

THE EUROPE AGREEMENTS: IMPLICATIONS FOR TRADE LAWS AND INSTITUTIONS. LESSONS FROM HUNGARY

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ABSTRACT

The Europe Agreements: Implications for Trade Laws and Institutions. Lessons from Hungary*

Trade liberalization in Czechoslovakia, Hungary and Poland was accomplished in record time between 1989 and 1991. Sustainability became, however, a major concern in Central and Eastern Europe as the 'honeymoon of trade liberalization' ended in 1991/2. The paper examines whether Europe Agreements (EAs) offer a credible mechanism to help in tying the hands of governments in favour of liberal trade policies. The focus is entirely on Hungary. The paper analyses trade policy formulation in Hungary and evaluates the actual constraint imposed by the EAs. It also examines the actual implementation of trade policies by Hungary *vis-à-vis* imports from the European Union and third countries. The paper concludes that the Hungarian experience suggests that EAs can be successful in sustaining trade liberalization in Central and Eastern Europe.

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NON-TECHNICAL SUMMARY

Trade liberalization in Czechoslovakia, Hungary and Poland was accomplished in record time. Between 1989 and 1991, these three countries completely abrogated state monopoly in foreign trade, freed over 90% of imports from licenses and quotas, and reduced the average tariff rate to less than 15%. This achievement is remarkable in comparison with developing countries where trade liberalization has usually taken place over several decades. The experience of many developing countries suggested that the main problem with trade liberalization would not be so much initial implementation as sustainability. This indeed became a major concern in Central and Eastern Europe as the 'honeymoon of trade liberalization' ended in 1991/92.

Several problems with the transition process led to increased protectionist pressures. First, it was argued not only by industrialists, but also by some academics, that excessively abrupt opening of the economy has unnecessarily exaggerated the initial shock of restructuring. According to this view too rapid and too profound a trade liberalization was endangering the survival of potentially efficient domestic producers. Second, the restructuring involved sales of domestic enterprises to powerful foreign investors who demanded concessions from local governments including trade protection. Such demands by multinational companies were soon emulated by domestic companies. Third, the collapse of the CMEA market created additional pressures on those domestic firms already suffering from import liberalization. This situation fits in well with political economy analyses by various authors which suggest that protectionist pressures are likely to dominate trade opening efforts during the transition from socialism, unless trade policy is credibly non-discretionary. These authors argue that institutional arrangements such as the Europe Agreements (EAs) can play a major role in this respect by limiting the discretion of governments in setting trade policy.

The purpose of the paper is twofold. It examines the impact of the Europe Agreements on the process of trade policy formulation in Central and Eastern Europe. It also investigates their role in constraining the actual outcome of trade policy. Therefore the central question of the paper is whether the Agreements are successful in tying the hands of governments in favour of liberal trade policies. A similarly important issue concerns the number of hands which are successfully tied. Tying only one hand would mean that the Agreements have simply led governments in Central and Eastern Europe to shift their supply of protection from all trade partners to those outside the European Union (EU), i.e. those not covered by the EA umbrella.

Comprehensive analysis of the process and outcome of trade policy for all Central and East European Countries (CEECs) covered by the Europe

Agreements would be a task far beyond the scope of this paper. It focuses instead on a single country, Hungary, which carries both advantages and disadvantages. A major advantage of selecting Hungary is the GATT (1991) review of its trade policies which constitutes an excellent benchmark for the present study. The main disadvantage is that Hungary's commitment to liberal trade policies probably lies at the far end of the spectrum in the region.

The first part of the paper examines the process of trade policy formulation and review in Hungary. The Europe Agreement imposes a certain number of bilateral obligations on the country's trade relations with the European Union. These obligations are in addition to multilateral obligations contracted under the GATT. Our study finds that, compared with its multilateral GATT obligations, the European Agreement imposes additional constraints on Hungary's trade policy formulation, but (obviously) these only apply in bilateral trade relations with the European Union. The extent of the added restraints imposed by the EA differs markedly between industrial and agricultural products.

For industrial products, Hungary now has very little room for unilateral manoeuvre *vis-a-vis* the European Union. All tariffs and QRs on imports from the EU will be eliminated at the latest by 1 January 2001. In the meantime they are, at the very least, bound at their 1 March 1992 levels. Para-tariffs are also bound and progressively abolished.

The situation is rather different in agriculture. Here the EA leaves largely untouched existing tariffs and quotas. Moreover it does not bind them at their 1992 levels, nor does it prevent Hungary from introducing variable levies.

Derogations from EA obligations in the form of increased tariffs are possible, but only for a limited time and in exceptional circumstances. The requirement that they maintain 'an element of preference' introduces discrimination against third parties, but also necessitates their approval. The safeguard clause also introduces discrimination since EA safeguard actions apply on a selective bilateral basis rather than multilaterally. Recall, however, that selectivity was already permitted under Hungary's Protocol of Accession to the GATT.

Perhaps the main additional constraint imposed on Hungary's trade policy lies in the process of consultation with trade partners. As a GATT member, Hungary is subject to regular consultation held by the Working Party on Trade with Hungary and to periodic review under the Trade Policy Review Mechanism (TPRM). It must also notify new trade policy measures and accept dispute settlement procedures. Together with other GATT obligations, these mechanisms significantly restrict the formulation of trade policy by Hungary. But GATT is also notorious for its lack of enforcement discipline. The World Trade Organization, due to come into being in 1995 as a successor to GATT, should partly remedy this situation. But the fact remains that bilateral monitoring by the

European Union, Hungary's main trading partner, is more likely to be effective than multilateral control. In addition, consultation under the Europe Agreement tends to take place during the process of formulating trade policy, whereas GATT consultations are largely *ex post*.

Analysis of the actual process of trade policy formulation in Hungary confirms the role played in it by the EA. In view of the EU's status as Hungary's premier trade partner, the Europe Agreement has acquired almost instantly a significance that may even surpass that of the GATT. In any trade matter, Hungarian authorities will probably have to consider their EA obligations prior to their GATT obligations.

The second part of the paper analyses the trade policy outcome in Hungary and the role of the EA. Since 1991 the demand for protection has risen substantially, and by 1992 it was in full swing. Several factors have fuelled the pressure for protection. The transition process produced the expected falls in output and resurgency. A second factor was the surge of imports. The last factor was the emergence of special interest groups, with a clear distinction between foreign and domestic firms. The large foreign investors were the first to campaign successfully for protection. For their part, domestic producers lacked the lobbying power that multinationals derived from Hungary's need for money, management and technology. Some of them, however, had substantial political weight, especially the agrarian lobby and large-scale state enterprises.

The Government's resolve to resist protectionist pressures and sustain import liberalization was strengthened by two complementary decisions. The first was the adoption in March 1991 of the liberal-minded four-year 'Programme of conversion and development for the Hungarian economy'. The second decision was the signing in December 1991 of the Europe Agreement.

We find that, in spite of strong protectionist pressures, Hungary was able to maintain the course and continue with trade liberalization, partly due to the EA. At the same time, little evidence of protection diversion was unearthed. There is a clear exception that proves this general rule. The Europe Agreement imposes little discipline regarding the protection of agricultural products. As a result much of the recent demand and supply of protection in Hungary has taken place in this area.

Nonetheless, the question arises as to whether the Europe Agreement provides a sufficiently solid environment to enable Hungary to continue with trade liberalization despite two major developments. The first concerns the deterioration of the trade balance, which has produced liberalization fatigue. In December 1993 the government presented an economic programme aimed at reducing the deficit through a combination of export promotion and import curtailing measures. The latter included the reintroduction of licenses and the

increase of import duties for certain agricultural products as well as the freezing for 1994 of the global quota for consumer goods at the 1993 level. The second development is the May 1994 election, which produced a new majority whose commitment to resist protectionist demands remains untested.

1. Introduction

The liberalization of trade played an important role in the early stages of Central and Eastern Europe's transition process. The high concentration of production in industry necessitated a radical opening of trade. Liberalization was viewed as one of the main tools to impose the discipline of competition on monopolistic domestic enterprises and, thereby, improve the efficiency of resource allocation.

Trade liberalization in Czechoslovakia, Hungary and Poland was accomplished in record time. Between 1989 and 1991, these three countries completely abrogated state monopoly in foreign trade, freed over 90% of imports from licenses and quotas, and reduced the average tariff rate to less than 15%. This achievement is remarkable in comparison with developing countries where trade liberalization has usually taken place over several decades.¹

The main factor responsible for the contrasting experiences of Central and Eastern Europe and the developing countries belongs to the realm of political economy. Within each country, trade liberalization is opposed by import-competing interests and promoted by export interests. Since the losses incurred by the former tend to be more clearly defined and more concentrated than the gains obtained by the latter, trade liberalization is usually difficult to implement in normal circumstances. The wave of trade policy reform that hit many developing countries during the 1980s owed a great deal to political changes induced by the acuteness of their macroeconomic-cum-debt crisis. The 1989 revolutions in Central and Eastern Europe were an even bigger political shock, with greater scope for trade liberalization. As Gacs (1993) notes, after the changes of 1989 "*the usual pressure groups resisting to economic reforms were either non-existent or virtually ineffective*".

The experience of many developing countries suggests that the main problem regarding trade liberalization is not so much initial implementation as sustainability. Rodrik

¹ See Michalczyk *et al.* (1991).

(1992) questions the credibility of liberal trade policies in situations of intense lobbying by import-competing groups. He insists on the need for liberal-minded governments to enhance the credibility of their policies by building reputation and finding mechanisms of commitment. "*Membership in the GATT, and placing a ceiling on maximum tariff rates by undertaking international obligations, can help*".² In this respect the NAFTA agreement is often regarded as a device "*to lock in...a set of liberal trade policies that the current [Mexican] government has adopted unilaterally, to make credible to the business community that they cannot be easily reversed by subsequent administrations*".³

Sustainability also became a major concern in Central and Eastern Europe as the "*honeymoon of trade liberalization*" came to an end in 1991-92.⁴ Several problems with the transition process led to increased protectionist pressures. First, it was argued not only by industrialists but also by some academics that excessively abrupt opening of the economy has and unnecessarily exaggerated the initial shock of restructuring. According to this view too rapid and too profound a trade liberalization was endangering the survival of potentially efficient domestic producers.⁵ Second, the restructuring involved sales of domestic enterprises to powerful foreign investors who demanded concessions from local governments, including in the form of trade protection. Such demands by multinational companies were soon emulated by domestic companies. Third, the collapse of the CMEA⁶ market created additional pressures on those domestic firms already suffering from import liberalization. This situation fits in well with political economy analyses by Hillman *et al.* (1993) and others which suggest that protectionist pressures are likely to dominate trade opening efforts during the transition from socialism, unless trade policy is credibly non-discretionary. These authors argue that institutional arrangements such as the Europe Agreements (EAs) can play a major role in this respect by limiting the discretion of governments in setting trade policy - like NAFTA is doing for Mexico.

² Rodrik (1992). See also Rodrik (1989).

³ See Cooper (1993), and de Melo, Panagarya and Rodrik (1993).

⁴ See Gacs (1993).

⁵ See, for instance, McKinnon(1991) and Nunn and Portes (1993).

⁶ Council for Mutual Economic Assistance.

Europe Agreements offer a potentially powerful mechanism for helping sustain trade liberalization in Central and Eastern Europe by influencing favorably both sides of the protection equation. The EAs should reduce the demand for protection in the countries of the region by expanding their export opportunities. They should also reduce the ability of governments to supply protection by increasing their international commitments. While acknowledging that both sides of the equation are equally important, this paper will focus entirely on the latter.

The purpose of the paper is two-fold. It will examine the impact of Europe Agreements on the process of trade policy formulation in Central and Eastern Europe. It will also investigate their role in constraining the actual outcome of trade policy. Therefore the central question of the paper is whether the Agreements are successful in tying the hands of governments in favor of liberal trade policies. A similarly important issue concerns the number of hands which are successfully tied. Tying only one hand would mean that the Agreements have simply led governments in Central and Eastern Europe to shift their supply of protection from all trade partners to those outside the European Union (EU), i.e. those not covered by the EA umbrella.

Two remarks should be made at the outset. First the paper is not about the desirability of liberal trade policies in Central and Eastern Europe. Rather, the focus is on their sustainability and, especially, the role of the EAs in enhancing their credibility. Second the purpose of the EAs is clearly not to establish free trade in Central and Eastern Europe. Therefore free trade is not the correct benchmark against which EAs should be evaluated. Instead, Europe Agreements must, and will, be judged against their more modest declared objective, namely helping sustain trade liberalization in the face of difficulties associated with the transition process and helping achieve membership to the Union.⁷

⁷ It would be absurd for anyone in favor of EU membership for Central and Eastern Europe to judge the EAs against the benchmark of free trade since the EU has not embraced free trade. I suggest, therefore, to those who insist on the ideal of free trade for Central and Eastern Europe that EU membership may not be desirable. As far as I am concerned I would be satisfied if the EAs could, not so simply, secure continued trade liberalization and EU membership for Central and Eastern Europe.

Comprehensive analysis of the process and outcome of trade policy for all Central and Eastern European Countries (CEECs) covered by Europe Agreements would be a task far beyond the scope of this paper. It focuses instead on a single country, Hungary, which carries both advantages and disadvantages. A major advantage of selecting Hungary is the GATT (1991) review of its trade policies which constitutes an excellent benchmark for the present study. The main disadvantage is that Hungary's commitment to liberal trade policies probably lies at the far end of the spectrum in the region.

The plan of the paper is as follows. Section two is devoted to the process of trade policy formulation and review. It starts with a discussion of the extent to which Europe Agreements might be expected to limit the discretion of Central and Eastern European governments in formulating trade policy. It then analyses trade policy formulation in Hungary and evaluates the actual constraint imposed by the EAs. Section three examines the actual implementation of trade policies by Hungary *vis-à-vis* imports from the European Union and third countries. Section four concludes.

2. The Process of Trade Policy Formulation and Review

Europe Agreements impose a certain number of bilateral obligations on the CEECs in their trade relations with the European Union. These obligations are in addition to multilateral obligations contracted under the GATT.⁸ This section will focus on the role of the EAs as an incremental constraint on the process of trade policy formulation in Central and Eastern Europe over and above the constraint already imposed by GATT membership. Because some of the CEECs (including Hungary) have a special status under the GATT, a short presentation of their GATT obligations must precede the analysis of EA obligations. Given the idiosyncratic treatment of individual CEECs under both GATT and EA the presentation will focus entirely on Hungary.

⁸ All the CEECs which are party to Europe Agreements are GATT Contracting Parties. Hungary, Poland and Romania became GATT members with special protocols of accession.

A. GATT Obligations⁹

At the time of its accession to the GATT in 1973, Hungary was not a market economy. Nonetheless, GATT's contracting parties accepted accession on the basis of tariff commitments in view of the introduction of Hungary's customs tariffs in 1968.¹⁰ However, it was judged necessary by contracting parties to include a number of specific provisions in Hungary's Protocol of Accession. Two are especially important. Paragraph 4(a) of the Protocol calls for the progressive elimination of quantitative restrictions not consistent with the non-discrimination clause of Article XIII of the General Agreement. Paragraph 5 of the Protocol includes a specific safeguard clause which - contrary to the general safeguard clause of Article XIX of the GATT - permits selective safeguard measures.¹¹

According to GATT (1991), "*In the light of the progress registered in the process of transition to a market economy, the Hungarian Government has indicated its intention to seek the elimination of all specific provisions of its Protocol of Accession*". However, as of today these provisions still stand.

The General Agreement has not been incorporated into Hungary's domestic law, but the Protocol of Accession was promulgated by government decree.¹² After its accession to the GATT, Hungary introduced a new legislation on foreign trade relations. Act III of 1974 on Foreign Trade is still today the law of the country, although some provisions (such as Section 3 on the State monopoly of foreign trade) were abolished in 1990. Section 20 of the Act gives authority to subject foreign trade to licensing.

Until January 1989, imports of all products into Hungary were subject to licensing, with a distinction between CMEA and non-CMEA countries.¹³ This was

⁹ This section draws heavily on GATT (1991).

¹⁰ Other planned economies, such as Poland and Romania, acceded to the GATT on the basis of import commitments which imposed certain minimum import levels.

¹¹ The selectivity clause could operate both ways, on imports into and from Hungary.

¹² This was due to the peculiarities of the Hungarian legal system.
¹³ Council of Mutual Economic Assistance (CMEA).

acknowledged in 1980, when Hungary signed the GATT Agreement on Import Licensing Procedures. It notified its import licensing as "non-automatic" in the terminology of Article 3 of the Agreement. By virtue of Government Decree 112/1990, imports into Hungary are no more subject to licensing since 1 January 1991, except in cases explicitly listed in the Decree.¹⁴ At present, the main purpose of the import licensing system appears to be the administration of QRs on consumer goods. Section 7 of the Decree specifies that "*For the import of products directly serving the supply of the population the Ministry [of International Economic Relations] may set up a six-month quota (consumer goods quota)*". The consumer goods quota specifies a global value as well as maximum values for individual products. The latter are further divided into country-specific quotas. This quota, which predates the process of transition to a market economy, has been a regular controversial issue in consultations held by the Working Party on Trade with Hungary instituted by the Protocol of Accession.

Until recently, Hungary did not have any specific safeguard legislation. However, being part of the Protocol of Accession, Paragraph 5 had legal status. Government Decree 113/1990, which entered into force on 1 January 1991, provides a safeguard legislation based on Paragraph 5. It indicates that safeguard actions are limited to a duration of one year and may be in the form of selective import quotas.

Since the dismantling of licensing requirements for most products, most-favored-nation (MFN) tariffs have become the principal instrument of trade protection in Hungary. In this respect it is important to note that, since the Tokyo Round, Hungary has had fully bound MFN rates on more than 80% of its tariff lines. More than 90% of the tariff lines for industrial products are bound against less than 25% for agricultural products.

Hungary has signed the Tokyo Round Agreements, except for the Codes on Government Procurement, Subsidies and Civil Aircraft. The texts signed by Hungary

¹⁴ Government Decree 112/1990 has been replaced by Government Decree 173/1993. The new decree modifies slightly the list of products subject to licensing and replaces the 6-month period by a 12-month period.

(including the GATT Standards Code and Anti-dumping Code) have been incorporated into Hungary's domestic law.

B. Europe Agreement Obligations

The Europe Agreement with Hungary was signed on 16 December 1991. Entry into force only took place on 1 February 1994 due to the lengthy process of ratification by all the 13 national parliaments. Nevertheless, the trade related parts of the EA were put into effect from 1 March 1992 by means of an Interim Europe Agreement (IEA).¹⁵ Since entry into force of the Agreement, its application is monitored, at ministerial level, by the Association Council aided by the Association Committee.¹⁶

Title III of the EA ('Free Movement of Goods') includes provisions for establishing a free trade area between the European Community (EC) and Hungary over a transitional period of maximum ten years starting from 1 March 1992. In principle, these provisions limit considerably the discretion of Hungarian authorities in formulating trade policies *vis-à-vis* the European Union in the following areas: tariffs and para-tariffs, quantitative restrictions (QRs), and safeguard and anti-dumping procedures.

Tariffs and para-tariffs

Article 10 of the EA imposes the gradual elimination of tariffs on imports into Hungary of industrial products originating in the EU. For most products, the reduction will start on 1 January 1995 and be completed on either 1 January 1997 or 1 January 2001. Special protocols lay down the arrangements applicable to textiles and clothing, steel and coal, and processed agricultural products.

¹⁵ In addition to provisions on trade in goods (Arts. 7-36 of the EA), the Interim Agreement also contains provisions on 'free convertibility' (EA Art.59), competition rules (EA Arts.62-64) and intellectual property rights (EA Art.65).

¹⁶ A lower-level Joint Committee was in charge of monitoring the Interim Agreement.

For industrial products, Article 11 of the Agreement also imposes the abolition of tariffs of a fiscal nature, although no schedule is specified. Article 12 further demands that Hungary abolishes on its imports from the EU the following charges having an effect equivalent to tariffs: the 1% licensing fee (by 1 January 1995),¹⁷ the 2% customs clearance fee (by 1 January 1997), and the 3% statistical fee (by 1 January 1997).

Moreover, all tariffs and para-tariffs on industrial products originating in the EU are bound as of 1 March 1992.

In agriculture, tariff reductions are restricted to a small set of products and only apply to limited quantities.

Quantitative restrictions

Article 10 also calls for all QRs and "*measures having an equivalent effect*" on imports into Hungary of industrial products originating in the EU to be abolished. For products subject to import licensing (i.e. those specified in Government Decree 112/1990) and listed in Annex VIa, the abolishment will start on 1 January 1995 and be completed on 31 December 2000. For the sub-set of products also belonging to the consumer goods quota and listed in Annex VIb, Hungary has opened from 1 March 1992 import ceilings for products originating in the EU.¹⁸ These ceilings are to be progressively increased until the QRs are entirely eliminated. No other QR or measures having an equivalent effect are permitted since 1 March 1992. Special protocols govern the arrangements applicable to textiles and clothing, steel and coal, and processed agricultural products.

Moreover, all QRs and measures having an equivalent effect on imports originating in the EU are bound as of 1 March 1992.

In agriculture, QRs are either increased or abolished for a small set of products.

¹⁷ This fee applies only to products subject to licensing.

¹⁸ Separate rules apply to textile products and processed agricultural goods belonging to the consumer goods quota.

Exceptional measures

Article 28 of the EA allows "Exceptional measures of limited duration which derogate from the provisions of [the Agreement to be] taken by Hungary in the form of increased customs duties"

Unfortunately, the scope of Article 28 is extremely vague. Paragraph 2 merely specifies that exceptional measures "may only concern infant industries, or certain sectors undergoing restructuring or facing serious difficulties, particularly where these difficulties produce important social problems." This stipulation raises at least two serious complications. First, just about every sector of Hungarian industry may claim to be either "infant", "undergoing restructuring" or "facing serious difficulties". Second, the Agreement provides no definition of "infant industries" or "restructuring"; nor criteria for evaluating whether a sector is "facing serious difficulties".

Exceptional tariffs are subject to further conditions:

They may not "*exceed 25% ad valorem*", nor cover more than "*15% of total imports from the Community of industrial products*". In addition, exceptional customs duties "shall maintain an element of preference for products originating in the Community" (Paragraph 3).

They may not "*be applied for a period exceeding five years*" and must "*cease to apply at the latest at the expiration of the transitional period*" (Paragraph 4).

They may not "*be introduced in respect of a product if more than 3 years have elapsed since the elimination of all duties and quantitative restrictions*" for that product (Paragraph 5).

Hungary must inform the Association Council of its intention to take exceptional measures, whereupon the Community may request consultations "on such measures and the sectors to which they apply before they are applied". When taking such measures, Hungary must announce a schedule for their elimination (Paragraph 6).

These conditions seem sufficiently strict to avoid any outright protectionist application of Article 28. Exceptional tariffs are time-bound and may only apply to a small fraction of imports. Moreover, the fact that they must maintain "an element of preference" in favor of the EU implies that other GATT contracting parties must be consulted and acquiesce if the MFN duty is bound. These conditions also create further complications because of their lack of precision, especially with respect to Paragraphs 5 and 6.

Anti-dumping

Article 29 of the Agreement authorizes both Parties to take appropriate measures against dumping in trade with the other Party "in accordance with the Agreement relating to the application of Article VI of the General Agreement on Tariffs and Trade". "Before taking the measures", the Association Council must be supplied "with all relevant information with a view to seeking a solution acceptable to the two Parties" (Article 33). However, the final decision is that of the importing Party alone. No arbitration procedure is specified.

Safeguards

Article 30 of the Agreement authorizes both Parties to take appropriate safeguard actions if imports from the other Party cause (a) "serious injury to domestic producers of like or directly competitive products", or (b) "serious disturbances in any sector of the economy or difficulties which could bring about serious deterioration in the economic situation of a region". Winters (1992) is critical of part (b) on the ground that its language is "ominously innovative" and vague. In particular, no criterion is provided to implement words such as "could", "serious deterioration" or "region".

The implementation procedure is similar to that for anti-dumping and is also stated in Article 33.

Other provisions

Additional provisions affecting the free movement of goods between the EU and Hungary are contained in other parts of the Agreement. Only the most important ones will be examined.

Title V of the EA ('Payments, Capital, Competition and Other Economic Provisions, Approximation of Laws') includes provisions relating to balance of payments problems. Article 63 authorizes both Parties, if faced with serious balance of payments difficulties (or threat thereof), to adopt restrictive measures *"in accordance with the conditions established under the General Agreement on Tariffs and Trade"*. Their introduction must, however, be accompanied by *"a time schedule for their removal"*.

Title VI of the EA ('Economic Co-Operation') includes provisions on industrial standards. Article 73 calls for various appropriate measures (such as the adoption by Hungary of Community regulations and European standards and the conclusion of mutual recognition agreements) in order *"to reduce differences in the fields of standardization and conformity assessment"*

Overall assessment: EA vs GATT obligations

Compared with its multilateral GATT obligations, the European Agreement imposes additional constraints on Hungary's trade policy formulation, but (obviously) these only apply in bilateral trade relations with the European Union. The extent of the added restraints imposed by the EA differs markedly between industrial and agricultural products.

For industrial products, Hungary now has very little room for unilateral maneuver *vis-à-vis* the European Union. All tariffs and QRs on imports from the EU will be eliminated at the latest by 1 January 2001. In the meantime they are, at the very least, bound at their levels of 1 March 1992. Para-tariffs are also bound and progressively abolished.

The situation is rather different in agriculture. Here the EA leaves largely untouched existing tariffs and quotas. Moreover it does not bind them at their 1992 levels, nor does it prevent Hungary from introducing variable levies.

Derogations from EA obligations in the form of increased tariffs are possible, but only for a limited time and in exceptional circumstances. The requirement that they maintain "an element of preference" introduces discrimination against third parties, but also necessitates their approval. The safeguard clause also introduces discrimination since EA safeguard actions apply on a selective bilateral basis rather than multilaterally. Recall, however, that selectivity was already permitted under Hungary's Protocol of Accession to the GATT.

Perhaps the main additional constraint imposed on Hungary's trade policy lies in the process of consultation with trade partners. As a GATT member, Hungary is subject to regular consultation held by the Working Party on Trade with Hungary and to periodic review under the Trade Policy Review Mechanism (TPRM). It must also notify new trade policy measures and accept dispute settlement procedures. Together with other GATT obligations, these mechanisms significantly restrict the formulation of trade policy by Hungary. However, GATT is also notorious for its lack of enforcement discipline. The World Trade Organization, due to come into being in 1995 as a successor to GATT, should partly remedy this situation. But the fact remains that bilateral monitoring by the European Union, Hungary's main trading partner, is more likely to be effective than multilateral control.¹⁹ In addition, consultation under the Europe Agreement tends to take place during the process of formulating trade policy, whereas GATT consultations are largely *ex post*.

¹⁹ In 1994 (January-May), the EU accounted for 50% of Hungary's exports and 44% of its imports.

C. Trade Policy Process in Hungary

So far, this section has described the constraints that GATT membership and the European Agreement should, in principle, impose on Hungary's trade policy. It is now time to examine the actual process of trade policy formulation in Hungary and the role played in it by the EA.

In Hungary, the overall trade policy is formulated by the Government. Within the Government, basic trade matters are discussed by an Economic Cabinet which prepares government decisions and actions. The Economic Cabinet has three main components: the Minister of Finance (who chairs the Economic Cabinet); the Minister of International Economic Relations; and the Ministers of Industry (and Trade) and Agriculture. The Ministry of International Economic Relations (MIER) is the main governmental outfit responsible for trade policy. It chairs the Customs Tariff Committee which plays an important role in formulating and implementing Hungary's tariff policy. The Committee also includes representatives of the Ministries of Finance, Industry and Agriculture as well as representatives of business.

In order to evaluate the actual process of trade policy formulation, two situations will be examined: the consumer goods quota and a safeguard action.

Government Decree 112/1990 does not contain any guideline for setting up either the global value of the consumer goods quota or individual product limits. No guideline is provided either in the accompanying MIER Decree 6/1990. Dunning interviews in Hungary it has not been possible to ascertain with precision how the quotas are specified. However, industrial policy considerations and lobbying by import-competing interests clearly dominate. This is confirmed by the fact that the Ministry of Industry and Trade and the Ministry of Agriculture appear to be the most active in a decision process which is said to last every year 6 months.

In the case of safeguard actions, the Ministres of Industry and Trade (or the Ministry of Agriculture), International Economic Relations and Finance are all explicitly involved in the process. They generally line up as follows. At one extreme, the Ministry of Industry strongly supports the petition of import-competing producers based on their narrow interests. At the other extreme, the Ministry of Finance tends to reject the demand based on broad considerations of the economy as a whole, although budgetary considerations also play a role. The Ministry of International Economic Relations adopts an intermediate position which takes into account diplomatic relations and existing treaties (especially GATT and EA). The outcome, therefore, depends upon the political weight of the respective Ministers inside the Economic Cabinet.

The role played by the Europe Agreement in the process of trade policy formulation in Hungary can also be appraised in these two situations.

The discretion enjoyed by government authorities in setting up quotas for consumer goods appears to have been greatly reduced by the entry into force of the Interim Europe Agreement. This has come about through a combination of two factors: (a) the imposition by the EA of ceilings for imports from the EU; and (b) the apparent and unilateral decision of Hungarian authorities to grant about 50% of individual product quotas to EU exporters.²⁰

On the other hand, the procedure for safeguard actions does not seem to have been considerably affected by the Europe Agreement since selectivity was already present in the Hungarian legislation.

In conclusion, the Europe Agreement appears to play a prominent role in the actual process of trade policy formulation. In view of the EU's status as Hungary's premier trade partner, the Europe Agreement has acquired almost instantly a significance that may even surpass that of the GATT. In any trade matter, Hungarian authorities will probably have to consider their EA obligations prior to their GATT obligations.

²⁰The 50% figure is slightly above the share of EU exporters in the total imports of Hungary. See Inotai (1993). In some instances, declarations attached to the European Agreement contain explicit obligations for Hungary to grant the EU a share of no less than 50% of a quota.

3. The Trade Policy Outcome

Hungary stands apart among the countries of Central and Eastern Europe for its gradual but steady process of transition to a market economy. The process started in 1968 with the introduction of the so-called New Economic Mechanism. However, despite market-oriented reforms, many features of a planned economy were retained. Foreign trade remained a State monopoly. Trade relations with other CMEA countries (mostly the Soviet Union) based on intergovernmental agreements (including obligatory delivery quotas at fixed prices) also continued to prevail. Finally, all trade transactions remained subject to licensing.²¹

According to Nagy (1993), the preparation of import liberalization in Hungary started around 1985. In spite of fierce internal opposition, the import liberalization programme was introduced by the Government in 1988. Its implementation was accelerated after the political changes in 1990. By 1991, more than 80% of imports were liberalized, i.e. freed from licensing.²² Also in 1991, the nominal average tariff rate was reduced from 16 to 13%.

Nagy (1993) argues that the ostensible lack of opposition to import liberalization in 1990 can be traced back to two main factors. One was the political change as a result of which "*the surviving special interest organizations became weaker, less influential or discredited*". The second factor was the poor understanding of the consequences of import liberalization "*based on many illusions concerning the advantages of a market economy in general and of competition in particular*".

This period of grace, however, was short-lived. In 1991, the demand for protection rose substantially and by 1992 it was in full swing. Several factors have fueled the

²¹ See GATT (1991), Commission of the European Communities (1992), and Nagy (1993).

²² According to figures compiled by Dr. Borszeki the share of liberalized imports was 84% in 1991, 85% in 1992 and 86% in 1993 (10 months). These figures, which are widely quoted in Hungary, are a very imperfect indicator of trade liberalization. The greater the restrictiveness of licenses and quotas, the larger the upward bias. According to Professor Turók the share of liberalized imports is now over 90% based on a tariff line count.

pressure for protection. The transition process produced the expected falls in output and employment. Together with the 50% decline in exports to former CMEA countries, the transition process led to a GDP decline of 12% in 1991 and of 6% in 1992. This generated a massive increase in unemployment, which reached more than 7% in 1991 and 12% in 1992. In 1993, GDP declined by between 1% and 2%, while the unemployment rate remained above 12%.²³

A second factor was the surge of imports. In 1991, imports into Hungary increased nearly 70% over the previous year. The fastest growth occurred in consumer goods (+110% in 1991) as a result of high pent-up demand. In 1993, imports continued to rise while exports collapsed. As a result, the trade coverage ratio fell to 70% and the trade account registered a \$3.2 billion deficit.

The last factor was the resurgence of special interest groups, with a clear distinction between foreign and domestic firms. The large foreign investors were the first to successfully campaign for protection. Under the pressure of foreign multinationals, the Government raised tariffs in 1991 for three product groups (passenger cars, fertilizers, and color TVs). The following year, large foreign investors set up their own powerful organization (the International Companies Hungarian Association) outside the Hungarian Association of Enterprises.²⁴ For their part, domestic producers lacked the lobbying power that multinationals derived from Hungary's need for money, management and technology. Some of them, however, had substantial political weight, especially the agrarian lobby and large-scale state enterprises.

The growing demands for protection facing the Hungarian Government were acknowledged already in April 1991 by its representative in the GATT Council meeting on the trade policy review of Hungary. The representative admitted that: *"Hundreds of requests had been introduced by domestic industries for the re-establishment of import licensing for products regarded as sensitive by them; pressure was also exercised to increase tariffs and lower the quota for consumer goods; there*

²³ European Commission (1994).

²⁴ See Nagy (1993) and Varga (1994).

*was a growing number of requests for the initiation of anti-dumping procedures and safeguard actions. For the time being, the Government was successfully resisting these pressures, but nobody could predict what actions might become necessary later this year in the light of further trade developments”*²⁵

The Government's resolve to resist protectionist pressures and sustain import liberalization was strengthened by two complementary decisions. The first was the adoption in March 1991 of the liberal-minded four-year 'Programme of conversion and development for the Hungarian economy'. The second decision was the signature in December 1991 of the Europe Agreement.

The previous section concluded that the Europe Agreement has added a significant constraint on the process of trade policy formulation in Hungary. The remainder of this section will examine whether the Europe Agreement has been equally effective in limiting the introduction of new protectionist measures in the face of growing demands for protection. It will also investigate whether the Europe Agreement has resulted in a diversion of protection from the EU to non-EU countries. The following trade policy measures will be examined: tariffs, QRs, anti-dumping actions, safeguard actions and other measures.

Tariffs

According to Nagy (1993), hundreds of demands for tariff increases were submitted (mostly by the Ministry of Industry and Trade) to the Customs Tariff Commission in 1992, including after the entry into force of the Interim Europe Agreement. It was "*argued that protection was needed because of severe under-utilization of capacities and large scale unemployment*" However, since all tariffs on industrial products are bound under the Agreement, the purpose of these demands is not immediately obvious.

The Interim Agreement offered the possibility of tariff increases on industrial products in only two circumstances: as exceptional measures in the sense of Article 28 (Article

²⁵ GATT (1991).

22 of the Interim Agreement); or as safeguard measures. A crucial difference between these two measures is that the former can be applied even without an increase of imports.

In February 1993, the Hungarian authorities informed the Joint Committee of their intention to increase tariffs on 17 industrial products as exceptional measures in accordance with Article 28. This was the first proposed application of Article 28 by any of the CEECs. The 17 products and the proposed measures had the following characteristics:

The products concerned fell into four product categories: chemicals (10 products), paper (3 products), tiles (2 products), and glass (2 products).

The manufacturers primarily concerned belonged to two groups: purely domestic firms (8 products), and joint ventures (9 products).

The measures concerned all the three types of sectors contemplated by Article 28: "infant industries" (3 products), those "undergoing restructuring" (11 products), and those "facing social problems" (3 products).

The current MFN and EU rates fell into two categories: zero rates (11 products), and positive rates (6 products).²⁶ The positive rates are either 4.9% (4 products) or 10% (2 products). For zero-rated products, the proposed exceptional rates would be, depending on the product: 5%, 8% or 15% for imports from the EC, and, respectively, 10%, 10% and 20% for imports from elsewhere. For products with positive rates, the exceptional tariffs would be: 6.5% for EU products and 8.5% for non-EC products (for the 4 chemical products with 4.9% bound rates); and 20% for EU products and 25% for non-EC products (for the 2 glass products with 10% bound rates). Therefore, the "element of preference" in favor of the EC, whose principle is required by

²⁶ The tariff rates on products originating in the EU are equal to the MFN rates for all the 17 products. The reason is that the tariffs on the 6 products with positive MFN rates will only reduced, for imports originating in the EC, from 1 January 1995.

Article 28, would be rather low: either 2 percentage points (for 5 products) or 5 points (for 12 products).

In response to the information provided by Hungary, and in view of the test-case nature of its proposal, the Community delegation at the Joint Committee raised a number of objections centering on three issues. The first involved the concepts of "infant industries", "restructuring" and "social difficulties" which the Hungarian authorities were asked to define. The second was the proposed measures and sectors concerned for which supplementary information was requested. The third was the issue of products with bound zero MFN rates. The Community claimed that no exceptional measures could be introduced for these products (which accounted for the majority of the Hungarian list) by virtue of Article 28 (Paragraph 5).²⁷ Both Parties agreed to continue consultations in the framework of an *ad hoc* working group.

Despite several meetings of the *ad hoc* working group, consultations had not been concluded after one year of discussions. Some Hungarian officials bitterly complained of the length of the procedure. They regretted that their Government had chosen to "ask the Community's permission" rather than "inform the Community of its decision" to apply exceptional measures. These officials felt that their Government should adopt a more aggressive attitude now that the Europe Agreement has been ratified and has entered into force. Others, however, seemed not at all unhappy that the long consultations had prevented tariff increases in Hungary.

The issue of Article 28 measures was again taken up in April 1994 at the first meeting of the Association Committee which followed the first EU-Hungary Association Council held in March 1994, a few weeks after entry into force of the Europe Agreement. There the EU delegation proposed to accept the Hungarian request for 6 products provided the request was dropped for the remaining 11 products. Further consultations were held in May, but no agreement has been reached as yet. In the end, it seems that an agreement will be reached and that exceptional measures will be

²⁷ The Hungarian delegation claimed, instead, that Paragraph 5 only applies to products for which tariffs have been eliminated by the Europe Agreement.

introduced for 7 products (4 chemical products, 2 glass products and 1 paper product). Meanwhile the Hungarian authorities have refrained from implementing any unilateral measures. As a matter of fact, it appears that no tariff increase has been implemented by Hungary against imports of industrial products from either the EU or elsewhere since the Interim Agreement came into effect on 1 March 1992.

Finally, note that the primacy of EA over GATT obligations, which was hypothesized at the end of the previous section, appears to be confirmed by the behavior of the Hungarian authorities in this case. The "element of preference" demanded by Article 28 implies that the implementation of exceptional measures requires the consent of GATT. But rather than simultaneously consulting with the EU and seeking GATT's approval, the Hungarian authorities have chosen to concentrate first on the former. They believe, probably rightly so, that agreement by the EC is a prerequisite for obtaining the assent of other GATT members.

Quantitative restrictions

As already indicated, there is no clear procedure in Hungary for setting up either the global value of the consumer goods quota or individual product limits. By implication, it is difficult to assess the extent of the demands to lower quotas. In any event, the Europe allows no scope for lowering quotas since they are bound as of 1 March 1992.

In 1993, the global quota for consumer goods was set at \$750 million, up \$100 compared with 1991. The global quota was divided into twenty individual limits corresponding to broad product categories, which fall into eight groups: textiles & clothing (6 product categories), agriculture (6 product categories), transport vehicles (3 product categories, the only ones subject to quantity rather than value limits), household detergent (1 product category), footwear (1 product category), tobacco (1 product category), jewelry (1 product category), and other industrial goods (1 product category).

Detailed examination of the individual product limits does not reveal any tightening of quotas nor any diversion in favor of EU producers during the period 1991-93. Since 1991, the value limits have been increased for all products, with the exception of beverages where there was a slight decrease. Some product categories have been broken down, implying an increase in restrictiveness. The only new product group subject to quotas has been transport vehicles. The Europe Agreement introduced a quota of 50,000 units for passenger cars originating in the EU in 1992. In 1993, the global quota for vehicles announced by MIER was 160,000 units, broken down into 80,000 new and 80,000 used cars. The quota for vehicles originating in the EU was 80,000 units, broken down into twice 40,000 cars. The 50% share in favor of products originating in the EU applies to nearly all individual global quotas.

Anti-dumping actions

Until 1991, Hungary had made no recourse to anti-dumping actions.²⁸ To date, the situation has remained unchanged.

Safeguard actions

Until 1991, Hungary never applied Paragraph 5 of its Protocol of Accession which authorizes selective safeguard actions.²⁹ Since then, the situation has somewhat changed.

Since the entry into force of the Interim Agreement, Hungary has never used the safeguard clause (Article 24 of the IEA or Article 30 of the EA) against imports from the EC. However, according to the Hungarian Business Herald (1993), since 1992 four actions have been taken against imports from non-EC countries. In accordance with Government Decree 113/1990, which is based on Paragraph 5, the actions were in the form of selective import quotas applicable for one year. The following products and countries are covered by these actions: various cements from the Czech Republic,

²⁸ See GATT (1991).

²⁹ See GATT (1991).

Slovakia, Romania, the CIS, Estonia, Latvia, Lithuania, and Georgia; various iron and steel products from the Czech Republic, Slovakia, Romania, Ukraine, and Russia; various paper products from countries other than the EU and Finland; and various chemical products from the CIS, the Czech Republic, Slovakia and Romania.

The limited number of safeguard actions seems to confirm the importance played by the predominantly liberal-minded Ministry of Finance in the trade policy decision process, at least until 1992. It also implies that the diversion in favor of EU producers, although probably real, was not very extensive.

Other measures

Since entry into force of the Agreement in February 1994 the Hungarian authorities have adopted no restrictive measures under Article 63 despite balance of payments difficulties. So far, Hungary is one of the few CEECs not to have imposed an import surcharge for balance of payments reasons.

On the other hand, Hungary has adopted in January 1993 a government decree on quality control for consumer goods which resembles closely a non-tariff barrier targeted at products belonging to the consumer goods quota. The Community delegation at the February 1993 meeting of the Joint Committee requested that Hungary follows Community procedures in the context of the gradual approximation of the Hungarian legislation to Community law. These procedures distinguish products between those requiring quality controls and those that do not. The Commission demanded that Hungary accept Community certificates of conformity for the former and abandon quality controls for the latter. Much of the dispute centered around footwear and clothing which are covered by the decree but are not subject to quality certification in the Community. The issue remained unresolved and was brought up again at the April 1994 meeting of the Association Committee. There the Hungarian delegation reiterated that the decree was adopted for consumer protection but announced its revision in consultation with the EU.

4. Conclusion

Since the 1989 revolutions, countries in Central and Eastern Europe have implemented major trade liberalization programmes, with a swiftness matched only by the rapidity of political changes. The experience of other reforming countries suggests, however, that trade liberalization is often difficult to sustain over a long period, unless governments succeed in building reputation and establishing mechanisms of commitment. GATT obligations can greatly help in this respect, although they lack enforcement discipline. Further international commitment can be obtained by gaining membership in regional groupings dominated by a single partner whose market size is large enough to enforce discipline. A free trade area between a small reforming country and a large country may, therefore, constitute a credible device for sustaining trade liberalization in the reforming partner.

The central hypothesis of this paper was that Europe Agreements potentially provided a powerful institutional mechanism for sustaining trade opening in the CEECs at a time when the "honeymoon of trade liberalization" was coming to an end. This potential was related to the ability of the EAs to reduce both the demand for and the supply of protection, even if only the latter was investigated. A secondary hypothesis concerned the potential diversion of protection created by the EAs.

These hypotheses were tested against the experience of Hungary. It was found that the Europe Agreement has had the expected impact on both the process of trade policy formulation and the actual outcome of trade policy. In spite of strong protectionist pressures, Hungary was therefore, able to maintain the course and continue with trade liberalization. At the same time, little evidence of protection diversion was unearthed. There is a clear exception that proves this general rule. The Europe Agreement imposes little discipline regarding the protection of agricultural products. As a result much of the recent demand and supply of protection in Hungary has taken place in this area.

At the end of the day, the question arises as to whether the Europe Agreement provides a sufficiently solid environment to enable Hungary to continue with trade liberalization despite two major developments. The first concerns the deterioration of the trade balance which has produced liberalization fatigue. In December 1993 the government presented an economic programme aimed at reducing the deficit through a combination of export promotion and import curtailling measures. The latter included the reintroduction of licenses and the increase of import duties for certain agricultural products as well as the freezing for 1994 of the global quota for consumer goods at the 1993 level. The second development is the May 1994 election which produced a new majority whose commitment to resist protectionist demands remains untested.

The important lesson to be drawn from the Hungarian experience is that Europe Agreements can be successful in tying the hands of the CEECs in favor of liberal trade policies and need not result in protection diversion. But these outcomes cannot be achieved by Europe Agreements alone. Liberal trade policies in the CEECs require a strong internal commitment to trade liberalization, but also a commitment by the EU to improve access to its market. Similarly, preventing protection diversion, demands a strong internal commitment to GATT rules.

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