate gains* are realised and shared widely and fairly. Global co-operation and effective global institutions and arrangements are also necessary to eliminate, or at least to control, the pathological forms of globalisation referred to earlier. The gains from globalisation will not be reaped without active institution-building efforts at all levels. It is not enough for governments to lower or even abolish all man-made barriers to trade and mobility, and to wait for spontaneous order to emerge out of chaos.

The benefits and costs from globalisation are not evenly distributed across countries, regions, sectors, industries, or across people with different skills or other characteristics. Some countries' experience of globalisation is limited to its pathological dimensions. Afghanistan has tasted the bitter fruits of external military interventions, the global drugs trade and global terrorism. For many decades now, it has tasted very few of its sweeter fruits: the gains from international trade in goods and services and from international risk-sharing through financial portfolio diversification; the benefits of access to global expertise, know-how and knowledge through foreign direct investment (FDI), cultural and educational exchanges.

Obstacles to realising the gains from globalisation: mismatched global markets and national governments

A key obstacle to ensuring that the potential gains from globalisation are realised in the aggregate and are distributed fairly is the growing gap between, on the one hand, the domain of mobility of key economic agents and activities, and, on the other hand, the domain in which effective, legitimate jurisdictions can regulate and control these agents and activities. The gains from trade and factor mobility, and the benefits from financial integration, from global specialisation and diversification cannot be reaped in a legal and regulatory vacuum. They require the rule of law and an effective supervision and regulatory regime. And they require that political institutions and mechanisms exist or are created to ensure that the final distribution of income is widely perceived to be fair, or at least acceptable.

There are many ways in which the domain of markets and of internationally active enterprises, investors, workers and consumers exceeds the span of control of legislators and regulators. Some examples:

- Financial markets are global, but financial regulation and supervision are national.

- There is no global lender of last resort.

- There is no effective mechanism for ensuring efficient work-outs of international sovereign debt defaults.

- Even when trade liberalisation produces aggregate global gains, individual countries may end up worse off (an example is a trade reform that weakens a country's monopoly power in global markets). Such mechanisms for compensating losers as do exist, tend to be organised at the national level, through the national tax-transfer system. Trade adjustment assistance promoting the adaptation of losers in a trade liberalisation programme to the new comparative advantage, also tends to be organised and funded at the national level. If the losers are numerous and/or well organised, potentially global welfare enhancing trade liberalisation may not be politically supported.

- Even when trade liberalisation makes any given country potentially better off *in the aggregate*, there are likely to be both winners and losers within the country.

Owners of factors of production that are specific to a sector that becomes more exposed to international competitive factors may see their rents eroded. Some of the blue collar workers demonstrating in Seattle were responding to the real threat to their existing livelihoods posed by past and future trade liberalisation.

Even within a country, redistribution or compensation mechanisms may have limited scope and effectiveness. This is particularly relevant in countries where the capacity of the state to administer and to tax is limited. All the EBRD's countries of operations share the feature that the least advanced aspect of the transition process is the transition of the state from a pervasive, intrusive but incompetent and incapable Leviathan to a limited but competent and capable regulator, supervisor and financier (and at times provider) of public goods and services. Two key public goods are macroeconomic stability and an effective social safety net. Reforms and liberalisations that could make everyone better off if the state were capable and willing to assist the losers, are not implemented because, in the absence of effective compensation, the reformers cannot round up sufficient political support.

- When workers move internationally, pension systems (including social security) and medical insurance, remain overwhelmingly national.

- Enterprises and owners of capital can move globally; taxation of enterprises and of capital owners remains national; environmental, labour and safety standards remain (by and large) national.

Globalisation and the EBRD's countries of operation

During the central planning period, the nations of Eastern Europe and the Former Soviet Union were forced into a massively inefficient pattern of regional specialisation and division of labour. Trade of the Comecon countries with the rest of the world was artificially restricted to very low levels indeed.[2] Also, within the Comecon area, excessive specialisation took place. Production of goods was concentrated in plant of excessive size. Quasi-public services such as health and education were given priority, but market-services or private services were starved of resources. Specialisation in production was excessive and paid little attention to the basic economics of proximity to inputs or markets.

While some Comecon area governments, including Poland, Hungary and the USSR, borrowed in the international financial markets prior to the collapse of the Soviet Union, the Comecon was not integrated into the international financial system. There was no internal, domestic financial market and only very a rudimentary system of retail and saving banks.[3] There was an occasional, one-off, FDI initiative, but no regular or systematic exploration by foreign strategic investors of commercial opportunities East of the Iron Curtain. Labour mobility was practically nil between the Comecon and the rest of the world. The exchange of scholarship, ideas, knowledge and know-how was severely restricted.

If there ever has been a group of countries for which the potential net benefits of globalisation would be both unambiguously positive and large, the countries of Eastern Europe and the former Soviet Union in 1991 were it.

The countries of Central Europe and the Baltics (CEB), richly endowed with human capital and with the memory of the market economy still alive among the old and in the collective sub-consciousness, needed access to global markets (as exporters and as importers) and access to foreign technology and capital to overcome the damage done by forty five years of

[2] The former Socialist Republic of Yugoslavia was not part of the Comecon. As a result the violations of the principles of comparative advantage were much less pronounced than in the former Soviet Union and Eastern Europe. Albania pursued a strategy of almost complete autarky – at enormous cost to its population. Some central European countries, especially Hungary, had begun to pursue trade opportunities outside the Comecon for some time before the break-up of the Soviet Union.
[3] Again, the Socialist Republic of Yugoslavia was more integrated into the international financial system than the EBRD's other future countries of operations.

central planning. Free trade in goods and services and FDI were the key to economic regeneration. The liberalisation of portfolio capital movements was not essential from the point of view of financing domestic capital formation, as long as the proceeds from privatisation were sufficient to finance both fiscal and external deficits.

For individual private savers (including pension funds and other institutional investors), international portfolio diversification would have been desirable from day one of the transition process. However, capital account liberalisation for portfolio transactions made little sense and could indeed contribute to systemic instability, until a strong, well-supervised and regulated domestic banking sector, non-banking financial sector and capital market had been established. Even today, not all CEB countries have created sufficiently robust and efficient domestic financial systems to ensure that international financial integration for portfolio investment purposes is likely to be a boon rather than a source of instability.

The CEB countries were able to finance and administer a social safety net that mitigated hardship and deprivation among those whose traditional livelihoods were destroyed by integration in world markets. This helped maintain political support for reform in general and for increasing trade liberalisation in particular.

The high (indeed excessive) degree of specialisation in production inherited from their central planning past made opening up to the global economy a necessity for all countries in Eastern Europe and the CIS. Like the CEB countries, the CIS started the transition with a highly educated and skilled labour force. Unlike the CEB countries, there was no surviving memory of a formal market economy, although informal markets were thriving in a number of countries, notably in republics on the periphery of the former Soviet Union, like Georgia. For the internationally exposed sectors, world prices could provide the benchmarks that could guide domestic producers and consumers towards efficient resource allocation patterns. For the internationally sheltered sectors, domestic markets often had to be created from scratch, without the benefit of price and cost benchmarks. This has turned out to be a long-drawn out and costly process.

Unlike the countries in the CEB and South East Europe (SEE), a number of CIS countries had independence thrust upon them. Some had no living tradition and experience of selfgovernment. Creating a limited but capable state has turned out to be the greatest transition challenge of all. The cost and administrative complexity of putting together a viable social safety net to protect the many losers in the transition process have thus far been beyond the reach of many CIS countries. The result is widespread poverty and hardship.

Is trade liberalisation and limited capital account liberalisation – often restricted to FDI - to blame for this? The answer is that it is not. The collapse of central planning was not a choice of any country or government. Communism and central planning collapsed because these economic and political systems were rotten to the core and could not survive. Trying to preserve the central planning apparatus in the individual successor states of the former Soviet Union was also not a viable option. Autarky was not a viable option even for Russia, the largest and most diversified of the CIS countries. Integration into the global economy was a matter of survival.

The experience of the CIS these past 10 years does underline the magnitude of the social and economic costs associated with inadequate public administration. This includes regulation, supervision and administrative support for the rule of law, the enforcement of property rights and of contracts in economic relations. It also includes the ability to finance and administer a social safety net that provides effective insurance for the losers in the transition process and maintains popular support for necessary market reforms.

Regionalism and the EBRD's countries of operation

There are two distinct, but potentially complementary, reasons for pursuing regional economic and/or political integration. One is the 'first best' argument for regional integration. It is based on the recognition that certain issues are addressed most effectively not at the national or global level, but at the regional level. For instance, certain kinds of positive or negative externalities and issues involving regional public goods (acid rain, river pollution, fishing rights, exploitation of a common resource), are best addressed at a regional level.

The other is the 'second-best' argument for regional integration as the poor man's substitute for, or half-way house on the road to, eventual global integration. It is based on the realisation that, although in the best of all possible worlds, a certain class of issues is best addressed globally, the political institutions for effective action only exist (or have some hope of being created) at a regional level.

There are several regional economic integration efforts under way in the EBRD's area of operations. Of these, the EU enlargement process is the most significant for the EBRD. It involves 10 of our members directly (by being part of the process) and the remaining 17 indirectly (by being excluded from the process). It also impacts directly on the EBRD's mandate to promote the transition. Much of what the accession candidates have to do in order to meet the requirements of the Acquis Communautaire is directly transition-enhancing for the candidate countries. A few items in the 'Acquis', like the Common Agricultural Policy (CAP) discussed below, are costly to the candidate countries and indeed to the world at large. For reasons of space, other regional initiatives are not discussed here, including the Stability Pact for SEE, and the economic, political or security-focussed arrangements bringing together different subsets of CIS countries

European Union enlargement and its impact on the EBRD's countries of operations

European economic and political integration, including the current phase of enlargement, can be justified with an appeal to both the 'first best' and the 'second best' arguments. The common heritage of a thousand years of bloody intra-European conflicts calls for political and social solutions at the regional, European level. Economic integration - the creation of a customs union and a single European market and the adoption of a common currency (by 12 of the 15 existing European Union (EU) members) - has been the means through which the political purpose of ending armed conflict among European nations has been achieved. That is the 'first-best' argument.

European economic integration has also been the second-best means through which the West-European (and soon the Baltic states and the Central, East and South-East European) nations have sought to reap the benefits from freer trade, enhanced financial integration, common regulatory and supervisory rules of the game, and greater mobility of persons – natural and legal.

Regional trade liberalisations are not always desirable from a global point of view. The benefits of *trade creation* among the members of a customs union may be dominated by the costs of *trade diversion* away from those excluded from the union. In the case of the EU thus far, it is likely that trade creation has carried the day in most areas, with the common external tariff of the Union lower than the average of the prior national external tariffs and real progress in the reduction of non-tariff barriers to trade.

Notable exceptions to this positive assessment can be found in agriculture, where the CAP has been a tax not only on the European consumer but also on farmers in the rest of the world, including the some of the very poorest. Also, in 'sensitive' industries like textiles, footwear and other semi-skilled manufactures, EU tariffs, quotas and other non-tariff barriers to trade have impaired the efficiency of the global allocation of resources and caused hardship in many emerging markets and developing countries. Ideally, in order to realise the gains from globalisation, some truly global arrangements or institutions are required. The World Trade Organisation (WTO) and the International Monetary Fund (IMF) are examples of such global arrangements. However, pooling and sharing sovereignty at a global level is only feasible to a limited extent. Regional integration efforts, although still very difficult, have a greater chance of success. Such regional integration efforts should be inclusive. They need not and should not involve the creation of additional barriers between the region and the rest of the world.

WTO Accession and the Transition Countries

Key to ensuring that the gains from globalisation are widely distributed will be further progress in the liberalisation of trade and in the movement towards greater uniformity of the rules governing trade between countries and regions. This is particularly relevant in the context of the transition economies. While a substantial number of transition countries, ranging from Albania to Moldova, have already acceded to the WTO, and others, such as Russia, Ukraine and the Caspian countries have started the process of accession, there remain major challenges facing these countries – particularly Russia – if accession is to occur speedily.

Indeed, much will depend on the progress with Russian accession, not least because of the demonstration effects to other countries in the CIS region, but also because of the sheer size and importance of the country. There have been encouraging signs. On a multilateral level there has been substantial progress in harmonising legislation. In bilateral negotiations, much progress has been made on market access for industrial products. Nevertheless discussions regarding both agriculture and services have barely commenced. In the case of services, Russia has recently put forward serious proposals for liberalisation but there remain many areas of disagreement, principally with neighbouring countries. Discussions concerning agriculture remain complicated by the ongoing debate over agricultural reform that is occurring in Russia. More generally, in many of the CIS countries existing legislation and practice on important areas such as industrial subsidies, as well as taxation, customs policy and anti-dumping, remain substantially different from the requirements of the WTO.

The importance of WTO accession and – more generally, of the shape of the agenda of any new Round of multilateral negotiations – issues that will be shortly discussed at the Doha Ministerial Meeting – has indeed been heightened by recent turmoil and the negative shock to global output that has resulted. Trade liberalisation has been a critical driver behind globalisation and an important factor, particularly in the context of the transition countries, for their greater integration into the world economy. Loss of impetus for continuing liberalisation and integration will undoubtedly be costly for countries that do not accede and for the world economy as a whole, if the impasse of Seattle is not quickly overcome.

The 15 EU members and the 12 candidate members with whom accession negotiations are under way, are engaged in a process that will create, for a while (until China or India develop their full potential or until the two American continents achieve a common market) the largest single market in the world. Enlargement means the removal of man-made (legal, regulatory or tax) obstacles to the mobility of goods and services, finance, enterprises and, after a transitional period, also of EU residents as workers, and the implementation of the Acquis Communautaire throughout the enlarged EU. It should be and can be an example of the realisation at the regional level of many of the potential benefits of globalisation. The existing EU members and the candidate countries have enough in common, through geography, history and culture, to create the institutions that permit more of the potential gains from globalisation to be realised and shared equitably.

The Enlarged EU and the Rest

It is key that the EU enlargement process be *outward-looking and inclusive* instead of *inward-looking* and *exclusive*. In the field of trade, care must be taken to ensure that the enlarged EU is *'trade creating'* for the world as a whole, rather than 'trade diverting' at the expense of the countries left outside the enlarged Union. More generally, in all dimensions of the accession process - economic, environmental, political and social - we must make sure that EU enlargement is *transition creating (or enhancing)* for all our 27 countries of operations, and not *transition diverting* towards the accession countries but away from our 17 countries of operation that are not candidates for accession.

The enlarged EU should open its markets to the goods and services produced outside its post-enlargement boundaries. It should not exclude such sensitive products as agricultural commodities, textiles, foot ware and steel and light engineering products.

Special and generous visa and work permit arrangements should be implemented for countries like Belarus, Moldova and Ukraine, that would otherwise be deprived by the Schengen Agreement of the current opportunities for employment of their nationals in countries like Poland and other accession candidates. The unique geographical position of Kaliningrad as a Russian enclave in what will soon be an enlarged EU makes a flexible and generous interpretation and application of the Schengen agreement unavoidable.

For forty years, Europe was divided by an *Iron Curtain*. We must, and we can, make sure that we do not create a *'Brussels Lace Curtain'* on the new frontiers of the enlarged EU. EU enlargement can be an example of how the potential gains from globalisation can, with the right institutional framework, be turned into strong realised regional gains that are not at the expense of those left outside the enlarged union. It is our joint responsibility to see to it that this happens.