



# Visegrad Group and Germany Prospects of Cooperation

Proceedings from the

| Policy Makers Seminar |

13. - 14. 11. 2012

## | Contents |

|  |           |
|--|-----------|
| <b>Preface</b>   | <b>3</b>  |
| <b>Cohesion Policy in the Multiannual Financial Framework 2014+</b>  | <b>4</b>  |
| <ul style="list-style-type: none"> <li>• MFF, Cohesion Policy 2014+ dilemmas facing the Czech Republic   <b>Arnošt Marks</b></li> <li>• Cohesion Policy: A view from Poland   <b>Patryk Toporowski</b></li> <li>• Considerations to the new Multiannual Financial Framework from a Hungarian researcher's point of view   <b>Attila Marján</b></li> <li>• Making Cohesion Policy in Slovakia more effective. Some challenges for Slovakia in preparation for 2014-2020   <b>Martin Obuch</b></li> <li>• Germany and the European negotiations on the Multiannual Financial framework   <b>Peter Becker</b></li> </ul>  |           |
| <b>European Energy Infrastructure</b>  | <b>19</b> |
| <ul style="list-style-type: none"> <li>• Possibilities for further co-operation in the Central and Eastern Europe region, Czech perspective   <b>Roman Portužák</b></li> <li>• Position of Poland on European energy infrastructure – with focus on electricity   <b>Robert Zajdler</b></li> <li>• Avoiding deadlock. The Hungarian position on CEE “loop flow” problem   <b>András György Deák</b></li> <li>• Position of Slovakia on European energy infrastructure   <b>Matúš Mišík</b></li> <li>• European energy infrastructures: Challenges and perspectives   <b>Frank Umbach</b></li> </ul>  |           |
| <b>Economic and business dimension of the Eastern Partnership with special focus in DCFTA with Georgia, Moldova and Ukraine</b>  | <b>38</b> |
| <ul style="list-style-type: none"> <li>• A Free Trade Area with Ukraine, Georgia, and Moldova: Estimates of effects on Czech economy   <b>Vilém Semerák</b></li> <li>• Poland's perspective on economic and business dimension of the Eastern Partnership   <b>Rafał Sadowski</b></li> <li>• Deep and Comprehensive Free Trade Agreement between the EU and Georgia, Moldova and Ukraine – What would that mean for Hungary?   <b>Sándor Richter</b></li> <li>• Economic integration between Slovakia and Eastern Partnership – mission impossible?   <b>Jana Kobzová</b></li> <li>• What economic benefits to expect from DCFTAs?   <b>Iana Dreyer</b></li> </ul> |           |

## | Preface |

The idea to organize an expert meeting devoted to the V4 – Germany cooperation was triggered by the increasing attention paid by both actors to each other. “Visegrad” is a label of successful cooperation, which makes the Group to be an important actor in the neighboring regions. Germany, besides being one of the most crucial partners of each V4 country, is also the Member State often consulted when the V4 intends to push ahead its common interests within the EU. A good example thereof was The Visegrad Group and Germany Foreign Ministers Statement on the Eastern Partnership adopted in 2011 in Bratislava.

Yet, bilateral (i.e. the V4 – Germany) relations were never formalized or systematized. Therefore, one of the underlying questions of this seminar was whether there is a space and need for a more organized cooperation. So far, the Visegrad Group has opened the V4+ format in order to discuss concrete projects and statements involving outside partners, and has not been established as a formal channel of communication with external actors yet. The tendency to employ rather project-driven form of cooperation between the V4 and Germany was largely confirmed during our November meeting’s debates.

However, participating experts and officials named fields of possible enhanced political cooperation other than only the Eastern Partnership initiative. Crisis management, technological cooperation, cyber and energy grids security, or research & development were mentioned as the most salient and logical areas of collaboration, mainly due to the physical proximity of countries engaged.

Another cooperation area worth exploring is the defense policy. The idea of placing the operational headquarters of the planned Visegrad battle group in German Potsdam seems to be a good starting point. However, number of other defense aspects can set off substantial debate, both in context of pooling and sharing initiatives, or prior to the 2013 EU December summit, when Common Security and Defense Policy will be formally discussed for the first time in many years. Therefore, Aspen Institute Prague and the Institute of International Relations with the support of International Visegrad Fund and Konrad Adenauer Stiftung, decided to organize another meeting in 2013 as a part of the series of events devoted to Visegrad – Germany cooperation, focusing on cooperation in defense issues.

**Radek Špicar**  
*Director*  
*Aspen Institute Prague*

## Cohesion Policy in the Multiannual Financial Framework 2014+

### | Panel summary |

The European Union (EU) aims for a smart, sustainable and inclusive economy. One of the key instruments developed for achieving these goals is the Cohesion Policy, established to overcome economic differences between the EU regions. Speakers from the first panel of the Policy Makers Seminar, focusing on the Multiannual Financial Framework 2014+, agreed that the EU Cohesion Policy has fundamentally helped to strengthen the economic convergence.

According to the panelists, Member States need to choose a limited amount of the Cohesion Policy priorities and work systematically on meeting them. Quality of spending is much more important than quantity. This applies particularly in the context of the ongoing economic crisis, when the budgetary cuts are being discussed and implemented all over the EU. That is also why the new Multiannual Financial Framework will focus on the effectiveness of the Member States' expenditures.

The biggest challenge the EU is facing in regard with the new Cohesion Policy Framework is to swiftly prepare clear priorities and rules. Member States' representatives need to develop simple, modern and effective implementation systems. Visegrad group and Germany should try to find a common ground and shared priorities before opening the negotiations within the EU institutions.

According to Daniel Braun from the Czech Ministry of Regional Development, structural funds have been particularly effective in promoting research and development capacities and IT technologies. The Cohesion Policy influences positively not only the recipient country, but also other Member States. For example 65 cents of each euro spent in the Czech Republic go back to EU-15 countries via subcontractors, imports etc. Braun believes that V4 cooperation on the Cohesion Policy implementation is already satisfying, but still leaves space for further improvement, particularly in creating a simple, modern and effective implementation system.

In her presentation, Alexandra Kisielewska from the Polish Ministry of Regional Development noted that the Cohesion Policy has to focus on achieving EU 2020 strategy goals. Kisielewska accentuated the discrepancy

between the importance of the Cohesion Policy and a lack of institutional setting at the EU level - although the Cohesion Policy represents one third of the EU budget, it still does not have its own formation at the EU Council. An idea advocated by Poland is that competent ministers meet at least two times a year at the Council level.

Laszlo Niyaradi from the Hungarian Ministry for National Development touched upon the need to further concentrate on the least developed regions, whose funding has decreased. According to Niyaradi the new Multiannual Financial Framework needs to find a suitable solution to deal with the least developed regions.

Dietrich Jahn from the German Ministry of Finance believes that the European Investment Bank should be further involved within the new Cohesion Policy framework. It is crucial to employ tools of innovative financing of the Cohesion Policy. Jahn also expressed his doubts about the value added of direct financial support towards some regions. According to the German government this policy might lead to countries' dependence on structural aid.

The expert panel on the Multiannual Financial Framework 2014+ was opened by Arnošt Marks from Strategia. Czech analyst focused on the main areas of Czech expenditures, stressing positive, as well as negative aspects of Czech projects. Marks welcomes improvements in the infrastructure and quality shift in research and development areas. On the other hand there is often lack of a clear long-term strategy, restraining from effective implementation of the EU funding. Marks mentioned three major priorities for the next budgetary period defined by Economic Council of the Czech Government: institutions, infrastructure, innovation; and the current state of these priorities in the Czech Republic.

According to Patryk Toporowski from the Polish Institute of International Affairs, the Cohesion Policy debate should primarily focus on the infrastructure. Polish representatives believe that structural funding should not be dedicated to the least developed regions solely, but also to phasing-in and phasing-out regions. Polish government also supports the ex-ante conditionality concept, as it improves the funding's efficiency.

Attila Marjan from the Hungarian Institute of International Affairs stressed that V4 countries should focus on the infrastructure interconnection, and hence he perceives the region's interest in guaranteeing sufficient level of Cohesion Policy chapter in the EU budget. Unfortunately the V4 countries' positions are not fully in line in the financial framework debate, particularly in the Common Agricultural Policy area.

Martin Obuch from the Consulting Associates shared experience from Slovakia, one of the fastest growing countries in the EU. According to Obuch, the Cohesion Policy in the new financial framework should be primarily performance-oriented.

German panelist Peter Becker from Stiftung Wissenschaft und Politik described the German role of a net paying Member State that wants the Cohesion Policy to reflect current public debt crisis. European funds should concentrate on the most backward regions without rejecting more developed countries from receiving European structural funding. According to Becker, the European funds shall become the main financial tool for implementing the Europe 2020 strategy.

Corruption was the leitmotiv of the panelists' debate. Experts agreed that the image of Central European countries is significantly harmed by the corruption. This issue needs to be tackled with an effective and transparent system, professional ethics and systematic cooperation with independent organizations, such as the Transparency International.

### | Speakers |

**Daniel Braun** - *First Deputy-Minister, Ministry of Regional Development, Czech Republic*

**Aleksandra Kisielewska** - *Head, Unit for Future of Cohesion Policy, Ministry of Regional Development, Poland*

**László Nyáradi** - *Expert, Department for Future of Cohesion Policy, Ministry for National Development, Hungary*

**Dietrich Jahn** - *Deputy Director, Financial Relations with the European Union, Ministry of Finance, Germany*

**Arnošt Marks** - *Strategia o.s., Czech Republic*

**Patryk Toporowski** - *Polish Institute of International Affairs, Poland*

**Attila Marján** - *Hungarian Institute of International Affairs, Hungary*

**Martin Obuch** - *Consulting Associates, Slovakia*

**Peter Becker** - *Stiftung Wissenschaft und Politik, Germany*

# MFF, Cohesion Policy 2014+ dilemmas facing the Czech Republic

**Author:** Arnošt Marks (arnost.marks@gmail.com), Strategia o.s., Czech Republic

## | Panel summary |

There is a whole complex of circumstances which influence the positions, priorities and behavior of the Czech authorities in the process of negotiating the Multi-annual financial framework. The EU 2020 and other documents set very clear priorities for the individual countries for their Cohesion Policy strategies. These priorities on EU level are accompanied by clear policy recommendations – so-called conditionalities. The purpose of this short paper is to bring three areas where the Czech Republic would face rather difficult dilemmas. The dilemmas concern three national priorities: quality of public administration, innovations and infrastructure. Any significant investments and progress in these areas are possible only if serious strategic approach is applied in domestic policies in these sectors. So the success of the Cohesion Policy in the Czech Republic is strongly dependent on reforms and complex changes in the area of public administration/civil service consolidation, strategic planning of the major infrastructure and on reform of the system of public spending in area of innovations, research and development.

**Keywords:** EU 2020, conditionalities, Cohesion Policy, Czech Republic

## | Brief introduction |

Economic situation of the country is defined by its dependence on the export and has one of the lowest public debts in the EU27. Opened liberal economy of the Czech Republic is heavily dependent on the export to markets of the EU. Key export partners are namely Germany and the neighboring countries, which make 51.5% of the export<sup>1</sup>.

The Czech Republic has a perfectly well regionally integrated economy, which is trying to escape total dependence on the region by shifting its focus on new markets of BRIC countries. The economy is dominated by industrial production closely linked to automotive. Also the production and assembly of computers makes a very strong line of exports namely to EU. Furthermore, there are numerous little niches in which limited set of Czech exporters make a success (electron microscopes, specific items of machinery, chemical industry segments, specific IT products like games, antivirus programmes etc.)<sup>2</sup>.

Competitiveness of the country is predestined by its location and still relatively cheap labor. Apart from several extremely successful multinationals there is only a limited number of SMEs building their competitiveness on research and development.

Fiscal and economic policy of the government is based on restricted fiscal policy and implementation of the reforms in areas like pensions, social policy and other segments of public spending. Results of these policies are a fiscal consolidation/restrictions on the background of very limited growth or recession, higher unemployment etc.

## | Cohesion Policy 2007-13 |

The country is currently subject to an extensive intervention of the EU Cohesion Policy equal to 1/2 of the annual state budget (approx. 700 mld CZK). At the moment, investments of the EU budget present most of the investment spending for many ministries, regions and cities. The country was able to pay 47.5% of the allocation to the recipients (i.e. individual projects) and managed to certify only 20% of the total allocation for 2007-13 by the end of September 2012<sup>3</sup>. Detailed, thorough and rational evaluation of the Cohesion policy for the economy is missing from the political debates and is also rather weak in public administration.

The process of implementation is hampered by very weak and almost non-existent critical evaluation and dubious role of the audit authorities. Major cases of corruption managed to overshadow the debate on economic impact of the intervention completely.

Priorities set for 2007/13 were influenced and defined during the period 2005-06. It was a period of massive economic growth, excessively cheap loans and optimism. The key elements of the strategy were developed to tackle the regional disparities and partly to enhance the competitiveness of the country. The key elements of the strategy were:

- a) filling in the missing infrastructure, and repairing the existing one

b) supporting upgrade of the work force

c) tackling regional disparities

d) building capacity for growth based on research and development.

The economic map of the country has slowly changed over the last 10 years. Several successful cities and agglomerations lead by Prague and whole regions are emerging as the leaders of the economic growth and many smaller towns and cities are either stagnating or still lagging behind.

The strategic consequences and achievements of the programming period 2007-13 were: improvements in some infrastructure services including the environment, positive shift in competitiveness of the companies and strong investment in Research and Development infrastructure. However, all of these positive outcomes are only potential opportunities and even challenges. The achievements are thus dependent on abilities of the public administration and political elites.

## | MFF and priorities of the Cohesion Policy 2014+ |

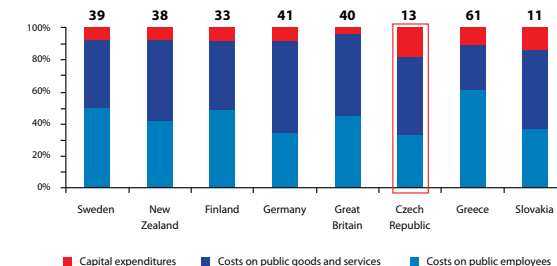
The debate on future priorities has been organised since the year 2011. National economic council of the government has prepared analytical documents, which produced analytical framework of critical points for the Competitiveness of the country also known as 3]:

- Institution
- Infrastructure
- Innovation

The Cohesion Policy basically consists of spending and infrastructure investment. In contrast, the key challenges of the Czech Republic are clearly linked to the QUALITY SHIFT needed. These changes are mostly linked to managing public policies and funds and critical improvement in detailed areas of many individual policies. The role of the future Cohesion Policy and priorities are thus heavily dependent on political and administrative changes, which are needed. I would like to point to three areas, which are critical to any success of future SF in the Czech Republic:

- 1) All indicators collected and published by international institutions of the performance of public administration/civil service show that this area is a key bottleneck of any progress. The Czech Republic is the only member state of the EU that has no enforceable legislation on civil service!

Figure: Composition of expenditure for public goods and services international comparison



Sources: NERV study on competitiveness of the Czech Republic 2011.

The figures above show excessive weight of the investment in the structure of public expenditure and rather lower amount dedicated to the cost of human resources in public sector. Systemic change is needed to bring forward any change along the needed legislation.

- 2) Second case is rather simple and similar to the case above. There is a lack of strategic approach towards finalizing the road infrastructure. National strategy that will clearly define the priorities of building the transport infrastructure is constantly under preparation. At the same time very limited number of national roads and railway tracks that are implicitly expected to be the priorities of the CR are precedent for documents such as the EU 2020 priorities.
- 3) Third case is from the area of innovations and management of the public research spending. Investments for the years 2007/13 will bring to life a set of major expensive research facilities. There is a critical need of change in managing the research spending and management of the public universities and research establishments<sup>4</sup>. The whole system is also producing weak scientific results (ditto). Research facilities do not contribute to improvements in the private sector and the private sector RD spending is very weak.

**The key challenges of the priority Innovation are as follows:**

- supporting measures which will make even the less advanced SMEs competitive through the use of research and development
- making the publicly funded RD institutions cooperate effectively with SME

<sup>1</sup> Czech Statistical Office, analytical data on exports September 2012

<sup>2</sup> NERV Framework of the Strategy of Competitiveness (NERV, the Czech Government (Office, February, 2012)

<sup>3</sup> Regular monitoring report non spending of the structural funds in the Czech Republic (Ministry of Regional Development, September 2012)



- making the public RD a high quality system with a high international reputation

- key priority is not to invest but to upgrade the efficiency of RD system

- key priority and goal is to stimulate and increase private spending of the private sector in RD

Czech dilemmas before the Cohesion Policy are defined: Simple comments on the main three priorities of the Czech government for Cohesion policy 2014+ demonstrate how difficult it will be for any Czech government to select investment priorities without taking very brave domestic decisions.

In the area of Institutions the fact that major piece of legislation is still missing after 20 years of post-communist development shows lack of strategic approach to management of the state by the political and other elites. In the area of road infrastructure the same problem is indicated – lack of effective strategic planning and the resulting inability to select the real priorities in road infrastructure.

In the area of innovation and research and development it is clear that the key obstacle has to do with strategic management and effective spending policy for Research and development sector for the relevant parts of public administration.

Clear, competent and opened debate on these issues is the only way through which the Czech authorities could bring together the quality priorities needed for the future Cohesion Policy.

The position of the Czech authorities to the MFF regarding the size of the future budget and the role of the Cohesion Policy seems to be partly defined by the facts above.

The government feels that its strict fiscal policy should be implemented also on the level of the EU and this political position explains a part of the position. The clear consequences for the Cohesion Policy at home are linked to badly needed reforms, which would be very difficult to perform.

And the lack of effective public administration brings the Czech political elites to the situation of critical perception of any administration and may cause unnecessary troubles linked to the negotiation of the MFF and to the Cohesion Policy negotiations specifically.

**Resources:**

- 1) Ministry of Regional Development (September 2012), Regular monitoring report non spending of the structural funds in the Czech Republic (
- 2) EU (2010), Europe 2020
- 3) Ministry of Trade and Industry (2012), Strategy for competitiveness of the Czech Republic, Back to the Top
- 4) Czech Statistical Office (September 2012), analytical data on exports
- 5) Eurostat, (October 2012), news release euroindicators
- 6) NERV, the Czech Government Office, (February, 2012) Framework of the Strategy of Competitiveness

# Cohesion Policy: A view from Poland

**Author:** Patryk Toporowski (toporowski@pism.pl), Polish Institute of International Affairs, Poland

| Panel summary |

This paper examines the issue of the new cohesion policy mechanisms to be implemented during the 2014-2020 period. Special attention is given to the “Polish view” on the changes that are being proposed to this policy. Before describing the current position, the rationale that underlies this approach to cohesion policy is presented. Next, the approach towards specific new mechanisms, such as transitional regions, CEF and conditionalities are described. The next element of this study lays out the possible areas of cooperation, and the last part is a conclusion.

**Keywords:** Cohesion Policy, Poland, Visegrad Group

| Brief introduction |

To understand the Polish approach towards cohesion policy properly, it is necessary to look at the rationale that is hidden behind the position on the common budget. In domestic debate, Poland’s position on the next Multi-annual Financial Framework (MFF) is often perceived as one of the most supportive to the European Commission’s proposal from June 2011<sup>5</sup>. Specifically, there are two important elements supported by Poland that currently point to this fact: first, there is a need to link the MFF with the Europe 2020 strategy, and second, the economic crisis appears to last longer than expected. Both of these ideas lead Poland to opt for much more of pro-investment and result-oriented character of MFF.

Before discussing specific new mechanisms of cohesion policy, one very important issue should be noted: mechanisms quite similar need to be used within the other budgetary lines.

In regards to the territorial scope, it is necessary to enable a use of cohesion policy-related funds for all regions of the EU; these facilities should not be addressed only to a less-affluent group of countries, but to the entire EU (thus even within EU-15). Therefore, the concept of transitional regions is supported by the Polish government, despite the fact that it is not directly beneficial to Poland. Only one region (Masovian) would be a transition one, whereas the rest of them would remain below 75% of EU GDP. The alternative mechanism of phasing-in and phasing-out regions is not what Poland wishes to welcome warmly, as it does not fulfill the criteria of level playing field.

| Polish position |

Another interesting solution is a Connecting Europe Facility (CEF). It seems to be no less attractive than structural funds, but Poland cannot ignore the positive effects of projects such as p. ex. “Rail Baltica.” The only concern is the €10 billion that comes from the structural funds to finance this facility, leaving a smaller amount of money available to projects that would appear to be necessary from the point of view of specific regions in the near future.

Another issue is a thematic concentration of the cohesion policy to the Europe 2020. In this context, an inclusion of all structural funds under one Common Strategic Framework is an advantageous solution for Poland, because it enables an optimization of particular funds’ impact on its regions. The common rules help to achieve the Europe 2020 goals more efficiently, especially as a result of better coordination of particular projects. The only problem is a link of funds with country-specific recommendations as opposed to National Reform Programmes.

Poland agrees with the ex-ante conditionality concept, as it improves the efficiency of the funding. Moreover, it does not generate an extra significant administrative burden. However, a sum of funds to be suspended due to problems with the conditionality should be limited in order to minimize losses in the region’s development. In this respect, the existence of a performance reserve is also welcomed by the Polish government. Such a reserve would motivate the managing authorities to do their best in achieving the desired results.

Among the analyzed types of conditionalities, the macroeconomic one could be troublesome to V4 countries, which are exposed to the foreign markets. This conditionality affects mainly the beneficiaries of cohesion policy, many of which are the countries that still need to overcome infrastructural deficiencies. Thus the scope of items covered by this conditionality should be extended to the all common spending.

| Areas of cooperation |

There is room to cooperate with V4 and Germany to continue the works on the notion of better spending

<sup>4</sup> Framework of the Strategy of Competitiveness (NERV, the Czech Government Office, February, 2012)

<sup>5</sup> See: Polish Presidency approach presented on Informal Meeting of Ministers and State Secretaries for European Affairs on 28-29 July 2011, Sopot, *Dziś w Sopocie początek rozmów o przyszłym budżecie Unii Europejskiej*, 28 July 2011. Available from <<http://www.euractiv.pl/prezydencja/artykul/dzi-w-sopocie-poczek-rozmow-o-przyszym-budecie-unii-europejskiej-002844>>

both in terms of effectiveness and efficiency; however, it should not be limited solely to cohesion policy, but also to the other areas. Specifically in terms of cohesion policy, a convergent approach may be easily obtained in case of result-oriented and ex-ante conditionalities, which might be beneficial to the recipients of structural funds. For instance, a performance reserve would be accepted by all parties in the region. Another possible cooperative field with V4, and probably with Germany, is CEF, aimed to minimize the share of funds that come from cohesion policy, as well as with regard to running common projects such as North-South electricity interconnector in Central and Eastern Europe. While not impossible, it is very

difficult to create a common platform on the transition regions given their strong divisions over which alternative is more advantageous to the EU.

### | Conclusions |

The work that is being conducted to improve cohesion policy marks a milestone in making the common budget an efficient source of growth in the entire EU. However, the cohesion should only be one small part of the changes that take place. Poland and other V4 countries should cooperate with the others to make these changes beneficial for themselves as well as for the EU.

## Considerations to the new Multiannual Financial Framework from a Hungarian researcher's point of view

**Author:** Attila Marján, Hungarian Institute of International Affairs, Hungary

### | Panel summary |

Regional policy is one of the most comprehensive European policies since it reaches out to and serves as a facilitator for several other policy areas, such as social policy, education, consumer protection or economic policy in general. Nevertheless, as the EU is just in the middle of its comprehensive budget review exercise, one should pose the question: why a regional policy at EU level? What are the possible paths of the reform? Looking ahead, one can see a few important challenges that the Union will have to face. Globalization, along with the management of global imbalances and global crisis, is an obvious candidate for the list. How can and should EU regional policy act under these circumstances to help face what is ahead of the EU? And how should regional policy serve the interests of the Visegrad countries? This is what politicians, officials and researchers are trying to find out these days in Brussels and all over Europe. This short paper enumerates a few aspects that are important for the Friends of the Cohesion Group and for Hungary.

**Keywords:** Cohesion policy, regional policy, MFF, Hungarian position

### | Brief introduction |

Europe is an asset for the entire world, the unprecedented experience of a peaceful and voluntary alliance of countries in Europe holds an important lesson to other continents as well. This historic endeavor's success is the key to peace and stability of the old continent but also for the entire globe. A stable and successful regional policy that guarantees a reasonable level of cohesion in the Union is of key importance in this.

The EU's cohesion (or regional) policy has been far from being stable during the last decades. It has been changing all the time and thus reflecting the change of the political landscape and the policy priorities of the EU. The heydays of the cohesion policy started with the integration of Spain and Portugal and it peaked during the 2007-2013 period as the EU needed to reflect the accession of ten –mostly poor – new member states in its budgetary framework. EU cohesion policy, although contributing

to a great extent to development and modernization of less-off states and regions has always been seriously criticized on several grounds but mostly on the grounds of efficiency. These concerns are found in the policy agenda of the “Better Spending” group of the EU member states under the current framework debate. They argue that not more money but money better spent is the answer to the needs. The Friends of Cohesion group, while more or less acknowledging it, strives to maximize its cohesion envelope. Ideally there should be no antagonism between the two approaches.

### | The current debate |

The European Commission published its proposal for the next MFF in June 2011. The Polish presidency started the political and technical debate over it right away. In parallel the Commission came up with all the important sectorial policy framework proposals for the next financial framework period. The “negotiating box” has seen the light since then but many stakeholders think that it is high time to think outside the box.

As far as the timing is concerned it is clear that by early 2013 a general political agreement by the heads of state is needed in order to avoid problems in dealing with the EP and to conclude the deals on the most important sectorial papers. There seems to be a strong drive to focus on better spending instead of more spending, which is somewhat understandable in crisis times; nevertheless, it is the interest of the Visegrad block to guarantee a good level of cohesion spending within the common budget. It is not easy, however, since the net contributor states intend to cut the MFF by 100 billion Euros or so mainly from the cohesion heading; moreover the net beneficiary countries are not completely in line regarding the details of the cohesion policy rules (issues like transitory regions can be mentioned here). The Visegrad countries are not fully in line in the MFF debate either. This is particularly true to the CAP heading and to cohesion policy to some extent.

The CAP and the new own resources system also provoke significant debates between member states. As taxation

is under the veto rule, a breakthrough here seems very difficult. Nevertheless the European Parliament will use its power to make this issue the frontline of the debates. As for Hungary, the main issue is the potential 20% drop of regional funding due to the capping and the low growth reference figures used for the calculations. The Hungarian issue is quite unique, other Visegrad countries do not face this problem. Even a small increase of the 2, 35 % capping would increase the funding needs for beneficiary countries to such extent that net contributors are not ready to accept. Nevertheless it is evident that the Hungarian interest is to minimize the loss of income compared to the present financial framework period.

But evidently apart from the net position, Hungary is also interested in the reform of the EU budget in order to face the 21st century challenges like climate change, energy security, or population ageing. All this necessitates a higher, not a lower level of common budget. Moreover in order to guarantee predictability, the multiannual financial system should remain the same.

The main purposes the EU budget should serve are the following: solidarity and cohesion; international competitiveness and presence; sustainable development, border control.

As for some of the key policy areas, the Hungarian interest dictates that the CAP and regional policy instruments are not renationalized. Moreover, like most of the other beneficiary countries from Central and Eastern Europe it opposes any correction or rebate mechanisms in the common budget.

### | A few points of key importance |

On the whole the key challenge for the EU is to have more Europe for the same amount of money (at best). The Lisbon Treaty delegated more responsibilities to Brussels; the crisis management and the need to better connect the member states in the internal market are also present. The population ageing, more and more unstable neighborhood and a more and more unpredictable climatic environment also add to the challenge. At the same time the net contributor states are less and less willing to finance even this rather modest 1% of the GDP budget.

As far as the revenue side (own resources) of the budget is concerned, introduction of any new tax as a key resource for the EU budget is rather difficult. Moreover the planned move to set the financial transaction tax as the new own resource is rather a short-sighted approach as it puts the financial institutions in the position of funding the EU budget which is politically delicate and, more importantly, it does not pull the citizens closer to the EU at all.

Better spending or smart spending should be a policy stressed not only by the net contributor states but also by the beneficiary states, since at the end of the day well-selected, meaningful, growth and modernization enhancing and sustainable projects should be financed by the EU funds. This is not always the case, unfortunately. It is very important that EU cohesion policy objectives and national development and economic policy objectives are set inline as far as possible right from the planning period. Absorption is also crucial and a lot of efforts should be put into this area as the absorption ratios for EU funds are disappointingly low across EU member states. This is true for the V4 countries as well. A short note on sanctions: Hungary is the only member state so far that has been threatened by the suspension of some parts of the Cohesion Fund. This is an atomic bomb option and the government reacted very rapidly and thoroughly to it. As a result, the Ecofin Council withdrew the decision within a few months time. In the future more and more such actions can be expected. One can state that the extension of the suspension possibility to Structural Funds is reasonable since sometimes (take the example of Spain) regions are the culprits of loose budgetary behavior.

As far as the Connecting Europe Facility is concerned one can welcome this move as it reinforces network interconnectedness of the internal market nevertheless, cohesion countries are worried about the fact that it bites into their national cohesion envelope. And finally concerning the transitory regions' case, one should notice that the amount of money devoted to phasing out will be increased significantly (from 7 to 12 %) which is very difficult for poorer states to accept.

### | Conclusion |

Against this backdrop, Visegrad countries will have to prepare for a reduced level of financial funding both from the agricultural and the cohesion heading. Despite a significant level of divergence in the Visegrad countries, there is a strong reason to build a common front, not only because of historical similarities but similarities in their economic profiles and interest. Their level of development and labor productivity in comparison with the EU is rather similar and so is their relative weakness in infrastructure development. Nevertheless differences in policies and arguments are sometimes significant among the four countries – the most significant factor here is the Czech position to reduce the overall level of the EU budget. On the long run, nevertheless, a stronger coordination between the V4 countries seems to be a beneficial approach. This is relevant to the future adoption of the key sectorial policy legislations as well, since a lot of technical details will be clarified by those legislative acts and these details will have important financial consequences as well.

### Sources:

MARJAN, A (2009): The efficiency of the EU's regional spending. In: Society and Economy, Vol. 30, No. 2. Special edition, 2009 February.

HETÉNYI, G (2012): Magyarország érdekei a 2014 és 2020 közötti többéves pénzügyi keret tárgyalásai során. (Hungary's interest in the 2014-2020 MFF debates). In: Európai Tükör, 2012/1.

EUROPEAN COMMISSION, COUNCIL 2012- 2012: Official documents and press releases.



# Making Cohesion policy in Slovakia more effective. Some challenges for Slovakia in preparation for 2014-2020

**Author:** Martin Obuch (obuch@ca-slovakia.sk), Consulting Associates, Slovakia

## | Summary |

Since the Slovak Republic has not defined its official strategy for 2014-2020 programme periods, the discussion paper focuses on the selected aspects of Cohesion policy. The author argues that new features of Cohesion policy after 2013 ask for important changes in policy making in Slovakia.

**Keywords:** Cohesion policy, sound public policy, Europe 2020, programme period 2014-2020, evidence-based policy

## | Brief introduction |

Slovakia is one of the fastest-growing economies in Europe, and it has made significant progress in catching up with more developed countries, particularly in the last decade. Nevertheless, Slovakia as a whole remains behind the EU average in economic terms, with GDP per capita standing at only 74 acquis of the EU-27 average in purchasing power standards in 2010.

EU Cohesion policy is conceived as one of the key mechanisms to support economic and social development in the country. The significance of the funding can be demonstrated by the fact that EU commitments under Cohesion policy represent one of the highest shares in EU. Slovakia<sup>6</sup> has received a budget line between 5-6 % of GDP in 2004 under the Cohesion policy. However, the overall expenditure for economic development was below the EU average in comparison with other Member States (MS). This is in contrast with approach of other MS that joined EU after 2003 and still do not reach the EU27 GDP per head average (in PPS). As a matter of fact, these countries allocate visibly more financial resources for economic development as proportion of GDP in order to catch up with more developed MS.

The overall economic situation in the world and EU in combination with the objective of Slovak government to stabilize public finances in short-term perspective puts high pressure on effective use of public resources available for development, including Cohesion policy. This in turn implies necessity to enhance the quality of public policies. Special attention must be paid to public policies to be

co-financed from Cohesion policy in 2014-2020 as EU money accounts for approximately 65% of all expenditure for development.

## | Need for shift in policy making |

The overall external convergence of the national economy produces positive effects on all regions. However, the significant disparities between regions represent a long-term challenge for regional policy in the Slovak Republic. Bratislava region has traditionally been ahead of other regions in terms of social and economic development, as is the case with most capital regions in the European Union. In the last decade, regions located in the western part of the country have constantly registered higher economic performance than eastern regions. Three groups of regions can be identified according to key structural economic data in comparison to national average: (i) the capital region, (ii) the above national average regions<sup>7</sup> and (iii) the below regions concentrated in south-east<sup>8</sup>. As a matter of fact, the regional dispersion of GDP has been growing and regional disparities have deepened.

**Table 1: Structural economic data at regional level (NUTSIII level)**

|             | Unemployment rate (%) |       | GDP per capita in PPS (% of national average) |                     | Household disp. income (% of nat. average) |        |
|-------------|-----------------------|-------|---|---------------------|--|--------|
|             | 2001                  | 2011  | 2000  | 2009                | 2005                                       | 2010   |
| Slovakia    | 18.63                 | 13.59 | 100 (9,551.69 PPS)                            | 100 (17,047.36 PPS) | 343.62                                     | 565.23 |
| Bratislava  | 5.79                  | 5.41  | 217.05  | 245.00              | 133.53                                     | 129.87 |
| Trnava      | 15.51                 | 8.88  | 105.24  | 111.36              | 104.53                                     | 102.06 |
| Nitra       | 23.12                 | 13.27 | 86.81   | 85.52               | 89.43                                      | 97.87  |
| Trenčín     | 12.70                 | 9.95  | 94.31   | 88.42               | 98.19                                      | 101.24 |
| Žilina      | 16.38                 | 11.91 | 81.92   | 86.46               | 99.58                                      | 101.00 |
| B. Bystrica | 23.59                 | 19.83 | 83.14   | 72.57               | 98.39                                      | 93.29  |
| Košice      | 23.55                 | 18.76 | 89.82   | 77.71               | 100.19                                     | 93.78  |
| Prešov      | 23.96                 | 18.95 | 60.92   | 57.32               | 84.10                                      | 87.02  |

**Source:** Štatistický úrad Slovenskej republiky.

In the next programme period 2014-2020, Cohesion

policy will become the key instrument to promote smart, sustainable and inclusive growth in EU and to contribute to Europe 2020 objectives. Stronger orientation of Cohesion policy on the growth factors imposes a specific challenge for the Slovak Republic. Legislation covering support of the economic, social and territorial cohesion<sup>9</sup> recognizes the need for strengthening economic performance and competitiveness of regions; however a single framework for relevant interventions is missing. Country's first own-standing national strategy for regional development adopted only in May 2010 does not contain instruments to effectively coordinate national policies for economic and social growth.

Slovakia has unique position at this moment as no comprehensive strategy for implementation of Cohesion policy in 2014-20 has been agreed and defined so far. The strategies for implementation of Cohesion policy in 2004-06 and 2007-2013 have been strongly sector-driven. Additionally, the implementation system has provided a very limited room for coordination. After 2013, the emphasis will be placed especially on coordination of interventions and integration of funds and policies. To date, these aspects played marginal role in the management of Cohesion policy in the country, and will therefore require special attention from responsible authorities. MS are supposed to describe links and connections between individual instruments (policies) at national and regional level in Partnership agreements. But these mechanisms should be agreed and set up already in the preparatory phase to be fully functional at the start of the implementation.

In its official positions, the Slovak Republic agrees with more strategic orientation of Cohesion policy, which means more thematic concentration of interventions. Contribution to the Europe 2020 strategy asks for utilization of public resources in a very effective way. Having the character of additional source of funding, cohesion policy does not have a capacity to stimulate sustainable economic growth on its own. Therefore, it is necessary to integrate Cohesion policy and its instruments well into national and regional policies in order to maximize its added value and leverage affect. Economic, social and territorial cohesion objectives are not prominent in the national policies at this moment. In this regard, Slovakia will have to make a special effort to fully comply with proposed ex-ante conditionalities,

which are supposed to ensure connections between national policies and Cohesion policy interventions.

In 2014-2020 period, the Cohesion policy should become more performance oriented. Slovak Republic fully supports result-driven policy management. However, this approach to policy making has not been applied in national policies and only partly in the framework of Cohesion policy. Setting up the realistic targets to be achieved goes far beyond mere monitoring. The concept assumes a profound understanding of the nature and scale of the socio-economic problems to be addressed with use of Cohesion policy funding. One has to know the real causes of problems, often multidimensional, in order to come up with an effective (responsive) policy. Understanding the causality is the key to choosing a proper strategy and instruments with a potential to address identified problems. Slovakia recently presented its thematic objectives and investment priorities for the next round of Cohesion policy, however without any serious socio-economic analysis. Absence of arguments and evidence for selecting these objectives and priorities will undermine the focus and effectiveness of the policy. Unfortunately, evaluations carried out in the framework of 2007-2013 programme period offer very little inputs for programming phase. Most evaluations were focused on administrative issues, implementation systems and absorption levels. So they provide no information on the real effects of Cohesion policy. Relevant knowledge and evidence on effects will be missing, particularly in areas that are critical for competitiveness of economy such as research, innovations, information society. Territorial aspects of implementation of Cohesion policy have not been a subject of research to avoid territorial "blindness" of strategies.

## | Conclusion |

Cohesion policy is the strategic source of funding for economic and social development in the Slovak Republic. Making the implementation of Cohesion policy in 2014-2020 highly effective must be therefore a top priority of the responsible authorities. Compliance with the requirements for management and implementation of Cohesion policy in future seems to represent a specific challenge for the country. Particularly, short towards sound and performance-oriented policy making will require significant efforts.

<sup>6</sup> Together with Bulgaria, Poland, Estonia and Lithuania  
<sup>7</sup> Trnava, Nitra, Trenčín and Žilina regions.

<sup>8</sup> Banská Bystrica, Košice and Prešov regions.  
<sup>9</sup> The Act on Support to Regional Development.

# Germany and the European negotiations on the Multiannual Financial framework

**Author:** Peter Becker (Peter.Becker@swp-berlin.org), Stiftung Wissenschaft und Politik, Germany

## | Summary |

Primarily, Germany's negotiation position is characterized by its role as a huge net paying country and by the German attempts to draw the right lessons from the current public debt crisis.

On the one hand, Germany tries to restrict its net payments by backing the 1% – capping demand for the MFF in concert with the other net paying member states. In addition, Germany seeks to secure some flow-backs from Brussels, especially through structural funds. On the other hand, Germany aims to reform and tackle the weaknesses of the European spending policies, using its better spending approach. As such, Germany proposes using the European budget as an incentive for structural economic reforms, especially in crisis countries.

However, Germany is still prepared to compromise on a realistic and future-oriented MFF, a point that distinguishes the German policy from the British.

**Keywords:** Germany, MFF, net paying country, Federal Government, Länder, MFF negotiations

## | The fundamentals of the German MFF policy |

The negotiations in the European Union (EU) on the fifth Multiannual Financial Framework (MFF) for the years 2014 to 2020 are now on the finishing straight. The MFF is the centerpiece of the European Union's budget policy and financial programming. It sets the upper limit for the EU's total annual spending and for the single budget headings. These negotiations are therefore highly political, because the EU has to lay out its political priorities and their funding for the next seven years. As such, the MFF often gives rise to severe conflicts between the institutions, member states and interest groups. As the EU's biggest member state, Germany tried to define its negotiation position early in the process. Within the Federal Government, its Foreign Office is responsible for coordinating the German stance and decision-making. However, the Ministries of Economics and Agriculture also play an important role, both in a policy sense and in attracting large flow-backs from the European budget. Moreover, the German Länder are directly

involved in the implementation and administration of the EU-Structural Funds and the national co-financing of the programmes, thereby playing an important role as well.

In general, the German position in this negotiation process is determined to a large extent by three fundamental premises: Today, Germany is expected to behave as a leading power in the European Union<sup>10</sup>. The united Germany is not only the biggest Member State of the European Union but also the wealthiest European economy. After years of decline, especially at the beginning of this century – Germany had been dubbed some years ago the “sick man of Europe” – today the German economy is strong enough to be seen as the European growth engine. German politicians recognize these expectations and perceptions of Germany's European responsibility. They are aware that Germany will have to pay more to the European budgets than other member states. Germany, therefore, is prepared to compromise on the European budget. Germany never played and never intended to play the British “I want my money back”-role.

Nevertheless, the complaints about the unfavorable German net payments are still an element of continuity and have been a central component of German European policy debates for decades. Beginning in the eighties and nineties, Germany asked for more equity in paying into the EU-budget and fair burden-sharing. It is mainly the relative situation of Germany as net payer vis-à-vis other big and rich member states which is criticized and which requires the reduction of the German contributions. This position certainly includes the abolition of the British rebate.

The MFF negotiations in general and the German approach are certainly influenced by the current Eurozone and debt crisis and, of course, its consequences for member states' public finances. The crisis has pushed nearly all member states to reduce public expenditures, which has affected the EU budget negotiations. European spending policies and especially European cohesion policy have to become both more efficient and effective

to promote its fundamental objectives: generating higher economic growth, creating more and better jobs and thus minimizing the discrepancies between rich and poor regions in the European Union. European expenditures have to be justified more reasonably. Hence, the crisis brought the question of the legitimacy of European spending to the fore.

## | The key points of Germany's MFF negotiation position |

These premises determine Germany's position in the current MFF negotiations, which follows three fundamental guidelines: Germany is an economically stable leading member of the like-minded group of net-payers. The German government, the Bundestag, and the second chamber, the Bundesrat, argue that the country's net payments to the EU budget are too high. The ruling Coalition of Christian Democratic Union (CDU) and Free Democratic Party (FDP) are strictly opposing any increase of the EU budget. The MFF should be strictly limited to a maximum of total expenditures of 1 % of EU-GNI. This German demand to freeze the European budget means that all European spending policies should contribute to the reduction of the Commission proposal. Additionally, the Commission's suggestion to install an ‘Outside the MFF’ framework is rejected. From the German perspective, the Commission's proposal for the next MFF had been at least 100 to 110 billion Euro too high. Consequently, German Chancellor Angela Merkel signed the letter dated 18 December 2010 to President Barroso together with her colleagues from the UK, France, the Netherlands and Finland, demanding a virtual budget freeze on the 2013 level. This letter was the starting point and remains the German government's guiding line for the negotiations on the MFF.

However, in order to add a more forward-looking and future-oriented approach to this restrictive position, the German government launched the “Initiative for better spending.” As a central part of European consolidation policy and budget discipline, the Federal Government demands more efficiency in spending policies and European added value as the focus point for a new MFF. It is not more money that is needed but a better use of the available resources. This better spending approach includes a shifting of spending priorities to allocative and modern policies, i.e. for R&D, innovation and education, climate and energy. This approach should serve as an incentive to enhance efficiency and effectiveness of all European spending policies. In general, the spending policies should therefore be degressive and, if possible, restricted in time. Germany backs all ideas and proposals to improve Cohesion policy and to apply structural

funds for more growth and employment – under the precondition that no additional funding will be available. As such, the German answer to all calls for increasing the volume of the European budget is increasing efficiency.

The German Government strongly argues against any effort to introduce some kind of a European tax and believes that the current own resources system generates sufficient financial resources for the EU. To improve efficiency and to simplify the own resources system, the German government advocates abolishing the VAT-based own resource. Although the Federal Government supports a financial transaction tax in Europe, or at least in some member states, the federal government rejects the Commission's proposal that the expected revenues should flow into the European budget. On the contrary, the financial transaction tax (FTT) should flow into national budgets and serve as a relief for the stressed national budgets.

## | Germany and the European Cohesion Policy |

For the period 2007-2013, Germany is the fifth largest recipient of Structural Funds in the EU; it attracts about 26.3 billion € out of the European budget. The biggest part of these funds, about 15.5 billion €, flow to the Eastern German Länder.

As a major net payer, the Federal Government tries to secure significant funding for the German Länder. Therefore, Germany follows a two-track approach. On the one hand, Germany backs the proposal to introduce transitional arrangements for former convergence regions to avoid economic disruptions and financial difficulties.

This safety net for regions would also help the economically weak Eastern-German regions. On the other hand, the Federal Government seeks to continue comprehensive funding in all regions of the EU, a benefit for the Western German Länder. Generally, European funds should be concentrated in the most backward regions, as defined in the “convergence” objective. However, richer regions, currently funded by the “regional competitiveness and employment” objective, should remain eligible for receiving European structural funds. The proposal to introduce a new objective for transition regions with a GDP between seventy-five and ninety % of the average EU GDP, however, is rejected by the federal government and the German Länder. Germany fears that this new category could create new demands with additional funding.

German claims for reforming European Cohesion Policy are manifestations of the “better-spending” approach. In times of economic crisis, the main purpose of European

Structural Funds should be generating sustainable economic growth and employment. This growth-oriented approach means basically that the European Funds shall become the main financial tool for implementing the Europe 2020 strategy.<sup>11</sup>

Following this approach, the Federal Government accepts and encourages the Commission's attempts to increase its monitoring and evaluation powers and capacities. The Commission is seen as the only institution to be able to control the efficient use of funds in the member states and to sanction and punish member states or regions in case of misuse or fraud.

The better spending approach also includes new concepts of conditionality. Although the German Länder perceive the concept of macroeconomic conditionality with some skepticism, the Federal Government supports this idea of the European Commission. Macroeconomic conditionality is seen as a lesson from the Spanish and the Irish cases. In both countries, European funds inflated real estate bubbles and thus led to banking crises and ultimately public debt crises.

Another German conclusion of the crisis is the demand to reduce the huge redistribution of funds from old to new member states. There is a fear in Germany that the massive influx of European funds could undermine the attempts in new member states to use European funds effectively. This is also a lesson from the experiences with some southern member states where the enormous inflow of European funds led to windfall gains, inefficient use of funds and unsustainable projects. Consequently, Germany argues together with the "Friends of better spending" in favor of a "reversed safety net."

Another German conclusion of the crisis is the demand to reduce the huge redistribution of funds from old to new member states. There is a fear in Germany that the massive influx of European funds could undermine the attempts in new member states to use European funds effectively. This is also a lesson from the experiences with some southern member states where the enormous inflow of European funds led to windfall gains, inefficient use of funds and unsustainable projects. Consequently, Germany argues together with the "Friends of better spending" in favor of a "reversed safety net."

## European energy infrastructure

### | Panel summary |

The energy security became one of the crucial issues within the V4 region, particularly after the gas crises in 2006 and 2009, which pointed out the region's vulnerability and served as the wake-up call for the region's governments.

Panelists emphasized the necessity to solve the infrastructure issues at the regional as well as the European level. One of the topics that need a united approach is the EU energy dependence on Russia. European energy system is under pressure due to insufficiency and overload of the transmission grids. Effective infrastructure is also a necessary precondition for the functional integrated energy market.

European energy infrastructure is the area where mutual understanding and cooperation is of crucial importance for European security. Some countries, such as the Czech Republic, are unable to generate electricity from wind, water or solar energy; therefore they need other energy sources, such as the nuclear energy. Therefore EU legislation should take into account diverse geographic conditions that determine energy mixes in all member states.

According to Roman Portužák from the Technical University in Ostrava, the Visegrad group and Germany should coordinate their priorities at the EU level. The Central European region is at crossroads between the East and the West as well as the North and the South. This means that most of the energy supplies are running through this region, which needs to be reflected in the energy policies.

The V4 position towards the energy priorities was described by Alena Žáková from the Slovak Ministry of Economy. Visegrad countries emphasize the need to develop an effective energy infrastructure and welcome the European Commission's draft regulation for trans-European energy infrastructure, which seeks to identify the main obstacles to the establishment of internal market. A proposal is currently negotiated in the EP and its large part is already agreed upon. Žáková also mentioned V4's aim to interconnect the liquid natural gas (LNG) terminals in Poland and Croatia.

Marta Babcz from the Polish Ministry of Foreign Affairs emphasized the importance of internal energy market,

whose effective functioning can be secured only via the establishment of a suitable legislative framework (in addition to the above mentioned physical infrastructure). The connectors between the EU and third countries need also to be taken into account and strengthened.

Stefan Bantle from the German Federal Foreign Office believes that Europe is currently too dependent on fossil and nuclear fuels and their imports and that this dependence should be reduced. He believes the key is to diversify the resources and develop energy storage systems.

In the expert panel Roman Portužák described three main pillars of energy policy: sustainability, independence (security of supply) and competitiveness. These pillars should be equal, although the sustainability is currently prioritized. Transmission grids are on the edge of the safety limits and are often dangerously overloaded in transmission countries.

Robert Zajdler from the Polish Sobieski Institute is rather skeptical about the Visegrad's ability to speak in one voice. In most cases V4 adopts different approaches, which diminishes the potential of joint actions. V4 and Germany need to cooperate on R&D, crisis-management mechanisms and technological security. An effective energy policy needs to be developed in cooperation with the private sector.

According to András György Deák from Hungarian Institute of International Affairs, the EU energy market integration is the major benefit for Hungarian policy makers, because Hungary will so gain access to the German market.

During the energy crisis in 2009, Slovakia and Bulgaria were among the most affected countries. Slovakia learned from this experience and hence it supports the North-South gas, oil, and electricity energy corridor, said Matus Misik from Comenius University in Bratislava. Even though the North-South corridor is of critical importance for the EU, there are insufficient financial resources in the next multiannual financial framework for such an expensive project.

German expert Frank Umbach is convinced that Russia should not control the gas sector. German position is however different from the one of the smaller V4 countries – thanks to its size, Germany does not need to integrate

<sup>11</sup> This approach is also backed by an agreement between the Federal Government and all parliamentary groups in the Bundestag (except the group "Die Linke"). This "Pakt für nachhaltiges Wachstum und Beschäftigung (Compact for sustainable growth and employment) dated 12 June 2012 tries to combine consolidation efforts with growth incentives and stipulates that the future MFF should shift European spending priorities in favour of innovation, education and research. Additionally this compact demands that there shall be no cuts at the expense of investments for growth and employment by European structural funds. This compact is an important support by the main domestic political actors of the government's better spending approach.



so quickly with other EU markets. In his presentation Umbach also pointed out the increasing issue of cyber security, still largely underestimated by the policy-makers in the region.

| Speakers |

**Alena Žáková** - Director, Department of International Relations in Power Industry, Ministry of Economy, Slovak Republic

**Marta Babicz** - Head of the European and Regional Energy Policy Unit, Ministry of Foreign Affairs, Poland

**Stefan Bantle** - Deputy Head of Division Energy Policy, Federal Foreign Office, Germany

**Roman Portužák** - Energy Units for Utilization of non-Traditional Energy Sources Project, Technical University Ostrava

**Robert Zajdler** - Sobieski Institute, Poland

**András György Deák** - Hungarian Institute of International Affairs, Hungary

**Matúš Mišík** - Comenius University Bratislava, Slovakia

**Frank Umbach** - EUCERS/King's College London, Germany

# Possibilities for Further Co-operation in the Central and Eastern Europe Region, Czech Perspective

**Author:** Roman Portužák (roman.portuzak@vsb.cz), Energy Units for Utilization of non-Traditional Energy Sources Project, Technical University Ostrava

| Summary |

Development of energy sector had been driven by increasing demand for energy for a long time. This demand was met by new sources on local and national level. Thanks to both technical interconnections and European integration the necessity of deeper and deeper co-operation is still very urgent even though it is being progressively fulfilled. Establishing internal energy market also evokes the need to strengthen technical infrastructure for better functioning. Because it is in the common interest of countries from the region they should have mutual approach to cohesion policy to maximize use of EU funds and programs for interconnections development and increase regional competitiveness.

**Keywords:** interconnection, market, energy mix

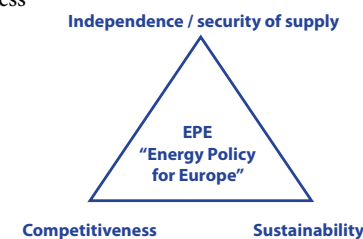
| Brief Introduction |

Development of regional co-operation has been influenced by a couple of important initiatives in the framework of European Union. Among those are European policy for Europe, Third Internal Market Package, Climate and Energy Package, Energy efficiency directives and also Raw Material Initiative. Regional co-operation, functioning and developing market are limited by the existence of real technical grids. Common approach to development of interconnections should be very useful.

| European Policy for Europe |

Presenting Czech perspective of the topic, it is suitable to begin with a wider point of view. European Policy for Europe is based on three pillars:

- Independence / security of supply
- Competitiveness
- Sustainability



Perception of those pillars is probably different. To join the activities and to speed up interconnections it should be reasonable to have similar approach to the Policy. Czech approach to the three pillars could be explained as follows:

- **Independence / security of supply** – to keep and/or to increase independence and security of supply means not only supporting the renewables, but also increasing energy efficiency of the use of energy by supporting best technologies available and maximizing use of domestic primary energy resources, again with high energy efficiency. Rely on import both primary energy resources and electricity could be inappropriate.

- **Competitiveness** – looking for new energy resources should not lead to a dramatic increase of energy prices. For this reason, the way of thinking is to have a balanced energy mix with variability of operational possibilities to ensure minimal especially electricity price. Recent experience shows that long-term support of especially the intermittent sources negatively affect final prices and competitiveness.

- **Sustainability** – energy sector is projected for decades. Therefore, long-term prognoses on market conditions are necessary, especially for the primary resources availability, market forecasts, environmental requirements and public acceptance.

Importance of these pillars is equal. From our point of view it is quite significant because prioritization would lead to imbalance.

| Priorities of European Infrastructure |

Looking at priorities of European infrastructure, it is possible to see focus on localities on the European Union borders. The priorities are:

- Southern gas corridor
- LNG terminals
- Baltic inter-connection plan

- Mediterranean energy ring
- North-south electricity & gas interconnections in central-south Europe
- North Sea offshore grid

Only north-south electricity & gas interconnections in central-south Europe deals with Central and Eastern Europe where priority is given to gas interconnections. But topic is wider, there could be a problem how to transport electricity from the locations of production (North Sea, Baltic Sea, Mediterranean area) to customer places for final consumption. Without co-operation and emphasizing the urgency of finding a solution the project will not become a priority. The importance of the solution shows on European dimension and full support in the framework of cohesion policy.

### | North South Interconnections |

The Czech Republic was facing a gas crisis during the first days of the Czech EU presidency in January 2009. Due to this fact there is a full support to the North South Interconnections Initiative. Also, the recent developments in the electricity sector (implementation of market mechanisms and integration of renewable in feed on a large scale) have significantly changed system operation conditions especially in the Central and Eastern area. Integration of wind farms and other renewable sources to power systems influences the operation of the latter in many ways, especially if done on a large scale. Specifically, the intermittent nature of wind farms (and to some extent also photovoltaic units) changes the load flows occurring in the highly meshed systems. From the point of view of the Czech Republic the main problems are transit and loop flows.

The reason is quite simple. CEE region is a kind of an energy crossroad in Europe and any problem could cause cascade effect affecting the reliability of electricity supply across continental Europe. Situation in the Czech Republic transmission grid is illustrated below.

Improvement of interconnections, especially in north-south direction, but also inside countries is necessary to enable wider market space for trade.

### | Transmission Network Development and Internal Market |

The Czech Republic is really looking for a solution to the loop flow problem so it welcomes initiatives like cooperation between the thirteen European transmission system operators (TSOs) known as TSC – Transmission System Operator Security Cooperation.<sup>12</sup>

In July 2009, TSC launched the TSO Real-time Awareness and Alarm System (RAAS), which provides a global view of the status of the electricity system in eleven control centers allowing them to take care of their responsibility better.<sup>13</sup>

Transmission System Operators are associated in ENTSO-E (European Network of Transmission System Operators for Electricity). They have prepared the Ten Year Network Development Plan 2010-2020 (TYNDP).<sup>14</sup> European Commission will present a list of supported projects (PCI – Projects of Common Interest) at the end of the first semester of 2013. It is very important to have similar view of priorities to negotiate together in favor of projects supporting transmission infrastructure in the region of Central and Eastern Europe.

Taking into account projects like DESERTEC and/or North Sea off-shore Wind Farms, they will have very strong impact on the transmission grid and without development new capacities it will be very difficult if not impossible to bring the electricity to final customers. North South interconnections and fulfilling the TYNDP especially projects for CEE Region will be vital.

Increasing electricity production from RESs and trading formulas influencing transit and loop flows are currently being solved by new investments into grids, but those new investments are not ready in time, due to the licensing processes. Due to that, network overload problems occur more frequently and also the duration is longer. It presents a threat for interconnected system security and stability.

Use of protective means like Phase-Shift Transformers could have a positive impact but mainly for the national grid. It could be a solution for short time but it is not a sustainable one. PST installation would have more negatives as follows:

- Loop flows will be shifted to another region/country,

- PST installation will limit internal market in terms of international co-operation,

- PST installation will impact prices for final customers in the country that will install them. PST is quite an expensive investment.

Possible solutions should lie in close co-operation (and Transmission System Operators are actively looking for possibilities) of all stakeholders, but should be pro-active. Pro-active solution means also to fully use the potential of market mechanisms that propose “software”, enabling effective use of existing infrastructure. Generally, it is possible to say that the bigger the market space/zone is, the higher is the probability of managing the unplanned transit and loop flows. It is because bigger zone consists of more sources of similar purpose at the same time.

Market coupling Czech Republic – Slovakia – Hungary is a good example and it also gives another added value to better market liquidity. Common market space of the Visegrad Group together with Germany and possibly Austria could be not a target from this point of view, but a tool for both, eliminating unpredictable transit flows and approaching the Internal Market conditions. Open questions still remain; it is a methodology of either Market Coupling or Flow Based Allocation. Both methods have their advantages and disadvantages. Potential solution is to find advantages of both methods and then discuss the final version.

Of the Visegrad Four and Germany we would expect to find a list of priorities, coming from TYNDP and other documents and actively negotiate them on EC level together. Those priorities should be also actively, not only verbally, supported on the EU level.

### | Balanced Energy Mix, Support for Internal Market |

For good co-operation it is important to accept and understand national specifics. The approach of the Czech Republic is to have a balanced energy mix of different primary

energy resources. The Czech Republic respects decisions on energy mix made by other countries and expects that in the framework of active co-operation it will be the general approach. It will also expect some kind of empathy.

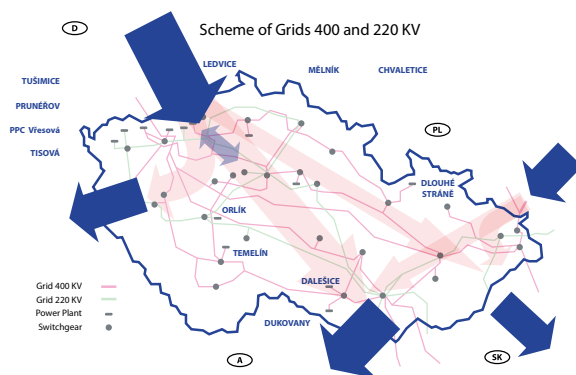
Conclusions of Meeting of the IEA Governing Board and Management Committee Meeting at Ministerial Level also recommend promoting diversity of supply by:

- The safe and sustainable development of natural resources
- New transit routes
- Renewable energy and low carbon energy technologies, including nuclear energy, where this is in accord with the national policies and circumstances

Balanced energy mix of both individual countries and CEE countries together would be a precondition for good market operation at least on regional level. Respecting and understanding each other is the base for further success in our common effort. Following European legislation, conclusions and recommendations of international organizations will give participants arguments.

### | Conclusion |

Implementing European internal energy market brings new challenges and opportunities, but also some risks. Many common activities have been done. To be successful and competitive in the future and to eliminate potential risks, it is important to continue and strengthen co-operation on regional level. Possibilities lie in areas of market, technical co-operation and research and development.



12 <http://www.tso-security-cooperation.eu/en/index.htm>  
13 <http://www.tso-security-cooperation.eu/en/17.htm>

14 <https://www.entsoe.eu/system-development/tyndp/tyndp-2012/>



# Position of Poland on European energy infrastructure – with focus on electricity<sup>15</sup>

**Author:** Robert Zajdler<sup>16</sup> (info@zajdler.eu), Sobieski Institute, Poland

## | Summary |

There is a wide scope of reciprocally beneficial cooperation between the members of the Visegrad Group (V4) and Germany, which includes not only the financial aspects of infrastructure development but also the coordination of day-to-day work. Moreover, social participation, better coordination of national energy policies and nuclear energy could be the additional areas of cooperation.

**Keywords:** Poland, Germany, energy, cooperation, Visegrad Group, infrastructure

## | Brief introduction |

The foundations for the *cooperation within V4 were laid by the similar history of its member states and the geographical proximity*. Nonetheless, in most cases V4 – instead of speaking with one voice - presents different approaches, which diminishes the real influence of the grouping. It takes a coordinated approach to achieve a success in the field of the EU electricity market regulatory activity. Finding common areas of cooperation gives a new momentum to the activities of the Visegrad Group. Electricity infrastructural issues, due to their supranational and regional influences, seem to be a good choice. –The question is, however, to what extent such cooperation receives additional support by German participation. So far, German policy has been concentrating rather on bilateral relations with V4 than creating an overall agenda for cooperation with the group. A wider cooperation with Germany should be anticipated by creating common areas of cooperation within the V4 group.

## | Position on cooperation in energy infrastructure development |

Electricity networks should be upgraded and modernized to meet a growing demand in electricity, foster market integration, enhance security of supply and better integrate renewable energy sources.

Based on the EC's proposal for a regulation on guidelines for a Trans-European energy infrastructure, there are several energy infrastructure priority corridors as well as areas of common interests for V4 and Germany. The most

important are: North-South electricity interconnections in CEE (NSI), smart grids deployment, electricity highways and cross-border CO2 networks. Cooperation could focus on project deployment within these priority corridors and areas. Support and solidarity in application for financial assistance from the EU could be included in this cooperation.

The EU requests that the Member States develop interconnector capacity of up to 10% of national consumption. It requires additional investments in V4 and Germany. A common policy on financing such investments needs to be introduced. Also, a financial support from the EU funds should cover investments in national transmission grids as there might be bottlenecks to the international electricity flow.

The aim of the NSI is to strengthen the regional electricity market by enhanced interconnections, better balancing system and improved trade rules. It will integrate renewable energy, improve stability and predictability as well as security of supply. Improving the investments is one of the ways of achieving these goals. However, a better targeted R&D regional policy, strengthened cooperation on technical safety of power systems, a better anti-crisis regional cooperation and a better coordination in assessment of common projects are also platform for cooperation.

Based on the EU electricity market rules (in particular Article 17 of regulation 714/2009) investing in direct current or - in exceptional cases - alternating current interconnectors or planning to invest in significant increases of capacity in existing interconnectors may apply for derogations from certain EU internal market rules. Derogation is supposed to ensure additional incentives for projects that commensurate with their risk level. A common approach of the V4 countries and Germany could make this instrument more beneficial to regional investors.

The new Multi-Annual Financial Framework 2014-2020 expects to finance the NSI from the Connecting Europe Facility. However, a part of the Cohesion Fund will be allocated to finance transport projects under the

Connecting Europe Facility. These changes should not have negative consequences on financing regional energy projects. Investment in energy infrastructure should be financed from both the Cohesion Fund and Connecting Europe Facility.

## | Position on cooperation in renewable energy deployment |

The EU law requires relatively fast expansion of renewable energy. The Member States take actions aimed at achieving this goal by introducing a favorable public support scheme and national energy policies. Divergence between investment in renewable energy production and transportation infrastructure on internal and trans-border levels pose threats to security of supply.

Grids operators have to cope with deviations between scheduled and actual flows in grids. Transit flows from one country lead to exhaustion of operational measures aiming at keeping the system in normal operational conditions in the neighboring countries. It may lead to non-compliance with fundamental network security criteria and threaten the security of electricity supply. Grid operators use operational and technical tools to limit negative consequences of this transit flow on their grids. Some of these measures temporarily endanger the security of the system, other generate additional costs. There is a place for enhanced regional cooperation between national administrations, national energy regulatory authorities and transmission system operators, whose aim is to coordinate support schemes for renewable energy production, to create coordinated rules for renewable energy integration with network development, to accelerate retrofitting programs of installations posing threats to the security of the system, to propose rules on cost sharing mechanisms for multilateral countermeasures and to coordinate amendments in national energy policies concerning generation which significantly affects the neighbor countries.

## | Position on cooperation in nuclear electricity production |

Nuclear power seems to be an important source of energy helping to achieve the ambitious climate goals of the European Union. All Visegrad Group members produce electricity from nuclear power plants or/and have plans to be developing this source of energy further. German nuclear policy noted many shifts; the last one – phrasing-out the nuclear energy up to 2022 was the most dramatic. It directly and indirectly affects neighboring countries, including V4 members. According to public

information, security reserves in German grids lowered, which influences the security of neighbor countries. Electricity prices rose not only in Germany but also on the neighboring markets. Price of the CO2 emission permits rose significantly and had an impact on all EU countries. Germany plans to give state aid to its industry that would compensate the electricity price rise; if approved, such plans may influence competition on the EU internal market. A decision to produce electricity from less predictable sources such as wind and solar energy in Germany might pose additional threats to security of the neighboring electricity systems.

The consequences of this decision may accelerate a future regional cooperation. It might concern early notice procedures of actions that may influence neighboring countries, technical cooperation in assessment of risks and safeguard provisions, regional mechanisms of loop flows compensation. Cooperation could also be seen in the area of financial support of activities enhancing nuclear safety. In result of the declared phase-out Germany will face problems connected with safety upgrades forced by stress tests, anticipated decommissioning and nuclear waste management. The V4 group will upgrade the safety of existing installations and deploy new units. Further availability of Euratom loans and other funds for decommissioning and nuclear safety seems to be crucial for this cooperation.

## | Position on coordination of rules of social participation |

The EU law as well as the Aarhus and Espoo Conventions provide for a set of requirements aiming to enhance social participation and to make it transparent. Participation of some non-governmental organizations may distort the sense of these rules. It might have negative consequences on investment process. These laws give competences to the Member States to add additional requirements related to the status of non-governmental organizations acting for the environmental protection. In practice, the Member States use different national rules to truly balance the environmental protection actions and investments objectives. Regional cooperation in this regard would be reciprocally beneficial to the members of the Visegrad Group and to Germany. It is especially the case in projects where common interests are involved. A new proposal for TENs regulation requires transparency, predictability and efficiency of national permit-granting procedures and, at the same time, requires social participation in this process in line with the EU law, which is difficult to achieve. Technical cooperation among the V4 countries and Germany in creating regional best practices or unified regional rules would be beneficial.

<sup>15</sup> The content of this publication does not reflect the official opinion of the Republic of Poland. Responsibility for the information and views expressed in the publication lies entirely with the author.

<sup>16</sup> The author is a doctor of law and a legal adviser conducting a law firm specialising in providing legal advice for the energy sector. He is an energy expert at the Sobieski Institute and a lecturer at Warsaw University of Technology.

## | Conclusion |

There are many areas of cooperation between V4 and Germany, which could turn out to be of reciprocal benefit. They include not only the financial aspects of infrastructure development but also the coordination of

day-to-day work. It should cover not only governmental cooperation but it could also be widened to national regulatory authorities and transmission system operators. Social participation in investment projects, coordination of national policies and nuclear energy might serve as a basis for future cooperation.

# Avoiding deadlock. The Hungarian position on CEE “loop flow” problem

**Author:** András György Deák (a.deak@hiia.hu), Hungarian Institute of International Affairs, Hungary

## | Summary |

Hungarian electricity prices are relatively high due to two fundamental factors: the high electricity generation costs (imported gas being the primary cause) and the proximity of the South East European markets, (through import from Hungary) potentially capable to influence prices. Both factors pose a considerable upside risk on domestic price levels, imports are set to rise in the years to come. Thus Hungary is interested in the fast implementation of the European market integration. Unlike the Czech Republic or Poland unplanned flows (“loop flows”) and their unpredictable levels do pose a system security risk in limited time-period “only” for the time being, but have a negative effect on trading volumes and reduce the benefits from the integration process. Hungary has a clear incentive to find a long-standing solution for the loop flow problems and to open up the way for a fast track integration process.

**Keywords:** Hungary, loop flows, CEE market coupling, IEM

## | Brief introduction |

Natural gas has a relatively high share both in the Hungarian energy balance (around 37% in 2010) and in the installed electricity generation capacity (around 40%). Since the bulk of the natural gas is imported, primarily from Russian sources, Hungarian energy policy is predominantly focused on gas market integration. Future gas market integration is expected to increase both the security of supply and, through cheaper gas, the competitiveness of the economy, inclusively that of the electricity sector. Integration of the electricity markets is still important due to its faster feasibility, further enhancement of electricity imports and other economic and efficiency benefits.

Both Visegrad and German markets are important in this regard. Hungary completed its market (price) coupling process with the Czech Republic and Slovakia in September 2012. In respects of interconnectivity and import flows (in 2009 54.6% of total imports, 16.7% of total demand came from the Slovakian direction), Slovakia comprises the most significant partner. Given its size and liquidity, the German market is the European benchmark, the major interface through which the efficiency and trading gains can be realized.

## | Dominant trends on the domestic market |

In the next couple of years the domestic market is set to stagnate, the recovered call from the South Eastern markets may put an upward pressure on price levels, while changing Western European production patterns erodes the competitiveness of the power sector even further.

- Hungarian electricity sector’s average generation costs are relatively high and that is why it’s import-oriented. Due to regional (emerging markets related) risks it has high capital costs in an EU comparison and regulatory uncertainty at the same time. New investments are relatively scarce in the renewable sector, incremental additions are mainly gas-based with the incumbent fuel-related risks. An older, low efficiency generation is set to be decommissioned or mothballed in the years to come. Thus imports will still play an important role in national price formation.

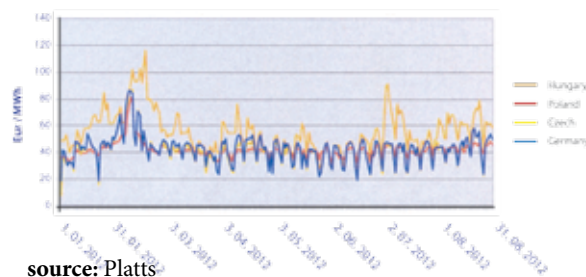
- Exports to South East European markets, primarily towards Croatia and Serbia were significant before the crisis (around 25% of the total national output in 2007). Given the wide price gap between SEE and CEE regions, the economic recovery in the particular region and the low level of investments into local capacities, it is perceived and assumed that the trade towards these countries will grow again. It opens up new opportunities for domestic producers, but also puts an additional squeeze on Hungarian prices and system balance. Further integration to European markets can optimally address these potential problems.

- Changing patterns of Central European electricity production, among others German and Czech solar capacities put a downsize pressure on peak-capacity demand. Since Hungarian gas-fired power plants had a comparative advantage in these fields, this trend further decreases their competitiveness.

As demonstrated in Figure 1, Hungarian price levels have already unbundled from the average CEE level. Even if the problem partly stems from some seasonal factors (dry weather in the Western Balkans), it has also a structural nature. An efficient market integration, further

anchoring to the German market and the enhancement of incremental imports from that region would close the existing price gap. What is more, given the long-standing macroeconomic problems and the regional context, market integration is the most accessible short-term instrument to improve business climate and provide welfare benefits for the consumers on the domestic market.

**Figure 1: Hungarian and CEE countries' base-load prices in 2012**



source: Platts

**Hungarian considerations regarding the loop flow problem**

Hungary is affected by the German loop flow phenomenon, even if it has not caused network security problems yet. The Hungarian TSO had to be constrained, in some particular cases cancel its monthly capacity allocations at the Slovakian section significantly due to volatility on these markets. Thus for Hungary the problem is important in two respects:

- Unplanned flows reduce the trading (dominantly import) levels and consequently the social welfare. The increased network loss is relatively small, especially in comparison to other Visegrad countries. However, the problem has not been solved and it bears a high level of unpredictability regarding future developments. In the light of the tendencies on the Hungarian market, unintended/unplanned flows are likely to become more systematic challenges, especially if they occur in combination with other particular regional outcomes, particularly on the SEE markets.

- Lack of compromise around unplanned flows hinders the market integration process and poses a threat to its fast implementation. The persistence of the problem increases the chance of individual actions, curtailments and in the medium run may conclude to suboptimal solutions.

It is important to underline that for the Hungarian TSO and NRA the market integration aspect is equally important. Given the high import/consumption and the high natural gas/TPES ratios, Hungary is keen to set a

solid institutional framework on its electricity markets as soon as possible. At the same time it has become obvious that the two issues are strongly interrelated, a fast track market integration in the CEE region is not feasible without setting a management scheme for the loop flow problem.

As demonstrated in Table 1, Hungary primarily has mercantilist considerations in the “loop flow” debate. It has an industrial pattern similar to the other Visegrad countries and supports rapid action. Like the other V4 countries, it thinks that the German side has to put something on the table and show readiness for some compromises. At the same time Budapest is relatively flexible, it does not handle the issue as a network security problem, but rather as one of cost-benefit relations.

**Table 1: Positions on the “loop flow problem”**

|                             | German position  | Mainstream V4 position  | Additional HU position   |
|-----------------------------|--|---|--|
| Context of argumentation    | The "loop flow problem" is RES-related. The problem is natural and manageable.                                       | Loop flows pose a threat to system security and hamper trade in CEE, offset benefits of market integration                      | The "loop flow problem" is RES-related. The problem is natural and manageable.   |
| Most accessible solutions   | Flow-based market integration will provide an optimal solution. Large-scale investments into the grid are necessary. | Status quo is unsustainable. Together with the market integration the loop flow problem must be managed (ensuring net benefit). | Emphasis on a fast track solution. FBA (Flow Based Allocation) assessment needed in order to identify the remedial actions and cost-sharing methods necessary and to finish the integration process. |
| Worst case scenario (fears) | Unilateral remedial actions (e.g. Phase Shifter Transformers) from V4 states.  | Market integration combined with further investments into Baltic wind capacity and German-Austrian "non-action".                | Deadlock. Both market integration with unmanaged loop flows and unilateral national management of the problem are highly suboptimal outcomes.  |

**Hungarian efforts to manage the loop flow issue**

Hungary took over the presidency at the Central-Eastern European Forum for Electricity Market Integration (CEEE Forum) on 1 July, 2012. This provided a good opportunity to make additional efforts to break the evolving impasse. The Hungarian Presidency tries to drive back the debate to a more pragmatic cost-benefit setting:

- Together with other Visegrad states it recommended to launch a short-term assessment in order to quantify effects of flow based allocation together with unplanned flows.
- It elaborated a set of potential common measures and instruments on the level of TSOs and NRAs that could contribute to the solution.

In line with previous communication, Hungary still supports some sort of reconsideration and potential modification of the existing system of price bidding

zones. The rationale of these actions is to allocate the necessary quantitative data on a common methodology for responsible decision making and to set a roadmap for common management of this issue. Hungarian presidency remains in the field of sectoral policy, it does not assume higher level of political representation.

**Conclusion**

Hungary has a strong economic rationale to conclude market integration and to couple its market with other the European and CEE ones. Hungarian pragmatism stems from its own economic calculus. The problem of unplanned flows represents an unavoidable obstacle in this process. For Budapest the gains of market integration can be certainly achieved only if this problem is solved and managed. Budapest



# Position of Slovakia on European energy infrastructure<sup>17</sup>

**Author:** Matúš Mišík<sup>18</sup> (misik@fphil.uniba.sk), Comenius University Bratislava, Slovakia

## | Summary |

Slovak Republic was hit significantly by the 2009 gas crisis that forced its government but also business to shift focus towards energy security and diversification of energy supplies and transit routes in gas, electricity and oil. The country therefore supports development of the North-South energy corridor (that consists of interconnectors of all three types of energy sources) and used its 2010/2011 presidency of the V4 group to accelerate this project. Moreover, it backs up the EC's initiatives in energy and wants to keep the possibility to gain resources from EU budget for infrastructural projects (the new Connecting Europe Facility). The main current issue concerning Germany in the electricity area are unscheduled transit flows from Germany that cause overloading and instability of the Slovak grid. Mutual cooperation with Germany should therefore in short term address this issue in the first place, in long-term perspective both countries can benefit from collaboration in the electricity grid development

**Keywords:** Slovakia, Germany, V4, TSO, transmission system, unscheduled flow

## | Brief introduction |

The 2009 gas crisis triggered cooperation between Visegrad countries (V4) in energy that manifested the most visible in the development of the North-South energy corridor. The proposed corridor includes natural gas, oil and electricity interconnectors that will link not only V4 countries, but also the whole Central European region. Such interconnectors are missing since gas and oil pipes had been developed only in East-West direction during the communist era as they had been built in order to transport energy sources from the Soviet Union to its satellites and to Europe. Slovakia was the most affected among V4 countries by the 2009 gas crisis, since the lack of infrastructure prevented it from efficiently substituting missing supplies from Russia with gas from other sources. Moreover, internal limitations restricted the use of gas storage facilities.

In order to prevent similar future crises several measures have been adopted at the domestic and business level (development of emergency procedures, changes in gas

storage rules, new contracts with alternative suppliers etc.). Moreover, Slovak government also supports regional and EU wide diversification activities. The government has been focusing on increasing diversification not only in gas, but also in oil and electricity, trying to utilize the V4 framework and gaining support of the EU budget for these projects (European Energy Programme for Recovery, the new financial framework Connecting Europe Facility).

## | Position of Slovakia in electricity |

Slovakia is a keen supporter of cooperation in the matter of electricity at the V4 level and tries to deal with challenges in this area within this regional framework. A good example of its activities in this area is the Slovak presidency of the group between July 2010 and June 2011. Slovakia has used it to push the project of North-South energy corridor forward and to intensify cooperation among V4 countries in this field. The corridor is considered to be a proper answer to Slovakia's energy challenges and is believed to contribute significantly to diversification of the energy sources and should also improve the trade position of the country. Diversification and good market position are seen as tolls for improving Slovak energy security. However, although the proposed interconnectors creating the North-South energy corridor are not going to supplant current Slovak energy supplies, their main advantage lies in creating several alternative ways for energy import.

During the Slovak presidency of V4 energy ministers of all four countries sent a joint letter to commissioner Oettinger in September 2010. In the letter they urged the European Commission (EC) to include the North-South energy corridor among priority infrastructural projects of the EU as it was not included in the original EC proposal for the development of energy infrastructure in the middle-term perspective. The corridor subsequently became one of the priorities in the communication "Energy infrastructure priorities for 2020 and beyond" published by the EC in November 2010. Moreover, it led to the establishment of a High Level Working Group on North-South Interconnections chaired by the EC and composed of V4, Romania, Bulgaria and Croatia. The

working group created an Action plan in 2011 listing all infrastructural projects necessary for diversification of energy supplies (gas, oil, electricity) in the V4+ region (V4 countries plus other involved countries of the region) that was later attached to Memorandum of Understanding on North-South Interconnections in Central and Eastern Europe. Moreover, sectoral working groups for gas, oil and electricity were established that composed of representatives of the involved states, regulators and business. Their aim has been to advance technical details of different interconnectors creating the North-South energy corridor.

Slovak presidency of the V4 made an effort to advance the development of the corridor also in January 2011 during a meeting of V4 energy ministers in Bratislava. The representatives of the V4 countries proposed concrete steps for the development of the project<sup>19</sup>. Extraordinary European Council meeting on 4 February 2011 adopted "Energy Strategy for Europe 2020" that confirmed the importance of new infrastructure in Central Europe and kept the possibility to finance such projects from public (i.e. EU) resources. Slovakia, together with other countries of the region, has also tried to include their preferred infrastructural project into the next financial framework 2014-2020 and supports EC's effort to allocate more resources on infrastructural projects in general. The country is underlying rather strongly the need to receive Community support for infrastructural projects also within the new infrastructural framework (Connecting Europe Facility) that is going to supplement existing TEN-E (Trans-European Networks for Energy) program regularly criticized for its small budget.

The resources provided by European Energy Programme for Recovery adopted in 2008 with the budget of around 4 billion euro (as a part of the European Economic Recovery Plan) supported few diversification projects that positively affected the Slovak Republic as well. The program partially financed the realization of reverse flows between Slovakia and the Czech Republic and between Slovakia and Austria in gas as well as in some other smaller projects. Still, its limited contribution was too small for main diversification projects (its contribution to Nabucco was rather minor). This was also the case of TEN-E that usually covered only feasibility studies. Therefore Slovakia supports increase of funds for energy infrastructure and its representatives want to gain support for energy projects from the EU budget, claiming that the interconnectors proposed are of EU-wide importance and are therefore entitled to community support.

The most important new infrastructural project

for Slovakia in the electricity area is improving its interconnectivity with Hungary that is being developed within North-South energy corridor. Contrary to the lack of power lines with Hungary connection with the Czech Republic is much better. Slovak TSO even describes electricity interconnection with the Czech Republic as "excellent"<sup>20</sup>. The reason for this can be found in the history as both electricity systems were developed during the period of Czechoslovakia as a part of federal transition grid. The main issue is the lack of high-voltage connectors with Hungary and therefore Slovakia plans to build new power lines in this direction with the financial support of the EU (line 2x400 kV Gabčíkovo - Gönyü, line 2x400 kV Rimavská Sobota - Sajóivánka). This issue is highlighted also due to currently launched electricity market coupling between Slovakia, the Czech Republic and Hungary on September 11, 2012. It was a result of cooperation between TSOs and regulatory authorities of these countries and is supposed to improve market conditions<sup>21</sup>.

## | Challenges of mutual cooperation |

The main current issue in the area of electricity is the problem with unscheduled (and unexpected) transit of electricity through Slovak transmission system from North Germany to South-East Europe (transit flows). They have become significant since August 2011 and on several occasions the Slovak transmission grid has been overloaded. Overall, the transit of electricity through Slovakia increased by 79% in 2011 compared to 2010<sup>22</sup>. This is considered to be a very pressing problem affecting negatively the stability of Slovak transmission grid that needs immediate action. In contrast with the Czech Republic, Slovakia does not experience problems with loop flows within the DE-APG profile due to lack of interconnection with Austria (mainly due to historical reasons but also because of Austrian reluctance towards nuclear power), but is still significantly affected by unscheduled flows to South-East Europe.

Generally speaking, nowadays there is a power surplus in the North of Germany and lack of electricity in Bavaria and South of Europe. The amount of electricity produced from renewables, mostly from wind energy but also from solar energy, is difficult to predict in Northern Germany and since there is a power surplus the electricity is transmitted to South part of Germany (especially Bavaria), Austria and South-East Europe where there is a shortage through transmission systems of Central European countries. Thanks to well-developed transmission system between Slovakia and the Czech Republic (2 lines of 220kV and 3 lines of 400kV) unscheduled electricity easily flows from Germany through the Czech Republic to Slovakia and

<sup>17</sup> Work on this paper was supported by the project "Changing patterns of EU foreign policy making and the small member states" (EUFORPOL) funded by the Slovak Research and Development Agency under contract no. APVV-0484-10.

<sup>18</sup> Department of Political Science, Comenius University in Bratislava, Gondova 2, POBox 32, Bratislava 814 99, Slovakia.

<sup>19</sup> Declaration of V4 energy ministers Bratislava, January 25, 2011 [online]. [cit. 2012-09-20]. Available from: <http://www.visegradgroup.eu/2011/declaration-of-v4-energy>.

<sup>20</sup> Position of ČEPS, MAVIR, PSE Operator and SEPS regarding the issue of Bidding Zones Definition [online]. [cit. 2012-09-23]. Available from: [http://www.mavir.hu/c/document\\_library/get\\_file?uuid=513b0ee-8eb1-405b-85f1-3df85c47237d&groupId=10262](http://www.mavir.hu/c/document_library/get_file?uuid=513b0ee-8eb1-405b-85f1-3df85c47237d&groupId=10262)

overloads Slovak transmission system. These unexpected flows cause several types of problems for Slovak transmission system. First of all, SEPS (Slovak TSO) is unable to execute scheduled trades in electricity due to system overload caused by these unscheduled transits. Moreover, these flows are significantly overloading cross border electricity lines (for example Velké Kapušany - Mukačevo from 7.3. to 8.3. 2012) and are causing higher losses in transmission system that have to be covered by Slovak customers. SEPS claims that under such conditions it is able neither to secure reliable operation of the grid nor to meet the N-1 rule required by the EU regulation.

At first these issues had been dealt with at the level of ENTSO-E (Network of electricity transmission system operators) but as these meetings had not brought the desired outcomes (almost any), they were brought onto bilateral Slovak - German ministerial level in 2012. Moreover, Slovakia has used the V4 platform to negotiate with Germany. However, neither of these talks has reached the desired outcome yet. Although the loop flows within DE-APG profile does not cause problems in Slovak grid, SEPS sees the cause of the problem (together with other three TSOs of the V4 countries) in the common bidding zone of Germany and Austria and therefore supports the suggestion to split German-Austrian bidding area into several zones. This bidding zone enables Austria to buy cheap electricity from Germany during the peak supplies period and therefore it supports the status quo together with Germany. Slovakia does not approve of extreme solutions like construction of blocking technologies (Phase-shifting transformer and High Voltage Direct Current) as they do not solve the problem and only shift it to other TSOs; instead, it prefers a dialogue about the cause of the issue. This is in accord with TSO, but also with Slovak government problematic use of renewables in Germany. Blocking technologies do not present a solution for Slovakia either, since the only place where they would prevent unexpected flows would be the borders with the Czech Republic and that is not feasible given the special relationship between both countries.

### | Cooperation within the V4 and with Germany |

Mutual future cooperation between Slovakia and Germany should concentrate on finding solution to the problem of unscheduled electricity flows from Germany. Slovak point of view is that isolated measures within such a small state are not sufficient for managing unexpected

electricity flow and Slovakia therefore calls for cooperation in this area. Slovak TSO does not favor single-sided measures that could negatively influence other TSOs in the region. Therefore, ENTSO-E utilized for discussing the issue of unscheduled transfer flow through Slovak grid. However, this strategy proved to be unsuccessful and therefore this issue was brought on bilateral and regional level. Slovakia has not reached any concrete outcome in this matter yet and the mutual cooperation with Germany can be characterized as complicated. V4 has proved to be a very fruitful platform for dealing with the energy challenges of the countries of the group and therefore it should be utilized also in this issue. TSOs of the V4 already cooperate in this matter<sup>23</sup> and there is still room for intensifying the cooperation within ENTSO-E. The issue with bidding zones has showed that energy-related issues have to be solved at regional level (at least) to prevent unwanted externalities.

Moreover, V4 countries and Germany could benefit from cooperation at the EU level in general. V4 already coordinates mutual positions and together with Germany it could create a group that would have enough expertise and votes in the Council of the EU to create a stable platform and successfully pursue its preferences. Since both Germany and Slovakia (V4 respectively) face similar problems in the area of electricity infrastructure (the need to expand their national resp. cross-border grids), both partners can benefit from such cooperation. Negotiations of the third energy liberalization package have proven that mutual cooperation between Germany and Slovakia is possible and can lead to success in wider coalition. The question remains whether the cooperation can also work when Slovakia initializes it in order to solve the challenges it faces in electricity area.

### | Conclusion |

The most pressing issue of today's relations between Slovakia and Germany are unscheduled flows of electricity from Germany through Central Europe. Solving this issue successfully is a precondition for further cooperation in energy matters between the two countries. Once solved, mutual cooperation between Germany and Slovakia (and the V4 countries) in electricity could significantly increase the ability of these members to pursue common goals at the EU level. Energy is one of the fastest changing policies at the EU level and close cooperation of these states can secure the best possible outcome for all.

## European Energy Infrastructures: Challenges and perspectives

**Author:** Frank Umbach (umbach@cess-net.eu), EUCERS/King's College London, Germany

### | Summary |

The EU's long-term strategy for energy supply security needs to cope with uninterrupted physical availability of energy products on the market, at a price which is affordable for all private and industrial consumers. Currently the EU-27 is importing about 55% of its energy demand, around 84% of its oil and 64% of its natural gas. Europe needs a complete overhaul to ensure its energy supply security, its economic competitiveness, a sustainable environment as well as climate protection policy and also for further integration of its internal market and interoperability of gas and electricity networks.

The article analyses the EU's actions to secure energy independence since the gas crisis in 2006. It sums up the main challenges in the EU's Electricity Sector, including growing threat of cyber-attacks, overload of electricity grids or dependence on external energy supplies. Impacts of the German "Energiewende" on Europe's power system and security of electricity supply are also discussed.

**Keywords:** energy, security, infrastructure, interconnection, EU, gas, oil, electricity, Energiewende

### | The EU's actions to improve energy infrastructure |

Until 2006 and the first Russian-Ukrainian energy crisis, the EU had neither a common energy policy nor was a single actor, which had assumed overall responsibility for the security of energy supply (i.e. gas supply, mostly transported by politically and technically inflexible pipeline systems during supply crisis). But the EU's long-term strategy for energy supply security needs to cope with uninterrupted physical availability of energy products on the market, at a price which is affordable for all private and industrial consumers. Currently the EU-27 is importing about 55% of its energy demand, around 84% of its oil and 64% of its natural gas. Its overall import dependency of its gross energy consumption was still less than 40% in the 1980s and 43, 2% in 1995. At the same, the EU needs to balance its future energy supply policies with growing environmental concerns, which has become an even more important objective in the light of the Kyoto-protocol. But Europe needs a complete overhaul to ensure

its energy supply security, its economic competitiveness, a sustainable environment as well as climate protection policies and also for further integration of its internal market and interoperability of gas and electricity networks.

In March 2007, the European Council under the German Presidency has agreed on the worldwide most ambitious integrated climate and energy policy with an 'Energy Action Plan' (EAP) for the years 2007-2009 and the three 20% objectives. In October 2008, the European Council called on the Commission to "reinforce and complete critical infrastructure". The strategic aim has focused on promoting the interconnection and interoperability of national networks, as well as getting access to such networks in order to strengthen political solidarity and security of supply in a "truly European energy network". This network also seeks to improve coherence between different national network plans of its Member States. Within the EU internal market, regional (cross-border and multi-country) networks are important for security of supply and solidarity and are seen as a first step towards a fully interconnected internal energy market.

According to the European Commission's "Priority Interconnection Plan" of 2006 and the "2nd Strategic Energy Review and its Energy Security and Solidarity Action Plan", six strategic priority infrastructure projects have been identified. In March 2009, the European Council agreed on financing energy infrastructures for the very first time, in particular gas and electricity interconnectors for enhancing the EU's crisis capabilities with a total budget of 4 billion Euro. The planned gas and electricity interconnectors between the EU Member States include new transnational pipelines and electricity grids (such as between Germany and Poland or between Baltic states and Poland as well as Sweden).

In 2010, the Commission calculated the need of around one trillion Euros in our energy system and alone 200bn Euro for the construction of new transmission networks by 2020: 140bn Euro for high-voltage electricity transmission systems, storage and smart-grid applications; 70bn Euro for gas pipelines, storage, and LNG terminals and reverse flow pipelines, and 2.5bn Euro for carbon

<sup>21</sup> SESP (2012) Successful start of the Czech-Slovak-Hungarian Day-ahead Electricity Market Coupling on 11 September 2012 [online]. [cit. 2012-09-20]. Available from: [http://www.sepsas.sk/seps/en\\_TlacSpravy.asp?Kod=125&Aktualita=590](http://www.sepsas.sk/seps/en_TlacSpravy.asp?Kod=125&Aktualita=590)

<sup>22</sup> MH SR (2012) Správa o výsledku monitorovania bezpečosti dodávok elektriny [online]. [cit. 2012-09-22]. Available from: <http://www.economy.gov.sk/sprava-o-vysledkoch-monitorovania-bezpecnosti-dodavok-elektriny--jul-2012-/127537s>

<sup>23</sup> Position of ČEPS, MAVIR, PSE Operator and SEPS regarding the issue of Bidding Zones Definition [online]. [cit. 2012-09-23]. Available from: [http://www.mavir.hu/c/document\\_library/get\\_file?uid=513b0eee-8eb1-405b-85f1-3d785c47237d&groupId=10262](http://www.mavir.hu/c/document_library/get_file?uid=513b0eee-8eb1-405b-85f1-3d785c47237d&groupId=10262)



dioxide transport infrastructure. Compared with the last decade, a 30% increase of investments will be needed in the gas sector and even 100% in the electricity sector. This investment is not only much needed because of the EU's own agreed target of its "Energy Roadmap 2050", but also because of its rising energy import and consumption costs, which undermine its economic competitiveness. This is particularly relevant in comparison to the U.S. with its low energy prices, enabled due to its shale gas and shale oil revolution (i.e. for Europe's energy intensive industries). Meanwhile Europe spends as much on energy as it does on labor.

But this "internal infrastructure", like gas and oil pipelines and even electricity grids, will be part of foreign infrastructure networks and connected to them (such as Russian gas and oil pipelines, North African solar power plants as well as Norwegian electricity nets or pump stations).

However, the ambitious investment program is only realistic with an active EU involvement because neither all of the investments can be shouldered by (the smaller) national states and can be made on time nor are all the investments commercially viable. Therefore, the Commission has proposed a number of projects of "Common Interest" to reach the core objectives of its climate and energy policies. In October 2011, the European Commission has tabled a new infrastructure plan, which will fund investments worth 50bn euro to improve Europe's transport, energy and digital networks. According to its newest calculations, it has estimated that by 2020 around 500bn euro will be needed to realize its ambitious network vision, including 250bn euro for removing strategic bottlenecks and completing missing links in the core network.

Furthermore, already in October 2010, the European Council adopted a Gas Directive as a legal framework "to safeguard security of gas supply and to contribute to the proper functioning of the internal gas market in case of supply disruptions", including new effective mechanisms and instruments to guarantee solidarity and coordination. The cross-border nature of the new infrastructure investments of the new gas and electricity interconnectors as well as harmonized security of supply standards should be overviewed and coordinated by the Agency for the Cooperation of Energy Regulators (ACER; established in 2009), the European Network of Transmission System Operators for Gas (ENTSO for Gas; established in 2009) and the Gas Coordination Group as an Advisory Body of the European Commission. In February 2010, the first ever European Council meeting dedicated to energy already decided that the internal gas and electricity market

should be completed by 2014 and declared the objective: "No EU Member State should remain isolated from the European gas and electricity networks after 2015 or see its energy security jeopardized by lack of the appropriate connections."

But a new draft report of the European Commission of September 2012 has identified the three Baltic states, Malta, Cyprus, Spain and Portugal still as "gas islands" because of insufficient infrastructure connections with the rest of Europe. The draft report has recommended to speed up the interconnections of their gas and electricity grids. Other countries such as Slovakia, Bulgaria, Hungary and Romania are still dependent on a single gas provider (Gazprom). But also Germany has been criticized for its important bottlenecks and failing or insufficient gas interconnectors at its border with Denmark and Poland in Southern Germany and on the north-south route.

These infrastructure projects are in particular important for the new EU member states in Central and Eastern Europe which lack both East-West and North-South gas stream as well as electricity connectors. Meanwhile the following gas interconnectors and related larger energy infrastructures are being discussed, in the planning stage or already being built.

In addition, Ukraine efforts to modernize its large gas transportation system (GTS), to reduce its overall gas imports from Russia and to diversify its gas imports, including to accept up to 5 bcm of natural gas from Europe (i.e. Germany's RWE). The Ukrainian government is also discussing with the EU the modernization of its GTS on the terms Kiev has proposed (34% owned by Ukraine and 33% each EU and Russia). But as the result of Russia's North Stream pipeline and its efforts to circumvent Ukraine as well as the overall economic recession in Europe, Ukraine has reduced its gas exports to the EU by around 20% over the last year. At the same time, the Kremlin is speeding up to build the South Stream pipeline with a capacity of 60bcm, albeit the project is not economically competitive with other projects (TANAP, Nabucco, TAP, AGRI etc.), is lacking gas resources for its supply (beyond using the pipeline gas through the Ukrainian pipeline network to Europe) and facing an already oversupplied European gas market, where the EU-gas demand increase is decreasing significantly.<sup>1</sup>

Figure 1

**New Gas Interconnectors in CEE countries and the Balkan Countries Being Implemented, Planned or Discussed:**

- Hungary-Slovakia gas interconnector with a length of 113 km to transmit over 6 mcm per day, becoming operational in 2014.
- Feasibility study for a Poland-Slovakia gas interconnector with an annual capacity between 2.5-5 bcm, potentially coming on-stream by 2017;
- A Bulgarian-Romanian gas interconnector with a length of just 25 km and an initial capacity of 1.5 bcm, becoming on-stream by May 2013. The Bulgarian government also plans a cross-border gas interconnector with Turkey
- A Greece-Serbia gas interconnector with a capacity of up to 5 bcm is being studied;
- Implementation of the Greece-Bulgaria gas interconnector (IGB);
- Study mandated for a 550 km long Polish-Lithuanian gas interconnector with a capacity of 4.5 bcm per year, completed by March 2013; For the first time, it will connect the future LNG-terminal at the Baltic coast with the planned LNG-terminal at the Polish coast and the European gas pipeline network;
- Agreement for a 294 km long Polish-Croatian gas interconnector with a capacity of 6.5 bcm/y to link both LNG-import terminals (09/2012);

Confronted with repeated Russian-Ukrainian gas conflicts, the EU has begun to diversify its gas imports away from Russia. Since 2009, Russia's export to the EU has decreased as well as its market share in Europe. Poland for instance has decreased its Russian gas import from 2.8bcm in 2011 to 2.1bcm last spring. Instead it is buying more gas from Germany (+22%) and the Czech Republic (+7%) via its (new) gas interconnectors to these countries.

But the present funding of the Connecting Europe Facility (CEF) – the future funding instrument for the trans-European networks (TEN) and overall objective of the CEF is improvement and integration of the internal energy market as well as to enhance Europe's energy supply security. – with a allocation of €9.1 billion, however, still uncertain for the EU's new financing period of 2014-2020 as the result of the present economic recession, unclear

selection criteria despite the prioritized 12 strategic trans-European infrastructure areas and the "selfishness" of individual EU-member states. In this light, the European Parliament and the ITRE-Committee are discussing new funding options such as the "Cohesion Funds", which could be used "to bridge the gap between the quality of energy infrastructure across Europe and to improve access for people to this infrastructure at a reasonable price. These cohesion funds have been adopted in October 2011 as a financial instrument to reduce regional disparities across Europe.

**| The Challenges in the EU's Electricity Sector |**

Almost every single service depends directly or indirectly on the secure supply of electricity. The physical, virtual and logic networks have grown in size and complexity. Despite the EU's efficiency target of 20% by 2020, the EU's gross electricity generation is projected to rise by at least 20% between 2007 and 2030. At the same time, the rapidly expanding RES need to be integrated into the EU's aging and often outdated grid system, which is largely unable to integrate the targeted 20% share of renewables by 2020 from present 9%.

In previous times, the energy supply system was decentralized with a power plant for each region and a local distribution network, which connected the producer with his consumers. If the power plant failed, the whole region was without energy. When the regional networks were interconnected by transmission networks, security of supply was enhanced by the possibility to exchange energy between the regional networks. It also saved financial resources particularly on the side of producers. Today those regional networks have been extended across national states, connecting individual EU member states with the objective of creating a common, liberalized energy market in the entire EU-27.

As a consequence of the political-economic integration process and the synchronization of the electricity systems of the new member states into the *Union for the Co-ordination of Transmission of Electricity (UCTE)*, the electricity systems of the EU member states are more than ever linked with and dependent on each other's resilience. In 2011, Turkey has joined the European electricity networks, market and UCTE (now called ENTSO-E), while the United Kingdom, the Scandinavian countries and the Baltic states have not yet been integrated into ENTSO-E.

But disrupting frequency and load control processes (based on SCADA systems) as well as failures in the coordination between *Transmission System Operators (TSO)* of control areas can cause cross-border damages and cascading effects, including electricity blackouts

with impacts on other critical infrastructures in different neighboring EU countries affecting millions of peoples and countries.

In order to streamline national infrastructure planning, its approval as well as financing and to establish the planned “projects of common interests” specifically designed fast-track permitting procedures, the regulatory framework relating to the electricity sector has also been expanded with the adoption of the Third energy package in summer 2009. This new legal framework also provides new instruments for better cooperation between *Transmission System Operators (TSOs)* and *Regulators*. The most important one is the *Agency for the Cooperation of Energy Regulators (ACER)*. It started its operations in 2011 and has the task to coordinate rules of accessing the network and investments across borders. The newly created *European Network of Transmission System operators for electricity (ENTSO-E)* has a task to provide a European view of network access and network investments, and drafting a 10-year network development plan for the EU-electricity sector.

The introduction of smart grids as the next transformation step in the electricity-subsector and a pre-condition for a combined use of renewable and conventional energy sources will require quantitative and qualitative changes in the way electricity is moved within and between countries. Smart grids utilize intelligent electricity transmission and distribution networks for a two-way flow of electricity and information based on advanced, but inexpensive metering systems (costing less than USD50) and sensors to help consumers monitor and optimize energy usage in real-time by measuring, collecting and analyzing data.

Those smart meter systems and networks, which acting as a distribution point and an endpoint for communication and sensor nodes, are automated mini-computers. They include a wireless network interface and mesh network software, known in the industry as remote disconnect. These advanced digital functions in the electrical infrastructure will enhance reliability, efficiency, flexibility, and security. But cyber systems are seen as the “weakest link” in the electricity system regarding to rapidly rising cyber-attacks and future supply security of electricity. According to engineers, safety and security needs to be built in during the start of the design stage and not afterwards. This new electrical grid and the smart metering systems in any future household and the industry (in Germany alone 40 million in the next decades) will be even more dependent on computer-based control systems and their inherent vulnerabilities. For cyber-attacks, they will multiply possible access points to the internet and potential viruses with even more cascading effects on many other critical infrastructures.<sup>2</sup>

With the strategic ICT-trends already underway - such as increased connectivity between networks, increased wireless networks, cloud computing and broadened use of commodity IT platforms and in particular smart grids as the next-generation technology for electricity supply and its management -, risks and vulnerabilities in the electricity sub-sector will increase further in the future as long as safety and security of those new technologies are not sufficiently addressed. Thus the present generation of different smart grid technologies has not been developed with inherent safety and security requirements. But if safety and security are not already been addressed in the design stage of those smart grid technologies, we will get not even third-best solutions after their implementation.

### | Impacts of the German “Energiewende” on Europe’s Power System and Security of Electricity Supply |

When Germany decided to phase out its nuclear power by 2022, it had no masterplan regarding either a strategy of implementation or of its costs or a plan for bolstering its future energy supply security. It also did not consult its neighbors or the European Commission about the direct and indirect impacts of its “Energiewende” on its neighboring countries and the entire common EU energy policies because it did not study those impacts in advance. With that, Germany also violated the “solidarity clause” in the Lisbon treaty, covering the case when national decisions on energy policies affect other member states.

The German “Energiewende” has created additional challenges not only for Germany’s future supply security of electricity, facing for the first time very serious challenges of transcoding electricity blackouts with impacts far beyond its borders, but also for its neighboring countries and the EU’s common energy policies. As the result of phasing out 8 nuclear power reactors, Germany is no longer Europe’s largest exporter of electricity. Furthermore, unplanned power flows resulting from integrating increasing amounts of intermittent RES have become a widespread concern for Europe’s entire electricity networks. The safe operability of Germany’s and Europe’s power system has been stretched to the limits in some areas and will increase in the years ahead. This has caused costly interventions in the power systems operations via-re-dispatching more flexible generation capacities and curtailing RES increases.

Thus the Czech and Polish governments have been concerned about north-to-south German electricity flows that rely on their grids to transfer electricity from Germany’s northeast to southern Germany and Austria. The German transmission hardware is simply inadequate to cope with the huge surpluses that the northern wind

parks generate on very windy days in its northern regions. With limited technical means of storing surplus electricity, German grid operators send the excess to other regions, whether they need it or not. The situation has become increasingly critical in the Czech Republic and Poland. The German overflow had even negative impacts on Hungary’s and Slovakia’s grids. The Czechs, like the Poles, have already begun building transformers and phase-splitters along the borders to Germany that will better regulate the German flow. They won’t be completed, however, until 2017. *Vaclav Bartuska*, the Czech ambassador for energy security, has recently lamented at a conference. “We’ve spoken to the Germans many times about this and all they say is they’re going to build new transmission lines. This is good but it will take at least ten years. We can’t wait that long. We have no other choice.”

The short- and mid-term solution lies in greater regional and trans-border planning of common infrastructures. Only a truly integrated, supranational electricity market can provide the capacity needed for synergetic interaction of diverse national power systems. But as long as Germany as the EU biggest country and economy is not living up its role as a model, smaller countries will hardly give up national sovereignty over their national energy policies and the energy mix. In the short-term, at least, one of the key provisions of a new Commission’s directive is the simplification of national permitting procedures in the case of energy infrastructure projects of common European interest.

### | Perspectives: The Challenges Ahead |

While the main focus of the EU’s energy security policies since 2007 has been the gas sector and diversifying the EU’s gas imports, expanding the RES and the needs for market integration, the main challenge ahead is linked with the electricity sector, its growing demand and the integration of the increasing shares from RES into the rather aging and outdated European grid system.

The building of those new gas and electricity interconnectors has manifold implications for the EU’s critical infrastructure security and its vulnerabilities and need to take into account that the gas share of the EU’s electricity production will increase in the next decade:

- As a result of the creation of those liberalized common energy markets and *transnational* physical interconnectors,

the supply of particular gas and electricity becomes to a certain extent even more centralized and transnational in the common EU energy markets for its 27 member states – alongside, simultaneously, of more decentralized supply structures as the result of the expansion of renewable sources (wind, biomass, solar for electricity production). The mix of centralized and decentralized structures enhances and decreases vulnerabilities and security efforts alike.

- Given the strategic importance of gas and electricity control centers for the EU’s future energy supply security and effective crisis mechanisms, the infrastructure safety and security of those gas and electricity interconnectors, including transnational gas and electricity control centers (i.e. their *SCADA-systems*), will acquire both a higher strategic value as well as new dimensions of vulnerability and dependencies of transnational infrastructures. Hence those *transnational* gas and electricity control centers could attract much more attention as potential cyber-attacks and terrorist targets of European vulnerability with much more devastating economic, social and psychological effects on governments and public opinion in EU member states than *national* gas and electricity control centers. Thus on one hand, the growing interconnectivity between EU member states offers better perspectives for a case of future supply crisis and its management. On the other hand, in case of terrorist and cyber warfare attacks, it simultaneously increases the vulnerability and dependency on this critical infrastructure with potential cascading effects on various EU member states.

While the EU has placed priority to extend its liberalized version of the integrated EU energy market to neighboring regions and countries such as Norway, candidate countries and the Energy Community (South-eastern Europe and Ukraine), it has also put much more attention to the Caspian region and North Africa for increasing and diversifying the EU’s oil and in particular gas imports.

Towards the objective of a liberalized and united energy market, the interaction of the EU liberalization of the energy markets and antitrust rules will also lead to increasing dependencies within the EU-27. It demands common and coordinated EU-energy policies as well as transnational infrastructure projects promoted by and decided in Brussels, leading to a decreasing sovereignty concerning (national) energy policies of the national EU member states.

## Economic and business dimension of the Eastern Partnership with special focus in DC FTA with Georgia, Moldova and Ukraine

### | Panel Summary |

The idea of the panel was to go beyond political declarations accompanying the Eastern Partnership (EaP) project from its onset and to analyze the economic aspects of the EU-Eastern Partnership relations, embodied by the Deep and Comprehensive Free Trade Agreements (DCFTA).

Besides outlining the current state of play in DCFTA negotiations with three chosen EaP countries, i.e. Georgia, Moldova and Ukraine the panelists discussed alternatives of economic integration of EaP countries with the EU. The main question was whether the implementation of the DCFTA should be decoupled from the conclusion of the Association Agreements, and as such it touched upon the core of EU as soft power and the democratic conditionality promoted in EU programs. Some speakers supported the view that trade should primarily be the facilitator of democratic change and should not hinge on broader political agreements. There was an overall consensus that in order to enhance pro-European moods in EaP countries, cooperation with specific sectors (industry, SMEs, research & development, ICT and tourism) should be supported.

According to Dagmar Repčėková from Slovak Ministry of Foreign Affairs, the Eastern European countries should deepen their reforms in areas such as the rule of law, or human rights, in return for economic assistance from the EU.

Gábor Brodi, representative of Hungarian Ministry of Foreign Affairs, stressed that Hungary aims to develop a strategic partnership between the EU and EaP states not only in economic, but also in political sphere. Unfortunately, the current conditions in Eastern European countries are not in favor of a deeper political integration due to the lack of true democratic mechanisms in those countries.

Economist Vilém Semerák from CERGE-EI, while applying econometric models, disputed the statement that “more trade is good”, and showed that the implementation of DCFTA in its proposed form would only insignificantly enhance trade volume between EU and EaP countries. The crucial determinant is the shadow economy and

incomplete statistics (in the EaP countries, the shadow economy presents up to 50 % of the GDP). Countries of EaP are, in general, not crucial economic partners for the V4 region. Hence Semerák expects only a slight increase of trade between the V4 and the EaP countries.

According to Sandor Richter from the Vienna Institute for International Economic studies, the economic importance of the EaP countries varies considerably. For obvious reasons, trade with Georgia is rather low in comparison with Ukraine. Ukraine is also a notable investor in some V4 countries, particularly in Hungary. Barriers and restrictions do not negatively influence the import to EaP countries; therefore DCFTA would not have such a great effect. Russia also needs to be taken into consideration, as it wants to reestablish its position in the region, especially in Ukraine. Thus Ukraine will have to choose between DCFTA and Euroasian economic community.

Rafal Sadowski from the Center for Eastern Studies notes that Ukraine is the tenth biggest trade partner of Poland. Poland would benefit from DCFTA thanks to elimination of trade barriers, implementation of EU standards and legislative, improvement of business climate, reduction of corruption etc. Leading role of Ukraine is important for the region. If DCFTA fails in Ukraine, it will influence the rest of the region.

Jana Kobzová from the European Council for Foreign Affairs stressed the need to systematically analyze the impacts of the DCFTA on the V4 countries. Slovakia perceives Ukraine as the most important partner from the group of EaP countries. However, their relationship is not fully developed, which could be changed thanks to the DCFTA.

Iana Dreyer from Montaigne Institute in France warns against focusing solely on economic goals. EaP countries need massive investments in order to be incorporated into the EU's supply chain. Also the cooperation needs to take into account migration, which might increase after the opening of some sectors of the EU market.

### | Speakers |

**Petr Mareš** - Ambassador at Large for the Eastern Partnership, Ministry of Foreign Affairs, Czech Republic

**Gábor Brodi** - Department of Common Foreign and Security Policy, Ministry of Foreign Affairs, Hungary

**Dagmar Repčėková** - Director General, Directorate General for Economic Cooperation, Ministry of Foreign Affairs, Slovakia

**Vilém Semerák** - CERGE-EI, Czech Republic

**Rafal Sadowski** - Centre for Eastern Studies, Poland

**Sandor Richter** - The Vienna Institute for International Economic Studies

**Jana Kobzova** - The European Council for Foreign Affairs, UK

**Iana Dreyer** - Montaigne Institute, France



# A Free Trade Area with Ukraine, Georgia, and Moldova: Estimates of Effects on Czech Economy

**Author:** Vilém Semerák (vilem.semerak@cerge-ei.cz), CERGE-EI, Czech Republic

**Keywords:** trade statistics, trade liberalization, Eastern Partnership, Georgia, Moldova, Ukraine

## 1. Instead of Introduction: Caveat Emptor

Economic forecasting is often an unrewarding activity. While suggesting which tendencies and influences are likely to influence the intensity of future trade can be useful (and not too time-consuming), the public often wants to know the numbers: rates of growth of exports, changes in GDP per capita or unemployment rates. We can often provide such numbers, but the reliability of the estimates is barely satisfying in comparison to the time invested. It is especially true in the particular case of trade between the Visegrad group (V4) and the three partners, Ukraine, Georgia, and Moldova (P3). While the numbers presented in this study are as good as it gets (i.e. they are based on standard methods and official statistics), there are too many factors that limit their reliability.

Out of all the models of trade described in international theory textbooks there is one relatively simple concept, which excels in both predictive power and versatility. This is the so-called gravity model according to which the intensity of mutual trade<sup>24</sup> of regions depends positively on their total economic activity (measured by GDP) and negatively on so-called trade resistance term which is related to the geographical, historical, and cultural distance of the regions, as well as to the trade policy barriers to their trade. If we have all the variables, we should be able to estimate the gravity equation and at least partially evaluate how trade liberalization or other expected change in the regions' policies affects future trade. It is the "if" which is causing us trouble in this particular case:

- While we seem to have plethora of detailed numbers on merchandise trade,<sup>25</sup> trade data of (not only) the new member countries are surprisingly imperfect as described in section 2.1 of this text.

- The analyzed countries have not been each other's important trade partners. The average total share of Georgia, Moldova, and Ukraine in Czech exports was below 0.9% during the past decade.

- The current levels of protection are already fairly small because of the role GSP (Ukraine, the most important of

the countries, was granted the GSP treatment in 1993) which decreases the opportunities for trade-related effects of the FTA.

- It is not quite clear yet how the future FTA will look like and work in reality, especially how successful we will be in removing the non-tariff barriers and the FTA will be phased in.

- Also, GDP of the countries can be expected to describe real economic activity and production in the analyzed countries rather crudely: while the average share of shadow economy during 1999-2007 amounted to some 18% of official GDP in the Czech Republic and Slovakia (similar to average for OECD countries), it was estimated to be at around 24% and 27% for Hungary and Poland respectively, and most probably it was reaching rather extreme dimensions in Moldova (45%), Ukraine (50%) and especially Georgia (66%).<sup>26</sup>

The implications? Responsible forecasting heavily depends on information about previous performance; if the data are flawed or incomplete, the reliability of forecasts tends to be low. While we can be rather sure that the general features of effects of trade liberalization as described especially in section 4 of this text will materialize, the quantitative results should be used with caution.

## 2. Main Features of Current Trade Relations

The description of current trade relations focuses on the "visible", i.e. merchandise trade. Services have been omitted because of (i) the lack of sufficiently detailed and reliable data, (ii) the analyzed countries seem to be more oriented on merchandise trade so far.

Intensity of mutual trade is described in Table 1 and Table 2. The countries can hardly be described as each other's important partners. The joint share of Georgia, Moldova, and Ukraine in exports of the V4 was less than 1% for the Czech Republic and Slovakia in 2011, and between 2 and 3% for Hungary and Poland.

| % of total exports | Georgia | Moldova | Ukraine | Total |
|--------------------|---------|---------|---------|-------|
| Czech Rep.         | 0.06    | 0.04    | 0.85    | 0.94  |
| Hungary            | 0.03    | 0.11    | 2.08    | 2.22  |
| Poland             | 0.03    | 0.10    | 2.49    | 2.62  |
| Slovakia           | 0.01    | 0.04    | 0.82    | 0.87  |

**Table 1 - Roles of Georgia, Moldova, and Ukraine in exports of the V4 in 2010. Eurostat data (COMEXT)**

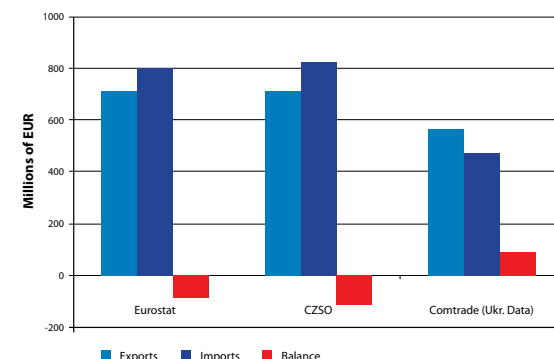
The role of the P3 countries in imports of the Visegrad group is similarly low (Table 2). These low shares (as well as absolute numbers) indicate that even in the case of very impressive effects of the FTA on rates of growth of mutual trade, the FTA is likely to have a very small total impact on aggregate exports, GDP and employment of the analyzed countries.

| % of total exports | Georgia | Moldova | Ukraine | Total |
|--------------------|---------|---------|---------|-------|
| Czech Rep.         | 0.01    | 0.01    | 0.90    | 0.91  |
| Hungary            | 0.00    | 0.02    | 1.31    | 1.34  |
| Poland             | 0.00    | 0.04    | 1.31    | 1.35  |
| Slovakia           | 0.00    | 0.01    | 1.11    | 1.12  |

**Table 2 - Roles of Georgia, Moldova, and Ukraine in imports of the V4 in 2010. Eurostat data (COMEXT)**

## 2.1. Problems with Trade Statistics

Before we start with attempts to predict the effects of FTA on future trade, it is important to realize how imperfect the available data on current trade are. The seemingly detailed and precise<sup>27</sup> data include many hidden problems as exemplified by Figure 1 which compares the data on Czech trade with Ukraine in 2010 from three different (official) sources. According to the data, the Czech exports are higher in Czech than Ukrainian statistics, the same is even more apparent in the case of imports. While the Czech statistical office believes that Czech Republic had a trade deficit with Ukraine in 2010, Ukrainian statistics<sup>28</sup> suggest that Czech Republic had a small surplus.



**Figure 1 - Differences in trade statistics – differences in trade data on Czech trade with Ukraine in 2010**

Similar problems with mirror statistics are common and they result from disturbances caused by many "natural" factors (FOB/CIF pricing, currency conversions, smuggling and omissions). Especially EU member countries are, however, struggling with the problems caused by various versions of the so-called Rotterdam effect. The abolition of custom controls of on intra-EU borders unfortunately means that we are often unable to determine precisely the origin/destination of intra-EU flows, therefore some of the goods which appear in Ukrainian statistics as Polish exports to Ukraine may figure as Czech exports to e.g. Poland in Czech statistics. The implications for the reliability of results of possible simulations are obvious.

## 2.1.1. Indirect and Embodied Trade

Unfortunately, a problem even deeper is omitted from the official statistics altogether. The V4 countries are very strongly attached to the core of the EU, especially to Germany. Both direct subsidiaries of German companies<sup>29</sup> as well as independent Czech companies manufacture components and semi-manufactured goods which are exported to Germany (recorded as Czech exports to Germany) where they are used for the manufacture of German goods intended for third markets (included the P3). If this effect is relevant, the FTA may increase the Czech/V4 exports not only to P3 countries, but also their trade with Germany. Some estimates of the importance of this kind of effects are provided e.g. in Loschky & Ritter (2006) and Semerák (2011).

## 2.2. Current Patterns of Trade and Revealed Comparative Advantage

Applied analysis of current patterns of trade is often based on simple empirical indicators such as the RCA (Revealed Comparative Advantage) indexes. Their logic is simple – if we identify the sectors in which the countries of interests (Czech Republic or V4) outperform the others (the whole EU) in their exports to the P3 countries, we might have also identified the sectors which are likely (after the liberalization of trade between the EU and P3 has taken place) to experience further positive expansion of exports.<sup>30</sup> Therefore we define the RCA indicators in the following way:<sup>31</sup>

$$RCA_i = \frac{X_i^{CR}}{\sum_{i=1}^n X_i^{CR}} \Big/ \frac{X_i^{EU}}{\sum_{i=1}^n X_i^{EU}}$$

<sup>27</sup> With breakdown to thousands of items and values in euros/cents.

<sup>28</sup> As reported to Comtrade database.

<sup>29</sup> Germany is used as the most typical example; similar effects can also be relevant for other EU 15 countries.

<sup>30</sup> While we should not forget that other barriers (e.g. capacity constraints) may exist, the RCA indicators still may be used at least for orientation.

<sup>24</sup> Not only trade, but also investment or migration flows. See van Bergeijk and Brakman (eds.) (2010) for a more complex exposition of both the model and its applications.

<sup>25</sup> Services are even more difficult to track so they are mostly omitted from our analysis.

<sup>26</sup> These estimates come from Buehn and Schneider (2011).

While applying the formula on trade flows between V4 and P3 countries in 2011 (at the 2-digit level and 4-digit level of SITC classification), we have also filtered out the sectors where the total exports of V4 countries to all P3 countries did not exceed 500 thousand Euros; this threshold was lowered to 100 thousand Euro for the separate analysis Czech exports to P3 countries.

The top 30 sectors of V4 exports to P3 (ranked by RCA indicator) are described in table A2 in the appendix, top 20 sectors for the Czech exports to P3 are outlined in table A3. Dealing with the identified items individually is beyond the scope of this brief paper. For the evaluation of the probability of significant effects of the FTA it is sufficient to remark that many of the identified sectors do not rank among the influential and important sectors in the V4/Czech economy.<sup>33</sup>

### 3. Gravity and Trade Flows

As mentioned in the introduction, gravity models seem to be the best simple option for evaluation of the logic of existing structures of trade (by trade partners). This approach has a long tradition in trade analysis, it was pioneered by Tinbergen (1962). We estimate a simple model of Czech exports based on gravity specification and data on trade with 177 trade partners during 1995-2009. Our model is based on unilateral trade flows (Czech Republic v. the rest of the world) and uses dummy variables designed to deal with the potential pitfalls outlined in Baldwin and Taglioni (2006). Several different specifications of the model were tested; the resulting random effect estimate of the model has this form:<sup>34</sup>

$$\ln(X_{it}) = -6.230^{**} + 0.940^{**} \cdot \ln(Y_{it}) + 0.898^{**} \cdot \ln(Y_{it}^{CR}) + 0.117 \cdot \ln(L_{it}) - 1.517^{**} \cdot \ln(D_i) + -0.254^{**} \cdot ERDI_{it} + 0.008^{**} \cdot Bus_{it} - 0.004^{**} \cdot Corrupt_{it} + 0.105 \cdot EU/EEA_{it} + 0.008 \cdot FTA/CU_{it} + 0.445 \cdot Borders_{it}$$

While the discussion of the estimation of the gravity model would require more space,<sup>35</sup> it seems that the Czech structure of exports corresponds well with the expectations which implies that the pattern of Czech exports is standard (in line with the gravity model). Disappointingly enough, the estimates of coefficients for dummies describing the role FTAs or EU integration have the right signs but are not statistically significant.<sup>36</sup>

This would suggest that any further liberalization of trade with more distant countries is unlikely to have immediate and profound effects on the structure (and volume) of Czech exports, the Czech economy is likely to

remain dependent on trade with Germany and its current main trade partners.

### 4. Evaluation of the Effects of the FTA

While being aware of problems with the reliability of the estimates, we attempted to get some quantitative results describing both the extent and the form to adjustment of trade flows and GDP to the creation of the FTA. The results were based on (i) input-output (IO) model, (ii) computable general equilibrium (CGE) models based on GTAP<sup>37</sup> data. As emphasized before, the results are mainly illustrative and should be treated with caution.

#### 4.1. Simple (IO based) Analysis of Sensitivity to Trade with the P3 Countries

At first we tried a simple projection estimating what would happen with total output of the V4 countries if they export in every single export category to all P3 countries increased by 100%.<sup>38</sup> The estimates are based on traditional input-output methodology and they include direct and indirect effects<sup>39</sup> of the assumed trade expansion based on the traditional Leontief equation:<sup>40</sup>

$$\Delta x = (I - A)^{-1} \cdot \Delta d$$

We used older IO tables (CPA rev. 1) where the individual economies of V4 countries are divided into 59 sectors of production for the calculations. The results are described in Figure 2 and their interpretation is rather straightforward – due to the currently fairly minor role of the P3 in exports, the aggregate effect of even a fairly large shock to direct exports would remain low, i.e. below 1% of total output of the countries.<sup>42</sup>

| Exporter        | % Change in Total Output |
|-----------------|--------------------------|
| Czech Republic  | +0.41 %                  |
| Slovak Republic | +0.46 %                  |
| Poland          | +0.82 %                  |
| Hungary         | +0.55 %                  |

**Table 3 - IO based simulations of effects of 100% symmetric increase in exports to P3 on output. Source: own calculations.**

#### 4.2. CGE Model of Trade Liberalization Based on GTAP Model

The IO model is incomplete as it cannot take into account the adjustments in final consumptions and also because it is focused on one country (and neglects possible interdependencies with other markets). For this

reason we constructed a simple CGE model (based on GTAP v. 7 database) with the following features:

- 10 regions (V4 countries lumped together in one region)
- 10 sectors of economy (both goods production and services)
- FTA was model as elimination of measurable (tariff) trade barriers between (i) V4 countries and P2<sup>43</sup> countries, (ii) EU23 (the remaining EU countries) and P2 countries.

The results of the simulated creation of the FTA lead to conclusions which are in line with the expectations and previous partial results. The quantitative outcomes are described in Table 4 (and in tables A4 and A5 in the appendix) and they can be summarized in this way:

- The creation of the FTA has positive effects on exports of the V4, P2, and EU23 countries.
- FTA should lead to higher GDP for especially the P2 countries, lower (but still positive effects) are predicted for the V4 countries and especially the EU. But even for the P2 countries the estimated effect remains quite low.

| Group of Countries / Region             | Change in GDP (%) |
|---|-------------------|
| P2 (Ukraine and Georgia <sup>44</sup> ) | 0.330             |
| V4                                      | 0.013             |
| EU 23 (EU27 without V4)                 | 0.002             |
| Other East and South Europe             | 0.001             |
| Asia                                    | 0                 |
| North America                           | 0                 |
| Latin America                           | 0                 |
| Oceania (Australia, New Zealand)        | 0                 |
| Middle East and North Africa            | -0.001            |
| Rest of World                           | -0.001            |

**Table 4 - CGE Simulation: Results for GDP. Source: own calculations**

### 5. Conclusions and Policy Implications

It seems that our ability to estimate the effects of the FTA is fairly restricted by problems with available data and by the relatively low current share of mutual trade. The gravity model suggests that we should not expect a dramatic change in the pattern of exports of V4 countries after the FTA comes into effect. Both the RCA analysis as well as the simple projections based on input-output methodology suggest that even if a more dramatic increase in mutual trade occurs, the macroeconomic effects will be positive, but very low. Finally, the presented CGE model suggests positive effects on both V4 and P3 countries (asymmetric

in favor of the P3 countries), but the effects are again so small that they are below the assumed statistical precision of our measures of economic activity.

The final evaluation should however be less skeptical than the afore-mentioned results seem to suggest. While the effects are very low, they are more than unlikely to be negative. In addition we should expect that the available historical data do not tell the whole story, they cannot provide us with reliable information on new future opportunities.

Our recommendation is therefore simple and sober. Neither the Czech Republic nor the V4 countries as a whole will lose anything by supporting the FTA. They are likely to gain, although the gains are likely to be small initially. Our policy makers should therefore support the effort, but they should avoid promising too much. While helpful, the FTA will not be the panacea to economic problems of the V4 countries.

### | References |

Richard Baldwin & Daria Taglioni (2006). “Gravity for Dummies and Dummies for Gravity Equation,” NBER Working Paper No. 12516.

Peter A. G. van Bergeijk & Steven Brakman (eds.): The Gravity Model in International Trade: Advances and Applications. Cambridge University Press; 1 edition; 2010. Andreas Buehn & Friedrich Schneider (2012): Shadow economies around the world: novel insights, accepted knowledge, and new estimates. Int Tax Public Finance (2012) 19:139-171

Alexander Loschky & Liane Ritter (2006). Import Content of Exports. In National Accounts and Economic Statistics - International Trade Statistics, Vol. 2006 of, [Paris]: Organisation for Economic Co-operation and Development, August 2006

Vilém Semerák (2011): “Obchod mezi ČR a ČLR – rozdíly v národních statistikách” (Trade between The Czech Republic and China – Statistical Discrepancies) in Němečková T. (ed.), Vzestup asijských zemí v mezinárodním obchodě (The Rise of Asian Countries in International Trade), MUP Praha, 2011  
Jan Tinbergen (2012): “Shaping the World Economy”. New York: The Twentieth Century Fund, 1962

### | Sources of data |

COMEXT – COMEXT database of trade flows published by Eurostat

<sup>31</sup> The RCA index compares the share of sector i in total exports of the selected country (Czechia) with the share of sector i in exports of a benchmark group of countries (in our case logically the EU).

<sup>32</sup> Due to space constraints and limited additional information value, the results for the 4-digit SITC are not provided here.

<sup>33</sup> E.g. sectors such as SITC 32 (coal, coke, briquettes).

<sup>34</sup> Standard tests (Hausman test, test of differing group intercepts, Breusch-Pagan test) were used to test the specification. Due to limited space we only report one version of the model, mainly for illustration. The asterisks denote statistical significance of the estimated coefficients.

<sup>35</sup> The author will share more details at request.

<sup>36</sup> This result is quite typical also for other tested specifications.



STAZO – database of foreign trade data published by the Czech Statistical Office

UN COMTRADE – global database of trade data (United Nations Commodity Trade Statistics Database) published by the U.N.

Input-output tables used in the analysis come from Eurostat (unless indicated otherwise)

GTAP database (version 7) was used in section 7.

| Appendix |

**Table A1 - Total Shares of P3 Countries in Exports of V4 Countries in 2010**  
(%, by sectors in CPA classification).

| Share in the sector's exports  | CR   | Hungary | Poland | Slovakia |
|--|------|---------|--------|----------|
| products of agriculture, hunting and related services  | 1.14 | 3.24    | 6.07   | 0.52     |
| products of forestry, logging and related services   | 0.00 | 0.01    | 0.03   | 0.02     |
| fish and other fishing products, services incidental to fishing                                    | 0.00 | 0.00    | 0.14   | 0.00     |
| coal and lignite; peat   | 0.22 | 0.00    | 3.47   | 0.64     |
| crude petroleum and natural gas; services incidental to oil and gas extraction excluding surveying | 0.00 | 0.00    | 0.00   | 0.00     |
| metal ores   | 0.00 | 0.00    | 0.08   | 0.00     |
| other mining and quarrying products  | 0.77 | 0.49    | 3.48   | 22.85    |
| food products and beverages  | 0.58 | 2.10    | 2.18   | 0.22     |
| tobacco products   | 0.13 | 0.00    | 0.01   | 0.00     |
| textiles   | 0.58 | 6.34    | 5.08   | 2.49     |
| wearing apparel; furs  | 1.08 | 3.30    | 3.81   | 0.59     |
| leather and leather products   | 0.38 | 1.37    | 9.95   | 0.45     |
| wood and products of wood and cork (except furniture), articles of straw and plaiting materials    | 0.33 | 2.28    | 3.39   | 1.05     |
| pulp, paper and paper products   | 1.25 | 3.99    | 6.42   | 3.50     |
| printed matter and recorded media  | 0.40 | 2.31    | 1.82   | 0.38     |
| coke, refined petroleum products and nuclear fuel  | 0.62 | 3.55    | 2.89   | 0.02     |

|  |             |             |              |              |
|--|-------------|-------------|--------------|--------------|
| chemicals, chemical products and man-made fibres                     | 1.75        | 4.09        | 4.02         | 2.53         |
| rubber and plastic products  | 1.14        | 4.88        | 4.29         | 1.03         |
| other non-metallic mineral products                                  | 1.15        | 0.64        | 5.24         | 1.67         |
| basic metals   | 0.29        | 1.03        | 1.52         | 1.29         |
| fabricated metal products, except machinery and equipment            | 0.73        | 1.83        | 3.25         | 0.62         |
| machinery and equipment n.e.c.                                       | 1.45        | 1.40        | 3.59         | 1.20         |
| office machinery and computers                                       | 0.87        | 0.51        | 0.64         | 0.81         |
| electrical machinery and apparatus n.e.c.                            | 0.94        | 3.00        | 2.51         | 0.21         |
| radio, television and communication equipment and apparatus          | 1.13        | 2.06        | 1.55         | 0.54         |
| medical, precision and optical instruments, watches and clocks       | 0.69        | 0.62        | 2.58         | 1.99         |
| motor vehicles, trailers and semi-trailers                           | 0.90        | 1.91        | 1.16         | 0.43         |
| other transport equipment  | 2.60        | 1.43        | 1.40         | 0.91         |
| furniture; other manufactured goods n.e.c.                           | 0.33        | 1.22        | 0.91         | 0.22         |
| electrical energy, gas, steam and hot water                          | 0.00        | 0.00        | 0.00         | 14.53        |
| computer and related services  | 0.04        | 4.03        | 0.00         | 0.27         |
| other business services  | 2.21        | 0.00        | 32.45        | 0.01         |
| sewage and refuse disposal services, sanitation and similar services |             |             | 0.00         | 0.00         |
| recreational, cultural and sporting services                         | 0.06        | 0.13        | 0.40         | 0.02         |
| other services   |             | 0.00        |              |              |
| <b>minimum</b>   | <b>0.00</b> | <b>0.00</b> | <b>0.00</b>  | <b>0.00</b>  |
| <b>maximum</b>   | <b>2.60</b> | <b>6.34</b> | <b>32.45</b> | <b>22.85</b> |

**Table A2 - RCA indicators for the V4 exports to P3 countries**  
(SITC 2 digit level, year 2011, top 30 sectors by RCA)

| Product   | RCA  |
|---|------|
| 35 electric current   | 3.56 |
| 32 coal, coke and briquettes  | 3.45 |
| 27 crude fertilizers, other than those of division 56, and crude minerals (excluding coal, petroleum and precious stones)   | 2.71 |
| 62 rubber manufactures, n.e.s.  | 2.21 |
| 41 animal oils and fats   | 1.91 |
| 76 telecommunications and sound-recording and reproducing apparatus and equipment   | 1.89 |
| 79 other transport equipment  | 1.82 |
| 05 vegetables and fruit   | 1.77 |
| 08 feeding stuff for animals (not including unmilled cereals)   | 1.68 |
| 58 plastics in non-primary forms  | 1.67 |
| 01 meat and meat preparations   | 1.62 |
| 68 non-ferrous metals   | 1.51 |
| 69 manufactures of metals, n.e.s.   | 1.49 |
| 77 electrical machinery, apparatus and appliances, n.e.s., and electrical parts thereof (including non-electrical counterparts, n.e.s., of electrical household-type equipment) | 1.48 |
| 63 cork and wood manufactures (excluding furniture)   | 1.48 |
| 64 paper, paperboard and articles of paper pulp, of paper or of paperboard  | 1.45 |
| 04 cereals and cereal preparations  | 1.44 |
| 66 non-metallic mineral manufactures, n.e.s.  | 1.31 |
| 67 iron and steel   | 1.25 |
| 57 plastics in primary forms  | 1.22 |
| 51 organic chemicals  | 1.21 |
| 89 miscellaneous manufactured articles, n.e.s.  | 1.20 |
| 81 prefabricated buildings; sanitary, plumbing, heating and lighting fixtures and fittings, n.e.s.  | 1.18 |
| 06 sugars, sugar preparations and honey   | 1.16 |
| 61 leather, leather manufactures, n.e.s., and dressed furskins  | 1.14 |
| 78 road vehicles (including air-cushion vehicles)   | 1.11 |
| 00 live animals other than animals of division 03   | 1.11 |
| 02 dairy products and birds' eggs   | 1.10 |
| 55 essential oils and resinoids and perfume materials; toilet, polishing and cleansing preparations   | 1.08 |
| 24 cork and wood  | 1.04 |

Source: own calculations based on data from the Eurostat COMEXT database.

**Table A3 - RCA indicators for Czech exports to P3 countries**  
(SITC 2 digit level, year 2011, top 20 sectors by RCA)

| Product   | RCA  |
|---|------|
| 75 office machines and automatic data-processing machines   | 4.12 |
| 79 other transport equipment  | 3.71 |
| 32 coal, coke and briquettes  | 3.27 |
| 76 telecommunications and sound-recording and reproducing apparatus and equipment   | 2.31 |
| 58 plastics in non-primary forms  | 2.05 |
| 00 live animals other than animals of division 03   | 2.00 |
| 51 organic chemicals  | 1.97 |
| 81 prefabricated buildings; sanitary, plumbing, heating and lighting fixtures and fittings, n.e.s.  | 1.97 |
| 24 cork and wood  | 1.96 |
| 78 road vehicles (including air-cushion vehicles)   | 1.79 |
| 73 metalworking machinery   | 1.77 |
| 57 plastics in primary forms  | 1.50 |
| 74 general industrial machinery and equipment, n.e.s., and machine parts, n.e.s.  | 1.39 |
| 77 electrical machinery, apparatus and appliances, n.e.s., and electrical parts thereof (including non-electrical counterparts, n.e.s., of electrical household-type equipment) | 1.38 |
| 71 power-generating machinery and equipment   | 1.25 |
| 69 manufactures of metals, n.e.s.   | 1.25 |
| 72 machinery specialized for particular industries  | 1.10 |
| 66 non-metallic mineral manufactures, n.e.s.  | 1.09 |
| 22 oil-seeds and oleaginous fruits  | 1.09 |
| 06 sugars, sugar preparations and honey   | 1.07 |

Source: own calculations based on data from the Eurostat COMEXT database.

<sup>37</sup> Global Trade Analysis Project

<sup>38</sup> As apparent from the previous section, it is very unlikely that exports would increase so much and in all the categories only because of the creation of the FTA (*ceteris paribus*), especially in the short run. We use this assumption to illustrate the likely upper bounds for possible effects of the FTA.

<sup>39</sup> I.e. type I multipliers.

<sup>40</sup> A is the matrix of technical coefficients, I is the unit matrix. The change in demand equals the vector describing the 100% symmetric change to exports.

<sup>41</sup> This decision was made because of time constraints and it meant that IO tables from year 2005 had to be applied. However, it is unlikely that results based on newer tables would lead to significantly different results.

<sup>42</sup> The output includes intermediate goods too, so the aggregate output it is not directly comparable with GDP.

<sup>43</sup> Moldova was not included because of missing data, hence P2 instead of P3.

<sup>44</sup> Data for Moldova were not available in the GTAP v.7 database. However, their omission is unlikely to have a significant effect on total results.

Table A4 - CGE Simulation: Results for Exports

| Group of Countries/Region   | Change in Exports (%) |
|-----------------------------|-----------------------|
| Ukraine & Georgia           | 3.698                 |
| V4                          | 0.041                 |
| EU 23                       | 0.020                 |
| NAmerica                    | 0.011                 |
| Oceania                     | 0.008                 |
| LatinAmer                   | 0.006                 |
| Asia                        | 0.003                 |
| MENA                        | 0.001                 |
| Rest of World               | -0.001                |
| Other East and South Europe | -0.091                |

Source: own calculations

Table A5 - CGE Simulation: Results for Exports by Sector

| % change    | V4     | Ukraine and Georgia | Other South and East | EU 23  |
|-------------|--------|---------------------|----------------------|--------|
| GrainsCrops | 0.276  | 22.608              | -0.039               | -0.107 |
| MeatLstk    | 2.927  | -3.881              | 0.132                | 0.274  |
| Extraction  | -0.12  | 0.159               | 0.157                | -0.046 |
| ProcFood    | 1.56   | 8.591               | -0.987               | 0.074  |
| TextWapp    | 0.014  | 53.415              | 0.003                | -0.029 |
| LightMnfc   | -0.078 | 4.968               | -1.05                | 0.036  |
| HeavyMnfc   | 0.036  | 2.688               | -0.306               | 0.031  |
| UtilCons    | -0.234 | -3.978              | 0.486                | -0.023 |
| TransComm   | -0.203 | -2.619              | 0.338                | -0.001 |
| OthServices | -0.367 | -4.547              | 0.446                | -0.034 |

Source: own calculations

# Poland's perspective on economic and business dimension of the Eastern Partnership

Author: Rafał Sadowski (rafal.sadowski@osw.waw.pl), Centre for Eastern Studies, Poland

## | Summary |

Economic and trade cooperation is one of the key elements of the Eastern Partnership (EaP). The importance of the economic dimension of the EaP is emphasized by fact that it is both one of the EaP's top priorities, and an instrument to achieve its goals in other areas. On one hand, the objective of cooperation within the EaP is the economic integration of the partner countries into the European Union, and in the long term, the EaP is designed to enable the neighboring countries to function in the European economic space by establishing a common Deep and Comprehensive Free Trade Area (DCFTA). On the other hand, the development of economic cooperation is regarded as an instrument to stimulate modernization and economic transformation in the partner countries, which in turn entails democratization and political reform. This is to ensure political stability in the region and stimulate social development.

The aim of this paper is to briefly discuss Poland's standpoint on economic cooperation within the EaP, particularly on the DCFTA and challenges with its negotiations and implementation.

**Keywords:** Poland, EU – Ukraine relations, Deep and Comprehensive Free Trade Agreement, trade

## | Poland's position on DCFTA |

From the standpoint of Poland's interests, the establishment of the DCFTA should fulfill two key goals: 1.) Integrate economies of partner countries with the EU market, which should strengthen their political, economic and social stability; 2.) Secure the interests of Polish and EU's companies and investors by opening and liberalizing of the partner countries' markets and adjusting them to the European model and standards.

The EU's offer to open its market to its partners and to provide them with economic support is an incentive for these countries to strengthen their cooperation with the EU and their integration with Europe. It is also intended to offset the high costs of transition in these countries and of their adaptation to the EU model. It should also

bring benefits to the economies, people and elites of the partner countries. At the same time, economically integrating the neighboring countries, opening up their markets and adopting European standards will increase opportunities for entrepreneurs from the EU to develop their businesses and bring tangible economic benefits to the EU and its member states. Poland, which advocates deeper integration of the partner countries with the EU, does not exclude the possibility of granting them EU membership (after fulfilling all necessary conditions). However, taking into account the long-term nature of this process (this issue is out of the question in the current EU debate), establishing the DCFTA is a first step towards real European integration. Full implementation of the DCFTA could pave the way for further action, e.g. a creation of a similar structure to the European Economic Area, which would imply partner states' participation in common EU policies and agendas, full access to the EU market and establishment of the 'four freedoms'.

## | DCFTA's potential benefits for Poland |

The main economic partners for Poland among EaP states are Ukraine and Belarus<sup>45</sup>, while the other partners play a marginal role. Hence, it is only the DCFTA with Ukraine which matters for Poland from the economic point of view, because Belarus is not currently allowed to negotiate on the agreement.

Table 1. Poland's foreign trade turnover with EaP states<sup>46</sup>

|     | ranking | 2011       |         |         | 2010       |         |         | change in dynamics of: |         | share in total Poland's: |         |
|-----|---------|------------|---------|---------|------------|---------|---------|------------------------|---------|--------------------------|---------|
|     |         | exports    | imports | balance | exports    | imports | balance | exports                | imports | exports                  | imports |
|     |         | in mn. EUR |         |         | in mn. EUR |         |         | in %                   |         | in %                     |         |
| U A | 10      | 3 377.2    | 2 011.8 | 1 365.4 | 2 979.9    | 1 385.4 | 1 594.4 | 113.3%                 | 145.3%  | 2.47%                    | 1.32%   |
| B Y | 22      | 1 340.1    | 972.8   | 367.3   | 1 228.2    | 632.2   | 590.0   | 109.6%                 | 153.9%  | 0.98%                    | 0.64%   |
| M D | 55      | 136.5      | 62.3    | 74.1    | 117.7      | 38.6    | 79.0    | 116.0%                 | 161.2%  | 0.10%                    | 0.04%   |
| A Z | 60      | 91.4       | 3.1     | 88.3    | 102.6      | 8.0     | 94.7    | 89.1%                  | 39.3%   | 0.07%                    | 0.00%   |
| G E | 76      | 46.3       | 7.8     | 38.6    | 38.9       | 7.0     | 31.9    | 119.2%                 | 110.8%  | 0.03%                    | 0.01%   |
| A M | 101     | 16.4       | 0.8     | 15.6    | 14.3       | 2.9     | 11.4    | 114.7%                 | 26.6%   | 0.01%                    | 0.00%   |

<sup>45</sup> In 2011, Ukraine was ranked as a 10th trade partner of Poland with 5,39 bln EUR trade turnover, while Belarus was ranked 22nd with 2,31 bln EUR trade turnover. Source: Ministry of Economy of the Republic of Poland (2012), Syntetyczna informacja o eksportcieimportcie Polski w 2011 roku, August 2012, Warsaw.

<sup>46</sup> Ministry of Economy of the Republic of Poland, available from: <[http://www.mg.gov.pl/files/upload/8437/PL\\_MG\\_DSA\\_Syntetyczna\\_inf\\_rok\\_2011\\_dane\\_ostateczne\\_20120802\\_w\\_ost.pdf](http://www.mg.gov.pl/files/upload/8437/PL_MG_DSA_Syntetyczna_inf_rok_2011_dane_ostateczne_20120802_w_ost.pdf)>

The potential benefits for Poland with the establishment of the DCFTA with the EaP countries could be identified as an increase of a trade turnover due to the abolition of customs tariffs and elimination of barriers for trade. The increase of exports will be achieved more by an effect of the trade creation than by trade diversion.<sup>47</sup> In the time of crisis in the eurozone, trade cooperation with the partner countries could limit the current recorded losses in trade with the eurozone states. In the first half of 2012, Poland's exports to the eurozone shrunk by 2.7%, while it increased by 20.7% to Ukraine and 17.9% to the CIS countries.<sup>48</sup>

By introducing EU standards and legislation, the partner countries will improve the functionality of justice systems, decreasing the level of corruption and a size of the 'insider economy', which is one of the most challenging obstacles for Polish entrepreneurs.<sup>49</sup> It will lead to the improvement of the business climate and to a stable environment for conducting business activities. Introduction of trade facilities (i.e. simplification of the customs procedures) should reduce the costs of imports and exports and with partner states, while dispute settlement procedures should secure interests of entrepreneurs.

### | Prospects for the EU-Ukraine DCFTA |

Development of the political situation in Ukraine is of key significance for the future of the EaP. Ukraine is the most important country in the East European Area. It makes up about 60% of the population of the entire region and its economy generates around 55% of GDP PPP. However, current EU-Ukraine relations are at an impasse due to the arrest of Yulia Tymoshenko and the actions taken by the Ukrainian government against other opposition figures, which in fact suspended the EU from signing the Association Agreement and DCFTA.

At this moment, the Polish government is in favor of implementing the DCFTA as soon as possible. It supports the idea of a temporary implementation of the agreement after signing it and before its ratification (Lisbon Treaty allows for such solution).<sup>50</sup> Firstly, it assumes that economic integration will strengthen the democratization process. Secondly, it perceives the DCFTA as an instrument supporting Poland's economic interests. Finally, the failure of DCFTA would significantly weaken the political significance of EaP, which is the main tool for European integration of these six Eastern European states. This approach is supported by business communities in Poland. On the other hand, Polish civil society representatives state for more principled position and assume that extending bilateral relations should depend primarily on respecting the democratic values and

human rights. The EU should not ignore these issues for the sake of economic cooperation with the regime.

The parliamentary elections in Ukraine in October are crucially important for the future of the DCFTA and whole European integration with Ukraine. If there are any serious infringements of the democratic standards, the EU will most probably refrain from signing and implementing the DCFTA and Poland will support this decision.

### | How to assist in DCFTA negotiation process? |

The two important challenges for the partner countries in the DCFTA negotiation process are political will and administration capacity. As far as the latter is concerned, there is a need for the EU to support the development of administrative capacities in partner states. This can be done by utilizing different instruments, such as the Comprehensive Institutional Building programmes (CIB). However, there is still a need to increase their efficiency and to shorten the program period. Poland itself has engaged in providing support for EaP states' administrations for example by launching the Eastern Partnership Academy of Public Administration programme.

Implementation of the DCFTA is a difficult exercise for governments and administrations of the partner states, which require strong political will. However, there is an important divergence of expectations and interests between the EU and EaP states. DCFTA will bring benefits to the partners in a long-term perspective, but it requires incurring significant costs now. In turn, political elites of partner states are mostly focused on short-term political and economic gains. The lack of clarity about the future shape of the EU market after the Euro crisis increases the concerns about the DCFTA among partners. The lack of prospects for EU membership raises the question about the point of implementing significant parts of the acquis, while partners will have no impact on its shape and will not be able to fully reap the benefits. In that situation, there is a need for a strong political signal from the EU side and increase of assistance. Poland has engaged strongly in conducting political dialogue on various levels with leadership and administrations of partner states. It also advocated for acknowledgment of the partner states for European aspirations, which was expressed in the 2011 Declaration of the EaP Summit in Warsaw. It also strongly supports "more for more" principle, which should increase efficiency of the EU assistance and attract the partners to take more efforts into the EU integration process.

## Deep and Comprehensive Free Trade Agreement between the EU and Georgia, Moldova and Ukraine – What would that mean for Hungary?

**Author:** Sándor Richter (richter@wiiw.ac.at), The Vienna Institute for International Economic Studies, Austria

### | Summary |

Hungary's economic relations with the three countries concerned are of low intensity, but their potential – especially with regard to Ukraine – is remarkable. No identifiable Hungarian interests can be found that would speak against a DCFTA with Georgia, Moldova and Ukraine.

**Keywords:** Eastern Partnership, Partnership and Cooperation Agreement, Free Trade Agreement, Deep and Comprehensive Free Trade Agreement, trade, FDI, gains and losses

### | Brief introduction |

In the framework of its new neighborhood policy, the EU intends to go beyond its current framework of cooperation, the bilateral partnership and cooperation agreements based on the "most favored nation treatment". The new framework, the Deep and Comprehensive Free Trade Agreements (DCFTA), offers the partners substantially more than a simple free trade agreement.

### | Hungary's starting position |

Hungary's attitude towards EU policies vis-à-vis the eastern neighborhood countries has been determined by the country's immediate interests, and, at least to some extent, by its current and recent experiences as a member of various economic integration blocks. In the four-decade-long communist period, Hungary was a member of the Soviet Union dominated integration bloc Council or Mutual Economic Assistance (CMEA). This involuntary membership in an integration block characterized by isolation from the rest of the world, non-market prices and negation of competition caused serious damage to the Hungarian economy and resulted in an unrealized development potential by the beginning of political transition to democracy.

From 1990 on, Hungary began its long march towards membership in the European Union. Up to the EU accession in 2004, Hungary had a free trade agreement

with the EU (except for agricultural and food industry products), and the country was a member of CEFTA, a regional free trade agreement (also without agricultural and food industry products) with other Central European EU candidate countries.<sup>51</sup> Since 2004, Hungary has been a full member of the EU, enjoying first the general benefits from the huge single market, and second, a beneficiary of the cross-member state redistribution within the EU, enjoying a net transfer from the EU budget amounting to about 2.5% of the GDP annually.

### | Hungarian interests |

What are Hungary's elementary interests in the context of the DCFTA to be concluded between the EU and Georgia, Moldova and Ukraine (GMU)? It is in Hungary's interest to expand its exports, and liberalizing trade in commodity and services between the EU and GMU would potentially increase the chances of Hungarian exporters on the three countries' markets. Another aim of the DCFTA is to gradually bring the EU's neighbors closer to the single market by ensuring approximation in legislation in areas with an impact on trade, such as competition policy, public procurement, customs and border procedures, certification standards, sanitary and phytosanitary rules, animal welfare and intellectual property rights.<sup>52</sup> More similarity of the three countries to the EU's single market in the above areas would help increase Hungarian exports to those markets. The other side of the coin is that less traditional and non-traditional trade barriers may boost imports to Hungary from these countries, increasing the competition from abroad imposed on (import competing) domestic businesses. Moreover, easier imports from GMU to the other 26 members of the EU may narrow the export opportunities of Hungarian businesses selling identical or similar products in the EU markets. Finally, any possible transfers from the EU budget to the three countries concerned is primarily against the interest of Hungary as net beneficiary of the cross membership redistribution within the EU, although indirectly, with a time lag, EU aid to these countries may increase Hungarian exports through import purchases from those new financial resources.

<sup>47</sup> Kaliszuk, E. – Ambroziak, L. – Błaszczuk, M.: *Konsekwencje ustanowienia strefy wolnego handlu między Unią Europejską a Ukrainą dla handlu towarami między Polską a Ukrainą*. In OSW (2009): *Konsekwencje dla Polski utworzenia strefy wolnego handlu między Unią Europejską a Ukrainą*, OSW, pp. 44 [cit. 2012-10-01]. Available from < [http://www.osw.waw.pl/sites/default/files/Raport\\_\\_SWH.pdf](http://www.osw.waw.pl/sites/default/files/Raport__SWH.pdf) >

<sup>48</sup> Ministry of Economy of the Republic of Poland (2012): *Sytuacja w handlu zagranicznym Polski po I półroczu 2012 r. na tle aktualnych uwarunkowań koniunkturalnych na świecie*. Warsaw [cit. 2012-10-01]. Available from < [http://www.mg.gov.pl/files/upload/8437/PL\\_MG\\_DSA\\_HZ%20po%20I%20p%20C3%B3%20C5%82%20r%202012\\_20120830\\_ost.pdf](http://www.mg.gov.pl/files/upload/8437/PL_MG_DSA_HZ%20po%20I%20p%20C3%B3%20C5%82%20r%202012_20120830_ost.pdf) >

<sup>49</sup> Paczyński, W.: *Badanie ankietowe dotyczące doświadczeń polskich przedsiębiorców współpracujących z ukraińskimi partnerami lub działających na rynku ukraińskim*. In OSW (2009): *Konsekwencje dla Polski utworzenia strefy wolnego handlu między Unią Europejską a Ukrainą*, OSW, pp. 44 [cit. 2012-10-01]. Available from [http://www.osw.waw.pl/sites/default/files/Raport\\_\\_SWH.pdf](http://www.osw.waw.pl/sites/default/files/Raport__SWH.pdf) > Kaliszuk, E. – Ambroziak, L. – Błaszczuk, M. op.cit.

<sup>50</sup> Poland's MFA information for the Commission of Foreign Affairs of Polish Sejm (parliament) in: *Kancelaria Sejmu Biuro Komisji Sejmowych* (2012), *Pelny zapis przebiegu posiedzenia Komisji Spraw Zagranicznych* (no 34), pp. 17, [cit. 2012-10-01]. Available from: <<http://orka.sejm.gov.pl/zapisy7.nsf/0/C3CF67CF8BAE02D2C1257A4C004BE926/%24File/0081507.pdf>>



Members of the current government, including Prime Minister Orbán, have repeatedly emphasized the importance of an opening towards the “East” which includes the three countries concerned. Beyond ideological and actual political reasons not discussed here, this idea is underlined by the fact that in recent years, Hungary’s exports increased much more dynamically towards the “East” than towards the old EU members, the “West.” Among non-economic motives of Hungary for supporting the conclusion of the DCFTA maybe, in the case of Ukraine, the Hungarian minority (approximately 150 000 people) living in Kárpátalja (the most western region of Ukraine), as such an agreement could ease cultivating cross-border Hungarian-Hungarian relations. In the case of Georgia, the Hungarian government has developed a special sympathy with that country since its resolute opposition to Russia’s interference in Georgia’s internal affairs.

| The current significance of economic relations |

The practical significance of the three countries for the Hungarian economy is strikingly diverging. As data in Table 1 demonstrate, Hungary’s trade with Georgia has been nearly non-existent in the last decade, and trade with Moldova is hardly any more significant. Although the bilateral trade with both countries expanded rapidly in the last ten years, the volume exchange has remained insignificant. The same picture emerges from FDI statistics: Georgia and Moldova are not even listed as countries of destination or origin for foreign direct investment from Hungarian point of view. Taking geographical distance into consideration, Moldova’s relative underrepresentation in Hungary’s trade is indeed surprising. Bulgaria, which is the same distance from Hungary as Moldova, absorbs about 1% of the Hungarian exports.

**Table 1. Hungarian trade with Georgia, Moldova and Ukraine**

| Hungary’s exports to   | 2000         | 2004   | 2011   | in%    |        |        |
|------------------------|--------------|--------|--------|--------|--------|--------|
|                        | Euro million |        |        | 2000   | 2004   | 2011   |
| Georgia                | 5            | 8      | 23     | 0.02   | 0.02   | 0.03   |
| Moldova                | 17           | 29     | 91     | 0.05   | 0.07   | 0.11   |
| Ukraine                | 180          | 500    | 1.672  | 0.59   | 1.12   | 2.07   |
| World                  | 30.525       | 44.671 | 80.616 | 100.00 | 100.00 | 100.00 |
| Hungary’s imports from |              |        |        |        |        |        |
| Georgia                | 0            | 0      | 2      | 0.00   | 0.00   | 0.00   |
| Moldova                | 4            | 12     | 18     | 0.01   | 0.02   | 0.02   |
| Ukraine                | 251          | 548    | 960    | 0.72   | 0.13   | 1.30   |
| World                  | 34.833       | 48.668 | 73.699 | 100    | 100    | 100    |

Source: Eurostat Database (Comext), and own calculations

Ukraine’s relative importance for Hungary is much more significant than that of the other two countries.

The mutual trade expanded rapidly between 2000 and 2011. Hungarian exports increased ninefold, imports fourfold. Notwithstanding, with regard to the extremely low basis values in year 2000, the weight of Ukraine in foreign trade of Hungary remained low: 2.1% in exports and 1.3% in imports of total trade. Concerning foreign direct investment, Ukraine is the 8th most important FDI target country of Hungarian investors abroad with a 3% share (€ 451 million) in the total in 2010.<sup>53</sup> Bilateral FDI relations are asymmetric: Ukraine is not listed among the 25 most important foreign investor countries in Hungary, meaning its share must be below 0.3% of the total.

Currently, the EU’s average customs level is substantially lower than the import customs level in the three countries. It is zero vs. Georgia and Moldova and amounts to 0.7% vs. Ukraine. Georgia’s tariff rate vs. the EU is 0.5% while that of Moldova and Ukraine amounts to 3.2% each.<sup>54</sup> That means that if tariffs were cancelled following the DCFTAs, the level of protection would hardly be reduced for Hungary (and any other EU member) contrary to the case of the three countries whose markets are currently protected by higher customs levels plus ample non-tariff measures. All in all, there seems to be no economic reason for Hungary to oppose the DCFTA conclusion between the EU and the three countries concerned.

**Table 2. Composition of Hungary’s trade with selected countries, 2011 (in %)**

| SITC group            | Export to: |            |            |            | Import from: |            |            |            |
|-----------------------|------------|------------|------------|------------|--------------|------------|------------|------------|
|                       | World      | Moldova    | Ukraine    | Georgia    | World        | Moldova    | Ukraine    | Georgia    |
| Food and live animals | 7          | 11         | 8          | 10         | 5            | 5          | 1          | 4          |
| Beverages & tobacco   | 0          | 0          | 0          | 0          | 1            | 0          | 0          | 0          |
| Crude materials       | 2          | 4          | 1          | 1          | 2            | 5          | 12         | 0          |
| Mineral fuels         | 4          | 17         | 3          | 0          | 12           | 0          | 17         | 0          |
| Animal & veg. fats    | 0          | 0          | 0          | 0          | 0            | 0          | 1          | 0          |
| Chemicals             | 10         | 18         | 18         | 53         | 12           | 0          | 4          | 95         |
| Semi-finished manuf.  | 10         | 11         | 11         | 4          | 14           | 6          | 13         | 0          |
| Machines, transp. e.  | 57         | 26         | 53         | 32         | 47           | 3          | 47         | 1          |
| Miscellaneous manuf.  | 9          | 12         | 6          | 1          | 7            | 81         | 4          | 0          |
| Not classified comm.  | 0          | 0          | 0          | 0          | 0            | 0          | 0          | 0          |
| <b>Total</b>          | <b>100</b> | <b>100</b> | <b>100</b> | <b>100</b> | <b>100</b>   | <b>100</b> | <b>100</b> | <b>100</b> |

**Table 3. Composition of the EU’s with selected countries, 2011 (in %)**

| SITC group            | Export to: |            |            |            | Import from: |            |            |            |
|-----------------------|------------|------------|------------|------------|--------------|------------|------------|------------|
|                       | World      | Moldova    | Ukraine    | Georgia    | World        | Moldova    | Ukraine    | Georgia    |
| Food and live animals | 7          | 6          | 7          | 6          | 7            | 15         | 9          | 12         |
| Beverages & tobacco   | 1          | 1          | 1          | 2          | 1            | 3          | 0          | 2          |
| Crude materials       | 3          | 2          | 2          | 1          | 4            | 12         | 21         | 34         |
| Mineral fuels         | 7          | 15         | 7          | 29         | 16           | 3          | 13         | 33         |
| Animal & veg. fats    | 0          | 0          | 0          | 0          | 1            | 6          | 3          | 0          |
| Chemicals             | 16         | 12         | 19         | 13         | 14           | 1          | 6          | 10         |
| Semi-finished manuf.  | 15         | 19         | 16         | 8          | 14           | 13         | 35         | 5          |
| Machines, transp. e.  | 37         | 33         | 37         | 33         | 31           | 10         | 9          | 1          |
| Miscellaneous manuf.  | 11         | 10         | 10         | 8          | 11           | 37         | 4          | 2          |
| Not classified comm.  | 2          | 1          | 1          | 1          | 1            | 0          | 0          | 0          |
| <b>Total</b>          | <b>100</b> | <b>100</b> | <b>100</b> | <b>100</b> | <b>100</b>   | <b>100</b> | <b>100</b> | <b>100</b> |

Source: Eurostat Database (Comext), and own calculations

# Economic integration between Slovakia and Eastern Partnership – Mission impossible?

Author: Jana Kobzová, jana.kobzova@ecfr.eu, The European Council for Foreign Affairs, UK

| Summary |

This contribution examines Slovakia’s aims and objectives in the sphere of economic integration with three selected countries of the Eastern Partnership region – Ukraine, Moldova and Georgia – and explores possibilities of greater/faster progress. It argues that Slovakia should continue in its pro-integration stance in relations with the EU’s eastern neighbors but complement this position with more initiatives aimed at sharing its own integration experience or developing greater cooperation in the sphere of sectoral integration with the EaP states.

**Keywords:** economic integration, conditionality, Eastern Partnership, EU, Ukraine

| Brief introduction |

Given its export-oriented economy and geographical location at the heart of Central Europe, Slovakia can ill-afford not to support closer economic co-operation and integration with countries lying east of the EU’s borders. Russia and Ukraine are among the obvious economic partners in the region, both due to the substantial size of their markets and potential demand for the products Slovakia exports such as cars. For Bratislava, economic integration with countries in the Eastern Partnership (EaP) region is neither the only nor the most important objective: Slovakia sees closer economic cooperation with the eastern neighbors as an integral part of these states coming closer to the EU – to the point that one day, most of them might become eligible for the EU membership. In short, the aim to foster greater economic integration between the EU (and Slovakia itself) and the EaP countries has both very strong political and economic rationale. Given the current status quo of economic integration in the region – i.e. concluded DCFTA talks with Ukraine and on-going DCFTA talks with Moldova and Georgia – this contribution focuses on these three countries rather than on all of the EaP region.

| State of play |

**Ukraine:** too many stumbling blocs?

Of the three EaP countries, Ukraine is the most important economic and political partner for Slovakia. Between 1999 and 2009, the value of Slovakia’s commodity exports

to Ukraine has more than doubled from \$199 million to more than \$433 million; in the same period of time, Ukraine almost tripled its exports to Slovakia. Although this increase is by no means marginal, mutual trade relations remain underdeveloped and would be greatly enhanced if Ukraine’s currency was stabilized, macro-economic reforms were carried out and if the agreement on DCFTA with Ukraine was signed, ratified and, most importantly, implemented.<sup>55</sup> That, however, seems a distant prospect, at least for now: Ukraine’s democratic backsliding and slow pace of reforms under the current President Victor Yanukovich remain the key stumbling blocks in the EU-Ukraine trade (and political) relations. Hopes of most Central European governments that the recent parliamentary elections in Ukraine would offer a new impetus for the EU to energize its ties with Kyiv have been dashed following the international observers’ criticism of the electoral processes and Ukraine’s democratic regress.

This leaves Bratislava in a precarious position: on the one hand, it is in Slovakia’s own economic and political interest to sign and ratify the DCFTA with Ukraine as soon as possible. Although the Kyiv authorities remain reluctant to implement number of necessary reforms that would improve business environment, cut red tape or fight corruption, the DCFTA would help expand the economic competition in Ukraine and open up its market for foreign investors – that in itself would be a progress for a country where economy remains under control of few selected business groups and where SME sector remains notoriously small (approx. 20% share in the economy, according to EBRD). Slovak economy and especially the country’s biggest exporters such as car-makers or electrical equipment makers would benefit from such opening (presuming Ukraine’s attempt to change its tariffs through the WTO process is unsuccessful) – this despite the fact that the DCFTA introduces longer transition periods and quotas on imports of cars (relevant for Slovakia) than Bratislava would have wanted. On the other hand, speeding up the reform process or addressing the cases of selective justice (i.e. the EU’s current conditions for taking the next step on the DCFTA) will have a lasting impact on Ukraine (and indirectly, on interested Slovak businesses), too: unless the country’s courts are de-politicized and impartial and business environment improves, Ukraine will remain in

<sup>51</sup> RICHTER, S. (2012): *Changes in the Structure of Intra-Visegrad Trade after the Visegrad Countries’ Accession to the European Union*. *Wiiw Statistical Reports No. 5*. September.  
<sup>52</sup> HAVLIK, P. et al. (2012): *European neighbourhood – Challenges and Opportunities for EU Competitiveness* p. 69. (Mimeo)  
<sup>53</sup> HUNYA, G. (2012): *Short lived recovery*. *wiiw Database on FDI*.  
<sup>54</sup> HAVLIK, P. et al. (2012): *European neighbourhood – Challenges and Opportunities for EU Competitiveness* p. 37. (Mimeo)

<sup>55</sup> There is no quantitative analysis projecting possible effects of the EU-Ukraine DCFTA on Slovakia’s economy or GDP growth, however, most interlocutors agreed that the effects for Slovakia and Ukraine would be mostly positive.

the category of markets attracting mainly those that are brave enough to work in a system based on patronage and corruption rather than in the category of “normal” market economy.

### Moldova and Georgia

Signature and ratification of DCFTAs with Moldova and Georgia will have far smaller economic implications for Slovakia than the similar process with Ukraine (Slovakia's trade has value of approx. \$4.5 million with Georgia and \$34 million with Moldova compared to \$1billion with Ukraine). Politically, however, implementation of these agreements fits Slovakia's objective to assist its eastern partners to come closer to the EU. When it comes to the ongoing negotiations on DCFTA with both Chisinau and Tbilisi, Slovakia is interested in going as far in trade liberalization as possible, with the exception of several agricultural products (including wine) where transition periods would be welcome. Overall, Slovakia is supportive of the talks and their timely conclusion ahead of the next EaP summit in Vilnius in 2013, at least with Moldova.

### | Recommendations |

The outlined divergences within the EaP have thus far not led to an adjustment of Slovakia's position on economic integration of EaP countries with the EU, not even in the case of Ukraine. While Bratislava's views on the timing of the signature and ratification of the DCFTA with Kyiv (i.e. the sooner, the better) might be shared by other countries in Central Europe, it is far from being the position of the entire EU: several states including Germany have indicated their uneasiness about taking any further steps unless the EU's conditions are met.

Until the current impasse in EU-Ukraine relations is solved and DCFTAs with Georgia and Moldova are concluded, Slovakia should look at number of practical ways to assist its eastern neighbors with modernizing and opening up their economies. What follows is a brief outline of areas where Slovakia's own experience with economic integration to the EU could be applied in assisting its eastern partners:

- Similarly to other Central European countries, Slovakia should use its experience and expertise accumulated during its own trade negotiations with the EU to assist EaP countries with implementation of their commitments and application of relevant parts of the *acquis communautaire*. To some extent, this is already happening thanks to several initiatives by the Slovak Ministry of Foreign Affairs but also bilateral consultations between various government agencies and their counterparts in the region, mainly in Ukraine. These activities should be expanded to

include all three countries: engagement of other relevant stakeholders such as the Slovak Chamber of Industry and Commerce or key export-oriented companies should be considered on an ad hoc basis.

- Need to sell the DCFTA to business: although a number of Slovak businesses might be interested in exploring investment opportunities in the EaP region, most of the SMEs remain unaware of what the benefits and risks of such step are. Given the absence of Slovak embassy in Georgia and Moldova and Ukraine's economic potential as well, Slovakia's eastern neighbor should be the natural focus of these efforts –in the form of either joint investment fora (at the national or regional level) or smaller workshops to discuss possibilities and opportunities the DCFTA would bring to both countries. Slovakia might explore possibilities of organizing similar platforms in Georgia and Moldova in cooperation with local EU delegations or European business associations in the region. Possibilities for greater mutual opening of labor markets should also be discussed, both bilaterally and within the V4+Germany framework. Where needed and feasible, civil society organizations as well as respective government agencies should be involved.

- More public diplomacy needed: Slovakia should follow the example of countries such as the United Kingdom that carried out information campaigns in Ukraine on potential benefits of the DCFTA. Engaging the pro-reform communities inside these countries and expanding their numbers is in Slovakia's and the EU's own interest: they can become allies in pushing the respective governments to implement the agreed reform steps.

- In Ukraine, explore possibilities of involvement of Slovak companies in the projects aimed at increasing energy effectiveness and use of alternative energy resources. These initiatives could be complemented by cooperation at the level of experts and officials and exchange of experience with implementation of the European Energy Community requirements.

- When possible, coordination with other V4 countries and Germany should be sought and prioritized, especially when it comes to formulation of joint positions at the EU level and communication towards the EaP partners. Today, there is considerable difference when it comes to Germany's and V4's views on when to sign the DCFTA with Ukraine. Eastern Partnership policy would greatly benefit if the V4 and Germany reached a consensus on how to foster greater cooperation and integration with the EaP region without compromising on their own principles and values.

### | Conclusion |

Economic cooperation between the EU and the EaP region has never been as intensive as it is today but much remains to be done, as the case of Ukraine shows. Greater progress on economic integration is in both sides' interest – yet unless the numerous

political, economic and social challenges in the Eastern Partnership countries are addressed, the region will remain just what it is now: a territory with great – and under-used – potential.

# What economic benefits to expect from DCFTAs?

**Author:** Iana Dreyer (idreyer@institutmontaigne.org), Montaigne Institute, France

## | Summary |

This paper discusses the EU's trade policy in its Eastern neighborhood. It assesses the "Deep and comprehensive free trade agreements" (DCFTAs) the EU is proposing to Ukraine, Georgia and Moldova against the economic and trade policy priorities of both parties. It points to alternative ways of integrating these economies with the EU. The core argument is that the EU is overemphasizing "exporting" the EU *acquis communautaire* and risks missing out on important market openings. "Deep and comprehensive free trade agreements" (DCFTAs) are one of the cornerstones of the European Union's (EU) current offer to its Eastern neighbors. These instruments were proposed in the wake of the "Color Revolutions" of the middle of the last decade, as a move to foster integration and economic prosperity by freeing up the movement of goods and services across borders.

In their content, the proposed agreements replicate the trade pillar of the Association Agreements the EU signed with membership candidates in the past. With Ukraine, negotiations started in 2007, ended in 2011 and were put on hold for political reasons. Negotiations with Georgia and Moldova started in early 2012.

Are these DCFTAs an appropriate economic answer to the needs of both EU and partner economies, especially in a context in which membership of the EU is not the ultimate goal? This is the issue this short paper will address.<sup>56</sup>

**Keywords:** economic rationales for deeper economic integration between the EU and Ukraine, Moldova and Georgia

## | What is the economic rationale for a DCFTA? |

Ukraine, Moldova and the Caucasus economies currently need massive investment to upgrade their infrastructure. Their industries should be able to join regional and global industrial supply chains by entering a duty and barrier-free economic area centered around a big market such as the EU. Ukraine's domestic market for selected goods is relatively protected – although its average tariffs are comparable to those of the EU. But Ukraine's investment climate is one of the most complex in the world - investors are not well-protected against graft. Some sectors, notably in services, industries, and infrastructure remain very closed to foreign investors.

Nonetheless, the EU has an overall trade surplus with the region, notably in manufacturing (Figure 2 in annex). All these countries need much improved market access for their agricultural products for which they have a comparative advantage and against which the EU is protective. Ukrainian metal industries will want to secure market access in an area where the EU still applies relatively high tariffs and is traditionally prone to antidumping measures.

A trade agreement signed with a powerful rule-of-law promoting partner such as the EU would significantly increase transparency and improve the signatory countries' investment climate. By opening up more to European imports, partner country consumers would enjoy better quality products and services. Greater competitive pressures would weigh on local producers and could be disruptive for local firms initially, but company performance and economic productivity would increase.

Economic simulations undertaken both in the EU and in Ukraine before DCFTA negotiations started estimated that the country could gain 4 to 7 GDP points in the short term, and much more in the longer term<sup>57</sup>.

The EU also stands to gain from greater integration, notably with Ukraine, because of the country's big size and already existing agribusiness and industrial potential. By importing more from Ukraine, the EU could enjoy lower prices for agricultural products. Free trade would enhance opportunities for European industries to stretch their value chains further as costs rise - along with rising living standards - in the Central and Eastern European member states, and thus increase investments in Ukraine. EU exporters could access a new consumer market.

The EU could gain significantly from opening up parts of its labor markets to these countries by allowing in foreign contractors in the services sector (such as healthcare, construction, culture, various consulting services) more easily. These are topics that contemporary trade agreements deal with increasingly, under negotiations of what is termed "Mode 4" access in services. Business visas are traditionally covered by bilateral FTAs. Demographic decline is setting in in some European countries. Germany currently reports labor shortages, notably of skilled labor. The latter its partner countries in the East can readily supply.

## | What chances for success for DCFTAs? |

In practice the chances for a successful outcome of the negotiations and of real economic integration are low. This is why.

As in previous and current negotiations for accession to the EU, the EU is asking its Eastern neighbors to implement the *acquis communautaire*. But this time around it is not offering EU membership at the end of the process. It is not offering an arrangement where these economies will be de facto part of the Single Market without being full EU members either, an arrangement which exists with European Economic Area (EEA) countries such as Norway. The latter enjoy, except in the agricultural sector, the Four Freedoms of the Single Market: the movement of goods, services, capital and people.

The EU is of course offering better market access to its Eastern neighbors– it seems ready to eliminate almost all its tariffs and quotas. But the scope of this market opening could well end up being limited in practice. In goods trade, the "rules of origin" for EU FTAs are complicated and restrictive<sup>58</sup>. These rules of origin have notably failed to enable the kind of economic integration sought in its 1990s FTAs with Mediterranean countries.

The EU has also not agreed to fully open its markets to Ukrainian wheat but only agreed to an extension of quotas.<sup>59</sup> The EU has not given indications that it will make major commitments in the services sector that go beyond its current commitments in the WTO, notably in Mode 4 topics. The movement of services contractors (consultants, construction workers...) and business visas are handled separately in mobility partnerships that hardly foster mobility<sup>60</sup>.

European business and investor interests are supportive of a deal with Ukraine. Alas, no such significant business support can be garnered in the case of Moldova and Georgia. The latter are two "lower middle income"<sup>61</sup> economies (about 3000 USD per capita income) with a very small population – about 4 million inhabitants each – and no energy reserves. What is more, with Georgia, there are no trade barriers to negotiate away. Georgia is fully open to foreign direct investment. It recognizes European standards, so there are no "non-tariff barriers" to trade in goods to speak of. It applies very low tariffs, significantly lower than the EU's average tariffs<sup>62</sup> (Table 1 in annex). It has also reduced corruption. The main reward to expect for Georgia is to make its current preferential trade status with the EU permanent: indeed Georgia already benefits from the "GSP+"<sup>63</sup> regime, the general preferential tariff regime of the EU. But this preference erodes with rising incomes. Moldova's situation is comparable.

The EU has not yet enough legal powers, nor the political drive, to include strong investor-to-state dispute settlement procedures in its bilateral trade agreements. This is something the US practices, and which gives US FTAs much stronger legal clout than EU agreements. Hence US FTA clauses are better implemented as US investors enjoy both better guaranteed market access and protection from various forms of expropriation<sup>64</sup>.

As a final remark: the EU does not seem to be adequately responding to the needs and demands of its partner economies, notably in the field of agriculture and mobility. This reduces, in my view, its ability to negotiate better market access and investor protections for its firms, as well as to garner political capital for the DCFTA.

## | DCFTAs: more about regulation than about trade? |

The EU uses DCFTAs to export the *acquis communautaire*, and makes its implementation a condition to access the EU's market. This approach is very likely to face harsh realities. The EU is much tougher with its neighbors than with the developing and emerging market free trade agreements (FTAs) the EU has been signing across the world. More importantly the very low income levels (Figure 1 in annex) of its Georgia, Moldova and Ukraine, their weak administrative capacities, combined with the political uncertainty surrounding their ultimate status as members of the EU - all this raises the costs for them to implement the *acquis*, and lowers significantly their willingness to do so.

The EU asks in its DCFTAs that the partner countries apply at home, and not only for their exports to the EU: sanitary standards, technical and environmental standards for industrial products and production processes, intellectual property regulations, geographical indicators, competition law, public procurement law. It is also asking these countries to set up extra institutions and courts to handle these issues: for example a special IPR court in Ukraine, or a body to monitor and certify EU sanitary standards in Georgia... Market access to the EU is dependent on this body being set up and on its capacities being recognized by the EU. This approach is too burdensome and slow, and it will not be effective in boosting the partners' exports.

Finally it is important to rethink the economics of its drive to export the *acquis* in the region. Economic growth in the new Central and Eastern EU member states can be seen as a precedent: these countries have enjoyed slower growth rates in the 2000s than in the 1990s. Some economists<sup>65</sup> attribute this phenomenon to their

<sup>56</sup> Note that the final content of the DCFTAs is not known. The text resulting of the DCFTA negotiations with Ukraine is not available to the public. Hence one needs to rely on official documents published and statements made by the institutions, on precedents set by other EU trade agreements, and on various formal and informal sources of information. Economic and political analysis is also in order, to help understand how these agreements are shaped.

<sup>57</sup> Shumylo-Tapiola O. (2012), *Ukraine at the Crossroads: Between the EU DCFTA & Customs Union*, IFRI Russia/NIS Center, April 2012.

<sup>58</sup> According to informal sources, the EU wants its partner countries to produce 60% of value added of the product locally, which is very restrictive by international standards and does not take into account the realities of today's manufacturing, where trade in parts and components is the dominant feature of regional and global production chains.

<sup>59</sup> Kononczuk, W. and Matuszak, S.; "The negotiations on the EU-Ukraine Association Agreement and Russia", *Eastweek*, Center for Eastern Studies (OSW), 13 April 2011.



implementing the *acquis*, especially social legislation and environmental standards. The problem is not that such standards and rules exist, the problem is applying them on a one-size fits-all basis to different economic contexts without a thorough cost-benefit assessment adapted to local circumstances. For instance, recent calculations show that adopting EU SPS standards in Georgia could raise food prices by 90%<sup>66</sup>. Research also shows that countries stand to lose from harmonizing their standards if less than half their trade is made with the partner country.<sup>67</sup> But Ukraine and the Caucasus countries trade a lot with Russia, Turkey and Central Asia: their geographic location explains this. Diversified trade relations are vital for these economies. Imposing EU standards across the board would shut them out from other markets and raise costs excessively.

**| Possible scenarios and alternatives for the DCFTAs |**

What could be the outcome of DCFTA negotiations, and what else could be done?

**The DCFTAs could see two different fates:**

- DCFTAs could be signed and ratified but only partly or not at all implemented by its partners. This is a major risk in Ukraine because it is a big, complex country with volatile politics and severe governance problems.

- The ultimate content of these agreements could be disappointing on all fronts: the text could include soft and not legally binding language, and carve out pockets of protectionism in areas of key interest to the EU's partner countries and to EU business (agriculture for the partners, services and investment for EU business).

As an alternative, the EU's priorities should be to focus on freeing up trade and investment. It should be very selective and apply gradualism in its endeavors to "export" the EU *acquis*<sup>68</sup>.

**The market openings should be as follows:**

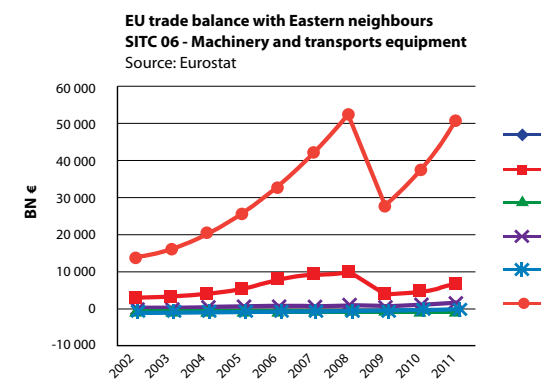
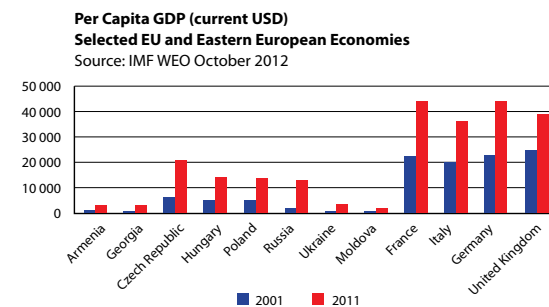
- 100% duty free trade in manufactured goods and agricultural products – without exception
- Opening up to foreign investment, notably in key services sectors (transport, telecommunications, environment/energy, banking and insurance, accounting and law);
- Opening foreign investment and strong investor-to-state dispute settlement

- A more liberal regime in the field of temporary movement of workers at the higher and lower end of the skills spectrum, ranging from engineering services to construction and healthcare workers;

- Liberalizing and simplifying the PanEuro system of rules of origin;

Adopting and applying the *acquis communautaire* should be conceived very gradually, tied to higher per capita income and matched with real opening of the EU Single Market to the temporary movement of contractors from its partners. Full implementation should be considered only if EU membership is clearly envisaged and these economies have raised per capita income. In the meantime, open government procurement procedures, especially for infrastructure services, should be the priority. The rest of the EU *acquis* in the partner countries is a bit less urgent. In terms of technical and sanitary standards, the EU should allow businesses based on the partner countries that want to export to the EU to directly access EU-based national technical and sanitary accreditation bodies, and facilitate this access as long as these countries are significantly poorer than the EU average.

**| Annex |**



**Table 1 Trade Policy Profile – Applied MFN tariffs – EU and Eastern neighbors**

| Country | Average applied tariff, percent and 2011. Source: WTO |               | Total number of services sectors with GATS commitments in WTO |
|---------|---|---------------|---|
|         | Agriculture   | Manufacturing |   |
| EU 27   | 13.5  | 4             | 115   |
| Armenia | 6.8   | 2.8           | 106   |
| Georgia | 7.2   | 0.7           | 125   |
| Moldova | 10.5  | 3.7           | 147   |
| Ukraine | 9.5   | 3.7           | 137   |

<sup>60</sup> See Hernandez i Sagrera, R. (2011), "Assessing the Mobility Partnerships between the EU and Moldova and Georgia, 23 August 2011, Eastern Partnership Community website [www.easternpartnership.org](http://www.easternpartnership.org)  
<sup>61</sup> According to World Bank classifications of countries according to their per capita income  
<sup>62</sup> For more details see Dreyer, I. (2012), *Trade Policy in the EU's Neighborhood. Ways Forward for the Deep and Comprehensive Free Trade Agreements*, Notre Europe, May 2012.

<sup>63</sup> GSP stands for General System of Preferences. "GSP +" applies to poor economies with decent human rights records Georgia will lose this benefit once it grows prosperous enough.  
<sup>64</sup> Note that investor-to-state dispute settlement also protects host states from abusive demands by powerful investors affected by regulations, as publicly available jurisprudence suggests. See annexes in S Woolcock (2011), "The EU approach to international investment policy after the Lisbon Treaty", edited by European Parliament.  
<sup>65</sup> Åslund, A. and Jenish, N., (2006), "The Eurasian Growth Paradox", IIE Working Paper WP 06-5.; Messerlin, P. (2008), "The EC Neighbourhood Policy: An Economic Review", *The Journal of International Trade and Diplomacy* 2 (2), Winter 2008, pp. 27-54  
<sup>66</sup> Messerlin P. et al (2011), "An Appraisal of the EU's Trade Policy Towards its Eastern Neighbours: The Case of Georgia", Joint GEM-SciencesPo/CEPS Policy Study, March 2011  
<sup>67</sup> Chen, M.X. and Mattoo, A., "Regionalism in standards: good or bad for trade?", *Canadian Journal of Economics*, vol. 41(3), 2008, pp. 839-863.  
<sup>68</sup> See Dreyer, I. (2012), *op. cit.*

| About organizers |

|   |  |
|---|--|
|    | <p>The <b>International Visegrad Fund</b> is an international organization founded by the governments of the Visegrad region. The Fund facilitates and promotes the development of closer cooperation among V4 countries through grant support of common cultural, scientific and educational projects, youth exchanges and cross-border projects.</p> |
|    | <p><b>Konrad-Adenauer-Stiftung</b> is a German political foundation. At home as well as abroad, our civic education programs aim at promoting freedom and liberty, peace, and justice. We focus on consolidating democracy, on the unification of Europe and the strengthening of transatlantic relations, as well as on development cooperation.</p>  |
|  | <p><b>Aspen Institute Prague</b> is a non-ideological and non-partisan institution for airing new ideas and diverse points of view. It provides a venue where all parts of society can join a neutral discussion on key topics of today. Aspen Institute Prague also supports talented and motivated young leaders in developing their skills.</p>     |
|  | <p><b>Ministry of Foreign Affairs of the Czech Republic</b></p>  |



ASPEN INSTITUTE  

---

PRAGUE