

---

Pub.

# **Reform in Eastern Europe and the Developing Country Dimension**

edited by  
**Christopher Stevens  
and Jane Kennan**

**Overseas Development Institute**

---





ODI Development Policy Studies

00014333



Overseas Development Institute

# **Reform in Eastern Europe and the Developing Country Dimension**

edited by  
Christopher Stevens and Jane Kennan

Overseas Development Institute

**A CIP catalogue record for this book is available from the British Library.**

ISBN 0 85003 181 8

© Overseas Development Institute 1992

Published by the Overseas Development Institute,  
Regent's College, Inner Circle, Regent's Park,  
London NW1 4NS

All rights reserved. No part of this publication may be reproduced by any means, nor transmitted, nor translated into any machine language without the written permission of the publisher.

Typeset in Postscript by Jane Kennan at ODI.

Printed by the Russell Press Ltd, Nottingham.



Printed on recycled paper.

## Preface

This book has grown out of a collaboration fostered by the EC Commission. In September 1990 ODI was asked to lead a European team of economists that would advise the EC Commission on its aid programme to Eastern Europe. The Commission is mandated to use this assistance to facilitate the transition from a centrally planned to a free market economy; the team's advice focused on the policies required to effect such a transition.

It became clear that some of the insights gained by the team during this exercise would interest a wider audience, particularly if combined with the members' broader knowledge of international trade, finance and structural adjustment. This book is the result. It identifies those salient features of events in Eastern Europe needed both to apply to this region's challenge the experience of structural adjustment gained elsewhere and to assess the implications for developing countries. The authors of the country chapters have both extended and updated their inputs to the EC project. Events are moving fast in Eastern Europe; the cut-off point for the updating was autumn 1991.

Thanks are due to the staff of the EC Commission's PHARE programme for their support in the initial enterprise of the team. It must be emphasised, however, that they bear no responsibility for this book, which differs substantially from the report submitted to them.

January 1992

C.S.  
J.K.

## Contributors

**Hans Aage** is a Reader at the Institute of Economics at the University of Copenhagen.

**Stephany Griffith-Jones** is a Research Fellow at the Institute of Development Studies at the University of Sussex.

**Ulrich Hiemenz** is Head of the Development Economics Department at the Kiel Institute of World Economics.

**Tony Killick** is Senior Research Fellow at the Overseas Development Institute, London.

**Rolf J. Langhammer** is a Research Division Chief at the Kiel Institute of World Economics.

**Peter Nunnenkamp** is a Research Division Chief at the Kiel Institute of World Economics.

**Sandro Sideri** is Dean of Studies at the Institute of Social Studies, The Hague.

**Christopher Stevens** is a Research Fellow at the Institute of Development Studies at the University of Sussex. He was formerly a Research Fellow at the Overseas Development Institute, London.

**Eirik Svindland** is a Senior Fellow at the German Institute of Economic Research, Berlin.

# Contents

<b>Introduction</b>	7
<i>Christopher Stevens</i>	
 <b>Part I Eastern Europe and Developing Countries</b>	
<b>1 Lessons from the Third World</b>	12
<i>Tony Killick and Christopher Stevens</i>	
<b>2 The Implications for Developing Countries</b>	37
<i>Christopher Stevens</i>	
 <b>Part II The Changes in Eastern Europe</b>	
<b>3 Bulgaria</b>	76
<i>Eirik Svindland</i>	
<b>4 Czechoslovakia</b>	92
<i>Stephany Griffith-Jones</i>	
<b>5 Hungary</b>	101
<i>Rolf Langhammer, Peter Nunnenkamp and Ulrich Hiemenz</i>	
<b>6 Poland</b>	114
<i>Hans Aage</i>	
<b>7 Romania</b>	128
<i>Sandro Sideri</i>	
<b>Statistical Appendix</b>	145
<b>References</b>	155



## Introduction

*Christopher Stevens*

The dramatic effects on international relations of the revolutions in Central and Eastern Europe will continue to reverberate for many years in many areas. This book is concerned primarily with one facet: the relationship between these countries and those of the Third World. It is based on an analysis of five states - Bulgaria, Czechoslovakia, Hungary, Poland and Romania - referred to collectively hereafter as 'Eastern Europe'.

The relationship is two-way: developing countries may be affected, for good or ill, by the economic restructuring of Eastern Europe; and the reformers of Eastern Europe can learn from the, now extensive, experience of structural adjustment in developing countries (ldcs). It is also a complex issue as the relationship will be affected in many indirect ways.

The task of charting possible changes in the relationship is made more difficult by the considerable uncertainty that surrounds the future of Eastern Europe and, now, of the former USSR. Central to the problems of Eastern Europe is the sheer pervasiveness of the old system. Attempts to alter one facet may produce unintended consequences elsewhere. In Czechoslovakia, for example, which adopted a particularly comprehensive form of central planning and was very closely integrated into CMEA trade, the unravelling of the economy is an especially complex task. More than 90% of the labour force were employed in the state and co-operative sectors, while the private sector (even including the informal economy) was responsible for only 2% of non-agricultural output. Action is being taken simultaneously in four areas: to adapt the inefficient and outmoded economic structures bequeathed by the *anciens régimes*; to alter the economic model; to alter the political model; and to reduce dependence on the former USSR.

The transition from a centrally planned to a free market system of allocating resources requires a whole new infrastructure of legal rules and institutions. Property rights and means for enforcing contracts need to be established. Without them, not only will investment be restricted but companies will be unwilling to supply inputs to other firms (as they have no assurance of being paid) and the whole system of economic relations will seize up.

Social conventions must also be redefined from scratch. Procedures for redundancies, provisions for facilitating re-employment, unemployment benefits, welfare provisions for the young, the elderly and the infirm all have to be debated and set in place. Failure to progress in these areas may undermine key reforms. In Hungary, for example, workers lobby against the liquidation of insolvent enterprises which, *inter alia*, is slowing down privatisation. A balance must be struck between the need to maintain public support (through generous social provisions) and the need to encourage labour mobility.

There are also shared problems of a decrepit physical infrastructure. Poor transport and telecommunications systems act as a constraint on the growth of production. Much of the fixed capital in industry is obsolete.

Most countries of the region are experiencing chronic difficulties with stabilisation. Inflation remains a serious problem. Output has slumped, although official figures have to be interpreted with some care. They may overstate the decline as they do not reflect activity in the informal sector or understate it because they do not take account of running down inventories. In Poland industrial production fell sharply in 1990. The sharpest falls have been in textiles, mining, metals and transport; agricultural output has not fallen. In Bulgaria production is estimated to have declined during 1990 by between 20% and 30% of GNP, a substantial part of the decline being due to shortages of imported raw materials and machinery spare parts. Industrial production is down, especially in the chemical, metallurgic and heavy machinery industries which, by the end of 1990, were, on average, utilising less than 50% of capacity. Once a substantial agricultural exporter, Romania is now unable to feed itself and is receiving large amounts of emergency food aid. The industrial sector is largely obsolete, highly polluting and uncompetitive even within Eastern Europe. GDP fell by 10% and industrial output by 20% in 1990.



Unemployment presents a particularly difficult problem. Although generally it has not yet reached very high levels (still only 8% even in Poland), the point of comparison is that under the centrally planned regime open unemployment did not exist at all. It may be very difficult for East European society to accept the substantial unemployment levels that may well occur in the near future, particularly since the shift to a free market economy is predicated on its being an improvement on the past. Such acceptance is more likely to be achieved if there is an adequate institutional environment for unemployment together with a social safety net, but the issue extends beyond welfare provision.

To facilitate the analysis of this confusing, and fast-moving, picture the present book is divided into two parts. In Part I, Chapters 1 and 2 provide an assessment of the lessons to be drawn by Eastern Europe from the structural adjustment experience of the Third World and of the potential impact on developing countries of the political and economic changes in Eastern Europe. Although there are substantial differences between the countries of Eastern Europe and many of the developing countries undertaking structural adjustment, there are also lessons that the former can learn from the latter. Moreover, the experience of Eastern Europe in undertaking what is, in effect, an extreme form of structural adjustment will in due course feed back into the design of similar programmes in the Third World.

Reform in Eastern Europe is both desirable and feasible; the key issues are the speed with which its benefits can begin to be enjoyed and the social costs that must be incurred in its pursuit. The chief threat is that unrealistic expectations will lead to premature, unjustified disillusionment and erosion of public support for adjustment. Third World experience suggests strongly that it would be wise for reformist governments to seek to dampen excessive public expectations and prepare their citizenry for a long slog. It also suggests caution over what may be expected from the West. In the developing countries' experience, the OECD countries tend to pursue inconsistent objectives and contradictory policies with regard to the external environment in which adjustment must take place. They have tended to undermine their aid policies with ungenerous debt (and export credit) policies, by practices which reduce the quality of the aid and by the pursuit of protectionism.

They have stated that they favour policies of 'adjustment with growth' without being willing to accept the financial implications.

The main factor determining the impact on developing countries will be the speed and extent of this economic transformation. Middle income developing countries could be *adversely* affected if Eastern Europe competes with them for commercial bank loans, foreign direct investment, semi-concessional aid and markets for exports of manufactures. The outcome could be potentially *positive* for the poorer developing countries that are still heavily dependent on exports of primary commodities and may not experience serious competition for aid (official development assistance) since most of the assistance to Eastern Europe ought to be on quasi-commercial or only slightly concessional terms. But if the outcome of reform in Eastern Europe is only economic stagnation, its principal effect on the Third World may be migrant worker competition in the West European labour market and greater aid diversion (as the West seeks to mitigate social or political unrest in its neighbours).

In Part II, Chapters 3-7 provide brief country-by-country analyses of the origins of the revolutions, the progress of reform to date, and the principal economic and political obstacles that have to be grappled with in the short to medium term. The short-term economic outlook for the countries of Eastern Europe is the essential starting point for any analysis either of the likely impact of the revolutions on developing countries or of the potential contribution of Third World experience in structural adjustment. These chapters represent the foundations for the analysis contained in Part I.

Part I  
Eastern Europe and Developing Countries

## 1

## Lessons from the Third World

*Tony Killick and Christopher Stevens*

Clearly there are many differences between the countries of Eastern Europe and those of the 'Third World', even the more advanced ones such as Brazil, Taiwan and Turkey. Because of the extent of communist-style central planning, and the particular deficiencies of this, the task now facing the governments of Eastern Europe is unique. At the same time, however, they are trying to grapple with a task that the governments of many developing countries have been confronting over the past decade or more: how best to reform policies and institutions in order to halt the deterioration of their economies, improve efficiency and restore economic growth. So while the differences between the Third World and the erstwhile Second World are large, there are also some important similarities in the situations of these two groups.

After first summarising the nature of the economic task facing Eastern Europe, the objective of this chapter is, therefore, to explore what lessons the region might learn from the attempts by developing countries to stabilise and adjust their economic structures.

### **Eastern Europe's Adjustment Task**

#### **What is the goal?**

All five of the countries studied in this book have made a commitment to abandon a command economy and replace the Communist Party as the central mechanism for allocating resources by the free market. So far, so good - but what is a 'free market economy'? As the Economic Commission for Europe has pointed out, 'from both the policy and analytical points of view the whole transformation issue is largely uncharted territory' [ECE, 1990:14]. It has argued that:

The transformation of a centrally planned economy into a decentralised market economy of the western ... variety is both a precise and a vague concept: it is precise in terms of the general direction which is to be pursued, but vague as to the precise destination.

In part the problem arises because no agreement exists on what a 'Western market economy' should look like. Beyond the stereotypes of the US liberal free market, the West European welfare state and the Japanese patriarchal system, there exist wide variations among the countries of the OECD. These apply to institutions, laws, social attitudes and political relations. Moreover, the starting point differs among the five East European states as a significant variety existed among their 'command economies'. Hungary and, to a lesser extent, Poland, for example, had attempted to reform the system from inside over many years.

Yet, however ill-defined, the desired new structures mark a dramatic break with the past in most of the countries of Eastern Europe. To function effectively a free market economy depends on a detailed infrastructure of property rights, laws, regulatory bodies, and financing institutions, operating within an environment shaped by cultural and social traditions. In Eastern Europe, many of these institutions and practices do not exist; in Chapter 3, Svindland shows how a whole array of standards and regulations must be incorporated into law before Bulgaria can make the transition effectively, and even then the break with the past will not be decisive. The new systems can be created, but this will take time and their form will be influenced strongly by the distinctive, and different, political and cultural environments in which they have to operate.

### **A background of economic decline**

The revolutions in Eastern Europe occurred against a background of poor economic performance during the 1980s. These problems, which have resulted from an inappropriate economic structure, have been largely the result of the command economy's shortcomings and have contributed to its demise.

There has been a secular decline in output performance since the early 1970s. At first, in most countries, the consequences of this for domestic consumption were cushioned by increasing trade deficits financed by foreign borrowing. However, this situation

could not be sustained after the second oil shock of 1979. With lending from the West virtually ended and a general weakening in export markets, there was no alternative to a massive squeeze on domestic demand and cutbacks in investment.

Partly as a consequence of the resulting cuts in imports of Western machinery and of interruptions to imports of essential intermediate goods, East European exports since the mid-1980s have grown less rapidly than world trade. Exports to the market economies grew by 3% in volume in 1987 and by 2% in 1988, but fell by 1% in 1989 [ECE, 1990:141]. Internal imbalances also worsened. Hidden or repressed inflation became pervasive. Large government deficits were built up in most states. Disguised unemployment became widespread. By 1985, real output per head in the East (including East Germany) was, on average, more than 40% lower than the level in the Federal Republic of Germany. If East Germany is removed from consideration, the average was even lower and the secular downward trend more marked.

These trends persisted in the last years of the 1980s. Growth in output fell even more sharply than expected in all states except Czechoslovakia (which performed relatively well), but there were two distinctly different policy responses. In Bulgaria the under-fulfilment of targets for output was reflected immediately in slower growth of living standards. By contrast, in Hungary and Poland wage and income growth plans were allowed to remain unchanged, or even to rise, despite the setback to production; the result was inflationary.

The legacy of economic problems varies in each of the countries of Eastern Europe. In most there is rising open inflation or, until recently, hyperinflation (as in Poland and Yugoslavia). In Bulgaria, Hungary and Poland there is also a high level of external indebtedness (see Appendix Table 9). Romania under Ceausescu repaid its foreign debt, but at the cost of a lower rate of capital formation.

### **Common problems of the transition**

Put at its least controversial, the overall objective of change in Eastern Europe is to move to a system that supports sustainable development. This requires, in turn, two sets of actions: reform and investment. Reform involves the substitution of one system of resource allocation for another, and carries with it a panoply of institutional, legal and cultural changes. This must be combined

with investment in the system of production and distribution to replace inefficient capital so that it is able to respond to the new allocative machinery.

The system of rules and regulations currently operating in Eastern Europe was devised to facilitate a command economy in which the state and the party regulated the interactions of economic operators. A free market, regardless of its precise characteristics, requires a different set of rules. Among the areas in which changes are required are:

- property rights, in relation to both land and companies;
- the rules governing access to factors of production in conditions of limited supply (very limited in the short term);
- the mobility of factors of production and the correct relationship between the need for a high degree of mobility and social considerations;
- the rules for establishing freedom of contract, which is a fundamental feature of a market economy.

Consider simply the changed relationship between the state and the private sector in relation to social security and fiscal policy elaborated in Chapter 3 by Svindland. In the past, social services such as kindergartens and health services were provided as part of the work system; now that employers' only obligation is to pay a contractual wage an independent system of social security (for which the principles have to be created) must be established. This will give rise to claims on public revenue. In the past the government could control directly not only its budget expenditure but also its income. Now income will depend upon the creation - and enforcement - of a taxation system.

#### *Conceptual controversies*

Several major conceptual controversies have attracted popular attention. They include:

- Big bang or gradualism. To use a well-quoted analogy, a chasm cannot be crossed in two bounds - hence the justification for a big bang; on the other hand, is it too broad to be crossed in a single bound? This issue has strong links with the problems of phasing considered below.
- A Western economy or a 'third way'. It has been suggested that the Eastern Europeans should not seek to move from a

centrally planned economy to a Western economy of either the welfare state or the liberal variety, but should rather seek a distinctive 'third way';

- The point of irreversibility. Is there a point at which the dismantling of a centrally planned, and the installation of a free market, economy becomes irreversible? If so, is there evidence on its location? If not, what are the danger signals of regression? Svindland argues that reforms may *always* be reversed; the mobilisation of public support for the new system is a continuous process.

In most cases, the country evidence of Part II suggests that the form in which these dichotomies are usually posed is unhelpful. For example, the problems of phasing tend to be much more complex than simply a choice between a big bang or gradualism. A clear, and enforced, timetable of reform is the main prerequisite, and the choice of speed may be determined by each country's situation. Poland, for example, was facing hyperinflation, a problem that requires a sharp remedy; for Hungary and Czechoslovakia a more gradual reform programme was a viable option. In general, the view expressed in Part II is that, paradoxically, neither the option of a Western economy nor that of a 'third way' exists in reality: on the one hand, there is a wide variety of modalities compatible with a free market; on the other, the claimed 'third way' may represent a continuation of the old methods with just cosmetic changes. There seems little likelihood of any state returning to a system resembling the *status quo ante* (too much has been destroyed already), but failure to achieve a self-sustaining free market system could result in a range of non-democratic, economically inefficient regimes.

#### *Social acceptability*

The basic objective of the reform programmes is to change the nature of the economic system, but the unsustainable disequilibria which require immediate action stem from the fact that consumption has been allowed to stay at levels that could not be justified by production. Hence, it goes without saying that reform will coincide with a sharp drop in the standard of living of many people, initially at least. Even if this could be largely and quickly offset by gains for others, the losers would still probably be more vocal than the gainers.



For the time being there appears to be some political support for austerity, at least in some countries. But the popular resistance that stymied retrenchment in the past could re-emerge if people are asked to accept austerity for an indefinite period. And governments brought to power on a platform of democratisation and rapid enrichment cannot (and should not) ignore indefinitely the wishes of the electorate. The trend of events in Poland since mid-1990 provides cause for concern that popular discontent may derail economic reform before it has run its course.

It is clear from the country analyses of Part II that unemployment presents a particularly difficult problem. It has two aspects: one to do with the social perceptions of unemployment and the other with the institutional response of the state to the unemployed. The official figures have begun to reach levels that would be considered a problem in the UK, let alone countries like Japan which offer examples of 2-2.5%. Such official data must be treated with circumspection, not only because they reflect in part the conversion of hidden underemployment to open unemployment but also because some of those registered as unemployed may have informal sector employment or may not genuinely be in the labour market, for example housewives. Nonetheless, whilst they may be inflated, the trend is still upwards.

East European society will find it difficult to accept the substantial unemployment levels that may well occur in the near future, particularly since the shift to a free market economy is predicated on its being an improvement on the past. Such acceptance is more likely to be achieved if there is an adequate institutional environment for unemployment together with a social safety net, but the issue extends beyond welfare provision. There are no agreed rules on the terms under which dismissals can be made or on rights of appeal. Failure to progress in these areas may undermine key reforms.

Moreover, no explicit provision was made for unemployment allowances and no agreement reached on the appropriate level of such social provisions in relation to prior earnings. As elaborated in the country chapters of Part II, a whole new socio-legal infrastructure of rights and obligations relating to redundancy and unemployment benefits has to be created. Some of the states have already introduced unemployment provisions, but it remains to be

seen how adequate they will be in the face of substantial and prolonged unemployment.

The appropriate level of unemployment pay is related not just to fiscal balances and to social perceptions but also to factor mobility. In cases where there may need to be substantial shifts of labour from one activity to another, generous social provision (which may be essential to maintain political support for the adjustment process) may be in conflict with the need for labour mobility. Heavy social provisions also have major fiscal costs; in Poland the social security system is disintegrating under the burden imposed by mass lay-offs. Similarly, governments wishing to avoid heavy political costs from structural adjustment may balk at closing down clearly unviable enterprises. In Hungary, for example, although it has been compulsory since May 1990 for insolvent enterprises to declare themselves bankrupt, there have been relatively few cases of liquidation. Employees fear unemployment; creditors (not least those that are state-owned) try to prevent major losses; and the tax authorities and social security system want to avoid losing revenues. The typical reaction of the authorities, therefore, is to launch a restructuring operation whenever insolvency is declared, even when there is no apparent possibility of a viable enterprise being created. Similarly, in Poland the law courts frequently call for another attempt at restructuring even when the government has requested a declaration of bankruptcy, and the state banks oppose the liquidation of large insolvent enterprises.

### *Phasing*

The problem of phasing is critically important. In a sense everything must be done before anything can be done! Since this is impossible it is important to have a clear idea of which steps must precede others. Those in charge must have a clear vision of the overall design of what they want to do, of how the various parts reinforce each other and of the sequence in which the various components should be introduced. However, as in Eastern Europe, the crisis conditions in which such programmes must be pushed through make such clarity extremely difficult. Examples can be cited from developing country experience in relation to price liberalisation, privatisation and currency convertibility to illustrate the problems that may arise from incorrect phasing.

The markets of Eastern Europe are segmented and inefficient; **price liberalisation** is only one element in their reform. Monopolistic structures tend to dominate, and limited market information is available to outsiders. Given the large suppressed consumer demand, these are ideal conditions for enterprises able to supply goods or services to make high profits once the price system is freed from control. Inflation in Poland was 585% in 1990. Although, from an economic viewpoint, high profits may be simply a beacon to attract additional suppliers, they may well provoke a social backlash against 'profiteering' which could undermine the process of reform. In order to make such profits acceptable markets must be improved as rapidly as price controls are eliminated to ensure that they do not reflect inefficient barriers to entry.

**Privatisation** can bring the expected gains in efficiency only if it occurs within a competitive or efficiently regulated framework; in other words, it must be preceded by demonopolisation. Otherwise, reform may simply change a public monopoly into a private one, regardless of whether foreign enterprises are involved. Indeed, it might even reinforce the inefficient production structures. But privatisation is causing practical problems in all the states in which it is seriously being attempted. If enterprises are to be sold, it may first be necessary to identify the profitable elements in which private purchasers would be interested (and possibly to close down the others). But this takes time, so privatisation must be delayed; otherwise a strong lobby of shareholders will be created to oppose the cutting of subsidies to unprofitable activities. Moreover, to whom are enterprises to be sold? Those with money are the beneficiaries of the *ancien régime*. But if assets are distributed at low cost to the public at large, the exercise will not mobilise resources. Although Czechoslovakia, Hungary and Poland have taken some steps towards privatisation, none has yet proceeded sufficiently far to demonstrate that these dichotomies (let alone the sheer practical problems inherent in such a massive exercise) have been resolved.

If privatisation is delayed, the control of state enterprises during this transition period becomes an important issue. What controls are required for state enterprises? Should they be allowed to operate as freely as possible in order to emulate private sector firms, or should they be tightly controlled on the grounds that they

can indulge in 'unfair competition' utilising public sector subsidies? The key task is to make budget constraints binding. The country evidence of Part II tends to support the latter option.

Similar problems arise in relation to **currency convertibility**. Exchange rates must reflect world prices much more closely and the economies must be made more open to flows of goods and capital. But significant changes in domestic economic policy will be required if the necessary realignments are not to disrupt the sequencing most suitable for domestic policy reasons. Some analyses suggest that these developments are unlikely to occur before the mid-1990s. One school of thought, on which the big bang approach of Poland was based, is that convertibility and liberalisation are essential to create a competitive environment. The alternative view is that much of East European production may be so inefficient that it subtracts value from the imported inputs. Since it cannot compete with foreign production at any exchange rate, instant liberalisation and convertibility are medicines that are too strong; they will kill the patient [McKinnon, 1991]. Whilst it is too early to judge definitively the validity of such competing arguments, the rapid increase in Polish exports in 1990 suggests that parts at least of this country's production are competitive.

### *Information*

Perhaps the most fundamental and most difficult of the problems to be dealt with is that of introducing policy reforms before the statistics needed to design them are available. The current statistical base in Eastern Europe is very poor. In the past, there has been widespread manipulation of statistics to suit political demands. Even though the new regimes are now much more open, and need statistics which describe the economy as it is rather than as they would wish it to be, there is no effective system of statistical collection and analysis yet in place. To a large extent, therefore, reforms are being undertaken 'in the dark'.

### *External shocks*

The fragile calculations on which the reform programmes were based have been badly hit by external shocks. In the second half of 1990, for example, three major shocks occurred almost simultaneously: the slump in CMEA trade and the expected shift to convertible currency accounting based on world market prices, the reunification of Germany (the GDR used to be a major market for

some), and the world oil price rise. Only the last of these has since disappeared.

The collapse of the CMEA trade system has hit the exports of all five states, and especially Czechoslovakia and Bulgaria, which had the highest share of their trade with socialist partners (although it is hard to calculate the real degree of concentration because of distortions in the exchange rates used). Adequate contacts have not yet been established with new trade partners. Moreover, the unexpectedly deep decline of its economy has reduced the capacity of the USSR to pay for imports from Eastern Europe. In Romania by the end of 1990 foreign exchange reserves had fallen to less than one month's import cover, as a result largely of falling exports (down by 42% during the year).

Such concentrations not only make Eastern Europe very vulnerable in the immediate term but may also indicate a relatively weak ability to diversify trade relations with the rest of the world in the short to medium term. In most cases the structures of exports to the CMEA and Western markets are significantly different. In the case of Czechoslovakia, for example, the share of machinery and transport equipment in exports to the CMEA area before its collapse, at 60%, was considerably higher than in exports to Western markets (21%). Czechoslovakia's international competitiveness in industrial exports, particularly of machinery, has declined over time: the share of electrical machinery in exports to the OECD, for example, was halved between the early 1970s and the mid-1980s. Hence, the capacity made idle by the slump in CMEA exports may not be able, without major new investment, to produce goods which are competitive in other markets.

A facet of the CMEA trade collapse that has been especially damaging in the short term (although desirable in the longer term) was the Soviet Union's shift to pricing its oil exports in convertible currency at world market prices. Much of East European industry is highly energy-intensive because oil imports from the USSR used to be cheap. The problem was exacerbated by the Gulf crisis. The short-lived but substantial hike in world oil prices hit all the states. Some were affected in other ways too. The Bulgarian government had intended to substitute Iraqi for Soviet oil, as Iraq owes Bulgaria approximately \$1.2 bn, but the Gulf crisis made this impossible. The direct and indirect losses for the Bulgarian economy have been estimated at \$1.4 bn (7% of GDP).

## Lessons from Developing Countries

Faced by such uncertainties, what insights can East European reformers gain from the experience of others? The widespread adoption of 'structural adjustment' programmes by developing countries, especially in Africa and Latin America and with the active encouragement of the IMF and the World Bank, was one of the main features of the economic scene in the 1980s. In varying degrees, these countries were confronting a similar task to that of the countries of Eastern Europe: to reform their economic institutions and policies so as to reduce (often very large) distortions in their economies, increase the efficiency of resource use, cope with often large external debt burdens and reverse deteriorations in production, investment and living standards. There are also strong similarities in the nature of the programmes introduced to achieve these goals, including measures to increase the role of the private sector *vis-à-vis* the state; a shift to liberalised market mechanisms as against direct state controls; reductions in internal and external macroeconomic imbalances; fuller and more advantageous integration into the world system of trade and payments.

Of course, there are many differences between the two groups of countries. Perhaps the most fundamental is that in most developing countries the environment in which structural adjustment had to take place was one in which the market economy was still quite well entrenched. They have not faced the problem confronting the East European states of simultaneously dismantling a command economy. Nonetheless, there seem to be sufficient similarities to make such a comparison feasible, whilst the absence of any obviously closer parallel makes it worthwhile. One point to be borne in mind, though, is that because of their additional need to dismantle the old system and ways of thinking, the difficulties that the East European countries will face are unlikely to be *less* than those of the Third World. A higher initial economic and social level and greater political commitment to reform may offset these additional difficulties, but it would be wise not to assume that this will be the case.

There is now more than a decade of experience with adjustment programmes and a burgeoning literature on the lessons to be learned from this. The following pages summarise the lessons that appear most relevant to Eastern Europe. For the purposes of

brevity these are asserted without the marshalling of supporting evidence or citations but are derived from a study of structural adjustment recently completed at the Overseas Development Institute.<sup>1</sup>

In brief, the following lessons are firmly established, important and relevant to Eastern Europe:

- The design of an adjustment programme is a more complex task, and the obstacles to successful, reasonably rapid implementation are larger, than is often allowed, which cautions against over-confidence.
- The sequencing of economic reforms is an important but poorly understood matter. There is much to be said for a 'stabilisation first' approach but that can get in the way of structural adaptation.
- Major changes in the distribution of income are likely to accompany adjustment. Important groups of the poor are liable to be placed at risk, including the urban proletariat. Measures to reduce or alleviate social costs must be incorporated in programme designs.
- The reforms should recognise that for the foreseeable future there will remain a large desirable economic role for the state, and that there are many obstacles in the way of rapid, successful privatisation of state enterprises.
- The quality and commitment of the political leadership is of central importance for success.
- Financial and other forms of external support have a potentially crucial role to play but the OECD donor countries pursue inconsistent objectives which lead to contradictions in their economic relations with adjusting countries.
- Unless it goes to countries whose governments are pursuing sound and sustainable policies there is a large risk that aid will be ineffectual.

---

<sup>1</sup> The study, by Tony Killick, was commissioned by the Economic Development Institute of the World Bank, on the principles of structural adjustment. The World Bank is not in any way responsible for the views expressed.



### **Complexity and over-optimism**

Modern economics draws attention to the many ways in which parts of the economy interact with each other, and to the effects of various time-lags on the outcome of a given policy change. This means that partial or *ad hoc* solutions to problems are at risk because of the danger that as the changes work their way through the economic system their final effects will differ substantially from their first-round effects. These 'general equilibrium' effects are liable to differ from - possibly to contradict - the intended results from a policy change. Thus, a devaluation may leave the currency even more over-valued if it sets off an inflationary spiral; or much of the value of a subsidy intended to protect the poor may end up in the pockets of the not-so-poor.

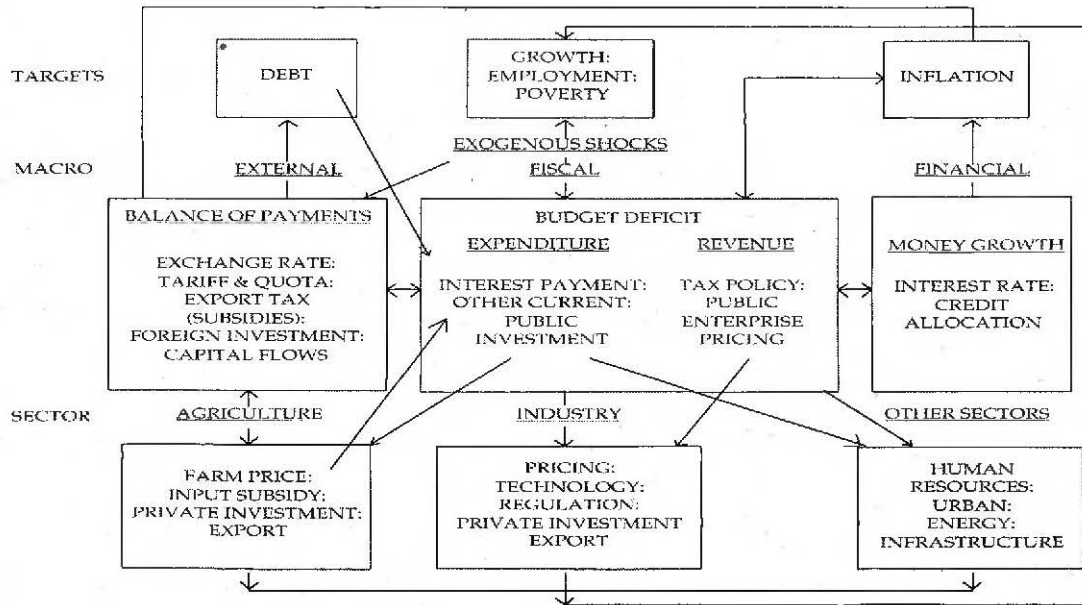
As is illustrated in Figure 1.1, another aspect of this complexity is that, as the effects of a policy change work their way through the economy, this will call for changes in other policy instruments. Thus, a liberalisation of interest rates may discourage investment in priority sectors, e.g. agriculture, requiring policies with respect to taxation or state provision of supporting services to be re-examined.

Policies, in other words, are best viewed as a whole. However, to do this requires levels of information and sophistication among policy-makers and their advisers which will not always be available. This has also become evident in Eastern Europe, where the economy has been so distorted (judged by the standards of Western market principles) for so long that policy-makers have very little idea about which enterprises, or even sectors, are viable. Accurate knowledge on these points - and on the likely consequences of adjustment measures - is required for prudent decision-making on many reform items.

In the absence of such capabilities, however, there is a real risk that specific measures will be ineffective, or may even produce perverse results. In developing country circumstances, many have been over-confident about the effectiveness of adjustment measures because they paid inadequate attention to the complexities of the task. In Eastern Europe, similarly, a tendency to underplay implementation problems is another potent reason for over-optimism about outcomes. An East European example is the ignorance in which policy-makers are operating about the potential viability of state enterprises and the desirable extent of import



**Figure 1.1**  
**The interaction of adjustment policies**



Source: World Bank, 1988, p.34.

liberalisation to reduce levels of protection against competing goods from abroad.

Difficulties of two types have arisen. Those charged with the execution of a policy are sometimes simply overwhelmed by the informational and administrative demands which it creates. More sinisterly, those responsible for, or influential in, the administration of a measure sometimes deliberately set out to thwart the intentions of policy-makers because they see their interests as threatened or for other reasons do not agree with it.

In the first category, tariff and other tax reforms too complicated to enforce, requiring unmanageable amounts of information and much scarce manpower to execute, provide obvious examples. Developing country examples in the second category include import liberalisations which threaten to reduce the income which customs officials can collect through bribery; agricultural services intended to benefit poor smallholder farmers that are captured by well-to-do élites; credit institutions intended to encourage small-scale business which channel much of their funds to larger businesses. It is often in the implementation phase that groups or individuals can influence who gains or loses by a measure; the administrative process can thus become an arena in which special interests are pursued, with an obvious risk to the intentions of the policy-makers.

The relevance of these considerations is clear in Eastern Europe. As an example of lack of realism, in Bulgaria the government promised in 1990 a comprehensive transformation to a social market economy by the end of 1991, but progress is lagging far behind despite a renewed commitment to reform from the coalition that took power in December 1990. The second problem - deliberate foot-dragging - is perhaps most notable in Romania, but it is a problem to be contended with throughout Eastern Europe. One of the key issues in the Polish presidential election of 1990 was the speed at which the bureaucracy - the *nomenklatura* - should be stripped of its powers.

Reformers therefore need to be aware of the interests and motives of those who will be involved in implementation. A measure that cuts against their interests may be doomed unless special care is taken. This point is of particular relevance because adjustment programmes incorporate the substitution of market measures for administrative controls and discretionary power. At

the least, civil servants are liable to see such changes as reducing their power and influence; they may well also see them as diminishing their ability to augment their incomes, or as threatening their job security.

In other words, there are particular difficulties in the way of successfully implementing liberalisation measures. It is no surprise, then, that in Hungary (and elsewhere) workers in inefficient industries are lobbying against liberalisation and the removal of existing subsidies. On the other hand, such measures will, once in effect, place fewer demands on the public administration: compare the bureaucratic needs of wide-ranging import controls with those of an active exchange-rate policy.

For similar reasons, experience has shown that institutional reform is particularly problematic and slow because of conflicts between what the reforms are trying to achieve and the interests of those who man or control the institutions. The special difficulty of institutional reform is one of the strongest lessons emerging from successive World Bank evaluations of their experiences with structural adjustment programmes. Governments, or those responsible for particular agencies, have proved themselves adept at evading changes which they do not wish to make. This is a sobering lesson in the East European context, where the requirements for institutional change are so comprehensive, albeit against a more favourable political background.

### **The relationship of stabilisation and structural adjustment**

Questions of sequencing have not featured much in traditional research on economic policy and, in any case, the desirable sequence is apt to vary according to the specific circumstances of each country. However, one or two tentative generalisations can be suggested from developing country experiences.

The chief of these is that an adjustment programme is unlikely to succeed well in the presence of rapid inflation, acute balance-of-payments difficulties and other large macroeconomic disequilibria. When the initial situation is one in which there are large macro imbalances the rule should be to stabilise first. By reducing uncertainty, macro stability encourages confidence in the future and long-term investment. It is necessary for rational planning and policy-making in both public and private sectors. Markets work better and policy signals have greater credibility in the absence of

rapid inflation and other symptoms of large macro imbalances. Policies for raising the efficiency of the industrial and other productive sectors will be stymied by inflation and import shortages. Inflation can undermine the effectiveness of balance-of-payments measures and instability brings major dangers to any liberalisation of the financial system. Severe balance-of-payments problems (including indebtedness) can result in the economy being starved of the imported inputs needed for the improved levels of capacity utilisation and capital formation that are essential for export expansion and adjustment success.

As noted earlier, macroeconomic imbalances are manifest in the countries of Eastern Europe. Despite displaying many of the symptoms of recession, almost all of them have inflation rates far above those in Western Europe (the unweighted mean in 1990 was 62%). Most of them are experiencing acute balance-of-payments difficulties, aggravated by the swollen cost of oil imports as a result of the USSR's switch to trade in hard currencies at world market prices and by the collapse of CMEA trade.

This combination of Eastern Europe's current disequilibria and the conventional wisdom from developing countries strongly favours a 'stabilisation first' approach. Poland took the plunge in a dramatic fashion, but it is essentially the path towards which all the East European countries are orienting themselves, even though their progress along it varies widely. As in many developing countries, the key to improved macroeconomic management in Eastern Europe probably lies with reducing public sector deficits, improving fiscal discipline by making budgetary constraints 'bite' and comprehensively reforming the tax system.

However, developing country experience shows that tensions can arise between demand-management stabilisation programmes and more supply-oriented structural adjustment programmes. These occur as a result of differences in the requirements for programme success in respect of three variables: import levels, volumes and terms of domestic credit, and government expenditures on economic services and/or capital formation. In principle, there is no inevitable contradiction in these requirements.

They can be reconciled, depending on: the amount of external finance available in support of the programmes and, therefore, the period of time over which macroeconomic balance must be achieved; the respective priorities placed upon the short-term

stabilisation and longer-term adjustment objectives; and the range of effective policy instruments available to the government. The first - finance and time - is often the crucial determinant. In a world in which supporting finance is scarce, it has happened in all too many developing countries that longer-term adjustment has had to take second place to short-term stabilisation. In turn, this has undermined the sustainability of the process. The reformers of Eastern Europe - and their Western backers - will have to be sensitive to the trade-offs confronted in this area and the delicacy of striking the best balance.

### **Liberalisation**

The issue of sequencing has been most studied in connection with trade liberalisation. This literature again points to a 'stabilisation first' approach, if only to ensure that exchange-rate policies are not undermined by inflation, so that devaluations stick in real terms. It goes beyond this, however, to favour the liberalisation of domestic factor markets as a precondition of successful trade liberalisation; otherwise export and import-substituting producers will be unable to take adequate measures to become internationally competitive. The literature also urges that liberalisation of capital movements - the logical extension of trade liberalisation - should come last because of the danger that premature liberalisation could spark large-scale capital flight or other destabilising capital movements which, through their influence on the exchange rate, could undermine trade liberalisation.

The literature also provides pointers concerning the liberalisation of the financial sector. There are a number of examples where this has gone seriously wrong (e.g. Chile and Turkey) because the preconditions for success did not exist. In conditions where markets either do not exist or are seriously imperfect (as in Eastern Europe), experience indicates that liberalisation must be cautious even though this may itself retard financial deepening. Until policies for regulation, competition and institutional promotion are in place, interest-rate, deposit and credit controls are likely to be needed. Premature liberalisation without safeguards and institutional diversity may have little positive effect on savings and investment. It may bring severe side-effects, including the risk of a financial crisis. And it may have adverse knock-on effects on monetary control and economic

stability. The risks are particularly severe when the banking system is carrying a large volume of bad or dubious debts on its books, as is the case in most, if not all, of the East European states. In this circumstance financial liberalisation needs to be proceeded with only cautiously.

### **Protecting the vulnerable**

Stabilisation and structural adjustment involve reallocating resources from the production of non-tradeables to tradeables through major changes in relative prices. As in Eastern Europe, it often requires a shift in the composition of employment from public to private. It involves the liberalisation of price and wage controls, and the elimination or reduction of budget subsidies. It usually involves the reduction of consumption and other expenditures ('absorption') relative to income.

Obviously, then, adjustment is likely to bring major changes in the distribution of income. Experience suggests that these are liable to endanger the living standards of various poverty groups, especially unskilled urban workers, through unemployment and cuts in food subsidies and other welfare provisions. This is pertinent to Eastern Europe.

The region is also showing increasingly that it shares another relevant characteristic with developing countries: the importance of ethnic considerations in distributing the burden of adjustment. The break-up of Yugoslavia and the USSR is well-known, but a tension is also developing between the Czech and Slovak regions, whilst ethnic conflicts are not far below the surface in some of the other East European states such as Hungary. The effect of such considerations is to divert attention away from 'protecting the vulnerable' as a policy objective.

Whilst there is no comparison between the levels of absolute poverty in the two groups of countries, the experience of developing countries in attempting to cope with the problem does have a relevance for Eastern Europe, for it illustrates how government policies can influence the impact on the distribution of income even under very difficult circumstances. While the truly poor are notoriously difficult to reach through official measures, if the political will exists there are things that can be done by measures which: increase the access of the poor to productive assets; raise their returns from the assets they already possess; improve their

employment opportunities; improve their access to education and health services; and supplement their resources with targeted transfers.

Policy can be brought into play at all these levels, and one fundamental principle is that measures to protect the vulnerable need to be integrated into the design of adjustment programmes, rather than being added on as supplementaries. This is a lesson that has apparently been applied in Hungary, and is under debate in Czechoslovakia. In recent years there has been growing interest in greater co-operation between governments and non-government (mainly charitable) organisations as a more cost-effective way of reaching poverty groups. Since the promotion of NGOs is widely seen (at least among donors) as a step towards the creation of a middle class, there would seem to be scope for Eastern Europe to utilise some Third World experience.

However, there can be trade-offs between measures to protect the poor and the adjustment of the economy. The administrative and informational costs of targeted welfare programmes, for example, are potentially high, and fiscal constraints may impose a choice between maintaining government social and economic services. In Hungary, for example, expenditure on social services reached an estimated 50% of the budget (and 30% of GDP) in 1990.

In short, the problem of trade-offs is a real one, although this is not a reason for inaction but for the careful design of programmes to minimise costs and maximise benefits. Perhaps one of the advantages of Eastern Europe in this connection is that there may be less tendency to blame the hardships on the adjustment programme, and a wider acceptance that it is the ill-chosen policies of the preceding era which are the chief culprit. However, it would be wise not to bank too much on this. The Polish presidential election campaign of autumn 1990 suggested that the liberal élite had failed to carry the public with it, and the low turnouts for elections in both Poland and Hungary indicate disillusionment with political processes.

### **The role of the state**

Among the dangers of developing country adjustment programmes is that ideological enthusiasm may lead to a 'reaction too far' against the state as an economic agent. Experience suggests that



the state needs to remain a large and active participant in the economic system.

For one thing, market failures must be expected to remain widespread even after successful adjustment (and even more so in most East European countries where there is so little recent tradition of enterprise and competition). We must anticipate the continuation of substantial monopoly powers (e.g. in the industrial and financial sectors), information failures and incomplete markets. External diseconomies (e.g. in environmental pollution) will remain an important source of difficulty. There will be a range of public goods which the nascent private sector cannot be expected to produce efficiently, if at all, but which may be neglected in a rush of enthusiasm about the efficiency of markets.

One particularly important task for the state during adjustment is to provide the infrastructural investments and institutional framework that will stimulate private sector investment and production. Similarly, where financial markets are highly imperfect, strengthened state supervision and interventions in favour of greater competition are necessary preconditions for financial liberalisation.

A further lesson from developing countries is that there are many pitfalls in the way of a successful programme of extensive privatisation (i.e. state divestiture) and that progress in this area is usually slow. The objectives of privatisation are sometimes unclear and conflicting: in the East European context, is it to mobilise resources or to distribute assets equitably, or to raise efficiencies? There are problems with the saleability of many enterprises, particularly in the absence of well developed capital markets. The fine details of each divestiture must be carefully planned - but bureaucratic opposition is apt to be fierce. Adverse effects on income distribution may not be well tolerated.

When, as in Eastern Europe, public enterprises are monopolies, expectations that final consumers will benefit from improved efficiency are liable to be disappointed unless the privatisation is undertaken in ways that create more competition - to which reduced levels of protection from competing imports will often hold the key - and unless the economy-wide economic and policy environment is a supportive one. In Eastern Europe the essential task is to tackle the problem of monopoly and there are few grounds for predicting major benefits when public monopolies are



merely replaced by private ones, whether or not foreign capital is involved.

Without question, given the dominance of large monopolistic state enterprises in the productive systems of most East European countries, extensive privatisation is desirable. But developing country experiences suggest that expectations of rapid beneficial progress in this area would be naïve. In this regard, there is much to be said in favour of suggestions for undertaking this in stages, with state enterprises initially transferred to holding companies which can then divest themselves of enterprises in a gradual, carefully planned manner. This permits divestiture to be concentrated initially on those enterprises where a change of ownership is critical to the success of the transformation exercise and where it can result in meaningful increases in competition.

Developing country experience points finally to another conclusion in this area: that it is important not to confuse reductions in the size of the state with changes in the modalities of state intervention. Both are needed in Eastern Europe. But it is easy to overlook the fact that much of what is involved in adjustment programmes is not so much to reduce the role of the state as to switch state interventions from administrative controls and other anti-market forms to other instruments, such as the use of the exchange rate or tax inducements, which operate through, and harness, pecuniary incentives.

### **Political leadership**

Implicit in the foregoing is the view that the quality of policies is paramount for successful economic adaptation. So, therefore, are the political processes - and the underlying distribution of power - from which policy choices emerge. It is also implicit that the process of adaptation is likely to be long-term and painful, which raises questions about the sustainability of the process - again a highly political question.

The politics of adjustment in developing countries is becoming an increasingly well-studied area and the conclusions arrived at point to important advantages among most East European countries. In determining whether governments can manage the process of change successfully the initial situation is very important: how bad things have become, how widely the existence of a problem has become recognised, and who is blamed for the mess.

There are times in a country's economic life when things have to get worse before they can get better; if the situation gets bad enough even the most conservative or timid government may begin to see change as being in its own interests. Even more frequently, perhaps, a new government is swept to power on a wave of economic discontent - as happened in most of Eastern Europe. Even within Eastern Europe, however, there are gradations in the 'newness' of the current regimes. Poland and Czechoslovakia are at one extreme, where there has been a clean sweep of the political leadership (although not of the bureaucracy), and Romania is at the other (where there is some suggestion that the downfall of the Ceausescu regime was simply a previously planned putsch organised by other factions within the communist élite).

The East European tendency for a deteriorating balance of economic costs and benefits to set up countervailing pressures for political change is, in fact, a strong finding of the most substantial study so far undertaken of the politics of adjustment in developing countries [Nelson, 1989:11-12]:

Among those governments pursuing particularly far-reaching programs of economic reorientation in the 1980s (plus a few cases from the 1970s), most share important political features. Consider Chile after 1973, Sri Lanka from 1977 to the early 1980s, Turkey and Jamaica since 1980, Ghana since 1983, and the Philippines since 1986. All of these countries had suffered long periods - in Ghana's case, two decades - of economic stagnation or decline or of deepening financial crisis, coupled with increasingly widespread political alienation and/or polarisation and violence. In each, in the years noted ... a new government took office, elected with overwhelming majorities in Sri Lanka, Jamaica and the Philippines; and taking power in military coups but with considerable or sweeping public support in Chile, Turkey and Ghana. In all of these countries, there was clearly widespread support - indeed *demand* - for major changes, although there were deep divisions in every case regarding the nature of the needed reforms.

What the last sentence implies, however, is that successful reform is likely to need more than a favourable cost-benefit balance. The author goes on (p.12) to write of the need for a *reform syndrome*:

Leaders firmly committed to major change, widespread public acceptance or demand for such change, new governments with strong centralized authority, and a disabled opposition constituted the political context for determined adjustment efforts.

The quality of leadership is a factor that she emphasises. This includes a willingness on the part of the head of government and his colleagues to influence and prepare public opinion; to initiate change; to exhibit shrewdness in the phasing of policy changes, to avoid upsetting too many groups at once and to keep potential opposition groups isolated from each other; and a willingness to offer compensation to those who may lose from the reforms and who could make political trouble.

Within Eastern Europe a clear division of political opinion has emerged over the vigour with which vested interests may be confronted. In Czechoslovakia, for example, opinion is divided between President Havel, on the one hand, who wants to avoid excessive social and political stress, and Minister of Finance Vaclav Klaus, on the other, who wants to proceed rapidly with economic reform. In Poland one of the issues between Lech Walesa and the former Mazowiecki government concerned the vigour with which the former party apparatchiks should be removed from positions of influence.

Other writers have similarly argued that authoritarian governments are necessary for the sustained execution of adjustment programmes. But this should be qualified by the consideration that the power of a government to implement and gain acceptance of its policies will be influenced strongly by its legitimacy - an acceptance by the general public that it has a proper claim to exercise authority, derived from some constitutional or other principle. Authoritarian governments, often military, tend to be short on legitimacy.

In fact, the evidence on the relationship between regime-type and ability to implement major programmes of policy reform is inconclusive. Indeed, it is not even clear that regime-type is a key determinant. Some dictatorships are weak, some democratic governments are strong. But a government which is in constant fear of overthrow, governing within a system which does not have deep roots in the loyalties of the public, whether or not it is

democratically elected, is unlikely to win prizes for persisting with unpopular policies.

One further conclusion derived from empirical research sounds a particularly ominous warning for Eastern Europe. Based chiefly on evidence from Latin America, it concerns relationships between political systems and the execution of adjustment policies: *new democracies find it particularly difficult to sustain adjustment policies.*

The last two of the 'lessons' listed earlier - the role of external support and the importance of the policy environment - are taken up in the final pages of Chapter 2.

## 2

## The Implications for Developing Countries

*Christopher Stevens*

It is clear from Chapter 1 that the countries of Eastern Europe face many obstacles in their path from centrally planned to free market economies. Their success in overcoming them, and the pace of the transition, are uncertain. Because of this, identifying the potential impact on developing countries of the changed political system in Eastern Europe is highly speculative. Much depends upon the speed as well as the direction of the changes. Nonetheless, it is possible to identify in broad terms some of the more likely potential positive and negative effects, the circumstances that influence their probability, and the developing country groups that could be affected. It is also possible to draw lessons for Eastern Europe from developing country experience on aid administration.

While, in the long term, growth in Eastern Europe is likely to be a positive-sum game benefiting most parts of the world, in the short to medium term there are likely to be both positive and negative effects. These will include both trade creation and trade diversion, increased global demand for savings, and a potential diversion of OECD resources that may affect developing countries whether or not this is dubbed as 'aid'. The trade creation and diversion effects are likely to be the most pervasive and complex in the early stages. They may include increased competition on OECD markets (especially the European Community) from East European exports, increased demand in Eastern Europe for primary products from developing countries, and a shift in demand in Eastern Europe away from imports from those developing countries which used to engage in barter trade in favour of other sources, possibly other ldc's.

## Trade Diversion

There are two reasons to anticipate some diversion of trade away from developing countries towards Eastern Europe. The first is that economic reform is expected to increase the competitiveness of some of Eastern Europe's exports. The second is that, in responding to the political changes in Eastern Europe, the OECD states are in the process of elevating some countries in the region in their hierarchy of trade preferences - the 'pyramid of privilege'. Whereas generalised trade liberalisation may be a positive-sum game, partial liberalisation tends to be a zero-sum game since it largely redistributes the economic rent arising from a protectionist restriction of supply.

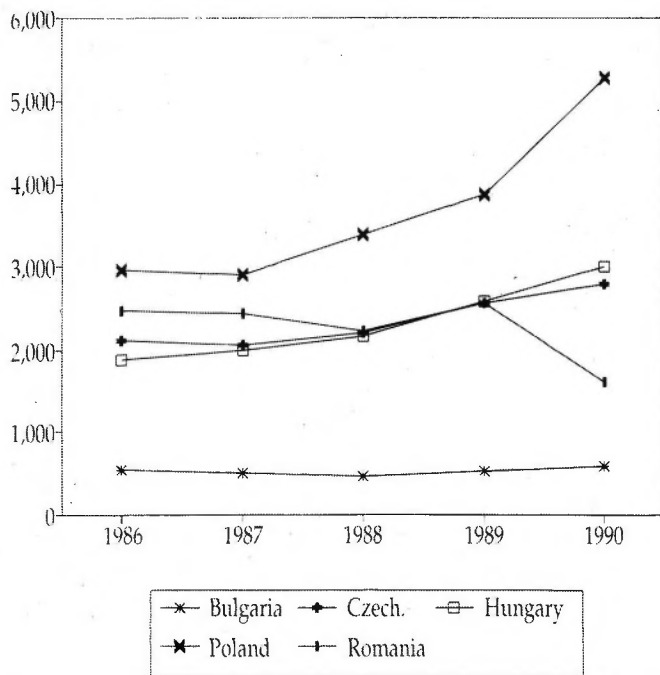
### Competitiveness

On the whole, Eastern Europe's exports to the European Community stagnated or declined during the second half of the 1980s (Figure 2.1). Only Hungary and Poland saw their exports increase in current value terms at an average annual rate that was faster than the growth of total EC imports from outside the Community (by 16% and 12% respectively compared to the extra-EC average of 8%).

The distribution of exports between broad commodity groups varies among the countries, although manufactured goods classified by material is the most important category for both Czechoslovakia and Poland and the second most important for Hungary (Table 2.1). Czechoslovakia's top three categories are all manufactured goods, whereas for both Hungary and Poland food is also significant. In terms of market shares the picture is broadly similar. Czechoslovakia's share of EC imports is greatest in manufactured goods classified by material, which is also the commodity group in which Poland has the second highest import share after food. Hungary's share of EC imports is also highest for food, followed by two of the manufactured good categories.

At this highly aggregated level, the region's main competitors on the EC market include Brazil, Argentina, Thailand, India, China, Turkey, Taiwan and South Korea. These are all significant suppliers in the product categories of most importance to Eastern Europe. The picture becomes clearer if data on imports are disaggregated to more specific product categories (Table 2.2). Of

**Figure 2.1**  
**EC imports from Eastern Europe, 1986-90**  
 (Ecu m.)



the 30 most important East European exports to the EC in 1989, the top 7 were relatively unprocessed raw materials and of the remainder 5 were basic engineering products and 5 were in the clothing/footwear categories. For clothing/footwear, Eastern Europe's principal competitors were the countries of the Mediterranean and East Asia.

Agriculture's recent contribution to the trade balance has been very mixed. Statistics are difficult to interpret because of the use of the transferable rouble and multiple exchange rates for intra-CMEA trade but, with this caveat, the data in Table 2.3 show positive trade balances in all the countries. Agricultural exports denominated in hard currencies are a very significant component

**Table 2.1**  
**Imports, January-December 1990**  
 (Ecu '000)

	<i>Eastern Europe</i>	<i>Bulgaria</i>	<i>Czechoslovakia</i>	<i>Hungary</i>	<i>Poland</i>	<i>Romania</i>
Food	2,104,773	93,887	180,358	603,231	961,925	-
Beverages and tobacco	112,267	43,645	13,442	15,490	5,734	7,181
Crude materials	2,614,210	46,544	291,167	221,622	481,737	33,650
Fuel products	10,471,042	38,282	155,063	84,479	545,888	395,970
Oils, fats and waxes	43,465	1,291	5,838	12,144	10,077	73
Chemicals	2,049,004	62,461	306,427	285,789	452,243	53,234
Manufactured goods classified by material	5,323,900	128,396	909,714	618,787	1,213,642	308,333
Machinery and transport equipment	2,558,333	69,622	465,695	487,655	599,211	120,672
Miscellaneous manufactured articles	2,978,263	88,816	391,522	627,035	872,571	660,041
Goods not classified elsewhere	3,018,269	20,016	66,654	48,249	134,820	9,551

Source: Eurostat.



**Table 2.2**  
**The 30 most important industrial products<sup>a</sup> imported by the EC from East European countries**  
**and their main competitors<sup>b</sup>, 1989**

<i>CN</i>	<i>Product</i>	<i>% Share of imports<sup>c</sup></i>	<i>Three most important competitors</i>
2710	Petroleum oils other than crude	19.83	Kuwait, Libya, Algeria
2709	Petroleum oils; crude	14.02	Libya, Saudi Arabia, Iran
4407	Wood sawn lengthwise; thickness exceeding 6 mm	4.09	Canada, USA, Malaysia
2711	Petroleum gases and other gaseous hydrocarbons	2.97	Algeria, Saudi Arabia, Libya
7502	Unwrought nickel	2.90	Canada, Zimbabwe, USA
7403	Refined copper and copper alloys; unwrought	2.30	Chile, Zambia, Zaïre
2701	Coal; briquettes and solid fuels made from coal	2.19	USA, Colombia, Canada
8703	Motor cars etc. for the transport of persons	2.19	USA, Brazil, Yugoslavia
9403	Other furniture, parts thereof	1.64	Yugoslavia, Taiwan, USA
7102	Diamonds; not mounted or set	1.60	India, Liberia, Israel
7208	Flat-rolled products of iron; hot rolled	1.36	USA, Brazil, Turkey
7601	Unwrought aluminium	1.25	Ghana, Yugoslavia, Brazil
6204	Women's/girls' suits, breeches, shorts, etc.	1.13	Hong Kong, Yugoslavia, Turkey
6203	Men's/boys' suits, breeches, shorts, etc.	1.11	Hong Kong, Yugoslavia, Tunisia
7204	Ferrous waste and scrap	1.03	USA, Yugoslavia, Canada
5201	Cotton; not carded or combed	0.97	USA, Pakistan, Turkey
2902	Cyclic hydrocarbons	0.95	USA, Canada, Brazil
7108	Gold (unwrought/semi-manufactured/powder form)	0.94	Canada, USA, Zimbabwe

*(continued/...)*

**Table 2.2 (continued)**  
**The 30 most important industrial products<sup>a</sup> imported by the EC from East European countries**  
**and their main competitors<sup>b</sup>, 1989**

CN	Product	% Share of imports <sup>c</sup>	Three most important competitors
4703	Chemical wood pulp; soda; non-dissolving	0.94	Canada, USA, Brazil
9401	Certain seats	0.80	Yugoslavia, USA, Taiwan
6403	Footwear with uppers of leather	0.71	South Korea, Brazil, Taiwan
2844	Radioactive chemical elements and isotopes	0.68	USA, Niger, Canada
2707	Oils; other products of high temperature coal tar	0.63	USA, Libya, Yugoslavia
7216	Angles, shapes, etc. of iron/non-alloy steel	0.54	Yugoslavia, Turkey, Egypt
7202	Ferro-alloys	0.45	New Caledonia a. dep., Dominican Republic, Yugoslavia
6202	Women's/girls' overcoats, wind-jackets, etc.	0.45	Yugoslavia, South Korea, China
6201	Men's/boys' overcoats, wind-jackets, etc.	0.43	Hong Kong, South Korea, China
3102	Mineral or chemical fertilisers; nitrogenous	0.40	USA, Nigeria, Yugoslavia
7207	Semi-finished products of iron/non-alloy steel	0.39	Brazil, Mexico, South Korea
4412	Plywood, veneered panels and similar wood	0.39	Indonesia, USA, Brazil

*Notes*

- (a) 4-digit positions of the goods classification of the Combined Nomenclature (CN).  
 (b) Only developing countries, USA and Canada.  
 (c) Share in total supplies of industrial goods by the respective country.

Source: Möbius and Schumacher, 1991.

**Table 2.3**  
**Agricultural trade as a share of total trade and trade balance**  
**in agricultural products (including processed products), 1989**  
 (% and US\$ or roubles m.)

	Exports	Imports	Trade balance <sup>a</sup>
<b>Non-socialist countries</b>			
Poland	19.9	19.9	173
Hungary	14.3	10.7	550
Romania	3.8	2.2	151
Bulgaria <sup>b</sup>	24.6	6.2	43
<b>Socialist countries</b>			
Poland	4.6	4.4	109
Hungary	13.5	2.3	557
Romania	4.9	1.0	176
Bulgaria	na	na	na

*Notes*

- (a) US\$ for non-socialist country trade, roubles for socialist country trade;  
 (b) OECD.

of total exports for all except Romania, which gave priority to its trade links with the CMEA bloc and to trade in industrial goods.

These data give only a snapshot of trade in agriculture for one year. Over recent years the evolution of trade has not followed any consistent pattern. Polish exports to the West were very buoyant over the 1980s. In dollar terms agricultural exports (including processed goods) have expanded by 49% since 1986 - though from a low base - while imports have risen by 45%. On the other hand, Hungarian exports have tended to stagnate after doing well in the first half of the decade. Bulgarian exports of agricultural goods to the OECD countries grew in dollar terms by nearly 30% and imports by 95% between 1984 and 1987.

The share of the agricultural sector amounts to about 20% of total output in Poland, Hungary, Romania and Bulgaria. Labour productivity tends to be somewhat, but not greatly, below that in the non-agricultural sectors, except in Romania where the shortfall

in output per worker is very significant. But managerial inefficiencies, lack of entrepreneurship and much lower inputs of working capital (fertilisers, pesticides) have resulted in arable yields in East European agriculture considerably lower than those in the more efficient of the Western producers. Much could be achieved by improving management on existing farms (perhaps by profit-sharing schemes), converting collective farms into individual holdings or co-operatives and other reforms of administration and tenure. Low yields could also be raised through higher inputs of working capital, in particular pesticides, fertilisers and feed additives.

Hence, it is reasonable to expect that in all except possibly Czechoslovakia the agricultural sector is the one most likely to produce an exportable surplus in the short term. The scale of this is uncertain because much of the produce formerly traded within the CMEA is of a quality that could not compete in Western markets. Much will depend, therefore, on the ability of the production and distribution system to upgrade the quality of output. Nevertheless, given the scope for small-scale private activity in this sector, the chances of early success appear to be greater than for many of the manufacturing and industrial units oriented to produce goods that have no market outside the CMEA.

Eastern Europe's industrial exports to the EC totalled \$10.8 bn in 1989. Hungary, Czechoslovakia and Poland were the top three traders on the East European side, with West Germany, Italy and France most involved on the Community side [Möbius and Schumacher, 1991]. The trade was mainly an exchange of investment goods and chemical products for intermediate and consumer goods. In this respect, it has similarities to EC trade with developing countries. In terms of skill intensity, the East European countries rank broadly between the OECD states and the developing countries: the skill intensity is higher on Eastern Europe's imports than on its exports, although the disparity is not as marked as is the case with developing countries [Möbius and Schumacher, 1991].

Because of the gross distortions which occurred during the centrally planned era, it is far from clear which existing East European exports will remain competitive and what new exports might emerge. However, on the basis of past flows and current expectations of competitiveness, it would appear that within the

industrial and manufactures sectors the sub-sectors in which Eastern Europe's continued competitiveness is most in doubt are machinery and equipment and other capital goods; those in which the outlook is more promising include light manufactures and assembly.

If these perceptions are applied to the analysis of recent trade data, they suggest that the products of most intense competition in the short term between Eastern Europe and developing countries will be footwear and clothing (together with agricultural products). In 1988, four of the East European states accounted for 6% of EC imports from outside the Community of footwear (CN 64). For some sub-sectors of clothing, their share has been even higher. In the case of category CN 5515 (other woven fabrics of synthetic staple fibres), Czechoslovakia alone accounted for 10% of EC imports from outside the Community in 1988, whilst the other four East European states accounted for a further 5%. In another miscellaneous clothing category (CN 62) the five East European countries accounted for 9% of EC imports in 1988.

As these figures show, an East European challenge to developing country dominance in these products is not imminent. Much can happen over the coming years that could lead to a reduction rather than an increase in such import shares. However, third parties should observe the process of restructuring in Eastern Europe with such possibilities in mind, in order to monitor progress and to identify both sources of future potential competition and opportunities for investment.

### **Trade policy**

Trade policy changes in OECD markets will be important because Eastern Europe's exports have tended to be of goods for which protectionism is high, and because the region has been near the base of the hierarchy of trade preferences in Western markets. Hence, there is scope for changes in Western trade policy to result in significant improvements in the competitiveness of East European exports.

The task of assessing the incidence of protection on East European exports is not straightforward. Attempts have been made to compare the tariff rates applying to East European exports with those applicable to imports from other countries. In Table 2.4 this exercise is done for imports into the European Community from

**Table 2.4**  
**EC tariffs applied in 1983 against groups of exporters**  
 (%)

SITC	Description	OECD	Soc.	Ldc	Med.
All	Total trade	3.2	2.7	2.1	1.9
00	Live animals	0.6	4.6	5.6	5.4
01	Meat and preparations	13.2	9.5	14.3	14.2
02	Dairy products and eggs	11.1	3.3	1.9	12.0
03	Fish and preparations	6.8	12.7	11.5	10.2
04	Cereals and preparations	0.0	0.0	0.0	0.0
05	Fruit and vegetables	7.1	13.0	9.7	5.7
06	Sugar, preparations and honey	27.0	26.6	25.9	15.2
07	Coffee, tea, cocoa, spices	1.9	2.8	2.5	3.5
08	Animal feeding stuff	0.1	0.3	2.3	0.6
09	Miscellaneous food preparations	10.7	7.3	14.2	1.5
11	Beverages	7.1	21.3	22.4	16.7
12	Tobacco and manufactures thereof	66.1	48.7	45.5	70.0
21	Hides, skins, inc. fur, undressed	0.0	0.0	0.0	0.0
22	Oil seeds, nuts, kernels	0.0	0.0	0.0	0.0
23	Rubber, crude, synthetic	0.0	0.1	0.0	0.1
24	Wood, lumber and cork	0.1	0.0	0.1	0.0
25	Pulp and waste paper	0.0	0.0	0.0	0.0
26	Textile fibres (not yarn, thread)	0.6	1.6	0.6	0.1
27	Crude fertilisers and minerals	0.0	0.2	0.0	0.0
28	Metalliferous ores, metal scrap	0.0	0.0	0.0	0.0
29	Crude animal veg. materials nes	3.8	0.8	2.7	7.9
32	Coal, coke, briquettes	3.0	2.8	2.7	1.8
33	Petroleum and petroleum products	0.4	0.6	0.2	0.4
34	Gas natural and manufactured	0.6	0.1	0.1	0.1
35	Electric energy	0.0	0.0	0.0	0.0
41	Animal oils and fats	0.6	2.4	0.2	0.7
42	Fixed vegetable oils and fats	9.9	7.4	6.5	8.4
43	Processed animal, veg. oil and fats	9.3	0.7	9.5	0.1
51	Chemical elements and compounds	3.2	4.1	4.0	3.6
52	Mineral tar and crude chemicals	0.1	0.8	0.3	0.1
53	Dyeing, tanning & colouring matrls	2.5	8.8	3.9	3.4
54	Medicinal & pharm. products	2.5	5.7	5.0	3.6
55	Essential oils & perfume matrls	2.5	0.7	1.6	1.1
56	Fertilisers manufactured	2.4	3.6	4.1	3.0
57	Explosives, pyrotech. products	3.1	5.7	5.4	2.3

(continued/...)

**Table 2.4 (continued)**  
**EC tariffs applied in 1983 against groups of exporters**  
 (%)

SITC	Description	OECD	Soc.	Ldc	Med.
58	Plastic materials etc.	5.6	12.5	8.7	3.6
59	Chemicals nes	3.3	5.2	4.0	0.9
61	Leather/furs inc. manufactures	1.2	3.7	2.8	3.2
62	Rubber manufactures	2.3	6.6	4.3	2.9
63	Wood and cork manufactures	2.8	8.3	5.9	4.2
64	Paper/board and manufactures	2.6	8.9	6.7	6.3
65	Textile yarn, fabrics & articles	3.2	10.1	7.6	3.0
66	Non-metallic mineral manufactures	2.0	4.2	1.1	0.7
67	Iron and steel	1.7	5.8	3.3	3.8
68	Non-ferrous metals	0.8	0.5	0.5	3.1
69	Metal manufactures nes	2.5	5.3	4.9	2.5
71	Machines non-electric	3.3	5.5	3.9	2.4
72	Machinery electric	5.7	6.2	7.0	3.5
73	Transport equipment	4.8	8.9	3.4	6.0
81	Sanitary, plumbing, heating, lighting equipment	0.9	6.8	4.7	4.3
82	Furniture	0.9	6.6	5.4	4.2
83	Travel goods, handbags	3.3	5.1	4.3	4.2
84	Clothing	2.1	10.5	9.3	5.4
85	Footwear	0.7	9.6	9.1	5.9
86	Prof. scientific etc. instruments	6.2	6.9	4.4	1.5
89	Miscellaneous manufactures nes	4.9	6.0	5.0	2.4

*Notes*

Missing values implies no imports in these categories.

Soc. 'Socialist' countries of Asia and Eastern Europe plus the USSR and Cuba, excluding China and Hungary.

Med. Mediterranean countries, not elsewhere included.

Ldc Developing countries, not elsewhere included, including China.

OECD OECD countries, including Spain and Portugal, excluding Turkey.

Source: Tovas and Laird, 1991.

the socialist countries, all developing countries, the Mediterranean states and the OECD.

The figures suggest that overall the barriers faced by Eastern Europe are higher than those faced by developing countries and the Mediterranean states, although the disparity is not great. However, these figures apply only to the common external tariff of the EC and do not take account of preferential trade arrangements. Since the latter are highly complex [see, for example, Mishalani *et al.*, 1981; Pomfret, 1986] it is not practical to make detailed comparisons between Eastern Europe and developing countries except on a product-by-product and country-by-country basis, but their general effect will have been to increase the relative barriers facing socialist exports.

Moreover, East European exports of sensitive goods face a range of non-tariff barriers in the EC market (Table 2.5). The socialist countries generally faced more NTBs than did developing countries, with the disparity being particularly marked in relation to the Mediterranean states. Furthermore, these country group averages conceal a wide range. The proportion of East European imports to the EC subject to special Community-level NTBs in 1987 ranged from 12% for Poland and Czechoslovakia to 17% for Hungary [Möbius and Schumacher, 1991:11]. Although this was a smaller proportion than applied to the most discriminated-against developing countries - such as Thailand (50%), Hong Kong (38%) and Pakistan (37%) - it was much higher than applied to most Mediterranean and Latin American states.

The sectors most heavily protected in the Community were textiles and agriculture, i.e. those of great potential interest to Eastern Europe. Within agriculture, the heavily protected sub-sector of most interest to Eastern Europe was animals/animal products (with 37% of Bulgaria's and 16% of Hungary's exports covered). Other protected sectors included precision and optical instruments (12% of Poland's and 22% of Czechoslovakia's exports covered) and chemicals (12% of Romania's exports covered) [Möbius and Schumacher, 1991].

Eastern Europe's exports have also faced NTBs in some EC member state national markets. Quantitative restrictions have been especially common, and there is evidence that they have constrained the volume of exports [Möbius and Schumacher, 1991:16]. Moreover, Eastern Europe has been a major target of EC anti-



**Table 2.5**  
**EC imports from partner groups affected by NTBs in 1988**  
(%)

SITC	Description	OECD	Soc.	Ldc	Med.
All	Total trade	16.0	21.4	20.7	7.5
00	Live animals	11.3	80.3	55.7	9.8
01	Meat and preparations	89.0	85.3	74.6	47.6
02	Dairy products and eggs	85.0	75.7	60.8	38.4
03	Fish and preparations	34.8	40.9	60.3	48.7
04	Cereals and preparations	100.0	100.0	100.0	100.0
05	Fruit and vegetables	68.4	56.7	38.0	61.7
06	Sugar, honey	78.1	87.7	99.3	94.8
07	Coffee, tea, cocoa	37.2	37.5	22.1	9.7
08	Animal feeding stuff	43.7	24.2	23.0	63.7
09	Miscellaneous food preparations	50.1	61.1	14.0	62.4
11	Beverages	3.5	0.8	0.2	0.2
12	Tobacco and manufactures	0.0	0.0	0.0	0.0
21	Hides, skins, fur	0.0	0.0	0.0	0.0
22	Oil seeds, nuts, kernels	2.7	0.8	0.1	0.0
23	Rubber, crude, synthetic	0.0	7.4	0.1	0.0
24	Wood, lumber and cork	0.0	0.0	0.0	0.0
25	Pulp and waste paper	0.0	0.0	0.0	0.0
26	Textile fibres	8.7	18.3	12.8	45.5
27	Crude fertilisers	3.1	17.1	16.4	3.5
28	Metalliferous ores	12.2	1.9	3.7	0.9
29	Crude animal veg. materials	14.0	30.2	19.4	14.7
32	Coal, coke, briquettes	0.0	0.0	0.0	0.0
33	Petroleum and petroleum products	17.2	28.1	10.5	14.0
34	Gas natural and manufactured	0.0	11.1	0.0	0.0
35	Electric energy	0.0	11.1	0.0	
41	Animal oils and fats	10.3	2.2	0.2	0.0
42	Fixed vegetable oils and fats	2.2	0.2	0.1	98.7
43	Processed oils and fats	0.0	0.1	0.0	0.0
51	Chemical elements and compounds	2.6	4.0	0.9	0.0
52	Mineral tar	0.1	3.0	1.0	0.0
53	Dyeing, tanning materials	0.7	15.1	5.1	0.0
54	Medicinal & pharm. products	5.4	4.9	2.7	4.4
55	Essential oils	0.5	0.1	2.0	0.0
56	Fertilisers manufactured	6.6	11.6	0.0	0.0
57	Explosives	0.0	21.7	5.6	0.0

(continued/...)

**Table 2.5 (continued)**  
**EC imports from partner groups affected by NTBs in 1988**  
 (%)

<i>SITC</i>	<i>Description</i>	<i>OECD</i>	<i>Soc.</i>	<i>Ldc</i>	<i>Med.</i>
58	Plastic materials etc.	1.1	20.2	1.9	0.0
59	Chemicals nes	14.3	6.6	19.4	8.7
61	Leather/furs inc. manufactures	11.2	32.1	12.1	92.7
62	Rubber manufactures	0.9	26.4	14.9	0.0
63	Wood and cork manufactures	23.8	52.1	46.3	4.6
64	Paper/board and manufactures	42.2	27.0	12.7	0.0
65	Textile yarn, fabrics & articles	1.4	77.6	69.7	0.1
66	Non-metallic mineral manufactures	5.0	36.4	4.6	11.0
67	Iron and steel	19.2	57.9	28.7	8.9
68	Non-ferrous metals	4.4	0.4	0.5	0.1
69	Metal manufactures nes	1.5	7.6	3.5	5.7
71	Machines non-electric	6.6	7.5	0.8	0.1
72	Machinery electric	9.9	18.9	7.1	5.4
73	Transport equipment	34.3	11.0	3.3	3.4
81	Sanitary, plumbing, heating, lighting equipment	1.1	1.6	5.3	0.2
82	Furniture	8.0	21.6	11.5	10.6
83	Travel goods, handbags	0.0	2.7	0.0	0.0
84	Clothing	0.2	93.7	77.3	0.3
85	Footwear	22.7	69.0	45.4	21.3
86	Prof. scientific instruments	7.5	24.1	1.5	0.9
89	Miscellaneous manufactures nes	5.5	8.5	3.1	0.1

*Notes* See Table 2.4.

*Source:* Tovas and Laird, 1991.

dumping action. Between 1980 and 1988, 34% of all EC anti-dumping investigations were directed at Eastern Europe (including the GDR and the USSR), as against 25% in respect of the Far East, the second most affected region [Möbius and Schumacher, 1991:17].

However, although the Community imposed an impressive array of quantitative restrictions on imports from Eastern Europe, many of these were not binding as the actual flow of competitive exports was too low. The analysis by Möbius and Schumacher concludes that constraints on supply were a more important factor

affecting the volume of exports than constraints on demand. Even so, the removal of such demand constraints may affect Eastern Europe's competitiveness with unconstrained developing country supplies.

Until the revolutions, Poland, Romania, Czechoslovakia and Hungary, as signatories of the GATT, were supposed to benefit from most favoured nation treatment (although they did not always do so), but only Romania (with Yugoslavia) benefited from the EC's Generalised System of Preferences (GSP). Following the revolutions, a renegotiation of the terms of access which had begun in the late 1980s has accelerated. For Hungary and Poland quantitative restrictions on EC imports of industrial products (except textiles and products covered by the European Coal and Steel Community) were reduced or abolished with effect from 1 January 1990 and the countries were admitted unilaterally into the GSP. By the middle of 1990 similar agreements had been reached with Czechoslovakia and Bulgaria.

However, Eastern Europe's hopes of a more ambitious liberalisation made slower progress. Finally, in autumn 1991, following tortuous negotiations, the Community agreed to an association agreement with Poland which paved the way for rapid completion of similar agreements with Czechoslovakia and Hungary. But further tough negotiations with other East European states are likely. Combined with predatory OECD exports of agricultural products to the USSR, a traditional agricultural market for Eastern Europe (see below), the trade outlook for the region was not particularly bright.

### **East European imports**

It is not only on OECD markets that developing countries may face some trade diversion as a result of the changes in Eastern Europe. During the centrally planned era a significant trade developed between the countries of Eastern Europe and the Soviet Union on the one hand and a group of developing countries on the other. The latter included both socialist states and others, like India, which favoured barter trade. With the collapse of the CMEA and the shift towards trade in convertible currency, it is likely that there will be some diversion away from such traditional Third World suppliers. Beneficiaries may be OECD states or other developing countries.

East European imports from developing countries originated in four main groups of countries, CMEA members, CMEA associates, developing countries with formal arrangements and the newly industrialising countries. Of these, the most important source of East European imports were the developing countries with formal arrangements (Table 2.6). In 1989, this group supplied \$2.2 bn of imports into Eastern Europe, which was equivalent to 48% of East Europe's imports from all four groups. Although imports from developing countries declined during the 1980s (being 23% lower in current value terms in 1989 than in 1980) they still formed a substantial flow at the time of the revolutions.

In geographical terms the most important source of East European imports has been Latin America, with 36% of the 1988 total (Table 2.7). Africa and the Middle East are the next two most important regions, followed by Asia. There are insufficient data available on the commodity composition of this trade to determine the danger of diversion and the possible beneficiaries. However, there is some reason to suppose that imports from Africa especially, and also from Latin America, may include a high proportion of primary commodities. As noted in the next section, this trade might increase in the medium term as a result of the changes in Eastern Europe rather than decline.

The countries at most risk of a decline in exports would seem to be those that had formal agreements with Eastern Europe under the centrally planned regimes; these are primarily countries in the Mediterranean and Asian regions. They are vulnerable in the short term because of the region's declining import capacity, and in the medium term, when the volume of imports may rise again, for competitive reasons. The CPEs' preference for barter trade gave those developing countries willing to supply on this basis an undoubted, but hard to quantify, competitive advantage over other suppliers. Now that trade is on a convertible currency basis the ex-CPEs may find alternative sources of supply more competitive.

### **Competition for jobs**

If the East European economies fail to grow sufficiently to satisfy popular aspirations there may be a marked increase in migration to Western Europe. Even though immigration tends to benefit the host economy, at least in the longer term, a resurgence of labour mobility of such magnitude would probably increase pressure on

**Table 2.6**  
**East European imports from selected developing country groups,**  
**1980-89**  
 (\$ m.)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
CMEA <sup>a</sup>	630	833	763	804	960	734	627	801	749	859
Associates <sup>b</sup>	1,583	433	436	124	188	399	479	510	802	748
DEFA <sup>c</sup>	2,274	2,128	2,784	2,581	3,017	3,104	1,894	1,998	2,227	2,236
NICs <sup>d</sup>	1,591	1,448	891	927	1,075	737	712	900	1,020	868

*Notes*

(a) Cuba, Mongolia and Vietnam.

(b) Afghanistan, Angola, Democratic Yemen, Ethiopia, Iraq, Mexico and Nicaragua. Data for Mozambique are too sketchy to be included.

(c) Developing countries with formal arrangements: Algeria, Cambodia, Egypt, India, Islamic Republic of Iran, Morocco, Pakistan and Syrian Arab Republic.

(d) Newly industrialised countries: Brazil, Hong Kong, Malaysia, Singapore, Thailand, Tunisia and Turkey.

Source: UN, 1991.

**Table 2.7**  
**East European imports from developing countries**  
**by region, 1980-88**  
 (%)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Africa	26.0	24.0	35.3	32.7	28.9	28.5	29.5	20.5	23.1
Latin America	26.9	30.2	27.1	27.8	34.4	30.3	30.9	39.0	36.2
Middle East	35.5	34.1	27.3	29.6	27.7	29.1	29.9	28.6	26.1
Asia	11.7	11.7	10.3	10.0	9.0	12.1	9.8	11.8	14.7

*Source:* UN, 1991.

migrants from the Third World. This could happen both directly through competition for jobs and indirectly if it sustains xenophobic and overtly racist tendencies in Europe (such as have been evident in Germany in the second half of 1991).

The dangers are the more serious because they arise at a time when, because of the Single European Market and the free movement of labour within the Community, the member states are being forced to reconsider their immigration policies. Whilst the six EC signatories of the Schengen agreement have already granted free entry to Polish nationals (though not rights to employment) with relatively little open hostility, it remains to be seen how governments will react to continued high rates of migration.

Any increase in labour movement from Eastern Europe will occur against a background in which migration is already perceived to be a problem by EC officials. It is held that markedly unequal rates of population and economic growth on the northern and southern shores of the Mediterranean are creating pressures for migration flows into the Community that exceed politically tolerable levels. Commission officials talk of the Straits of Gibraltar as being 'Europe's Rio Grande'.

The Mediterranean periphery is already the main source of legally registered aliens (and probably of illegals as well). Of the 12.9 million aliens residing legally in the Community in 1987, 7.9 million originated outside, and some 75% of these came from the

Mediterranean periphery [Tovias and Laird, 1991]. Over 4 million of the non-EC aliens are in the economically active social groups. They still form a very small share of the total EC population of 324 million, but they are not evenly spread among member states. The two principal hosts are Germany (with 41% of the 1987 stock) and France (with 27%). These two countries also have the highest proportions of non-EC foreign workers in relation to their labour force: 3.6% in the case of Germany, and 2.3% for France (with Luxembourg, UK, Netherlands, Belgium and Denmark having shares of over 1% but less than 2%). Estimates of illegal migrants reach up to 1 million in France, 600,000 in Italy, and 90-170,000 in Spain; in May 1991 5,000 illegal Moroccan workers were expelled from Spain in a single week [Tovias and Laird, 1991].

The numbers wishing to migrate can only increase. Current demographic projections put the population of Turkey in the year 2000 at 65 million and that of the three Maghreb states at 72 million (an increase of 28 million over 1988). It is improbable that their economies will expand sufficiently rapidly to absorb all of this increase in the labour force. One ILO forecast is that there will be some 4 million people of working age unable to find suitable work in these four countries by the end of the decade [Tovias and Laird, 1991].

This increased supply of potential migrants will face competition from other sources. After a decade in which the flow of new legal immigrants fell to very low levels (less than 0.1% of the EC population), there has been an upsurge in the past three years. This has been due largely to inflows from Eastern Europe into Germany. Although this flow *may* have fallen off following the revolutions, the experience of population movements between the eastern and western parts of Germany suggests that there remains strong potential for economic migration from the east. If economic growth is slow (as is quite likely in the short term) the movement of people will continue. Moreover, one effect of post-1992 industrial rationalisation could be an increase of unemployment in the EC periphery and, with the free movement of labour, greater intra-EC migration.

Even without the undoubted racist pressures to exclude non-white migrants, this increase in potential supply is considered to be a source of concern by the Community. The response is likely to be to restrict immigration from developing countries.

## Trade Creation

In the longer term the Third World could benefit along with other regions from the fillip to world growth provided by a more buoyant East European economy. Of more immediate interest is that East European consumption of tropical products and imported consumer goods may rise. Under the twin forces of low incomes and administrative controls, East European consumption of many tropical products was extremely low during the centrally planned era. *Per capita* import levels in 1989 in Western Europe were higher than those in Eastern Europe by a factor of 2 in the case of tea, 3 for cocoa beans, 4 for coffee, 5 for bananas and 370 for canned pineapple. As the market outlook for many of these commodities in the OECD is depressed, a rise in *per capita* East European imports to Western levels could represent a significant improvement for the exporters. The benefits would tend to accrue mainly to Latin America and sub-Saharan Africa, with the latter gaining most relatively as it is still heavily dependent upon the export of traditional primary products.

More generally, growth in Eastern Europe would tend to improve the terms of trade of many countries. Global imports would increase, providing export opportunities for developed and developing countries alike. At the same time, East European exports would tend to reduce world prices to the benefit of those countries which are net importers. To put the scale of such changes into perspective, if *per capita* GNP levels in Eastern Europe were to increase to the current average OECD levels the effect would be an increase to world GDP equivalent to some 6% of its 1989 level.

As such figures make clear, a great deal depends upon the speed with which the reformed economies of Eastern Europe start to grow. As is clear from the country analyses in Part II, evidence of such growth is at present patchy to say the least. Until the transitional problems, which currently darken the outlook for all the countries of the region, are overcome in at least some of them the long-run trade-creating potential of the East European revolutions must remain an area for speculation.



## **Finance**

### **Financial needs**

There have been many estimates of the financial implications of reform in Eastern Europe. Some simulate the financing that Eastern Europe would require to achieve specified growth targets within a particular period of time. Others concentrate instead either on the absorptive capacity of Eastern Europe or on the volume of finance likely to be available.

Naturally, the figure in the bottom line of such calculations varies considerably according to the approach adopted. Estimates based on East Europe's 'need' have tended to produce very large figures. One estimate, for example, suggested that global real interest rates could rise by 1-3 percentage points as a result of the increased demand for finance [Collins and Rodrik, 1991]. This was based on the assumption that foreign capital inflows to the region would reach \$55 bn annually, of which \$18 bn would be destined for Eastern Europe (including Yugoslavia) and the rest for the states of the former USSR and (the bulk) for the former GDR. The rise in interest rates is on the assumption that there is no decline in flows to developing countries; if, by contrast, interest rates are to remain stable, these flows would have to fall by between 0.8% and 2.3% of their GDP. A review and analysis of seven such 'needs-based' estimates show a range of total costs required over a 10-15 year period of \$770-2,800 bn, or an annual requirement of \$56-171 bn [Colijn, 1991].

Whilst it is easy to see how such large figures have provoked fears of financial diversion among developing countries, it is perhaps naïve to assume that external finance, whether private or official, will be available to satisfy all of the region's needs or that the countries could actually absorb such large inflows. The alternative approaches, based on the likely level of supply or absorptive capacity, tend to produce much lower figures. One assessment of absorptive capacity has produced a figure of \$14-15 bn p.a., whilst an assessment of likely supply produces an even lower figure of \$6.8 bn p.a. [Colijn, 1991]. The evidence from flows in 1990 and 1991 noted below suggests that even this low figure of supply errs on the side of optimism.

An attempt has been made by the World Bank to marry estimates of need and availability. The Bank has estimated the

external financing requirements of six Eastern and Central European countries at \$9-10 bn a year. This is the financing required simply to achieve a moderate rate of growth sufficient for them to return to their 1989 levels of GDP *per capita* by the late 1990s. It also excludes scheduled amortisation payments on debt, which average another \$11-11.5 bn a year until 1995 [Qureshi, 1991:7]. A more ambitious scenario, in which 1989 real *per capita* income levels are restored by 1995, would increase the financing requirement by about \$5 bn p.a.

The World Bank estimates that there is a gap of at least \$3 bn per year for the first half of the decade on the low growth scenario. Moreover, there is a pressing need to restructure and refinance the heavy burden of debt amortisation payments. The Paris Club agreement with Poland reached in spring 1991 will reduce these payments by an average of \$5.5 bn until 1995, but this will not remove the problem completely, even for Poland, and no relief has yet been negotiated for the other East European countries. Not all of them are seeking debt reduction - Hungary, for example, is reported to have chosen not to request a rescheduling, preferring to safeguard its existing access to the capital markets. However, Bulgaria faces a significant debt burden (as does Yugoslavia) which it is difficult to see being serviced without major disruption to economic recovery.

### **Commercial flows**

#### *Investment*

One source of external capital is foreign direct investment, and the countries of Eastern Europe have put great emphasis on encouraging investment from the OECD. This is seen not only as a source of foreign exchange but also of technical and marketing knowledge, and forms part of the strategy to increase competitiveness. As noted in Chapter 1 - and emphasised in Part II - a privatisation that involves simply the replacement of a public sector monopoly by a private sector one is unlikely to increase efficiency. By the same token, a monopoly/oligopoly situation involving foreign private firms is unlikely to be significantly more efficient than one involving only domestic capital. Indeed, the OECD has warned that 'given the extremely imperfect asset markets in the region there is a risk that private investment will in part be characterised by predatory manoeuvres rather than longer-term developmental

considerations' [OECD, 1990]. Because of the pressing need for foreign exchange and grossly inadequate information about underlying market values, there is a danger that privatised state enterprises will be used for asset-stripping and non-market transfer pricing.

Thus far, however, foreign investment inflows have been modest. The level of direct foreign investment into Czechoslovakia, Hungary and Poland (the three countries most likely to be favoured in this respect) was a mere \$400 m. in 1990 and \$1.2 bn in 1991 [Feinberg, 1991:Table 9]. As indicated in Chapter 5, inflows into Hungary, at least, may be picking up and it is not unreasonable to expect investment to begin slowly but to accelerate as the economic reforms start to take effect. However, it is notoriously difficult to monitor foreign investment flows. Well publicised announcements of large investments, such as the Volkswagen stake in Skoda, may have provided a false impression of actual flows. It would be prudent, therefore, to wait until evidence is obtainable from balance-of-payments statistics before assuming that there has been a quantum leap from the 1990 level.

#### *Commercial lending*

Another source of external capital is commercial and semi-commercial lending from the banks and public sector institutions. Commercial banks' attitudes will be influenced by each country's debt-servicing record as well as its current level of debt, the prospects for stable government and export potential in terms of the resource base and its economic and cultural ties with the West. Such considerations might support lending to Czechoslovakia and Hungary. But there is a problem with Poland, as the country least able to service fully its foreign debt. It remains to be seen how far the generous official debt reduction negotiated for Poland in 1991 will influence commercial bank practice. Bulgaria and Romania will probably be of limited interest to commercial lenders because of the weak reform movement and limited economic potential.

Thus far, however, commercial bank lending has been very limited. Figures up to December 1990 from the Bank for International Settlements provide no evidence of a significant inflow: the stock of East European loans was barely higher (0.6%) than a year earlier, indicating that any new loans have simply offset the repayment of old ones. Estimates for 1991 suggest a net outflow of

funds by commercial creditors to the extent of \$200 m. from Czechoslovakia, \$1,800 m. from Hungary and \$400 m. from Poland [Feinberg, 1991:Table 8].

Will the newly created European Bank for Reconstruction and Development, established specifically for Eastern Europe and oriented towards the private sector, provide the necessary finance? Although the bank will have an important function to perform, its impact in the early years of the transition should not be overestimated. For a start, it is relatively small. Its capital base has been described as less than half the cost of cleaning up Poland's power industry alone. Second, its loans will not be cheap. It will essentially be on-lending money which has been raised on the international capital markets. In this respect, its funding will be similar to that of the World Bank. To some extent its net impact may be more muted still because it may simply replace funds that would otherwise have come from the World Bank.

### **Aid**

In the absence of adequate commercial funds, will concessional finance fill the gap? Figures for 1990, and estimates for 1991, suggest that inflows of official finance have been modest and have barely offset the outflows of commercial money. In 1990 the level of net transfers to the three more developed East European states ranged from a small positive flow for Czechoslovakia (of \$200 m.) to negative flows for Hungary (of \$1.7 bn) and Poland (of \$8.1 bn); the estimated position for 1991 is for a positive, but still modest, flow for Czechoslovakia (of \$1.1 bn), a continued outflow for Hungary (of \$600 m.) and a marginal inflow for Poland (of \$300 m.) [Feinberg 1991:Tables 5 and 6]. These figures exclude short-term capital movements and direct foreign investment but, as noted above, the latter has been modest thus far.

The management of official Western assistance has been entrusted to five key regional and international organisations: the European Community, the European Investment Bank, the EBRD, the IMF and the World Bank. The bulk of funds being channelled both through these agencies and bilaterally is being predicated on the recipient country reaching an 'understanding' with the IMF about macroeconomic stabilisation. This reflects the direction of much of the assistance: whereas in late 1989 most was in the form

of emergency aid, by 1990 the focus had shifted to balance-of-payments support.

#### *Food aid*

Partly because of the past emphasis on emergency relief, food aid has formed a substantial part of the aid received so far by Eastern Europe, having increased significantly in volume during the past two years. When it substitutes for commercial imports food aid can be a form of balance-of-payments support as well as emergency relief, so it is expected that in the next five years much larger commitments will be made. As the scale of these actions increases resources could be diverted from Third World countries, although in the case of the EC at least there has been no such diversion thus far.

In 1989/90 Poland was the single largest recipient of EC cereals food aid, receiving 1.4 m. tonnes compared to 300,000 tonnes granted to the second largest recipient, Ethiopia. In 1990/91 Poland and Romania look set to be the third and fifth largest recipients of US food aid. Food aid to Eastern Europe in recent times began in 1980/81 when some 14,000 tonnes of cereals food aid was granted to Poland, which has since received food aid in some form in every year (Tables 2.8 and 2.9). In 1989/90 a record 1.6 m. tonnes of cereals food aid, representing 13.3% of the world total, was granted to Poland. In 1990/91, substantial additional food aid donations of around 1.0 m. tonnes were made to Poland and also Romania. A further \$133 m. in food aid for Bulgaria and Romania was approved by the EC in early March 1991. There was, also, high profile provision of 'emergency'-type food aid, partly privately funded, from Germany to the USSR during the winter of 1990/91. Meanwhile the EC was considering a \$333 m. food aid programme to the USSR until the August 1991 coup; the programme was later reinstated.

A sizeable volume of food imports at highly concessional rates has also been received by East European countries and the USSR in recent years. For example, between the inception of the US Export Enhancement Programme, in 1985, and March 1990, Eastern Europe was approved the right to purchase 3.1 m. tonnes of wheat and 1.1 m. tonnes of barley under the scheme. During the same period, the USSR was given the opportunity to purchase 20.3 m. tonnes of wheat (26.5% of the world total). In Eastern Europe there

**Table 2.8**  
**Total world and East European cereals food aid receipts, 1981/2-1990/91**  
('000 tonnes)

		1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9	1989/90	1990/91
<b>Wheat</b>	World	6,820	6,824	7,433	9,122	7,960	10,171	10,708	7,367	7,986	7,414
	Poland	14	57	26	58	5	0	0	0	1,238	129
	%	0.2	0.8	0.4	0.6	0.1	0.0	0.0	0.0	15.5	1.7
<b>Rice</b>	World	869	1,274	1,134	995	1,175	1,073	1,118	904	828	509
	Poland	23	7	13	8	0	0	1	0	13	0
	%	2.6	0.5	1.1	0.8	0.0	0.0	0.1	0.0	1.6	0.0
<b>Coarse grains</b>	World	1,451	1,140	1,282	2,394	1,815	1,355	1,677	1,773	2,449	2,845
	Poland	381	20	3	3	0	0	0	0	312	403
	Romania	0	0	0	0	0	0	0	0	0	480
	E. Europe	381	20	3	3	0	0	0	0	312	883
	%	26.2	1.8	0.2	0.1	0.0	0.0	0.0	0.0	12.7	31.0
<b>Total cereals</b>	World <sup>a</sup>	9,140	9,238	9,849	12,511	10,949	12,599	13,303	10,044	11,759	11,256
	Poland	417	83	42	68	5	0	1	0	1,563	533
	Romania	0	0	0	0	0	0	0	0	0	480
	E. Europe	417	83	42	68	5	0	1	0	1,563	1,013
	%	4.6	0.9	0.4	0.5	0.0	0.0	0.0	0.0	13.3	9.0

*Note*

(a) Includes blended/fortified cereals in 1989/90 and 1990/91.

Sources: *Food Aid in Figures*, 1990; *The Food Aid Monitor*, March 1991, WFP.

**Table 2.9**  
**Total world and East European food aid receipts of dairy products, vegetable oil and fats, 1981-91**  
('000 tonnes)

		1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
<b>Dairy products</b>	World	369	293	305	408	382	393	344	283	242	138	111
	Poland	0	8	35	5	19	11	0	0	0	5	0
	Romania	0	0	0	0	0	0	0	0	0	0	8
	E. Europe	0	8	35	5	19	11	0	0	0	5	8
	%	0.0	2.9	11.6	1.2	5.0	2.7	0.1	0.0	0.0	3.3	6.8
<b>Vegetable oil and fats</b>	World	368	387	366	399	433	572	669	673	696	527	497
	Poland	0	13	9	11	5	5	3	0	0	7	0
	%	0.0	3.3	2.4	2.9	1.2	0.8	0.4	0.0	0.0	1.3	0.0

Sources: *Food Aid in Figures*, 1990; *The Food Aid Monitor*, March 1991, WFP.

are complaints that these concessional supplies have displaced their exports. The region has traditionally exported agricultural goods to the USSR which are of too low a quality to be redirected on to other markets. Despite the need for substantial food imports in some East European states, there is a continuing requirement to earn foreign exchange by exporting agricultural goods.

#### *Financial aid*

The total of official financial commitments by the 'Group of 24' rich countries to Eastern Europe was estimated as of April 1991 at Ecu 30 bn, plus contributions from the international financial institutions and debt reduction/rescheduling [UN, 1991:26]. These sums are upper-limit commitments, with disbursements being spread over several years; in most cases the planned period is 1990-93, but some lag is likely. As is clear from the fragmentary information in Table 2.10 on commitments for 1990-92 reported to the OECD, the bulk of these funds is in the 'other project financing' category rather than as 'aid', i.e. they are insufficiently concessional to be classified as 'development assistance'. Moreover, it must be suspected that items such as 'export credit ceilings' will be drawn down only if the recipient countries have sufficient foreign exchange to cover the foreseen level of imports.

The EC's Community-level programme of aid began in 1990 with an allocation of Ecu 300 m. for Poland and Hungary, later increased to Ecu 500 m. for the region as a whole. The budget allocations foreseen for 1991 and 1992 are Ecu 850 m. and Ecu 1 bn respectively.

The aid is intended to support the reform process. In pursuit of this, the Commission has identified two types of action:

- the alleviation of key constraints (both financial and technical) hindering the implementation of the policy reform process, narrowly defined;
- investment needed to restructure the physical fabric of the economy to enable it to respond to the new economic stimuli.

This two-way split is particularly important, given one of the salient administrative characteristics of EC aid, namely that the aid must be committed in the year that it is voted by the Council. In the case of the 1990 programme, but not subsequent ones, this rule



**Table 2.10**  
**Aid commitments and other official finance to Eastern Europe**  
**to be implemented during 1990-92**  
 (Ecu m.)

	<i>Bulgaria</i>	<i>Czechoslovakia</i>	<i>Hungary</i>	<i>Poland</i>	<i>Romania</i>	<i>Unspecified</i>
Grants	82.0	69.0	185.4	1,869.2	263.8	3,105.0
Loans	na	436.5	946.2	727.8	na	370.4
Export credit ceilings	na	72.5	1,318.9	2,805.5	na	
Other project financing	na	508.0	2,558.2	2,270.9	na	
Grand total		1,086.0	5,008.7	7,673.4		

*Source:* OECD.

was accompanied by the requirement that the aid had to be disbursed within two years. This is a manageable limitation for some applications but for others it may be a serious shortcoming. In particular, if East European governments are looking to the EC to help bridge the effects of a savings gap (through balance-of-payments support or a credit line for small/medium-scale enterprises) the uncertainty created by annual allocations may be very disruptive. There is a strong case, therefore, for the Community to address the legal and political issues of multi-annual commitments. These have already been resolved in relation to other aid programmes financed from the EC budget, notably those in the Mediterranean.

Possibly the most important impact on developing countries so far has been in the realm of debt relief. Favourable treatment for Eastern Europe on debt may have a spin-off effect. Already the Polish precedent has been used to the advantage of Egypt. And if there were to be generalised debt relief in Eastern Europe it would increase the negotiating power of developing country debtors for a major improvement in their terms.

The experiences of heavily indebted developing countries which have attempted adjustment indicate that the debt overhang has reduced the growth of output and exports by cutting back import capacity, investment and maintenance of the existing capital stock. It has introduced additional uncertainties into economic life, further discouraging investment and diverting the attention of policy-makers away from longer-term problems of adaptation.

A vicious circle can come into play: import strangulation holds back export growth thus perpetuating import shortages. The uncertainties created by the debt situation and the nature of debt renegotiation processes further discourage investment and this, in turn, holds back the restructuring necessary if economies are to 'grow out of debt'. Depressed export earnings, import volumes and economic activity reduce government revenues, widening budget deficits and reducing government abilities to improve the balance of the economy.

Given these levels of funding, will the development agencies begin to divert aid from developing countries? Thus far, almost all OECD donors have been meticulous in insulating transfers to Eastern Europe from their normal aid programmes. In the cases of both the UK and the EC, for example, aid to Eastern Europe is

additional to development aid (and from a separate budgetary line). Only in the USA, Sweden and Italy (which often has difficulty spending all its pledged aid) is there believed to have been a diversion.

Whilst there may not have been significant diversion so far, in the medium term the boundary between assistance to Eastern Europe and aid to middle-income states may become blurred. If it does, the scale of the diversion could be quite marked. Middle-income regions such as North Africa, the Middle East and Latin America combined currently receive levels of OECD aid that are not greatly in excess of even the EC's lower estimate of Eastern Europe's balance-of-payment needs. Moreover, there could be a major diversion of technical skills towards Eastern Europe.

## **Aid policy**

Setting aside concerns about the diversion of funds, does a case exist for providing aid to Eastern Europe, and if so what may be learned from developing country experience, and should the expertise of agencies oriented towards the Third World be tapped? A number of non-governmental aid organisations, for example, are debating vigorously among themselves whether or not Eastern Europe is a legitimate area of activity for them. This section identifies lessons from Third World experience relevant to the task now facing those concerned with administering concessional flows to Eastern Europe.

### **Justification for aid**

Why should the West provide financial and trade support for policy changes which are in any case in the interests of the adjusting country? This question, which is sometimes asked of developing countries, may also be asked of Eastern Europe. To respond in summary form, the case for financial support has been established in terms of:

- easing the period of transition, to give the economy more time to respond to changed policies and prices, and to augment domestic saving so as to permit the investment levels necessitated by structural change;
- reducing the costs of adjustment by providing governments with more resources with which to cushion the poor; and

- reinforcing the political sustainability of the process by making it easier for governments to buy off key opposition groups and helping them to persevere with their reforms without too greatly endangering their own survival.

In the case of Eastern Europe there are additional reasons for intervention. It is clearly in Western Europe's political interests to have stable rather than unstable neighbours, and in its ideological interests that these neighbours be informed by the same economic and political values as are accepted in the West. Moreover, it is in the economic interests of the OECD (and, indeed, the world) as a whole for growth to occur in the East, thus increasing the opportunities for profitable trade.

If there exists a case for public financial support to Eastern Europe, does it extend to the aid being taken from existing development budgets, suitably expanded? How 'aid-worthy' are the countries of Eastern Europe in terms of the criteria normally used to allocate development assistance? Is it desirable for the geographical terms of reference of existing development administrations to be extended, or should 'aid' to Eastern Europe be insulated from 'aid' to developing countries with different budgetary sources and spending arrangements?

The task of locating the position of the East European countries in the 'league table of development' is complicated by the low quality of statistics in many areas, by the price distortions which they often reflect and by the fact that there may be a difference in the relationship of economic to social/cultural development between Eastern Europe and Third World states.

Subject to these limitations, both economic and social indicators place the East European countries, as a group, in an intermediate position between most developing countries and the OECD industrial countries (Table 2.11). Estimates of *per capita* incomes in 1985-88, based on purchasing power parities, give all except Romania average incomes well above those in all but a few developing countries, but well below most, but not all, OECD levels (although estimates for Eastern Europe based on black market exchange rates are far lower and would bring several of these countries down to developing country levels).

Eastern Europe also has some other advantages by comparison with low-income developing countries. Chief among these are

**Table 2.11**  
**The relative economic and social position of Eastern Europe**

	<i>Real GDP per capita<sup>a</sup></i>	<i>Life expectancy at birth (Year 1990)</i>	<i>Mean years of of schooling<sup>b</sup></i>	<i>Maternal mortality rate<sup>c</sup></i>	<i>Population per doctor 1984</i>
Germany	13,388	75.2	8.8	12	380
Portugal	5,980	74.0	3.8	12	410
Czechoslovakia	7,420	71.8	7.8	10	...
Hungary	5,920	70.9	8.6	26	310
Bulgaria	5,110	72.6	7.0	13	...
Poland	4,190	71.8	7.3	11	490
Romania	3,000	70.8	6.6	150	570
Brazil	4,620	65.6			
India	870	59.1			
Developing country aggregate			3.5	290	4,590

*Notes*

(a) PPP \$ 1985-88.

(b) Those aged 25 and over, 1980.

(c) Per 100,000 live births, 1980-87.

Source: *Human Development Report 1991* (New York, UNDP).

relatively good levels of education, training and public health; advantages of geography and political congruence relative to capitalist Europe; and the positive influence on the responsiveness of the population of the demonstration effect of conditions in their West European neighbours. Nonetheless, the many rigidities in their systems already caution against expecting rapid transformations.

Detailed international comparisons of real income and product are made at regular intervals (usually of five years) under the auspices of the International Comparisons Project carried out by the UN Statistical Office. There has been some analysis of the data from 1980 which is relevant to the current task [Roy, 1987]. This has compared economic structure, the structure of manufacturing, labour productivity and comparative life expectancy in three of the East European countries with the level in Brazil in 1980. The results are shown in Table 2.12.

All of the countries of Eastern Europe are much smaller than Brazil: the *combined* total of the three appearing in Table 2.12 is only two-thirds of the Brazilian level. However, manufacturing forms a higher share of production and agriculture a smaller share than in Brazil. Within manufacturing, chemicals and engineering are more important in the East European countries, and food less important, than in Brazil. Labour productivity is significantly lower in all of the East European countries than in Brazil. One lesson to be drawn from the table is that the production structure of East European countries is sufficiently similar to that of a developing country like Brazil which has attempted structural adjustment for the comparisons made in Chapter 1 to be useful.

### **Absorptive capacity**

Of equal importance with Eastern Europe's 'aid-worthiness' is its absorptive capacity. The transformation in Eastern Europe initially gave rise to calls for 'a new Marshall Plan', on the grounds that the problems being addressed are similar to those facing post-war Western Europe. To a degree this is a correct analogy: post-war Western Europe had to remove an array of regulations that had replaced the free market, to restructure the production system, and to repair badly run-down infrastructure. However, there is a crucial difference.

**Table 2.12**  
**East European economic and social indicators**  
**in 1980, compared to those of Brazil**

	Brazil	Poland	Yugo.	Hung.	Greece	Port.
<b>Economic structure</b>						
Total size (\$ bn)	456	149	92	48	44	39
Manufacturing (%)	26.41	39.44	33.29	31.24	20.05	26.04
Shares of (%):						
• government services	6.72	9.67	8.40	6.43	9.51	17.28
• agriculture, forestry & fishing	9.29	6.28	6.55	6.09	10.52	4.22
• mining & quarrying/ fuel & power	0.54	8.05	2.18	2.45	2.89	0.96
<b>Structure of manufacturing (%)</b>						
Food, drink & tobacco	18.25	10.48	11.93	12.27	23.16	21.87
Textiles, leather & clothing	12.83	12.53	15.31	11.23	26.80	26.97
Chemicals, etc.	13.30	20.21	8.66	19.60	10.63	6.35
Base metals	6.11	5.73	9.24	10.30	4.39	2.15
Engineering	26.69	31.76	36.51	35.03	15.78	14.53
<b>Labour productivity (\$'000)</b>						
Agriculture, forestry & fishing	3.1	1.8	2.3	2.6	4.6	1.5
Manufacturing	16.4	12.7	15.4	9.9	13.5	11.0
Whole economy	10.3	8.6	10.5	9.5	13.1	8.6
<b>Social indicators</b>						
Estimated real <i>per capita</i> income of poorest quintile	263		739	907		621
Real <i>per capita</i> government spending on health care	58.9		84.5	147.1		138.4

Source: Roy, 1987.

The Marshall Plan assisted Western Europe through the provision of capital to return to a traditional system of production and exchange from which it had departed only temporarily. In Eastern Europe the task is to replace the system that has been in place for many years and substitute something that is, in most cases, completely new. The problem of capital is less one of its destruction, as in war-torn Europe, than of its past misallocation and the need to modernise obsolete technology. Institution-building is of greater relative importance, although substantial financing may still be desirable - not least to ease the process of transition and, thus, increase the probability of success.

During the 1980s the Eastern economies exhibited some difficulty in absorbing Western technology (in marked contrast to the NICs). They also received substantial loans which had no marked impact on productive capacity. Although the process of economic transformation is designed to increase their capacity to absorb new funds and technology productively, it may be over-optimistic to assume that, during the transitional period when large-scale finance is required, absorptive capacity will have improved significantly.

### **Aid administration**

All aid donors to Eastern Europe are having to grapple with a range of common problems. These relate in particular to the type of finance to be provided, the form in which it is to be provided, and the conditions to be attached. Here, the experience gained over the past decade or so of a gradual shift in aid to developing countries from short-term balance-of-payments support plus project aid towards structural adjustment lending may be valuable. Perhaps the most important lesson from this experience is that structural adjustment is an extremely difficult process and that donors should be willing to modify preconceived, cookbook remedies in the light of experience.

Given the rapidly changing situation in Eastern Europe, there is concern about appropriate conditionality. To what extent will donors be legally, morally or politically obliged to continue to provide aid that is no longer appropriate either because a country has adjusted much more rapidly than foreseen or, more gloomily, because it has abandoned the process?



One 'lesson' from developing countries is that it is the quality of the policy and institutional environment in the recipient country, above all things, that determines the economic effectiveness of aid. The literature on the effectiveness of development assistance is virtually unanimous on this. Where policy mistakes are causing large macroeconomic imbalances and price distortions aid is unlikely to do much good. Indeed, it will be largely wasted, which is particularly serious because the finance available is strictly limited.

The obvious way of raising the effectiveness of development assistance is to concentrate more of it on those governments that have created an 'enabling' policy environment and have a demonstrated ability to put aid to productive use. This would leave governments that do not pass this test with little or no aid until they can persuade donors that they have genuinely mended their ways or until they are replaced by more effective regimes. Of course, it is not always easy to spot the winners and losers in advance. Nonetheless, the desirable general direction is clear.

The implications for assistance to Eastern Europe are obvious. The evidence favours those who argue that it is wrong on developmental grounds to offer large-scale assistance to East European governments which have yet to put in place convincing reform packages. This conclusion may be overturned in practice by humanitarian, foreign policy or commercial considerations, but the desirability of development-oriented selectivity on the part of the donors in the governments they assist is a clear lesson from developing country experiences.

If donors have reason to worry about the intentions of East European governments, the latter have even greater cause for concern about Western policies. Such differences are less the result of 'selectivity' (which implies a conscious choice) than of a lack of consistency; to the extent that there is selectivity it is not prompted primarily by development considerations. Third World experience indicates aid policies and practices which substantially reduce the value of the assistance and which may also infect aid to Eastern Europe. Many of the difficulties stem from the use of aid to promote foreign-policy or commercial objectives. This leads to confusion and to practices, such as procurement-tying, which substantially reduce the real value of the aid offered. Donor agency weaknesses further diminish its value: inadequate staffing;

pressures to spend; short time horizons; and biases towards large, capital-intensive projects. There are also various proliferation problems: of donors, of projects, and of policy conditions. Donor co-ordination is another weak spot, partly because both donors and recipients are ambiguous about it. The donors who so frequently urge policy reforms upon developing countries have been slow to reform their own policies.

The lesson that emerges from developing country experience is that the OECD countries tend to pursue inconsistent objectives and contradictory policies with regard to the external environment in which adjustment must take place. They have tended to undermine their aid policies with ungenerous debt (and export credit) policies, by practices which reduce the quality of the aid, and by the pursuit of protectionism. They have stated that they favour policies of 'adjustment with growth' without being willing to accept the financial implications. Whether they will avoid such contradictions in their policies towards Eastern Europe remains to be seen; the region should not depend on it.

**Part II**  
**The Changes in Eastern Europe**

## 3

## Bulgaria

*Eirik Svindland***The Economic Legacy**

The Bulgarian government used to be reluctant to publish statistics. Much information which in Western countries is published regularly was treated as secret. Some statistics were even fabricated. Using official statistics, for example, the Foreign Trade Bank claimed in January 1990 that the economy was in good health with a steady growth of average real wages, rising from 1% in 1985 to 4.6% by 1988; but three weeks later the new Prime Minister had to admit the existence of an economic crisis that had been developing for a long time. Far from there having been a rise in real wages, he revealed that, while consumer prices had risen by 69% between 1985 and 1989, average nominal wages had increased by only 15.2%. Moreover, in March 1990 the Foreign Trade Bank disclosed that it was practically insolvent and would have to suspend credit repayments for up to two years.

These economic problems are reflected in the standard of living of the population. In August 1990, the Grand National Assembly stated that the subsistence level of income was leva 165 per month, equivalent to about \$23 at the official exchange rate and half that on the black market. At that time, 30% of the population was below and 60% only slightly above this level [*Sofia News*, 23-29 August 1990].

The factors behind this long economic decline are wide-ranging and include demographic changes, education, productivity and the incentive system. The labour force has been falling in size: between 1955 and 1989 it fell as a share of the population from 59% to 56%, whilst the proportion over working age grew from 13% to 22%. This is a combined effect of improved health care, low pensionable ages (60 years for men and 55 for women) and stagnation in the

natural rate of reproduction (down from 3.4 persons per thousand in 1980 to 0.8 persons in 1989).

Inadequate investment has been made in maximising the economic potential of this declining labour force. Only 15% of the population is in education, compared to 25% in Western Europe. Even so, agriculture has been unable to retain this uneducated labour force which has moved primarily into rural processing industries, which now employ 37% of the labour force; to put this into perspective, the respective proportions in Austria and Belgium are 28% and 19.5%. A further 17% is still employed in agriculture (compared with 8% in Austria and 2.5% in Belgium). The services sector remains a relatively small employer by international standards with 8% of the labour force, compared to 18% in Austria and 16.5% in Belgium, although in transport and communications the proportion (at 6%) is in line with international standards.

Productivity in both agriculture and industry is low. Yields per employee in Austria, for example, exceed those in Bulgaria by 150% for maize, 700% for potatoes, 300% for meat and 400% for milk. In Belgium the disparity is even greater: 300% for maize, 3,000% for potatoes, 1,300% for meat and milk. Low initial productivity combined with drought and a mass emigration of ethnic Turks has led to a sharp decline in production in 1988-90. Some traditional exports have ceased and, indeed, in 1990 the government had to prohibit some exports in order to maintain domestic supply.

By Western standards Bulgarian industry is inefficient, out-moded, uncompetitive and shows little capacity to adjust to changing international market conditions. Until now it has survived and grown simply as a dependency of the Soviet industrial system. In 1989 the USSR was the market for 66% of Bulgaria's exports by value, consisting mainly of production equipment (machinery, computers), chemicals and tobacco, and the source of 54% of its imports, mainly energy (petroleum, petroleum products, gas, electricity), transport equipment (tractors, cars, aircraft) and crude materials (metals, chemicals and paper). As a result of the need to dovetail its productive system into the wider Soviet structure, there has been an increasing emphasis on the production of capital goods, which rose as a share of aggregate industrial output from 62% in 1980 to 65% by 1989. There has been

an offsetting under-investment in consumer goods production leading to a growing structural trade deficit in this sector.

An inappropriate incentive system has reinforced these problems and is a major reason for low productivity. Few workers take a pride in their efforts or feel responsibility for the maintenance of plant. There is over-manning both in productive enterprises and in the public administration. Production is often of inferior quality. There are habitual delays in the completion of investments. The housing stock is depreciating, and there is widespread damage to the environment.

Since the change in government, there has been a re-emphasis on the beneficial results from private involvement in production. However, it is a mistake to expect that a transition to a market system will produce rapid improvements in economic conditions. The underlying causes of long-term decline will have enduring effects.

### **Current Economic Problems**

The poor performance of agriculture in particular has led to a deterioration in the standard of living, particularly for the urban population. Basic foodstuffs, such as meat, sugar, milk, sunflower oil, rice and coffee, became scarce and some were rationed in the official stores. Even before prices were freed on 1 February 1991 they were sold at rapidly rising prices on the black market. The official cost of living index has been rising fast, even though it excludes important consumption items such as gasoline and ignores black market prices. As a result, it understates the rate of inflation so that even 'indexed' wages have lost real value. Effectively the cost of living rose by at least 100% during 1990, and by the third quarter of 1991 inflation was reported to be running at an annual rate of 400%.

GDP was officially forecast to fall by 26% in 1991. Industrial production has fallen, especially in chemicals, metallurgy and heavy machinery. In October 1990 these sub-sectors were utilising on average less than 50% of their capacity, ranging within the chemical industry from zero for plastic tube production to 60% for plastic materials, whilst the oil processing industry operated at 30% of capacity. The decline continued into 1991, with industrial output during the first quarter 17.5% below its 1990 level. There

has been a slight increase in light industrial production for exports as this sector is not heavily dependent upon imports. Agriculture has not yet responded to the new incentives, with production believed to have declined moderately. Tourism also dropped by 20% in 1990.

The main reason for this downturn, as reported by 56% of manufacturers in mid-1991, has been the squeeze on imports owing to foreign exchange shortages. An estimated 52% of the decline in industrial production, for example, has been due to shortages of imported raw materials and spare parts. This situation has arisen both because of a fall in exports and because Bulgaria has lost access to foreign credit since it suspended its repayment of debt principal. Hence, imports have had to be cut by more than the fall in exports and the current account actually improved slightly: the deficit shrank from \$1.34 bn in 1989 to under \$1 bn in 1990. These problems have been compounded by the termination of Soviet deliveries of oil and other materials in exchange for Bulgarian industrial exports. The government had intended to substitute Iraqi for Soviet oil, as Iraq owes the country approximately \$1.2 bn, but the Gulf crisis made this impossible. As a result of the oil shortage, the Bulgarian economy lost directly and indirectly about \$1.4 bn, or 7% of GDP. The USSR also realised the disadvantage of a sudden collapse in trade relations and agreed to a short-term contract with Bulgaria for 1991 to supply 6.5 m. tonnes of crude oil - approximately two-thirds of the country's energy requirements - at world market prices and denominated in US dollars. Bulgaria continued to pay by exporting industrial products.

The acute shortage of hard currency for the purchase of spare parts etc. is well-documented. In two foreign-exchange auctions in May and June 1990 several bids were made at a rate exceeding 20 leva to the dollar and the mean bid rate appears to have been considerably higher than expected. Nonetheless, the government decided to maintain a three-tier exchange rate with effect from end-June 1990: an official rate for CMEA trade of 0.797 leva to the dollar, a 'basic rate' for certain commodity imports at 2.9072 leva to the dollar, and a 'cash rate' for other trade at 7.1-7.24 leva to the dollar, depending on whether the currency is being bought or sold.

Such a multiple exchange rate creates its own problems. It is an open invitation to different forms of arbitrage and deception.

Moreover, the tiers were set at an obviously unrealistic level. By the end of 1990 the dollar was being sold on the black market for at least 15 leva. In February 1991, however, an aggressive cash rate devaluation removed the attractions of the black market by reducing the value of the leva to 28.25.

In Bulgaria, as in other East European countries, the reform process itself has contributed to the economic downturn. The old system of institutions and policy instruments no longer functions as it used to, but new procedures and institutions have yet to be introduced. Many economic decision-makers lack the information that they need. Decisions are often postponed, production slowed and delivery contracts cancelled. Economic conditions deteriorate because the network of organised economic relations falls apart and the economy enters a vicious circle that is the more pronounced the longer the uncertainty lasts.

Intervention from outside, in the form of either political decisions or foreign assistance, is necessary to halt the process. In March 1991 the IMF approved assistance of \$503 m. Unfortunately, the net impact of external factors has been to aggravate economic problems rather than to ease them. Traditional CMEA relations had accounted for over 80% of Bulgaria's foreign trade. Insufficient new contacts have been established with other trade partners to make good the loss of the old relations. During 1990 the volume of foreign trade shrank by 30%. Trade with the USA fell by 45% in dollar value terms in 1990, although the signing of a bilateral trade accord in April 1991 may provide the framework for a recovery. Hence, only strong political measures will prevent the further deterioration of the Bulgarian economy.

## **The Transition Process**

### **Legal and institutional needs**

The overall objective of the current economic changes is to establish a system that functions in accordance with voluntary individual decision-making, and the political challenge is to identify and introduce the crucial reforms that are necessary and sufficient to achieve this. The task has been simplified somewhat by Bulgaria's announcement that it wants to join the European Community. This is certainly a distant objective, but EC practices



may now be considered an appropriate standard against which to judge the current reforms.

The framework created by law and accepted conventions determines the day-to-day operation of any socio-economic system. Hence, a transition from one system to another requires the adoption of new laws and conventions. Ideally, all the required changes should occur as part of one comprehensive reform - a 'big bang'. Although, in practice, changes will tend to be introduced successively, it is important to minimise the duration of the legal transition. Legal lacunae and inconsistencies create uncertainty and inefficiency, and tend to induce demands for a return to the *status quo ante*. This last is particularly serious because there does not exist a 'point of no return'; legal reforms are always reversible and will be maintained only if popular preferences are in favour of them as a result of positive experience.

The first priority for legal reform concerns property rights: rules for access to productive resources, for the mobility of factors of production, and for establishing and enforcing contracts. In addition to an overall framework of commercial law, special regulations are required for specific circumstances: banking, competition, insurance, labour contracts, leaseholds, etc. In some cases such special provisions will effectively regulate markets (in order to avoid fraud, for example), but even in such cases what is required is not a carry-over from the old legal system but a freshly designed set of permanent exemptions from the general rules of the market economy.

The essential feature of this legal reform is that every democratic society must choose its own version of a market economic system. The question of whether reform will bring forth a 'Western-type' or a 'third way' system reflects a misconception. So long as the fundamental principles of individual freedom of choice prevail, the system is effectively a market economy. Differences of procedure and convention that distinguish, for example, Finland from the USA do not alter this fundamental characteristic.

The individualistic underpinnings of a market economy give rise to the need for a system of social security because there is no obligation on an employer to support his workers other than by paying the contractual salary. If extras like kindergartens, pensions, health services, etc. are provided, they are substitutes for additional monetary compensation. Individual needs for security and

services are supplied either by public provision or by private purchase. The principles under which public goods and services will be supplied, therefore, are an important factor shaping the market economy.

In order to accommodate the friction that naturally arises when a multitude of independent decision-makers interact, every prospering modern market economy has a complex system of information and standards. Rules of measurement, quality and pricing, for instance, simplify the task of consumers in comparing the array of goods and services available to them. Similarly, standards are applied to public statistics. The development of these systems of conventions is a complex and lengthy process. Fortunately, the task of their introduction by Bulgaria can be simplified by the adoption of EC standards.

Although the thrust of reform is towards 'liberalisation', controls are also necessary. Modern market economies have several independent supervising agencies. These tend to include a trade commission to enforce market regulations and the adherence to anti-trust laws. There also are inspectorates of banking, insurance and the stock exchange to control investment. An audit office is required to oversee public procurement, and an office of weights and measures to enforce certain standards in commercial life. In Bulgaria some of these required agencies are still missing. The adoption of Western models will be easier than creating new ones.

Because of the mistakes committed in earlier attempts to reform centrally planned economies, and the impossibility of undertaking all necessary changes simultaneously, a discussion has developed about the phasing of reform. Which steps must precede others? Should prices be freed before or after the reform of government control of industry and trade, or the installation of a competitive two-tiered banking system? The idea behind such questions is that there exists some optimal order for the reforms. A package approach, which is sufficiently large to encompass all the main core laws and regulations but sufficiently small to be feasible, would help to avoid the tedious Polish or Hungarian style of trial and error transition. It is the adoption of this core that marks the beginning of the new market economy, since it is from this point that every Bulgarian legal entity (both individuals and institutions) will have to begin to live and work within the bounds of the new system.

### **Adjustment problems**

There is also a need for careful phasing within the initial starting and learning period. Adjustment problems must be solved in a certain order. Among the problems to be confronted are the need to ensure convertibility of the domestic currency, to mop up excess purchasing power, to bring public budgets and inflation under control, to demonopolise the economy, to improve management and to privatise large sections of the public sector.

Bulgaria has a huge foreign debt, the service of which requires the country to produce a substantial surplus from net private capital movements, foreign trade and tourism. As prices for export products are already very low, increasing this surplus will depend upon improvements to quality and design.

If all restrictions are removed on currency convertibility, market forces will lead to an initial very strong devaluation of the leva. This is because there is likely to be a flight of domestic private capital, given the large surplus of private domestic purchasing power over available goods. The argument in favour of currency convertibility is that it will induce a rapid adjustment of relative prices. The counter-argument rests on two ideas: first that the maintenance of a more centralised management of the country's currency reserves will mitigate the deterioration in the terms of trade, and second the infant industry argument as applied to the learning phase of new market economic systems.

The experience of Poland provides evidence on the negative effects of attempting the transition under the shelter of a variable, market-oriented form of currency inconvertibility. As a minimum, it is necessary from the outset to grant legal protection as well as external convertibility to foreign investment. Otherwise, foreign capital inflows will be deterred. But beyond this, it is possible to envisage a gradual introduction of convertibility. In Western Europe, for example, the return to convertibility was introduced gradually after World War II and according to a format tailored to each country's needs.

Excess purchasing power exists in a situation where the total cost of products available for consumption is less than the level of demand and prices are officially pegged at sub-market levels; it is commonly termed 'repressed inflation'. In Bulgaria this situation has arisen from the government's practice of granting incomes (in the form of wages plus subsidies and credits) that are greater than

the supply price of the resulting output. This excess in purchasing power is accompanied by forced savings by households in order to balance the public account. Now that it is no longer possible to do this, the government must opt for a combination of: inflation to erode the real value of money debts and savings; privatisation to mop up the overhang of purchasing power and the volume of enterprise debts; and monetary reform to reduce debt and the purchasing power of creditors.

The abandonment of central planning radically changes the state and structure of public finance. The government still has to pay the salaries of a large number of public servants and, in addition, it takes on the responsibility to supply services such as pensions, unemployment benefits and social security. But it can no longer set the level of its income through direct control over the finances of firms. Even in the case of companies that remain within public ownership, the level of control will depend upon the form of the new organisational structure which is adopted. Government will have to consider the profitability of its firms and their investment projects before it pre-emptes the firms' income. To a significant extent, therefore, government revenue will depend upon the tax payments of firms and households. These receipts will be sufficient only if the tax base is sufficiently broad, if new, appropriate standards of accounting have come into general use, and if the tax collecting agency has been adequately organised and equipped. These three conditions will not be fulfilled immediately. The training of tax officers, the establishment of functioning local offices and the general adoption of a new accounting standard may take considerable time. Only as the transition progresses will the tax base gain in size. Hence, the switch to a decentralised, individualistic organisation of the economy tends to increase the public budget deficit in the first instance. This unavoidable consequence of the transition contributes to short-term inflation.

An important feature of a market economy is its need for mechanisms to deal with the inclination of individuals to indulge in unfair competition, cartels and monopolies. Legal provisions are required against the undesirable manipulation of prices, with adequate institutions to supervise these laws. Whilst it is a necessary condition, however, a legal framework is not a sufficient condition to avoid market manipulation. In addition, it is desirable for there to be more than one supplier in each sub-market

wherever possible. This may involve the government in splitting its own monopolies into competing firms and actively supporting the establishment of new private or co-operative firms. Competition can also be increased by allowing foreign firms access to the market. If privatisation occurs before such measures are in place it will have an adverse rather than a constructive effect on the economy. Public monopolies will be changed simply into private ones.

The decentralisation of investment decisions, which is probably the key positive feature of a market economy, will be blocked until there has been a separation of political and economic management. The choices currently being made by the Bulgarian government on the organisation of state-owned property are, therefore, decisive for future economic development.

The use of holding companies may provide a solution to the combined problems of decentralisation, monopoly and privatisation. Each such entity could be organised as an independent company which would take sole responsibility for the business of several firms operating in a competitive environment. It would have the obligation to privatise some or all of the firms for which it is responsible within a specified time period.

The appropriate size of each holding company will depend upon a range of factors. These include the influence of single decision-makers on the development of the economy, the opportunities for anti-competitive collusion by company boards, the inclination to a command-type economic policy, a tendency for the existing bureaucracy to maintain its power, and the capacity of the political leadership to resist market forces. All of these factors favour a large number of holding companies. But the smaller the companies the weaker their capacity to deal with the financial problems facing their constituents. A balance needs to be struck between these two competing determinants of the optimum size. The most important thing is that there is a simultaneous reorganisation of state property, introduction of a new tax-based foundation for public finance, and installation of currency management suited to a market economy. As a second step, a non-inflationary financing of public deficits will be possible. Monetary reform will not be useful until the conditions for stabilisation have been established.

## **Previous Reforms**

Until 1990, economic reforms had been intended primarily to improve the efficiency of the command system whilst leaving its operating principles unchanged. Reforms to industry and the banking system during 1985-90 are cases in point. There was a two-tier structure to industry: 128 combining units controlled over 2,000 'enterprises', and were, in turn, overseen by ministerial departments. In early 1986 the control of the departments was formally ended on the grounds that the industrial units should take responsibility for their own finances. The departments were replaced by one large Economic Council which remained in existence until August 1987 when it was renamed the Ministry of Economics and Planning. In practice, however, the ministerial departments maintained their hold on the system and the principal effect of the reform was simply to install a central agency as the highest tier of authority. A year later, in 1988, this super-ministry was abolished and the control of the ministerial departments was reinstated.

The 1986 reforms also created a two-tier financial structure with the Bulgarian National Bank supported by eight 'commercial banks' which were designed to provide banking services for specific sectors, e.g. the auto-technical bank, the biochemical bank and the transport bank. Nonetheless, there was still central control of the system: the National Bank controlled the commercial banks by ownership of their capital and was, in turn, controlled by the government. In 1989 54 branches of the National Bank were transformed into independent local banks, but without a fundamental change in the power structure. The State Savings Bank retained a monopoly of banking services for households and, hence, prevented the 'independent local banks' from becoming effective.

The 1986 reforms appeared to provide formal autonomy to firms but the effective decentralisation of economic decision-making was limited. The government kept control of production by allocating inputs and outputs. Up to three-quarters of the output of an enterprise remained at the government's disposal and financial ties together with other connections extended this degree of control even further.

Despite these limitations, the opportunity provided by Decree No. 56 of January 1989 to establish joint stock companies and other forms of private ownership has been used for some degree of privatisation. This has been concentrated mainly in the area of services, commerce and transport and has been dominated by members of the *nomenklatura* [*Sofia News*, 26 July and 1 August 1990]. Some of these investments must have been very profitable because the buyer gained a local monopoly, and there have been complaints about the organisation of sales. The Grand National Assembly has therefore put a moratorium on further privatisations until all the necessary legal reforms have been adopted. The first of these is the change to the constitution which was approved on 10 June 1990. Following this, Bulgaria is now formally a democracy based on the rule of parliament and law, whereas previously the government ruled by decree. A new land law was adopted in February 1991, and in May a new law on competition was accepted by the National Assembly, prohibiting a single producer from controlling more than 35% of the domestic market.

The formal autonomy of enterprises has stimulated reform within individual firms which may prove to be a major obstacle to future measures designed to increase efficiency. The board of directors is now controlled in many cases by a general assembly of all employees which appoints the management. The dominance of a firm by its own labour force generally hampers reorganisation and the adoption of new working rules, and reduces management's ability to resist money wages rising faster than productivity.

Four important liberalising measures were introduced during 1990. The first was to grant private farmers permission to lease additional fields and to decide for themselves what to grow on their additional acreage. Taxes which discriminated against private farmers as compared to co-operatives were abolished. Second, exports were stimulated by lifting formal controls and permitting exporters to retain 50% of hard currency earnings (20% in the case of agricultural exports). Third, limits on the size of private firms were abolished (previously there had been a ceiling of ten employees). Finally, about 40% of all retail prices were decontrolled.

These reforms were intended to improve the economy but they actually strengthen the case for further and more radical reforms.



Partial freeing of agricultural prices, for instance, has adversely affected the supply of those products which remain price-controlled. On 1 February 1991, therefore, most prices were freed. The initial response was a very sharp increase in price levels (up to tenfold), but this was because producers held back supplies. When additional supplies came to the market prices began to fall again.

## **The Reform Programme of October 1990**

### **The reform movement**

All the parties contesting the June 1990 elections to the Grand National Assembly made a public commitment to transform the country from a centrally planned to a market economy. The goal is an economy that can sustain both good material conditions of life and an effective social policy. The Bulgarian Socialist Party (BSP), formerly the Communist Party, won 47% of the vote. Its 'programme for overcoming the economic crisis and launching economic reform', which was adopted on 29 March 1990, advocated a gradual transition to an economy in which private, state, co-operative and municipal enterprises could compete. It drew its support primarily from the more conservative, older and rural voters. The main opposition group, the Union of Democratic Forces (UDF), a coalition of social democratic and agrarian parties, favours a 'big bang' approach similar to that of Poland and its ultimate goal is a more radical change in the nature of the economy. It won 37% of the vote, mainly from the younger, urban electorate, and declined an invitation from the BSP to participate in a coalition government because it did not want to depart from its election platform or to prolong the rule of the former communists and thereby accept responsibility for the continuing crisis.

Elections in September for a new Supreme Council of the BSP strengthened the conservative wing of the party which opposes reform. In response, the Lukanov government tried to continue ruling with the support of the opposition and launched a programme that included most of the emergency, stabilisation and reform measures which the UDF had demanded. The UDF was still reluctant to form a coalition and Lukanov was forced to resign after his party lost a trial of strength with the labour unions and anti-socialist demonstrators in November.



In December 1990 a coalition government with a strong UDF involvement was formed under a new, non-party Prime Minister, Dimitar Popov, a former judge. Although the ex-communists are still in a majority, since then there has been a major commitment to reform. The reform coalition also has the support of the two labour unions which agreed a moratorium on 'offensive strikes' with the employers' association. New elections to the Grand National Assembly were planned for May 1991, but had to be postponed because of slow progress in drafting the legislation required to meet the government's ambitious targets. They were held finally in October, and the UDF was returned as the largest party, but without a clear majority. It has formed a government under its leader, Filip Dimitrov, but its stability is in question.

### **Short-term policy issues**

The principal short-term objective of economic policy since 1990 has been to effect a drastic cut in budget expenditure and to combat inflation both directly, via monetary policy, and indirectly by breaking up monopolies and encouraging competition. There is uncertainty, however, on the phasing of the policy. The budget cuts will sharply reduce the central government's investment in production, loans for investment and financing of local government expenditure. But, to avoid causing severe disruption, this assumes that there is a new organisation of state property establishing a clearer separation of political and economic management, and also that there has been a comprehensive reform of public finance. In a Western-type market economy local government has its own tax funds as well as central government transfers, but this does not yet apply in Bulgaria.

The two cornerstones of the programme are a severely restrictive monetary policy, designed to stabilise the leva and sharply reduce the stock of money, and the introduction of interest rates in line with inflation. The freeing of prices on 1 February 1991 effected a rapid, once-for-all reduction in the real value of private monetary balances. Future changes in the nominal money supply will determine the long-term rate of inflation. On 1 February, the National Bank increased its discount rate from 6% to 15%, but this change passed almost unnoticed - probably because the expected long-term rate of inflation is much higher. Shortly afterwards a second rise, from 15% to 45%, provided evidence of the determina-

tion of the new government to impose positive real interest rates. By the third quarter of 1991 interest rates exceeded 50%.

The government has fulfilled its commitment to a consistent and rapid price liberalisation, but it has not carried out its promise of providing compensation to vulnerable sections of the population for the resulting increases in prices. Nor has it followed Polish-style wage indexation. It has followed IMF policy advice and limited wage indexation to 70% of increases.

Other measures that will help to reduce the overhang of purchasing power are the issuing of long-term government bonds, together with the sale of shares, land and public housing. In addition, the government has pledged itself to sell 20% of the shares of each firm to its employees on preferential terms. This will give unequal opportunities to people working in different branches of the economy. The government also plans to sell land and housing to their respective users at officially determined rates and so dispose at subsidised prices of assets that one could argue belong to the population as a whole. A complex aspect of such sales is that, in general, the land already belongs to someone; the communist government never expropriated agricultural land but merely took possession of it and transferred it to co-operatives. The UDF prefers the alternative of restoring land to the *de jure* owners.

### **Problems of reform proposals**

The BSP government promised to start the comprehensive transformation of the country into a social market economy immediately by adopting new economic legislation and creating new institutions, setting itself the unrealistic target of completing the main elements by the end of 1991. It became clear that the demanding nature of the required changes meant that they could not be done in haste. The programme of phased privatisation is a case in point. Effective privatisation requires an efficient organisational structure. The BSP government favoured establishing a privatisation agency and for the municipalities to privatise local property, but failed to obtain any agreement on the precise content or shape of the programme which, as is evident from German and Hungarian experience, will take several years to effect; there will remain a substantial state sector for a significant period of time.

Moreover, effective privatisation requires the existence of appropriate management skills. German experience, with the conceptual and practical problems of the Treuhandanstalt, shows that it makes little sense to embark upon a privatisation programme before ensuring that the necessary management structures and skills are in place. They also demonstrate that it is not sufficient to concentrate on the sale of property: those managing privatisation also have to take responsibility for business decisions before sales can take place.

A further serious consequence of inappropriate phasing is the problem that has been described as 'queuing', whereby illiquid companies delay paying their suppliers, who in turn postpone settlement of their own debts. As a result, 'credit' is provided involuntarily by firms rather than by the banking system. This problem is a serious one in Hungary, where it was caused by an inappropriate phasing of price decontrol, ownership reorganisation, the reduction of subsidies and the introduction of monetary restrictions.

Among the lessons from developing country experience identified in Chapter 1 were the important role of strong political leadership and the advantage of adequate finance to underpin reform. On these criteria, the outlook for the Bulgarian 'revolution' is none too bright. The elections have produced a government which is expected by early commentators to be unstable. Meanwhile, the economic outlook for 1992 is for a further, though hopefully more modest, decline in GDP.

## 4

## Czechoslovakia

*Stephany Griffith-Jones*

### The Economic Legacy

#### Positive features

In East European terms, Czechoslovakia had a relatively healthy economy when the Communist government was overthrown by the 'velvet revolution' at the end of 1989. Its GDP *per capita* was the second highest in the region (after the GDR), and its living standards were high relative to most other countries in Eastern Europe (see Appendix Table 1).

The new government inherited a relatively small external debt (\$7.9 bn) and scheduled debt service obligations (in comparison with other countries in the region, see Appendix Tables 8 and 9) and a very low level of inflation (Appendix Table 5). This legacy may mean that, in contrast to Poland and Hungary, structural adjustment need not be accompanied by so much contractionary stabilisation, unless external shocks are very severe.

Czechoslovakia's relatively favourable economic situation (in comparison with the rest of the region) is to an important extent explained by its history. In the 1930s Czechoslovakia ranked among the most highly industrialised countries in Europe, with a strong tradition of skilled craftsmen producing machinery and other manufactures and businessmen able to export. As the post-war period began, the quality of its industrial products and exports was comparable to that of similarly advanced countries.

During its forty-two years as a centrally planned economy Czechoslovakia broadly followed the Stalinist Soviet model, despite differences in initial levels of development; industries and services were nationalised, development of heavy industry was emphasised and trade flows were diverted from West to East. Its economic growth performance was variable, with declining trends over the past twenty years. During the 1960s and 1970s, growth

rates, though fairly high, were around 30% below the OECD average; the gap has since been higher - 50% during 1981-85 and 33% during 1986-89. Rates that take hidden inflation into account show that the real growth rate was lower than official estimates, and that in the late 1980s growth became slightly negative [Drabek and Dyba, 1990]. Even though growth slowed down, given the nature of the economic system, there was no open unemployment in Czechoslovakia even in the 1980s.

The 1989 revolution was brought about more by political than by economic issues, and its peaceful nature bodes well for the future. In spite of tensions (particularly nationalist ones between Czechs and Slovaks), there seems to be a very good chance that - drawing on its pre-war political traditions - the country will consolidate democracy successfully. Furthermore, at the time of writing, nationalist tensions have been diminished by institutional measures, such as the new powers given to the Czech and Slovak governments, and a compromise has been reached over the distribution of economic power between them. However, structural economic changes, if not appropriately handled, may once again accentuate these tensions.

Nonetheless, even in Czechoslovakia splits have emerged over the path to economic reform. In certain circles, the relative strength of the economy has been seen as an argument for a more cautious and gradual movement towards a free market economy, because of fears that very radical and rapid change could destroy positive aspects of the inherited economic structure. Such fears are not shared by those led by Finance Minister Vaclav Klaus, who have been the dominant group within the Cabinet. They argue that the best way to ensure an improvement in the population's welfare is through swift and extensive reform. Support for this view was strengthened initially by Klaus's election in mid-October 1990 as president of Civic Forum, and also by media support and the difficulties linked to trade with the CMEA. But growing divisions within Civic Forum (based largely on different perceptions of economic reforms and policy) led to a decision on 23 February 1991 to split the movement into two at the time of the next election campaign: the Civic Democratic Party proposes to open the way to economic reforms previously blocked by Civic Forum; and the Civic Movement advocates 'tolerance' - rapid reform without massive social effects.

**Negative features**

Despite its positive legacy, Czechoslovakia is not unambiguously favoured as compared with its neighbours. During the 1980s the communist authorities were committed to raise consumption levels at rates higher than output growth. As a result, the proportion of net fixed investment to NMP (Net Material Product) fell significantly. The repair and replacement of the old capital stock was neglected.

Moreover, Czechoslovakia adopted the centrally planned economy particularly fully, so making its unravelling a more complex task. Economic reform, though attempted several times, was in practice very limited. The most ambitious attempt, started in the mid-1960s, was crushed by the Soviet invasion of 1968.

More than 90% of the labour force are employed in the state and co-operative sectors, while the private sector (even including the informal economy) is responsible for only 2% of non-agricultural output. Because political changes in late 1989 were so revolutionary and unexpected, blueprints for a market economy - and for the transition to it - had not been prepared or thoroughly debated (a clear difference from Poland and Hungary). This also has positive aspects, in that the economic reform process starts at a point when it has strong popular and political backing.

A third problematic feature of the economy is its very close integration into the CMEA. Except for Bulgaria, Czechoslovakia has the highest socialist trade intensity (60% by the end of the 1980s) in Eastern Europe. Over 40% of Czechoslovak exports in 1989 went to the Soviet Union, one of the highest concentrations on a single trading partner in the world. This makes the country very vulnerable to the rapid changes occurring in the CMEA. It may also indicate a relatively weak ability to diversify trade relations with the rest of the world in the short term since the structures of exports to the CMEA and Western areas are significantly different. The share of machinery and transport equipment in exports to the CMEA area (60%) is considerably higher than in exports to Western markets (21%). Czechoslovakia's international competitiveness in industrial exports, particularly of machinery, has declined: the share of electrical machinery in exports to the OECD, for example, was halved between the early 1970s and the mid-1980s.

The change to the conduct of intra-CMEA trade at world prices and in convertible currencies will harm Czechoslovakia as the prices of its exports are likely to fall while those of its imports of raw materials and energy imports will rise. In mid-1990 the Soviet Union cut supplies of oil, forcing it to import from the world market at the same time that prices rose with the Gulf crisis. Although the world price hike was temporary, the World Bank has estimated that, even at a price of \$18 per barrel (the 1989 average), the switch of Soviet sales of oil and gas to market prices would add \$1.8 bn, or about 3.6% of GDP, to Czechoslovakia's import bill.

Whilst the difficult balance-of-payments situation may add an initial spur to the government's commitment to reform, buttressed by external pressure (via the international financial institutions), there is a risk that in the medium term resistance to reform may grow in the face of increased economic and social costs caused by external factors. There is an unfortunate overlap in the effects of economic reform with those of the deteriorating international environment, which may not allow the public to distinguish clearly between them. Vaclav Klaus put this point plainly, as reported in *The Times*, 25 September 1990: 'To our great regret, we will be blamed now. Our citizens will not be able analytically to distinguish what was involved by our reform strategy and what is coming from abroad.'

The Czechoslovak authorities have a range of options to control the timing and sequencing of reform, particularly as regards trade liberalisation. A difficult balance-of-payments situation would seem to require them to bring up-front reform measures that directly encourage exports (such as a competitive exchange rate and very active efforts in fields like international marketing), while possibly slowing down liberalisation of imports which are not directly necessary for the export promotion effort. Particularly if it were backed by some international financial support, the appropriate handling of economic reform in difficult international circumstances could strengthen support for the reform programme amongst the population.

### **Developments in 1990 and 1991**

At a macroeconomic level conditions worsened somewhat during 1990, mainly as a result of a deterioration in the external environment and the uncertainties and complexities associated with the



economic reform. Gross domestic product is estimated to have declined by about 3.5% in 1990. The balance of payments also deteriorated in 1990, due to declining exports to the other CMEA countries and increased cost of oil imports at high world market prices, which were not fully compensated by rising exports to the industrial country markets. The resulting trade deficit reached around \$1 bn. As a result of devaluation and some restructuring of prices, retail prices increased by 20% during 1990.

During 1991 the deterioration worsened and the country entered a deep recession. NMP is expected to have fallen by about 20% (against a government forecast of only 5-10%), with no recovery in prospect for 1992. Unemployment has begun to rise. By late 1990 open unemployment, at around 60,000, was only about 1% of the labour force, but during 1991 it averaged 4%. Inflation, forecast by the government at 30% in 1991, actually topped 60%. A further deterioration of the trade situation is expected, with the 1991 trade deficit being projected to reach at least \$1.5-2.0 bn. However, the availability of important credits already approved for 1991 (e.g. from the IMF) would seem to imply that, though the balance-of-payments situation will be tight, it will be manageable.

## **The Reform Programme: Aims and Problems**

### **The initial reform**

The 1989 revolution was a fundamental watershed. The transitional government that held office from December 1989 to June 1990 allowed reform measures already prepared by the Communist regime to take place as planned, but committed itself to a broad plan for the country's transition to a market economy, and took a number of important initiatives to set this in motion.

- Legislation was passed to remove restrictions on **private economic activity**, to encourage foreign investment and to prepare for denationalisation of state enterprises.
- The existing law on joint ventures was amended to allow 100% **foreign ownership** in Czechoslovak enterprises. Some 640 joint ventures were reported in early 1991 already to have been set up since the revolution.
- **Fiscal reforms** were introduced with the aim of achieving a budget surplus. Although the primary instrument was to



restrain expenditure, some provision was made for a social safety net, including a programme of retraining and relocation for displaced workers.

- The exchange rate for convertible currencies was unified and devalued; another, major, **devaluation** was later carried out by the elected government (in October 1990). This has been accompanied by an increase in exports to the West.

Given the unexpected nature of the revolution, the time constraints and the differences of opinion within the government, the initial progress of reform during the transitional government was fairly impressive.

### **Future reforms**

While these initial measures were being taken, extensive discussions on economic issues took place. The major disagreements were over the concepts and speed of privatisation and the extent of devaluation [Charap and Dyba, 1990]. In May 1990 a resolution setting out the government's preferred economic strategy was made public, and was later endorsed by the new government formed following the June 1990 elections.

A lively debate on the speed and depth of different aspects of the reform process has continued since then. However, a convergence in thinking has gradually emerged, and has been reinforced by the difficult external circumstances; furthermore, the need for a clear path to be chosen seems to have strengthened the commitment to more rapid and radical economic reforms. The leading five economic research institutes, including the (now to be disbanded) Institute of Forecasting headed by Valter Komarek, who leads thinking favouring a more gradualist approach to reform, backed the reform programme sent by the government to Parliament with only minor reservations.

In the autumn of 1990 Parliament approved as the framework for economic reform a number of simultaneous major measures, most of them starting on 1 January 1991. The core measures of the reform programme address: 'internal convertibility' of the koruna, price liberalisation, privatisation and support for private sector development, anti-inflationary macroeconomic policy, and support for a social safety net and for environmental protection. Great priority is placed on the control of inflation.

The government made the koruna internally convertible on 1 January 1991. This means that the buying and selling of foreign exchange for current account transactions has been liberalised and that the exchange rate is determined on the foreign exchange market. If accompanied by relatively low, uniform tariffs together with limited use of licensing and company subsidies, this will provide a close link between the domestic and international economies. However, if the measures to cushion the impact of internal convertibility are initially too limited, this may lead to an excessive expansion of imports or a dramatic initial devaluation. The large devaluation of October 1990 had been planned for 1 January 1991 but had to be brought forward, partly because the 'excessive' public debate on the subject had made enterprises increase imports unnecessarily. To make this exchange rate sustainable, a temporary international credit facility would be very helpful.

The **reform of price formation** has begun already. In July 1990 the negative turnover tax was eliminated on many items, including basic foodstuffs, which led to an average price increase of 25%. Further changes (e.g. in transport tariffs) were introduced during 1990, and a substantial liberalisation of both retail and wholesale prices began in January 1991. Fears have been expressed that, given the present monopolistic organisation of industry and commerce, this could lead to an inflationary spiral. It needs therefore to be supported by cautious macroeconomic policies, encouragement of domestic competition and an increase in foreign competition.

The government has determined a broad programme for **privatisation**. Small and medium state enterprises will be sold quickly, and this will be implemented at a municipal level. The first auction took place on 28 January 1991, with encouraging results: reserve prices were generally exceeded, although it was unclear who was effectively buying - the nominal buyers may have been acting as fronts for foreigners. Prior restructuring and demonopolisation will be required for privatisation of the larger state companies. Only a few key industries and natural monopoly social service providers will remain in the state sector. Furthermore, a restitution law was passed on 21 February 1991, detailing property nationalised by the communists which former owners may reclaim. It is seen as the 'legal anchor' for subsequent reforms

as it will start to clarify property rights, which is a key precondition for private entrepreneurship (both domestic and foreign) to develop.

Whilst there is strong government and public support for privatisation two aspects in particular have been debated: to whom to sell, and how to structure the transactions. The debate was particularly heated in relation to large companies. There is agreement about the initial step of transferring ownership to a National Assets Foundation. It is the next step - transferring ownership to private investors - which will be the most complex. Under a law passed on 26 February 1991, large enterprises are to formulate their own plans for approval by the relevant ministry. The government has stated its preference for distributing the equity amongst all citizens, but as ordinary people do not have sufficient means there is concern that ownership will become concentrated in the hands of those who acquired capital on the black market and/or were members of the *nomenklatura*. Furthermore, capital markets do not exist and there is little expertise for valuation of the assets being offered.

Detailed discussions within the government produced a variety of proposals, most notably the use of vouchers which was supported by Minister Klaus. Citizens were to receive free or low-cost vouchers to be used to bid for shares in state-supervised auctions. This would avoid the need for prior valuation and permit the process to start soon; furthermore, it would delay - though not prevent - concentration of share ownership. But it would place a great administrative burden on the government and would risk creating shareholders who were too fragmented to control management effectively. Giving citizens high-risk shares could also create political pressure to use public funds to bail out non-viable firms. Finally, such a privatisation would not mobilise resources for enterprise restructuring, let alone for expanding the social safety net and increasing spending in social sectors and on the environment. The law of 26 February has adopted the voucher idea but indicates that they will be sold rather than distributed free. There is no perfect solution, and privatisation can probably best be carried out by different mechanisms. In the Czechoslovak case, however, speed may be particularly important, as the size of the state enterprise sector is so overwhelming; there is a need to create a meaningfully large private sector rapidly, both by supporting

new private sector development and by beginning to privatise state-owned enterprises.

At the end of February 1991, Parliament approved the privatisation of large industrial and financial companies, as well as a 'restitution' law for the same category of companies. This covers about 90% of total companies in these categories and can be seen as a major step forward for market reforms.

## 5

## Hungary

*Rolf Langhammer, Peter Nunnenkamp  
and Ulrich Hiemenz*

**The Economic Legacy****The pre-1990 institutional reforms**

Hungary has gone a long way towards decentralising its economic management system since the introduction of the so-called 'new economic mechanism' (NEM) in 1968. During the first decade of reform compulsory annual planning for enterprises was abandoned, profit taxes and a somewhat more rational pricing structure were introduced and foreign trade arrangements were liberalised slightly. As a result, planners' preferences were less dominant over those of consumers; a rapid growth in the supply of consumer goods was accompanied by a better match of products produced and consumed. However, there was a proliferation of special taxes, subsidies and central supervision of large enterprises, centralised wage control remained strict, and neither labour nor capital markets functioned effectively before 1980, thus limiting the economic success of the initial reform efforts.

The second decade of NEM began in 1979 and included several waves of new reform measures designed to facilitate market-building and improve the efficiency-orientation of the economy. New rules for 'competitive pricing' were introduced to connect most producer prices directly to foreign trade prices. Consumer prices were to be directly tied to producer prices through a uniform turnover tax. Multiple exchange rates were replaced by a unified rate in an attempt to bring the forint into line with world currencies and prepare it for later convertibility. In an effort to free enterprises from undesirable central interference, industrial branch ministries were eliminated in favour of a single Ministry of Industry. In order to strengthen competition, efforts were made to

promote small-scale private and co-operative enterprises and a number of monopolistic state trusts were broken up.

To improve the labour market mechanism, contract work associations were allowed to operate within enterprises, enabling groups of workers to subcontract their services; and in an effort to enhance enterprise autonomy and worker self-management, a substantial part of the property rights was transferred to enterprise councils with the right to select managers. Liberalisation occurred in the wage system, with the aim of establishing a closer linkage between wages and enterprise performance. To promote a more flexible adjustment to world market requirements, autonomous foreign trading rights were given to a large number of producer enterprises.

More recently, in a move towards competitive banking, the centralised monobank structure was altered; autonomous, profit-seeking commercial banks were created, and some measures were taken towards a limited capital market with the introduction of new financial instruments, such as bonds, that allow some non-state-intermediated flows of funds among enterprises and from the household to the enterprise sector. To encourage inter-enterprise resource flows, a limited stock exchange began to operate. A bankruptcy law was passed, under which unprofitable firms may be rehabilitated or closed down. In 1988, the old tax system, which was riddled with all kinds of *ad hoc* exceptions, was replaced by a new regime based on value-added taxes and a progressive personal income tax. Furthermore, private households were allowed to save in hard currencies and joint venture regulations were relaxed to the extent that wholly foreign-owned companies are now allowed and minority participation (up to 49%) is approved automatically.

Despite these far-reaching reform measures the Hungarian economy remained caught between weak market mechanisms and ineffective central economic decision-making. Some of the major reasons for the continuing deterioration of the economy over more than a decade can be summarised as follows:

- There was a lack of a truly competitive environment in many product markets owing to a failure to establish the institutional preconditions of a market mechanism through an extensive reduction of monopolistic and oligopolistic

concentration in industry and an increase in import competition by the adoption of a more liberal import regime.

- The factor market mechanisms functioned particularly poorly throughout, owing to the absence of the appropriate institutions and continued interference from the centre. The excessive reliance on fiscal redistribution acted as a poor substitute for real capital market mechanisms. Factor prices remained distorted, mainly because of an overvalued capital stock.
- Another policy error was the gross overvaluation of the forint, necessitating widespread use of company-specific export subsidies and related over-taxation of the best performing enterprises.
- The excessive central intervention in the profit formation process through differentiated taxes and subsidies as well as administrative pricing rules generated substantial divergence between true (intervention-free) and reported (post-intervention) profitability, which consequently weakened the profit incentive.
- The price system continued to suffer from numerous distortions and, as a result, was constrained in its ability to send the appropriate market signals. Price controls continued on a wide range of products, and experiments with administered pricing schemes, such as 'competitive pricing', failed to bring about the desired simulation of a competitive environment.
- The piecemeal nature of the reforms limited their impact. Hungarian leaders were late in recognising that the positive effects of partial reforms reach their limits relatively soon if there are no parallel reform measures in other related areas - as the experience in many developing countries has demonstrated. Moreover, the failure of stabilisation policies, especially lax fiscal policies and the soft budget constraints of public enterprises, seriously impeded the effectiveness of attempts to deregulate the economy.

### **Economic performance**

By the end of the 1980s, internal inconsistencies and the partial and selective nature of the reforms undertaken had driven Hungary into a deep-seated economic crisis of major proportions. A sort of

socialist stagflation set in. The excessive reliance on foreign borrowing as the main policy response to the external shocks affecting the country since the mid-1970s and the consistently declining export market shares had led to a persistent and largely intractable debt crisis. Imbalances in the domestic economy had grown substantially. The fiscal deficit had increased, and shortages had reappeared in markets where a reasonable balance existed before. Most importantly, Hungary's 'consumer revolution' had come to a halt. In recent years the population has been forced increasingly to bear the brunt of adjustment, as the possibilities for foreign borrowing and a reduction of domestic absorption through cuts in investment have been exhausted. Real wages and living standards for a large proportion of the population have declined steadily. Poverty is rising rapidly and about one-fifth of the population, including people formerly among the middle classes, have fallen below the social poverty line.

The quantitative dimensions of the crisis are mirrored in the basic data on the Hungarian economy given in the Appendix Tables. Net material product declined by 4.5% in 1990 and is expected to fall by about 3% in 1991. The main factor behind the bad performance and the gloomy forecasts is the sharp decline of industrial production in response to the depression on the domestic market and the virtual collapse of CMEA trade. Industrial production, which fell by 3.4% in 1989, declined by another estimated 10% in 1990 and is forecast to slump by a further 12% in 1991.

The corollary to output reduction was reduced investment and employment. Investment in the public and the co-operative sector increased by roughly 10% in nominal terms in 1989 but, assuming price increases for investment goods of about 14%, real investment declined considerably. A major reason was high inter-firm indebtedness (of around \$1.5 bn); 177 enterprises were registered as insolvent by the National Bank owing to liquidity problems by the end of March 1990. Total unemployment had increased to 103,278 by January 1991 (approximately 3% of the labour force), and is expected to rise to at least 200,000 by the end of 1991.

Real *per capita* income is also likely to show a substantial decline in response to accelerating inflation in 1990. Subsidy cuts and subsequent price increases for many essential items like food led to an increase in consumer prices of 32.4% by the end of 1990



(see Appendix Table 5). The annual rate of inflation reached 29% in 1990, resulting in a decline in real income of 2-2.5%, and is forecast at 35-40% in 1991.

The only bright spot was the rapid growth of foreign trade and the major shift in favour of hard currency trade (the European Community accounts for about 45% of Hungarian trade with OECD countries). Total exports increased by 16% in forint value terms in 1989, while exports to hard currency areas grew by 23.7%. Since total imports increased less rapidly (13.6%), owing largely to the stagnation of imports from the rouble area, trade surpluses were substantially larger in 1989 than in 1988. These trends continued and a hard currency surplus of \$945 m. on the trade balance was achieved in 1990 (some 77% higher than in 1989).

The trade surpluses of 1989 were not, however, sufficient to prevent a sizeable current account deficit of \$1.4 bn, which was mainly due to high debt interest obligations and significantly increasing travel expenditures in convertible currencies. The faster-than-expected growth of hard currency exports resulted in a current account surplus of \$150 m. for 1990. The current account outlook for 1991 is better than initially expected, and figures for the early part of the year suggest that the country is weathering the transition to hard currency trade, with a current account surplus of \$175 m. being recorded in January. The Central Bank expects a deficit for the year as a whole of around \$700 m., which is half its original estimate.

Of great concern is Hungary's rising indebtedness in convertible currencies, amounting to approximately \$22 bn by end-November 1990 (i.e. 74% of GDP, a ratio considerably higher than for the seventeen most highly indebted developing countries). Debt-service payments amounted to roughly \$3 bn in 1990 (representing a debt-service to exports ratio of 45%). An estimated \$2.5 bn fresh money was required in 1990 to maintain international liquidity.

## **The Reform Programme: Aims and Problems**

### **Objectives and concept**

The first free elections since World War II, held in 1990, brought to power a coalition government led by the right-of-centre

Hungarian Democratic Forum, which chose Jozsef Antall as Prime Minister. This began a radical restructuring of the economy.

The overall medium-term objective of the government is to initiate a process of sustained economic growth and employment creation through competition, private ownership and individual responsibility. This process is to be supported by supplying adequate social services, modernising the existing public utilities and establishing new infrastructure. In view of the shortcomings of previous reform efforts, the Antall government has designed a reform programme for the transformation of Hungary into a competitive market economy in a period of 4-5 years. Key elements are a fundamental reform of ownership, primarily by means of privatisation, the promotion of market competition through deregulation and the enforcement of financial discipline, and a revamping of social welfare programmes; at the same time, tight fiscal, monetary and credit policies are to ensure macroeconomic stability. The aims of the programme are: to stop the decline of the official economy, to contain inflation, to mobilise domestic and foreign investment funds and allocate them efficiently, to improve living conditions and to prevent a further marginalisation of the middle class, without jeopardising the country's credit-worthiness.

Central to the envisaged structural reforms is **the reform of ownership**. Following the transformation of state enterprises and co-operatives into joint stock companies, ownership is to be transferred to 'external owners', including foreign investors (although private equity in 'strategic' industries such as energy, some engineering sub-sectors, aluminium and pharmaceuticals will be limited to 49%). A state property agency was established in 1990 to be responsible for identifying enterprises suitable for privatisation and formulating criteria and timetables for bringing this about. But, following considerable criticism, the agency is likely to lose its leading role. New legislation is in preparation which will determine the parameters for privatisation. A primary aim will be to provide a more stable climate for foreign investors, who will be able to own property directly and not just via joint ventures.

This is to go hand in hand with **the promotion of competition**. This includes a large package of different measures affecting product and factor markets and the behaviour of the state sector. Key elements are:

- deregulation of entry and exit provisions and further price decontrol; changes in the regulatory framework include the dismantling of state trading monopolies and of restrictions on the activities of private enterprises;
- enforcement of the bankruptcy law and initiation of liquidation procedures for insolvent enterprises and co-operatives;
- establishment of a cartel office to prevent unfair market practices, and design of adequate safety, health and environmental standards;
- gradual elimination of import licensing, and provision of tax incentives for foreign investors;
- promotion of new ventures through accelerated depreciation allowances, access to preferential credit and the supply of supporting services;
- sharply reduced subsidies and tighter regulations for commercial banks, with particular regard to valuation practices, accompanied by a credit policy geared towards maintaining a positive real rate of interest;
- financial sector reform, with the aim of establishing uniform reserve requirements, decentralising foreign-exchange operations, building a regulatory framework for a stock and securities market, and alleviating the banking sector from the burden of housing subsidies;
- budgetary reform to reduce the role of the state in economic decision-making; in addition to subsidy cuts, the reform encompasses the improvement and harmonisation of the tax system, a reduction in enterprise profit taxes (from 50% to 40%) and top income tax rates (from 56% to 50%), and a redirection of public investment towards physical and human infrastructure.

To limit the negative impact of the reform programme on the welfare of the population the government has proposed a set of **social policy measures**. The higher prices resulting from subsidy cuts are to be offset by increased pensions and family allowances, at least at the lower end of the social stratum. Larger budget allocations will be required for unemployment compensation, employment services and retraining programmes provided under the Employment Policy Fund created in 1988 to counter the effects of higher unemployment, particularly during the transition period.

At the same time, however, all social welfare programmes will have to undergo serious review as they are widely perceived to be ineffectual, even though total expenditure on them is substantial and was forecast to absorb 50% of the government budget (and 30% of GDP) in 1990. Comprehensive reforms are particularly necessary in respect of housing, health care, and social security programmes, in order to reduce costs and achieve a better targeting of the measures applied.

### **Problems of credibility and inconsistency**

Successive governments have enjoyed little credibility in post-war Hungary. Large parts of the population concentrate their innovative capacities on the shadow rather than the official economy. This does not appear to have changed to any great degree since the end of the communist regime. Public response to the first democratic elections in 1990 was extraordinarily apathetic, and municipal elections have had to be reheld because of insufficient turn-out.

Given this environment, the short-term efficacy of introducing new rules and institutions 'from the top down' is at best limited. In the face of public scepticism the government is reluctant to confront the people with hard facts about former mismanagement and the expected short-term adjustment costs. Instead, it presents over-optimistic scenarios. Statements promising positive rates of economic growth during the transition period, convertibility of the forint by 1991/92 and full membership of the European Community by 1995 may raise unrealistic expectations and lead to further frustration.

In the light of previous experiences with half-hearted reforms, the credibility of the present effort will hinge on the implementation of across-the-board policy changes and the length of the transition period. Yet the Antall government's reform programme relies on gradualism, without committing itself to a pre-scheduled agenda of timing and phasing. This suggests a lack of perspective and clear priorities. There are also serious inconsistencies in the application of the reform of ownership, privatisation, deregulation and institution-building, which will impede investment:

- The question of **land ownership** has become the most controversial dispute within the coalition. The smallholders' party has made the reprivatisation of land on the basis of

1947 ownership its main policy objective. In early October 1990 the Constitutional Court declared this concept illegal because of its unequal treatment of land and other assets. This decision has postponed a settlement of the land ownership issue which is detrimental to investment prospects. New entrepreneurs in both the agricultural and the industrial sectors are likely to face difficulties in obtaining credit and starting operations.

- The legislation regarding ownership of property and land by foreigners appears ambivalent. A law giving enterprises equal rights, regardless of the nationality of ownership, contradicts another which disallows **foreign ownership** of land and property. Government statements that it would be irrational to rely too much on foreign capital may confuse foreign investors in a situation where Hungary is far from being 'sold off' to foreigners.
- Further inconsistencies exist in relation to the role of the state property agency, which is under direct government control. The agency seems to focus on rescuing and restructuring large state-owned enterprises, **privatisation** of which is likely to be postponed. This policy priority slows down the imposition of hard budget constraints and renders it difficult to achieve greater transparency regarding the net financial position of these enterprises and their creditors.
- Even if the pace of privatisation quickens in future the extent of the gain in economic efficiency will remain uncertain unless privatised enterprises are exposed to **competition**. Hungary still lacks the institutional framework required to dismantle its monopolistic structures, most notably an anti-trust office.
- Bureaucratic barriers to entry are seen as particularly high for **new exporters**. Pressure groups to lobby for an opening of markets, such as consumer associations, are either extremely weak or non-existent.
- Despite the existence of a two-tier **banking system**, commercial banks are barely able to perform their tasks of resource mobilisation and allocation. This is due in part to the large share of non-performing assets in their portfolios and in part to the absence of the accounting rules essential to make fixed assets and financial claims tradeable in capital markets.

### **Vested interests**

There are considerable obstacles to the implementation of critical parts of the reform programme. The guiding function of prices continues to be limited. Persistent subsidies (estimated at 9% of GDP in 1990), licensing arrangements and thousands of other regulations hamper the adjustment of production structures to changing relative prices.

An outstanding example of implementation problems is the application of the bankruptcy law against large state-owned companies. Since 1 May 1990 it has been compulsory for insolvent enterprises to declare themselves bankrupt. But implementation of this rule is sporadic. There are powerful vested interests opposing liquidation: employees fear unemployment; creditors (above all the three major state-owned Hungarian banks and other state-owned bodies) try to prevent major losses; and, finally, the tax authorities and the social security system would lose resources. Links of mutual ownership between banks and enterprises facilitate strategic coalitions against insolvency proceedings, especially under the present strategy of *à la carte* gradualism. The state authorities are not entitled - unless they are creditors - to initiate bankruptcy proceedings against insolvent firms. Moreover, evidence so far suggests that the typical reaction of the authorities is to launch a rescuing and restructuring operation whenever insolvency is declared, helping to maintain business activities even in clear cases of insolvency. Hence, the budget constraint of public enterprises continues to be soft.

The government has obviously not considered the possibility of selling the profitable parts of otherwise insolvent entities to private investors. Furthermore, foreign investors are reported to have been deterred by a maze of unclear intercompany linkages and non-transparent net positions of liabilities and assets. Negotiations on the valuation of assets are said to be extremely time-consuming and frustrating, causing potential investors to withdraw.

### **Problems of stabilisation**

#### *Domestic failure*

Until mid-1990 Hungary was successful in bringing the current account in convertible currencies into equilibrium. This, and the fact that it has always met its debt-service obligations, stabilised the country's credit rating under almost all professional rating

schemes. However, this achievement has to be set against the failure of three major policies critical to the success of stabilisation.

- First, although the budget deficit for 1990 was kept within the target of 10 bn forint (0.5% of GDP), a record deficit of 78 bn forint was expected for 1991 (exceeding the original target of 70 bn).
- Second, there has been no progress in fighting inflation, which increased to 29% in 1990. This was above the target level, and prices were expected to rise further.
- Third, the government has so far failed to deter public companies from allowing large intercompany debts to accumulate. At the end of 1989 total arrears among enterprises and banks, excluding those of less than 25 m. forint, amounted to 73 bn forint (4.3% of GDP).

Each of these three failures undermines the credibility of the government's attempts at stabilisation and adjustment, and together they have imposed a heavy burden upon the strategy to privatise and deregulate major parts of the economy. There is an imminent danger that the fiscal situation will deteriorate further and that Hungary may be caught in a prolonged period of stagflation which will diminish public support for the reform package, which was in any case never very great. The need to consolidate the budget and to contain inflation is in conflict with the actual or perceived need for increased public expenditure. Higher social expenditure may be required if unemployment rises faster than expected, which is likely to be the case if bankruptcy procedures are enforced against insolvent enterprises. The fiscal impact of solving the problem of non-performing intercompany debt may be considerable. It is questionable whether cuts in other subsidies and a revamping of social policies can be implemented rapidly enough to balance the envisaged expenditure increases.

#### *External shocks*

The sustainability of reform is also under pressure on the external front. As a small and relatively open economy, the country is extremely vulnerable to external shocks. Since mid-1990 Hungary has been plagued by several major shocks which have occurred almost simultaneously: the slump in CMEA trade and the expected



shift to convertible currency accounting, the reunification of Germany, and the world oil price rise.

The collapse of CMEA trade has deprived Hungary of important export markets, particularly the USSR. In addition, German reunification has interrupted exports to the former GDR, which had been an important export market (accounting for more than 5% of total Hungarian exports in 1989). This collapse is reflected in the dramatic decrease of one-third in Hungarian exports to the rouble area between the first two quarters of 1989 and 1990. Attempts to switch idle capacity to production for Western markets will be hampered by uncompetitiveness in the short run, leading to a further fall in domestic industrial production.

On the import side, the USSR cut its oil deliveries by about 30% in 1990, thereby exacerbating the problems of Hungary's dependence on a single source of energy. The Soviet Union was due to supply 3 m. tons of oil in 1991, and Hungary also reached a barter agreement with Iran to trade agricultural machinery for 5 m. tons of oil. Agreement has also been reached to build a pipeline to Turkey.

Additional problems will arise if the continued drought makes increased imports of animal fodder and seeds necessary. It is doubtful whether sufficient external private savings will be available to smooth over the transition period. However, inflows of foreign direct investment have been more substantial than expected. The initial expectation was of an inflow of \$1 bn in 1991 (on an end-1990 capital stock of \$1.25 bn). In fact, inflows are expected to have reached \$1.5 bn in 1991. The government expects the lion's share of FDI to originate from Western Europe, but as a host country Hungary will face increasing competition from Mediterranean countries and the eastern part of Germany.

### **The physical and human capital stock: an undisputed bottleneck**

By West European standards Hungary's physical capital stock is largely obsolete. Public utilities in particular are in decay. Transport, telecommunications and the supply of energy and water are in urgent need of modernisation. Environmental pollution is serious and leads to high external costs in terms of medical treatment and low life expectancy. Without some concept of environmental protection Hungary may attract pollution-intensive



investment from abroad, which would accelerate environmental destruction and clearly be self-defeating. The transition to a market economy is also seriously hampered by a bottle-neck in human capital. An example of this is the shortage of experienced bank managers, accountants, brokers, economists, lawyers and other professionals needed to provide business services. Services depend on information networks and related software, which are also scarce. Universities lack well-equipped libraries and retrieval systems, not to mention teachers in business administration and economics. Other barriers to international communication were created by Russian having been taught as the second language.

By the end of 1991 the government was reported to be deeply unpopular. Unemployment had reached an estimated 8% and real incomes had fallen during the year by around 2-3%. But, to lighten the gloom, the private economy was reported to be booming and foreign investment inflows had exceeded expectations. Clearly the task facing the reformers is a substantial one. Success is not guaranteed, but neither (on the evidence so far) is it doomed.

## 6

## Poland

*Hans Aage*

### Underlying Economic Problems

Poland's fundamental economic problem is that production and living standards for its 38 million population are considered to be inadequate. With a GDP *per capita* about one-third of the USA's, Poland is a middle-income country, not very different from the least well-off European Community member states [Summers and Heston, 1988:20-22]. During the 1970s the Gierek government tried to tackle the problem through a policy of rapidly expanding consumption and investment financed by foreign borrowing. For several years it obtained growth rates of about 10% p.a., but the policy failed owing to mismanagement, recession in Western export markets, bias towards products in weak demand and heavy import- and energy-intensity of production. The result was an economic crisis (negative growth rates during 1979-82 totalling over a quarter of net material product) and a political crisis that saw the creation of the Solidarity movement in 1980 and the introduction of martial law in 1981. During the 1980s the country managed to regain earlier production levels, and at the end of the period there was some restructuring of production: from heavy industry to food processing, light industry and services, and from state to private activity. The private sector now accounts for about one-third of the labour force (22% in private agriculture and about 10% in other parts of the economy) [Nuti, 1990b:19]. However, former policies have bequeathed persisting economic problems in terms of inefficiency, foreign debt and market imbalances.

#### Inefficiency

**Agriculture** accounts for 13% of national income, 28% of employment and 12% of export earnings. It is predominantly (75%) private, but productivity is low and stagnant, and has fallen progressively behind that of Poland's East European neighbours.

This is mainly owing to an inefficiently small size of farms (10 hectares or less), inefficient production methods (such as extensive use of potatoes for fodder), lack of investment incentives and limited access to inputs such as fertilisers and pesticides, the distribution of which has been controlled largely by the state.

**Industry** (including energy and manufacturing) produces about 50% of GDP and employs 29% of the labour force. It is biased towards heavy industry and large state enterprises. Over 90% of industrial output is produced by the roughly 6,000 state-owned enterprises. The outmoded productive base needs to be restructured. Industry is excessively vertically integrated, over-manned and energy-intensive. Energy consumption is 2-3 times higher per unit of output than in Western Europe [Gomulka and Rostowski, 1988]. There are considerable reserves of coal, oil and gas in the eastern part of Poland, but advanced technology is required for their exploitation; the country is no longer a net energy exporter. Investment in environmental protection has also been neglected.

Incentives for management and for workers have been distorted. Distortions include unrealistic prices (e.g. low energy prices and low pollution charges), soft budget constraints and employment guarantees; enterprise control is often in the hands of groups of workers.

### **Foreign debt**

Largely created during the 1970s, this totalled some \$48 bn before the more than 50% reduction of official debt in March 1991. The remaining \$28 bn debt is still a heavy burden on the economy. The debt service due in 1991 amounted to \$4 bn, or 40% of 1989 exports. To put this in perspective, the hard currency surplus during the last five years averaged \$1 bn, to which may be added \$1.5 bn of remittances from abroad [ECE, 1990; Chilosi, 1990:12]. The government fell into arrears with many creditors. Two-thirds of the debt is owed to foreign governments (the Paris Club). A further one-quarter is owed to commercial banks (the London Club). This debt was being traded in the secondary financial markets at 15 cents on the dollar in March 1990, down from 40-42 cents at the end of 1988. The US dollar has been widely used as an internal means of transaction, and the population holds \$5 bn in deposits with state banks and an amount of \$4-8 bn in dollar bank notes [Nuti, 1990a:174].

### **Market imbalances**

Shortages and excess demand for consumer goods and factors of production were deeply ingrained in the system until the reform of January 1990. Subsidies accounted for 14% of GDP (down from 17% in 1983), and the budget was running a deficit of 8% of GDP in 1989. In 1986-88 real subsidies to households increased (especially in housing, medicine and inputs used in private agriculture), and subsidies to enterprises decreased by about 30%. Of total enterprise subsidies, foreign trade received 46% and coal-mining 21%. Most food subsidies and food price controls were lifted in August 1989, and, together with successive devaluations, 100% wage indexation and an accommodating monetary policy, this led to a rapid increase in prices.

### **The Reform Process**

Against this background the Mazowiecki government adopted, after discussions with the IMF, a rapid and radical reform programme for 1990. The aim was to effect a transformation to a market economy based on proven institutions with market determination of prices and convertible currency, and the programme included measures of stabilisation, liberalisation and restructuring.

#### **Stabilisation**

A number of policy measures were directed primarily to stabilisation objectives, notably:

- Budgetary balance: increasing taxes by about 50%, reducing government investments, and reducing subsidies from 14% of GNP to 6% in 1990.
- Tight monetary policy with positive real interest rates to eliminate the hidden subsidies from household savers to state enterprises via low interest rates in the banking sector that were estimated to total 10-15% of GNP in 1988 and 1989.
- Eliminating controls on more than 90% of prices in the economy, the main exceptions being energy, public transport and housing.

- Wage restraint, providing only mild wage indexation. Excess wage payments were taxed at a punitive 500% enterprise tax rate [Blanchard and Layard, 1990:23].
- Foreign debt was rescheduled by an agreement with the Paris Club in March 1990 and reduced by at least 50% in March 1991. A structural adjustment loan of \$394 m. was obtained from the World Bank in 1990 as well as an IMF stand-by of \$569 m., plus commitments from the G-24 stabilisation fund of \$1 bn and financial aid from the EC [Mihalyi and Smolik, 1990:11].

### **Liberalisation of foreign trade**

This implies the lifting of most quantitative and licensing restrictions, and the lowering of tariffs to between 15% and 50% for most goods. Since 1982 an increasing number of enterprises (more than 1,000) have been granted authorisations to conduct foreign trade activities in addition to the 60 specialised state enterprises. Export incentives include export-related income tax reliefs, a foreign-exchange retention system introduced in 1982 (granting exporting enterprises priority rights to buy foreign exchange for production-related imports for their own use or, as of 1987, sale at auction), and export subsidies under the equalisation settlement system (which equalises domestic and overseas transactions prices for products subject to administered prices). After the amendment of the licensing system of July 1988 some 80% of imports took place on the basis of general as opposed to specific licences (compared to about one-third prior to the reform).

The zloty was devalued by 32% on 1 January 1990 to Z9,500 to the dollar, and again in May 1991 to Z11,400 to the dollar. The zloty has been made 'internally convertible', i.e. for current transactions, and full convertibility is envisaged within two to three years.

### **Restructuring of the economic system**

This is the aim of several radical measures to be introduced more gradually:

- Deregulation of state enterprises and enforcement of strict payment procedures; new bankruptcy legislation and anti-monopoly legislation intended to harden budget constraints and to reduce monopoly power. The system of *ad hoc*, ex

post tax differentiation with respect to sectors, firms and factors of production will be replaced by uniform enterprise tax, personal income tax, VAT instead of turnover tax and reinforced tax collection rules. Industrial associations are being abolished, preventing informal co-ordination of their activities.

- Well-defined property rights. The new government inherited a system under which workers' councils were directly involved in enterprise decision-making and the appointment of managers. A major difficulty is the reconciliation of existing workers' rights with the privatisation law adopted in July 1990, which envisages far-reaching privatisation, regulated by a newly-established ministry. State enterprises are being transformed into companies in which the shares, initially state-owned, will be sold later to the public. At most, 20% can be sold to the workers on preferential terms, and another 10% to foreigners without certification. But larger sales to foreign investors are possible subject to government approval, which is expected to be granted virtually automatically. During the privatisation process, as long as more than 50% of shares are state-owned, workers are entitled to three out of the nine seats on the board of directors [Privatisation Law, 1990; Nuti, 1990b:19-23].
- A new monetary system based on a two-tier banking system. The monopoly bank was broken up in February 1989. Interest rates are to reflect market forces, government bond sales (started in November 1989) can be used to manage possible budgetary deficits, and commercial paper will be issued, which can be used to cope with the problem of inter-enterprise arrears (many firms have several weeks' worth of sales in arrears) by turning them into tradeable securities to be discounted at commercial banks.

## **The Results of Reform**

The reform programme led initially to remarkable results, but not all of these have been sustained. Inflation, after an initial jump, fell to a much lower monthly rate; but it did not fall as low as hoped, and is clearly not yet beaten. Although much lower than the 585%

of 1990, inflation in 1991 was still high, at a forecast 80% against an initial IMF target for 1991 of 36%.

Relative prices responded rapidly to the 1990 price liberalisation and convertibility (with the exception of the controlled prices, notably in energy, transport and housing); shortages largely disappeared. Strong positive real interest rates were established. The budget was initially in surplus but has since gone back into deficit, which stood at Z5,900 bn in the first quarter of 1991.

The economy remains in a deep recession. GDP is expected to have fallen by 8-12%, and output by 12-18%, in 1991. This comes after sharp falls in 1990. Industrial production dropped by about 25% in 1990, and real GDP by some 12%. The steepest output decreases have been in textiles, coal/lignite, metals and transport. Investment in the first quarter of 1991 was 15% below the level of a year earlier.

However output in the private sector increased in 1990 by 17% and, excluding agriculture, by 26% [*Rzeczpospolita*, 2 February 1991]. Agricultural output has not decreased so far despite a drop in fodder and fertiliser sales to one-third of former levels. Moreover, the statistics for marketed production may overestimate the decline. They do not reflect activity in the informal sector or that inventories in retail and wholesale trade have shrunk, while finished goods inventories of producers have increased. Bankruptcies have so far been rare, and, against this, new private firms have been established: there was a net increase in firms in 1990 of 362,200 (516,100 new firms were set up and 153,900 liquidated) [*Rzeczpospolita*, 2 February 1991]. Enterprises have been cushioned by increasing inter-company debt and low real wages. They have cut investment expenditure, have even sold capital assets and stocks, and have used resources to secure short-term survival and avoid lay-offs.

Unemployment is also low compared with the decline of production, although high compared with former levels. By May 1991 it stood at 1.4 million, some 8% of the labour force. Mass lay-offs account for only a small share of unemployment; most is due to the failure of new entrants in the labour market to find employment. It is also concentrated in certain sectors and regions, which is aggravating the social and political problems. These include the coal-mining area in Silesia, the textile area of Lodz and the agricultural area of the North-East. Private employment has

increased, with its share in sectors outside agriculture increasing from 12% in 1989 to 16% in 1990.

Real wages have fallen sharply. They fell by about 25% immediately after the reforms in January 1990, and since then have fluctuated around a continued downward trend. During the first quarter of 1991 they fell by an average of 5.4%. However, these changes do not reflect a corresponding drop in consumer welfare as goods were largely unavailable in 1989 at prevailing prices.

The current account moved initially into surplus (\$3.9 bn in 1990) as a result of an increase in convertible currency exports (up by 34% in 1990) and a fall in imports (down by 10%). But imports have since risen, with a year-on increase of 77% in the first quarter of 1991. As a result, the balance of trade has moved into deficit. The hard currency deficit for 1991 is expected to have reached \$1.3 bn. Almost all trade is now in convertible currency (97% of exports and 96% of imports in the first quarter of 1991).

## **Problems of Reform**

The ultimate aim of the reform is to infuse dynamism into the economy by means of marketisation (making economic agents responsive to real prices) and privatisation (in order to stimulate entrepreneurial culture). The full range of the necessary and sufficient conditions for economic growth is not entirely clear, but a minimum requirement for successful reform is political, cultural and economic sustainability [Aage, 1991]. This is discussed below under the headings of popular attitudes, institutional reform, supply responses and the world environment.

### **Popular attitudes**

Initially, both the government and the population were fully committed to reform. In the first months of 1990 the government could claim an unprecedented degree of legitimacy and support from the population. In public opinion polls the proportion of people who felt that their economic situation was at least 'not bad' rose from 13% in autumn 1989 to 20% in January 1990 and 27% in March. A similar improvement was recorded concerning perceptions of the state of the economy. On the other hand, the so-called index of optimism - the share of respondents expecting the economic situation to improve in the next two years - declined from about



60% in autumn 1989 to around 45% in mid-1990. In the past, when this index was secret, falling below the threshold of 25% is said to have been a reliable predictor of political upheaval.

Since then, however, this 'honeymoon spirit' has become decidedly tarnished. Polls in mid-1991 showed that most people expected social tensions to increase. The CBOS polling organisation had never before March 1991 recorded so large a gap between pessimists (54%) and optimists (6%). For the first time pollsters are recording 'net disapproval' (the difference between those against and those for various institutions) of Solidarity. The army is now ahead of the church in the 'net approval' league table.

The October election produced a turnout of only a little over 40%. The result, which put eighteen parties into parliament, is unlikely to lead to political stability as the lengthy process of appointing a prime minister and government acceptable to both the parliament and the president has demonstrated.

The driving force of the reform process is the wish for higher living standards. The proponents of reform believe that a 'Western-type market economy' is a short-cut to wealth. They have been reinforced in this belief by Western economists and politicians. If the present austerity and hardships continue and the aspirations of quick results and prompt delivery prove false, then the crucial condition for the survival of reform, namely popular support, may disappear. A clear indication of dwindling popular support was provided by the presidential elections of November 1990 and the parliamentary elections of October 1991. During spring 1991 tensions between the government and groups of the population worsened sharply. Workers in state enterprises, for example, feel discriminated against by a punitive tax on wage increases, introduced in 1991, from which private enterprises are exempt.

As a response, no doubt, to such pressures, the government has become more pragmatically interventionist during 1991. Indeed, the IMF in September 1991 suspended Poland's drawing rights because of concern over the level of commitment to sound money.

### **Institutional reform**

A huge amount of new economic legislation is required to establish a general rule of law and institutions appropriate to a market economy. A major debate is taking place on the various elements of reform, their necessity, speed and sequencing,

including: stabilisation, liberalisation of prices, liberalisation of trade, demonopolisation, privatisation, deregulation and depoliticisation of state enterprises, transformation of the production structure, creation of labour market institutions, restoration of banking and capital markets, and democratisation.

Given the initial situation of severe macroeconomic imbalances and hyperinflation it was decided to take immediate action on stabilisation and liberalisation of prices and trade, with the aim of stimulating competition, price adjustments and a reorientation of trade. Other reforms are to follow.

A crucial aim of reform is to improve incentives for private and state-owned enterprises. Property rights are to be clearly defined and contracts and payment procedures strictly enforced. Privatisation has high priority, but the privatisation law of July 1990 left open several issues to be covered by follow-up legislation and governmental discretion. These include the scale and timing of privatisation, the size of free distributions, credit sales and foreign acquisitions, as well as the role of financial institutions [Nutti, 1990b:22-23].

The large-scale privatisation of state-owned enterprises began with the floating on 30 November 1990 of seven medium-sized companies, all financially strong with established Western export markets [Grosfield and Hare, 1991]. In order to facilitate the process in a situation of domestic and foreign capital shortage, it is intended to distribute capital vouchers to the population. These will be used mainly for the purchase of shares in mutual investment funds which, in turn, will buy shares in at least one-fifth of the 500 largest enterprises (out of a total of 6,000 state-owned enterprises) [Fallenbuchl, 1991].

During 1991 the privatisation exercise became more complex, with several variants appearing: public flotations, direct sales to workers/management, a search for strategic investors, and 'sectoral privatisations'. In June 1991 the government announced a rapid mass privatisation, with a target of transferring the ownership of 400 top industrial concerns by the end of the year. But this ambitious goal had to be scaled back in late October because of widespread public concern that the result would be the creation of monopolies, that it concentrated too much patronage power in the government and that the shares would not be immediately tradeable.

The privatisation of small-scale production, commerce and services started in 1990, when there was a net increase of 362,200 small businesses, and 28% of existing state and co-operative stores were transferred to private ownership. The government's preference is that former owners should acquire the state enterprises or receive compensation. It is intended that the state agricultural farms, which cover 19% of the arable land, should be privatised in large units and that inefficiently small farms should be restructured into larger units, but these remain tasks for the future.

The case for privatisation - stimulating entrepreneurial effort, private investment and enterprise efficiency - is particularly strong in the case of small- and medium-sized enterprises. With respect to sequencing it may be appropriate to privatise small businesses, such as commerce and consumer services, early in the process and larger firms later when a rational price structure is well established [Nuti, 1990b]. It is important also that new firms are created, especially in retail trade, as this is at present often a local monopoly. The creation of private monopolies could compromise the reform process, as evidenced by the popular resentment towards co-operatives in the Soviet Union. On the other hand, chopping up firms in order to restrain monopolies should not be done in a way that endangers efficiency.

The main argument for fast privatisation is to make reform irreversible, but it may incur heavy costs in various ways. It is expensive in terms of fees to foreign consultants. It requires an expensive administration to keep track of ownership rights. There is a danger of insider acquisitions, and the nomenklatura is already a target of public resentment. There could be an adverse reaction from foreign creditors if they consider Polish enterprises as collateral for their loans. Selling prices are particularly difficult to establish without a period of enterprise adjustment, and there is a risk of decapitalisation. Chaotic economic conditions might scare away prospective foreign investors [Murrell, 1990].

Privatisation policies also involve problems of consistency. In particular, prospective shareholders must have sufficient financial resources. Yet the money holdings of the Polish population have fallen during the first phase of the reform programme as prices jumped sharply. The government is now actively seeking foreign investors, but widespread foreign ownership might create future

problems, and the government is opposed to debt-equity swaps [Nuti, 1990a:181].

State-owned enterprises will remain an important feature of the Polish economy for a long time to come, and their deregulation and depoliticisation is therefore an essential part of the reform. The aim is to reduce the system of bilaterally bargained, bureaucratic, vertical relationships and transform the production structure [Murrell, 1990; Newbery, 1990:3]. This requires stable legal relationships, efficient taxation, price adjustments and even improved central planning and industrial policy.

The difficult and time-consuming task of creating capital and labour market institutions is an urgent one which is reinforced by fast privatisation. Under the present banking system it is difficult for sound enterprises to obtain loans, and transaction costs are high. Capital markets are necessary not only for managing budgetary deficits but also for mediating private investment. A law on capital markets is being prepared, and it is intended to open a stock exchange in June 1991 [Fallenbuchl, 1991]. Housing mortgage institutions are important and may contribute to inducing middle-class values.

Adequate labour market institutions are absent, and workers typically still appeal to the state authorities rather than to enterprise management when claiming higher wages and other improvements. A system of collective bargaining is needed, and the private enterprise sector needs representative organisations. The tradition of full job security is disappearing, but unemployment benefit, labour placement systems and retraining possibilities should be improved. The incentive and allocational role of relative wages is a vexed question. Proposals for linking wages to labour productivity are questionable as productivity reflects not only labour quality but also earlier investment and relative prices.

### **Supply response**

Institutions that can transmit market signals to producers are lacking. And even if signals are received indicating what to produce and for whom, widespread rigidities often prevent the required drastic changes being made. Facing declining sales and being reluctant to take hard decisions early (partly owing to the need to obtain the consent of workers' councils), most enterprises have responded by building up inventories of finished goods and

inter-company debts as well as sending workers on vacation. Many enterprises are being decapitalised by workers and management for the purpose of short-term survival, and this practice is possible because the owner, i.e. the state, is losing its authority.

For an increasing number of firms the only possibility in the longer term will be to close down. It has been argued that if inputs are valued at world market prices some factories subtract rather than add value to their raw materials. Besides chemicals, cement and non-ferrous metals, these also include food-processing industries (meat, fish and dairy products, fruit and vegetables, oils and fats) [Hughes and Hare, 1991]. Unfortunately because of the distortions to energy and transport prices, large inter-enterprise debts and the inadequate financial system, there is no guarantee that it is the most unprofitable enterprises which go bankrupt. Generally it is easy to demolish and destroy, but difficult to do it so as to create new industries. An active industrial policy is required to achieve this.

A crucial question is whether the increase in hard currency exports is an indication of supply-side flexibility. A case study of eight enterprises shows considerable response to emphatic price signals, but more general evidence of flexibility is lacking [Jorgensen *et al.*, 1990]. About one-third of investment is genuinely enterprise-financed, and the tendency seems to be a switch from new projects in favour of modernisation and the quick-yielding completion of projects already undertaken.

Given the initial level of unsatisfied demand for consumer products, a full opening of the domestic market to foreign imports may not be warranted. In Western Europe the liberalisation following World War II took over a decade, and a lengthy transition period has also applied to new entrants to the European Community (except for the GDR).

There is a case for making state enterprises more efficient rather than just privatising them. The government should aim at an active industrial policy. This has been done successfully in various Western-type market economies. Efficiency appears to be related less to ownership and administration *per se* than to the competitive and legal environment in which institutions operate and to the quality of leadership [Vickers and Yarrow, 1988:40; Newbery, 1990:9; Nuti, 1990b:14].

### **World environment**

This is crucial to the success of reform in accelerating economic growth. Poland has had the misfortune of three recent blows to the economy: reduction of the former GDR market after the German reunification, severe cuts in exports to other parts of the former CMEA, especially the USSR, and increases (albeit temporarily reversed) in world oil market prices.

German reunification has meant the repatriation of, or cuts in remittances from, 35,000 Polish migrant workers. Polish exports are uncompetitive with Western goods in the former CMEA markets for reasons of quality and finance, among others. Declining exports to the USSR have hit the textiles and electro-machinery industries especially hard (the latter used to export 20% to the USSR). Poland's terms of trade have deteriorated seriously owing to cuts in Soviet deliveries of oil on preferential terms. The extra convertible currency costs which have arisen because of this shortfall in Soviet supplies have been estimated at \$1 bn, or approximately 10% of total convertible currency export earnings. Domestic output of coal is expected to fall, placing additional strains on the economy.

Access to the important EC market will improve significantly under the Association Agreement negotiated in autumn 1991. But trade barriers are probably not among the most important factors limiting exports to the Community. Several quantitative restrictions and tariffs were lifted in 1990, 4-5 years ahead of schedule [Mihalyi and Smolik, 1990]. The principal constraints are mostly on the Polish side in terms of marketing, packaging and other problems of market adaptation.

Foreign credit has been obtained for a variety of projects including telecommunications, railway rolling stock, livestock feed processing, frozen food processing and natural gas utilisation. It has proved difficult to implement these opportunities at a fast enough rate. Currently Poland does not appear to lack the ability to obtain credit; rather, it lacks absorptive capacity and projects that offer profitable returns.

In a still longer perspective it is necessary to form a coherent picture of economic conditions some decades hence, rather than leaving all decisions to market forces which have their potency in relation to short-term efficiency but are notoriously myopic. The present strategy of tapping into the current boom in some

Western-type market economies raises the question of the time horizon both for the persistence of the boom and for the process of catching up. For Western Europe the process of catching up with the USA after World War II required about 30 years under extremely favourable conditions. It is unlikely that this amount of time will be at hand for Eastern Europe before a mounting multitude of problems will fundamentally change the economic outlook. These problems include environmental damage, scarcity of clean energy resources and the need to cut carbon dioxide emissions.

## 7

## Romania

*Sandro Sideri***The Economy**

On the whole, the major imbalances of the Romanian economy are 'reflected in the backwardness of agriculture, the over-dimensioning of the primary processing industries, the deepening of the energy crisis and the neglect of the tertiary sector' [GCEP, 1990:5]. Yet the extensive falsification of data and information relative to practically all features of economic life makes it impossible even to draw a simple picture of the structure of the economy and its main social characteristics. The following account should, therefore, be read with this basic data constraint in mind.

**Population**

No census has been taken since 1977, but the population is currently estimated to be just over 23 million. Its low, and declining, natural rate of increase - from 9 per 1,000 during the 1970s to 4.9 in 1985 - is due to the combination of a rapidly falling birth rate (from 19.1 per 1,000 in 1978 to 15.8 in 1985), a fall in total fertility and a slightly increasing death rate (from 9.7 per 1,000 in 1978 to 10.9 in 1985). These factors are connected with the country's declining living standards.

At least 2.5 million people officially belong to minorities: in order of magnitude, Hungarians, gypsies, Germans, Turks, Ukrainians, Serbs and Jews. The continuous violation of human rights, including the attempt to destroy the cultural heritage of the Hungarian minority and to uproot it through the rural urbanisation programme, caused deep concern abroad during Ceausescu's last years. Relations with Hungary worsened dramatically and Romania kept fortifying its frontiers, at costs that it could barely afford, increasing its isolation within both the international community and the CMEA. By early 1989 relations with the European Community countries had deteriorated to the point that



Paris and Bonn recalled their ambassadors from Bucharest, followed by Ceausescu's withdrawal of their Romanian counterparts. The violation of human rights, and particularly the treatment of the Hungarian communities, has been constantly condemned by Amnesty International and other organisations.

### Social conditions

Natural factors, climatic conditions and misguided economic policies all contributed to the serious and widespread worsening of social conditions during the 1980s. This period saw frequent food shortages, rationing of the domestic use of power and the drastic reduction of public transport.

On the government's own information the country's economic and social conditions are 'disastrous'.<sup>1</sup> Estimates of *per capita* GDP vary from about \$1,000 to \$7,000, with an average of around \$4,000 - the lowest in Eastern Europe [*The Economist*, 10 March 1990:81. See also Appendix Table 1]. If estimated on the basis of purchasing power parity, Romanian *per capita* income barely reaches one-third of the average for the whole EC [DB, 1990:14, Table 1].

Only 4.6% of the population aged 25 or over has received post-secondary education, but the literacy rate was put officially at 96% in 1983. The proportion of the economically active population employed in agriculture declined from 75% in 1950 to 28% in 1986, yet almost half the population continue to live in rural areas. The collapse of the transportation system has had particularly negative effects because it is estimated that almost one-third of urban employment is carried out by rural commuters, i.e. males working in towns while their wives or mothers cultivate the private plot and take care of the children. The breakdown of the system has either stopped this flow or made it very arduous for those who must continue to commute.

---

<sup>1</sup> This disaster is the result of 'absurd measures [which] gradually and irreversibly [have] eroded, under any acceptable limit, the people's living standard' [GCFA, 1990:5; BEE, 26 March 1990:104]. According to Report No. 1 of the Government Commission for Development of the Government's Economic Policy 'in 1989 Rumania occupied the last or the last but one position in the case of virtually every social indicator' [GCEP, 1990:7].

### **The economic structure**

After 1948 most of Romania's economic activities were nationalised, but the low level of productivity led the government to reduce central controls slightly. In 1978 greater flexibility of management was introduced, followed in 1982 by the possibility of allowing the sale of shares in state-owned firms to workers. Yet, on the whole, the regime's 'economic and social policies have proved disastrous during the 1980s' [EIU, 1989:4].

#### *Agriculture*

Agriculture, forestry and, later, petroleum production constituted the main economic activities in Romania before the country started its industrialisation in the early 1950s. However, rapidly declining food supplies and exports have forced the government officially to shift its priorities back to agriculture and away from industrialisation since the early 1980s. Nonetheless, agriculture's share in net material product in 1988 (at 15%) was still marginally lower than in 1975 (16%). The sector accounts for only a little over a quarter of formal sector employment.

To stimulate output in the private farming sector new regulations were introduced in 1984, followed in 1988 by ambitious, but controversial, plans for the creation of large agro-industrial centres. Food production did not increase sufficiently, however, and the improvements recorded since 1984 largely reflect changes in statistical methodology and involve non-comparable data [EIU, 1989:19]. For example, while the grain harvest of 1988 was officially put at almost 33 m. metric tons, US Department of Agriculture estimates put it at below 22 m. [USDC, 1990:6].

Romania's main agricultural products are wheat, maize, rye, sunflower seed, sugar beet, potatoes, plums, apples and eggs. It is also a leading producer of grapes, output of which reached 2.5 m. metric tons in 1988. Plans were made to expand vine planting, but wine production declined from almost 12 m. hectolitres in 1986 to 8.1 m. in 1988.

Extensive farming is dominated by the co-operatives and state farms, which account for almost 91% of the cultivated land area. Private farms are more important, though, for the labour-intensive production of livestock (except pigs). Although they account for only 9% of the cultivated land they contributed, in 1985, an

estimated 45% of the total meat supply, 40% of vegetables, 56% of fruit and 60% of milk.<sup>2</sup>

In 1988 the total area of land under irrigation reached 3.7 m. ha., an increase since 1980 of 1.4 m. compared to the 0.3 m. ha. increase in arable land during the same period. This should increase further once the Danube delta development programme is completed, thereby fostering the production of cereals and rice, fish-breeding and the cultivation of reeds. The last is already an important input into the paper and cellulose industry.

Attempts were also made to put to economic use the forests that cover almost one-third of Romania's territory (27% during the 1980s), whilst also regenerating them.

### *Industry*

Following the Communist takeover Romania embarked on a programme of rapid industrialisation, concentrating investment in the build-up of energy-intensive industries, notably ferrous and non-ferrous metallurgy, heavy engineering and, later on, oil refining and petrochemicals. Mining and timber processing are also relevant sectors.

The industrial drive started with the development of the metallurgical and the heavy engineering sectors, the output of which was largely exported within the CMEA. Romania's steel output reached 14.3 m. metric tons in 1988 and was planned to reach a yearly production of 20 m. tons. There was a single-minded pursuit of economic independence reminiscent of the autarkic nationalism of the 1920s. Herein lie the origins of Romania's economic plight. Despite contributing more than 60% of the national income and about 37% of employment of the economically active population since 1983, the industrial sector, created at

---

<sup>2</sup> According to a Ministry of Agriculture proposal 'state agriculture holds at present 14% of the country's farm land, but produces 23% of the grain output, ... 40% of the milk production, 80% of the pork and 84% of the white meat production'. As it is not clear what is meant by 'farm land' it is difficult to compare these figures with those presented in the text. Furthermore, the definition of state farms as 'a safety valve for society' does not help make the other information more acceptable [*Romanian News*, 10 July 1990:8].

huge human and social costs, is largely obsolete, highly polluting and uncompetitive even within Eastern Europe.

In the early 1970s the emphasis of investment shifted to light industrial commodities such as textiles, clothing, shoes and furniture, aimed largely at the West, with exports of machinery and equipment, mainly for petroleum exploration and refining, concentrated on the Third World. In the second half of the 1970s, as 'it was becoming clear that Romanian economic performance was slowing down' [Shafir, 1985:109], oil refining and petrochemical capacity was expanded in order to increase exports to the West. The early 1980s saw an attempt to move into sectors such as electronics and microelectronics, automation, and precision machinery.

#### *Mining and energy*

Romania's oil and gas reserves have been rapidly depleted by the industrial strategy followed so far. The heavy and growing energy requirements of the industrial sector had transformed the country into a net energy importer by 1975 and a net oil importer a few years later. Unless consumption is reduced, gas reserves could be exhausted by the late 1990s and oil reserves by the end of the century [EER (part 1), 1989:10].

Romania has the largest gas fields in Eastern Europe and natural gas accounts for more than 60% of domestic energy production. The difficulties in meeting oil and coal production targets made it necessary to keep increasing the production of gas from 33 bn cubic metres in 1980 to 37.3 bn in 1987, followed by a decline in 1988 [EER (part 2), 1989:6]. Meanwhile, imports of natural gas from the Soviet Union rose steadily, pointing 'towards greater integration of the Romanian petrochemical industry with Comecon' [EER (part 2), 1989:7].

The domestic production of lignite has expanded rapidly, from 26 m. tons in 1980 to 42 m. in 1987, but so have imports of hard coal since the early 1980s as domestic production continued to fall below planned targets. Furthermore, the quality of Romania's lignite is considered very poor and its energy content low, so that to substitute lignite for oil and gas in power generation adds heavily to an already high level of pollution.

Despite the oil discoveries, oil output has continued to decline since 1977, reaching its lowest level in 1988 at 9.4 m. tons, so that

it now contributes less than 20% to the generation of domestic energy. Growing oil imports, mainly from hard currency markets, have been largely responsible for the country's indebtedness. Net oil imports were cut during the first half of the 1980s, but then started rising again until they reached 7.6 m. tons in 1988.

In the second half of the 1970s the country expanded its petrochemical industry and its exports of refined oil products, which have made up a large part (one-third in 1985) of hard currency earnings. As the refining capacity grew from 16 m. tons in 1970 to over 30 m. in 1981, imports of oil were needed to maintain even 50% capacity utilisation. Yet, some estimates indicate that in the early 1980s Romania may have been exporting refined oil products at a price lower than that paid for the imported crude. The situation improved only after 1986, when the Soviet Union resumed exporting to Romania large quantities of crude on soft currency terms.

Energy demand is 3 tons *per capita* (oil equivalent), higher than that of Yugoslavia or Hungary though lower than the average for Eastern Europe [DB, 1990:14, Table 1]. Attempts at reducing energy consumption have meant severe restrictions in the non-industrial sector. Yet even with drastic rationing to households power supply has remained insufficient, making it necessary to rely on growing imports from Soviet sources.

### *International trade*

The broad trend of Romanian foreign trade is given in Appendix Tables 6 and 7. Its main exports in 1986 included industrial and transport equipment (37%), fuels (22%), foodstuffs and agricultural raw materials (13%), chemicals (10%), furniture and manufactured consumer goods, mostly textiles and clothing. Its imports, also in 1986, concentrated on fuel and raw materials (49%), machinery (30%), foodstuffs (10%), chemicals (7%), and industrial consumer goods (4%). However, not only did almost two-thirds of Romanian trade take place within the CMEA, but the composition of this trade also differed from that with the West. Exports to the CMEA (and also the Third World) were mostly industrial goods in exchange for oil and raw materials. Exports to the West, which have rapidly declined, concentrated on petroleum products (33%), clothing (14%) and furniture (9%), while imports were mostly crude materials and mineral fuels (30%), manufacturing inputs

(25%), chemicals (16%) and textile yarn (11%) of which Romania appears to be a net importer.

The sharp reduction of credit flows following the announcement in July 1981 of Romania's inability to service its debt forced a debt rescheduling in 1982. A policy of rapid repayment was then enacted, with severe consequences for the economy and the people. Imports of machinery and consumer goods from the West were all but stopped, while exports were boosted at the expense of domestic consumers. Furthermore, cutbacks in imports of raw materials, food and machinery and equipment contributed to a slowdown in output and employment, in the metallurgical, chemical and engineering industries, with depressing effects on other sectors. Unable to obtain repayment in hard currency of most of its credits from Third World countries, Romania instead accepted imports of goods, including oil.

#### *Prices, wages and productivity*

Until the early 1980s most retail prices were kept stable, but as wages were allowed to increase the result was repressed inflation. In 1982 prices were increased by 35%, but after 1984 the government re-established rigid price controls. This was against a modest rate of growth of labour productivity in the industrial sector which reached its lowest level at 2.1% in 1987. When deflated by the 24% official price increase it appears that real private consumption grew yearly by less than 1% between 1981 and 1986, even on official figures [EIU, 1989:18].

In 1988 wages started rising while prices were kept stable, consequently contributing to the multiplication and extension of shortages. Even so, some 4.3 million workers - 56% of the work force - fall into categories that earn leu 2,250 or less a month, which is about 25% less than the average wage in 1985. The average monthly salary of Romania's 8 million wage-earners is currently only leu 3,063 [CFP, Annex 28:135].

#### *Infrastructure*

Romania's communication network comprises about 73,000 km of roads (64% paved), 11,300 km of railways (less than one-third electrified), and 1,700 km of canals and inland waterways. Figures for *per capita* car, TV, radio and telephone ownership are the lowest in Eastern Europe. Even the existing infrastructure has not always been fully and properly utilised; the ambitious and

expensive Danube-Black Sea Canal, for example, inaugurated in 1984, has never operated at more than 10% of capacity. While the basic infrastructure was neglected, a series of grandiose projects *ad Ceausescu's gloriam* made up most of the country's construction activity and bloated the sector so that by the end of 1987 it employed almost 800,000 workers.

The lack of adequate infrastructure, in addition to political considerations, has also hampered the development of the tourist industry, despite ample potential. In recent years hard currency earnings from tourism have declined.

## Recent Events and Consequences

### The new government

The series of popular uprisings that in 1989 started to change the face of Eastern Europe extended to Romania, where they precipitated an apparently already planned palace coup. As a result, whilst in many parts of Eastern Europe the Communist governments were overthrown, in Romania the old regime has largely survived. Elections have failed to produce a government around which the people have rallied; democratisation is faltering, making it even more difficult to undertake painful but essential economic reforms. The then Prime Minister, P. Roman, stated at the 45th Session of the CMEA Council on 10 January 1990 that 'Romania is not yet ready to give up the entire old economic model; first the economy must be consolidated and only later can a new, market-oriented model be adopted'.

The events that brought down the previous regime started with the huge demonstrations at the Red Flag tractor plant in Brasov, Transylvania, in November 1987. These were followed a month later by others in Timisoara and Bucharest, all reflecting the worsening social conditions and the growing hardship inflicted on the country by the regime's policy. Yet the government appeared to be in firm control until almost the end, able and willing to use any means to repress the popular uprising.

Taking advantage of the popular movement, those who engineered the palace coup eliminated the Ceausescu clique and regained control over a population which was disorganised and still largely unable properly to articulate its demands. For a while the new government also tried to resist the request for elections,



but then held them before other forces could organise themselves and reach a population which was completely unprepared for free elections. At the same time, the government of the National Salvation Front (NSF) did not hesitate to utilise most of the instruments and techniques developed by the previous regime. The NSF's capture of the presidency and of a sizeable parliamentary majority should not, therefore, be very surprising. New elections have been promised by President Iliescu for May/June 1992.

There has been increasing violence between ethnic Hungarians and Romanians, skilfully utilised, if not openly directed, by the government. To date the pledge to create a ministry for ethnic affairs has not been fulfilled, thus breeding distrust and fear among the minorities.

### **Economic policies**

The government seems hesitant to embark on the process of reform that is so badly needed. The minister responsible for the transition has indicated that he expects the process of 'marketisation' to take from six to eight years. Playing on the industrial workers' fears of mounting unemployment - already more than 10% of the labour force - and higher prices, the government tends to theorise about an elusive 'third road' which sometimes sounds more like the corporatism that in earlier times was also popular in Romania.

Although the government has announced that 3 m. ha. of arable land have been distributed, its legal status has not been defined. However, from various statements by the authorities the Economist Intelligence Unit concludes that this action constitutes a distribution of allotments rather than a transfer to private property [EIU, 1990:19-20].

As part of a loan agreement with the IMF, the government has set as its target the elimination of the monetary overhang, the correction of price distortions, the reduction of inflation to 15%, an increase in export growth, a cut in import growth and the building-up of reserves. It remains to be seen how such commitments will be implemented.

As well as being frustrated by the government's lack of representativeness and its inertia, people in the street are also pushed towards violence by the behaviour of the police, the same force that has kept them down for the last forty-odd years.



Deprived of legitimacy, the present government could not proceed to economic reconversion even if it wanted to.

### **Living standards and economic decline**

GDP fell by 10%, industrial output by 20%, agricultural output by 5% and investment by 35% in 1990. Similar declines occurred in 1991: output is believed to have fallen by 17% during the first half the year, and investment by 31%. Labour productivity declined by some 20% in 1990 owing to the introduction of a 5-day week. The sharp decline in the output of basic raw materials worsened the situation of manufacturing industry while pushing up the demand for imports [REO, 1990:9]. Metallurgy and shipbuilding, mining, gas and oil production are particularly affected, while agriculture continues to stagnate. Freight-transport and construction levels in 1990 were down by 40-50% from the previous year.

Although the prices of gas, electricity and other public services (kept very high by the previous regime) have been reduced, retail prices have risen at an increasing rate. Inflation is estimated to have been around 30% in 1990, but nominal wages increased by only 8%. The government installed after the May 1990 elections called for a six-month moratorium on pay rises, promising in return to cushion employees against the adverse effects of the planned reforms but without explaining how [*Romanian News*, 24 July 1990:4]. The substantial liquidity pumped into the economy before the elections also contributed to aggravating the inflationary threats from the liquidity overhang. A second round of price rises, planned for January 1991, had to be delayed following public opposition and threats of strikes. It was finally pushed through in April 1991, and was accompanied by a sharp devaluation of the leu. As of June 1991 prices had risen by 145% over the previous nine months.

### **The energy sector**

During 1990 domestic production of oil fell by 11% (after a drop of 20% in 1989), but the consumption of oil-derived fuels rose by more than a factor of three, absorbing most of the oil and refined oil imported. These imports reached almost 22 bn tons in 1989, with 4 m. tons coming from the Soviet Union and the rest from Saudi Arabia and Iran. Of this, 7-8 m. tons were consumed domestically and the rest re-exported to the West. Not only have these exports dried up, but imports from the Soviet Union now

have to be paid for in hard currency. In mid-1990 the domestic prices of both gasoline and diesel oil, which were much lower than those prevailing in neighbouring countries, were raised. Meanwhile, restrictions on household use of energy were lifted, Romania's imports of electricity reached 1,000 mgw and the domestic rate remained fifty times lower than the real cost of electricity.

Domestic power supply could have been significantly expanded by the Cernavoda nuclear power plant, but the completion of this has been halted because of serious doubts with respect to its safety levels [EJU, 1990:9].

### **The external sector**

The country will remain dependent on imports of oil, most probably from the Soviet Union, and of food and pharmaceutical products, both largely from Western countries. Aside from these products imports will concentrate first on basic consumer goods (Romania's *per capita* imports of these in dollars are the lowest among East European countries [UNECE, 1988:256, Table 3.9.1.]) and agricultural inputs and then on machinery and equipment to modernise the economy. Furthermore, the new government has temporarily halted the export of agricultural items and redirected them to the domestic market. The pressure to import, together with the current shift away from transferable-rouble to hard currency trade with the other East European countries, cannot fail to contribute to the erosion of the trade surplus posted in 1989 (\$2.5 bn with OECD countries alone). This pressure will increase once the upgrading of the various productive sectors starts. Exports in both non-convertible and hard currency have declined. Hard currency exports fell by 42% in 1990, and rouble exports fared similarly. As a consequence, the balance of trade recorded deficits of \$858 m. with the hard currency area and almost 1 bn roubles with the CMEA area during the first seven months of 1990 [*Romanian News* (25), 1990:5 and REO, 1990:12]. Over the same period the balance of payments deficit reached almost \$3 bn - most of it with the hard currency area [REO, 1990:17]. Reserves were depleted to less than one month's import cover by end-1990 as a result of the government's imports of food and other basic commodities. The current account deficit for 1991 is expected to reach \$2.2 bn (with only a slight improvement forecast for 1992).

Internal convertibility of the currency (i.e. liberalisation of the currency market for current account transactions) is scheduled for 1992, in accordance with the agreement with the IMF. However, despite the devaluations a substantial gap remains between the official and black market rates for the leu.

### **Agriculture**

While the government maintains that 'the main mutation achieved in the short period since the revolution consists in diminishing the state role in controlling 25% of the arable land, the rest being held as the property of individual producers (31.6%) or under the control of farmers' associations and co-operatives which have acquired a total autonomy' [GCFA, 1990:8], independent sources emphasise that the co-operatives are allowed to lease only 6,000 square metres to any member, that the entire food industry sub-sector has been closed to private operations, that private enterprises are not expected to participate in input distribution, and that agricultural exports remain restricted. To assure a more enthusiastic response from private farmers the offer should have included the prime lands of the state enterprises and the amount allowed should have been larger.

The systematisation policy was officially abrogated in January 1990, followed by two decrees on the restructuring of agriculture which permit small private plots in state and co-operative farms. The latter are also allowed to allocate arable and pasture land to hill farmers for private use, after all fodder needs for co-operative livestock have been met [EIU, 1990:19].

Favourable weather in 1989 helped produce an excellent harvest, including about 17 m. metric tons of grain, yet food rationing was expanded and strictly enforced in Bucharest from October 1989. Early in 1990 the trade in agricultural products was fully liberalised, but the domestic supply of foodstuffs remains inadequate and the utilised capacity of the food industry is currently very low, except for milling where installed capacity is below the required amount. The utilisation rate varies from 50-60% in the dairy sector, 50-70% in meat, and 38-85% in oil, in all cases owing to the lack of raw materials. A lack of packing facilities keeps the capacity utilisation rate at 45-65% in the sugar industry, while dilapidated plants in the fishing, tobacco and vegetable

conservation sectors lead to a utilisation rate of about half their capacity [CFP (May-June), 1990:7].

Once one of the richest agricultural countries in the world, Romania remains unable to feed itself and is currently importing large amounts of food commercially and as aid, even though it has the potential to become a large exporter of cereals and beef [Turnock, 1974:203]. To realise this potential it has to reform and modernise production methods and introduce realistic pricing policies. It also needs to obtain reasonable access to foreign markets, which are often highly protected.

### **Faltering reform**

Government sources envisage the transition taking place in two broad stages: the first, of one to three years, is meant to lay the foundations for a market economy<sup>3</sup>; the second, of at least five years (on the most optimistic estimate and assuming massive doses of international assistance), is for the modernisation of the national economy [GCEP, 1990:10-11]. The gradualist approach apparently favoured might be the only one feasible in the Romanian situation, yet it also carries risks. It facilitates the resistance of the former party nomenklatura to the transition, while at the same time slowing down the expansion of consumer goods production which is badly needed to buy popular support [EIU, 1990]. There appears to be little government support for such an expansion, even though it could satisfy existing demand, create employment and absorb some of the monetary overhang.

Both houses of parliament have agreed in principle to the establishment of 'a share-owning democracy'. In August 1991 the government announced that it planned to privatise 10% of enterprises each year until 70% of them have been transferred to private ownership. To finance this, plans have been announced for the distribution of vouchers enabling millions of Romanians to buy shares in about 80% of state-owned enterprises. Each voucher

---

3. According to the Prime Minister's declaration to Parliament, the government formed after the spring 1990 elections proposed to put before Parliament - within 18-24 months, if the necessary support could be found - a package of legislative measures which would allow enterprises to operate under market economy conditions [PNG, 1990:9].

allocation will be worth 45,000 leu, or about \$250, and cannot be sold for at least one year. Nevertheless critics emphasise that the only people in Romania who have large sums of money to invest are black marketeers or officials of the former regime.

Meanwhile, the appearance or worsening of unemployment (the largest trade union group expects half a million jobs to go from the over-staffed chemical industry alone when the economic reform is enacted), declining production, the government budget deficit, inflation, a balance-of-payments deficit, growing social inequalities and shortages may very well tempt the government 'to go back to some of the instruments characteristic of the old regime' [GCEP, 1990:35].

### *Economic reform*

Since the beginning of 1990 production associations and co-operatives in all sectors have been authorised to conduct foreign trade, but in order to become effective this decentralisation requires initiative and organisation. As these are evident only in a few areas, confusion and waste remain the rule rather than the exception.

In February 1990 a decree was issued authorising the establishment of private enterprises employing up to 20 people, and some 15,000 licences had been issued by mid-year. However, most of these went to pedlars, taxi drivers or other suppliers of small-scale services, 'most of which sell roughly the same commodities as the state but at far higher prices'. Clearly, this development 'does not mean much in the large-scale privatisation process' which the country urgently needs to pursue [*Romanian News*, 17 July 1990:5]. More recently private enterprises have also been allowed to open hard currency accounts with the Romanian Foreign Trade Bank for half of their receipts from abroad. But the mechanics of how to establish and operate these new enterprises are still to be worked out, so holding back implementation.

The grip of the Romanian Foreign Trade Bank and the Central Bank over all foreign-exchange activities continues, although the Romanian National Bank, the Bank for Agriculture and Food Industry, and the Investment Bank are now permitted to engage in all forms of payments transactions, including hard-currency operations, to issue bills of exchange, to extend credit and to participate in joint ventures. Furthermore, these banks are per-

mitted to keep 75% of the revenue they earn on services rendered [BEE, 13 August 1990]. At the beginning of February 1990 the leu was devalued and the previously divergent exchange rates have been unified and are now adjusted weekly by the National Bank on the basis of a basket of currencies [REO, 1990:15]. Romanian citizens have also been allowed to hold foreign currency accounts domestically, and since October 1990 Romanian enterprises have been able to purchase hard currency at bi-monthly auctions.

Some Western banks are expected to establish branch offices which could facilitate external trade operations by easing the opening of letters of credit. But it remains unclear how the initiation of the new system is to take place, how much the powers of the Central Bank are to be reduced, and which credit functions will actually be transferred from the Central Bank to the commercial banks.

Many of the restrictive measures of the 1972 joint venture law - which was substantially less liberal than those in other East European countries - were removed by the March 1990 decree 96/14 which allows foreign direct investment. The decree permits foreign companies to rent land and property and to have complete corporate ownership, but only with the government's full approval [CFP, 1990:45]. Also, all prices for inputs and outputs purchased and sold by the enterprise in Romania or abroad have to be negotiated with the government. Only 8% of the profits made can be repatriated when hard currency earnings are not sufficient to meet the foreign partner's profit share. No profit tax is to be levied during the first two years of operations; thereafter a rate of 30% will be applied, 15% for reinvested profits. On the whole, foreign enterprises are not put on the same footing as domestic ones.

#### *Problems of the transition*

In the case of Romania the problems of transition appear to revolve basically around the fact that there is not enough reform. The present government has chosen gradualism rather than the big bang approach to the country's transformation. Although this has been defended on the grounds of the country's appalling economic situation and its lack of experience with both democracy and a market economy, it could also be argued that, these considerations notwithstanding, the way in which the present government took power required its firmer commitment to a wide reform movement

which would have rendered the worsening economic situation more acceptable while unhinging the established powers and the bureaucracy and consequently their ability to grind the transformation down, as is in fact happening. If it is correct to assume that governments brought to power on a democratisation platform cannot easily ignore the wishes of the electorate, it is equally correct that the more unpalatable the measures to be taken the more crucial becomes the government's representativeness and, consequently, its acceptability. At any rate, the Romanian government has not so far made much effort to gain such acceptability.

A revealing feature of the government's inability, or unwillingness, to face the hard choices posed by Romania's eventual transformation, is the lack of consideration being given to the timing and sequencing of specific reforms. Most of the deadlines established by the GCEP document for the implementation of its 'strategy of the transition to a market economy' have not been met. Privatisation is not taking place; the leu has not become convertible; and the government has followed 'a gradual approach in the liberalisation of prices' [GCFA, 1990:15 and 13]; only in October 1990 did it announce the lifting of several price and wage controls, starting on 1 November, with subsidies being maintained on energy, rent and some food items [*International Herald Tribune*, 19 October 1990]. If the government really intends to start liberalising prices and decontrolling the pay process, it should also start creating a 'social safety net' to provide income-related and socio-political measures to lessen the most negative and destructive effects of the reform.

The attempts to deal with the economic system are causing both recessionary and inflationary pressures which do not enhance government popularity. By May 1991, exactly one year after the elections, an opinion poll revealed that only 31% of respondents would vote for the NSF. The problem here is that, since these measures are not part of an overall programme of reform, the damaging effects are taking place in vain. The government is being blamed for an austerity which is not perceived as being the foundation of the country's economic reconstruction. The process of democratisation tends to breed inflation, but Romanian inflation is due merely to the government's inability to revitalise production.

As Romania is in a worse position than some other countries in Eastern Europe, and even than many in the Third World, with respect to the availability of a rudimentary legal and institutional framework essential to the working of a market economy, structural adjustment is currently hardly feasible. Fortunately, this is an area in which technical assistance is appropriate and one which can be supported regardless of any doubts that may remain about the government's real commitment to the reform process.



## **Statistical Appendix**

**Appendix Table 1**  
**GDP and standard of living indicators**

	<i>GDP per capita (US\$) estimates for 1988</i>	<i>Automobiles per 1,000<sup>a</sup></i>	<i>Telephones per 1,000<sup>b</sup></i>	<i>Human development ranking<sup>c</sup></i>
Bulgaria	5,633	120	200	104
Czechoslovakia	7,603	173	226	106
Hungary	6,491	145	134	101
Poland	5,453	105	118	98
Romania	4,117	11	130	90

Sources: (a) *Plan Econ Western Investor's Guide to Eastern Europe and Soviet Union*, Plan Econ Report Vol. VI, no. 42-43, November 1989; figures also used in *OECD Economic Outlook*, June 1990.

(b) Institute for International Finance, *Building Free Market Economies in Central and Eastern Europe: Challenges and Realities*, Washington, D.C.; April 1990.

(c) UNDP, *Human Development Report 1990*. Oxford University Press. Countries are ranked from lowest human development (1) to highest human development (130). Variables used are life expectancy at birth, adult literacy rate and purchasing power parity real GDP.

**Appendix Table 2**  
**Industrial production**  
(monthly average, 1980 = 100)

	4/1988	1/1989	2/1989	3/1989	4/1989	1/1990	2/1990	3/1990	4/1990	1/1991
<b>General index</b>										
Bulgaria	140	---	142	---	140	133	148	137 <sup>a</sup>	na	na
Czechoslovakia	122	128	124	123	122	124 <sup>a</sup>	121	116	118	111
Hungary	126	107	111	103	116	103	103	92	111	na
Poland	113	116	114	100	105	82	79	80	89	76 <sup>a</sup>
Romania	na	na	na	na	na	na	na	na	na	na
<b>Manufacturing</b>										
Bulgaria	na	na	na	na	na	na	na	na	na	na
Czechoslovakia	123	128	125	123	123	125 <sup>a</sup>	122	117	119	112
Hungary	128	104	110	106	115	99	101	93	109	na
Poland	112	109	114	100	106	79	79	80	79	76 <sup>a</sup>
Romania	na	na	na	na	na	na	na	na	na	na

*Notes*

(a) Average for two months.

Source: EIU Country Reports.

**Appendix Table 3**  
**Cereals production**  
 (million tons)

	1985	1986	1987	1988	1989
Bulgaria	5.49	8.63	7.40	7.97	na
Czechoslovakia	11.76	10.79	11.77	11.90	na
Hungary	14.42 <sup>a</sup>	na	14.17	14.97	15.42
Poland	23.70	25.00	26.10	24.50	26.60
Romania <sup>b</sup>	23.00	30.30	31.70	19.30 <sup>c</sup>	18.40 <sup>c</sup>

*Notes*

(a) Average 1981-85.

(b) Figures include moisture content.

(c) Recently revised data.

Source: EIU Country Profiles.

**Appendix Table 4**  
**Employment: % distribution by sector, 1988**

	<i>Agriculture &amp; forestry</i>	<i>Industry</i>	<i>Construction</i>	<i>Transport &amp; communications</i>	<i>Other</i>
Bulgaria	19.3	38.0	8.3	6.7	27.7
Czechoslovakia	12.5 <sup>a</sup>	37.3	8.9	6.5	34.8
Hungary	18.4	30.4	7.0	8.3	35.9
Poland	na	35.9	9.2	8.5	10.7
Romania <sup>b</sup>	31.5	43.6 <sup>c</sup>	7.7	7.9	9.3

*Notes*

(a) Agriculture, forestry and water.

(b) Romanian figures are for 1989. No absolute figure for 'occupied population' has been provided for 1989; there is a new category, 'active population', but this, at 11.129 million, appears higher than occupied population.

(c) Mining, manufacturing and utilities.

Source: EIU, *Country Profiles*.

**Appendix Table 5**  
**Consumer prices**  
 (percentage change year on year)

	4/1988	1/1989	2/1989	3/1989	4/1989	1/1990	2/1990	3/1990	4/1990	1/1991	2/1991
Bulgaria	na	na	na	na	na	na	na	na	na	na	na
Czechoslovakia	0.5	1.1	1.4	1.5	1.6	3.5	3.9	14.2	18.3	56.1	na
Hungary	17.1	14.3	17.4	17.8	18.4	24.3	26.0	29.9	32.4	na	na
Poland	70.0	76.0	85.0	186.0	550.0	1,111.0	1,076.0	726	290	73	70
Romania	na	na	na	na	na	na	na	na	na	na	na

Source: EIU Country Reports.

**Appendix Table 6**  
**Exports**  
 (quarterly totals, US\$ m.)

	4/1988	1/1989	2/1989	3/1989	4/1989	1/1990	2/1990	3/1990	4/1990	1/1991	2/1991
Bulgaria <sup>a,b</sup>	4,169	3,271	3,353	3,141	3,796	2,688	2,550	2,112	3,146	na	na
Czechoslovakia <sup>b</sup>	2,737	3,458	3,660	3,262	4,086	2,180	3,061	2,769	3,261	1,854	na
Hungary <sup>b</sup>	3,360	1,820	2,410	2,270	2,930	1,670	2,400	2,173	3,331	na	na
Poland <sup>b</sup>	4,121	3,130	3,615	2,670	3,742	2,606	3,221	3,354	4,446	2,850	3,504
Romania <sup>b</sup>	na	3,636	3,639	3,582	2,060	1,395	1,452	1,389	1,268	961	958

*Notes*

(a) Bulgarian figures in leva million.

(b) Fob.

Source: EIU Country Reports.

**Appendix Table 7**  
**Imports**  
 (quarterly totals, US\$ m.)

	4/1988	1/1989	2/1989	3/1989	4/1989	1/1990	2/1990	3/1990	4/1990	1/1991	2/1991
Bulgaria <sup>a,b</sup>	3,696	3,050	3,092	2,983	3,427	2,720	2,681	2,165	2,594	na	na
Czechoslovakia <sup>b</sup>	2,607	3,059	3,475	3,297	4,442	2,804	3,248	3,290	3,760	2,266	na
Hungary <sup>c</sup>	2,950	1,750	2,150	2,160	2,580	1,540	1,990	2,031	3,074	na	na
Poland <sup>b</sup>	3,886	2,621	3,098	2,258	2,040	1,505	1,526	1,936	3,140	3,184	3,299
Romania <sup>b</sup>	na	2,471	2,580	2,502	na	1,913	2,287	2,184	2,164	962 <sup>d</sup>	na

*Notes*

- (a) Bulgarian figures leva million.  
 (b) Fob  
 (c) Cif  
 (d) Total for two months

Source: EIU Country Reports.



**Appendix Table 8**  
**Estimated convertible currency debt**  
 (\$ bn, year-end)

		1986	1987	1988	1989
Bulgaria	: gross	4.8	6.2	7.2	10.6
	: net <sup>a</sup>	3.4	5.1	5.4	9.5
Czechoslovakia	: gross <sup>b</sup>	5.4	6.8	7.3	8.0
	: net <sup>c</sup>	3.1	3.6	4.4	5.8
Hungary	: gross	16.9	19.6	19.6	20.6
	: net <sup>d</sup>	14.6	18.0	18.2	19.4
Poland	: gross	33.5	39.2	39.2	40.0
	: net <sup>a</sup>	31.8	36.2	35.6	36.5
Romania	: gross	7.0	6.7	2.8	0.4 <sup>e</sup>
	: net <sup>a</sup>	6.4	5.3	2.0	-1.3

*Notes*

(a) Gross debt minus assets at BIS banks.

(b) Excludes hard currency debt to Comecon banks and partners.

(c) Gross debt minus assets at BIS banks. Assets with other banks are unknown, and so excluded.

(d) Gross debt minus total reserves (excluding gold).

(e) EIU estimate.

Source: EIU *Country Profiles*.

**Appendix Table 9**  
**External debt indicators, 1989**

	<i>External debt as % of goods and services exports<sup>a</sup></i>	<i>External debt<sup>b</sup> (US\$ bn)</i>	<i>External debt as % of exports of goods and services<sup>a,b</sup></i>
Bulgaria	74.4	9.2	227
Czechoslovakia	18.6	7.9	104
Hungary	54.5	20.6	319
Poland	90.6	40.5	486

*Notes:*

(a) In convertible currencies.

(b) End of year.

*Source:* International Monetary Fund.

## References

- Aage, H.** (1991); 'Convergence of Preferences, Proposals, and Prospects', in W. Andreff, H. Brezinski and B. Dallago (eds) *Convergence and System Change*. Aldershot, Hants: Dartmouth Publishing Company Limited.
- BEE**; *Business Eastern Europe*, various issues.
- Blanchard, O. and Layard, R.** (1990); 'Economic Change in Poland'. *Discussion paper No. 3*, Centre for Economic Performance, London School of Economics.
- CFP** (1990); C.E.E./FWC PO12 Mission PHARE, *Mission d'Evaluation en Roumanie dans les Domaines Agricole et Industriel*, May-June 1990.
- Charap, J. and Dyba, K.** (1990); 'Transition to a Market Economy: the Case of Czechoslovakia' (personal communication).
- Chilosi, A.** (1990); 'Poland's Programme of Economic Transformation'. Paper presented at the NATO-Colloquium: The Central and East European Economies in the 1990s: Prospects and Constraints. Brussels, 4-6 April.
- Colijn, Leendert** (1991); 'East Central European economies in transition: Long-term performance, new aspirations and the costs of realising them'. Background material for the Institute of East West Security Studies Task Force Workshop on Western Assistance, the European Studies Center at Štířín, Czechoslovakia, 27-29 September. Revised November (mimeo).
- Collins, S. and Rodrik, D.** (1991); *Eastern Europe and the Soviet Union in the World Economy*. Washington: Institute for International Economics.
- DB** (1990); *Special: Eastern Europe*. Economics Department, Deutsche Bank, Frankfurt.
- Drabek, Z. and Dyba, K.** (1990); 'Reformni politiky, rustovy vykon a makroekonomicka stabilita', *Eckonomicky Ustav*, CSAV.
- ECE** (1990); *Economic Survey of Europe in 1989-1990*. New York: UN Economic Commission for Europe.
- EER** (1989); *European Energy Report*, 'Profile: Romania', June 16, 1989 (part one) and June 30 (part two).
- EIU** (1989); *Romania; Country Profile 1989-90*. London: Economist Intelligence Unit.
- EIU** (1990); *Romania, Bulgaria, Albania; Country Report*. London:

Economist Intelligence Unit.

- Fallenbuchl, Z.M.** (1991); 'The New Government and Privatisation'. Report on Eastern Europe, pp.11-16, 22 March.
- Feinberg, Richard E.** (1991); 'Financial Assistance to Central Europe: How Real Is It?'. Paper presented as discussion material at the Institute of East West Security Studies Task Force Workshop on Western Assistance, the European Studies Center at Štířín, Czechoslovakia, 27-29 September (mimeo).
- GCEP** (1990); *Report No. 1*, Government Commission for Development of the Government's Economic Policy, Bucharest, March.
- GCFA** (1990); *Initiatives of the Romanian Government Concerning the Negotiations with Group of '24'*, Governmental Commission for the Co-ordination of Foreign Economic Aid, Bucharest.
- Gomulka, S. and Rostowski, J.** (1988); 'An International Comparison of Material Intensity'. *Journal of Comparative Economics* 12, No. 4:475-501; December.
- Grosfield, I. and Hare, P.** (1991); 'Privatization in Hungary, Poland and Czechoslovakia'. *European Economy*, special edition No. 2, pp.129-156.
- Hughes, G. and Hare, P.** (1991); 'Competitiveness and Industrial Restructuring in Czechoslovakia, Hungary and Poland'. *European Economy*, special edition No. 2, pp.129-156.
- Jorgensen, E.; Gelb, A.; and Singh, I.** (1990); 'Life under the "Big Bang": Representative Episodes'. Paper presented at the World Bank Conference on Adjustment and Growth: Lessons for Eastern Europe. Poltusk, Poland, 4-5 October.
- McKinnon, Ronald I.** (1991); *The Order of Economic Liberalisation: Financial Control in the Transition to a Market Economy*, cited in *The Economist*, 5 January.
- Mihalyi, P. and Smolik, J.E.** (1990); 'Lending is not enough: An Assessment of Western Support for Reforms in Hungary and Poland, 1989-1990'. Paper presented at the First Conference of the European Association for Comparative Economic Studies (EACES). Verona, 27-29 September.
- Mishalani, P.; Robert, A.; Stevens, C. and Weston, A.** (1981); 'The Pyramid of Privilege', in Christopher Stevens (ed.) *EEC and the Third World: A Survey 1*. London: Hodder & Stoughton, in association with the Overseas Development Institute and the Institute of Development Studies.

- Möbius, Uta and Schumacher, Dieter** (1991); 'Eastern Europe and the EC: Trade Relations and Trade Policy with regard to Industrial Products'. Paper presented to Joint Canada-Germany Symposium, Toronto, November 1-2, 1990. Revised January 1991.
- Murrell, P.** (1990); "'Big Bang" versus Evolution: East European Economic Reforms in the Light of Recent Economic History'. *PlanEcon Report*, No. 26:2-11, 29 June.
- Nelson, Joan M.** (1989); *Fragile Coalitions: The Politics of Economic Adjustment*. (New Brunswick: Overseas Development Council and Transaction Books).
- Newbery, D.M.** (1990); 'Reform in Hungary: Sequencing and Privatization'. Paper presented at the Fifth Annual Congress of the European Economic Association, Lisboa, 31 August-2 September.
- Nuti, D.M.** (1990a); 'Internal and International Aspects of Monetary Disequilibrium in Poland'. *European Economy*, No. 43:169-182.
- Nuti, D.M.** (1990b); 'Privatisation of Socialist Economies: General Issues and the Polish Case.' Paper presented at the First Conference of the European Association for Comparative Economic Studies (EACES). Verona, 27-29 September.
- OECD** (1990); *Economic Outlook*, cited in *The Financial Times*, 29 June 1990.
- PNG** (1990); *Programme du Nouveau Gouvernement de Roumanie Présenté au Parlement*, Bucharest.
- Pomfret, Richard** (1986); *Mediterranean Policy of the EC*. London: Macmillan.
- Privatisation Law** (1990): 'Republic of Poland: Act on the Privatisation of State-Owned Enterprises. The Office of the Minister of Ownership Changes Act'. Warszawa: The International Foundation for Capital Market Development and Ownership Changes in Poland. Center for Privatisation.
- Qureshi, M.** (1991); 'Sustaining the Development of Central and Eastern Europe'. Speech to UK House of Commons All Party Group on Overseas Development; 3 July.
- REO** (1990); *Romanian Economic Observer*, 1, 1. Institute for World Economy; September-October.
- Romanian News*; various issues.
- Roy, Donald J.** (1987); 'Size and Wealth in Perspective: Their

- 'Effect on Economic Structure and Poverty', *Development Policy Review*, Vol. 5, pp. 341-359 (London: Sage for the Overseas Development Institute).
- Shafir, M.** (1985); *Romania; Politics, Economics and Society*. London: Frances Pinter.
- Summers, R. and Heston, A.** (1988); 'A New Set of International Comparisons of Real Products and Price Levels Estimates for 130 Countries, 1950-1985'. *Review of Income and Wealth* 34, No. 1:1-25.
- The Economist*; various issues.
- Tovias, Alfred and Laird, Sam** (1991); 'Whither Hungary and the European Communities'; *PRE Working Paper*, WPS 584. Washington: The World Bank; January.
- Turnock, D.** (1974); *Economic Geography of Romania*. London: Bell & Sons Ltd.
- UN (1991); DIESA paper prepared for Special Meeting of the UN Economic and Social Council; 4-5 July.
- UNECE (1988); *Economic Survey of Europe in 1987-1988*. New York: United Nations.
- USDC (1990); *Foreign Economic Trends and Their Implications for the United States*. Washington: U.S. Department of Commerce; May.
- Vickers, J. and Yarrow, G.** (1988); *Privatization: An Economic Analysis*. Cambridge, Mass.: MIT Press.
- World Bank** (1988); *Adjustment Lending: An Evaluation of Ten Years of Experience*. (Washington: World Bank).









**How will the dramatic economic and political changes in Central and Eastern Europe affect developing countries? And have the reforming economies of Europe anything to learn from the experience of countries like Brazil and Turkey in structural adjustment? These are the important questions discussed in this book.**

**Much remains uncertain about the evolution of the Central and East European economies. The problem of maintaining popular support for austerity measures during the often lengthy period before they bring results is a common one in developing countries, which can provide lessons on the content, phasing and impact of structural adjustment programmes.**

**The prospects for the Third World will depend on the success of reform in stimulating the economies of Central and Eastern Europe. A virtuous circle of economic growth would benefit most regions in the long term, although there could be short-term disruption for some. By contrast the results of economic stagnation and political collapse would be negative for all.**

£9.95

ISBN 0 85003 170 2



OVERSEAS DEVELOPMENT INSTITUTE

---