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of Prof. Dariusz K. Rosati, Ph.D., D.Sc.

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INTRODUCTION

The purpose of this Report is to evaluate the progress in the process of transformation and economic integration of the countries of Central and Eastern Europe in 2004 and in the first half of 2005. The analysis encompasses 27 countries in the region of Central and Southeastern Europe and the former Soviet Union. The common feature of these countries is that in the years 1989–1991, they started a process of fundamental transformation of their political systems, aimed at building democratic states and competitive market economies.

The most important event of last year in the region was the accession of the eight states of Central Europe to the European Union. The experience gained from the first year of membership demonstrates that accession brought a number of crucial economic and political benefits for the new member states. Developments in the situation in the region show also that European integration and the pursuit of accession to the structures of the European Union have become an appealing and steady direction of the policy of the remaining states of Central and Eastern Europe. Recently, that direction has also been taken by certain countries from the area of the Commonwealth of Independent States. This demonstrates the success of the policy of the eastward enlargement of the European Union and confirms that economic integration is a factor in the political stability and faster economic growth of the countries undergoing transformation.

In its structure, this Report is similar to those of previous years. The first chapter contains a brief summary of the most important findings of the analysis. The second chapter is devoted to the political situation, the main directions of internal and foreign policy, and institutional transformations within the scope of the functioning of state structures and a civil society. The third chapter comprises an assessment of the development of the economic situation and the progress level of market reforms in the region. Chapter Four presents country profiles, including details of the most important economic and political events and basic statistical data for individual countries. Chapter Five discusses the international economic cooperation of the region's countries and the status of integration and cooperation with the European Union. As usual, the final part of the Report is a special study, which this year is devoted to the issue of health care system reform in the countries undergoing transformation, against the background of international trends.

The most important conclusion of this year's Report concerns European integration. It is the fundamental factor guaranteeing long-term security, development and well-being on the European continent. It is also a very important factor in political stability and a stimulus for essential reforms in the countries that are candidates for the European Union. At the

same time, the division of the region into two groups of countries that differ substantially in terms of their political systems and the policies they adhere to, has been growing and strengthening. The countries of Central and Eastern Europe, striving for integration with the European Union, have tried to build an identical or a very similar system of the state and economy to that which functions in the states of Western Europe. The majority of countries in the area of the Commonwealth of Independent States, on the other hand, have adopted different solutions for their political systems and sought other forms of cooperation.

This Report has been compiled by independent experts representing, among others, the Warsaw School of Economics, the Polish Academy of Sciences, the Lazarski School of Commerce and Law, and the Foreign Trade Research Institute. The Report has been prepared on the initiative and with the support of the Foundation Institute for Eastern Studies. It contains, however, the personal views of the authors themselves and does not represent the opinions of any institution, either public or private. The authors hope that the Report will contribute to a better perception of the process of systemic transformation in the countries of the region in transition, and that it will become, like the Reports from previous years, a basis for discussion on the direction for further development for the countries in our region.

Prof. Dariusz K. Rosati, Ph.D., D.Sc.
Coordinator of the Report

A WORD FROM THE PUBLISHER

I have the pleasure of presenting the latest, fourth, edition of the Report “New Europe – Report on Transformation”. Publication of this Report, to be presented at the Economic Forum, is sponsored by the Programme Council of the Economic Forum and the Institute for Eastern Studies. One of the projects for enriching the Forum is to elaborate and publish systematically an analytical Report every year on the economic and political situation in the region of Central, Eastern and Southern Europe and the former USSR countries, with special emphasis on the key economic and political problems and challenges faced by the individual countries.

The mission of the Economic Forum, being held for the fifteenth time, is to create a favourable climate for the development of political and economic cooperation between the member states of the European Union and their neighbours. The Forum, which in accomplishing its mission has been independent and impartial, enjoys the reputation of the most important Central and Eastern European meeting of people from the political, business and media circles who are interested in building a beneficial climate and creating better conditions for the development of co-operation among the countries in the Region.

I would like to extend my thanks to Prof. Dariusz Rosati for his coordination of this Report. I would also like to express my thanks to the following authors and institutions: the Warsaw School of Economics, the Polish Academy of Sciences, the Lazarski School of Commerce and Law, the Foreign Trade Research Institute, and all those who have contributed to the creation of this publication.

Zygmunt Berdychowski
Chairman of the Economic Forum
Programme Council

CHAPTER I

REPORT OVERVIEW

Dariusz K. Rosati

1. The years 2004 and 2005 abounded with important political and economic events in the countries of Central and Eastern Europe and the Community of Independent States. Five countries of Central Europe and the three Baltic States successfully completed the first year of their membership in the European Union, taking advantage of that membership to increase the rate of their economic growth. In the CIS countries, a good economic situation was accompanied by political tensions, and in several of them a fundamental turn in internal and foreign policy was made (Ukraine, Kyrgyzstan).
2. There is no doubt that the eastward enlargement of the European Union was the most crucial political and economic event of last year. It became a crucial element in shaping a new political order in Europe. In parallel, the political and economic strength of the European Union was growing in the region. The accession of the eight countries of Central Europe to the European Union means – in political and symbolical terms – a positive end to the transformation process in those countries. The pro-European trend was consolidated in the Balkan countries. Within the last two years, some CIS countries – Ukraine, Georgia and Moldova – fundamentally reoriented their foreign policies by undertaking a series of initiatives to make progress in their co-operation with the European Union and reducing their engagement in previous co-operation within the framework of the CIS. This proves the growing attractiveness of European integration to the countries of the former USSR.
3. The division of the area of systemic transformation that had been formed in the previous years into two distinctly separate groups of countries – countries integrating within the framework and around the European Union and countries of the Community of Independent States – remains the primary distinguishing feature, determining the systemic solutions and policies of separate countries. The countries of Central and Eastern Europe have adopted the solutions of a liberal democratic state model, which is characteristic of Western Europe. The main features of this model have been the observance of the rules of democracy, the rule of law and obedience to law and order, and the protection of civil freedoms and liberties. A parliamentary-cabinet system has been established in the countries of this group, with the strong role of a government that is accountable to the parliament, with an independent judiciary and a wide scope of local self-government. The countries of the Community of Independent States have been developing the opposite state model, based on strong presidential power, with a limited role for Parliament, a weak judiciary and little scope for local self-government. The level of law and order in the second group of countries is lower, and a much greater role is played by informal power groupings, based on influential groups of interest (oligarchisation).
4. The events of recent years prove that the borders between these two groups of countries are not something solid and immutable. The course of transformation in Central Europe and in the area of the former USSR so far seems to confirm the conclusions following from the “centre-peripheries” model (Wallerstein, Krugman, Emerson), according to which Western Europe, being an attractive “centre” of economic and cultural power, attracts “peripheries” – less developed countries, located in its closer and remote neighbourhood. The first of those subjected to this “gravity force” were the countries of Central Europe, next the Baltic States and the region of the Balkans, and in recent times, a Pro-European

orientation in foreign and internal policy has been adopted by several states created after the collapse of the Soviet Union (Georgia, Ukraine, Moldova). Extending the influence and impact of Western Europe and its institutions – mainly the structure of the European Union and the North Atlantic Treaty Organisation – proves its civilizational and cultural attractiveness, which is so strong that it outweighs traditional divisions, resulting from ethnic, historic and religious differences. It proves that borders between “civilizations” (in the sense of Huntington) have not been set once and for all, but they can be changed as a result of a positive cultural and economic impact – i.e. the “gravity forces” – of more attractive, stronger and more developed “civilizations”.

5. The new EU member states enjoyed a series of successes in the first year of membership. The lifting of all other barriers in mutual trade after May 1st, 2004 resulted in exports to the EU markets increasing substantially, and greater access to the structural funds allowed the speeding up of investment and provided for an increase in agricultural incomes thanks to the introduction of the system of direct subsidies to farmers. This overall good economic situation was accompanied by an unstable political situation that manifested itself in the loss of social support for governments and the political parties they came from. In the last 18 months, a turning point was reached by the governments of the Czech Republic, Poland and Hungary, as well as in the Baltic States, all of which experienced a change of government. At the same time, the opinion polls showed a low level of social support for the ruling governing parties in these countries, which suggests that the political forces that successfully brought the EU accession process to a conclusion are likely to lose power in the upcoming elections. This quite paradoxical situation is a result of a series of factors, such as the effects of the economic slowdown in the years preceding accession, the high number of affairs and scandals, the shaking up of the political scene of Central European states, and political tensions connected with the last phase of preparations for accession.
6. The political situation in Southeastern Europe was gradually stabilising. This refers chiefly to Bosnia and Herzegovina, where the institutions of the central state authority step by step gained control over the consecutive areas of state functioning, and Kosovo, where the international administration managed to restore elementary public order and prevent serious ethnic conflicts. Romania and Bulgaria signed accession treaties with the European Union, on the basis of which both states will become members of the EU on January 1st, 2007, providing that they meet certain conditions, stipulated in the Treaties. However, this process is not free of risk. Unfavourable evolution of the social atmosphere in the old member states, evidenced by negative results in the referenda on the European Constitution in France and the Netherlands, have led to a hardening of government positions in part of the member states on further enlargement. This may cause a change in the date of EU accession of Romania and Bulgaria, if these countries do not fulfil their obligations made in the accession treaties. It also seems that Croatia compromised its chances of rapid accession to the European Union, by rejecting cooperation with the International Criminal Tribunal for the Former Yugoslavia. Cooperation with the European Union within the framework of the pre-accession programmes and a perspective (although still very remote) of becoming EU members was an important factor in the

political stability and favourable to introducing democratic and market reforms in the other states of the Western Balkans – Albania, Macedonia, and Serbia and Montenegro.

7. Similarly to the Central European countries, also in the Community of Independent States a relatively good economic situation went hand-in-hand with the growth of political tensions. Prices of fuel and raw materials that remained high supported the high growth rate in the biggest economy in the region – Russia – and many other countries exporting fuels and raw materials (Kazakhstan, Turkmenistan). The good economic conditions in Russia were in turn conducive to other CIS states – the average economic growth rate in the whole area of the CIS remained at a level of above 8% per annum, and the rate of registered unemployment did not exceed 10%. But the fast economic growth did not translate into parallel growth of wealth and improved living standards among the population. Income and property gaps were growing, the level and availability of public services were becoming worse, numerous inherent problems persisted in economic life, such as corruption, the wide scope of the grey economy, and the prevalence of the intervention by the administrative authorities in the activities of firms. A shortage of more profound political reforms, restricted democracy and many violations of civil liberties gave rise to social protests. The latter gained particular momentum in Ukraine, Georgia and Kyrgyzstan, where the authorities were changed as a result of “colour revolutions”. Mass social protests took also place in Belarus, Uzbekistan and Azerbaijan.
8. However, there are no reasons for expecting that other CIS countries will experience “colour revolutions” and fundamental changes of the political orientation in the near future. The authoritarian governments in some of these countries, their high dependency on Russia within the scope of fuel and energy imports and the transit and sale of their products, and the considerable distance from Western Europe represent a stumbling block on the way to democratic and pro-European transformation. However, the process of the political emancipation of individual countries can gain in speed as a result of a clear deterioration of the economic situation in Russia, for example, as a result of a lasting slump in fuel prices on world markets.
9. Development of the political situation in Russia in recent years has started to be a source of justified anxiety both in the countries that are neighbours of Russia, and in other countries of the European Union. In terms of internal policy, the administration of President Vladimir Putin is attempting to centralize power and weaken the role of the political opposition, especially by restricting the freedom of independent media. There have also been an increasing number of cases of violating civil rights and liberties, something that the judiciary is failing to prevent, since it is weak, corrupt and reliant on political power. No prospects for an end of the conflict in Chechnya are yet evident. Imperial ambitions prevail in the foreign policy and attempts are being made to restore the influences of Russia not only in the territory of the former USSR, but also in the global arena. Such a strategy has been implemented with the help of both traditional instruments of pressure, in the form of differentiating conditions of access to Russian fuel and energy resources and support for separatist and self-proclaimed regimes in certain CIS countries (Abkhazia and Northern Ossetia in Georgia, Trans Dniester in Moldova), as well as with the help of attempts made to play on differences in interest that exist within the

framework of the European Union and between the EU and the United States. This policy has exacerbated the relations between Russia and some of its neighbours (Poland, the Baltic States) and sooner or later must cause a cooling of the relations between Russia and the whole European Union.

10. The neo-imperial ambitions of Russia came to the surface most obviously during the “Orange Revolution” in Ukraine. Direct involvement in the support of one of the candidates in the presidential elections in Ukraine, who was a declared supporter of close ties with Russia, clearly indicated that Russia was striving to hold Ukraine in the domain of its own political influence. The methods used to this end are particularly worrying, like the personal involvement of President Putin in support of the pro-Russian candidate, regardless of the accusations and suspicions concerning frequent abuses of the law that were levelled against the latter, and a lack of reaction to evident instances of the results of the presidential elections being fixed. The course of events in Ukraine indicates that Russia is not interested in the progress of democracy in the former Soviet republics, and is more concerned about keeping them within its own sphere of influence. Russia treats Belarus in a similar manner, agreeing to common violations of the rules of democracy and human rights in this country at the expense of keeping Belarus in isolation from the West. In pursuit of stronger control over the remaining states created after the collapse of the Soviet Union, Russia treats both the European Union and the United States as rivals, who are interfering in its vested interests. Such a policy provokes anxiety not only because of its negative consequences for the societies of individual countries, but also in view of the threat to European security brought about by the attempts at strengthening the international position of Russia by restoring traditional zones of influence and the method of political pressure.
11. Last year was a year of rapid growth for the majority of countries in the area undergoing transformation. The average GDP growth rate in the new member states of the EU reached more than 5% in 2004, higher than in 2003, and significantly above the average for recent years. The countries of the Balkan region were developing at a similar pace. Even higher growth rates, on average 7%–8%, were recorded in the CIS area. The reasons behind such high dynamics were chiefly one-time and external; the increase in national demand and the growth of exports in connection with accession to the Union and the economic boom as regards fuels and raw materials. Nevertheless, the impact of these factors will decline in the coming years and in the conditions of slow progress or the lack of necessary structural reforms, the economic growth will slow.
12. Rapid economic growth in the region occurred under the conditions of a maintenance or even a strengthening of the economic balance. Inflation remained in the majority of countries at a fairly low level – after a temporary increase in the growth rate of prices in 2004 caused by accession to the EU and the growth in world prices of fuels, energy and raw materials, the dynamics of internal prices clearly declined in 2005. The fairly restrictive monetary policy conducted in the majority of the countries, and the appreciation of national currencies against the euro and US dollar were conducive to low inflation. Only in a few CIS countries (Belarus, Russia, Moldova, Turkmenistan, Uzbekistan) and in

certain Balkan countries (Romania, Serbia and Montenegro) was year-on-year inflation above 10%.

13. In parallel, the situation on the labour market was improving slowly but consistently – registered unemployment fell a little in the majority of new member states, but in some of them it still continued to be very high, ranging from 15% to 20% (Poland, Slovakia). The worse situation in this regard appeared in the countries of Western Balkans, where the unemployment rate reached 30%–40% (Bosnia and Herzegovina, Macedonia, Serbia and Montenegro). The high unemployment in these countries was mainly structural in character and curbing it will only be possible in the long term, provided that sustainable political stability and an essential increase in investment are achieved. The high unemployment reduced the pressure for pay rises and was conducive to keeping a tight rein on inflation. Traditionally low rates of official unemployment were recorded in the CIS countries. However, these countries have significant hidden unemployment, and the official high employment rate is maintained to a large extent thanks to low wages and unpaid leave.
14. The situation in public finances improved in all the new member states in 2004 (except Poland); although in some countries the level of the budget deficit remains high (close to 5%–6% of GDP). This situation is a reason for concern especially in the case of countries where a high deficit in public finances goes hand in hand with a high level of public debt (Hungary, Croatia). In the CIS countries, budget deficits have generally been lower, and in certain cases high surpluses occur (Russia, Ukraine, Turkmenistan, Uzbekistan). However, it is worth remembering that official statistics in these countries do not fully reflect certain liabilities of the public sector, including pension dues and indebtedness of state-owned companies and institutions.
15. The balance of payments has also improved in the majority of countries. In the new member states, payment deficits were reduced thanks to the expansive growth of exports and the influx of financial funds from the European Union. The high prices of fuels and energy were conducive to an increase of the payment surplus in certain CIS countries (Russia), while in others, growing exports were a source of improvement (Ukraine, Uzbekistan). The highest payment deficits occurred traditionally in the Balkan countries (Bosnia and Herzegovina, Serbia and Montenegro), where they were financed by inflows of aid funds and private transfers, and in the Baltic States, where the current account deficits were partially the outcome of a high inflow of foreign direct investment. The highest inflows of FDI in 2004 were recorded by Romania, the Czech Republic, Poland and Hungary (from US\$3.5 billion to 5 billion), and Kazakhstan among the CIS countries (US\$3.3 billion). Further growth of FDI inflows to the majority of the region's countries is expected in 2005.
16. Despite fast economic growth, important differences in the level of development and economic well-being were still persisting in separate groups of countries in the region. GDP per capita (according to purchasing power parity) in the new member states of the EU was on the average two times higher than in the Balkan countries and three times higher than in the CIS countries (except Russia). In addition, other indices of social

well-being – such as the poverty rate, infant mortality rate and life expectancy – were running at a firmly higher level in the new member states than in other countries of the region. Differences in the development level were being compounded in the area of separate country groups, especially within the CIS. This is a confirmation of earlier remarks that the countries in transition do not constitute a homogeneous group, and that the differences among them have tendencies for further consolidation. This proves that the hypothesis of real convergence, an approximation of development levels among highly and less developed countries, is correct in the case of the area of the countries in transition only in a limited scope.

17. The macroeconomic policy in the new EU member states and in the states of the Balkan region was quite restrictive in general and it helped to maintain and strengthen the internal balance. The fiscal policy in the majority of countries was targeted at reducing imbalances in the public finances. Fiscal deficits were consistently decreased, and in some of the countries, budget surpluses appeared. Monetary policy was aimed at holding inflation at a low level. In the majority of countries, money supply remained under control, and was not a factor conducive to inflation (except Romania). In the majority of countries, the degree of the restrictive character of the monetary policy was strengthened due to the appreciation of the majority of national currencies. Monetary policy in the majority of CIS countries was much more expansive, where, thanks to the inflow of foreign currencies, and increase of international reserves, the national supply of money and credit was growing faster, despite generally high national interest rates.
18. The progress of market reforms in individual groups of countries remained diverse. The new member states completed their systemic transformation in practice at the time when they joined the EU, although further progress is required in many areas (competition policy, restructuring of state-owned enterprises, development of financial markets, economic judiciary). According to assessments by the EBRD, the EU candidate countries – Bulgaria and Romania – as well as Croatia, are fairly advanced in the reform process. The next group is composed of the remaining Balkan countries and the more advanced CIS countries – Russia, Ukraine, Armenia and Kazakhstan. Considerable progress was recorded last year by Georgia and Moldova. The least advanced in the systemic reforms have remained, as in previous years, Belarus, Turkmenistan and Uzbekistan, where authoritarian regimes have not been interested in developing the market economy and building democratic state structures or a civil society.
19. The diverse progress in market reforms in separate areas confirms that countries undergoing systemic transformation start on the whole to reform their economies with the liberalization of prices and trade, opening their economies, and small privatization. Privatization of large state-owned enterprises and the building of new market institutions, such as capital markets, system of economic judiciary and implementing effective competition policy and also the building of a modern infrastructure, turn out to be much more difficult and time consuming. The above are indeed the areas with the greatest differences among separate groups of countries. The countries that are the least advanced in terms of transformation are still characterized by a low share of the private sector in the economy, institutional underdevelopment of separate markets, the small scope of

economic freedom and, respectively, a large scope of direct state control. These are at the same time the countries with the least competitive economies, whose international exchange is based either on the export of raw materials or on the use of privileged contacts with larger neighbours, mainly Russia.

20. One of the key transformation tasks that still lie ahead of the most advanced countries is to complete privatization. Experience shows that the maintenance of state-owned enterprises or companies with a large share of state property, is not conducive to effective restructuring and improvement of competitiveness, and furthermore is the source of frequent problems. The many scandals and affairs, which came as such a shock to the political scene in the new EU member states in recent years, had their source in the fight by separate political groupings for control over large enterprises. This experience shows that attempts should be made to complete the privatization process as soon as possible and withdraw the state from the performance of ownership functions. Major and justified social interests – such as the protection of consumers and employees' rights, environmental protection, and the pursuit of full employment – can and should be realized by means of other instruments, such as appropriate legal regulations, a friendly business environment, and low taxes.
21. Advancement of the transformation depends not only on formal changes in the law, but also on the actual efficiency and effectiveness of the new institutions. Considerable shortcomings are still being reported in this area in the countries of the region. This is related to the key areas of functioning of the market economy, i.e. the freedom of “entry” and “exit” to and from a branch, the observation of contracts, including particularly the pursuit of claims in the courts, the duration of bankruptcy proceedings, and the flexibility of labour markets. From this point of view, the most effective market institutions are present in the Baltic States, Slovakia and Poland (although ineffective and lengthy court procedures blur the by and large favourable image of the latter country).
22. The countries undergoing transformation have built in general functional and modern tax systems. Receipts of the national budgets are based chiefly on indirect taxes – VAT and excise tax – while income taxes play a much less important role than in the countries of Western Europe. At the same time, tax rates are lower, and the scale of tax progression is smaller. In several countries, uniform income tax – the so-called flat income tax – has been successfully introduced with limited rates (Russia, Estonia, Slovakia, Romania). It is to be expected that the “old” member states of the European Union will sooner or later follow the example of the new states in this regard, and take action in the direction of simplifying their tax systems and lowering rates.
23. Accession of the eight Central and Eastern European to the EU was a very important factor in maintaining a good economic situation in the region. The balance of the first year of membership has been positive for all the new member states. The removal of the remaining trade barriers, especially in agricultural trade, caused a surge of mutual exchange within the confines of the enlarged Union. Exports to the EU markets were growing in 2004 at the rate of 10%–30%, two times faster than in the preceding year. The import dynamics from the EU markets were even faster. All the new member states

(except Hungary) recorded a surplus of transfers from the structural funds of the European Union over the membership fees, which proves how generally good were the preparations made by governments and local self-governing administrations in the new member states for making use of the EU funds.

24. Undoubtedly, agriculture has been the sector that made the most of the accession in the first year of membership. The profitability of agricultural production has improved considerably in almost all the new member states, the most in Poland (from -1.6% in 2003 to 8.2% in 2004) and Lithuania (from -6.7% to 4.4% respectively). Hungary has been an exception again, where the profitability of agricultural production declined, from 0.1% to -13.9%. The main factor in the changes in profitability were the changes in the prices of agricultural products after the May 1st, 2004. The main beneficiaries were the countries where the price level before accession was generally lower than on the European Union markets. The improved material situation of the rural areas and farmers was a result not only of the higher prices of agricultural products and the improved profitability of production, but also of the direct subsidies received. This relates to the greatest extent to Poland and the Baltic States. In Poland, the beneficiaries of the subsidies were 1.5 million farms, in Lithuania 290,000 farms, and in Latvia, 85,000 farms, while in the Czech Republic and Slovakia, the figures were 21,000 and 17,000 farms respectively. These differences are chiefly a result of the different agrarian structures in different countries.
25. Among the negative effects of the accession, one should mention first of all the increase in prices of consumer goods and services, in particular, certain food articles. Yet it should be emphasized that the increase was connected not only to accession, but also to the influence of other factors. The main reason was a surge in consumer spending in the months directly preceding accession, caused by fears of price increases as a result of the opening of the borders with the EU. Additional reasons were the higher world prices of raw materials and fuels caused by the rapid economic growth in China and India, and the increase of VAT and excise tax rates on certain goods and services (e.g. construction materials). Only in two new member states (Slovakia and Slovenia) were the increases in prices in 2004 lower than in the preceding year.
26. Three new member states – Estonia, Lithuania and Slovenia – joined the ERM-II system (*Exchange Rate Mechanism II*) in June 2004, directly after their accession to the EU. This was possible thanks to their stable public finance situation and their low budget deficits (below 3% of GDP), and to the stable position of the national currencies. In the case of the Baltic States, a decisive role was played by the system of currency management employed in these countries and maintained after accession to ERM-II. This opens opportunities for the accession of the three countries to the Eurozone as early as in the middle of 2007, provided that they meet the criteria required for nominal convergence. The remaining member states are not yet ready to join the ERM-II, chiefly because of considerable fluctuations of the exchange rates of their national currencies, and high budget deficits.

27. Foreign direct investment introduced into the territory of the new member states, the lion's share of which came from the EU-15, have had a significant influence on the development of their trade relations. The share of the European Union in foreign direct investment leveraged by these countries was predominant, and ranged from 55% in Latvia up to as much as 85% in the Czech Republic and Estonia. Companies with foreign capital have played an important role in the trade turnover of the aforementioned countries. The share of companies with foreign capital in the total exports of Poland in 2003 amounted to 54%, while for imports it was 58%. In the case of the Czech Republic, these indices were respectively 53% and 47%. Meanwhile, in Hungary entities with foreign capital accounted for 73% of exports in 2000, a proportion that was as much as 10 percentage points higher in 2002. It is worth emphasizing the considerable role of companies with foreign capital in the growth of exports in the countries under discussion – the higher level of international competitiveness of these companies and their products have had a specific bearing on the commodity structure of exports as well as their dynamics.
28. The accession of new member states to the European Union has also stimulated substantially further development in their mutual economic relations. Two-way trade among the new member states has increased, and its share ranges from 7%–10% of total trade turnover in the case of Poland, Slovenia and Hungary, to as high as 20%–24% in the case of Slovakia. This is a result not only of earlier existing reciprocal trade preferences within the framework of CEFTA (and a customs union between the Czech Republic and Slovakia), but also of a full opening of the markets of these states after their accession to the EU. The scope of mutual direct investment, which still remains at a fairly low level, is smaller in the regional cooperation. Slovenia is an exception, where local firms were the first to start investment expansion abroad due to the limited size of the internal market and the relatively high capital resources.
29. After the accession of the eight countries of Central and Eastern Europe to the EU, out of the two structures of commercial cooperation that existed until the time of accession, i.e. CEFTA (Central–European Free Trade Area) and BAFTA (Baltic Free Trade Area), only CEFTA is still functional after May 1st, although its membership has been reduced to three countries (Croatia, Bulgaria, Romania). Each of these states joined CEFTA later than its initial members (the Czech Republic, Poland, Slovakia and Hungary, as well as Slovenia), the first of which was Romania (July 1st, 1997), next Bulgaria (January 1st, 1999) and Croatia (March 1st, 2003). A presence in CEFTA was recognized as a certain step in pursuit of membership of the European Union by all these countries. Romania had the largest share in the total exports among these three states, which in 2003 accounted for 57%, while the share of Bulgaria amounted to 37% and Croatia, only 6%. The distribution of the share on the side of mutual imports was even more proportional, with Bulgaria accounting for 42%, Romania, 33%, and Croatia, 25%.
30. The trade relations of Bulgaria and Romania with the EU countries are regulated by the provisions of the European Agreements of Association, and, outside agricultural trade, they have been entirely liberalized in practice. However, the countries of the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro) are participating in the Stabilization and Association Process (SAP), which anticipates,

among other things, a broad scope of unilateral EU preferences in trade, depending on the fulfilment of specific political and economic conditions. Transfers of goods between the EU and the countries of the Western Balkans are regulated to varying degrees by interim agreements, which are a part of the Stabilization and Association Treaties, and which have come into force in recent years. According to these treaties, goods that originate from the countries encompassed by the SAP process are granted duty-free access to the EU market, with only small exceptions (agricultural and steel products, textiles). However, the abolition of tariff barriers by the Balkan countries is proceeding in accordance with schedules set out for separate groups of commodities.

31. Cooperation between the European Union and the majority of CIS countries has been progressing further. In May 2005, an agreement was signed with Russia on the so-called "four areas" of cooperation, although a follow-up to that agreement with specific action is still awaited. The scope of cooperation of the EU with Ukraine increased, thanks to new initiatives that complemented the so-called Action Plan and the allocation of additional funds for that purpose. Despite pressures brought by Ukraine, and also certain new member states (Poland, Lithuania), still the European Union refused to offer the prospect of membership to Ukraine. Separate "action plans" were prepared also for the majority of the remaining CIS countries. Only cooperation with Belarus remains virtually suspended, due to the undemocratic internal policy carried out by the authorities of that country.
32. Despite a very high number of agreements and declarations, the integration processes within the scope of the CIS were limited in principle to the functioning of preferential trade agreements (and with many exceptions) with certain elements of a free trade area. The share of inter-regional trade in the total trade of individual countries declined considerably in the systemic transformation period, to a large extent influenced by the transition of these states to trade according to world prices and clearances in convertible currencies, and also to the application of the rules of double taxation in mutual trade, and numerous customs duties, defaulted payments by companies and government institutions, low discipline in contract execution, the weakness of national currencies and the instability of exchange rates, as well as high business risk. The CIS countries have so far not developed integrated economic structures, and their cooperation has been confined in practice to mutual trade, while a bilateral character still remains its typical feature.
33. There are many reasons for the failure of more advanced attempts at wider economic integration in the territory of the countries that emerged after the collapse of the Soviet Union, and they have both a political and an economic character. A barrier to real integration has undoubtedly been the weakness of the market mechanisms and the large extent of administrative regulation of economic processes. The fact that, since the beginning of the CIS, Russia as the dominant state that determines through its stance the character of the integration processes in the CIS territory, has not presented a project attractive enough for the other members states of the organization, has, in effect, effectively reduced its capabilities to influence individual states.

34. Difficulties connected with economic integration within the scope of the CIS persuaded Russia to initiate other, narrower agreements within the scope of economic cooperation in the post-Soviet area. The most advanced among them has been the Union of Belarus and Russia, in which one can distinguish elements of a trade union and common market, and even economic union. The integration structure has achieved so far a relatively high level of integration within the scope of economic, defence and security issues, antiterrorist action and the control of crime, and also in the area of migration policy and ensuring equal rights for its citizens. In April 2005, both states made a decision on pursuing a single joint foreign policy for the union state, and the most important tasks for 2005 became: harmonization of customs and tax procedures, continuation of the process of currency integration, and further drawing together of the economic systems in all fields. However, the date for introducing the Russian rouble as the only legal tender in Belarus, which was to precede the introduction of a new common currency in the territory of the Union State, has been put back. The deadline for the realization of this task was initially set as January 1st, 2005, and then moved to January 1st, 2006, but even this seems wholly unrealistic. Even the date for tying the exchange rate of the Belarusian currency to the Russian one has not been decided, although initially it was to happen on July 1st, 2004.
35. Another important integration initiative in the territory of the CIS, besides the Belarus–Russia Union State, has been the Euro–Asian Economic Community (EURASEC). This structure was established in October 2000 by Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan; Ukraine, Moldova and Armenia have been granted observer status. EURASEC has clearly-voiced economic goals. A free trade area functions within its framework and multilateral projects are realized, chiefly in the power sector and transport. Work on the creation of a uniform customs area with shared external borders has also been progressing gradually. Preparations to introduce a customs union in the area are planned for the end of 2006.
36. Recently, a new integration initiative has been inspired by Russia in the CIS territory, which is the Agreement on creating a Common Economic Area (CEA). This agreement anticipates that the creation of a free trade area will be followed by a customs union and common market (including guarantees of the free transfer of goods, services, capital and labour), and also arrangements within the scope of tax, credit and currency financial policy. The necessary agreements were signed by Russia, Belarus, Ukraine and Kazakhstan on September 19th, 2003, and ratified by the national parliaments of these states in April 2004. A top level group for creating the CEA was appointed, and its members became representatives of the countries involved with the rank of deputy prime minister. The scope of the CEA includes the preparation of 85 agreements related to different areas of economic cooperation.
37. Politically, an important integration initiative created without the participation of Russia has been GUUAM – a structure created by Georgia, Ukraine, Azerbaijan and Moldova in October 1997, which in April 1999 was joined by Uzbekistan. The CIS states that are members of GUUAM created the organization mainly in pursuit of the creation of a counterbalance to the dominance of Russia in the area of the CIS, but also in order to ensure supplies of Caspian and Central Asian oil to western markets, by circumventing

Russian pipelines and ports. The main purpose of the organization was the development of economic, political and military cooperation. However, the goals have been implemented to a small extent, and the main task of GUUAM became the development of transport corridors that avoid Russia. GUUAM has ceased to exist in practice for a few years now, but the democratic changes that have taken place in Georgia and Ukraine, and also the pro-Western turn in the policy of Moldova and the meetings of the leaders of these three states, have given rise to many voices suggesting a reactivation of the organization.

38. Changes and reforms of the health care systems have been conducted all over the world, for the most part in view of the costs of medical care, including the costs of modern diagnostic equipment and the costs of developing modern medicines, and also due to the ageing of the societies in the developed states. In the countries in transition, these reforms have a special significance because of the gradual abolition of the traditional state health care systems and their replacement with systems based on private insurance and self-financing. These changes can be assessed by considering their influence on the achievement of the most important aims of the health care system, such as the provision of common access to the main basket of medical services, raising of the quality of medical care and its results, the allocation of an appropriate part of the resources of the public sector and the economy for the health care sector (macroeconomic efficiency), and the pursuit of the achievement of the required cost efficiency (microeconomic efficiency) of the rendered medical services. These aims show that the process of reform must follow very diverse and often even mutually-exclusive tasks.
39. The health care sector is exceptional in respect of the high value attributed to health by people and the level of expenditure on health care. From the point of view of the economic analysis, the factors that determine the functioning of the markets for medical services and medical insurance are important. These markets have certain typical features that distinguish them clearly from other markets. These features include ineffectiveness of the market mechanism, as well as external influences, the existence of public goods and of goods that are socially desirable. Moreover, asymmetry of information leading to selection and the temptation to commit abuse have been particularly strong on these markets. These factors justify intervention and regulation by the government, relating to the functioning of the health care system.
40. The method of financing the health care sector constitutes an important factor determining the effectiveness of health care and the functioning of the two markets of medical services and medical insurance. It encompasses several key issues. The first is the accumulation of funds earmarked for financing of the sector's operations. The second is the allocation of those funds among alternative uses within the health care system. The third is the system of remuneration for people employed in the system. Departure from a centralized health care system, financed mainly from the general revenue of the state budget and a shift to the decentralized system based on contracts within the framework of social health insurance, meant a beginning of reforms in the majority of the post-socialist countries. That shift denotes a change of direction in the flow of monetary streams in the created "triad" made of payers, service providers and consumers of medical services.

41. Expenditure on health care has been extremely diverse in individual countries. The European post-socialist countries are led by Bosnia and Herzegovina, which in 2002 allocated 9.2% of its GDP for health care, while Estonia and Latvia recorded the smallest amount of spending, of only 5.1% of GDP. A high share was demonstrated by Slovenia (8.3%), Hungary (7.8%), Serbia and Montenegro (8.1%), the Czech Republic (7%), Bulgaria (7.4%) and Poland (6.1%). By comparison, the average share of expenditure on health care in the EU countries amounted to 8.9% in 2001. In the CIS countries, the highest share of expenditure on health care was recorded in Moldova (7%). The least in relation to GDP was spent in Tajikistan (3.3%). In Russia, that share reached 6.2%. Expenditure per capita measured in US dollars according to purchasing power parity (in 2001 or the latest available) fluctuated from 3,248 in Switzerland to 12 in Tajikistan (in 1998). The average for the EU reached US\$2,226, while the average for the Central–Eastern European countries was four times lower and amounted to US\$539. The highest expenditure was incurred – according to expectations – by the richest countries; Slovenia (1,405), the Czech Republic (1,106), Hungary (911), while the lowest was by the poor countries; Macedonia (229), Bulgaria (214) and Albania (67). In turn, the average for the CIS countries was US\$182. Higher-than-average expenditure was covered only by Belarus (351) and Russia (243), while the least was spent in the Central Asian and South Caucasian countries.
42. Compulsory insurance as the main or supplementary form of financing the health care was introduced by all the Central European countries and – among the CIS countries – Georgia, Kyrgyzstan, Russia and Turkmenistan and Belarus. Currently, it is under implementation in Armenia, Azerbaijan and Moldova. It plays a dominant role in financing in all new member states of the EU and in Croatia and Romania, where during the implementation of reforms, the share of health care financed directly from the state budget was quite radically reduced. Financing of health care is still based on taxes in Ukraine and Belarus. Despite the introduction of the health care system reform based as a target for social insurance, financing from taxes still plays an important role in such countries as Bulgaria, Albania, Macedonia and the majority of the CIS countries. However, according to many sources (among others WHO and the World Bank) the system of public financing of health care in these countries collapsed and direct payment by households are prevailing in importance at present. Voluntary insurance – offered by profit-oriented private insurers and (much less frequently) by *non-profit* organizations – has appeared in the majority of the countries under discussion. It includes surcharges on the prices of services excluded from the main package of medical care, health care in private medical establishments, and the refunding of medicines and other expenses. Its share in the financing of health care remains insignificant in the discussed states, not exceeding 2%. The richest, Slovenia, is an exception in this, where the share of voluntary health insurance equals more than 10% of the total expenditure on health care purposes.
43. The overall assessment of the health care systems in the countries undergoing transformation is unsatisfactory. Medical care fails to respond to the needs of patients, the health care sector is underfinanced, the official remuneration of medical personnel is painfully low, and instances of corruption are common. The quality and availability of medical services is incomparable to that received by patients in the countries of Western Europe or the U.S.. A series of reforms have been introduced, but there is still a long way

to go to reach the required effectiveness of functioning of a social health care system. It will be neither an easy nor a short-term task to answer the challenges confronted by the health care system. Development and economic growth translating into an abundance of financial streams supplying the health care system is only one of the conditions necessary to improve the situation. Moreover, it is necessary to conduct organizational and institutional changes and to overcome the mental legacy of the past, which leads to corruption and is a reason for passivity, and encourages excessive demands on the health care system and the whole social welfare system.