THE ECONOMIC RELATIONS OF THE UNITED STATES AND THE CENTRAL EUROPEAN COUNTRIES, ESPECIALLY TO HUNGARY, IN LIGHT OF THE EU ENLARGEMENT; WITH SPECIAL EMPHASIS ON THE TARIFF ISSUE

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ECONOMIC RELATIONS BETWEEN THE U.S. TO THE CENTRAL EUROPEAN COUNTRIES

The assessment of economic relations between the U.S. and the central European countries

The importance of economic relations between the United States and the central European countries is less determined by trade turnover itself than by political and strategic factors. Taking bilateral trade alone, these countries would not deserve any special attention from the U.S. administration or business community, as they represent less than 1 percent of the total foreign trade of the U.S. This group comprises countries – Poland, Hungary, Slovakia, Slovenia, Czech Republic, Romania, Bulgaria, Estonia, Latvia and Lithuania – in which political and economic reforms were commenced in the mid-1980s, culminating in the so-called peaceful revolution in 1989/90 and the ensuing political and economic transformation processes. In order to ensure a permanent end to the cold war, the United States has always actively supported the political and economic reforms in central Europe and is very interested in the success of the transformation process. This means the United States pays special attention to political and economic developments in these countries, including economic relations between itself and this region.

These countries have always considered the United States to be a leading power in the world, representing the highest level of political democracy and market economy. They consider the United States a dominant strategic partner determining their political and economic future by setting up the preconditions and final decisions on their Euro-Atlantic integration. This was the case in 1997, when the United States proposed that three countries from central Europe (Poland, Hungary and the Czech Republic), on the basis of their political and economic performance, be admitted to NATO. A similar dynamic will almost certainly unfold this autumn in Prague, when decisions about the further enlargement of the NATO are due. For these counties, NATO enlargement means not only the right to participate in the transatlantic alliance, which grants them international security, but also the adoption of common values of democracy and market economy that are shared and protected by this alliance at the same time.

From this political point of view, the development of economic relations to these central European countries signals the commitment of the United States to support the economic transformation in these countries and to help them to complete a political and economic transformation that aims to achieve the living standard of the western countries.

At the same time, the economic transformation in these central European countries opens a lot of special business opportunities in the form of privatization and new green field direct investments for U.S. companies. Privatization is considered as a necessity, as a first step of economic transformation, an important tool and goal at the same time to form a real functioning market economy. The central European countries have selected two different forms of privatization, both of which involve foreign investors in the process. Some of them, first of all the Czech Republic, have chosen the easier method, the so-called coupon privatization, by which the former nationalized companies were privatized via distribution of their special shares, called coupons, free of charge or at very low price to the citizens of the country. Others, like Hungary, were not in a good position to be able to give coupons to their citizens free of charge; they had to sell their nationalized companies to gain revenues aiming at reducing their international debts. They have chosen a market oriented, transparent way of privatization by tendering and selling their nationalized companies. Not having national private entrepreneurs, this meant the invitation of foreign partners to participate in the privatization and consequently in the economic transformation of the country.

There is neither space nor time to go into detailed discussion of the complicated issue of privatization, although it has been proven that the easier, popular method of privatization, distributing coupons to the citizens did not turn out to be successful in terms of establishing a functioning market economy. Citizens could not act as real owners, using their ownership rights and responding to their ownership responsibilities, in contrast to the market oriented privatization, where the public might have been disappointed not to participate in the nationalized companies, causing some domestic political tensions, but the new owners, mainly multinational companies, proved to be responsible owners, even good corporate citizens. As a final result of both methods of privatization, the foreign companies, collecting the coupons with the help of special funds or buying the shares of the privatized companies directly, became important players in the economies of these countries.

As all the conditions of privatization could not be fixed before the procedure started, European companies, especially German and Austrian firms, familiar with the political-economic conditions and enjoying good personal relations in this region, became the main beneficiaries of this privatization process. U.S. companies, not enjoying all these advantages, were reluctant to take the legal and business risks of privatization, or as they did not want to miss their strategic opportunities, they asked their European subsidiaries or partners for help. This “wait and see” attitude resulted in their missing most of the special chances of early privatization, leaving room for the neighboring Austrian and German companies. With the passage of time and the fixing of privatization frameworks, U.S. companies represented by their European headquarters played a growing role in the privatization of more difficult sectors such as telecommunications, energy and banking. After having successfully participated in privatization, the turnaround of the acquired companies generated further investments in the region, and the positive experience attracted new U.S. green field direct investments to these countries. Finally, the United States comprises about 30 percent of all the foreign investments of the region, playing a key role in the modernizing of the economies of these countries.

These U.S. investments based on privatization or on foreign green field investments in the central European countries have generated a sufficient increase in volume of bilateral trade. The increased volume of trade and the nature of the products traded reflect the massive changes underway in the economy of the central European countries, and in particular, the strong influence of U.S. investments upon both U.S. exports to and imports from this region. This shows the growing strategic importance of this region not only from a political point of view but from American economic perspective as well.

Bilateral U.S.-Hungarian trade, with special reference to U.S. investments in Hungary

<u>The overview of bilateral trade between the U.S. and Hungary.</u>

Among the central European countries, Hungary has played the most active role already as the reforms of the 1980s began and as they resulted in the alteration of the system. Ever since then Hungary has been able to keep its pioneer position regarding the political and economic transformation, including the formation of a real functioning market economy with the help of market oriented, transparent privatization and the attraction of foreign investments by reliable, predictable economic policy. After having consequently completed the austerity economic policy, causing pains and domestic political problems in the years 1995-1996, Hungary could modernize its economy with the help of foreign direct investment, which amounted to $23 billion – the highest per capita FDI inflows in the entire region. The United States represents 38 percent of foreign green field investments and 16 percent of foreign investments through privatization in Hungary, thus sharing first place in this respect with Germany. That is the reason why one can say with confidence that the development of U.S. trade and economic relations with Hungary can be considered as characteristic for the whole region.

U.S. –Hungarian bilateral trade has grown substantially over the past decade, from $623 million in 1991 to more than $3.2 billion in the year 2000, an almost five-fold increase. Bilateral trade in high tech products, in particular, has grown dramatically. In 1991, the U.S. exported some $13 million in computers and related parts to Hungary. By 2000, this level had grown to over $77 million. Meanwhile, imports of computers and related parts from Hungary grew from virtually zero in 1991 to over $ 1.3 billion in 2001. This growth is mainly due to U.S. investments, which incorporated Hungarian manufacturers and assemblers into U.S. companies' global production networks. Other leading imports from Hungary during 2001 were chemicals ($673 million), passenger vehicles ($335 million), video games ($144 million), plastics ($39 million), auto parts ($35 million), and light bulbs ($29 million).

Major U.S. exports to Hungary in 1991 included media ($2 million), telecommunications equipment ($1.3 million), and vehicle parts ($5 million). U.S. exports of media have grown ten-fold to $20 million in 2000 and vehicle parts grew six-fold to $30 million. Newly emerging areas where U.S. exporters have found success are glass ($38 million) and optical and medical equipment ($26 million), for example.

The volume of bilateral trade grew at a 12 percent rate in 2001 and thanks to the U.S. investments in Hungary, influencing the development of trade volume and trade structure with a strong trend towards higher tech products, there is a good chance that this positive tendency will prevail.

Actually there are major discrepancies between U.S. and Hungarian statistics on bilateral trade. For example, in 1999 U.S. statistics accrued a $ 1.3 billion deficit. In the Hungarian statistics, on the other hand, the United States had only a $334 million deficit. The discrepancies in the trade data system are related in part to a large amount of two-way trade in computer parts. As part of IBM's global operations, for example, the U.S.

exports parts to Hungary, some of which are assembled to form disk drives in Hungary, and then undergo further value added in Germany before returning to the U.S. These products (totaling $1.3 billion in 2001) appear in U.S. statistics as an import from Hungary, but in Hungarian statistics as an export to Germany. Further, in U.S. statistics, the full value of the computers is registered as coming from Hungary, when in fact only part of value added actually occurs in Hungary. In any event, in both U.S. and Hungarian statistics, U.S.-Hungarian bilateral trade has surged in the last few years from approximately $875 million in 1995 to around $ 3.7 billion in 2001.

The history and assessment of U.S. investments in Hungary

Although Hungary, as a pioneer and front-runner of the reform and transformation process in central Europe, has deserved the special attention and political support of the American government, U.S. investments took only a very cautious start in Hungary. Not being familiar with the situation in Hungary, not taking into account the regulations and the legal frameworks completely, U.S. companies hesitated to take part in the first phase of Hungarian privatization, which put trade and service companies up for sale. They felt themselves in an ambivalent position. On the one hand, they understood perfectly well that the enormous changes in this region opened up great short and even long term strategic chances for them, but nevertheless the lack of sufficient information and personal contacts meant they were not ready to take the political and economic risks attending the early wave of privatization.

To be prepared for further steps of privatization and to direct investments in this region offering excellent production and service opportunities, they asked their German partners (subsidiaries, affiliates or agents) to act on their behalf. This referred not only to multinational industrial and technological concerns like GM, Ford, and IBM, but also to the representatives of the "new economy" in the United States like Microsoft, Ameritech, and financials institutions too.

With the involvement of German companies, a trilateral economic relationship between the United States, Germany, and Hungary has been created, which uses Germany as a hub and gateway in the transatlantic economic relations between the United States and Hungary. Thanks to the excellent official and informal relations Germany has traditionally enjoyed in Hungary this role as a mediator turned out to be very effective and satisfactory for all participants. The Americans could rely upon the experience and market knowledge of the Germans; using their personal connections, participation on the privatization process was mostly successful; Hungary, enjoying the sympathy of the German mediators, has been given preferential treatment several times in investment decisions, and the Germans were able to strengthen their position in the United States and in Hungary simultaneously.

This phenomenon has caused some confusion and discrepancies in the trade and investment statistics. Without going into minute levels of detail, this study considers all investments as American, where the U.S. partner's involvement is evident and the final investment decisions have been made or at least approved in U.S. headquarters of the given concern.

The first U.S. company to take part in the privatization in Hungary was Guardian Glass, using its European headquarters to negotiate with the Hungarian government on taking over the glass factory in Oroshaza in the late 1980s. As the intention was to turn around the factory and use the modernized plant to supply the European market, the tariff issue played an important role. With the help of the Hungarian Government in cooperation with the Europe office of Guardian, the duty-free quota for Hungarian glass to the EU could be increased and the factory could start a profitable operation. Since then this plant has played a decisive role in the regional operations of Guardian; the CEO of the Hungarian factory is responsible for production and distribution in the entire region.

The next very important step was made by GE in 1990, taking over the 100-year old, world-renowned light bulb factory Tungsram. This turned out to be a typical case for privatization showing all the positive and negative sides of this procedure. The Hungarians realized that the traditional company Tungsram, having been the pride of Hungarian industry for 100 years needed reconstruction. Not having enough resources, the decision was made to sell 51 percent of the shares of the company to a financial investor with the help of an Austrian investment bank. As the Austrians could not find a financial investor prepared to take over the company and to manage the reconstruction, no other option was open but to accept GE as a strategic investor, acknowledging its interest in taking over the production capacities and distribution networks of Tungsram. After the deal was completed GE started a turn around, splitting and divesting all those activities that were not closely related to light bulb production. This was certainly not favorably accepted by the Hungarian public opinion, still believing that Tungsram could continue as it did earlier. After having fired about 50 percent of the staff, a positive development took place. Today, Tungsram is the center of GE Europe light bulb production, concentrating not only the production but also the R+D activities of GE in Budapest. By now, Hungarian public opinion has come to recognize the importance of being a member of a global corporation, having found a long-term position within the activities of GE.

Taking the positive experience with Tungsram, using the contacts created by this privatization, GE pursued further investments in Hungary. As a first step they took over and turned around the Budapest Bank, establishing a financial basis for their further activities in Hungary. With the help of this bank some important green field investments followed, the most important of them was the new production plant for generator recently opened in Veresegyhaza. As a new type of cooperation, GE participates in the Hungarian company Euromed, supplying central European hospitals with high tech equipment. This is how they create their central European networks, preparing them for the EU accession of these countries.

Two American car producers penetrated the Hungarian market by setting up production and assembly capacity there. GM was the first to take over a plant from Raba in Szentgotthard and to start engine-production for its European plants in close cooperation with its Vienna plant. It was accomplished by assembling small-sized cars for Hungarians, to be sold in Hungary. Hungarian production proved to be very competitive, and although the assembling of cars lost its importance due to the tariff reduction in Hungary, the plant in Szentgotthard had been developed to the gear productions center of GM Europe.

Ford followed the example of GM early in the 1990s. With the help of their German headquarters, they were looking for a reasonable production capacity for car components. The factory in Szekesfehervar turned out to be so profitable that its production capacity has been enlarged and modernized; it now supplies all the European plants with electric parts made in Hungary.

Alcoa took over the production facilities of the Hungarian Aluminum Works, which historically had enjoyed a monopoly in supplying central Europe with aluminum products. After effective modernization, the plant became a major player in the European market. The concept of profitable operation relies on duty free import of the raw material from Russia. That is why it was of great importance for Alcoa to ensure the further duty-free import even after Hungary's admission to the EU. After long negotiations the EU accepted a Hungarian request for derogation; thus the production can be maintained under the same conditions even after common EU tariffs are applied in Hungary after admission.

Transferring its production from Singapore to Hungary, IBM became one of the most important foreign investors in Hungary. After long negotiations Szekesfehervar has been selected by the German headquarters as the center of the European production of IBM. In highly sophisticated plants, the production of disk drives began in 1996-97 and has been enlarged since then. With exports amounting to $1.3 billion, IBM is one of the most important Hungarian exporters, contributing to the positive trade balance of Hungary with the United States.

World-famous U.S. companies like PepsiCo, Coca-Cola, and McDonalds concluded cooperation agreements with their Hungarian partners prior to the transformation, and used these connections to establish their own production base to service the Hungarian market. These investments, similar to that of Marriott, were designed to penetrate the Hungarian market only, in contrast to that of Procter & Gamble, which looked at these countries as one market and tried to set up an optimal production and distribution network for the whole region. Trying to select one country like Hungary for a specialized production of some products and to supply the whole region from this hub turned out to be not an easy task. At the beginning it had to struggle not only with the problem of a different mentality, but with significant tariff and non-trade barriers too. The problem of tariffs was solved as the CEFTA (Central European Free Trade Association) was created, but the company still has to realize that this region cannot be easily treated as a single market.

The participation of U.S. companies in the privatization of the Hungarian telecommunications sector turned out to be one of the success stories of U.S.-Hungarian economic relations. US West was the first to realize the business opportunities in Hungary while forming a joint venture with Hungarian Telecom, which enjoyed a monopoly position on the Hungarian market. At that time nobody could foresee the prospects of mobile telephones, but thanks to the commitment and high tech investments of US West the Hungarian company, Westel, turned out to be the market leader not only in Hungary but in the entire region, viewed from the perspective of technology, product quality, and last, but not least, profitability.

Ameritech has chosen the state-owned German company Deutsche Telecom as a partner in the tender for 50 percent of the shares of the leading Hungarian Telecom company, MATAV. This team, backed by the German Government, acquired the stocks and started a long and hard turnaround of the Hungarian concern. They invested a total of more than $1 billion in the company, and, in addition to introducing state-of-the-art technology, they had to transform the mentality of the employees to encourage market oriented service behavior. It took almost five years until they managed to modernize the company and prepare it for the level of market competition foreseen in the telecom regulation.

This successful transformation entitled the Hungarian subsidiary to participate in the privatization of telecommunications companies in the surrounding countries. They managed to get the stocks of the Macedonian Telecom and are checking into the possibility of acquiring Bulgarian Telecom too. Due to the recession, which caused a lot of problems for the telecom companies, the American partner has decided to withdraw from central European markets. In accordance with this move, U.S. West and Ameritech sold their stocks to their German partner at a very profitable price, but as a result of this action, there is no longer a U.S. presence in this new technology branch in this region.

Examining the chances for further new U.S. investment in Hungary, the military and energy markets seem to offer the best prospects. Hungary, after joining NATO in 1999, committed itself to modernize its army in order to make it compatible with the forces of the alliance. This means a lot of technical investments in all fields of military operations. To save resources, Hungary, in a manner similar to other countries in the region, has set up guidelines to help offset these procurements with foreign direct investments. In preparation for this, Lockheed Martin, Boeing, and GE signed an agreement with the Hungarian Government in 1997 entitling them to commence this offset activity prior to the tenders, and enabling them to get their investments in Hungary accounted for the procurement. Lockheed has been the most active in this respect, since the signing of the agreement they have generated investments worth $100 million in Hungary.

The Hungarian energy market was privatized in 1995. U.S. companies examining the conditions found that the regulations would not provide them with the necessary security to avoid uncertain risks. German and French companies felt that they could manage these risks and participated successfully in these tenders. The modernization of the Hungarian energy market, from the production plant on to wholesale and retail distribution, required investments of more than $1 billion, but as a result the domestic energy market is modern and internationally competitive, and prepared for the next wave of market liberalization. As the regulation has been set to a state-of-the art level with the help of USAID assistance, the market is open to penetration by U.S. companies. This would involve additional U.S. investments of $1 billion, influencing both U.S. exports to and imports from Hungary.

U.S. companies with their total investment of more then $8 billion in Hungary essentially contributed to the transformation and modernization of the Hungarian economy. They have not only provided Hungary with badly needed resources in this highly indebted country, but thanks to their participation in privatization and especially to the green field investments, they introduced leading high-tech technologies, management, and marketing know-how to the Hungarian economy. Their products, representing the highest level of competitiveness, are not intended to cover merely the demand of the relatively small Hungarian market, but that of the total European market.

In this respect, U.S. companies had to experience some disappointments in this region. They had to understand that the central European countries, although integrated by the CEFTA, still do not form a single united market. There are a lot of administrative and mental barriers to be taken into consideration when dealing with these countries. The most important of them is that they look at each other not as partners but as competitors regarding the attraction of foreign investments and even regarding EU accession. They expect foreign partners to treat them on an individual basis; they simply cannot tolerate any preference given to one of them. That is why U.S. companies, accustomed to dealing with regions populated by hundreds of millions of customers, have to invite their German partners to take over this time consuming, sensitive role in this region. In my opinion, this unpleasant situation will persist until these countries have joined the EU. Even after admission, it will take at least ten years until these countries can form a truly unified market economically and psychologically as well.

EU ENLARGEMENT AND THE TARIFF ISSUE

One of the major issues influencing the economic relations of the United States with the central European countries of EU enlargement is that of tariffs. The Association Agreements between the EU and each of the ten central European countries provide for an accelerated drop in tariffs for goods imported from each other, but not for those originating elsewhere. This so-called asymmetric tariff reduction started in favor for the central European countries in the year 1991 and was completed by 1995, applying a zero tariff for the industrial goods imported from the central European countries into the EU. As a compensation, the central European countries gradually reduced their tariffs on imports of industrial products from the EU starting in 1996, and these tariffs were completely phased out at the end of 2000.

Although the United States has always stated that it does not want to see its companies disadvantaged by the application of an import tariffs differential not applied to European firms, as a result of this mutual tariff reduction between the EU and the central European countries the U.S. products have been experiencing a growing tariff barrier in both the EU and central European markets.

The tariff handicap of U.S. exports on the EU markets

In the EU market, the average handicap of U.S. products in competition with central and eastern European goods is 4 percent. The differential is especially high in the case of automobiles, where the EU applies a tariff rate of 10 percent. This means that U.S. automobiles face a tariff handicap of 10 percent on the EU market not only in competing with the EU products, but also with the products coming from the central European countries. This has encouraged a lot of investors, especially from Asia, to set up their new production capacities in these central European countries. Suzuki was the first to set up a production and assembly plant in Hungary. Daewoo has production capacities in Poland and Romania, while VW took over and totally modernized the Skoda Works in the Czech Republic and Toyota has just recently decided to develop a new production plant in Poland. The output of these plants can only partly be sold in the countries mentioned; thus, a high percentage goes to the EU market, enjoying a 10 percent duty preference in competing with the U.S. automobiles. One could remark that the production of these plants consists exclusively of cars with engines smaller than two liters. This is not a product market in which the United States is especially competitive; nevertheless, this creates a substantial barrier to trade and the price distortions introduced by the tariffs prevent the U.S car producers from penetrating the EU markets in these categories.

This unfavorable situation is of special concern to the U.S. car industry, and several attempts have been made to alert the U.S. government to this situation. Chrysler, not having major European subsidiaries, raised the alarm with the U.S. administration, and managed to put the issue of EU barriers to U.S. automobile exports on the agenda of the U.S.-EU Sectoral Trade Liberalization Investigation in 1997. At the invitation of the International Trade Commission, Chrysler submitted their statement to be addressed in the report of the International Trade Commission concerning the likely impact on U.S. commerce of a potential U.S.-EU sectoral trade liberalization in selected economic sectors.

Thanks to the interventions and effective lobbying of Chrysler, one of the sectors to be analyzed by the International Trade Commission in trade liberalization between the United States and EU was automobiles and light trucks. The International Trade Commission issued a comprehensive report on the tariffs issue, stating that the most significant unfair barrier to U.S. exports of passenger cars to the EU is the unacceptably high tariff levied by the EU against U.S. automobiles. While the U.S. sets its tariff rate for passenger cars from the EU at just 2.5 percent, the EU assesses a tariff of 10 percent on automobiles from the United States, which is unacceptable from the point of view of balanced trade liberalization. This report was a part of a U.S.-EU joint study on areas for further trade liberalization and formed a part of the New Transatlantic Agenda signed at the U.S.-EU summit in Madrid 1995. Although the report was used as a basis for joint recommendations for U.S.-European Union sectoral trade liberalization in selected economic sectors at all the subsequent summits, no progress has been achieved; the EU is reluctant to introduce any tariffs reductions for cars.

The tariff disadvantage of the U.S. products, especially that of passenger cars on the EU markets, has been raised and discussed by U.S. delegates in several multilateral and bilateral fora since 1995. The U.S. delegations negotiating on international trade issues have always declared that this tariff barrier injures the global automobile market by unfairly penalizing producers, but the EU has always defended its position by referring to WTO regulations, which permit special tariff preferences for integration. This explanation indicates that there is almost no real chance to achieve any progress in this issue in the near future. Especially now, facing the problem of steel products, where the new tariffs imposed by the U.S. on certain foreign producers, among them to the major European steel works, are understood by the affected counties as a hostile action on the part of the U.S. and thus risk escalating into a new trade war, the chance is minimal to realize any progress on this sensitive tariff issue.

The tariff handicap of U.S. products on the markets of the central European countries.

The situation regarding tariff barriers is even worse on the markets of the central European countries. The average “most-favored-nation” (MFN) duty rates in these countries well exceed 10 percent (in the case of Hungary 13.6 percent) and for special products like automobiles it goes up to 43 percent in Hungary, 35 percent in Poland, 17 percent in the Czech Republic, and 14 percent in Slovenia.

As the Association Agreements between the EU and the central European countries provide for the implementation of the EU common external tariffs (10 percent in case of cars) only by the time of the accession, these high tariffs are valid on the markets of the central European countries to vehicles imported from countries eligible only for MFN tariff rates. As a result, U.S. car producers will have to pay these high duties until these countries become a member of the EU and implement the common EU tariffs of 10 percent, applicable for cars imported form non-member countries. This situation is considered by the U.S. auto-industry as discrimination – a violation of the principle of equal treatment.

Theoretically the high tariffs alone cannot be considered discriminatory. This instrument serves to protect the domestic industry against foreign competitors and to create extra revenues for the budget. In the case of the central European countries, which produce only small and compact size vehicles, the intention of maintaining these high tariffs for automobiles was to reduce imports of middle-class and luxury cars.

The high tariffs very much influence the selling price and thus reduce the demand for middle-class and luxury cars in these countries, but as all imports are affected at the same level, it does not deform the competitive position of the exporters. This was the case in the central European countries since 1990 as after the dissolving of the COMECON all the exporters were facing the same tariff barriers.

This situation of equal treatment has changed dramatically; commencing in 1996, these high tariffs were gradually reduced and zeroed out by the end of 2000 first only in favor for the EU and later on for the CEFTA countries (Central European Free Trade Association – formed by the "Visegrad countries" i.e. Poland, Hungary, Slovakia and the Czech Republic, later enlarged by Slovenia, Rumania and Bulgaria).

As the central and eastern European countries are implementing their GSP treatment not only for poor developing countries but also for emerging auto exporters like South Korea and Malaysia, the high MFN tariff rates are applied only to the United States and Japan and not to the EU and to the other Asian producers. The U.S. and Japanese governments, backed by their car industry, consider this an unacceptable discrimination of their products.

When the Association Agreements were negotiated and signed in 1991, the assumption was that EU enlargement would be completed by 2000, and the central European countries would then apply the lower common EU tariffs. It was taken into account that the gap of tariffs paid by EU and other MFN countries would widen from 1996 until 2000, but then reduced to the 10 percent duty generally applied by the EU. In the late 1990s, U.S. producers originally protested against this idea of an incremental reduced-duty system, demanding that they should be granted a parallel reduction of the tariffs applied to them, but today, as the step-by-step reduction is completed, their main concern is that the time of admission has been postponed and they have to face the maximum tariff difference between the high tariffs applied to them and the zero tariff of their EU competitors. This is particularly troublesome the longer the transition goes on. As the date of accession is uncertain, it is not even clear how long this discriminatory situation will endure.

The impact of the tariff handicap on the market position of the U.S. car industry in the central European countries.

As tariffs of these magnitudes cannot be compensated, the impact of this discrimination would be the loss of market share. It is clear for everyone that once a firm leaves a market, returning is almost impossible. That was realized by U.S. car producers in the middle of the 1990s. While GM's and Ford's first reaction was to use their production plants in Europe and supply the market of the central European countries from European production, Chrysler, not maintaining European production (the assembly plant in Graz/Austria is also negatively affected as the vehicles produced in Graz are considered to be of EU origin for purposes of free circulation within the EU, but they do not benefit from the Association Agreement's duty reductions as they do not have at least 60 percent EU/Pan European content) reacted immediately, threatened with a loss of terrain in these growing markets.

Already in 1996, as the step-by-step tariff reduction in the central and eastern European countries in favor for the EU began, Chrysler started actions of its own and asked the U.S. administration for help. Despite some opposition from GM and the reluctant neutrality of Ford, Chrysler has been successful in making the issue of the large disparity between the high import tariffs paid on their products and the zero tariff applied on imports from the EU on the central European countries' markets a high priority for the U.S. government.

President Clinton, Vice President Gore, Under Secretary of Commerce Aaron, and Under Secretary of State Eizenstat took up the matter in all their bilateral meetings, trying to press their counterparts for a solution. USTR Barshefsky raised the issue with EU officials. As no positive result was in sight, twelve U.S. Senators wrote a letter to the governments of the central European countries on Chrysler's behalf and told them that this was considered unacceptable tariff discrimination. They forced these governments to reduce the differential to no more then 10 percent (this is the tariff on imported cars in the EU) and warned them that they were risking the loss of GSP (Generalized System of Preferences) benefits in the United States, which makes them eligible to receive duty-free access to the U.S. market for many export items, if they continue to grant "reserve preference" to the EU, which violates the U.S GSP law. (The U.S. GSP legislation contains a provision that makes a country ineligible for GSP benefits if it affords preferential treatment to the products of a developed country other than the United States, which has a significant adverse effect on U.S. commerce.)

In the interim period prior to these countries' accession to the EU, the United States Government has been consulting with the central European countries to address this tariff differential problem. In 2000, the United States held talks with the four countries most affected by the tariff issue (Poland, Czech Republic, Hungary and Slovenia), but only partial progress could be achieved. (Slovenia has announced a plan to lower its high MFN tariff rates on industrial products to the level of the EU' common external tariff rates over a three-year period; the Czech Republic agreed to tariff waivers for civil aircraft and key parts.)

Further hopes regarding a more comprehensive temporary solution were connected with the election of President George W. Bush; expectations were that the central European countries, acknowledging the role and influence of the U.S. car industry, would take some unilateral steps as a gesture to the new administration. As even the following visits with the president did not bring any progress, the new administration committed itself to take up this issue and has raised the problem of tariff discrimination at all subsequent bilateral and multilateral meetings.

Chrysler's attempt to find a solution to the tariff problem on the market of the central European countries

As all these bilateral and multilateral actions and interventions turned out to be ineffective, Chrysler saw itself at risk of losing its distribution network in these countries and of losing some 40,000 units in sales in the 1999-2003 period. This would represent a lost export opportunity for the U.S. of approximately $750 million and a significant reduction in business activity at the Graz production facilities. The principal markets were Poland, Hungary, Slovenia and the Czech Republic, which account for 85 percent of the Chrysler/Jeep unit sales projected for the central and eastern European countries during this period.

To reduce this risk, they felt obliged to start individual negotiations in these four countries, requesting a temporary reduction in vehicle import tariffs to a level no more than ten percentage points above the tariffs applied to vehicles imported from the EU. This reduction should cover all vehicles with engines size above 2.4 liters. Their calculation was that by limiting their request to this category, the central European countries' industry would be fully protected, and by maintaining a tariff differential of up to ten percentage points, the EU automobile industry would continue to enjoy the same level of protection as they currently enjoyed. With the help of their new partner Daimler-Benz, which was not only a European producer but also enjoyed excellent contacts and a fine reputation in these countries, they started separate consultations in Warsaw, Prag, Budapest and Ljubljana.

Their position criticizing the given situation included the following points:

- Tariff preferences granted to imported vehicles from the EU and from the CEFTA countries do not bring any direct benefit to the central and eastern European countries;
- Absence of non-EU competition of advanced producers protects only the EU producers, thus raising import prices and the domestic price level;
- Costumers are denied access to technically advanced products from DaimlerChrysler;
- Tariff revenues decline as import levels diminish;
- Gray market imports increase;
- Investments made by distributors are jeopardized by this trade policy;
- Employment levels will be affected;
- The United States considers this treatment as discriminatory and unfair, as the United States has been granting the GSP treatment unilateral to the central and eastern European countries;
- Trade with the United States may suffer if GSP status is lost.

On the other hand, a lot of general and specific arguments in favor of a tariff reduction were listed:

- Reduced import tariffs would result in greater customs revenues (40,000 units paying 10 percent duty generate approximately $75 million, while only 1,000 units paying approximately. 30 percent duty generate only $2 million) and lower prices for consumers;
- The requested reduction would be only temporary, until the date of EU accession for the central and eastern European countries when, as anticipated in the Associations Agreements, the common tariffs would be applied anyway;
- This reduction would help to restore good relations with the U.S. and the continuation of each country's eligibility under U.S. GSP (reduction of the vehicle tariff would help these countries remain eligible for this program which is important for small and medium size enterprises exporting to the U.S.);
- DaimlerChrysler's request does not aim at a comprehensive solution to the discriminatory tariff situation; rather, it is simply looking for a partial solution for the most affected portion of the U.S. car industry – namely, vehicles with engines larger than 2.4 liters;
- Chrysler's sales in these countries do not pose a threat to the domestic car industry as Chrysler competes primarily in segments – 4x4 sport-utility vehicles and minivans – that are not filled by domestic production;
- Preservation of employment in DaimlerChrysler dealers and the national distribution companies;
- Key Chrysler suppliers, such as Guardian Industries, are also located in this region and they will be directly affected.

In these DaimlerChrysler's arguments even the impact of a tariff reduction on the EU was elaborated, stating that it would be in the EU's interest to promote the gradual adoption of all EU laws and regulations (the A*cquis Communautaire*) during the pre-accession period. By maintaining high tariffs that would have to be abruptly reduced on the eve of accession, the central European countries could cause major economic dislocations in their economies. Moreover, foreign investment decisions are affected by the temporally imposed high tariffs applied in the central European countries, which cannot be in interest of the EU. All these well-reasoned, logical arguments, backed with the support of Daimler being a highly reputed partner in these countries, could not convince the four central European countries to go ahead together or alone and take actions to solve this problem.

Their main explanation for not feeling themselves in a position to commit to take unilateral steps was that the situation arose as a result of an association agreement aiming to lead to integration with the EU. This would be fully in compliance with the international foreign trade regulations and accepted by the WTO. The tariff policy of these countries would be fully shaped by their commitments to the WTO; thus there would be no reason to consider it as discriminatory. Based on this they would not see any reason to make any unilateral concession in favor for the U.S. or other countries affected by this situation.

It turned out that their general rejection of the U.S. position was based on EU pressure. The European Commission has been defending the preferences of EU companies arising out of the application of the association agreements, and strongly advised the central and eastern European countries not to do anything to reduce these differences. As the accession negotiations with the EU are still ongoing and crucial chapters including competition policy have not been closed, the central European countries felt they had better follow this advice.

This position of the Commission is in contradiction with the former explanations of the EU officials. In bilateral negotiations with U.S. representatives they have always expressed their understanding of the unpleasant situation arising from the delay of accession. They explained that they would be in favor of the central European countries harmonizing their external tariffs to that of the common tariffs of the EU, or would not mind any unilateral actions in this direction but just could not push these countries to do so. The positive explanations and promises of the EU proved to be merely lip service and it turned out again that they are looking after their particular interests very carefully, and will do nothing to reduce the preferential treatment of their companies on the markets of the central European countries.

Out of the four countries mentioned, Slovenia has been the most forthcoming, putting forward a tariff reduction at least for minivans, as of September 1, 1998. The effect of it alone is not tremendous, but still this was better than the status quo and it has indicated to the other countries that there is room for movement prior to EU accession. Following this positive example the Czech Republic announced a drop in the MFN tariff rates from 19 to 17.1 percent, which was more than nothing although could not be considered completely satisfactory. Even Polish officials have shown an understanding of the problem and some willingness to solve it. They have been exploring a reduction in vehicle tariffs for cars with engines over 3.0 liters. The advice of DaimlerChrysler that a 3.0 liter solution is not acceptable could not be followed taking into account the interest of companies producing in Poland, notably Daewoo and Fiat.

The special case of Hungary regarding the tariff barriers on Chrysler cars

From the beginning, Hungary, with the highest auto tariffs, has been more reluctant to do anything. Hungary also maintains higher tariffs against larger engine vehicles for social, political, and environmental reasons. In bilateral negotiations, Hungarian officials argued that lowering the tariffs for cars with engines above 2.4 liters would be contrary to their policy to encourage use of smaller cars to assist in limiting air pollution. They generally referred to budgetary reasons, still believing that reducing tariffs would cost them revenue. In this respect they mentioned that to be in compliance with the WTO regulations, Hungary would be obliged to extend any duty preferences to all the countries of MFN tariff treatment status. This would include Japan with its very competitive and aggressive auto industry, which they argued is ready to pounce on the Hungarian market.

Coming to the particular question with the United States, it turned out that instead of a unilateral step, the Hungarians would prefer to reach a comprehensive solution that entails compensation for any changes they would make. Placing this issue in a broader context has never been of interest to DaimlerChrysler, as a general solution cannot take into consideration the special interests of DaimlerChrysler, which faces the risk of losing the Hungarian market because of the high tariff barriers, and is therefore seeking a quick temporary tariff reduction for this product alone.

Generalizing the tariff issue unavoidably means that more and more products would be involved and that the whole procedure would take on an international character in compliance with WTO regulations. Both of these are very time-consuming and would endanger a bilateral solution. This was exactly what happened in this case as well. Hungary and the U.S. started to set up a comprehensive list of their tariff reduction proposals. Hungary requested the extension of its GSP preferences to additional products, like light bulbs produced by General Electric in Hungary and a lot of agricultural products. The United States demanded tariff reductions in favor of the already mentioned and mostly disadvantaged autos, and additionally for gas turbines, aircrafts, automatic data processing machines, chemicals and pharmaceutical products among others.

Both sides exchanged counter-proposals and began negotiations on the balance of the proposed concessions. A mutually acceptable compromise could not be achieved as the U.S. based its demand on the assumption that Hungary has to compensate the handicaps caused by the Association Agreement, while Hungary considered it as a new round of tariff negotiations of balanced mutual concessions foreseen by the WTO.

In addition to this clearly insoluble problem, some further questions were to be discussed too. Should the tariff reductions be granted on an applied, or on a binding basis, and how far would they be accounted as a pre-payment from the Hungarian side at the necessary compensations after the EU accession pursuant with the provisions of the Article 24(6).

As time passed and no sign of a solution was in sight, the U.S. administration lost its patience and threatened Hungary with the loss of its GSP status in the U.S. if the two countries were unable to find an acceptable solution by February 1, 2002. Hungary was certainly upset about this possibility, but later on they had to consider this as a realistic danger. The Hungarian officials understood the extraordinary economic and political importance of this threat. Hungarian exports worth some $400 million annually would be endangered and the producers affected by this (mainly small and medium entrepreneurs) would be unwilling to accept the loss of export opportunities in U.S. Facing election in April 2002, the political impact of this would have been hardly manageable. That is why the new Hungarian negotiating delegation urgently asked for a mandate from their government and an agreement on cutting import tariffs on U.S. products was signed at the last minute on January 31, 2002.

CONCLUSION

The evaluation of the U.S.-Hungarian Agreement on Tariffs Reduction

In this U.S.-Hungarian Agreement on Tariffs Reduction, Hungary committed itself to reduce or suspend its tariffs on $180 million of key U.S. agricultural and industrial exports annually, starting in April 2002. On the industrial side, the U.S. export products covered by the agreement include steam and gas turbines, large engine autos and auto and tractor parts, automatic data processing machines, office machine parts, cosmetics, various chemicals, plastics, medical instruments and equipment, laser disks, and telephone equipment. On the agricultural side, the U.S. export products include almonds and pecans, grapefruit, and bovine semen. Hungary has also made a substantial increase to its 2002 tariff rate quota for baby chicks.

In light of Hungary's commitments, the U.S. intends to continue its support for Hungary's participation in the U.S. trade preference program (GSP) and would consider enlarging the list of products affected by it. There was a general understanding that the concessions granted by Hungary would be considered and accounted in favor for Hungary during the Article 24 compensation talks after Hungary's accession to the EU.

U.S. Trade Representative Robert B. Zoellick praised the agreement, noting that its implementation would "establish a more level playing field for U.S. exports to Hungary. As a result, U.S. exports will be more competitive in the Hungarian market, generating new market opportunities for American exporters."

Although the agreement is called a comprehensive trade package, it can by no means be considered a final solution. Regarding cars only a weak compromise could be achieved, cutting tariffs from 43 to 23 percent. This seems to be a substantial reduction of twenty percentage points at first sight, but it is still not satisfactory for the U.S. car industry, particularly for DaimlerChrysler. The remaining disadvantage of 23 percent against EU producers means a difficult barrier to tackle, and there is almost no chance that this situation will change, since the Hungarians have not committed themselves to further reductions.

The reason for the Hungarian reservation, apart from the above-mentioned political, budgetary, and environmental considerations, was that they were not willing to go below the tariffs applied for small cars (23 percent). Giving a duty preference for larger cars would have been unreasonable and inexplicable from a political and economic point of view. Reducing the tariffs for all the cars was not even accepted for consideration. The main concern, in this respect, was that this would advantage Japanese cars, causing substantial losses in the budget revenues and jeopardizing the competitive position of the Hungarian car producers (Suzuki, GM, AUDI). They argued that the negative impact of a general tariff reduction for all cars in Hungary would have far outweighed the benefits to the U.S. car industry.

The argument of the U.S. delegation that reducing tariffs on all cars to 10 percent would simply create the same competitive situation in Hungary as exists in the EU, and that it is really unfair to discriminate against Japanese cars in Hungary since Japan was the first country in the world to grant GSP treatment to Hungary, was not accepted. Thus the U.S. delegation was given only a take-it-or-leave-it option.

Coming to this point, they had to take into consideration that accepting this compromise would leave just the most handicapped branch of the U.S. industry – i.e. the car industry – as the driving force behind all these long and hard tariff negotiations, unsatisfied. Still refusing the Hungarian proposal would have helped neither DaimlerChrysler nor all the other industrial branches actually well served by this agreement.

At the same time, the general aspect of the Hungarian-U.S. economic and political relations was also taken into consideration, knowing that once the GSP was withdrawn it would be very difficult to reinstate. Both delegations were delighted that with the last minute signature of this agreement they have managed to avoid this worst-case scenario.

In their announcement the Hungarian officials praised the agreement as a successful attempt to save the GSP for Hungarian products in the U.S. market and used this argument as an explanation for the unilateral step.

The U.S. car industry and in particular DaimlerChrysler find themselves now in an ambiguous situation. The issue initiated and driven by them came to a solution where the achieved tariff reduction does not meet their original expectations. Both governments and most of the parties affected by the agreement are satisfied with the results; thus, they can only hope that the time is not too far when, with EU enlargement complete, the tariff issue will finally be resolved. Prior to this eventual inevitability, they can only hope that after the election in April 2002. new negotiations on tariff reductions can be started in Hungary inviting the Japanese as supporting partner on their side.

Further aspects of the tariff issue concerning the EU enlargement

There are a few additional dimensions of the relationship between the tariff issue and EU enlargement that are worth exploring. With EU accession, the customs union would be implemented, which means that the common import tariffs would be adopted in all the central and eastern European countries. The tariffs applied in the EU are generally lower than those of the accession countries but there are still some exceptions. The central and eastern European countries today are still applying special low tariffs or giving duty free quotas for raw materials, textiles and for some agricultural products. With the accession these tariffs would have to go up, matching the EU's common external tariffs. This would mean a handicap for U.S. producers; they should have to be compensated pursuant to provisions of Article 24 (6). In this respect the U.S. delegation committed itself to take the tariff reductions provided by Hungary in the agreement of January 30 into consideration as a part of Hungary's obligations for compensating the U.S. for the negative impact of the implementation of the common external tariff system of the EU, but further negotiations will follow.

Not only have the compensation aspect of the tariff changes following accession to the EU customs union have been of importance for the U.S. Representing the interests of U.S. investors in Hungary, but the U.S. government also has been concerned about the higher tariffs for raw materials applied in the EU. Raising these tariffs and cutting the special duty free quotas would jeopardize the production conditions and profitability of the U.S. investors in Hungary. Sharing these concern with the Hungarian administration and enjoying the support of the European headquarters of the interested companies, they formed a successful team defending their position during the accession negotiations on the chapter of Common Tariff and Customs Union.

In order to protect the interest of the producers in Hungary, to provide them with a proper adjustment period, the Hungarian delegation asked for a derogation period for 5 years for a large list of commodities. During the negotiations, the list of these commodities had to be reduced to the two most important ones, raw aluminums and vinyl-chloride. Referring to the industrial and political interests of Hungary and to all those potential international problems, which could arise in relation with Russia and Ukraine as exporters of these commodities on the one hand and with the U.S. representing the interests of the foreign investors coming from the United States on the other hand, a compromise was achieved. It means that Alcoa, which operates an important production plant in Hungary, was awarded an adjustment period of five years after the anticipated accession of Hungary to work under unchanged conditions. This case shows that in connection with EU enlargement, even in the field of tariffs a common platform of interests can be formed and represented in mutual understanding during the negotiations with the EU.

The United States considers EU enlargement as a strategically positive step. The enlarged, unified EU will be a more stable, reliable political and economic partner in the long term. Enlargement will enhance the economic performance, competitiveness, and thus the transparency and predictability of the EU as one of the engines of the world economy. This is very much in the interest of the United States but besides the transatlantic partnership and sharing responsibilities in the world economy, Americans consider the EU as one of their major competitors, and cannot afford to be handicapped by EU enlargement, either in the EU market or in the markets of the central European countries. As USTR Barshefsky indicated several times in Brussels negotiating with the EU or in Geneva at WTO meetings "… the U.S cannot allow the enlargement process to become a source of trade preferences that disadvantage U.S. exports," and added that the United States would watch this very closely to make sure it did not happen.