

The Evolution of East-West Trade relations and European Integration. A case of Poland

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CREATING A BASE OF STRUCTURED RELATIONSHIP. Brief history

The historical evolution of trade relations between Poland and the European Union has been a step-by-step transition from a stage of non-agreement type trade regime of the years 1975-1989 through the phase of the first generation Free Trade Agreement of 1989 up to the second generation association agreement signed in the form of Europe Agreement in 1991 (Zielinska-Glebocka, 1991).

Given the absence of both a multilateral agreement between the EC and the CMEA, and a bilateral agreement between the EC and Poland, the Community introduced an autonomous import regime in 1975. This regime transferred full competence from the national governments to the Commission. An autonomous import regime applied to state-trading countries imposed a certain type of trade discrimination in a form of specific quantitative restrictions and common rules on imports. This regime, combined with the central organization of the foreign system in Poland characterized by the state monopoly of foreign trade and foreign exchange, proved an entirely restrictive economic environment.

The introduction of the political and economic reform in Poland in 1989 has opened up room for the establishment of a formalized trade regime with the European Community. In 1989, the EC decided to abandon its autonomous import regime and to get involved in the programme of coordinated aid for Central and Eastern Europe (PHARE). In accordance with the declaration to renegotiate Poland's status in the GATT, the Polish authorities decided to liberalize foreign trade as of 1 January 1990. The state monopoly of foreign trade was abolished by the new Customs Law, most kinds of direct import control instruments were abandoned and replaced by indirect measures, such as the rate of exchange, customs duties and taxes. The Foreign Exchange Bill enacted in December 1989 introduced internal zloty convertibility and eliminated the central allocation of foreign currencies. In this new environment Poland and the European Community concluded the first generation agreement on Trade and Commercial and Economic Cooperation on 19 September 1989 (OJ L 339 of 22.11.1989).

The 1989 Agreement included a number of concessions and actions leading to the liberalization of trade and strengthening of economic ties. It introduced non-discrimination as the basis of mutual trade in accordance with the GATT rules and also dealt with various forms of commercial and economic cooperation. In 1990, the liberalization of trade was followed by the integration of Poland into the EC System of Generalized Preferences as regard trade in products covered by the EEC Treaty. As a result, Polish products having the GSP treatment enjoyed much better access to the internal market than products originating in countries from outside the system, such as certain less developed economies. Both the Agreement and the GSP concessions have caused an upward shift in the Community's pyramid of preferences granted to various trading regions and countries (Hine, 1985; Gawlikowska-Hueckel, 1993).

It has appeared very soon that the EC-trade regime shaped by the 1989 agreement has proved to be an unsatisfactory solution to the political aspirations of both sides. As a result, discussions with Poland, Hungary and Czechoslovakia on the development of the second generation agreements began in 1990. In September 1990 the European Commission defined a general framework for association agreements for the eligible Eastern countries in a form of Europe Agreements. Europe Agreements represented a unique political initiative based on the declared "commitment to the rule of law, respect of human

rights, the establishment of a multi-party system, free and fair elections and economic liberalization leading to introducing market economies" in the countries of Eastern and Central Europe. As a result, the agreements were predicted to play a role of a political and economic anchor of further transformation in the post-communist region. The final versions of Europe Agreements have been negotiated individually with particular countries on the basis of country memoranda.

The commercial part of the Europe Agreement concluded between Poland and the EC provides the liberalization of trade aimed at the creation of a free trade area for industrial products and the introduction of special arrangements to promote trade in agricultural and fisheries products. Completion of the free trade area implies a phasing-out of customs duties, the remaining quantitative restrictions and equivalent measures. Such phasing-out is asymmetrical in the sense that in the first stage the Community should rapidly improve the access of the associated country to EC markets, while former could maintain its protective rules. In the second stage, however, the associated country should catch up with the Community in improving market access until reaching full reciprocity.

The provisions on the free movement of goods entered into force on 1 March 1992 (Interim Agreement) whereas the whole agreement began operation in February 1994. The concessions offered by the Community in the Interim Agreement proved to be insufficient for Poland's transition to a market economy. This was particularly true when recognizing the crucial importance of the growth of markets for the restructuring of the Polish economy. The requirements of an improved market access are underlined by Mayhew in his paper of 1994 where he writes "the CEEC need access to markets if they are to grow rapidly. Growth will require the import of investment goods and technology on a massive scale; the CEEC will only be able to achieve a high level of imports if they can finance them through a sustained volume of exports".

Having recognized an urgent need of an improved access to the internal market, the Polish authorities insisted on the acceleration of the Community efforts to offer further trade concessions. The Copenhagen Community summit in June 1993 introduced additional measures leading to the accelerated liberalization of trade in non-sensitive products (COM/93/321 final). However, the problem of the EU sensitive sectors and the use of commercial policy instruments have not been solved.

Poland's application for the EU full membership of April 1994 is a final linkage in the chain of political initiatives of the recent years. The Union has reacted to this application by adopting: A Strategy for Accession of Central and East European Countries to the EU at the Essen European Council meeting in December 1994. The strategy aims at setting-out guidelines for future steps to be taken to prepare the EU and the countries of Central and East Europe to accession. It will be followed by the Commission White Paper on the conditions and timetable of building up the enlargement process.

TRADE RELATIONS IN A CHANGING EUROPEAN ENVIRONMENT

In the recent years, the evolution of trade relations between Poland and the EU has been affected by the changes in European and Pan-European environment. In this paper the notion of European environment is used to describe various aspect of the European Union developments whereas the idea of Pan-European environment concerns the dynamics of Europe-wide architecture.

European environment

European Union has been experiencing significant changes in the last years. The completion of the 1992 programme brings about increased competition on European markets. The elimination of market barriers and the subsequent boost to competition require greater efforts by firms buying and selling goods on the internal market. The market game between actors operating within the Community is expected to produce economic and financial incentives for European and non-European firms for gaining competitive advantages, exploiting economies of scale and profiting from the larger size of the marketing operations. The new environment related to the internal market effects poses severe challenges to less experienced firms from Poland and other Central and Eastern Europe. On the one hand the new-comers from this part of Europe are exposed to fierce competition from more advanced western firms, and on the other hand, being confronted with more competitive behaviour, they are forced to operate in a more efficient way. The latter effect is likely to stimulate market-

oriented transformation and restructuring. The competitive conditions on the internal market have accelerated the privatisation process in the Polish trading system. As a result, trade with the Union is conducted mainly by private firms whereas trade with the Central and Eastern Europe and the former Soviet Union is still concentrated in the hands of state trading houses.

In the year 1994, the share of transactions with the Union in total exports of the private sector amounted to 78% when the share of the former COMECON countries accounted for only 13%.

Strong competition effects, both positive and negative, can be also expected from the creation of the European Economic Area and the last EU enlargement. The inclusion of Austria, Sweden and Finland into the internal market will increase competitive requirements for non-EC suppliers of goods. Similar effects might result from the implementation of the EEA treaty as regards the four fundamental freedoms, cooperation in the field of horizontal policies, flanking policies and institutional matters (Evans and Falk, 1992). Poland will have to face increased competition from the more privileged countries, while having much more constrained access to the EU instruments and funding.

The Treaty of Maastricht introduces new ambitions to the EU integration. Creation of the Economic and Monetary Union will require fulfilling several convergence criteria concerning not only macroeconomic stabilization as provided for in the Treaty, but also conditions of economic competitiveness as emphasized in the recent Commission White Paper (Growth, Employment, Competitiveness). Meeting these criteria will be the target of economic policies in the Member States and in the Central and Eastern European countries (CEEC) which intend to join the European Union. Poland and Hungary belong to the pioneering CEEC in the sense that they have formally applied for the membership.

Pan-European environment

In the recent years Pan-European environment has been significantly affected by the political and economic transformation in the Centre and East of Europe. Disintegration of the CMEA bloc called for the foundation of new European networks leading to a new architecture of Europe based on an idea of a "common European house". The drive towards a common Europe has increased a role of the European Union as a centre of gravity for a number of newly-emerging democracies. For these countries the major role of the Union is to provide common rules and coordinate policy efforts. Gravitation to the Union leads to formal and informal integration and to the emergence of what Deutsch (1957) calls a "sense of community". In consequence, the European community has expanded through the attraction of its neighbours, and the European dimension has gained a new impetus. The EU idea of a Europe of diversity gave rise to the redefinition of Europe's core and its outer limits. The traditional definition of "core Europe" as the countries of the Rhine valley and delta needs re-consideration. As Wallace (1990) writes "successive waves of applications for Community membership, the developing network of multilateral and bilateral agreements between the EC and other European countries, indicate a pronounced tendency towards convergence of institutionalized bargaining around the Community framework". In this light the boundaries of the European community are very unclear because its outer limits are broadening. The EU *acquis communautaire* are becoming a model for the integration processes with non-member countries. They govern the implementation of various types of external relations regardless the level of their formalization. In the Association Agreement between Poland and the EC the European *acquis* constitute the basis for all the integration steps, including the creation of the free trade area and maintaining competition for the proper functioning of the Agreement. The provisions on competition which are based on the European competition law (Articles 85, 86, and 92 of the EEC Treaty) are the guards of the fair trade between Poland and the EU.

Reconstruction of the broken commercial and economic ties among the countries of Central and Eastern Europe forms another important element of Pan-European environment. The Visegrad process resulted in the creation of Central European Free Trade Area (CEFTA) lies at the grounds of this reconstruction. The four CEFTA countries (Poland, Hungary, the Czech and Slovak republics) decided to liberalize their trade on the basis of symmetry and full reciprocity. The Agreement on CEFTA entered into force on 1 March 1993 and it provides the creation of a free trade zone by the year 1997. The main aim of this agreement is to reduce barriers to trade between the member countries on bilateral terms until reaching the final objective of a free area. The CEFTA cooperation is an initiative parallel to the Member States' objective of full integration with the European Union, and as such is

compatible with Europe Agreements concluded by particular countries with the Community. Liberalization of trade within CEFTA belongs to the strategy of intra-regional cooperation aimed at strengthening the competitive position of the member economies in their ways to the European Union. Thus, it should not slow down the dynamics of integration with other European regions, particularly with the Community. The Visegrad countries have rejected the concept of replacing CEFTA cooperation for further integration with the EU what has been proposed by certain EU politicians.

The CEFTA process fits in very well with the recent trans-European initiatives of the Union to stimulate economic cooperation throughout Europe. All these initiatives are to favour Pan-European convergence in the face of subsequent applications for membership from other Central and Eastern European countries, as well as from the Baltic States and Slovenia. This concept appears in the Strategy to Prepare for the Accession of the Associated CEEC in the form of the diagonal cumulation principle applied to the EU rules of origin. The strategy proposes the extension of the cumulation rules between the four CEFTA countries to Romania and Bulgaria, and further on to other countries who become associated such as the Baltic States and Slovenia. Combining the EC-EFTA system treated as one territory for the purposes of rules of origin with the cumulation rules of the associated countries should result in the so-called European cumulation. The introduction of full cumulation is envisaged, however, for the end of the association process scheduled in Europe agreements and will be conditioned by the evaluation of the effects on European industry. The safeguards applied to the cumulation rule may limit the positive effects on Pan-European cooperation.

The multidimensional design of European architecture based on various regional initiatives and centred around European *acquis communautaire* is an important input to the construction of a common European house. It will allow securing shared interests across a very broad agenda and maintaining common traditional values among a group of countries that have diversified national identities and represent differentiated levels of economic development. Trans-European trade relations are a crucial component of this construction.

THE IMPACT OF EUROPE AGREEMENT ON TRADE

The commercial part of the Association Agreement entered into force on 1 March 1992 in the form of Interim Agreement. It has initiated the process of step-by-step dismantling of quantitative restrictions and customs duties on the basis of the adopted timetable with a built-in asymmetry preference for Poland.

In accordance with the provisions of the Agreement followed by further concessions agreed upon during the Copenhagen Summit in June 1993 and the Essen Summit in December 1994, trade in industrial products was fully liberalized as of 1 January 1995 with the exception of textiles where the EU trade restraints shall be totally ceased by 1998, and with exception of steel products for which liberalization will be completed by the end of 1995. Poland will maintain a narrow margin of tariff protection by 1999 in accordance with the Agreement provisions on asymmetry in tariff reduction. Tariffs on industrial products will be lowered by 20% each year. The exception are motorcars where full tariff liberalization is scheduled on the beginning of 2002. In this light the main objective of Europe Agreement to create a free trade area in industrial products will be achieved in the forthcoming years. There remains the problem of agricultural products for which the scope of liberalization is relatively narrow as confronted with their share in total trade.

Trade with the EU will be also affected by the provisions of the Uruguay Round and the accession to the World Trade Organization which is expected in July this year. Following the Round obligations the average tariff on industrial goods was reduced in January from 10.3% to 9.3%. Further concessions are expected in the forthcoming years; Poland is obliged to reduce its tariffs on industrial products by 38% and on agricultural products by 37% by the year 2001.

The three-year time of the implementation of the Agreement allows assessing its impact on trade performance and on national economies of both sides. It is Poland that has been particularly affected by the Agreement because of a high magnitude of trade with the Union. Trade between Poland and the Community is characterized by a significant asymmetry as regards its magnitude for each of the trading partners. For Poland the Union represents a large and significant export market and is an important supplier of agricultural and manufactured goods. Poland's dependence on EU markets is

dramatically higher than the importance of the Polish market for the EU countries. This dependence has grown systematically in the last years. In the years 1983-94 the EU share in total Polish exports increased from 23.5% to 62.6% and the Community share in Polish imports from 17% to 57.6% with a significant increase in the last three years. Polish economy, however, is a small and not very important trading partner for the Community. Poland with a population of more than 38 million represents only 1.8% of total EU trade. The share of Poland in extra-EC trade is not much higher and amounts to about 2.0% in exports and 1.6% in imports (in spite of a considerable rise in the last years). At the same time the six former EFTA countries, with a total population of 32 million represent 26.5% of total EU exports and 23.6% of total imports.

The existing potential of a large market in Poland has attracted European exporters in the last years. This resulted in a steep increase in the EU exports to Poland and its high trade surpluses. The increase in EU imports was much smaller, partly due to the 1991-93 economic recession. The overall rise in trade volumes is a reflection of the removal of trade barriers and creation of a free trade area between Poland and the EU.

The effects of the Europe Agreement on the Polish economy are direct and indirect, static and dynamic. Static effects are described by the traditional theory of trade and trade policy, including the theory of customs union. They can be related to such elements as:

- the commodity pattern of trade shaped by the specialization factor
- the trade creation and trade diversion effects
- the dynamics of trade and conditions of trade equilibrium

Trade specialization

Present commodity pattern of trade between the EU and Poland has been shaped by the differences in structural developments of the trading partners' economies. The EU countries are following the path of economic development based on advanced industrial and market structures typical of the high level of economic welfare. As a consequence, trade structures are characterized by a large share of intra-industry specialization and a high proportion of advanced differentiated goods in total exports. In turn, Poland's specialization pattern is dominated by inter-industry trade based on the Heckscher-Ohlin type of comparative advantages. Polish specialization in certain labour-intensive and natural resource-intensive sectors such as textiles and clothing, footwear, furniture, agricultural products and the food industry is due to the supply of relatively cheap labour combined with an abundance of natural resources. The shortage of capital and expertise results in a Polish import pattern including mechanical appliances, vehicles, prefabricated chemicals, as well as high technology products such as electrical equipment, professional instruments and appliances. The implementation of the Europe Agreement has brought about slight changes in the pattern of Polish exports to the EU. There was a decrease in the share of primary sectors such as agricultural products, mineral fuels and raw materials, and an increase in the share of processed manufactured goods. The changes in the import pattern have been much smaller, Poland continues to import investment goods and chemical products from the EU.

The present Polish specialization export and import factor in trade with the EU is characterised by:

- the dominance of traditional agricultural and manufactured products in total exports. Such products as food, textiles, footwear, leather, basic metals and metal products, mineral products are the most important items in Polish exports which share in total exports amounted to 49.3% in 1993;
- the high share of investment goods and technologically advanced capital-intensive products in total imports;
- the dominance of inter-industry specialization and trade with a small scale of trade overlap;
- the large proportion of highly standardized products with a low degree of product differentiation in Polish exports. The recent OECD computations from the STAN data base give the classification of low differentiated or homogenous products and differentiated products (Martins 1994) in trade of the OECD countries. On the basis of this classification the most important items of Polish exports belong to low differentiated goods (the examples are textiles and clothing, mineral products, metal products, leather goods, iron and steel) while the most important imports items are differentiated products such as electrical and non-electrical machinery, chemicals, professional goods, motor vehicles.
- Poland's heavy dependence on the EU markets for the exports of products classified as sensitive imports items for the Community, such as steel and steel products, textiles, clothing and certain agricultural products.

All the above characteristics constitute a structural base of Poland's trade relations with the EU. They are likely to affect competitive advantages and the distribution of gains to trade between the trading partners in the near future. In the face of increased international competition export specialization based on traditional products for which the pace of demand growth on global markets is relatively low points to structural weaknesses of the Polish economy. These weaknesses can be overcome by the acceleration of structural transformation, as well as by the improved access to the internal market combined with stronger exposure to international competition on home and European markets.

Trade creation and trade diversion

Tariff liberalization has led to welfare effects in the form of reduced prices and increased consumption known as traditional static trade creation effects. According to the calculations of the Polish governmental office for European Integration, trade creation effect for the European Union was twice as the effect achieved by Poland (Biblioteka.,1993). This means that the EU has profited from expansion of trade with Poland much more than Poland from new trade flows to the internal market. The same holds for static trade diversion effects which were stronger in the case of the Union than for Poland. However, the value of the calculated trade diversion effects was half of the value of trade creation effects. In Poland, trade diversion effects are connected with a dramatic fall of exchange with the regions of the former CMEA (Eastern Europe and the Soviet Union). This fall is reflected in a significant decrease in the region's share in total Polish exports and imports from more than 50-60% in the 1970s and 80s to about 13-14% in the years 1993-94. It is trade with Russia that has been considerably diverted in the last years, however, it began to be rebuild during 1994 when its dynamics was higher than the dynamics of total Polish trade. The commodity pattern of trade with Russia is very specific, food and agricultural products account for 45% of Polish exports and mineral fuels and electricity for 56% of Polish imports.

Trade diversion effects are also related to the so-called preference margin which represents the value of exports induced by annual preferential reductions in duties whereas maintaining unchanged level of tariffs imposed on the third countries. In the last years the preference margin for Poland and Union has been relatively evenly distributed and it amounted to about 3% in manufactured goods and 0.2% in agricultural trade in 1993.

The even levels of the preference margin for the Union and Poland point to weak effects of the asymmetry offered by the Agreement in the provisions on the duty reduction schemes. The asymmetry preference which aim was to favour Poland has not produced expected benefits in the form of accelerating trade without producing large trade imbalances.

Trade dynamics and equilibrium

The dynamics of trade between Poland and the EU has been systematically growing since the entry into force of the Agreement. However, until 1994 it was Polish imports that has been indicating the highest indices of growth. The high growth rate of Polish imports to the Union was a consequence of a number of factors, including a relatively low level of the base imports from industrialized countries at the starting point to the transition (Zielińska-Głobocka, et.al. 1994). This pointed to a large size of the delayed demand for western products inherited from the central planning regime. The dynamics of Polish exports to the Union has been much smaller due to expansive sales strategies applied by European producers on a newly emerging Polish free market. As a result, the EU has profited from the liberalization of trade in the form of rising volumes of its exports and a moderate growth of imports. According to the East-West's statistical report (Together in Europe,1994), in the years 1990-93 the absolute increase in EU exports to Poland amounted to ECU 5.4 billion while the increase in EU imports accounted for ECU 2.4 billion.

During the first years of the implementation of the Europe Agreement the European Union has recorded large trade surpluses with Poland and all other central and eastern European associated countries. Trade imbalances were extremely high in the years 1992-1993, when Poland's trade deficit increased from ECU 1.0 billion to ECU 2.3 billion. This deficit resulted from the fact that Polish imports of industrial products grew much more than Polish exports whereas exports of agricultural products fell and imports considerably increased. This trend was slightly reversed in the second half of 1994 due to economic recovery in the European Union which caused an increase in demand for imported products. As a result, trade deficit in 1994 fell from \$ 1833 in 1993 to \$ 1640.

Trade imbalances have revealed Poland's difficulties in operating in an open competitive environment. They pointed also to the weaknesses of the Europe Agreement as regards Poland's access to the internal market. Europe Agreement has offered new export opportunities which have been effectively used by the competitive European suppliers. For less experienced Polish exporters penetrating the more competitive EC market is more difficult because competing not only against European producers but also against suppliers from non-EC industrialized economies or newly industrializing countries. Many start-ups having no experience of operating in a fully competitive environment are not able to gain stronger bargaining position vis-a-vis expansive European and NICs' firms.

The market access concessions offered to Poland by the Europe Agreement and by the EU Copenhagen summit have turned up to be insufficient, particularly in respect of the Community sensitive products where Poland enjoys revealed competitive advantages. The real market access was much smaller than conventional because of the application of protectionist safeguard measures against Polish exports in the course of the last years. The EU safeguards were heavily applied as regards certain agricultural products in the case of which Polish producers experienced relatively good trade performance in the internal market.

Indirect and dynamic trade effects

Liberalization of trade under the Europe Agreement has produced a number of indirect and dynamic effects in the form of increased competition, improved competitiveness, price stabilization, technical standardization and certification, multiplier effects on national income, etc.

Indirect static effects are mainly related to the reform of the legal system aimed at the approximation of Polish rules to the Community legislation. The changes in the customs law and procedures, indirect taxation, technical rules and standards, as well as in the intellectual property law are the most evident examples. The reform of the Polish legislation is conducive not only to further development of trade relations with the Union but also to the whole process of market-driven transformation.

Increased competition and higher economic growth belong to the most important dynamic effects of the Association Agreement. Removal of trade barriers had a spill over effects on the behaviour of economic agents who were forced to adjust production structures and prices not only to the demands of markets but also to the operations of European competitors. In this sense, the Europe Agreement has contributed to the price stabilization and reductions in the level of inflation in the last years.

The dynamic development of trade with the Union has produced an additional element of economic growth. High volumes of imported investment goods has induced what can be called the "import-led growth" and what resulted in the acceleration of GDP growth in the last years. A high dynamics of industrial production, domestic demand and GDP per head are the main symptoms of economic recovery in Poland. The improved export performance which signals appeared in 1994 may contribute to further growth in the form of "export-led growth" and multiplier spillovers.

ADJUSTMENT TO FURTHER INTEGRATION

The experience of the last years has proved that trade is of crucial importance in the transition to a market economy. This calls for the improved trade-related adjustment to further integration with the Union. In the face of expected Poland's membership in the EU adjustment efforts must be done by both sides. The Union should adjust its abilities to absorb increased cooperation with Poland, and Poland must improve its abilities to cope with competitive pressures within the Union.

The problem of trade-related adjustment concerns mainly two aspects: structural adjustment and protectionism.

Structural adjustment

For the European Union, the requirements of structural adjustment to cooperation with Poland (and other CEEC associated countries) relate to three issues: improvement in international competitiveness, reduction in unemployment, and acceleration of the traditional sectors' restructuring. Over the last decades the EU competitiveness on international markets has worsened. This process has

been particularly significant in relation to the USA and Japan. The EU poor competitive position became a source of negative spill-overs in the form of high unemployment and technological lags. In this light, the Community interest defined by the EU authorities as the ability to maintain its position in the world economy has been threatened. The emerging threats to the Community interest have produced sceptical opinions about the accession of the associated CEEC economies to the Union. The Community efforts to improve its competitive position may favour the accession process and remove political obstacles to the hoped-for acceleration of the Union's decision on the membership timetable. A high rate of unemployment which has been rising since the beginning of the 1970s became the most significant concern within the Community. With 17 million people out of work the Union is conducive to protecting its markets and jobs rather than absorbing cheaper labour and cheaper goods from the countries of Central and Eastern Europe. A complex programme to combat unemployment and stimulate job-intensive growth proposed by the Commission in the White Paper is likely to relax protectionist pressures and favour future enlargements. Crucial adjustment is needed also in traditional sectors which are subject to various interest groups' rent-seeking and lobbying. The validity of the negative "Stolper-Samuelson" effects of trade on income distribution in these sectors may lead to conflicts among the owners of relatively scarce production factors such as low-skilled labour. This is a source of strong resistance to full liberalization of trade with the countries which are characterized by large comparative advantages in labour-intensive traditional sectors. Increasing import penetration in these industries may threaten jobs and produce serious social difficulties. Structural modernization of the sectors adversely affected by import competition would help the countries of the Union to prepare to absorb new CEEC members.

In Poland, the agenda of structural adjustment policies and actions is much bigger than in the Union. Except for general market transformation and privatization there is a number of structural changes which will help Poland to cope with competitive forces on the internal market. The reform of agricultural structures and policies in order to adjust them to the reformed Common Agricultural Policy is of crucial importance. The same holds for heavy industries, including the steel industry where there is still large overcapacity. A rapid progress in the reform of the banking sector, financial services and infrastructure will facilitate adjustment to competitive pressures on European markets. More efforts should be made in support of small businesses and private sectors in their operations in the domestic and European markets. In the face of full integration into the Single Market, Poland must adjust its competition rules and policies to the market forces which direct allocation of resources in a free market. Implementation of a transparent policy concerning state aids and subsidies has a crucial role to play in this respect.

Protectionism

Tariff liberalization in trade between Poland and the European Union does not eliminate the problem of protectionism in mutual relations. As provided for in the Europe Agreement, in the transitional period to full association (or membership) both sides are authorized to use trade defense instruments to protect their economies from injuries and disturbances. Poland may also use exceptional protectionist measures in relation to infant industries and sectors undergoing restructuring or facing social difficulties.

Application of defense measures is the subject of continued debate in economic theory and practice. Two theoretical concepts based on empirical observations of the last decades deserve particular attention when considering Polish-EU relations.

The first was expressed by Krugman in his paper of 1993 on the rethinking of the theory of international trade and trade policy. Krugman argued that the strategic trade argument based on the assumption that governments are likely to protect strategic industries (such as high-externality industries, oligopolistic industries, and technologically-advanced industries) is of minor real importance. As a result, protection in traditional sectors producing low externalities is still stronger than in strategic ones. This is true for the current EU-Poland relations. Poland has recently introduced strong protectionist measures to protect agricultural and food products against foreign competition. It has not applied exceptional rules as regards infant industries. The European Union keeps protecting its sensitive sectors, such as textiles and clothing, steel products, and agricultural goods (recent examples are fresh fruit, live animals, meat).

The second theoretical concept comes from the 1994 paper by Bhagwati and concerns the growing demands for Fair Trade as a precondition for Free Trade. Bhagwati considers an unprecedented

increase in demands for fair trade as "level playing fields" in all industrialized countries, including the European Union. The demands for fair trade include not only fair trading practices but also harmonisation of a number of governmental policies such as environmental regulations and labour standards. This phenomenon can be partly explained by the fact that for less competitive domestic producers it is easier to claim "that the foreigner is gaining because of his resort to unfair trade" than to accept the competitor's higher efficiency. Bhagwati argues that in many cases fair-trade mechanisms such as anti-dumping and countervailing duties have been used unfairly to get protection rather than to maintain free trade. The question of fair trade is becoming the main issue of the EU Common Commercial Policy, in particular after its recent reform in 1994. The 1994 CCP reform focused on the strengthening of protection against illicit commercial practices and concerned mainly the Community anti-dumping rules and procedures applied to imports from the third countries. Poland has been in the past and present the subject of the EU anti-dumping law. Since many Polish producers are complaining about the protectionist impact of the applied anti-dumping measures, the Polish government insisted on their relaxation in the course of the functioning of the Association Agreement. The EU Essen summit brought about slight changes in this respect. The Commission will offer information to the associated country before the initiation of proceedings and will give preference to price undertakings, where appropriate. The essence of the EU anti-dumping law as one of the main defense instruments has not been changed. Poland will have to face the challenges and threats associated with the EU Commercial policy stance.

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