

*Gabor Hunya\**

## **EU Membership – Support and Challenge to the Competitiveness of the Polish and Romania economies**

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### **Introduction**

The competitiveness issue discussed in this paper refers to the international competitiveness of countries, which depends on the performance of industries and firms on the world markets. We shall not enter into the general debate on the competitiveness of countries (see Krugman, 1996) but apply the broad concepts of Trabold (1995), Porter (1990) and Fagerberg (1996) on the international competitiveness of industries. The link between firm-level and country-level competitiveness has been established by Porter (1990). He argues that industries and companies can be competitive if the national environment and government policy support companies' profit-earning and innovative efforts. Firm-level competitiveness depends on production factor costs, demand conditions, firm strategy and firm networking. The environment in which the firm operates is shaped by government policies, chances/opportunities and the international business environment. Internationalization of markets, in particular EU integration, opens up new opportunities for firms and leads to transnational alliances, among them foreign direct investment (FDI). The new environment demands from governments in the EU to set policy targets and use policy tools in an internationally competitive environment regulated by the EU agreements.

The competitiveness of countries as defined by Trabold (1995, p. 182) includes the ability to sell, the ability to attract and the ability to adjust – all these leading to the ability to earn. These components can be measured by specific economic indicators concerning trade and FDI as well as economic growth.

- The ability to sell in terms of international competitiveness means the ability to export. The market shares on the main export markets and their development can be taken as the basic indicators of international competitiveness.
- The ability to attract refers to attracting activities and investments from abroad. Attractiveness for foreign investment is the summary effect of location factors in the country. Although other forms of international capital flows may also be important, a basic indicator of attractiveness can be the size of annual FDI inflows and FDI stocks.

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\* Dr. Gábor Hunya is senior research economist at The Vienna Institute for International Economic Studies (wiiw), in Vienna Austria. Tel.: +431533661022, Email: hunya@wiiw.ac.at.

- The ability to adjust can be measured by the speed of structural change. Through structural change the country changes its product and export specialization in order to increase its capacity to earn. Structural upgrading means a shift towards higher value-added, higher-technology products, which generally allow for higher earnings.
- The ability to earn is shown by the per capita level and increase of GDP. GDP growth compared to other countries expresses whether a country is catching up or falling behind. The structure of GDP growth reveals the main driving forces of growth and also the imbalances which may endanger further growth.

Based on the above considerations, in this paper competitiveness is measured by the rate of GDP growth, the size of exports, the structure of exports and unit prices of exports, as well as by the amount and structure of FDI. We compare two countries: Poland, which has two and a half years experience of EU membership, and Romania, which is going to join the Union in 2007. We look for lessons from Poland which may be relevant for Romania's competitive position after EU accession.

At the outset we argue that economic conditions in Romania at the time of EU accession are less favourable than they were in the case of Poland, but there is also a higher dynamic of change. Romania is less developed, less competitive and is characterized by a more backward economic structure than was Poland two years ago. In Romania the economic transformation to a market economy started late, market conditions have not yet consolidated, and the institutional environment and physical infrastructure is underdeveloped. We shall demonstrate these differences between the two countries in the following sections and raise specific questions related to Romania: How will the economy withstand competitive pressure? Will the external balance deteriorate and if yes, will the stability of the currency be in danger?

## **Differences in competitiveness between Poland and Romania in the 2000s<sup>1</sup>**

### *Economic growth patterns*

In the 1990s, Poland grew fast due to successful economic transformation, while Romania was falling behind due to stop-go policies and hesitant transformation. In comparison with the EU-25 average per capita GDP at purchasing power parity (PPP), Poland caught up from 32% to 47% between 1991 and 2000 while Romania fell behind from 29% to 25% (Table 1). Thus the current development gap between the two countries is virtually of recent origin.

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<sup>1</sup> Research regarding Poland was done by wiiw economist Leon Podkaminer (Podkaminer, 2006a and 2006b).

In the past six years, however, Romania performed much better than did Poland: in 2005 Romanian per capita GDP advanced to 35% of the EU-25 average at PPP, while Poland's GDP level hardly changed by moving to 50%. Nevertheless, Romania is still a more backward country and has a long way to go to catch up.

To illustrate the difficult way ahead, a simple growth projection can be made based on the assumption that in the next decade the EU-25 will grow by 2%, Poland by 4% and Romania by 6% - thus the trend of the last few years continues (Table 1). The results show that by 2015 Poland will be at 60% of the EU-25 average, at the same level as Hungary in 2005, and Romania will climb to the current Polish level of 50%. As economic history has shown, there is little room for miracles; catching-up processes take a long time and can be rather cumbersome.

Table 1

**GDP per capita at current PPPs (EUR terms), EU-25 average = 100**

	1991	1995	2000	2005	2010 projection	2015 projection
Poland	32	40	47	50	55	60
Romania	29	30	25	35	42	50

Projections: EU-25: 2%, Poland: 4%, Romania: 6% annual GDP growth; zero population growth.

Source: wiiw Database.

As a possible impact of EU accession, Poland has grown more rapidly in the past two-three years than it did in the three years before it joined the EU (Table 2). Polish GDP growth was particularly high in the accession year, slowed down one year later and has recovered again in 2006. Romania recorded similar fluctuation during the same period, but its growth rates were higher than those of Poland. The slow economic growth in both countries in 2005 had to do with poor harvests. As of now, optimism prevails that the estimated 2006 growth rates can be sustainable over the coming years.

Judging from the recent growth performance of the two countries, it may be concluded that they are able to grow faster than their competitors in the old member states. In general, the new EU member states (NMS) and accession countries improve their competitive position in the wider European context. But Poland's and Romania's growth rates are not particularly high as compared to the other NMS, which tend to be competitors of both countries on the EU market.

*Demand structure of the current economic growth*

The individual items of expenditure have played differing roles in generating growth in aggregate demand (and GDP) in the two countries (Table 2). In 2004, the year of

EU accession, Poland just emerged from a recession characterized by declining investment. Stagnating domestic consumption in the early 2000s had helped the foreign trade balance to improve, but it expanded again along with the resumption of economic growth. But, in fact, the deterioration of the foreign trade balance in connection with EU accession lasted only for a few months, and in the past three years exports have grown faster than imports. Poland could withstand the competitive pressure on the European market, it has been able to sell more while its import reliance has been moderate (see also next section).

Table 2

**Percentage contributions of domestic demand, consumption,  
gross fixed capital formation and foreign trade  
to yearly GDP growth, 2000-2005**

<b>Poland</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006 estimate</b>
<b>GDP growth rate (%)</b>	<b>4.2</b>	<b>1.1</b>	<b>1.4</b>	<b>3.8</b>	<b>5.3</b>	<b>3.4</b>	<b>5.2</b>
Consumption	2.2	1.8	2.4	2.1	3.3	2.2	
Gross fixed investment	0.7	-2.3	-1.3	0.0	1.2	1.2	
Trade balance	1.0	2.6	0.5	1.1	-0.8	1.1	
Other items*	0.3	-1.0	-0.2	0.6	1.6	-1.1	
<b>Romania</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006 estimate</b>
<b>GDP growth rate (%)</b>	<b>2.1</b>	<b>5.7</b>	<b>5.1</b>	<b>5.2</b>	<b>8.4</b>	<b>4.1</b>	<b>6.5</b>
Consumption	1.3	5.5	4.2	7.0	10.3	7.5	
Gross fixed investment	1.0	1.9	1.6	1.8	2.4	2.9	
Trade balance	-2.4	-3.4	0.9	-3.9	-5.0	-5.4	
Other items*	2.2	1.7	-1.6	0.3	0.7	-0.9	

\* Other items: change in stocks and statistical discrepancy.

*Remark:* The growth rate of each individual position was weighted with its share in GDP. The sum of the components' growth rates adds up to the GDP growth rate.

*Source:* wiiw Database relying on national statistics.

In Romania, the high rate of economic growth in the past five years has been driven by domestic consumption and, to a lesser extent, by investment, while the foreign trade balance has deteriorated continuously. Romania is in a phase of rapidly adjusting industry and services, with a lot of technology being imported and domestic production hardly in a position to meet the demand for investment goods. Private demand has also expanded rapidly as consumers have benefited from growing wages, improved creditworthiness and an appreciating local currency. Private demand grew much faster than domestic production, in both quantitative and qualitative terms, and was met by rapidly growing imports. At the same time, production developed in such a way that exports also increased at two-digit

annual rates, albeit slower than imports. Thus, the contribution of net exports to economic growth is increasingly negative in Romania, while it is positive in Poland.

As to the performance of the external sector, the difference between the two countries is also indicated by the current account deficit to GDP ratio: in Poland, it was below 3% in the early 2000s, jumped to 4.2% in the year of accession and came down to 1.4% in 2005. Romania, on the other hand, will report a current account deficit of more than 10% of GDP in the year before accession. Keeping in mind that in Poland, due to accession, the current account balance deteriorated sharply, a similar impact in Romania would increase the deficit to really high levels.

The difference between the two countries in terms of consumption growth may be explained by the difference in wage growth. Wage increases have been modest in Poland, keeping consumption growth moderate: real wages expanded by only 7.6% between 2001 and 2005, while GDP grew by 14.6%. In Romania real wage expansion was as much as 42% while GDP grew by 25%. (Average monthly wages in 2006 can be estimated as EUR 650 for Poland and EUR 310 for Romania.)

We conclude from the above that Poland joined the EU with an economy modestly growing, and with an improving foreign trade balance. In the past two years, expanding consumption has boosted economic growth while the foreign trade balance has improved further. Romania will join the EU with an economy growing more rapidly and displaying signs of overheating. This growth is fuelled primarily by domestic consumption while the external deficit is high and expanding. This deficit is financed by abundant foreign currency inflow which appreciates the local currency triggering a further widening of the foreign trade deficit.

#### *Exports size and structure*

The competitiveness in relation to other countries can be expressed by the change in market shares on the main export market, the European Union. Both countries have increased their market shares in the EU-15 in recent years (Table 3) which may be interpreted as an indicator of increasing competitiveness. Due to the more rapid export expansion, Poland's share in EU-15 imports increased faster than that of Romania. Considering the larger size of Poland, a market share 2.3 times higher than that of Romania in 2004 is more than justified as Poland's nominal GDP in euro terms is 2.7 times higher than the Romanian.

As to the specialization pattern of exports, both countries hold the strongest position in low-tech and medium-low-tech industries, while the market shares attained in high-tech industries are very small (Table 3). Still, Poland has had a more advanced export structure and recent market share gains took place mostly in the medium-high-tech sectors.

Romania's market share is concentrated on the low-tech industries and it was this sector which achieved most of the gains on EU markets. Currently both Poland's and Romania's exports undergo a structural change due to the diminishing role of low-tech industries, in particular textile, clothing and footwear, caused by Chinese competition. These commodities are primarily replaced by increasing exports of cars, car components and electrical machinery.<sup>2</sup>

Table 3

**Manufacturing goods exports to the EU-15:  
shares in EU-15 total imports, annual averages for two periods, in %**

		Low-tech	Medium-low-tech	Medium-high-tech	High-tech	Total manufacturing
Poland	1995-1998	1.60	1.43	0.63	0.20	0.92
	2002-2004	1.94	1.81	1.56	0.40	1.35
Romania	1995-1998	0.86	0.61	0.14	0.02	0.35
	2002-2004	1.73	0.61	0.32	0.11	0.58

*Source:* wiiw calculations based on COMEXT Database. Low-tech goods are the products of NACE industries 15-22, 36-37; medium-low-tech: NACE 23, 25-28; medium-high-tech: NACE 24, 29, 31, 34-35; high-tech: NACE 30, 32-33.

Qualitative changes in exports are typically reflected in the prices received for the products. The measurement of such price/quality improvements involves the calculation of average prices per 'ton' of various types of goods.<sup>3</sup> In this comparison Romania outperforms Poland (Table 4). In the second half of the 1990s the unit values of Romanian exports to the EU-15 had been below those of Poland, but by 2004 they had surpassed the Polish level. This superiority is present in all technological categories of industries. Romanian products have been modernized so that they can be exported at relatively higher price. But high prices set a narrow limit for increasing the volume of exports. Poland expanded exports mainly by quantity, competing on the basis of prices but not of quality.

Table 4

**Central and East European countries' exports to the EU-15:  
unit value ratios**

		Low-tech	Medium-low-tech	Medium-high-tech	High-tech	Total manufacturing
Poland	1995-1998	0.802	0.846	0.665	0.860	0.789
	2002-2004	0.869	0.872	0.864	0.821	0.867
Romania	1995-1998	0.720	0.796	0.663	0.596	0.731
	2002-2004	0.956	0.895	0.903	0.838	0.924

*Source:* wiiw calculations based on COMEXT.

<sup>2</sup> For the time being only national statistics support this statement; Eurostat data are not yet available.

<sup>3</sup> The calculations were done by Robert Stehrer, wiiw. For the methodology see, e.g., Landesmann and Stehrer (2003).

The diverting development of export competitiveness in the two countries may be linked to the differences in unit labour costs. As pointed out in the previous section, wage increases have been moderate in Poland but surged in Romania. In Poland, productivity increased more rapidly than wages, thus unit labour costs in manufacturing declined, by 17.8%, between 2002 and 2005. The costs of Polish producers diminished and they could compete with lower prices and sell larger quantities. In Romania, by contrast, productivity did not increase as fast as wages during the same period, which resulted in an increase in manufacturing unit labour costs of 24.5%. Romanian producers could not sell as much as before in the same quality were pushed to increase export prices even if quantities had to be limited.

Despite the above differences in development, unit labour costs in both country's industries are much below the EU-15 level; this fact can attract the relocation of production. Polish unit labour costs are on average still higher than the Romanian ones. Using Austria as a benchmark (a slightly higher base than the EU-15 average), Polish unit labour costs in manufacturing were at 37% in 2005, while Romania's at 32%. However, whereas Polish unit labour costs were above the Romanian ones in the manufacturing sector as a whole, they were below the Romanian level in key export industries: textiles-clothing-leather, and machinery-electrical equipment-transport equipment (Table 5).

Table 5

**Unit labour costs in Poland and Romania  
in comparison to Austria, 2005, euro-based, %**

	Poland	Romania
D Manufacturing	36.9	32.2
DA Food products; beverages and tobacco	36.9	19.0
DB Textiles and textile products	50.9	61.8
DC Leather and leather products	74.6	127.2
DD Wood and wood products	38.3	31.1
DE Pulp, paper & paper products; publishing & printing	43.4	17.0
DF Coke, refined petroleum products & nuclear fuel	121.1	37.4
DG Chemicals, chemical products and man-made fibres	47.0	24.7
DH Rubber and plastic products	28.0	23.7
DI Other non-metallic mineral products	29.1	28.8
DJ Basic metals and fabricated metal products	33.8	21.2
DK Machinery and equipment n.e.c.	43.2	60.3
DL Electrical and optical equipment	31.8	58.5
DM Transport equipment	34.9	68.5
DN Manufacturing n.e.c.	32.7	31.7

Source: wiiw Database.

We can discover a relationship between the wage surge and quality upgrading of exports in Romania, but the way of causality is not obvious. Did rapidly increasing unit labour costs push producers to upgrade their products and improve the quality, or was it the fast technological change that triggered productivity and quality gains which in turn allowed for rapid wage increases? There is no answer to this at the current level of analysis but the conclusion is clear: Romanian exporters could align costs and prices and maintain competitiveness, but they could not substantially increase the amount of exports. Polish producers increased the quantity of exports relatively more rapidly than the quality.

Another related effect of the strong increase in Romanian unit labour costs concerns the competitiveness on the domestic market. Domestic producers find themselves in a disadvantaged position in the face of imported goods. This may explain the sluggish growth of manufacturing output in the past five years and the high import growth.

### *FDI patterns*

Finally we look into the ability of the two countries to attract FDI. In absolute terms, large countries receive higher amounts of FDI than do smaller ones. The largest country, Poland is the most important recipient among the NMS as of end-2005, with an FDI stock of more than EUR 70 billion. Romania is the most important recipient in Southeast Europe, registering an FDI stock of EUR 20 billion. But in relationship to their size, FDI is quite low in both countries. The FDI stock amounts to only 29% of GDP in Poland, and to 25% in Romania – the second and third lowest rates among the new members and accession countries after Slovenia (Table 6).

Table 6

#### **FDI inflow and stocks in NMS and accession countries**

	FDI inflow, EUR million						Stock per GDP, % 2005
	2001	2002	2003	2004	2005	forecast 2006	
Czech Republic	6296	9012	1863	4007	8837	5000	51.2
Hungary	4391	3185	1888	3754	5559	5000	58.9
Poland	6372	4371	4067	10279	6566	8000	29.1
Slovakia	1768	4397	593	1016	1694	3000	34.8
Slovenia	412	1700	300	665	445	500	21.9
Bulgaria	903	980	1851	2727	2326	3000	39.8
Croatia	1503	1195	1785	990	1403	2000	42.6
Romania	1294	1212	1946	5183	5197	8000	25.4

Source: wiiw Database on FDI and wiiw estimate.

FDI in Romania is of much more recent origin than in Poland which may be a reason for lower accumulated stocks. Inflows started to reach significant amounts only in 2004. Most of the inflows in recent years have been privatization-driven. For the year 2006 high amounts of FDI can be expected to flow into both countries (see Table 6 for wiiw estimations based on half-year balance of payments data). This year there is a general trend in the NMS for accelerating inflows, and Poland is on track to confirm its position as the largest receiver of FDI. Romania will book one-time high amounts of privatization-related FDI which will certainly be followed by a backdrop in 2007.

As for the structure of FDI, up to 2005 the two countries differed in so far as in Romania industry had a higher share of FDI than services, whereas in Poland services, first of all banking and trade, were more important. Romania will change to the Polish pattern in 2006 when the recent privatizations to foreign investors in banking and electricity distribution appear in the statistics. Poland will move in the other direction as the share of manufacturing in new FDI is growing again. The country has recently attracted some larger investment projects in the motor industry and household electronics. These are hoped to boost the exports of medium-high-tech products and speed up the upgrading of the export structure. In the past few years Romania has attracted FDI of labour-intensive production from Poland but its current wage surge and Asian competition may force these plants to move on. Larger green-field projects are still missing in Romania but may come after the country's accession to the EU; as a precondition, however, a general development of the transport infrastructure is essential.

### **Conclusion and outlook**

In the above analysis we have found that the competitiveness of both Poland and Romania is improving by some important indicators. They have been growing faster in 2004-2006 than earlier, they have attracted more FDI and they have exported more, in an improving structure and in improving quality. Problems for Poland were identified in terms of slow structural upgrading and for Romania in terms of expanding foreign trade deficit. These problems are not easy to solve, therefore optimism concerning medium-term economic prospects has to be cautious. This refers especially to Romania current imbalances and competitiveness problems may even aggravate in the first few years of EU membership.

In general, the conditions for doing business, for foreign trade and for investment flows improve when a country joins the EU. The 2004 enlargement showed that the first year of membership may stir economic imbalances: many countries registered a push to inflation, an acceleration of imports and an increase in the budget deficit. All these difficulties have been successfully overcome by Poland. Economic growth in 2006-2007 is and will be sustainable, at a rate of about 5%. Rising incomes of wage-earners, pensioners, and farmers (the chief beneficiaries of Poland's EU accession) are likely to strengthen consumer demand. At the same time there is every reason to expect strong fixed

productive investment: the corporate sector is highly liquid, interest rates are relatively low, capacity utilization levels are fairly high, domestic and foreign demand seem to be forthcoming. Despite its populist rhetoric, the current government keeps budgetary spending under control and its foreign policy statements do not discourage investors either.

Romania will accede the European Union on 1 January 2007 with a dynamically growing economy, high current account deficits, high but falling inflation, and a low but increasing budget deficit. In 2007, private consumption may increase less rapidly than in past years, but a somewhat less restrictive fiscal policy and enhanced confidence of foreign investors will support economic growth further on, still less rapidly than before. After 6.5% GDP growth in 2006 one may realistically expect for 2007 only about 5.5%. The deceleration of growth has partly reasons which are connected to the one-time nature of the 2006 growth acceleration (agricultural recovery). The forecast mainly reflects growing uncertainties due to the increasing external imbalance. Adverse effects of EU accession may appear in the form of stronger competition on the domestic market, surging imports and thus even higher current account deficits. Wage restraint and productivity-enhancing investments will be necessary to reduce unit labour costs as compared to competitors such as Poland. In addition, in the first year of membership there will be no surging inflow of EU funds yet. It will take a few years more for Romania to fully benefit the system of EU funding.

The development of the balance of payments in Romania may cause uncertainties regarding inflation and the exchange rate. Inflation may decline due to increasing competition, but the obvious overheating of the economy may impose the opposite. The current account deficit may become a problem and trigger a depreciation of the currency, but this may also be prevented by an improved risk perception that supports the inflow of further foreign investments. Abundant foreign financing would allow for even larger deficits. Despite all these uncertainties, due to the generally optimistic attitude in and around the Romanian economy, there is little likelihood of an inverse investment flow triggering a currency crisis. The most important danger Romania has to face is that the currency stays firm while competitiveness in terms of ability to sell and to adjust will not improve properly.

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