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**Adjustment through Opening of Socialist Economies**

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# ADJUSTMENT THROUGH OPENING OF SOCIALIST ECONOMIES

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**INTRODUCTION**

The socialist countries experienced a considerable decline in their economic growth rates in the late 1970s and early 1980s.[1] Both internal and external factors are considered to have contributed to this slow-down. On the domestic side, deep structural and sectoral disproportions, rigidities of the centralized planning and management system, and failures in economic policies, produced growing internal imbalances manifested by inflationary tendencies, shortages and reduction of real consumption growth. On the external side, shocks and disturbances which occurred in international markets worsened the socialist countries' terms of trade and financial conditions, reducing their hard currency earnings and increasing foreign debt burdens.

The socialist countries responded to those challenges with a variety of policy measures - involving domestic expenditure shifts, foreign trade adjustments and systemic reforms. The purpose of the present paper is to explore the problem to what extent these policy responses were meant to increase the degree of openness of the socialist economies and whether measures actually adopted have made these economies more outward oriented.

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[1] For the purpose of this study socialist countries includes Bulgaria, Czechoslovakia, the GDR, Hungary, Poland, Romania and the USSR. The paper does not discuss the developments in the Peoples' Republic of China, which differs in many respects from those takning place in Eastern Europe.

The paper is organized as follows. Part I gives a picture of the economic situation of socialist countries in the late 1970s and explains briefly the systemic, policy-specific and structural barriers to growth.

In Part II a process of policy adjustment to the international crisis of 1980-82 in particular countries is discussed with special emphasis on measures undertaken in the field of foreign trade, investment and foreign debt management. An attempt to accelerate growth through 'extensive' investment expansion in 1985-86 is critically examined.

Part III starts with a theoretical discussion of the concept of international' openness', which has been traditionally understood as a high or growing share of foreign trade in GDP. For our purposes however, a different definition is adopted. 'Institutional openness' means that no (or very few) restrictions are put on foreign trade of goods and services, foreign exchange transactions and international mobility of production factors. This concept is next applied to assess the degree of openness of socialist countries through examination of existing foreign trade regimes, foreign exchange regulations and codes on foreign direct investment.

The international context and the role of international organizations and institutions like CMEA, IMF, and the World Bank is discussed in Part IV. There, also intra-German

economic relations are given special attention as they represent a specific form of 'openness' for the GDR.

Policy recommendations are formulated in Part V, although in a rather general form as every socialist country would require an individual approach and individually designed policy package. The main findings of the study can be summarized in several points.

First, as demonstrated by statistical evidence, the adjustment process in all socialist countries in the 1980s took a rather traditional form of administrative restrictions put on investment, consumption and import, with little effort directed to more sophisticated and comprehensive policy packages involving sweeping, market-oriented solutions. Although in two countries substantial economic reforms have either been continued (Hungary) or undertaken (Poland) in the early 1980s, these reforms, however, have not yet produced the expected improvements in terms of growth, domestic equilibrium and alleviation of external balance constraints.

Second, the process of opening, as seen through changes in foreign economic relations regimes, has to be regarded as still inadequate to help particular countries to overcome existing barriers to growth. Moreover, this process has taken place with varying intensity in particular countries. Hungary and Poland seem to be the most open economies although numerous restrictions still remain, e.g. in the system of foreign exchange allocation (Hungary), or foreign trade

incentive structure (Poland). On the other hand, in real terms the share of these countries in international trade has even diminished through the 80s. The Soviet Union and Bulgaria have undertaken remarkable steps towards more openness in the legal framework since 1985; however, in Czechoslovakia, the GDR and especially Romania the degree of openness is still low.

Third, the analysis of the structure of incentives and disincentives given in socialist countries to import-substitution activities versus export-oriented activities, shows, that a significant anti-export bias is still characteristic of economic policies in those countries, with an unrealistic exchange rate being perhaps the most important component of the bias.

Fourth, the conclusion which clearly emerges from the analysis is that the East European countries, traditionally considered in Western literature in a rather uniform manner as so-called, 'centrally planned economies' (or CPEs), constitute nowadays a very diversified, heterogeneous group, differing not only in the level of development and in historic traditions, but displaying also significant divergences in their economic systems and policies.

Finally, our analysis leads to some policy recommendations which we formulate in a rather general way, indicating desirable directions of further reforms and policy changes. Further economic reforms would have to take the form of a comprehensive package of market-oriented measures,

including elimination of price and quantitative distortions, real devaluation of domestic currencies, radical increase of monetary and budget discipline, sweeping de-bureaucratization of economic activities, and creation of genuine market for production factors and foreign currencies. The composition of this package and the time-schedule of implementation would, of course, be different for different countries, according to individual conditions and objectives.

From the point of view of lessons for future developments in fields discussed in the paper, the experiences of Hungary (the CMEA-country which underwent serious reforms earliest) and Poland (where regulations in foreign trade have changed most rapidly through the 1980s) have been paid the most attention.

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# I. SLOW GROWTH AND EXTERNAL IMBALANCES IN EASTERN EUROPE IN THE SECOND HALF OF THE 1970s

## 1.1 Systemic barriers to growth in the socialist countries in the 1970s

The middle of the 70s represented a real turning point in the development of the European centrally planned economies (CPE's). Until approximately that time all of them could continue what is called in the East European professional literature, somewhat imprecisely, an extensive growth pattern. This model had more scope in the least developed parts of the region, i.e. on the Balkan, while causing more structural tensions from the beginning in the more developed economies, particularly Czechoslovakia or the GDR. (However, even these countries were able to mobilize additional resources for the growth of large organizations in the heavy industries by increasing the share of non-agricultural labour force, by involving females in the production process on a large scale, by increasing the accumulation capabilities of the national economy with the help of central resource allocation, and by reallocating resources in the industry on behalf of heavy industries at the expense of traditional, export oriented branches with a high level of human skills involved.)

The traditional system of central planning and command was especially instrumental for the purposes of creating *strongly autarchic economic structures* in the region and also in national economies. This system was, as it is well known, also more appropriate to international political conditions

featured by confrontation. Finally, the trade pattern of these countries with the Soviet Union harmonized well with the other elements of economic structure: while the latter badly needed the more advanced industrial goods from Eastern Europe (especially from its more developed parts), the small countries could rely upon raw material and energy imports (whether cheap or not) (see Marese-Vanous 1983) from the Soviet Union. The historical paradox with autarchy is that the East European countries have ended up with more dependency than when they started their experience with central planning, as this study intends to illustrate.

The traditional system of central planning and allocation was able *to limit* the individual and collective *consumption* of the people in each country by the use of economic methods and by the functioning of the system itself, which created a general shortage phenomenon, and also by applying coercive methods to suppress demands for higher levels of consumption. The historical process of development under central planning can also be characterized briefly by a *cyclical increase of the accumulation fund in national income distribution* as against decreasing share (though presumably increasing volume) of consumption. (In aggregate investment efficiency, on the other hand, a cyclical deterioration took place throughout the socialist period).

Finally, one has to emphasize that the East European countries have rather neglected the simultaneous development of the broad range of infrastructure (especially that of

traffic system and telephone network) and services in the whole socialist period. They did it for doctrinal reasons (superiority of material production in industry over 'superstructure') and also for political ones: they wanted to get as much as possible out of the existing stocks to achieve high rates of economic growth on the shorter run. This growth pattern had its institutional roots as well: in the CPE's bargaining power of heavy industrial bureaucracies overwhelmed the representation of consumption goals or support on behalf of infrastructure development as compared with market economies.

At the turn of the 1960s and 70s, two economic policy responses differed markedly from the traditional path: that of Hungary and Poland, in two different ways. Hungary tried to increase the efficiency of its economy by systemic reforms, including, however, very moderate and inconsistent adjustment in the foreign trade domain; Poland, by comparison, attempted to solve its burning economic and social problems by a greater opening in volume terms, while avoiding reforms in the institutional dimension. For this reason these two cases will be given special attention in the following sections of Part 1.

## 1.2 Growing need for reform and the Hungarian experience

This model lasted from the late 1940s till the middle of 70s with serious and periodically intensifying disturbances (Goldman 1969, Bauer 1978) but with some corrections it had

enough internal dynamism to overcome cyclical crises. Until this period only Hungary achieved a significant systemic change by introducing the New Economic Mechanism (NEM) in the late 1960s as well as giving more room for the development of various forms of small-scale business activities (Antal 1985). It is important to underline in this paper that *the Hungarian reform concept almost totally ignored the question of systemic tasks in the field of foreign economic relations* as well as the requirements of harmonizing the economic policy of the country with the new systemic conditions. (For more detailed criticism of this neglect see: Mizsei, 1987).

The consequences of this failure influenced the outcome of the reform as well as its *impact on the openness* of the country in many ways. First of all, the Hungarian reformers, due to pressures from outside and also of domestic political hard-liners, as well as lack of sufficient professional elaborations, could not change the mechanisms of the relationship between Hungary and the CMEA-area, though the logic of reform would have needed the decentralization of decision making and financial responsibilities to the enterprise level. This caused contradictions since the firms had to bear the consequences of long-term decisions of branch ministries and the Planning Office. In this situation they could successfully 'soften up' the 'budget constraint', (Kornai 1980) i.e. apply for fat subsidies.

Secondly, *the economic mechanism did not build into the system strong export incentives* in connection with the hard-

currency area. *It seemed* to the economic policy makers at that time *that the Soviet market was inexhaustible, and that the Soviet Union could secure the necessary quantity of energy and raw materials for a continuous extensive economic growth,* and this helped to maintain the existing structure. In the period just after the Hungarian reform, Hungary's (and Eastern Europe's) trade with the hard currency area grew rapidly and this helped policy makers to overlook the fact that, even at that time, world trade generally was expanding at a much quicker pace.

Moreover, the reform did not establish those *'systemic bridges'* which finally could have contributed to an 'organic' opening of the economy by establishing material incentives on the company level to export to markets with high standards. Some economists and politicians tended to speak about Hungary's 'open economy' meaning the high share of foreign trade (FT) to national economy.[2] This indicator, however, does not tell us too much about the 'institutional openness' or separation of the domestic economy from the outside markets.

Behind the ignorance of the FT field by the mainstream reformers lay *an intellectual failure and a political consideration.* The Hungarian politicians and experts really believed that by appropriate regulation of the domestic economy they could solve the whole problem. 'The one who has forints has also dollars' was the semi-official slogan at that

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[2] Exports (together to East and West) increased to about 40 per cent of GDP, by the mid-70s. (Lakos, 1987).

time. The economic policy makers seriously expected an automatic development towards currency convertibility. Behind this practice and view was the belief that a disciplined cost-economizing atmosphere among the enterprises could be created by changing the domestic rules. The recognition emerged only during the experiences of the first years of the NEM that *having such a high degree of monopolization of the domestic market* as in the case of Hungary, *import competition was absolutely crucial* to establish a sufficiently competitive market. The political considerations mentioned above can be summed up as efforts to minimize political tensions and troubles in consequence of new systemic realities both domestically and in international context. *Institutional aspects of FT activities* were also rather *neglected* at that time. Therefore re-organizations were limited to the growth of influence of the Ministry of Foreign Trade, as well as to giving export rights to a limited number of industrial organizations.

Still, the Hungarian NEM considerably exceeded systemic changes elsewhere in the CMEA. From a longer perspective it was the beginning of a *long march towards breaking up the traditional monopolized structure of the FT process*. Although the policy of distributing FT rights deliberately tried to exclude competition by giving it only to large, monopolistic production units, this process started to erode the traditional view on FT monopoly.[3] The number of production

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[3] One should mention that, as one of the few remaining elements of the earliest economic reforms, a very limited number of large firms maintained their foreign trade rights in the period from 1957-1968.

enterprises licensed to execute export activities was 35 in 1976 though *the bulk of Hungarian export was provided by specialized foreign trade companies.*[4]

There were moderate efforts to change the financial regime of FT as well. The *system of 'deviza multipliers'* was replaced by a unified commercial exchange rate. (Esze, 1968.)[5] However, the so-called *average exchange rate was chosen* which meant that a considerable number of companies should have stopped some of their export activities owing to the lack of financial help from the authorities. Moreover, the Hungarian *price policy tried to prevent the transformation of international inflation to the domestic market.* Both factors encouraged formation and escalation of *various forms of export as well as import subsidies* and also redistribution of profits gained in international trade. The first oil price boom found this system unprepared and unable to react properly. While in 1974 import subsidies accounted for 8 per cent of the total budget expenditure, this element sky-rocketed to a 20 per cent share by 1975.[6] (Wass von Czege 1980)

The financial authorities, trying to find the sources of this expenditure-increase, used broadly in the 1968 founded 'fund of price risk'. Its function was to carry away part of revenues from profitable exports. This practice radically

[4] Figyelö, December 31, 1987.

[5] While in 1976 the artificial devize-print was finally abolished.

[6] The amount of import subsidies was 0.4 billion in 1969, 1 billion in 1970, 2.2 billion in 1971 but 26.8 billion in 1974 and 50.0 billion in 1975.

decreased the export motivation of producers when large *terms of trade* losses and consequently need of export expansion occurred. This factor collided with *a politically motivated generous subsidization of large production companies* which contributed to an unfavourably high concentration of export production in a relatively small number of enterprises.[7] In the middle of the 70s over half of Hungary's export earnings were produced by as few as 20 enterprises. (Wass von Czege) Although exports to the socialist countries had always been burdened by a so-called production tax (indeed: export tax),[8] a large number of the companies had the necessary political bargaining power to maintain their export with the help of large budget subsidies.

From the middle of the 70s the *worsening external balance* made Hungarian economic policy makers attempt to increase the motivation of the producers to turn towards more demanding hard currency markets. However, new elements of FT regulation made the system only more vulnerable to pressures for preferences. Several times *foreign exchange bonuses* were applied as a premium for export growth. However, no clear rules were established for the long run. *Tax breaks* were introduced *for* increased *export* in hard currency areas. Taxation on profits, the wage fund and the bonus fund were eased, but the rules could not be strictly and neutrally established in these cases either.

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[7] In 1972, as a major act of anti-reformism at that time 50 important large firms were drawn under strict central control.

[8] Due to the extreme uncertainties of price formation in the CMEA (see more in Part 4.1).

Economic policy also tried to support hard currency exports by direct financial support or through the bank channels by forming so-called *investment credits for export promotion*. These latest amounted to 40-50 per cent of investment credits in general in the 1976-80 five year period while the largest part of enterprise investment spending could not have been influenced this way having been financed from own sources of the firms. This programme counted on the enormous investment hunger of the enterprises typical in the system of CPEs. Even so, it achieved modest gains; the growth of hard currency exports of enterprises participating in the programme exceeded that of the rest only by approximately 10 per cent. (Greskovics, 1986.) A rather negligible share of the credits was given in hard currencies for increased export earnings in return. The bank's behaviour in this case was like that of an administrative organ and not that of a bank in a normal market-environment. Credits for export promotion were given on the condition of increased FT earnings from the beginning of the investment instead of after its realization, (A. Török 1983) for instance. The relationship between credit and export became rather formal than real. (Mizsei, 1986)

Although the Hungarian economy was undoubtedly the most active of the socialist countries in engaging in East-West industrial cooperation at the level of firms in the 70s (with the number of such ventures rising from 500 to 1000 at the end of the 1970s), the share of these businesses was marginal and could not really penetrate the whole industrial production or

the innovative capacity of the Hungarian economy. Direct capital involvement, on the other hand, was not seen in that period as a significant opportunity to support economic development and technical modernization.[9]

It is difficult to measure how much the 'openness' and integration of the Hungarian economy into the world system was facilitated by NEM. (For a detailed theoretical analysis of the problem, see Part 3.) No doubt, *Hungary's per capita export as well as import volume considerably exceeded that of the other CMEA-members* in the last few decades. However, only for the first three years of the reform period can one see a clearly stronger export expansion towards the Western countries than that of the European CPEs. *In the 1970s,* however, *the expansion of Hungary's Western trade did not exceed that of the other socialist countries.* In fact, the export growth of, oddly enough, Romania and Poland was markedly higher than in the case of Hungary. Romania's trade balance towards the OPEC-countries deteriorated extraordinarily after the two oil price increases[10] due, on the one hand, to the strong effort of the country's leadership to build up a large oil-refining industry and, on the other hand, to the fact that Rumania received only 1.5 million tons of oil per year from the Soviet Union for transferable roubles. Poland experienced an extraordinary rapid increase of Western imports in the first half of the 1970s which caused

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[9] L. Antal

[10] The Romanian trade deficit with the OPEC-countries amounted to 80 million dollars in ..... while two years later it peaked at 1.3 billion dollars. (G. Fink, 1981)

unmanageable deterioration of balance of payments in the second half of the decade, in spite of the export expansion above the CMEA-average through the 70s.

The trade data can not prove a very significant difference in the performance of the Hungarian economy and that of the rest of Eastern Europe. Moreover, though the level of openness of Hungary measured by trade per capita in terms of convertible currencies was much higher than in the European socialist partners, it lagged very considerably behind the openness of Western market economies of comparative size in this respect, (Lakos, 1981). (Similarly, the commodity structure of Hungarian exports to advanced countries was obsolete in the later comparison but was somewhat better than that of other socialist countries and showed a more favourable dynamism.) Finally, one should mention that the supply situation of consumer goods was also significantly better on the Hungarian market than elsewhere in the area.

### 1.3 Systemic reforms vs. external financing. Case of Poland

Developments in the Polish economy in the 1970s provide perhaps the best example of how *neglect of the need for comprehensive systemic reforms and disastrous economic policy* led to the economic collapse and deep political crisis. It should be recalled that when the new leadership came to power late in 1970, the need for economic reforms was widely accepted, and the government established a high-level committee to prepare a desired programme, not without

influence from recent Hungarian decisions. In 1971 so-called large industrial organizations (WOG) were created with a relatively high degree of independence from powerful branch industries. However, the *decentralization drive was quickly reversed* and the traditional command system has been restored, the reasons being the temporary improvement at domestic markets, eroding pressure for decentralization, political and ideological fears, and also extrememly favourable external environment. Unlike the 1960s, *Poland started to borrow heavily abroad* and embarked on an extensive investment programme, attempting to accelerate growth and at the same time rise consumption levels and improve radically the standard of living of the population.

*The period between 1970 and 1975 was actually the 'golden era' in Poland's post-war history.* The Net Material Product grew at an annual rate of 9.8%, individual consumption at the rate of 8.5%, and total exports at the rate of 10.8% (in real terms). However, imports grew at a much faster pace, especially from hard currency area leading to a rapidly growing trade balance deficit. The latter has been covered with an inflow of foreign credits, allowing for breath-taking increases of investment expenditures - by 156% within a five year period.

This investment 'leap ' could not, however, produce expected results in terms of substantial increase of consumer goods supply, technological advance and hard currency exports, because the traditional economic system did not allow for

efficient allocation of resources and produced tremendous wastages. The use of investment funds was totally outside public control and no rational efficiency criteria had been used whatsoever. The excessive investment expenditures, financed largely with foreign credits led inevitably to deep disequilibria in external and internal balance. The so-called policy manoeuvre undertaken by the government in 1976, with the objective to curb investment and stimulate exports, turned out to be total failure because the measures undertaken were designed to deal with symptoms and not with real causes of growing imbalances. Rigidity and inefficiency of traditional systems were ignored by the policy leadership, calls for reforms were consistently rejected and the only reactions were tightened administrative controls over enterprises and across-the-board cuts in imports.

The deep political and economic crisis in 1980-81 demonstrated painfully how futile were hopes to avoid radical systemic reforms. Looking from the perspective of the late 1980s, one can still wonder, however, to what extent this lesson has been learned and memorised by consecutive Polish governments.

### 1.4 Growth stagnation in the late 70s

Even with its half-heartedly reformed economy Hungary could not avoid the fundamental macroeconomic troubles of other nations in Eastern Europe from the middle of the 70s. Primary reasons of that general failure of the whole area were endogenous which only appeared with an unusual sharpness in

consequence of radical changes in the structures of the world economy. *The socialist economies,* being unable to react properly to those challenges for their own systemic reasons, *suffered a dramatic set-back in their trade balances with the hard currency area as well as a sharp slowing down of macroeconomic expansion and growth of living standards. The loss of the area in terms of share in international trade accelerated from the second half of the 70s* because the socialist countries being unable to increase sufficiently their deliveries to hard currency markets, had to slow down the growth of their purchases from those markets (see Table 1.1).

With the *lack of proper market mechanisms,* and more directly because of the rigidity and bureaucratic character of price formation, the *microeconomic agents were completely insensible to* the changes, most notably *the oil price increase on the world market.* Therefore, no serious adjustment process started on the level of the companies while the macroeconomic management regarded the changes as temporary phenomena and therefore did not act in time. Given the existing system, economic policy could react to the international challenges only by *general economic restrictions* (any selective measure could have been jeopardized by lack of proper prices making impossible any real evaluation of microeconomic performance). These direct measures (and in the case of Hungary also by the help of financial macro-management), forced a slowing down of growth of the economy as well as in investment activity. Moreover, there was a shift in the distribution of national

Table 1.1A: FOREIGN TRADE OF THE EUROPEAN CMEA -COUNTRIES WITH THE DEVELOPED WESTERN COUNTRIES (US $ Mn)

| | | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|
| Bulgaria | E | 434.5 | 562.4 | 608.0 | 731.5 | 1277.5 | 1639.5 | 1445.8 |
| | I | 1278.4 | 1037.5 | 996.0 | 1150.2 | 1320.7 | 1661.6 | 2167.8 |
| | S | -843.9 | -475.1 | -388.0 | -418.7 | -42.8 | -22.1 | -722.0 |
| Czechoslovakia | E | 1657.9 | 1646.6 | 1898.6 | 2117.4 | 2626.9 | 3240.0 | 2920.5 |
| | I | 2236.9 | 2420.3 | 2633.8 | 2929.3 | 3432.9 | 3691.1 | 3246.3 |
| | S | -579.2 | -773.2 | -735.2 | -801.9 | -806.0 | -451.1 | -325.8 |
| GDR | E | 2259.6 | 2760.7 | 2477.1 | 2616.0 | 3135.1 | 4171.4 | 5252.9 |
| | I | 3274.1 | 4196.3 | 3784.1 | 3712.8 | 4991.4 | 5815.2 | 6144.5 |
| | S | -1014.5 | -1435.6 | -1307.0 | -1096.8 | -1856.3 | -1643.8 | -891.6 |
| Poland | E | 3241.0 | 3525.0 | 3834.1 | 4417.0 | 5056.7 | 5849.1 | 3908.4 |
| | I | 6182.3 | 6781.1 | 6330.0 | 6518.6 | 6665.3 | 6690.5 | 4474.5 |
| | S | -2941.3 | -3256.1 | -2495.9 | -2101.6 | -1608.6 | -841.4 | -566.1 |
| Romania | E | 1853.5 | 22129.8 | 2120.3 | 2649.2 | 3510.3 | 4035.9 | 3781.6 |
| | I | 2318.3 | 2206.5 | 2575.6 | 3571.1 | 3896.7 | 40921.0 | 4088.0 |
| | S | -464.8 | -76.7 | -455.3 | -921.9 | -386.4 | -56.2 | -306.4 |
| Hungary | E | 1328.9 | 1554.5 | 1714.2 | 1927.8 | 2639.7 | 3045.8 | 2629.1 |
| | I | 1694.8 | 2023.9 | 2439.5 | 3129.2 | 3327.1 | 3714.1 | 3671.5 |
| | S | -635.9 | -469.4 | -725.3 | -1201.4 | -687.4 | -668.3 | -1042.4 |
| Eastern Europe | E | 10775.0 | 12179.0 | 12652.3 | 14458.9 | 18246.6 | 21981.7 | 19969.7 |
| | I | 17254.9 | 18665.7 | 18759.1 | 21001.2 | 23634.1 | 25664.6 | 23829.3 |
| | S | -6479.5 | -6486.7 | -6106.7 | -6542.5 | -5387.5 | -3682.9 | -3859.6 |
| USSR | E | 8511.1 | 10391.5 | 11973.5 | 12738.1 | 19090.2 | 24431.3 | 23859.3 |
| | I | 13451.7 | 14356.6 | 13459.3 | 16059.9 | 20203.1 | 24228.4 | 25107.2 |
| | S | -4940.6 | -3965.0 | -1485.9 | -3321.8 | -1112.9 | 202.9 | -1247.9 |
| European CMEA | E | 19286.5 | 22570.5 | 24625.8 | 27197.0 | 37336.8 | 46413.0 | 43829.0 |
| | I | 20706.4 | 33022.3 | 32218.4 | 37061.1 | 43837.2 | 49893.0 | 48936.5 |
| | S | -11420.1 | -10451.8 | -7592.6 | -9864.1 | -6500.4 | -3480.0 | -5107.5 |

Table 1.1B: FOREIGN TRADE IN THE 1970's

Percentage growth in current $s

| | | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Bulgaria | E | 29.4 | 8.3 | 20.3 | 74.6 | 28.3 | -11.8 |
| | I | -18.8 | -4.0 | 15.5 | 14.8 | 25.8 | 30.5 |
| Czechoslovakia | E | -0.1 | 15.3 | 11.5 | 24.1 | 23.3 | -9.9 |
| | I | 8.2 | 8.8 | 10.8 | 17.6 | 7.5 | -12.1 |
| GDR | E | 22.2 | -10.3 | 5.6 | 19.8 | 33.0 | 25.9 |
| | I | 28.2 | -9.8 | -1.9 | 34.4 | 16.5 | 5.7 |
| Poland | E | 8.8 | 8.8 | 15.2 | 14.5 | 15.7 | -33.2 |
| | I | 9.7 | -6.7 | 3.0 | 2.3 | 0.4 | -33.1 |
| Romania | E | 14.9 | -0.4 | 24.9 | 32.5 | 15.0 | -6.3 |
| | I | -4.8 | 16.7 | 38.7 | 9.1 | 5.0 | -0.1 |
| Hungary | E | 17.0 | 10.3 | 12.5 | 36.9 | 15.4 | -13.7 |
| | I | 19.4 | 20.5 | 28.3 | 6.3 | 11.6 | -1.2 |
| Eastern Europe | E | 13.0 | 3.9 | 14.3 | 26.2 | 20.5 | -9.2 |
| | I | 8.2 | 0.5 | 12.0 | 12.5 | 8.6 | -7.2 |
| USSR | E | 22.1 | 15.2 | 6.4 | 49.9 | 28.0 | -2.3 |
| | I | 6.7 | -6.3 | 19.3 | 26.0 | 19.9 | 3.6 |

Source: Data from the Wiener Institut für Internationale Wirtschaftsforschung.

income in favour of consumption aiming to prevent major political discontents.

*Sharp reduction in growth of volume* of aggregate investment (at the end of the 70s in some countries even of its absolute magnitude) inevitably led to a diminishing growth of national income in each country of the region. Beside the direct link between the volume of investments and growth of production, this later had to slow down by the above mentioned exhaustion of the so-called extensive resources of growth. In fact, *capital-productivity continually decreased* in the whole socialist industrialization process. (Tuitz, 1983) Share of the investment in the national income could not have been increased any more at the expense of consumption (on the contrary it had to be reduced). Similarly, the share of heavy industry in aggregate investment had to be reduced as well so that sources could be reallocated, particularly on behalf of the especially ineffective agriculture in order to prevent more serious food-shortages. In exporting industries there was either new investments or lack of sufficient maintainance of the exisiting capabilities. Involvement of additional labour force in the preferred sectors was not available on such a scale as earlier for demographic reasons; and finally, the underdevelopment of the neglected infrastructural fields became increasingly an obstacle to further growth.

Given these burdens and the slow reaction of the overbureaucratized economy to changes in the external conditions, the above mentioned reallocation of resources was

Table 1.2: SHARE OF ACCUMULATION IN NATIONAL INCOME IN THE EUROPEAN CMEA-COUNTRIES, 1974-1986 (PERCENT)

| | Bulgaria | Czechoslovakia | GDR | Hungary | Poland | Romania |
|---|---|---|---|---|---|---|
| 1974 | 30.7 | 24.9 | 27.8 | 25.2 | 37.2 | . |
| 1975 | 32.8 | 26.0 | 26.9 | 26.4 | 35.7 | 38.1 |
| 1976 | 29.0 | 25.4 | 27.7 | 25.8 | 34.3 | 37.3 |
| 1977 | 26.4 | 23.9 | 28.0 | 26.9 | 31.4 | 39.2 |
| 1978 | 23.9 | 24.6 | 26.3 | 30.3 | 30.6 | 42.3 |
| 1979 | 24.2 | 24.6 | 24.7 | 24.1 | 25.7 | 40.9 |
| 1980 | 25.0 | 26.0 | 26.2 | 21.5 | 20.3a | 41.4 |
| 1981 | 26.7 | 20.1 | 25.3 | 21.6 | 20.7 | 39.2 |
| 1982 | 25.3 | 20.4 | 21.6 | 20.2 | 21.6 | 34.4 |
| 1983 | 24.1 | 19.5 | 21.5 | 18.2 | 21.4 | 35.1 |
| 1984 | 24.3 | 19.8 | 21.2 | 17.7 | 21.9 | 34.5 |
| 1985 | 23.8 | 20.0 | 21.4 | 17.1 | 19.0b | 32.8 |
| 1986 | 27.2 | . | 21.6 | 19.4 | 19.1 | . |
| 1987 | . | . | . | 20.1 | 18.3 | . |

Source: National Statistical yearbooks.

a,b: price base of accounting of national incomes changed.

not enough to get rid of the piling-up of debt repayment difficulties. Both the East European debtors and their creditors reacted too late to the indebtedness problem: for both parties it was a new phenomenon. *The debtors* often *believed that high international inflation would* rather *depreciate their credits.* They also thought that the new international price structure was something temporary, as we mentioned earlier. Western creditors, on the other hand, were convinced that the Soviet Union would exercise an umbrella function in case of payment-trouble of any socialist country and central planning would make it easier anyhow to reallocate resources so as to meet financial obligations. In reality, *the Soviet Union was not able* and not willing *to protect the credit-worthiness of its small socialist partners* beyond a certain limit. One should not forget, that international opinion regarded Hungary and Poland in the 70s as two of the 'miracle-cases' of the world economy - a view based on an improper analysis of developments briefly discussed in this paper. Moreover, since the *terms of trade* of the European socialist countries deteriorated considerably vis-a-vis the Soviet Union in the second half of 1970, due to its role as raw-material supplier and also of the application of the Bucharest price-principle, the small member-countries accumulated a considerable debt towards the Soviet Union as well. (Fink, 1981)

Summing up, the crisis which emerged at the end of the 1970s was much deeper than only a temporary adjustment-inability to turbulent structural changes and uncertainties in

the world economy. The international impact only brought to the surface the inescapable fact that the dynamism of the economic system of CPE's had been historically exhausted. Two interconnecting changes seemed to be imperative in this situation. The East European economies badly needed profound systemic changes, much more radical than the Hungarian reform in 1968 or the Yugoslav reforms in the 1950s and 1960s. Apart from this, they needed a radical change in their economic policy - towards a strategy oriented to exports to the competitive, hard currency markets. As was recognized by economists already at that time in Hungary and Poland, the old industrialization pattern based on Soviet raw material deliveries for manufactured industrial goods, was basically exhausted at the time: the Soviet Union was unable to increase its deliveries. Furthermore, only increased export potential could secure the credit-worthiness of the East European countries as well as an uninterrupted flow of high-quality goods from the developed countries. The two tasks were closely interconnected without market reform, export-orientation could not be developed and without export-orientation, radical internal reforms had no chance to yield spectacular results either.

# II. ADJUSTMENT POLICIES IN EASTERN EUROPE IN THE 1980's

## 2.1 The impact of the crisis of 1980-82 on socialist economies.

The series of various shocks which struck the international economy in 1980-82 is usually referred to as a recession, but it seems that the term "crisis" would be more in order. It started with the two-fold oil price increase in 1979 and accelerated inflation in 1979-1981. Dramatic change in economic policies of most industrialized countries, attempting to curb inflation, led among other things, to a sharp increase of real interest rates and prolonged recession in 1980-82, the deepest in the after-war period. This, in turn contributed to the reduction of overall demand in world economy, which affected primary goods exporters in the first place. Drop in export earnings coupled with soaring interest rates and high fuel prices resulted in global financial crisis. The rigid and inefficient economies of socialist countries struggling already against large domestic imbalances and facing growing social and political discontent, were not prepared to cope with these external challenges. The crisis of 1980-82 uncovered all these systemic weaknesses and policy failures, so characteristic of centrally planned economies of traditional type.

The global crisis 1980-82 was transferred to the socialist countries through increased tensions on their current account, adding to existing internal difficulties. Three channels turned out to be of particular importance.

First, *demand for the socialist countries' non-oil exports in the West declined sharply* both because of the recession which started in 1981 in Western Europe and was quickly spread to America, and because of the *specific structure of socialist exports,* where raw materials intermediates and food stuffs play a dominant role. Next, all *European socialist countries (except the USSR)* are net oil-importers and *were* subsequently *affected by the two-fold increase in oil prices in 1978-79.* This impact was not initially as strong as in other oil-importing countries, since 80-90% of oil requirements of Eastern Europe are covered by supplies from the Soviet Union under long-term agreements, where prices are fixed according to the five-year moving average principle and therefore they lag always behind international spot prices. However, in 1980-81 this effect was already strong enough to produce a substantial and still growing worsening of East-European terms of trade. For *instance, in case of* Poland *terms of trade with* so called "first payment area" (i.e. with CMEA countries) dropped down by 1.6% in 1980, by 5.1% in 1981 and by 8.8% in 1982 as compared with 1979.

Another factor exerting unfavourable influence was a *gradual rise of interest rates.* The LIBO rate increased from 6.97% in 1977 to 16.56% in 1980 and up to 18.80% in 1981. This fact was of special importance for heavily indebted CMEA countries like Poland, Hungary, Romania. Higher interest charges dramatically widened financial gaps in current account balances of these countries, forcing eventually some of them to suspend debt service payments in 1981.

It would not, however, be justified to claim that unfavourable external developments bear sole responsibility for economic turbulences in socialist countries. Foreign shocks notwithstanding, *the roots of the difficulties laid rather in the apparent inability of the socialist countries to embark on a suitable adjustment policy programme*. The need for such a programme was totally ignored after the first OPEC crisis in 1973-74 and the socialist countries were attempting to continue economic growth without making structural and institutional adjustments necessary. The policy of not leaving the "old track" was made possible by a unique combination of political "détente" and abundant availability of financial funds being recycled from surplus to deficit countries. After the second oil price shocks both elements were missing and socialist countries were suddenly trapped in a number of external and internal constraints and bottle-necks. As experience has shown, their willingness and ability to make necessary adjustments at the beginning of 1980's were still very much limited.

## 2.2 The Policy Options

When the global financial crisis developed in 1980-81, coupled with deep recession in market economies, socialist countries were confronted, generally speaking, with four main policy options. They could have tried *to continue their economic growth and consumption at the cost of deepening external imbalance*. But to increase foreign debt became

extremely difficult after main debtor countries like Mexico, Brazil, but also Poland and Romania, had declared their inability to meet due financial obligations. On the other hand, foreign debt levels in some East European countries were already very high relative to hard currency export earnings, and foreign banks were increasingly reluctant to extend new credits to those countries. 'Even though, suspension of debt service by Poland in March 1981 was a real shock for the international financial community, as it destroyed long established beliefs on inherent credit worthiness of centrally planned economies, connected either with their specific features (dominance of public sector and government control) or with the so-called "umbrella"-theory (the Soviet Union as the lender of last resort for its East-European allies). Anyway, further reliance on foreign financing became practically impossible for most of the socialist countries, and for those not so deeply indebted like Czechoslovakia or Bulgaria, availability of foreign funds has been also much more limited than before.

*A second possibility was to curb growth and consumption and to start austerity programmes trying to restore external balance through cuts in imports and expanding exports.* This policy in its purest form was applied in Romania, where domestic equilibrium objectives were totally subordinate to the goal of repaying external debt. Some elements of this policy were also adopted in Poland and Hungary, but domestic austerity measures have never been so drastic as in Romania.

*Another option was to change priorities in economic policy, cutting investment,* especially in heavy industry, and concentrating resources in labour-intensive sectors producing consumer goods, services and for exports. The practical feasibility of such a policy change may however be strongly doubted, if not accompanied at the same time by radical institutional reform of economic mechanism. This reform constituted a fourth possible (perhaps the farthest reaching) option to counter-react challenges posed by changing conditions in international environment.

## 2.3 Foreign trade adjustment

As it seems now, reactions to the crisis 1980-82 in socialist countries went rather along two first policy options, although Poland and Hungary intensified also their reformist efforts. Unlike in developed market economies, where important structural changes in the production sector have been initialized already after the first oil shock, in socialist countries quite different approach has been applied. Here, the adjustment process took merely the form of even more rigid foreign trade controls through direct administrative measures, aimed at producing necessary surplus in the current account to meet foreign debt service obligations. Systemic changes were of much lesser significance. Tables 2.1 and 2.2 provide some statistical evidence on foreign trade flows in socialist countries.

**Table 2.1:** ANNUAL RATES OF CHANGE OF EXPORTS, IMPORTS IN CMEA COUNTRIES, 1981-1986.

| Country | 1970-80 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|---|
| Annual rate of change of exports, at current prices, in %. | | | | | | | |
| Bulgaria | 18.4 | 3.1 | 6.9 | 6.1 | 5.9 | 3.9 | 5.8 |
| Czechoslovakia | 15.0 | -0.1 | 4.8 | 5.6 | 4.4 | 2.0 | 16.6 |
| GDR | 14.1 | 14.7 | 9.5 | 9.4 | 4.4 | 1.7 | 9.7 |
| Hungary | 14.1 | 14.7 | 9.5 | 9.4 | 4.4 | 1.7 | 9.7 |
| Poland | 18.1 | -22.4 | -15.2 | -2.0 | 6.4 | -1.7 | 3.8 |
| Romania | 20.1 | -1.9 | -9.5 | 0.4 | 5.5 | 2.5 | 6.8 |
| USSR | 20.6 | 3.3 | 10.0 | 5.1 | 0.3 | -5.0 | 11.8 |
| Annual rate of change of imports, at current prices, in % | | | | | | | |
| Bulgaria | 18.6 | 11.9 | 6.7 | 6.6 | 3.5 | 7.4 | 9.4 |
| Czechoslovakia | 16.2 | -3.2 | 5.0 | 6.0 | 4.6 | 3.2 | 19.4 |
| GDR | 15.4 | 5.8 | 0.0 | 6.6 | 6.6 | 2.1 | 17.0 |
| Hungary | 14.1 | -1.2 | -3.4 | -3.5 | -4.8 | 1.7 | 16.8 |
| Poland | 18.9 | -20.2 | -33.0 | -2.0 | 5.5 | 2.0 | 3.2 |
| Romania | 21.5 | -16.8 | -24.2 | -8.2 | -1.1 | 12.2 | 8.4 |
| USSR | 20.1 | 6.5 | 6.6 | 3.4 | 0.3 | 2.6 | 7.4 |

Source: Handbook of International Trade and Development statistics, Supplement, 1987, *United Nations*, New York, 1988.

**Table 2.2:** INDICES OF NET MATERIAL PRODUCT (NMP) AND FOREIGN TRADE IN SOCIALIST COUNTRIES IN 1986 (1980=100)

| Country | NMP | Total Exports | Hard currency exports | Total imports | Hard currency imports |
|---|---|---|---|---|---|
| Bulgaria | 126 | 136.1 | 60.0 | 154.8 | 141.2 |
| Czechoslovakia | 111 | 137.3 | 99.0 | 138.9 | 94.1 |
| GDR | 130 | 160.0 | 189.4 | 143.6 | 131.9 |
| Hungary | 107 | 105.9 | 95.8 | 104.2 | 98.0 |
| Poland | 101 | 70.0 | 70.0 | 58.2 | 55.3 |
| Romania | 133 | 102.9 | 93.7 | 69.6 | 37.2 |
| USSR | 124 | 127.2 | 76.7 | 129.7 | 93.0 |

Source: Statisticzeskij Ezhegodnik Stran-Czlenov SEV, Moskva 1987.
Handbook of International Trade and Development statistics, Supplement, 1987, United Nations New York, 1988.

Import reductions were most visible in Poland and Romania, and to a lesser extent in Hungary. Apparent inefficiency of systemic (modest) modifications in the foreign trade sector is confirmed by low export growth rates. In Poland, export in 1986 were still 30% lower than in 1980, and in Hungary and Romania it was only slightly higher.

In case of other socialist countries imports were growing rather steadily, although in general at a much slower pace than in the 1970's. The highest dynamics *has been* observed in Bulgaria, where it was financed by increased foreign debt.

All socialist countries have tried in the 1980's to switch their imports from the West to the CMEA area (Table 2.2). Hard currency imports of all of them - except for Bulgaria and the GDR actually diminished between 1980 and 1986. The process of cutting off from Western markets was most spectacular in Romania, where hard currency imports in 1987 were not more than one quarter of those in 1980 in real terms, and also in Poland, where import cuts were, however, enforced rather by the western credit embargo, than by an endogenously controlled expenditure switch.

The measures undertaken to restore external equilibrium produced mixed results at best. *Inability to increase hard currency exports* together with deep import cuts allowed only for slight improvement in trade balances of socialist countries, reducing substantially their degree of international "openness" and putting enormous strains on their

Table 2.3: FOREIGN HARD CURRENCY DEBT OF SOCIALIST COUNTRIES, IN US $ BILLIONS

| | 1980 | | 1987 | |
|---|---|---|---|---|
| Country | gross | net | gross | net |
| Bulgaria | 3.5 | 2.7 | 5.9 | 4.7 |
| Czechoslovakia | 4.9 | 3.6 | 5.1 | 3.7 |
| GDR | 14.4 | 11.8 | 15.5 | 7.3 |
| Hungary | 9.1 | 6.7 | 17.5 | 11.2 |
| Poland | 24.1 | 22.8 | 39.2 | 37.2 |
| Romania | 9.6 | 9.2 | 5.7 | 4.3 |
| USSR | 23.0 | 14.9 | 29.8 | 16.2 |
| CMEA Banks | 4.5 | - | 4.8 | - |

Source: WIIW Data, Monatsberichte, 5/1988.

domestic markets. As a result GNP dynamics was much lower in 1980-86 than in the previous decade and, despite all efforts, foreign indebtedness actually increased for all CMEA countries, except for Romania (see Table 2.3).

## 2.4 Adjustment in investment

In the field of domestic policies the only remarkable change was *substantial reduction of investment*, especially in Poland, Hungary and Czechoslovakia where investment expenditure actually diminished in 1986 as compared with 1980 (see Table 2.4), in attempts to protect consumption levels.

In GDR and Romania the level of investment, after substantial drop in 1981-84, has been recently recovered. Only Bulgaria and the Soviet Union have attempted to continue investment expansion, although again there is no comparison with the previous decade. One may wonder, however, to what extent high investment dynamics in Bulgaria contributed to a severe balance of payments crisis which developed in 1986-87. (See Part 2.9.)

Analysis of the investment structure in particular countries reveals also, that except for Hungary and Poland, there was no major shift of investment from material production sector to services. A slight change of proportions has been observed in the USSR and Czechoslovakia, but Romania, for instance, actually increased the share of production sector in total investment.

Table 2.4: ANNUAL RATES OF CHANGE OF INVESTMENT IN CMEA COUNTRIES, 1981-1986

| Country | 1970-80 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|---|
| | Annual rate of change of investment, at constant prices, in %. | | | | | | |
| Bulgaria | 7.3 | 8.0 | 5.6 | 0.9 | 0.0 | 8.7 | 8.0 |
| Czechoslovakia | 5.4 | -5.0 | -1.1 | 0.0 | -4.3 | 5.6 | 1.1 |
| GDR | 4.1 | 2.0 | -4.9 | 0.0 | -5.2 | 3.3 | 5.7 |
| Hungary | 4.6 | -5.0 | -2.1 | -3.2 | -3.3 | -2.3 | 2.4 |
| Poland | 6.8 | -22.0 | -14.7 | 10.3 | 10.7 | 6.0 | 5.7 |
| Romania | 10.0 | -7.0 | -3.2 | 2.2 | 6.5 | 1.3 | 1.2 |
| USSR | 5.1 | 4.0 | 2.9 | 5.6 | 2.7 | 2.6 | 8.4 |
| | Annual rate of change of investment in material production sector, at constant prices, in %. | | | | | | |
| Bulgaria | . | 90.0 | 5.5 | -0.9 | 1.8 | 11.2 | 5.4 |
| Czechoslovakia | . | -4.0 | -1.0 | 1.1 | -4.2 | 5.4 | 1.0 |
| GDR | . | 2.0 | -4.9 | 0.0 | -6.2 | 3.3 | 6.8 |
| Hungary | . | -5.0 | -3.2 | -5.4 | -5.7 | -2.4 | 0.0 |
| Poland | . | -24.0 | -17.1 | 7.9 | 13.2 | 9.1 | 4.8 |
| Romania | . | -7.0 | -3.2 | 4.4 | 7.4 | 2.0 | . |
| USSR | . | 3.0 | 3.9 | 4.7 | 1.8 | 2.6 | 6.8 |

Source: Statisticzeskij Ezhegodnik Stran-Czlenov SEV, 1987, Moskva, 1987.

It is worth noting that according to official declarations cuts in investment should be even higher, but in practice investment expenditures in Eastern Europe have shown a consistent pattern of overrunning planned limits, thus deepening internal disequilibrium.

### 2.5 Foreign debt management

Three socialist countries were in serious balance of payments difficulties at the beginning of 1980's. *Poland and Romania suspended debt service payments in 1981* and formally requested re-scheduling of their foreign debts in convertible currencies. Early *in 1982 also Hungary found itself in an intense liquidity crisis* due to a rapid outflow of foreign-owned short-time deposits. In this latter case, however, formal re-scheduling was avoided with the assistance of Western Banks and the IMF. It is interesting to see that all three countries, facing essentially the same problem, adopted different methods to cope with it.

In *Poland,* where the situation was perhaps the most difficult because of strikes, political tensions and collapse of industrial output, deep import cuts from Western countries were accompanied by *a wide spectrum of systemic changes,* introduced in 1982 within the programme of economic reform. Those changes, however, failed to produce a breakthrough - hard currency exports grew at the rate only slightly higher than hard currency imports and *Poland has not been able to*

*stabilize its foreign debt.* The tiny surplus of 1-1.2 billion US $ per annum was achieved mainly through cutting imports and curbing domestic consumption; however, that was definitely not sufficient to cover even interest charges, running in the first half of 80's at the level of 2.4-2.8 billion US $, not to speak about repayment of due principals.

The main reason for the poor performance of the Polish economy in overcoming the crisis was a deep contradiction between the nature of pro-efficiency reforms initiated in 1982 and the traditional character of the economic and social policy. The government, still assuming paternalistic responsibility for the financial position of particular enterprises, followed a very soft monetary policy, subsidizing heavily inefficient units and applying excessively high taxation on profits of those enterprises, which fared above the average. On the other hand, trying hardly to arrive at some sort of political reconciliation with the society and therefore avoiding any policy measure that could again raise social discontent, the government continued administrative controls of prices and foreign exchange rates preventing them from going up to levels more corresponding to actual relations of demand and supply. As a result the proefficiency mechanism of the new system remained suspended and the whole reform was largely "paralysed".

The additional reason for low export dynamics was the embargo for new credits imposed on Poland in 1982 and virtual overnight cut off from external financing. New conditions

under the martial law regime in 1982-83 were not very favourable for economic restructuring either.

The development of situation in *Hungary,* although not so dramatic as in Poland, was in a certain sense even worse.

It is a common view, that the liquidity crisis in Hungary in the spring of 1982 was triggered by unproportionally high reliance on eurocurrency, commercial credits, bearing normally higher interest rates, and an unfavourable maturity structure of hard currency deposits (high share of short-term deposits). Clearly these factors contributed to the balance of payments difficulties, but were rather of supplementary nature, with internal systemic and policy-specific causes playing the fundamental role. Hungary's heavy debt payments obligations in 1982 totalling ca. 2.8 billion US $ were not a sudden result of an adverse debt structure but constituted an inevitable outcome of notoriously low export capabilities and of the inability of the Hungarian economy to adapt to changing external conditions.

Hungary managed to avoid formal rescheduling of debt in 1982, because of the massive help of international financial institutions in the first place. The country joined the IMF in May 1982 and immediately got "bridging" credits of 510 mln US $ from the Bank for International Settlements, and later in this year - a 600 mln US $ stand-by loan from the IMF. During 1983 Hungary obtained two large loans from the World Bank (totalling more than half a billion US $) and further in 1984

a second stand-by from the IMF of 440 mln. US $ and new credits from the World Bank. This highly cooperative approach of two prestigious *financial institutions* helped Hungary to arrange a series of other refinancing arrangements with commercial banks which eventually permitted an easing of the liquidity crisis. For its part, Hungary committed herself to pursue an adjustment programme largely supported by the IMF because of its absorption-cutting and export-promoting orientation (see Marer, 1986).

Enjoying a much better position (both for political and economic reasons) in the West than Poland, the Hungarian economy could not manage to overcome stagnating tendencies and continuously worsening of current account balance. Like Poland, this was mostly due to a hesitant pace of implementing the necessary reforms, but in the case of Hungary this so-called "transition period" has lasted much longer (since 1968) and seems to be of more permanent nature that anyone would have expected before. Probably lack of strong social and political pressure led the Hungarian reform process to a stalemate where neither central planning nor market mechanism could work properly (see e.g. T. Bauer, 1983, J. Kornai, 1983).

*Romania* is a maverick case, where, in contrast to Hungary and in Poland, deep cuts in consumption have been imposed and imports have been reduced by more than 3/4 from 1982 to 1986. Restoring the external balance was given the highest priority in the economic policy. As a result Romania was able to

service the foreign debt in full and decrease it substantially, but the draconian measures adopted may well backfire in the future and provoke both social unrest and the collapse of industrial production, deprived of majority of raw materials, intermediates and spare parts. Anyway, the final outcome of this policy still remains to be seen.

Other East-European countries, although not so deeply indebted, have not shown a strong export dynamics either (see Table 2.5).

## 2.6 Weakness of systemic adjustment

To summarize, the reaction of the East-European countries to the global crisis has to be seen as entirely inadequate. Policies adopted were mostly "symptom-oriented" instead of dealing with real causes deeply rooted in low efficiency and inflexibility of their economies[11]. Systemic reforms in Hungary and Poland, although aiming in the right direction, were not consequently implemented and elements of the old rigid centralized system still prevailed, especially in the area of resource allocation. Recent changes introduced in Bulgaria and the USSR in 1985-87 have not yet had a chance to produce some positive results, but it is very likely that they will encounter bureaucratic and political obstacles of the same nature as in Poland.

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[11] In the period 1973-1985 energy intensity of GNP in OECD countries decreased by 6% in Canada and Australia, by 18-23% in European countries and the USA and by 31% in Japan. During the same period, consumption of coal per unit of Net Material Product in Poland increased by 14%, of lignite - by 26% and of electrical energy - by 25%.

Table 2.5: Foreign Trade of the CMEA-countries with the Developed West, 1981-1987 (US $ Mn)

| | | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| Bulgaria | E | 1438 | 1299 | 1267 | 1167 | 1136 | 983 | 1080 |
| | I | 2159 | 1917 | 1712 | 1754 | 2080 | 2347 | 2433 |
| | B | -721 | -618 | -445 | -587 | -944 | -1364 | -1354 |
| Czechoslovakia | E | 2921 | 2777 | 2709 | 2782 | 2763 | 3207 | 3607 |
| | I | 3246 | 2920 | 2734 | 2586 | 2699 | 3472 | 4136 |
| | B | -326 | -143 | -25 | +196 | +64 | -265 | -529 |
| GDR | E | 5445 | 6298 | 7102 | 7462 | 7595 | 7904 | 8600 |
| | I | 5953 | 5507 | 6218 | 6651 | 6703 | 7671 | 8840 |
| | B | -507 | +791 | +884 | +611 | +893 | +234 | -240 |
| Poland | E | 3908 | 3649 | 3757 | 4059 | 3982 | 4094 | 5041 |
| | I | 4474 | 3154 | 3055 | 3136 | 3494 | 3703 | 4280 |
| | B | -566 | +495 | +702 | +923 | +484 | +391 | +761 |
| Romania | E | 3785 | 3410 | 3675 | 4298 | 3773 | 3707 | 3700 |
| | I | 3527 | 1934 | 1448 | 1576 | 1470 | 1472 | 1400 |
| | B | +258 | +1476 | +2227 | +2722 | +2303 | +2235 | +2300 |
| Hungary | E | 2629 | 2627 | 2875 | 2971 | 2629 | 2917 | 3527 |
| | I | 3671 | 3215 | 2928 | 2826 | 3170 | 3639 | 4081 |
| | B | -1042 | -587 | -53 | +145 | -541 | -722 | -554 |
| Eastern Europe | E | 20126 | 20060 | 21385 | 22738 | 21879 | 22812 | 25555 |
| | I | 23030 | 18646 | 18095 | 18528 | 19615 | 22303 | 25170 |
| | B | -2905 | +1414 | +3290 | +4210 | +2263 | +509 | +380 |
| USSR | E | 23859 | 25935 | 26442 | 26305 | 22316 | 18694 | 22566 |
| | I | 25107 | 26040 | 25260 | 24164 | 23073 | 22538 | 22069 |
| | B | -1248 | -104 | +1182 | +2141 | -757 | -3844 | +497 |
| ~~RGW~~ CMEA | E | 43.985 | 45995 | 47827 | 49043 | 44198 | 41507 | 48121 |
| | I | 48136 | 44686 | 43355 | 42692 | 42720 | 44842 | 47239 |
| | B | -4150 | +1310 | +4472 | +6351 | +1478 | -3335 | +882 |

Source: Fink et al. 1988

GDR and Czechoslovakia enjoyed a comparatively good economic situation and this is perhaps one of the reasons for the apparent lack of enthusiasm for more radical reforms in these countries. Their economic performance, however, has not been impressive either, although the GDR managed to increase her hard currency exports in the first half of 80's at the annual rate of 8.1% (the best result among East-European countries), maintaining also an average GNP growth rate of about 4.5%.

Policy responses in socialist countries to the crisis 1980-82 demonstrated also for the first time, that those countries cannot anymore be considered as a homogeneous group where similar if not identical policy measures are followed in essentially identical systemic and institutional conditions. It can be argued that the traditional concept of the "Soviet-type economy", applied extensively in the past to grasp the characteristic features of economic organisms of East-European countries may have become of rather historical meaning in the aftermath of 1980-82 crisis. Clearly, this concept cannot be used in its "classical" sense and there is a need to discriminate among various socialist countries describing their systemic solutions and policy measures.

It is worth noting that *policy reactions* in socialist countries in the field of foreign economic relations have been also of *"protectionist" character,* although protectionist tendencies have manifested themselves in a quite different

form than in Western countries. There, protectionist measures have been used to protect employment and output levels. Along with traditional tools like tariffs and quotas, applied extensively by the EEC, the USA and Japan, new forms of protectionist measures have emerged, like "monetary" protectionism (or "foreign exchange" competition) or attempts through political pressure or even intimidation, to impose "voluntary export restraint" (or VER's) on commercial partners. In socialist countries in turn, administrative restrictions were put on imports and on domestic spending essentially to protect the foreign balance rather than domestic market. At least from this point of view the use of trade policy tools (e.g. quotas) to restore an external equilibrium is more justified than the use of these tools for maintaining higher levels of domestic output and employment, as it is done in the West.

Deep cuts in imports and strict controls over hard currency transactions transformed East-European economies into separate, isolated markets, suffering from various disequilibria. Despite the fact they have all been CMEA members for 40 years, their economies work largely in isolation and economic links among them are comparatively weak. Administrative controls over imports are probably more difficult to penetrate by foreign competitors, than traditional protectionist barriers adopted in Western economies.

Therefore, both systemic and policy-specific deficiencies contributed to the low export dynamics of East-European countries, affecting the degree of their "openness" towards international markets.[12]

## 2.7 Hungarian response to crisis phenomena: Adjustment through import reduction and growing central interference without reform-breakthrough

As described in Part I, the inability of Hungarian economic policy to adjust to the new requirements in the framework of the given economic system led to heavy external imbalances at the end of 1970s. The danger of serious crisis urged the policy-makers to change the course of the economy. On one hand, *for the first time from 1956, the external balance-improvement got a clear priority over the goal of improvement of living standards of the population.* On the other hand, after a long silence, *reform debates were initiated* with involvement of reformist professionals.

For political considerations, the macroeconomic policy still gave *priority to consumption against capital accumulation* in distribution of national income on the short run. The share of net accumulation in national income started to fall, like in the other countries of the area (see Table 1.2).

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[12] Some 'internal' causes of low export dynamics of East-European countries are discussed in Section 2.8.

This time this fall of the share of accumulation in national income meant, not only a cyclical intensification of macro-economic tensions, but rather a real turning point: the system reached the limits of its capacity to increase (in a cyclical way) accumulation at the expense of consumption. In other words, this time *the recession* had not a temporary, as usually before, character but *signalled a general systemic phenomenon*. Since, as it was already mentioned, the capital productivity has been usually falling through the period of central planning this time the above shift in the macroeconomic proportions could not be continued: systemic change towards marketization was an absolute imperative; even the ultimate source was by that time exhausted: involvement of external resources for prolongation of economic expansion along the traditional line could not be continued simply because of the huge indebtedness.

The authors will not discuss here efforts of the government for systemic changes, since they are fairly extensively covered in a companion study by A. Török, undertaken within the same research project. At this place we are going to present adjustment measures in the Hungarian foreign trade sector.

It was the fear of repayment-crisis which finally encouraged the Hungarian leadership to overcome political resistance and to apply for membership at the two main international monetary institutions in 1981. Not independently from the exchange rate policy of the country changed in this

period; after years of revaluations the course for devaluation of the Hungarian currency got the upper hand; efforts to encourage exports received priority over anti-inflationary considerations.

Hungary's ability to export to the OECD-area did not increase in the early 1980's, even in nominal terms it slightly decreased. Therefore the only way to stabilize the position of the country as debtor was, like in the case of the other small CMEA-countries (with the exception of the GDR, see Part 4.3) to cut imports drastically.

Hungary's international position was very adversely affected by some external factors as well in the same period. *The Soviet Union froze its raw material deliveries* on the level of 1980 and in 1982 it even reduced them by 10 percent. Even more severe implications had *the Polish debt crisis* on the shorter run. After introduction of martial law in that country at the end of 1981 the confidence of the creditors to the East-European region drastically decreased. Huge amount of hard currency was withdrawn from East-European banks first of all by oil-exporter governments. Credit flows dried up almost overnight. This chain of events caused serious liquidity problems even in countries which otherwise could have avoided it for years ahead. In the same period debt service burden exploded as a consequence of growth of international interest rates. Hungary's average interest rates after her debt increased from 4.9 to 14 percent in three years after 1978.

Administrative import-restrictions caused tensions in the cooperation-process in the economy as well as on the consumer markets; import-substitution was generally encouraged in the whole economy. Growing share of the export-supporting credit fund (mentioned in Part 1.2) was given rather to import-substitution goals already at the end of the 1970's and even more so in the next 5 year period (Török 1983). The autarchic and defensive reflexes of the system were reflected in changes of the branch structure of investments in the first half of the 1980's; the raw material and energy sector increased its share in the industrial investments substantially. Similarly, materials and intermediaries got a preference in sinking imports so that the continuity of production process on the existing capacities could be secured with a minimum of disturbances.

This kind of anti-crisis policy and processes (which did not differ basically from the reaction on the new situation of the other socialist countries) caused a loss of Hungary's position on the international markets, especially on that of the OECD-countries. According to the calculations of a Hungarian author, the share of resource-based (less sophisticated) goods increased in Hungary's industrial exports from 33 percent (1976) to 36 percent (1984). In a different division, the share of the engineering industry decreased in the same period from 26% to 22%.

In this situation the share of the socialist countries increased in Hungary's trade. It was not the result of an

extraordinary expansion of intra-CMEA-trade (which, on the contrary, was very sluggish in this period), but of falling volume of trade with the developed market economies. Intensifying economic ties with the socialist countries was not a real alternative in the 1980's since neither the Soviet Union nor the other socialist countries could provide technology and more sophisticated materials needed to economic growth.

On the other hand, majority of the *privileged large companies* were still strongly interested in hanging on the traditional trading pattern, namely, on relying on the East-European (mainly the Soviet) market in their expansionary drive. There was a growing conflict in this respect between the central government (which wanted to force out more engagement of the firms on the Western export markets but was not able to find the economic stimuli to achieve this goal) and the companies which were strongly bargaining for maintenance or broadening of their own export-quotas to the Soviet market.

Still, due to *import cuts* and an active credit-taking policy, Hungary recorded some successes in the first half of the 80's: while some other countries of the area had to renegotiate their debts (and many others from the Third World were drawn into a hopeless debt-spiral), *Hungary was able to improve its credit standing in the bankers' community.* However, the consolidation was based on shaky grounds: *the general performance of the national economy had not improved -*

*only a temporary regrouping and massive hard-currency-deliveries to socialist countries* (mostly to the Soviet Union) *contributed to the positive trade balance* in 1983 and 1984. Falling real wages could be partly and temporarily compensated by opening up opportunities for second jobs in the private sphere but political tensions inevitably grew in this period. Investment cuts (among some other factors) of the previous years caused bottle-necks and delivery-disturbances at the enterprises. In this critical period, in the middle of 1980s, the economic government decided to try to accelerate growth of investments as well as of national income in the five-year period of the second half of the 1980's.

## 2.8 External constraints. Case of Poland

The point which is often raised in discussing the problem of East-West trade is the question of free access to financial assistance from the West, and in particular the question of availability of new credits. This point has been of particular relevance to Poland as she was cut off abruptly from Western sources of funds in the aftermath of the 1981 introduction of martial law. It is true that the Polish economy fared badly at that time and the overall credit-worthiness went low enough to reconsider the justification for the inflow of new credits unless some major changes both in the economic system and in the policy would be made. But it's true also that this decision was taken by the West mostly not on economic but on political grounds (see e.g. Z.M. Fallenbuchl, 1986). One can find many examples of other countries where financial

assistance continued to pour in even though their economic position was at least as bad as Poland's.

The *credit embargo* imposed on Poland in 1982 had at least three important and unfavourable consequences in the next few years. First, it *produced a tremendous shock for the economy* which suddenly had to cut down imports by more than 50% with no time or chance for a more smooth restructuring. Total output sunk by 12% in 1982 as compared with 1981, largely because of acute shortages of imported raw materials and intermediates. Second, it pushed Poland economically (and politically) towards the CMEA countries, mostly USSR, in a desperate attempt to compensate for lost sources of supplies in the West. This enforced "reorientation" of Polish foreign trade, however, could not have brought expected results, because the whole CMEA group experienced at that time serious problems with satisfying its demand for various commodities and was not in a position to substitute for an entire range of former Western supplies. As a result Poland entered a prolonged period of low growth dynamics and permanent shortages. Part of the effort undertaken by polish governments to 're-orient' polish economy towards east-european partners, trying to alleviate domestic and external imbalances, was the attempt to attract capital from socialist countries to fo-finance a number of various investment projects in Poland which had to be discontinued due to lack of funds. In 1982 the Polish government submitted a list of more than 100 projects to be considered as joint capital ventures with the participation of other socialist countries. However, the

timing for this initiative was not particularly fortunate. Other programmes, curbing investment activities and revising down their growth targets. On the other hand, the completion of many projects would require substantial hard currency inputs in the form of foreign technology and this kind of contribution was increasingly scarce in the region. Apart from these constraints, it seems also that particular governments were not prepared at that time to implement in practice the otherwise widely discussed idea of joint capital socialist ventures, and conceptual differences in planning and management systems in particular countries. As a result, the polish offer was not picked up and sharp invesment reductions had to be made in Poland.

It is interesting to see that joint venture concepts were not considered seriously by the Soviet Union, which preferred rather to use traditional, 'central-level' assistance measures, extending large credits to Poland in the form of additional supplies of consumer goods and intermediates. During 1980-82 the Soviet Union provided also a convertible currency financial credit of more than 1 billion US$ to stabilize, Poland's current account balance, badly hit by the drop of exports and sudden worsening of terms of trade. Thirdly, the credit embargo had a significant negative impact on the readiness and willingness of the Polish authorities to implement systemic reforms, not only because of fears of making such deep changes virtually with no reserves and with no chance for any kind of emergency financing if such would be necessary to alleviate social costs of reforms, but also

because the embargo strengthened the orthodox, conservative wing of the Polish leadership. The Official statements stressed the point that the West is not a reliable partner and should not be counted on.

Even now, with political obstacles largely removed, Western credit policy towards Poland remains in sharp contrast with what is being done in case of Mexico (bond swap plan supported by the U.S. Administration), Brazil (recently agreed 20-years re-scheduling on 67.5 billion US $ of private debt) or many other heavily indebted countries. Also within CMEA other socialist countries are treated more favourably (viz. Hungary).

## 2.9 Growth acceleration and its failure around 1985 in Eastern Europe

The long adjustment process by import and investment cuts and restrictions on domestic consumption sufficiently improved the balance of Western trade of the socialist countries in the first half of the 1980's but also increasingly exhausted the domestic economy. Consumption fell and social tensions increased throughout the region. Investment cuts caused overutilization of the existing capacities and enterprise managers, association directors urged governments to give more investment funds. Poland was the most heavily affected. Here the volume of investments went well below 50% of its highest level by 1982. In Poland even a new term was invented for the phenomenon: decapitalization of productive assets. From

ideological point of view stagnation or almost stagnation was also hardly bearable. For these reasons with relaxation of the debt crisis the opinion grew among economic politicians throughout the region that a substantial growth in the investment activity was an absolute imperative. As there was also a widespread understanding that consumption levels could hardly fall further, economic policies in the region counted on an improvement in the overall efficiency of production. However, as we demonstrated in Part 2, the institutional and systemic preconditions for that improvement were not established in the early 1980's; even where they were attempted, reform measures were vague and contradictory throughout the region. In this situation the only way to increase the volume of investments *and* at least to keep up consumption at the existing level was to fall into a new debt crisis. That actually happened in Eastern Europe with the only exception of Romania where the top priority remained debt repayment combined with strong systemic orthodoxy.

*Acceleration drive* in the first period of the new Soviet leadership also contributed to the formation of the atmosphere of "uskorienie" all over the region in the time of preparation of the new five-year plans in 1985. The Soviet Union had a sluggish growth in the first half of the 1980's despite the fact that it had huge terms of trade gains from the oil-price boom having had a more than 60% content of oil in its Western exports.

In analysing the Table 2.4 one should keep in mind that in the earlier years Poland suffered a war-like loss in its flow-indicators and it started its recovery around the middle of 1982. Therefore the rapid growth of investment is rather analogous of after-war reconstruction periods. Apart of the case of Poland, every country of the region started a strong recovery of the investment activities in 1985-86, except for Romania. The latter country has aimed at repaying its debts regardless of its extreme social costs. Furthermore, the Romanian statistics are getting briefer every year. Serious doubts have been raised about their reliability since the data seem to be highly inconsistent. For instance, in spite of extremely sluggish investment activity (in Romanian standards where growth of investments used to be rather two-digit earlier) growth of national income was still solid. Cuts in Western imports could not have contributed too much either. Moreover, the extreme poverty and extensive rationing of goods is raising questions about the reality of continuing economic growth, as well.

In Bulgaria, the GDR, and Czechoslovakia investment activity grew spectacularly in 1985, while in Hungary the fall was moderated and in 1986 and 1987 gave way for an increase. It turned around the trend of the early 1980's and in 1985 but especially in the next year the trade balance of the region deteriorated spectacularly.

This process led to a sharp increase of indebtedness as well, especially in Hungary and Bulgaria. In case of the

former, net debts grew more than twofold in dollar terms between 1984 and 1987 while the latter increased its net indebtedness more than threefold. Net debts of the GDR started to grow again in 1987 according to the WIIW accounts but more detailed analyses suggest that it started to deteriorate already in 1986 and continued in 1988 showing a perspective of serious problems for the end of the decade. Czechoslovakia has benefited from the fact that earlier it had not been seriously indebted and accelerated its Western imports. The first time from 1979, the country had a negative trade balance in 1987. The price of the prudent import policy of the earlier period was that according to some analyses the industrial base of Czechoslovakia is so obsolete that around 10 billion US $ of technology imports would be needed to restore its Western competitiveness on the moderate level of the early 1970's. (Trade balance with the West was negative already in 1986). Finally, the Polish case shows that the trade surplus reached its peak also in 1984 and from this time decreasing in spite of the weakening dollar (i.e. in real terms the fall is stronger). Poland could meet its repayment obligations after re-scheduling only with the help of a jump in private hard currency savings. If the people can not use their savings for capital formation in the future, it can cause problems for the state on medium run: in a way, a part of debts has been transformed from Western partners to the domestic population which has to be repaid once.

The lesson of the last acceleration of investment activity in Eastern Europe shows that the reason for manoevre

of economic policy in the traditional framework has narrowed sharply in the 1980's. In the investment cycles of the earlier periods the tensions came usually later and were weaker. Now after only two years of not extraordinary investment expansion Bulgaria and Hungary reached their debt-ceiling and had to impose restrictions on capital expansion. In the GDR and Czechoslovakia the situation in 1988 was not as bad but imbalances were serious and most probably would force restrictive measures as well. Poland had to face a new wave of popular unrest in the spring of 1988 mainly because of desperation with the economic situation. Romania followed a different path, the possibilities of which seem to be increasingly exhausted and social discontent was present there, as well as in October, 1987.

After the failure of acceleration it is even clearer than before that the present systemic and institutional frameworks are not sufficient to stop economic crisis and social desperation throughout the region. In the Soviet Union there have been efforts to replace "uskorienie" by "perestroika", i.e. the political demand of acceleration in the existing frameworks has partly given way to demands of changes of those settings. It has also increased the room of manoeuvre in the other socialist countries and encouraged reformism forces to look for new solutions energetically.

# III. DEGREE OF 'OPENNESS' OF SOCIALIST ECONOMIES

## 3.1 Conceptual remarks

It is commonly believed that systemic and policy changes in East European economies are assumed to make these economies more open towards international markets. Numerous statements about the necessity to develop further economic links with foreign countries, both from the East and West, have been made repeatedly by politicians and decision makers in socialist countries (viz. Program of the Implementation of the IInd Stage of Economic Reform in Poland or recent declarations by new leadership in Hungary). However, this rhetoric reflect wishes rather than real facts. The data provided in Tables 2.1-2.2 and 2.5 suggest that the process of opening of socialist economies has not developed as fast as expected and that serious obstacles remain.

Along traditional views borrowed from neoclassical trade theory, 'opening' of an economy was understood simply as entering international trade, following the specialization pattern as determined by the principle of comparative advantage. Consequently, the degree of 'openness' used to be determined by the extent to which a given country participated in international trade. Therefore, the degree of 'openness' has been measured by such indicators like the share of exports and imports in GNP or the volume of trade per capita. (See e.g. Grassman 1980, Bryant 1980, Beenstock and Warburton 1983.) These traditional measures however, fail to discriminate

between large and small economies, which are naturally characterized by substantial differences in trade-income ratios. Moreover, a closer look into statistics reveals that high trade-income ratios do not necessarily mean that a given economy is 'open' in the sense that it can be easily penetrated by foreign competitors. As S. Grassman (1980) demonstrated, the degree of 'openness' of major industrialized countries - if measured in the traditional way - has been roughly the same for more than a century. The traditional measures of openness become even less reliable when applied in case of centrally planned economies.

At the end of the 1970s East-European countries achieved the share of foreign trade in their GNP comparable with that of West European countries, i.e. 25-30%. (Of course the Soviet Union stands as a clear exception). During the 1980s both groups of countries experienced a visible slow-down in the foreign trade dynamics, although on average both GNP and foreign trade growth rates were slightly higher in socialist countries. For the period of 1981-1986 elasticities of exports and imports with respect to GNP were 1.243 and 0.857, respectively, for European socialist countries as compared with 1.451 and 0.722 for developed market economies. So the changes in both groupings were going in the same direction and were roughly of the same magnitude. But it does not mean that the degree of openness has been also similar. To assess it properly one must resort to other measures which given more insight into real links between socialist economies and international markets.

It seems more promising to start with the question, to what extent it is possible for the foreign exporter, importer or investor to penetrate socialist markets and also for local socialist enterprises to enter international markets - because this is probably what should be meant as 'openness'. At least that conclusion can be drawn from writings of most trade and development economists. A. Krueger, for instance, defines an open economy 'as one in which domestic disturbances (such as increased demand for imports or reduced supply of exports) spill over into the international market place as excess quantities of goods and services demanded or supplied', and also 'international disturbances (such as altered terms of trade) are directly reflected in domestic variables and especially in domestic prices'. Here the openness works as a 'two-way street' and can be interpreted in terms of familiar 'price-specie-flow' mechanism (Krueger, 1983, p.22-23). Bhagwati and Krueger (1973) use the concept of 'liberalization' to describe essentially the same phenomenon, although regarded rather as a process: 'Liberalization may be said to occur when the official price of foreign exchange assumes an increased role in the allocation of resources'. Both definitions are somewhat vague and imprecise, since they do not specify the measuring of 'spilling over' or 'reflecting' with respect to international and domestic variables or of 'increasing role' of official foreign exchange'. For purposes of our analysis it is, however, desirable to rely on a more concrete concept. We shall connect the degree of openness with the extent of unrestricted flow of

goods and services production factors and foreign exchange transactions. *An ideal open economy - in purely theoretical terms - can be described as one with a free trade, perfect international factor mobility and perfectly convertible currency*. Possibilities for goods, services and production factors to flow across state borders is, however, determined by the extent of administrative restrictions in market mechanism. These restrictions are generally introduced by the government in order to create or maintain certain departures from competitive market mechanism. This is done usually for various reasons starting from protection of domestic industries and ending up with non-economic, income-redistribution objectives dictated by social or political considerations. All these interventions generate price- or non-price (quantitative) distortions, the more widespread restrictions are - therefore the total amount of distortions observed in a given economy provide an indicator of the degree of 'openness'.

As is well known, in socialist economies, prices of goods and factors, as well as levels of demand and supply are to a large extent - varying from country to country - controlled by governments. Trying to maintain autonomous price systems, egalitarian wage structure, unrealistic foreign exchange rates or interest rates, central authorities in socialist countries were bound to impose a number of administrative restrictions on economic activities from the very outset of socialist economies. The dogma of central planning in a traditional Stalinist model, left virtually no area outside government

control, so of course, the foreign trade sector and foreign currency allocation system were dominated by these bureaucratic centralist rules, making exchange of goods and services extremely rigid and depending in each and every case on government decision.

One has to admit that this traditional, highly centralized system which dominated in socialist countries in the 1950s, has gradually been modified and relaxed, although to varying degrees in various countries. In some countries, like Poland or Hungary, many distortions, especially on goods market, have been reduced in the process of reforms, but important 'leftovers' still remain in force. By and large, therefore, socialist markets have to be regarded as much more distorted than markets in developed capitalist economies. Below we shall try to identify most important, policy-specific distortions which reduce the magnitude of real openness in socialist countries. Specifically, we shall demonstrate that economic policies pursued in socialist countries have always revealed a strong anti-export bias, in fact discouraging local producers from entering foreign markets, and on the other hand, these policies were very restrictive towards imports, making socialist economies relatively closed for foreign exporters of goods and services. Also, for many years socialist economies were closed for foreign direct investment, although recently the situation in this field has changed with remarkable speed. To arrive at as comprehensive a picture of openness in socialist countries as possible, we shall examine existing distortions in the three areas:

- foreign trade in goods and services
- foreign exchange transactions
- international factor mobility

### 3.2 Foreign trade regime

Liberalization in exchange of goods and services depends on systemic rules regulating the foreign trade in particular socialist countries, and specifically, on the extent to which market mechanism guides decisions on exports and imports. There has been a general tendency over the last decade to increase the role of the market in socialist economies. Basically speaking, the reforms being actually undertaken in socialist countries are generally allowing for a transition from directive central planning to a market oriented system. The idea is not to abolish economic planning, but rather let the market mechanism work to achieve important social objectives.

The extent to which the market regulates the economy differs from country to country, but nowhere has it gained the decisive influence over the resource allocation and production structure. Poland and Hungary are relatively most advanced, although many constraints are still limiting the regulating role of the market. It seems that Bulgaria and the USSR will also gradually proceed in this direction, but at a much slower pace. The need for larger reliance on market is, however, much less accentuated in GDR, Romania and Czechoslovakia.

A switch to the market mechanism does not mean also that its well known deficiencies and imperfections have been suddenly forgotten, but rather it reflects the belief that the market mechanism, as imperfect as it is nowadays, allows nevertheless for much higher economic efficiency than rigid centralized planning. This is a crucial observation, for the drive towards increased efficiency is the central point of the reforms.

It is well known that domestic producers are faced always by the alternative of selling (buying) their outputs (inputs), either on the domestic market or on foreign markets. Their decisions upon how to allocate their sales (purchases) are guided, under market conditions, by profit maximization criterion. This in turn will depend on applied policy measures which determine the level of relative profitability from local sales as compared with exports. The policy measures embody such familiar 'price' instruments like taxes and subsidies on production, consumption, investment and foreign trade multiple exchange rates, and also administrative, or 'non-price' tools of direct controls, like quantitative restrictions on exports, imports, foreign currency flows or resource allocation (see e.g. Balassa, 1971). It can be shown that these policies have always been anti-export oriented.

Following standard analysis on trade policy and distortions of the Balassa-Krueger-Bhagwati type, one can

measure the extent of restrictions on goods and services market with the formula:

$$R = \frac{X_I}{X_D}$$

Where $X_I$, $X_D$ stand for the value of output at international prices and domestic prices, respectively. In practice however, non-tradable goods are difficult to value at international prices and in most analyses they are omitted. Moreover, in centrally planned economies with large price controls, the value of R does not reflect the real magnitude of domestic distortions, since $X_D$ is expressed at official prices which are kept at artificially low levels and do not balance supply with demand. In view of these limitations, the more realistic and more practical measure of distortions can be approximated by the following formula:

$$R^* = \frac{X_I}{X_D + F_S} \simeq \frac{M_{CIF} + E_{FOB}}{(M_{CIF} + E_{FOB}) + (T + S) + F_S}$$

Where $M_{CIF}$ is the value of importables (imports plus domestic import substitution) at cif prices, $E_{FOB}$ is the value of exportables at fob prices, T stands for the (net) total of custom duties and indirect taxes on importables, S stands for (net) subsidies on exportables, and $F_S$ is a 'shortage factor', defined as a relative price increase necessary for reaching equilibrium between supply and demand in fixed-price economies. This price differential may result either from controlled price policy, or from quantitative restrictions (quotas,rationing), or from foreign exchange undervaluation, or from all of them.

In a liberal, free trade economy the value of R* should be close to 1 which means that no restrictions of 'price' or 'non-price' character are present in the system, or at least 'shortage factor' is zero and other measures like taxes and subsidies cancel out.

However, there is abundant evidence that the value of R* is well below unit for all socialist countries, although more accurate accounts are extremely difficult because of the lack of data.

To estimate the range of value for R*, we have to figure out what is the magnitude of (T+S) and $F_S$. To do this, a more detailed discussion of price systems in socialist countries is necessary.

A distinct feature of this system is that prices for primary products are set normally below their international level, even if converted at official (lower) exchange rates, presumably to keep down production costs and ease inflationary tensions. As a result domestic relative prices are thus distorted away from world relative prices, with primary goods being too cheap (see K. Crane, (1985), for more extensive discussion). On the other hand, the general price level is not allowed to rise together with ever-increasing nominal demand, which means that there is a permanent surplus of demand over supply and shortages of many goods.

In some countries all prices are kept fixed for many years (GDR, USSR, Czechoslovakia) and there, shortages are stronger relative to price inflation (see Kolodko, McMahon, 1987). In others, like in Poland and Hungary, only prices for basic raw materials, fuels and necessities are kept constrained over some longer periods, whereas other prices are allowed to rise more or less on a continuous basis. But at higher inflation rates, these partial controls lead inevitably to growing distortions of relative prices, with finished goods becoming dearer, and primary goods cheaper. Periodic price 'regulations' (as in Poland in February 1988) can eliminate these distortions only temporarily, as the rise of 'free' prices immediately follows and distortions reproduce themselves.

*Whatever variant of domestic price controls is adopted, it always results in substantial differences between domestic prices and cif import or fob export prices.* A system of direct taxes and subsidies on foreign trade transactions had, therefore, to be set up in order to compensate importers and exporters for price differentials which were due to institutional restrictions. In most countries the system took the least efficient form of *direct transfers* covering price differentials and equating roughly the rate of profit on foreign trade transactions with that on domestic sales (purchases). In general, due to distorted price structure in socialist countries, their exports have to be - on average subsidized (total amount of subsidies paid exceeds total amount of taxes). Imports in turn fall into two main

categories. In general, *imported producer goods are sold domestically at relatively lower prices;* therefore, these kind of imports also have to be subsidized on a large-scale. On the other hand, imports of finished products is normally taxed because their domestic prices are in most cases, higher than cif prices at official exchange rates. In the last instance the tax increases the level of protection for domestic import-competing production. In the group of producer goods the level of protection is generally lower and it does not give a sufficient stimulus to expand their domestic supplies. Another element which adds to the amount of taxes is connected with *explicit tariff protection.* Tariffs are currently in use in the majority of socialist countries (except for Bulgaria and GDR) but their significance in regulating foreign trade flows is rather low relative to other policy measures, particularly quantitative limits. Nevertheless, the average custom duty of ca 10-15% on manufactures increased correspondingly with the level of domestic market protection, if tariff is binding constraint in imports.

It is extremely difficult to assess the value of (T+S), because comparable data on taxes and subsidies in socialist countries are not published. Some very crude estimates can be done for Poland to serve as an example.

Assuming that taxes and subsidies for imports cancel out, we are left with direct subsidies for exports which amount, on average to ca 15-20% of exports earnings and with an average tariff on imports of ca 7-10%. This would mean that the

domestic value of output surpasses the international value by ca 25% on the account of taxes and subsidies only. This rate is much higher than the nominal protection rate of 11.4% estimated by Konovalov for industrial production but he worked with a very limited sample and ignored turnover taxes (Konovalov, 1988).

The element FS is even more difficult to estimate. Leaving aside for the moment, unrealistic exchange rates, the FS will be positive whenever domestic price is below market-clearing level. This may be due to licensing of foreign trade operations, which may result either in a quota imposed on imports of a given commodity or in a monopolistic position of a particular foreign trade enterprise (import licence). In both cases there would be a premium on imports had the domestic price been allowed to rise to reach equilibrium level. Otherwise, a shortage of a given commodity is observed with all typical accompanying phenomena like queuing. speculation, external shocks etc. If such a situation persists for a long time, which is the case of socialist countries, permanent shortages evade quality and technical standards of domestically procured output. This element would give rise to a tendency among domestic producers to favour rather local markets over international ones even independently from other anti-export incentives discussed earlier, since exports would have to meet much higher requirements in terms of quality, technical level, terms of delivery, after-sale service and also in terms of competitive financial conditions. On the other hand, supplying domestic markets is virtually risk-free

and no additional effort is necessary. This situation is further aggravated by the monopolistic position of many public enterprises on domestic markets.

*Licensing of foreign trade* operations have been largely liberalized in some socialist countries. In *Hungary* export rights to the hard currency area have been significantly broadened in the early 1980s. In 1982 already 160 producing firms had export rights, while 180 firms were granted temporary licences to export commodities. (Wass von Czege, 1983). In 1988, the regulations were further liberalized and now practically every enterprise can apply for and obtain permission to export. Imports activities are however, more restricted. Theoretically, producers can be granted import licences for primary commodities, but in practice the required procedure is very cumbersome and complicated, so only very few such licences have been issued so far, and primary imports are carried out by specialised foreign trade enterprises with largely monopolistic powers. Licensing is slightly less restricted in case of finalised goods.

In *Poland*, according to rules adopted in 1982, export licenses could be granted for those companies, which achieved a certain level of exports (the limit was initially set at 1 billion zl. and in 1987 it was raised to 3 billion zl.) or, alternatively, the share of exports in total output exceeded 20%. In addition, some organizational and logistic requirements have to be met also (qualified personnel). If in the late 1970s only a few industrial firms were allowed to

export directly to international markets, the rest of the foreign trade turnover being carried out by some 40 state-owned foreign trade enterprises, in 1987 their number reached over 450. It should be noted, however, that more than two thirds of them were small-scale private or cooperative enterprises, sometimes belonging to Poles living abroad (so-called 'Polonian' firms, operating on the basis of regulations from 1978). Import licensing is in turn organized slightly different from that in Hungary, i.e. only imports of basic commodities is still concentrated in large specialized firms, which are also responsible for distribution of these commodities to the domestic market. This means, that both in Poland and in Hungary, import licensing is more restricted than export licensing which can be seen as natural consequence of the balance of payments position.[13]

Also in *Bulgaria* substantial liberalization of foreign trade is taking place. According to rules introduced in 1986-87, state enterprises can either carry out exports and imports on their own account or, they can hire specialized agents. Establishment of a joint foreign trade company by several enterprises is also possible (see Grosser, 1988).

In the *USSR* some moves towards more 'openness' have taken place in 1987. On the basis of a new law 'On the State Enterprise', a resolution on improving the foreign economic activities in new economic conditions was adopted in the fall

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[13] Licensing regulations have been further liberalized in Poland from January 1988.

of 1987. The resolution passes the right to have direct access to foreign markets to more than 20 branch ministries and about 80 large organizations (unions and enterprises) (see Andreev, 1988). Taking into account dimensions of the Soviet economy and the acute need for rapid expansion of trade, these figures, however, are viewed as insufficient by some Soviet economists. As O. Bogomolov observes: "Despite the measures taken recently to make the Soviet economy more open to the external world, no real shifts to the better have taken place so far" (Bogomolov, 1988).

In other socialist countries foreign trade licensing is still very much restricted. The so-called 'state monopoly of foreign trade' takes the most traditional form of a limited number of specialized foreign trade enterprises carrying out exports and imports of goods and services according to central plan targets. Only a few industrial organizations have been granted licences to autonomous export activities.

### 3.3 Foreign exchange transactions

Discussing foreign exchange policy in socialist countries, two aspects are of particular importance for the question of 'openness'. One is the policy of foreign exchange rate, which determines the differential between official and real (or equilibrium) exchange rate, and the other is the system of foreign exchange allocation among various economic units. If the first issue has been solved very much along similar lines in all socialist countries, the second one

reveals large differences among particular countries. Both aspects of the foreign exchange policy will be briefly discussed below.

The official foreign exchange rates in socialist countries have been permanently lower than *real exchange rates*. The overvaluation of domestic currency has led to a chronic disequilibrium between supply and demand for foreign exchange, thus contributing to large and persistent balance of payments deficits. This of course, created the necessity of strict currency regulations, involving government control over all foreign transactions, non-convertibility of domestic currency and distribution of scarce foreign exchange among competing users via administrative procedures. Apart from inefficiency of such systems, one of its inevitable consequences is that it creates a substantial premium on all foreign purchases due to a limited availability of foreign exchange. The premium can be higher or lower, depending on the extent of the foreign currency shortage and on the extent of the price control, but in any case it pushes up the profitability of every domestic production which can substitute for imports (even potentially).

The foreign exchange premium can be expressed as a relative differential between equilibrium and official rates. It is extremely difficult to assess the actual level of these premiums in the socialist countries, because the data available does not allow for accurate calculation of real foreign exchange rates. But some rather intuitive and vague

estimates indicate, that they can vary from ca 30%-50% in Hungary up to 200-300% in Romania and Poland.

Now let us turn to the issue of the foreign exchange market in socialist countries. Actually, nothing of this kind, or at least of what is meant in the West as foreign exchange market, existed in the East. In the traditional Soviet-type economies of pre-80s all foreign currency earnings from exports of goods and services were compulsorily transferred to the government, through state-owned banks, whereas exporters were obtaining the equivalence of the export amounts in domestic currency converted at official rates. Foreign exchange proceedings were next allocated via central rationing according to planned targets for imports of goods and services. It must be stressed that even in the 1970s, when some countries experimented with some modest market-oriented changes in their economic mechanism, the system of foreign exchange collection and allocation maintained its very traditional and highly centralized form.

Also now it may be observed that it is the least 'open' element of the economic system. Foreign exchange transactions are still under almost total government control which is partly a logical consequence of unrealistic exchange rates. The so-called 'state-monopoly of foreign exchange', twin-brother of foreign trade monopoly, seem to be of much higher importance to central authorities in socialist countries where significant market-oriented changes in trade have not been so far matched by foreign exchange flow liberalization.

There have been some elements of *decentralized allocation of foreign exchange* in Poland since the early 1980s, and more recently also in Bulgaria, Hungary and the USSR. In *Poland,* a system of *foreign currency retention quotas* (or ROD) has been introduced in 1982. Exporters were allowed not to sell all foreign exchange earning to the bank, and they could use certain parts of their exports proceeding for imports of intermediates and raw materials. ROD rates varied from 2-3% up to 50% of export earnings, but on average they did not exceed 20%. During 1983-1986 some 14-16% of total hard currency imports were covered from ROD sources. The overwhelming proportion of imports, however, has still been financed through central rationing of foreign exchange. Despite their very limited role, ROD's were generally considered as fairly strong export-promoting instruments, especially in the first half of the 1980s.[14]

Poland has been also experimenting with some other elements of foreign exchange market. From 1983 to 1986 there were some possibilities for non-exporters to apply for foreign exchange quota for specific projects, evaluated by a joint government-banking committee. The funds were then allocated among competing users on the basis of prospective profitability of submitted projects. This 'competitive allocation did not however, play any significant role in Polish imports, because the amount of foreign exchange set-off

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[14] Yugoslavia experienced a similar system connected with elements of foreign exchange market. This country, however, is out of the scope of the recent study.

for those bidders was usually less than 1 million US$ annually.

Another, more promising experiment was launched in Poland in 1987, when a *foreign exchange auction* has been established with the Export Development Bank. This institution works, however, in a different way than regular foreign currency markets in the West. Here, the EDB collects offers from sellers and buyers of foreign exchange asking them also to state their minimum and maximum rates for US dollar. Next, the EDB works to tie-up particular transactions trying, however, to keep the transaction rates as low as possible. In 1987 more than 8 million US$ have been sold at 12 such auctions, and the average rate was slightly below 1200 zl./US$, i.e. more than 3 times higher than the official rate.[15])

The foreign exchange auction clearly simulates market mechanism, although still the scale of the experiment is extremely narrow. It is not clear for the time being, whether the Polish government intends to develop this instrument in the near future, or to leave it in its preliminary form.

Also in *the USSR* a system of foreign currency retention quotas has been implemented from the beginning of 1988, albeit the right to retain 30-50% of hard currency earnings is limited only to those enterprises and organizations with direct access to foreign markets. However, the ultimate goal

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[15] The system works in a more complicated way, but it is not necessary to discuss it in detail here.

of the current Soviet policy seems to be to extend this foreign-exchange self-financing system to all state enterprises (Andreev, 1988).

Some tiny retention quotas are also allowed in *Bulgaria*, where enterprises are permitted to retain 1% of planned exports proceedings and also up to 70% of additional, above-target exports. Since the funds involved are very limited indeed, these allowances, except for creating some incentives to increase exports, do not practically change the otherwise highly centralized allocation system.

In *Hungary* the foreign exchange market does not exist at all, which comes as a surprise vis à vis relatively large degree of reforms undertaken in this country. Only in 1988 enterprises have been granted permission to retain part of the increase of export earnings over the previous year level. The need for some sort of foreign exchange market was less felt in Hungary, probably because the official rate there is much closer to the real rate and on the other hand, domestic and external imbalances were not so deep as in Poland. This explains also that the black market did not gain so much ground and importance in Hungary as in other socialist countries.

It is worth noting, that in a constant effort to stabilize the foreign exchange situation, *Poland* has had traditionally a very liberal system of hard currency accounts for private individuals - a unique solution in Eastern Europe.

Now the regulations have become even more relaxed, as individuals are not only allowed to possess, transfer or use foreign currency for a number of purposes, but they can also sell it or buy it at market exchange rates. Hard currency accounts for individuals have also been introduced in Hungary, Romania, and very recently, in the Soviet Union.

Other socialist countries - Czechoslovakia, GDR and Romania - are still maintaining the traditional, centralized system of foreign exchange controls. Both internal and external convertibility is, in those countries, extremely restricted.

When speaking about foreign exchange regulations one has to mention also regulations for intra-CMEA non-convertible currency transactions. Because of the very nature of transferable rouble (it is an accounting unit) and the barter character of CMEA trade agreements, there is practically no room for any type of foreign exchange market for CMEA currencies. However, this situation may change in the future, as the new soviet leadership is insisting on fundamental reconstruction of monetary relationships within CMEA (see Section 4.1).

### 3.4 International factor mobility

*International mobility of labour force* is, in general, very limited in the socialist countries. Exports of manpower can essentially occur only through official channels as

exports of specialised services in such fields as construction, medical and educational services, and various advisory services. *Unofficial exports of manpower* gain relatively higher importance in the case of *Poland*, where it is estimated that roughly half a million people every year spend 1-3 months abroad working on a more or less illegal basis, and another 30-50 thousand emigrates permanently every year. This has been made possible by a relatively liberal emigration policy in Poland. In other countries except Hungary, however, *foreign travel regulations are* traditionally much more *restrictive* and one can hardly speak about any significant exports of manpower. Also the inflow of the foreign labour force to socialist countries is on a very low level - unlike the case of developed market economies - mostly because of low compensation levels and primarily because of administrative controls.

This leaves us with the question of *international capital mobility*. One of the distinct features of the process of opening now going on in socialist countries is the rapid development of *foreign direct investments* in form of joint ventures. Once banned and considered as a serious threat to the very foundations of socialist state, joint ventures are now seen as a vehicle for accelerating growth and structural transformation. Among CMEA countries *Romania* was first to permit joint ventures in 1971, followed by *Hungary* in 1971. *Bulgaria* enacted necessary legislation in 1980, *Poland* and *Czechoslovakia* in 1986, and the *Soviet Union* one year later. It is interesting to note that European socialist countries

were in this field well behind China, where pragmatic policy towards direct foreign investment started in 1979 with the creation of four special economic zones.

The objectives the European socialist countries wanted to pursue through *joint ventures* with western partners included: obtaining new technology and technical know-how, expanding exports and thus increasing foreign exchange earnings, substituting imports and obtaining in this way hard currency savings, eliminating shortages and "bottlenecks" at domestic markets, upgrading managerial skills, raising labour productivity and training host country manpower (see e.g. Scott, 1988). However, the economic benefits of foreign direct investment in form of joint ventures have been much more limited than expected. First, number of joint ventures established in European socialist countries turned out to be rather limited. At the end of 1987 Hungary had the largest number of joint ventures - 111, followed by the Soviet Union (19), Bulgaria (15), Poland (13), Romania (5) and Czechoslovakia (3). The comparatively high figure for Hungary is partly explained by several dozens of joint ventures in services and financial areas. In Poland in turn, over seven hundred small enterprises were set up after 1979 with capital invested by Poles living abroad - but these "Polonian" firms are not covered by joint ventures law and constitute a rather special case. What is more important however, is that inflow of foreign capital through joint ventures to socialist countries has been actually not large enough to produce any significant change either in their balance of payments

position or in overall investment outlays. Although comparable data are not in all cases available, the capitalization of joint ventures domiciled in European socialist countries varies from ca. US$ 200 mln. in Poland and Hungary to 7 mln. in Czechoslovakia (see "Economic, Business, Financial and Legal Aspects of East-West Joint Ventures", 1988, and "Polish Economy in the International Environment in the 1980s", 1988). Even taken together this capitalization is still much lower than in *China*, where in the period 1979-1987 more than US$ 10.5 billion has been invested in form of joint ventures (see Zhang Yunling, 1988). An average East-West joint venture seems therefore to be rather a small or medium size enterprise. Moreover, the new technology transfer to socialist countries was not of the proportions assumed originally, partly because most of new companies were established in various branches of light industry (food processing, wooden products) or in services (hotels), where rather traditional technology has been used (see Table 3.1).

Among the reasons for slow growth of foreign direct investment in East European countries restrictive foreign exchange regulations and financial arrangements are commonly cited. It is argued that profit transfers abroad are subject to numerous limitations, depending on the proportion of profit allowed to be converted into hard currency and tax rates on repatriated profits. Also tax incentives are often seen as insufficient to attract foreign investors and make East-European markets competitive as compared with other countries. Income tax rates vary at present from 20% in Bulgaria and 30%

Table 3.1: SUMMARY OF REGULATIONS ON JOINT VENTURES IN THE CMEA COUNTRIES (as at the end of 1987)

| | Romania | Hungary | Bulgaria | Poland | Czechoslovakia | Soviet Union |
|---|---|---|---|---|---|---|
| Year when rules first issued | 1971 | 1972 | 1980 | 1986 | 1986 | 1987 |
| Approving authority | State Council | Ministry of Finance | Council of Ministers | Ministry of Foreign Economic Relations | The Federal Ministry having jurisdiction | The USSR Ministry or agency, or Council of Ministers of the Union jurisdiction jurisdiction |
| Maximum foreign participation | 49% | 49%; exceptions possible | No upper limit | 49%; exceptions possible | 49% | 49% |
| Purchasing from (a) domestic markets | in convertible currencies | as local enterprises | as local enterprises | as local enterprises | as local enterprises | as agreed in the contract with Soviet enterprises |
| (b) foreign markets | free | must obtain foreign trade permit | must obtain foreign permit | must obtain foreign permit | must obtain foreign permit | free |
| Marketing to (a) domestic markets | in convertible currencies enterprises | only through wholesale market | directly to the domestic market | directly to the domestic market | directy to the domestic with Soviet enterprises | as aggred in the contract |
| (b) foreign markets | freely in convertible currencies | must obtain foreign trade permit | must obtain foreign trade permit | must obtain foreign pemit | must obtain foreign trade permit | free |
| Currency transfers abroad | only out of JVs own currency earnings | only out of JVs own currency earnings | only out of JVs own currency earnings | Limited by: (1) 15-20% of currency earning to be sold to Polish banks (2) Right to foreidn currencies proportionate to share in statutory capital | to be defined in the foreign currency permits | only ot of JVs own currency earnings |
| Income tax rate | 30% | 40% | 20% | 50% | 50% | 30% |
| Incentives: lower tax rate | Case by case: first profitable year; tax free following 2 years: 15-30% | (1) Case by case (2) Production and hotels: first 5 years - 20 % from 6th year - 30 % (3) activities of outstanding importance: first 5 years tax free; from 6th year - 20% | Case by case: first 3 years: reduction to be negotiated yearly | (1) first 2 years tax free (2) export: each 1% of production exported - 0.40% reduction in tax rate | | (1) case by case (2) first 2 years from declaring profit, tax free |
| Withholding tax | 10% if transferred abroad | | 10% if transferred abroad | | 25% | 20% if transferred abroad (unless provided otherwise in a tax treaty) |
| Posts to be occupied by host country nationals | | | (1) Chairman of Management Board (2) Chairman of Board of Directors | Manager or Chairman of Management Board | Presiding members of management bodies | (1) Chairman of the Board (2) General Manager |
| Rules on salaries of employees (a) domestic employees | (a) Rules of state enterprises (b) To be specified by the the Board of Directors | To be specified in employment contract for both domestic and foreign employees | (a) Bulgarian law (b) To be specified in employment contract | To be specified in joint venture contract or by decision of joint venture organs for both domestic and foreign employees | Czechoslovak rules for both domestic and foreign employees; Ministry of Labour may grant right to deviate | (a) Soviet law (b) To be specified in contract |

Source: 'Economic, Business, Financial and Legal Aspects of East-West Joint Ventures', GATT, Geneva, 1988.

in Romania and Soviet Union to 40% in Hungary and 50% in Poland and Czechoslovakia. Similarly the limits on foreign participation fixed in most cases at 49% of initial equity capital and also the restricted access by foreigners to top managerial positions have been regarded as serious shortcoming of the present status of joint ventures. There are, however, other important obstacles, not so often mentioned. One of them is connected with financing of large scale joint ventures, where partners contribution is not sufficient to cover investment cost of large plants and some form of project finance has to be used (commercial bank loan, export credit financing etc). In such cases interbank arrangements may be necessary, often guarantied by government agencies from western countries. As the experience demonstrates, this is sometimes very difficult to secure. Another difficulty of more practical nature arises when joint ventures have to deal with local administration in socialist countries, which is famous by its lengthy and time-consuming bureaucratic procedures.

Critical evaluation of the recent experience in the field of direct foreign investment does not mean that there is no potential for further, much more dynamic development of East-West joint ventures. On the contrary, one may argue that overall conditions for foreign investment could be easily improved through modifications of existing legislation. Actually this fact has been recognized by some of the socialist countries; several significant changes have been introduced recently, and some more are under preparation. For instance, Hungary made revisions to its existing law in 1986,

and Bulgaria followed in 1987. In Poland, substantial amendments are now under parliamentary scrutiny and are expected to enter into force in the second half of 1988. In the Soviet Union, existing regulations were modified in September 1987, and Czechoslovakia is expected to enact similar legislation in 1988. All these changes provide for much more flexible legal and financial regime for joint ventures and make East-European markets more open and attractive for foreign investors. For example, Poland will probably lower the income tax rate to 30% and will extend the tax holiday period to three years.

It is interesting to note how different and contrasting the general trend in foreign investment policy is in the GDR. This very cautions approach can be illustrated by the following statement by one of the East-German economists:

> "Joint enterprises should emerge from several years of effective experience in production cooperation only if there is a realistic prospect by partners of equal efficiency of using a new ready-for-production technique to turn out marketable products... The utilization of common enterprises, such as also joint ventures with capitalist partners, would require the existence of adequate conditions which are to be geared to the command of modern productive forces, export profitable product ranges and to the availability of indispensable advance performance..." Sydow, 1988).

An interesting feature of existing joint ventures is that almost all of them were set up by West-European partners. The Federal Republic of Germany is an unquestionned leader with 51 joint ventures (more than 30% of all joint ventures), most of them located, however, in only one country (Hungary - 42 joint

ventures). Austria comes second with 37 joint ventures, also concentrated in Hungary (33 joint ventures), followed by Switzerland and the United States each having 17 joint ventures, Japan (14) and the United Kingdom (13). Except for the American and Japanese investors only capital from Canada, India, Libya, Panama and Saudi Arabia participates in some selected ventures. The almost complete absence of participation of capital coming from newly industrialized countries like Republic of Korea, Taiwan or Singapore can probably be attributed to political motives rather than to economic ones.[16]

### 3.5 Anti-export bias

As can be easily seen from former analysis, the nature of existing *restrictions* and *distortions* in socialist economies reveals a strong anti-export bias. *Undervaluation of foreign exchange at official rates, combined with specific price control system,* numerous *quantitative restrictions and widespread shortages* at the domestic markets create relative preference for import-substitution activities.

In contrast, export-promoting elements are of much lesser significance and they cannot alter the general anti-expert bias. In socialist countries exports are essentially supported by two instruments - direct subsidies and tax and income incentives.

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[16] Quite recently a joint venture has been established in Hungary with a South Korean firm in the machinery industry.

In traditional, and still more or less prevailing, foreign trade regimes the subsidies form part of the price differential transfer system, and their task is merely to assume no loss can occur to exporters provided the cost of acquiring a unit of foreign exchange doesn't surpass certain marginal exchange rate, usually 50-100% higher than the official rate. Assume that the total cost of one US $ through exports of commodity A is 600 zl, and though commodity B - 450 zl. With official rate fixed at 450 zl the subsidy on export of commodity A will be 150 zl (per 1 $ of earnings), whereas in case of commodity B will be nil. In such a system subsidies are determined as aritmetic differentials between the two prices, and not as predetermined proportion of the domestic (or foreign) price.

This construction, which has been universally applied in socialist countries since the very beginning of central planning has a number of serious deficiencies. First it equates rates of profit on various kinds of exports and does not provide information on relative profitability. Exporters and producers are not guided therefore to areas of high export profitability or areas of potential export expansion. Second, these subsidies also equate the average rate of profit on exports with the average rate of profit on domestic sales. Third, they do not provide sufficient funds to develop exports via increased investment. Finally, under such a system any effect by an exporter to increase selling price is effectively neutralized by automatic reduction of subsidy.

Despite these obvious shortcomings, 'differential' subsidies are still commonly used in socialist countries because of distorted price relations and unrealistic exchange rates. In Poland, for instance, the average export subsidy within this system is about 15%, but for some commodities it can reach 100% or more. Similar systems are in force in Hungary, Romania, GDR, Czechosclovakia and Bulgaria. In the Soviet Union a complicated system of multiple exchange rates for various vouches and commodities is adopted with essentially similar logic; the only difference being that in this case banks are responsible for covering price differentials.

Tax and income incentives in turn are gaining importance recently. In Poland income tax deductions for exports have grown from 2-3% in 1982 to ca. 8-10% of total export earnings in 1987. Various tax rebates are used for various kinds of exports with industrial exports enjoying highest preferences. Another tax incentive refers to the amount of wage and salaries tax which is paid by enterprises on excessive increase of wage and salaries fund. Finally, a preferential tax scheme applies also to export-oriented investment. A similar system of income-tax deductions has been used in Hungary since 1981. Bulgaria introduced in 1982 export-oriented income incentives in form of a system of bonuses paid for fulfilling planned targets of export growth. More recent changes (1987) include also tax deductions in proportion to export earnings (Grosser, 1988).

Other countries have been so far experimenting with these incentives on much more limited scale.

Poland and Hungary have also been using same very specific export-promoting measures. It is a common opinion that export retention quotas (RCD) have contributed strongly to considerable increase of polish hard currency exports in 1983-1984, but later their impact weakened (see 'Polish economy in the International Environment..', 1988). Hungary in turn has applied in the 80's solutions of the so-called "price-club" and "wage-club" (see Török, 1988) which allowed free price-setting or liberalized wage-formation mainly for enterprises which took the task of dynamic export-growth towards free-currency areas. This practice has, of course, softened further up the regulation by them, giving a broad way for financial bargaining of enterprises vis-a-vis authorities.

On balance one cannot expect that export-promotion measures can offset anti-export bias, strongly connected with domestic price distortions, overvalued domestic currency and shortages. Taking all elements into account and following rather conservative estimates we can find out that the average level of protection of domestic markets as compared with average level of export subsidy can be anything from 1,5:1 (Hungary) up to 4:1 (Romania, Poland)[17]. The necessary change must therefore bring back reasonable proportions between

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[17]The reader should be aware that these are very rough estimates.

incentives and support given to both alternatives.[18] But to make socialist economies more "open", a sweeping reduction of all distortions is also required in order to eliminate or substantially limit administrative constraints which otherwise would continue to be regarded as necessary. The most important component of the protection level is of course the difference between real and official exchange rate. But this is extremely difficult to estimate, because of strict price controls and disequilibrium in many markets. In one of very few studies on the protection level in socialist countries, Konovalov (1988) found out, that nominal protection rate for polish industry was 11.4% and effective protection rate was 40.14%. However, Konovalov based his analysis on a sample of 85 enterprises only, and he ignored the premium on official foreign exchange rate.

## 3.6 Conclusions

As we already mentioned, East-European countries cannot be considered as a homogenous group. Not only the degree of "openness" differs from country to country, but also the process of opening is taking place with various intensity. Poland and Hungary are certainly leading in both respects and Poland's "openness" increased significantly during the 1980's. Similar change has been observed also in *Bulgaria*, though to a much lesser extent in the *Soviet Union*. It is, however, difficult to formulate a definite opinion about the nature of

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[18]Not all authors subscribe to this view. See (1. Taylor, 1988) for an extensive discussion of the issue of optimal trade policy under distortions.

the processes occurring in GDR and Czechoslovakia. In both countries certain moves towards "openness" intermingled with intensification of traditional distortions (e.g. cautions opening for foreign direct investment in Czechoslovakia was not accompanied by any liberalisation in foreign exchange regime).

*Romania,* in turn, reduced her degree of "openness" and actually started very autarchic policy in the 1980's, becoming without doubt the most isolated country in the CMEA group.

Policy measures aimed at increasing "openness" also varied in socialist countries, but our analysis indicates that certain common elements can be identified. It seems that the *foreign exchange system is still the least liberalized element in all countries,* and that substantial changes in the foreign trade system and in the foreign investment system are not matched by a corresponding reduction of differentials between official and real (shadow) exchange rates and by removal of many restrictions imposed on foreign exchange transactions. Even limited convertibility of domestic currencies was therefore to be seen in a rather longer perspective.

# IV. THE INTERNATIONAL CONTEXT

## 4.1 Cooperation within the CMEA -- structural and institutional barriers, new proposals

The deteriorating economic situation all over Eastern Europe, stagnation in mutual trade and cooperation as well as the new innovative approach of the Soviet political leadership together led to new initiatives, to an expressed need for a reform of the integration mechanisms in the CMEA. The intra-bloc trade was affected by internal troubles of the member-countries (most generally by slowing down of the economic progress) as we well as by foreign trade imbalance in the hard currency area. Because of this latest fact, almost every country of the region was compelled to make efforts to sell more hard goods to western countries instead of trading with them in the framework of CMEA barter-trade. The latest worsening of the balance of payments situation in Eastern Europe has strengthened this trend. In the last few years, after the "adverse oil-price boom" an additional factor was the steadily deteriorating terms of trade of the small member countries with the Soviet Union; these countries have improved radically their trade balance in this relation and therefore, on the macroeconomic level, their motivation has weakened in the expansion of the Soviet exports representing a high share in total trade (Köves, 1988). While this situation has caused tensions in the member-countries between the agents of macroeconomic policy and the large exporting firms (Rácz, 1986), and led to considerable current account surpluses in

some cases (mainly in the case of Hungary, Czechoslovakia and Bulgaria), the present trends can not be held much longer; systemic solutions are needed.

From the Soviet point of view, 'perestroika' of relations with the European socialist countries would mean gradual elimination of the existing trade pattern of exporting raw materials in exchange for not fully hard manufactured industrial goods from Eastern Europe. It should be replaced by more intra-branch cooperation as well as import of higher level ("harder") harder machinery and intermediary goods from the CMEA-partners.

The Soviet partner took the initiative very energetically after the changes in its leadership in 1985. Restructuring became a campaign task for the CMEA administrative staff as well. However, the obstacles to achieving this goal are considerable. Introduction of decentralized mechanisms in the intra-bloc economic relations would presume radical economic reforms (at least of Hungarian type of 1968 and preferably more radical) in the member-countries or minimally in some dominant national economies, especially in the Soviet Union. What is needed is a sufficient degree of enterprise autonomy as well as a relatively free flow of the national currencies domestically. In that case the conditions could, at least theoretically, be settled. In other words, predicting the chances of an effective, market-type integration presumes a prediction of the domestic economic systems of the Soviet Union and also of some more developed members of the CMEA.

As far as the Soviet economic system is concerned, what we have experienced until now with perestroika is that in spite of radical words and intentions of the leaders, bureaucratic resistance has been able to prevent any real, country-wide reform-steps. This concerns measures to revitalize small-scale, semi-private activities as well as mainstream changes in the state sector (Åslund, 1988, Vernikov, 1988, Bunich, 1988).

In terms of turnover as well as of technology-exports the second most important country of the CMEA is the GDR which is unwilling to reform its economy, claiming that only "perfectioning" of the existing and, in principle, properly functioning system is required. Central planning and intergovernmental coordination is the preferred form of CMEA-relationship for the leadership of that country. The Romanian leadership regards the reform efforts of the Soviet Union and its urging for rebuilding the integration as an interference into its national policy and energetically opposes them. Czechoslovakia and Bulgaria have elaborated reform blueprints and legislation similar (partly following) to the Soviet measures. The only two countries where profound reforms are a real perspective in the medium run are Hungary and Poland. It would be useful to experiment with decentralising economic interactions to the level of enterprises in the case of both countries after elimination of central balancing and administrative distribution of materials in Poland. (This concerns partly Hungary as well.) In this respect

difficulties can occur at the elaboration of new monetary principles: whether the partners should use hard currencies in their transactions or their national units mutually. In the first case, one should expect a significant decrease in the trade-volume on the short run; radically curtailed in lack of interest among enterprises. It could cause fears that this kind of CMEA-reform is "disintegrating". Though this selection process would only wipe out exchange of low-quality goods, the above argument might be powerful among macroeconomic administrators accustomed to quantitative success-indicators for such a long period. Using domestic currencies could cause problems as well: the money-flow is restricted by a lot of low-level legal regulations in both countries. It would be hard to let accept domestic producers to allow foreign firms to buy and sell on their highly protected markets. Nevertheless, one should try to go ahead with such experiments; but one cannot expect too spectacular longing effects given also other low share of trade between the two reform economies.

The latest events of the last two Sessions of the CMEA illustrate the above mentioned dilemma and difficulties in restructuring of mutual relations towards a more market oriented pattern. The 43rd Session is regarded as the one where efforts of restructuring came to surface very explicitly. *The Session clarified better the radical words already present on the 41st Session*. The Soviet leadership pushed forward two major lines simultaneously. One, which is called Collective Concept for the International Division of

Labour for the Period 1991-2005, concerned intra-CMEA specialization. This represents a rather traditional form of above distributed set of tasks for the national economies in cooperation mostly in branch division. There is also some shift in the preferences: electronics is a new and emphasized field of desirable closer cooperation among the socialist economies. However, the old structure, based on branch committees has not been affected by the organizational measures at the end of 1987 (Csaba, 1988).

The other direction of the high-level CMEA-talks has been that of institutional and "systemic" changes in the international socialist cooperation. Having been aware of the crucial importance of the lack of really functioning money in the integration, the Soviet and some other participants urged realization of limited convertibility of the national currencies already on this 43rd Session. The Soviet prime minister underlined that the realization of 'perestroika' in his country "provided better conditions for development and strengthening of our foreign economic relations, first of all with the countries of the CMEA". He also listed two important dynamizing fields from the Soviet point of view: the direct links and joint ventures between enterprises and associations of the member countries.

At the same time, resistance of some delegations, that of Romania, Vietnam, and the GDR, moderated the formulation of goals in the common resolution as well as refused to accept a resolution on the convertibility of national currencies. The

Czechoslovakian and Hungarian prime ministers, on the other hand, expressed publicly their concern about the slow progress made in the Session on institutional and systemic matters.

The 44th Session used an even more radical vocabulary. According to the Hungarian Head of delegation, vice-prime minister József Marjai, it also provided an irreversible breakthrough. Undoubtedly, the "acceptance of gradual formation of conditions for the free movement of goods, services, and other factors of production among (the member countries) aiming to form a unified market in the long run"[19] represented a radical ideological shift approved by all member-countries except Romania. Nevertheless, the Session did not make clear the ways to achieve this goal[20]. The Hungarian prime minister, Károly Grósz, expressed before his visit to the Soviet Union his view that the radical change in the CMEA-mechanisms is *not* a question of the foreseeable future. Similarly, Hungarian scholars repeatedly argued that in the next decade or so, one cannot expect any significant dynamisation-effect from this factor (Csaba, 1988). In fact, for the purposes of restructuring, rather a drop in the volume of the mutual trade seems to be unavoidable as well as desirable in order to shift to more qualitative trade, more exchange of hard goods (Köves, 1988).

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[19] Komunike o 44-m zasedanii sessii Sovieta Ekonomitscheskoi Vzaimopomoshchi, Izvesthia July 8, 1988.

[20] The Soviet Union and Czechoslovakia achieved an agreement in March, 1988, on using national currencies in setting accounts by enterprises. It is highly doubtful, however, that any of the parties can apply this practice given the general shortage situation as well as strict administrative distribution of goods.

The 44th Session repeated the need for more enterprise-level connections, but one should clearly see that the crucial preconditions for that is decentralization of decision-right to the enterprises in the course of domestic reforms as well as eliminating central price-formation and interference in the practice of domestic regulation. None of these changes is a question of the near future in the Soviet Union. Similarly, though the cooperation-law in this country, as well as the latest efforts to open up leasing possibilities for those new small-scale units are very promising, one can not expect any impetus from the appearance on the horizon of these small market-oriented units as far as CMEA-integration is concerned. CMEA-trade will inevitably be dominated by large organizations of the state sector for a long time to come.

Finally, one has to add a relatively new problem in CMEA-trade which might well have a lasting effect on the dynamism of mutual trade. It is namely the drop of oil-prices (gradually according to the Bucharest price-formula) and consequently an increasing imbalance of trade causing deficit on the Soviet side vis-a-vis some member-countries . In this case the traditional maximizing approach can be especially harmful since the Soviet Union can balance its deficit only by low-quality manufactured goods, if at all. A better option for the small member countries seems to be to allow the volume

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[21] Table 4.1 shows a strongly diminishing Soviet-trade surplus, while the Soviet Union has usually had significant deficit in services towards its East European partners.

Table 4.1: TRADE OF THE USSR WITH THE EAST EUROPEAN COUNTRIES

| | | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|
| | | | | Mill. Rubel | | | |
| Bulgaria | E | 4884.6 | 5510.8 | 6124.6 | 6455.5 | 6752.3 | 6276.3 |
| | I | 4288.1 | 5053.3 | 5617.8 | 6056.0 | 6191.3 | 6551.7 |
| | S | +596.5 | +457.5 | +506.8 | +399.5 | +596.5 | -275.4 |
| Czechoslovakia | E | 5047.4 | 5871.6 | 6590.8 | 6829.9 | 6947.0 | 6776.7 |
| | I | 4731.9 | 5420.4 | 6024.1 | 6632.1 | 6556.4 | 6907.4 |
| | S | +315.6 | +451.2 | +566.7 | +197.8 | +390.6 | -130.7 |
| GDR | E | 6419.6 | 6797.8 | 7481.4 | 7669.9 | 7884.2 | 7635.9 |
| | I | 5776.2 | 6595.7 | 7367.6 | 7591.7 | 7128.1 | 7093.2 |
| | S | +643.4 | +202.1 | +113.8 | +78.2 | +752.3 | +542.7 |
| Poland | E | 4812.9 | 5274.3 | 5070.6 | 6531.5 | 6813.8 | 6542.2 |
| | I | 4097.0 | 4786.7 | 5307.0 | 5600.1 | 6127.2 | 6329.3 |
| | S | +715.9 | +487.6 | +763.5 | +931.4 | +685.6 | +212.9 |
| Romania | E | 1423.6 | 1639.6 | 1807.4 | 1956.6 | 2823.3 | 2539.2 |
| | I | 1683.4 | 1665.3 | 1758.7 | 2302.6 | 2415.2 | 2347.3 |
| | S | -259.8 | -25.7 | +48.7 | -346.1 | +408.1 | +191.9 |
| Hungary | E | 3707.2 | 4058.0 | 4320.9 | 4576.7 | 4678.2 | 4600.0 |
| | I | 3746.4 | 4007.0 | 4437.1 | 4891.9 | 48734.4 | 5080.3 |
| | S | -39.2 | +51.0 | -116.2 | -315.2 | -195.2 | -480.3 |
| Eastern Europe | E | 26295.4 | 29152.1 | 32395.7 | 34020.0 | 35898.8 | 34370.3 |
| | I | 24323.0 | 27528.4 | 30512.3 | 33074.4 | 33291.6 | 34309.2 |
| | S | +1972.4 | +1623.7 | +1883.4 | +945.6 | +2607.2 | +61.1 |

Source: Fink et al. 1988, p. 286

Note: E means Soviet exports to the given country

of trade to decrease temporarily than to bind themselves to the myth of continuously growing economic ties (Köves, 1988).

Sluggish economic growth, more particularly growing unit costs in the energy and raw material production in the Soviet Union have caused in the last one and a half decade an increasing effort to involve the East European countries in financing new investments in these branches in increasingly remote areas of the country. In time of decreasing share (sometimes also volume) of investments in these countries it imposes an ever less tolerable burden on the small partners. In the last few years, increasingly analysts in Eastern Europe claiming moderate engagement in the common investments, in the case of need even to buy raw materials on the world market increasingly. On the other hand, the Soviet prime minister expressed his country's view that the recent investment-contributions can only secure the stabilization and not increase of the raw material and energy deliveries.

To sum up this argumentation, the small East European countries in deep systemic, as well as structural difficulties, can not expect dynamisation impulses from their trade with the Soviet Union in the foreseeable future without a far-reaching reform in the dominant country of the region. The partners in the regional integration have to face conflicting interests in their mutual economic relations on the medium run. This fact emphasizes even more clearly the fundamental significance of the necessity of opening to the

world as the key to the desired real turning point in the economic trends of the region.

## 4.2 Influence of the IMF and the World Bank on the national economic policies in Eastern Europe

Four countries of the East European region are members of the International Monetary Fund and the International Bank of Reconstruction and Development. One of them, Yugoslavia, challenges our interest only marginally, since it is not the task of the present analysis to discuss developments in this country. However, its conflicting relationship with the mentioned two monetary institutions, still contains relevant lessons for the analysis of the mutual approach of the international financial community and the CPE's. The East European members of the IMF and World Bank have a very different history of relations behind them. It is a common feature, however, of all of them that each distanced from these institutions for a long time after World War Two for strong ideological considerations. For all of them, entering the monetary institutions meant a major political step demanding some firmness against ideological fears inside and outside the country. However, the perspective of gaining better terms on credits as well as of easing repayment burdens on existing debts was strong enough to overcome resistance. The institutions accepted the applications of Romania in 1972, of Hungary in 1982, while that of Poland after years of consideration in 1986.

Romania entered the IMF and the World Bank earliest (except Yugoslavia) from the socialist countries[22]. Its connections with them were basically harmonious through the 1970's in spite of not having met the conditions of membership, as requirements of providing a necessary amount of statistical data as well as of moving towards market relations in the domestic economic policy (Pussula, 1984; Fallou-Shiroff, 1982; Jackson, 1986). This harmony collapsed in the early 1980's in consequence of the country's debt crisis and of the growing self-isolation policy of Romania against foreign institutions like governments, private and public institutions, and also banks up to the point that the country threatened to leave the World Bank in December 1987 and refused the Most Favoured Nation status with the U.S. in February 1988. Romania also declared that it would not like to take any more credits on the financial markets. The genesis of this *anti-openness policy* and its consequences makes Romania a *test-case* of consequent denial of the therapy suggested in this study. At this place we briefly refer to this process leading Romania to the lowest per capita gross debt in the region but at the same time to the worst ranking in the eyes of the international creditors.

Romania eased its forced growth policy at the end of the 70's with delay compared with the other economies in the area. Still, the country's debt situation seemed to be much better than of most of the other socialist countries, in spite of the

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[22] The authors would like to express their thanks to Anneli Ute Gabanyi of the Munich Südost-Institut for her valuable comments on the Romanian case.

heavy impact of the second oil-price boom (See Section 4.1 and Table 1). More ambitious investment policy was compensated by a high level of leadership-autonomy in curtailing the standard of living in the country. Still, quite unexpectedly, Romania fell into repayment-trouble as early as in the first quarter of 1981 because of some inabilities of a professional nature; the foreign exchange reserves fell to an unduly low level ($147m).

In this case Romania asked for urgent help from the IMF. The programme of the Fund announced in June 1982 included a $195m loan to offset part of the short-term deficit and a $1.265m stand-by credit available in the following three years. In return for its support Romania was required to "avoid any arrears in debt service", to decrease trade deficit substantially and to undertake some reform measures similar to the ones formulated in the country's "reform programme" in 1978 (Jackson 1986, pp 497-503).

The IMF-therapy was strongly criticised by the Wharton Econometric Forecasting Associates as one the realization of which could lead Romania into a worse economic situation, and finally into heavier debts. One should add that the "reform" plans of 1978 did not deserve that name if we think of it as measures taking a country closer to market type regulation. Other sources mention that the IMF insisted upon restrictions on domestic consumption and devaluation of the exchange rate of the domestic currency. This kind of proposals have one thing in common: they suggest changes which can affect the

functioning of a market-type economy but the influence of which are highly doubtful in a planned economy and certainly do not take the economy closer to market regulation.

By the end of the year arrears in debt service reached a considerable amount, and Romania had to approach the lending banks for rescheduling. Credit channels dried up completely for the same reason and also because of the exaggerated panic of the banking community after the Polish debt-crisis and introduction of Martial Law in December, 1981. The IMF froze further payments on the stand-by credit at the end of 1981 but released it half a year later. Romania, even more than the other East European debtors, achieved a positive foreign trade balance by cutting imports drastically from the free currency area (see Table 2.5).

In 1983, the Romanian leadership, being upset with the treatment of the country by the international financial community reacted with several uncooperative steps; it refused without consultations to pay its obligations due in that year, it imposed a heavy "education tax" on those who wanted to emigrate and it spoiled the relations with the U.S. because of this commitment to human rights and with the Federal Republic of Germany because the majority of the emigrating people were Germans.

Cumulating conflicts on the international arena took the Romanian leadership closer to the Albanian model: the conviction increased that the country should not take any new

credits. In the meantime the IMF suspended the last tranche of the 1981 stand-by credit while Romania declared its unwillingness to benefit from it, partly because the country had brought down its debts at an unprecedentedly rapid pace and partly because it was totally unwilling to accept the conditions of the IMF; among others to decrease wages and/or increase prices to a "realistic level", to devaluate the lei, the national currency. The situation could not have been more absurd: the IMF wanted to impose measures which could have some sense in market economies but which were total irrelevant in the case of an orthodox CPE. On the other hand, Romania overestimated the negative significance of the IMF-advices. It regarded the devaluation of the lei as devaluation of the national economy though the exchange rate had practically no influence on imports and exports, neither on their rentability. Similarly, price increases could not have shifted too much of the production towards exports (which were in a sharp surplus because of import cuts anyway), on the other hand they could not have caused too much harm either at such an extremely high level of shortage. Furthermore, the consumption cuts as advised by IMF in a situation when consumption had already radically diminshed (bringing about nearly war-time circumstances) were entirely inadequate.[23] In this situation radical market-type changes were absolutely needed but the whole conflict was not about that.

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[23] The IMF oddly expected that new material price increases would rationalize consumption of those countries (Salap, 1981, p. 262). By 1983 utilization of Romania's massive refineries (see part 1) dropped below 50%.

In 1984, Romania upset the international banks by revaluating its currency (as a matter of fact the so-called valuta-lei which is only an accounting unit in foreign transactions anyway) and by lowering interest rates on domestic savings. With doing this the country restored the situation before the 1982 "adjustment" measures. In 1985 Romania was already keener to participate in common investments in the Soviet Union and increased the share of the socialist countries considerably in its trade. Although the country systematically built down its debts, its evaluation in the bankers' eyes did not recover because of the above described uncertainities concerning Romania's future behaviour. In 1986 Romania had to ask for a repeated rescheduling of its already minor debts. Its reason was the extremely low level of its foreign exchange reserves which made the country vulnerable to any unexpected event. It was at that time the drop in agricultural exports after Chernobyl. The talks were again unnecessarily conflicting and the IMF was not involved because of Romania's fear of conditions imposed on it by the Fund.

Finally in December 1987 Romania had a confrontation with the World Bank as well. The country protested against "unfair" interest rates and threatened to leave the institution (Sinteia December 2, 1987). This event followed only by a month the workers' protests. The economic system and policy followed the highly centralized traditional pattern, and living standards are unprecedentedly (in European standards) low, but the country's net debts are already around $3bn with

the goal to eliminate them totally by 1990. This is the odd balance of a combination of these traditional structures on the one hand, and of misunderstanding of the nature of the system and the ways to handle with it from outside, on the other.

Although on a much lower scale, these problems were present in the relations of the IMF and IBRD with Yugoslavia and Hungary. Since in these countries the economic system was somewhat more market-oriented and the political approach less obsessive the cooperation could be smoother. Some demands of the IMF have corresponded to the requirements of marketization. In the Yugoslavian case, price-liberalization, interest rate adjustment to inflation seem to have been legitimate requirements. Some others have been questionable, although certainly not so absurd as in the Romanian case; a pressure on the economic policy to devalue the dinar has only recently been partly replaced by a demand to marketize the exchange rate (Financial Times, March 8, 1984).

Paradoxically enough, Hungary's relations with the IMF in the 1980's have been the least conflicting though this country was a newcomer, entering the financial institution only in 1982 and is *one of the most heavily indebted* in the region. One important element of this relative success is Hungary's commitment to being on good terms with the banks, to pay debt service in due time and its effort to meet (at least formally) the reform-demands of the IMF and World Bank. Still, the other side of the coin is that, years after the "second wave" of

reform, the Hungarian economy still does not work mainly according to market rules and from 1987 the country was in a serious threat of repayment crisis (Török, 1988), which was a failure from the point of view of mutual relations with the IMF as well.

The stabilization efforts of Hungary in 1987 and 1988 contained some new elements of possible opening as well. In line with personal changes in the top political structures, Hungary's economic diplomacy became more active in this period. The country achieved a favourable cooperation-agreement with the EEC and also a better entry to it vital for its Austrian market in 1988. Hungary has more joint ventures than any of the other socialist countries and, at the time of the Hungarian prime minister's visit to the U.S., the largest yet East-West joint project was established with an American firm (Magyar Hirlap, July 18, 1988). The Hungarian joint venture regulation has also abolished the majority stake requirement for the domestic partner.

Members of the new Hungarian leadership have also expressed their interest in the recent thinking about a new Marshall-plan like financial help for Eastern Europe, circulating among some western politicians (Die Presse, June 15, 1988). There is, in addition, much talk and, as yet, some very moderate measures concerning FT-regulations. In an organizational sense, obstacles have by and large been removed. For public firms, entering FT-activity has become relatively simple while from this year private firms also can

export directly (as in Poland from 1982). Introduction of the so-called "saldo-regulation" in 1988 for a circle of enterprises is just a very moderate step perhaps in the direction of retention quotas advocated by the authors of the recent study (Mizei 1987; Rosati 1988). The logic of the saldo-regulation is that for a certain increase of western exports the enterprise is entitled to increase its imports, by a lower proportion though. In its actual adoption in 1988, maintaining the 1987 import-quota required a considerable (8%) increase in exports because of the emergency external situation. This way the ratchet-principle has been applied with all its negative consequences.

As far as Poland's relationship with the IMF and the World Bank is concerned, this country applied for membership in 1981 but for political reasons it could achieve it only in 1986. There is also some paradox in it, given that Poland's human rights record has been much better than that of many countries which have had the opportunity to get credits from the IMF. In mid-1988 the IMF and World Bank were waiting for a reliable stabilization programme from Poland and would share the first stand-by credit, hopefully in the beginning of 1989. The measures taken in the framework of the second stage of the reform in 1987 were not convincing, though, oddly enough they were based on the old (not present) IMF-therapy of large scale consumer price increases. They were not accepted by the society and major wage concessions led to accelerated inflation. The changes the international monetary institutions have been stressing in the case of Poland (and partly also of

Hungary) show a better understanding of the situation recently than a few years ago. They want to persuade the Polish government to drop some costly public investments with long realization cycles in the energy and raw material sector. Moreover, they urged abolition of central price control as well as subsidies for enterprises and of negative interest rates on savings in domestic currency. In 1988 the Polish government showed a certain amount of willingness to accept those demands which also correspond to the views of home reformers. It seemed that if the shadow agreement could be put into effect, Poland would probably qualify for a stand-by credit in a short time. It could pave the way for better terms on rescheduling and possibly for some new credits after 7 years of virtually complete lack of private loans.

Though the recent experiences with IMF and IBRD relationships with Eastern Europe can hardly be seen as a success story, a certain mutual learning process can be detected. It is yet to be seen if a future long term cooperation between the international monetary institutions and the reformist forces in Eastern Europe has a real chance.

### 4.3 The intra-German Trade and its impact on the Openness of the Economy of the GDR

The foreign trade pattern of the GDR has not differed in general from that of the other small East European countries in the last two decades. Still, two phenomena of the GDR's trade are worth special attention. The predominant special

feature of the trade conditions of the East German State is undoubtedly the so-called intra-German trade/innerdeutscher Handel, IDH/. The other phenomenon in the foreign trade of the GDR is that in the period of major external imbalances of the small CPE's it was the only country of the region which improved its trade balance not by cutting its import substantially, but by increasing its hard currency revenues (by 70% in current dollar terms) between 1980 and 1985 (Fiur-Manler, 1987, p. 13).

The IDH has its roots primarily in a political consideration: the West German state has not recognized the separate-state-status of the GDR (every West German government has shared this view) therefore they have treated the trade between the two Germanys' as one inside a single economic entity (Cornelsen, Lambrecht etc. 1983, p.34-35). Paradoxically the main beneficiary of this status has been the GDR, though, arguably, the Federal Republic has also gained by paying low prices for goods imported from the GDR.

The advantages of East Germany from IDH are the following:

a) their export is not hampered by duties normally existing at deliveries of the COMECON-countries to the EEC.

b) their agricultural export is treated as intra EEC-trade, i.e. they can enjoy the benefits of artificially high agricultural prices in the European Community,

c) at the purchase of commodities the East German partner must pay a reduced (6 or 11%) VAT[24],

d) they can benefit from the so-called swing credit. It was originally established for the purpose of covering the trade deficit of any of the parties in a given year. In fact, since the East Germans have usually had a negative saldo, the swing has always been used by the GDR. The swing credit is not subject to an interest-rate, its maximum amount is DM 850m per year. In 1978 9% of the accumulated debt of the GDR towards West Germany was financed by the swing-agreement (Cornelsen, 1980, p.4).

e) the GDR covers a relatively big share of the energy and food as well as services supply of West-Berlin,

f) for transit between Berlin and the FRG the West German government pays DM 252 million (until 1979 it was DM 400 million). Furthermore, the West German budget has contributed to the maintenance and improvement of the road-network connecting Berlin with West Germany. In some years the sum of this

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[24] Instead of the degree paid by really "domestic" buyers

service amounted above DM 400 million in much needed hard currencies (Cornelsen, 1988, p.77). Similarly, the West German budget has contributed to environmental investments (though in much smaller amount) affecting the natural conditions of West Berlin or the FRG.

g) the GDR has benefited increasingly from the large number of West German tourists visiting relatives in the East.

The direct payments of the West German budget and of the minimal currency exchange at the border amounted to DM 1.5 billion in 1987, which was approximately one fifth of the earnings of the GDR from IDH. This kind of hard currency injection has made the situation of the GDR unique in Eastern Europe. It also enabled the country to import from the developed countries relatively most of the socialist countries, especially in the 1980's (see Table 4.1).

On the other hand, the structural features of this trade have been almost identical through the period in discussion. While generally final products have dominated the exports of both countries, it was not true for the bilateral trade. Raw materials and energy have traditionally represented the biggest part of the mutual deliveries. Especially oil and refined oil products had a big share in the intra-German trade. Raw materials and energy have traditionally represented the biggest part of the mutual deliveries. Especially oil and

refined oil products had a big share in the intra-German trade. The GDR, *as a quasi-developed socialist country*[25], has not been able to fill a bigger part of its exports with highly manufactured goods while, as a consequence of lack of proper market-impulses in the domestic economy as well as in the CMEA, it neither has been able to secure a higher domestic and CMEA share in providing the necessary materials and semiproducts to the production process.

Therefore, the share of investment-goods could be much less than needed in light of the growing technical backwardness of the East German industrial branches. Still, because of the special revenues in IDH and through services for Berlin, this share has been usually somewhat higher than in the case of the other small CPE's, representing in the GDR-import about a quarter of total spending (Cornelsen, Lambrecht, etc. p.22).

The share of machinery, the most preferred area of socialist modernization, in the East German deliveries to the other German state has been very low: generally between 3 and 4% since the early 1970's. On the other hand, this share has not decreased through the 80's which means an increase in terms of volume. For comparison it is worth noting that Hungary had been able to achieve a significantly higher share in the 1970's but both, volume and share have been decreasing through the 1980's.

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[25] In the sense as it was used by (Jànossy, 1969).

The unfavourable commodity structure (low level of value added in exports) caused terms of trade deterioration in the IDH as well for the GDR in the 1980's. Though full aggregation of terms of trade is not available, a detailed analysis of the trade with chemical goods seems to be rather typical for the whole commodity exchange. In this branch the average price of deliveries by the GDR per ton decreased from DM 1.000 to DM 6.000 between 1980 and 1986. In the same period the average tonnage price of West German chemical goods' deliveries to the GDR in the same branch increased from DM 1.500 to 1.900 (Cornelsen p.9). It was not that the commodity structure of the GDR-export changed much in this period but the price-dynamism of those mass-products was unfavourable while that of West German exports (usually of higher value added) was stronger.

The same pattern concerns the exchange of industrial consumer goods. In this area the GDR usually has a surplus as a consequence of typically low level of imports. This surplus is to balance the deficit in the trade of investment goods. GDR-exports of consumer goods are typically mass products with very sluggish price dynamism, while the imports are usually of higher quality and value added (Cornelsen, Koch, 1985, pp. 279-280). The same pattern persists in the change of agricultural products. Moreover, because of the general low price-dynamics of the agricultural products, the share of this sector has been diminishing through the last two decades in spite of the still relatively high prices in the EEC.

While the structural features of the GDR-trade with Western Germany do not differ much from that of the other CPE's with developed market economies, the GDR was able to increase its exports to West Germany and to the other industrialized countries quite considerably in the critical years of the period 1980-1984 when the other European socialist countries had to cut their imports since they were unable to increase exports to the hard currency area (Fink-Mauler, 1987, p.13). East Germany could do it, however, by dynamizing exports of materials and using special help of the West German side (Financial Times, August 2, 1988). The economic policy took the risk of creating more severe shortages on the domestic market in order to be able to import approximately the same level as in previous years. They could do it also because they did not have to face such trade barriers of the EEC as the other socialist countries and not because of general improvement in efficiency of the economy.

## V. THE NEED FOR A NEW POLICY APPROACH

From what has been said above, the clear conclusion can be reached that there is an urgent need for a complex, well projected, fundamental, systemic reform with heavy stress on the foreign trade dimension, as well as for a new economic policy stressing export orientation in the East European region. At the same time, a radical transformation of the East European economies toward far-reaching marketization as well as opening to the international markets could be supported by the developed countries on the ground of mutual benefits. In this part of the paper we are concentrating on the outlines of systemic reform in external relations and on the problems of the export-drive in economic policy. Yet it is important to emphasize that the suggested changes can be effective only in the framework of a coherent reform package. This should, first, aim at restoration of a balance between fiscal and monetary policies, which means a marked shift to monetary tools in regulating economic activites (interest rates, credit ceilings, reserve requirements, open-market operations etc)[26]. Second, it should include a liberalization of money-flows in the domestic economies with the establishment of capital markets and deregulation of the labour market and wage systems. In particular, the government should radically simplify legal regulations for enterprise mergers and acquisitions, allow for bankruptcies of inefficient firms and secure sufficiently free entry of newcomers in different

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[26]The studies on the Polish and Hungarian stabilization efforts in this project discuss this problem extensively.

production and services branches. Discrimination on the ground of ownership has to be gradually eliminated and replaced by efficiency criteria.

Furthermore, price and non-price distortions should be scaled down; price setting should be left to market-mechanisms. Important non-economic objectives, reflecting individual conditions of particular countries should be realized mainly through social policy. Indirect tax-rate differences could also serve macro-economic preferences. It is important to stress that at present the extent of distortions is clearly excessive in all countries. Finally foreign exchange market should be gradually developed with foreign exchange rate responding to changes in demand and supply.

The above and forthcoming considerations apply especially to the two most radical reform processes (that of Hungary and Poland) and therefore concern them most clearly. It is an open question if the "newcomers" to socialist economic reform necessarily have to go through the same phases as the previous countries or can aim at more radical solutions in their earlier phase. It should also be added that countries that are more advanced in terms of the economic system, are not necessarily so in terms of level of economic development. Therefore the degree of urgency can be different in other countries concerning reform radicalism.

This is especially true in the case of the GDR (see 4.3). However, the symptoms of already exhausted growth capacities

through investment expansion, persistent tensions on the consumer markets and debt crisis in some mixture of combination are present in each East European country including the Soviet Union; consequently the need for a new look can only grow in the region.

The crucial point for the socialist countries is to increase radically their export capabilities, especially in manufacturing industries. Traditionally, this objective could have been followed through vigourous export-oriented policies, including wide spectrum of classical trade policy tools like direct and indirect export subsidies, moderate tariff protection and devaluation of domestic currency. This at least was the method applied by Japan and the NIC's, by now most successful exporting countries in the world. However, *in the case of socialist countries this classical package would not be sufficient* and much broader array of steps should be undertaken. They must concentrate on two main interrelated areas simultaneously - systemic changes and policy adjustments. The aim of the former is to introduce new institutional rules and principles of economic activity, based on market mechanism and oriented towards increased efficiency. The aim of the latter is to allow the new mechanism to work at its full power; but also to ensure via indirect measures, that national development objectives are being followed.

Speaking in most general terms the necessary policy and systemic changes, allowing for establishment of flexible, open economies in Eastern Europe, can be done in three steps,

although the transition period and various elements of the package would of course vary for different countries.

Within Phase I, the gradual but *rapid devaluation of domestic currency* against the main convertible currencies must be carried out, up to the point where the official rate would approximate real rate. This could be done within 18-24 months using the sliding peg technique. At the same time *price reforms* have to be implemented in order to eliminate major distortions; in particular a substantial rise of producer goods prices vis-a-vis finished goods prices should be expected to restore desired proportion.

Devaluation coupled with price changes would allow for elimination of the present form of price differential transfers' system in the foreign trade and replacing it with a much more flexible system of product-tied subsidies for a limited range of goods. Part of these subsidies would be gradually reduced within the next two phases.

During Phase I the mobility of production factors within particular economic units should be largely increased through elimination of many existing administrative controls. This refers particularly to the *foreign exchange* which *should be freely auctioned at equilibrium rate* (solution adopted in 1987 in Poland, though at experimental stage). At least 50% of total foreign exchange earnings received by exporters should be eligible to be sold and purchased on the foreign exchange market during Phase I. This would not only provide a reliable

information on the size of potential demand and the level of real exchange rate, but would greatly increase the flexibility of the production sector, opening access to foreign currencies to all potential exporters.

It should be assumed, that during Phase I, the government embarks also on an *aggressive export-promotion policy* with the use of classical tax-cum-subsidies tools. A wide spectrum of direct and/or indirect export subsidies for manufacturing industries, and agricultural products should be envisaged together with incentives for export-oriented investments. This should be made particularly attractive for foreign investments. It is felt that measures undertaken so far in countries like Hungary, Bulgaria and Poland fall with this respect short of expectations of potential investors from Western countries. Higher risks connected with very uncertain future prospects of economic development in some socialist countries and also with political and bureaucratic constraints should be offset by much more far reaching economic incentives in form of tax holiday periods (if there is a start-up period), lower tax rates, simplified administrative procedures, and - above all - better conditions and guarantees for profit transfers.

Countries with the most painful debt burden should try to elaborate ways of transformation of some parts of the debts into direct capital investment. Forming capital market as well as government activity on the bond market in Hungary and

partly also in Poland can make it easier to offer mutually favourable deals of this kind.

It is often argued that adjustment programmes backed by the IMF rely excessivley on devaluation, ignoring its pro-inflationary effects and constraints in the supply side (see Taylor, 1988). In the case of socialist countries, however, these fears may be less justified, because the devaluation, apart from its effect on the balance of payments, contributes to the elimination of domestic distortions, improves relative prices and reduces budget expenditures, allowing thus for better allocation of resources and exerting actually deflationary effect on the economy. The final outcome will depend on the degree of flexibility of enterprises to adjust to changes in costs and prices. The flexibility in turn may be substantially increased under disciplined monetary supply, liberalized tax schemes and vigorous efficiency regime. Devaluation, as was already argued, can not replace allocation of free currencies dominantly through the foreign exchange market.

Within Phase II, the socialist countries would achieve the *internal convertibility* of their currencies, i.e. *compulsory foreign exchange quotas* to be sold by exporters to central banks *would be gradually eliminated*. Governments, to cover their requirements, would buy foreign currencies from banks at the current exchange rate, determined by supply and demand. However, some restrictions would still hold for capital transfers abroad and also for private transactions.

Phase II would allow also to reduce substantially direct subsidies of marginal exports (mostly agricultural products). However, the general system of indirect incentives for exporters would be maintained to assure, that during this Phase the ratio of implicit tariff to implicit subsidy would approach 1:1.

The length of Phase II would vary for particular countries, but it can be safely assumed that in systemic sense the most advanced of them (Hungary and perhaps Poland) would be able to complete this Phase within another 2-3 years. This period would bring about substantial structural changes, laying foundations for strong and large export-oriented sector in industry. This is at the end of this stage, that the current account balance of most of those countries should turn from deficit to surplus - this time not via administrative cuts on imports, but rather through natural export expansion.

Finally, Phase III would be marked by steady expansion of export industries and *gradual decrease of foreign debt* to manageable proportions. This in turn would create favourable conditions to achieve *the external convertibility* of domestic currencies - probably within the period of 5-10 years from the end of the Phase II depending on the pace of applied changes.

Needless to say, the outlined scenario does not pretend to be a rigourous analysis - it rather indicates desirable ways of dealing with present problems. Whether it can be

effectively followed depends on many internal and external conditions. Especially for Hungary and also Poland the proposed transformation may be completed by the end of the century, provided there is sufficient political willingness and determination to continue market-oriented reforms. For other countries the transition period may be longer and some of them may even decide to continue traditional policy without deep market-oriented reforms.

The position of the Soviet Union should be seen in different perspective. There not only the final outcome of reformist process is unclear, but also the desired degree of economic openness depends much more on political and military considerations than in the case of smaller socialist countries. The Soviet Union can and probably should maintain a higher degree of selfsufficiency also because of the size of the domestic market and the availability of natural resources. It seems, however, that the problem of striking an optimal balance between openness and independence is still to be solved in the future.

The desirable degree of openness depends therefore also on external conditions - which brings us to the role the West can play in this process.

Basically, two alternative strategies can be adopted on the Western side vis-a-vis developments taking place in Eastern Europe. One is the *"wait-and-see"* strategy, which has been largely followed by western countries in the 80's,

especially vis-a-vis Poland. The alleged rationale behind this course is that since one could not expect any major change both in the political and economic position of Eastern Europe, nothing really meaningful can be done to recover borrowed money not to speak about engaging in new assistance programmes.

The alternative strategy is to adopt a more *positive approach* and try to influence the course of events in Eastern Europe, encouraging systemic reforms and policy changes. This "step-up" strategy would be built around three main pillars: (1)a distinct improvement in the overall political climate in Europe, (2)new initiatives in the financial relations (see 4.3), and (3)some departures from generally protectionist foreign trade policy, now being "à vogue" in most of western countries.

The discussion of political aspects clearly goes beyond the scope of the present paper, so we shall concentrate on points (2) and (3). The regular access of socialist countries to new credits is of vital importance for the successful implementation of the on-going economic reforms. Deep changes require substantial reserves in terms of time and financial means for necessary adjustments - both have been already stretched to limits. This is not say, however, that without additional credits, reforms in Eastern Europe would be stopped and eventually the traditional system would be restored. But without active role of the Western countries on the ground of a system of material benefits the whole process would take

much more time and be more painful and costly for East-European societies. One of the possible outcomes would be stronger reliance of the socialist countries on economic relations with Far-East Asia and with developing countries. This scenario would be also likely if protectionist tendencies in trade against socialist countries will prevail in the future. It may well happen that Eastern Europe, if eventually open for international trade, will become an important area of expansion for fast growing Asian exporters and investors. Europe would thus miss a chance for consolidating her economic organism for the future. This consideration is, however, not to neglect the fact that the crucial starting point of the process must be a reliable (both domestically and internationally) and feasible reform package.

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