East-West Economic Relations in the 1980's: Problems and Perspectives

Dariusz K. Rosati*

This study deals with recent developments in East-West economic relations. It is widely recognized that the era of "detente" and cooperation has been replaced in late 1970's and early 1980's by the period of increased political confrontation and growing restrictions in mutual trade. A careful observer however would find out that in recent years this highly unfavourable situation has been changing gradually and that prospects for the future may be more optimistic.

The purpose of this paper is to give a general overview of process and to examine problems and perpectives for future cooperation. The paper is organized as follows. A brief description of the present state of mutual economic relation East-West is given in Section I. The overview of economic policies pursued during last fifteen years in the East and West is presented in Section II, where also main structural and institutional barriers hampering East-West trade and cooperation are identified and discussed. In Section III the adjustment policies adopted in both groups of countries in the wake of the crisis 1980—1982 are examined. Section IV provides an overview of economic reforms now implemented in socialist countries. A traditional anti-export bias of socialist economies and means and ways to increase export potential of these economies are discussed in Section V. Questions of East-West joint capital Ventures and of foreign direct investment in socialist countries are reviewed in Section VI. The paper ends up with conclusions in Section VII.

I

The development of East-West economic relations has been subject to serious fluctuations during last two decades. In the 70's a unique combination of favourable political climate and abundant availability of financial resources contributed to the unprecedental expansion of East-West trade and cooperation. But affluent "seventies" have long ago been replaced by gloomy and austere

*World Economy Research Institute, Central School of Planning and Statistics, Warsaw, Poland.

Table 1. Average annual rates of growth of exports for major groups of countries

(%)

Groups of countries	1972-74/ /1975-77	1975-77/ /1978-80	1978-80/ /1981-83	1981-83/ /1984-86
World	17.8	18.2	4.4	2.1
Developed market economies (DME)[a]				
—total exports	16.0	18.1	3.6	3.7
—exports to SC(E)	23.5	12.1	0.6	−4.6
—exports to SC(A)	10.8	32.1	3.7	19.1
Socialist countries — SC(E)				
—total exports	18.4	15.7	7.0	2.7
—exports to DME	18.6	18.4	7.2	−2.1
Socialist Countries — SC(A)				
—total exports	17.3	26.0	14.3	9.0
—exports to DME	14.5	28.1	15.5	7.6

[a] Developed market economies include 23 OECD member-states (without Turkey), South Africa, Israel, Gibraltar and Faroe Islands. Socialist countries of Europe or SC(E) include european socialist countries and the Soviet Union. Socialist countries of Asia or SC(A) inlcude China, Mongolia, Vietnam and the People's-Democratic Republic of North Korea.

Source: Handbook of International Trade and Development Statistic, UNCTAD, Supplement 1987, New York, 1988.

"eighties", when numerous restrictions of various nature have been imposed on mutual trade. The present situation can perhaps be best characterised by stagnation and increased protectionism on both sides. Table 1 provides some statistical evidence on the slow-down of East-West trade.

The presented data support the general observation that the world trade dynamics dropped down dramatically in the 80's, mostly due to a deep recession in developed market economies and to foreign debt problems in developing and socialist countries. More striking however is the fact that mutual East-West trade actually has been shrinking by 4.6% p.a. (exports from DME to SC(E)) and by 2.1% p.a. (exports from SC(E) to DME). Another interesting observation which can be derived from Table 1 is that trade between developed economies and socialist countries of Asia has been expanding rapidly, unlike with socialist coutries of Europe. The reason for this different pattern can perhaps be found in a profound policy change in the People's Republic of China, where radical domestic reforms have led to a substantial opening of the chinese economy and attracted the inflow of large foreign financial resources. In case of european socialist countries however the described situation must have caused concern and disappointment both on eastern and western side.

II

Large variety of reasons contributed to this highly unfavourable course of events. Some of them were political in nature, connected with increased political tensions between the two superpowers. Arms race, regional conflicts, human rights disputes have produced a number of restrictions put on economic relations, especially on sales of high technology goods and on the extent of financial credits flow from the West to the East. Detailed discussion of political questions goes however beyond the scope of this paper, so further on I shall concentrate on economic aspects of East-West relations.

Economic obstacles to mutually beneficial trade can be found both on eastern and western side. One of the reasons of the present stalemate has been certainly a lack of appropriate adjustment of economic policy and economic mechanism in order to respond to a rapidly changing international environment during last fifteen years. Systemic and policy-specific causes were particularily strong and visible in socialist countries, which due to political, ideological or conceptual reasons were not able or willing to carry out necessary structural and institutional adjustments in their economies after the two energy shocks in 1973—74 and 1978—79. On the contrary, these countries were trying to continue economic growth on the "old track", largely ignoring structural barriers gradually emerging in the second half of 70's. Domestic policy in those countries have been for many years dominated by the persistent tendency to excessive investment expansion, what — in the absence of sound efficiency crteria and due to concentration of resource allocation decisions at central government levels — produced constant disequilibrium at domestic markets. This tendency was further strengthened by bureaucratic management systems, where enterprieses, largely or totally dependent on administrative and political authorities were interested mostly in meeting central plan targets, hiding their production reserves and paying little or no attention to efficiency criteria, quality improvement or optimal technology selection. As a result, numerous shortages of more or less permanent character have developed in socialist countries, spurring inflationary tendencies (first in form of "hidden" inflation, later as open price inflation) and eventually reducing the rate of economic growth.

Little help could have been obtained via foreign trade, as the same bureaucratic rules dominated the area of foreign exchange allocation, making the foreign trade regimes extrmely rigid and inefficient. Substantial overvaluation of domestic currencies (presumably to avoid additional pressure on domestic price level) led to strict controls of imports and foreign currency transactions. Under such a regime exports could not expand significantly because of low profitability of foreign sales, lack of appropriate incentives and poor quality of domestic output; on the other hand any import substituting production was welcome practically without bothering about real opportunity cost. As a result either chronic open current-account balance deficits developed, or even if a country managed to match her imports by exports, it was achieved through administrative import controls, thus creating an "implicit" balance of payments deficit.

Market economies of developed countries did not display so many domestic distoritions as centrally palnned economies, but their domestic and foreign economic policies were in 70's also erratic and dominated by short-sighted, "societal", income-distribution objectives to the detriment of efficency objectives. Trying to protect not only achieved levels of social well-being, but even certain rates of growth of real income, irrespective of deep structural changes in the production sector, produced inflation and stagflation. Budget deficits have grown to historic-record levels, forcing eventually Western countries to undertake some austerity measures, when it became clear that growth cannot continue any longer without reducing current consumption.

At the same time (1980—1982) the international monetary system one more time demonstrated its inability to restore equilibrium in the world economy. The classic mechanism of exchange rates adjustments could not have worked not only because of restrictions put on convertibility of many domestic currencies, but also because of extremely destabilizing fiscal and monetary policies of the U.S. government, who clearly was much more interested in pursuing purely domestic goals like fighting inflation, reduction unempolyment and expanding federal budget, than in looking after international equilibrium. Actually the concept was to take full advantage of the fact that the American dollar traditionally has been an international reserve currency, and exploit the fluctuations in interest rates and dollar supply to serve domestic interests of the republican Administration. This rather selfish and inward-oriented policy contributed to increased uncertainty in international markets and precipitated the financial crisis of 1979—1982.

III

Reactions to the crisis of 1980-1982 were different in various groups of countries. The strongest adjustment process took place in market economies, where we have observed important structural changes in the production sector, initialized already after the first oil crisis in 1974. Probably the most spectacular symptom of structural adjustment was dramatic drop in energy consumption due both to switch to energy-saving technologies and to reduction of the share of most energy-intensive branches in the GDP. Significant shifts in economic and social policies have also undergone in the OECD countries. Policy changes involved restrictions on public expenditures, considerable reduction of social welfare programs, reprivatization of many formerly nationalized industries and general deregulation of market mechanism. This therapy contributed undoubtedly to the deep recession which struck western countries in 1981-1983, but at the same time lowered substantially inflation rates and probably left their economies stronger and economically more viable than before. However, social cost of this policy, which in various forms has been adopted in the U.S., the U.K., West Germany, France and other countries has been high enough to raise doubts about stability and durability of obtained results. It seems quite likely, that within next 3-4 year we shall be facing another wave of social pressure to restore some of the discontinued welfare programs and to put more reins on private sector expansion and market mechanism in order to assure more equitable distribution of national income.

One of the characteristic features of the adjustment process in the Western economies since the first oil crisis was gradual rise of protectionism. It comes to no surprise that this has been the means to protect employment and output levels in the period of recession, coupled with foreign accout imbalances. However, what is new in this phenomenon is that along with traditional protectionist measures like tariffs and quotas, applied extensively by the EEC, the U.S. and Japan, new forms of protectionist policies have emerged, e.g. Foreign exchange protectionism. This contemporaty mutation of the "beggar-thy-neighbour" policy restrains from necessary intervention at the foreign exchange markets, allowing for international rates of domestic currency to run at artificially low levels to encourage exports and cut on imports.

Quite different approach has been applied in East-European countries. Here the adjustment process took merely 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. In the field of domestic policies nothing remarkable changed. Although officially a substantial cut in investments in general, and in investments in producer goods in particular had been declared to protect consumption levels, investment figures for all Eastern countries have shown consistent pattern of overrunning planned limits in both categories, deepening internal disequilibrium.

Three countries which defaulted de facto (but never officially) in 1981-

82—Poland, Hungary and Romania—adopted, however, different methods of solving their foreign debt problems. In Poland a wide spectrum of systemic changes have been introduced in 1982 in spite of extremely difficult and complicated political situation. 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 on 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 2.5-2.8 billion US \$, not to speak about repayments of due principals.

The main reason for this poor performance of the Polish ecnomy was a deep contradiction between the nature of pro-efficiency reforms initialized in 1982 and the traditional character of the economic and social policy(Rosati, 1988). The government, still considering itself responsible for financial position of particular enterprises and trying not to antagonize powerful industrial lobbies, followed very soft monetary policy, subsidizing heavily inefficient units and applying prohibitive taxation on profits of those enterprises, which fared above the average. On the other hand, trying hardly to arrive at some sort of poltical reconcilliation with the society and therefore avoding 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 embargo for new credits imposed on Poland in 1982 and virtual overnight cut off from external financing.

The development of situation in Hungary, although not so dramatic as in Poland, was in certain sense even worse. Enjoying much better position (both for political and economic reasons) in the West than Poland, Hungarian economy could not manage to overcome stagnating tendencies and continuously worsening of current account balance. Like in Poland, this was mostly worsening of current account balance. Like in 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 expect before. Probably a lack of strong social and political pressure led Hungarian reformist process to a stalemate where neither central planning nor market mechanism could work properly(Bauer, 1983. Kornai, 1983).

Table 2. Selected data on export changes, trade balance and external debt of East-European countries, 1981-1986.

Country	1980	1981	1982	1983	1984	1985	1986
	Volume of exports (annual change in %)						
Bulgaria	12.2	8.4	11.3	4.4	11.6	2.2	−1.2
Czechoslovakia	4.7	0.5	6.1	5.7	8.5	2.6	2.0
GDR	3.6	8.4	5.4	10.6	3.7	1.7	−0.9
Hungary	1.0	2.6	7.3	9.4	5.8	−0.3	−2.0
Poland	−4.2	−19.0	8.7	10.3	9.5	1.6	4.6
Romania	4.4	13.6	−7.6	0.9	15.0	1.6	1.6
USSR	1.6	1.9	4.5	3.3	2.5	−4.3	7.1
	Trade balance with market economies (in billion US $)						
Bulgaria	−0.6	−1.0	−0.8	−0.9	−0.8	−1.2	−1.6
Czechoslovakia	0.2	0.3	0.3	0.5	0.7	0.4	0.3
GDR	−0.4	−0.1	0.7	0.3	0.9	0.7	0.3
Hungary	−0.6	−0.8	−0.7	−0.4	−0.1	−0.3	−0.6
Poland	−1.2	−0.9	0.0	0.3	0.8	0.6	0.6
Romania	−0.6	0.4	0.8	1.4	2.2	1.9	1.9
USSR	2.8	0.2	0.7	1.0	2.3	−0.3	−1.8
	Gross external debt in hard currency (in billion US $)						
Bulgaria	—	3.2	2.9	2.4	2.1	3.6	4.3
Czechoslovakia	—	4.1	3.7	3.5	3.1	3.4	3.9
GDR	—	14.2	12.6	12.1	11.6	13.7	14.9
Hungary	—	8.7	7.7	8.3	8.8	11.8	13.9
Poland	—	26.2	26.2	26.4	26.8	29.3	31.3
Romaina	—	10.2	9.8	8.9	7.2	6.6	6.4
USSR[a]	—	29.0	28.4	26.9	25.6	32.0	35.2

[a] Together with CMEA banks.

Source: Economic Survey of Europe, 1986-1987, United Nations, New York, 1987.

Romania is a maverick case, where unlike in 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 near 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. Table 2 provides data on foreign trade and balance of payments of the socialist countries.

To summarize, the reaction of East-European countries to the global crisis has to be seen a entirely inadequate. Policies adopted were mostly "symptom-oriented" instead of dealing with real cause of low efficiency and inflexibility of their economies. Systemic reforms in Hungary and Poland, although aiming at 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 1985-1987 have not had still a chance to produce some positive results, but it is very likely that they will encounter the same bureaucratic and political obstacles than in Poland. GDR and Czechoslovakia enjoyed comparatively good economic situation and this is 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 GDR managed to increase her hard currency exports in the first half of 80's by 10% (the best result among East-European countries), maintaining also an average GNP growth rate of 4%.

It is worth noting that policy reactions in socialist countries have been also of "protectionist" character, although the protection referred to a 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 tranformed East-European economies into separate, isolated markets, suffering from various disequilibria. In spite they all are CMEA members for 40 years, these 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 defficiencies contributed to the low export dynamics of East-Europen countries. But there were also other causes not necessarily on the Eastern side.

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 martial law introduced in 1981. It is true, that Polish economy fared badly at that time and the overall creditworthiness 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. Fahlenbuchl, 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. Another point is that Poland embarked on an ambitious genuine reform program despite all difficulties and the lack of convincing success so far can be to some extent attributed to the credit embargo from Western countries.

The credit embargo imposed on Poland in 1982 had at least three important and unfavourable consequences within 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 "restructuring" 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. 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 propaganda stressed the point that the West is not a reliable partner and should not be count 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.), Brazil (recently agreed 20-years rescheduling on 67.5 billion US $ of private debt) or many other heavily indebted countries. Also within CMEA other socialist countries are treated more favourably.

To summarized, limiting factors to further development of East-West cooperation and trade lie both on Eastern and Western side. However, it would probably be fair to agree with the view, that the most binding constraint is low export potential of socialist countries (see e.g. Dietz, Fink, Grosser, 1988).

This in turn is caused mostly by systemic and policy-specific features of the centrally planned economies. Therefore the main stimulus for improving economic and trade ties between East and West would have to come via sweeping, efficiency-oriented reforms of the economic mechanism and the adoption of outward-looking policies. This task, however, may still be extremely difficult to carry over without a more cooperative attitudes of Western countries. Two points are particularlily important with this respect. First, full support is urgently needed from this group of countries for financial expansion to the East in form of government guarantees for further credits and for foreign direct investment. The second element of a new policy towards the East would be a substantial relaxation of protectionist measures, possibly within the scope of long term trade and cooperation agreements. It seems that recently signed agreement between the EEC and the CMEA would provide a suitable framework for new policy approach from the Western side.

Two immediate questions certainly would be raised at this point by Western politicians, bankers and businessmen. First, what might be the reasons for the West to embark on a track of closer cooperation with the East and what benefits can thus be obtained? Second, what are the guarantees that new inflow of Western funds—if materializes—will be used in a productive manner for export-oriented projects to ensure their future repayment, and will not be diverted to expand current consumption, cover large budget programs or otherwise be used inefficiently with equally catastrophic results as in the 70's.

These are both legitimate questions and more detailed answers are certainly in order.

Addressing the first objection, a number of arguments can be advanced to support the view that expansion of trade with East-European markets can potentially bring about substantial benefits to the West. The capacity of those markets is comparable with that of EEC-e.g. European socialist countries alone have a combined population of about 110 millions and the GNP of more than 350 billion US $. The USSR comes with much higher potential. Even if the purchasing power of these markets is comparatively limited at the moment because of foreign exchange shortage and comparatively low income levels per capita, in the future they may become the fastest growing region—if economic reforms succeed and political climate improves. East-European countries can offer large markets for a number of producer goods, foodstuffs and in the longer perspective also for a wide range of consumer goods. When the process of opening accelerates, it may be much more difficult to enter these markets than at present, because any other countries, also from outside of Europe, may become keenly interested in penetrating East Europe. Strategic decisions whether to establish strong position at East-Europen markets in the future should therefore be taken now.

Other favourable factors stem from geographical proximity of socialist countries, what makes their markets a natural area of expansion for West-European companies. Low transport costs, easy access via land and sea routes, close cultural and historical links together with comparatively high level of skills of East-European manpower and acceptable industrial infrastructure can make any business activity in this region highly profitable. East Europe may become also an interesting area for investors and exporters from Far East Asia, as they now have to confront growing difficulties on their traditional export markets because of sharply increased protectionism (like in the case of the U.S. market) or due to balance of payments problems (in case of Latino-American countries).

One has to point out also that at present Western firms operating in East-Europe practically do not face any significant competition because of still high degree of central market controls. This will not last forever and probably barriers to entry will be gradually diminished in the future.

Turning to the second question it has to be admitted that of course no full guarantee can be offered that new funds, if made available, will not be misused again. But can such a guarantee be given by any responsible government in any country in the world? The question is not to multiply legal agreement, which—as demonstrated by numerous examples of defaulting countries in Latin America—cannot provide a sufficient safeguard against the unknown future, but rather to look into long-term tendencies prevailing in the economic growth pattern and evolution of economic policy. This is not to say that pro-reformist orientation now observed in some socialist countries cannot be reversed; but there is a good deal of evidence that his orientation may be of permanent character and eventually some sort of market socialist system may emerge in Eastern Europe by the end of the century. If can be argued that the process of change has been already advanced in some countries to such extent as to justify more active and cooperative approach from the West.

One should point out that there exists a certain interaction between the Western policy towards socialist countries and the pace of democratic changes which are taking place there—and this interaction is often overlooked in discussion the East-West economic relations. Generally speaking, closer cooperation enchances larger liberalization and stimulated economic reforms in Eastern Europe—simply because the position of pro-reformist forces becomes stronger within the leadership. The question remains whether the West prefers rather to take a "wait and see" position vis-a-vis socialist countries or it should step up actively supporting current developments in its own interest. It is also worth noting that the problem of the foreign debt of socialist countries can probably be tackled only through long-term growth-oriented policy, and not by short-term austerity measures. This approach has been increasingly recognized recently not only amongst debtor countries, but also in the West (viz. the underlying idea of the Baker's Plan).

IV

In the official propaganda in socialist countries it is often stressed that present difficulties in East-West economic relations are mostly caused by politically-biased trade restrictions and discriminative policies towards foreign debt problems by western countries. A more balanced approach should probably be advocated. Foreign sanctions and restrictions notwithstanding, the crucial problem for socialist countries is to increase radically their export capabilities, especially in manufacturing industries. Traditionally, this objecive 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 mechansim and oriented towards increased efficency. 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.

Basically speaking, the reforms being actually undertaken in socialist countries are generally allowing for a transition from directive central planning to market oriented system. The idea is not to abolish economic planning, but rather let the market mechanism to work achieve planned objectives. There are views expressed sometimes that market mechanism is incompatible with central planning. This is not necessarily the truth. If the plan is understood as a set of objectives and goals, the market may be guided by economic policy instruments as to move the economy towards these objectives. The crucial point here is to distinguish between the formulation of goals which is done within the framework of the national planning system, and their realization which is largely left to market forces.

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 much slower pace. The need for larger reliance on market is, however, much less accentuated in GDR, Romaina and Czechoslovakia.

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

Within the new system the efficency is supposed to be ensured by rational behaviour of individual enterprises, guided by the profit maximization principle. This will carry their activities entirely on their own account, being independent from central government. The growth potential of the enterprise and also, to a large extent, the level of income of its employees will be dependent on profit. Individual initiative will in turn be decisive in achieving higher profits and incomes. The price setting will essentially be left to market forces. Basic producer good prices will be directly related to international prices: other domestic prices will be determined by supply and demand relations.

Even though some foundations of such system have been already laid down some time ago in Hungary and Polad, many restrictions on market mechanism are still in force. This refers mostly to limited mobility of capital and foreign exchange resources and to still strong dependence of individual enterprises on central administration. Also banking system is excessively dominated by current government policy and plays a passive role in the process of resource allocation. These and other shortcomings have to be removed if the market mechanism is to work properly.

But even a flawless system would not be sufficient to transform sluggish Eastern economies into efficient and dynamic ones, with a strong export sector. A specific export-oriented policy must follow systemic changes, otherwise the market mechanism remains suspended in many areas and cannot produce expected results.

V

It is well known that domestic producers are faced always by alternative of selling (buying) their outputs (inputs) either on 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 instruments like taxes and subsidies on production, consumption, investment and foreign trade, and also administrative tools of direct controls, like quantitative restrictions on exports, imports, foreign currency flows or resource allocation. It can be easily demonstrated that policies adopted in socialist countries have always revealed a strong anti-export bias, notwithstanding equally strong rhetorics about the need of export expansion.

This is the fundamental "policy-specific" cause (as distinguished from "system-specific") of the notoriously low export potential of East-European economies. The anti-export bias (or, equivalently, import-substitution bias) of policy favouring domestic markets can be explained by four elements artificially increasing the relative profitability of local sales versus exports. Three of them come from specific solutions of the present foreign trade regime prevailing in socialist countries, whereas the fourth one comes as a necessary outcome of the overall economic situation at their domestic markets.

First, 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 persistant 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 system, 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 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. (Balassa, 1977). It is extremely difficult to assess the actual level of these premium in the socialist countries, because the data available do not allow for accurate calculation of real foreign exchange rates but some very rough estimates indicate, that they can vary from ca. 50%-100% in Hungary and Czechoslovakia up to 200-300% in Romania and Poland.

The second component of the anti-export bias is connected with specific pricing policy followed in socialist countries. A distinct feature of this policy is that on one hand prices of basic producer goods are kept at artificially low level, presumably to keep down production costs, and on the other hand the general price level is not allowed to rise together with ever-increasing nominal demand. As a result of domestic price controls, substantial differences may arise between domestic prices and CIF import prices 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 controlled price levels in socialist countries, their exports have to be on the average subsidized (total amount of subsidies paid exceeds total amount of taxes). Imports in turn fall in two main categories. Impoted producer goods are sold domestically at relatively lower prices; therefore this kind of imports has also to be subsidized on large scale. On the other hand, imports of finished products is normally taxed because their domestic prices are much 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.

Third element which increases the relative profitability of import substitution as compared with exports is connected with tariff protection. Tariffs are currently in use in all East-European countries but their significance in regulating foreign trade flows is rather low, relative to other policy measures. Nevertheless, the average custom duty of ca. 10-15% on manufactured products increases correspondingly the level of domestic market protection.

The last element is brought about by the situation of permanent shortages on domestic markets, which have eroded 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 monopolistic position of many public enterprises on domestic markets.

We can see therefore that anti-export elements in the East-European economics system and policy are strong and widespread. In contrast, export-promoting elements are of much lesser significance and they cannot alter the general anti-export bias. Exports are supported essentially by two instruments—direct subsidies and tax and income incentives. The subsidies form part of the price differential transfer system and their task is merely to assure no losses can occur to exporters up to a certain marginal exchange rate, usually 50-100% higher than the official rate. But these subsidies, because of their construction (they are supposed only to equate the rate of profit on export with the average rate on domestic sales) are not guiding exporters and producers to areas of potential export expansion and do not provide sufficient funds to develop exports via increased investments. The average export subsidy within this system is about 15% in Poland and does not differ significantly for other countries.

Tax and income incentives are of even lower importance, although they have grown in Poland from mere 2-3% in 1982 to ca. 8-10% of total exports earnings in 1987. Hungary and Bulgaria have comparable incentive system; other countries have been so far experimenting with these incentives on much more limited scale.

As a result one cannot expect that export-promotion measures can offset anti-export bias. 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 2:1 (Hungary) up to 5:1 (Romania, Poland). These estimates, however, should be taken "cum grano salis", since the most important component of the protection level is of course the difference between real and official exchange rate—which is extremely difficult to assess, because of government price control and disequilibrium in many markets. The necessary change must therefore bring back reasonable proportions between incentives and support given to exports and import substitution. The extent to which the process of change can succeed in reasonable time horizon depends however on many internal and external conditions—which brings us to the role which West can play in this process.

Basically, two alternative strategies can be adopted on the West 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. The alleged rationale behind this course is that since one could not expect any major change both in political and economic position of Eastern Europe, nothing really meaningful can be done to recover lended money not to speak about engaging in new assitance programs. This policy has been successfully fueled by increased political tensions between East and West after the martial law had been imposed in Poland in 1981. (Hardt and Boone, 1985). But the results of this strategy remain dubious at best. It may be argued that the "wait-and-see" strategy contributed to the present stalemate in East-West relations, cutting drastically western exports to the East and forcing some socialist countries to suspend their foreign debt service payments.

The alternative strategy is to adopt 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) distinct improvement of overall political climate in Europe, (2) normalization of financial relations, and (3) some departures from generally protectionist foreign trade policy.

Leaving political aspects to be discussed at another occasion, we should however elaborate briefly on points (2) and (3). The regular access of socialist countries to new credits is of vital importance for the successful implementation of the ongoing economic reforms. Deep changes require substantial reserves in terms of time and financial means for necessary adjustments—both have been already stretched tolimits. This is to say, however, that without additional credits, reforms in Eastern Europe would be stopped and eventually the traditional system would be restored—although this scenario is still possible, it does not seem very likely. But without active role of Western countries the whole process would take much more time and be more painful and costly for East-European societies. One of the possible solutions would be much faster expansion of economic relations with newly industrialized countries of Far-East Asia and with some developing countries. This possibility is currently under careful consideration among politicians, businessmen and economists in countries like Poland and Hungary. It seems there is an enormous potential for mutually beneficial trade between East Europe and Far East Asia, if some political issues and prejudices can be overcome.

VI

One of the distinct features of the process of opening now going on in the socialist countries is the rapid development foreign direct investments in form of joint ventures. Once banned and considered as 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 1972. 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 SC(E)'s 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, sustituting 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 SC(E)'s turned out to be rather limited. At the end of 1987 Hungary had the largest number of j.v.-111, followed by the Soviet Union (19), Bulgaria (15), Poland (13), Romania (5) and Czechoslovakia (3). Comparatively high figure for Hungary is explained by several dozens j.v. in services and fnancial 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 rather special case. What is more important however, is that inflow of foreign capital through j.v. 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. Although comparable data are not in all cases available, the capitalization of j.v. domiciled in SC(E)'s varies from ca. US $ 200 mln in Poland to 7 mln in Czechoslovakia. The value of foreign participation in Soviet and Hungarian j.v. is around US $ 100-150 mln. ("Economic, Business, Financial and Legal Aspects of East-West Joint Ventures", 1988 and "Polish Economy in the International Environment in the 1980's", 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 (Zhang Yunling, 1988). An average east-west joint venture is therefore 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).

Among the reasons for slow growth of foreign direct investment in SC(E)'s 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% in Romania and Soviet Union to 40% in Hungary and 50% in Pooland and Czechoslovakia. Similarily the limits on foreign participation fixed in most cases at 49% of initial equity capital and also restricted access by foreigners to top mangerial positions have been regarded as serious shortcoming of present status of j.v. 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 guaranteed by government agencies from western countries. As experience demonstrates, this is sometimes very difficult to secure. Another difficulty of more practical nature arises when j.v. have to deal with local administration in socialist countries which is famous by its lengthy and time-consuming bureaucratic procedures.

Critical evaluation of recent experience in the field of direct foreign investment doesn't 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 legislatures. Actually this fact has been recognized by some of SC(E)'s, and some 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 in 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 attractive for foreign investors.

Interesting feature of operating j.v. is that almost all of them were set up by west-european partners. The Federal Republic of Germany is an unquestionned leader with 51 j.v. (more than 30% of all j.v.), most of them located however in only one country (Hungary-42 j.v.). Austria comes second with 37 j.v., also concentrated in Hungary (33 j.v.), followed by Switzerland and the

United States each having 17 j.v., 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 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.

VII

The further development of East-West economic relations depends heavily on the nature of economic and political processes taking place in both groups of countries. It is in the interest of both sides to give these relations a new stimulus and to overcome existing obstacles and barriers. For Eastern countries, closer cooperation would mean larger possibilities of technological advance, faster growth and gradual elimination of external imbalances. This in turn would allow to strengthen internal equilibrium and increase substantially the level of national welfare. It is believed that the general improvement of material well-being would also consolidate democratic reforms in these countries. For Western countries considerable benefits would stem mostly from fast and steady expansion on largely unsaturated markets of socialist economies. In addition, closer economic links would certainly contribute to further improvement of political situation in Europe and in the world.

To achieve these goals, however, a radical change of economic policies is required on both East and West side. East-European countries have to restructure profoundly their economies and this cannot be done without deep reform of economic system and socio-economic policies. The speed and the extent of the process of reforms in socialist countries depend on the genuine willingness and ability of respective governments to follow through on their promises to implement necessary reforms. The danger of being trapped between reluctance and even opposition of party and administration bureaucrats from one side, and strong pro-egalitarian and income-vindicating pressures of many social groups from the other side, is by all means real. The determination of political leadership to continue the process of reform can further be weakened by unstable market situation, deep disequilibrium and price inflation, running already at 15% in Hungary and 40-45% in Poland. Without necessary speed and determination, the process of reforms can be again slowed down and extended over many years—like in Hungary after 1968. Such "Hungarization" of the reformist process in Poland, USSR or Bulgaria poses an immediate danger, but again can be avoided by more active involvement of Western countries.

Western countries are urged to respond more actively and positively to these market-oriented reforms; financial assistance in form of debt or equity participation in economically sound projects and general reduction of the protection level of Western markets against East-European exports would constitute two most important features of the new policy approach. However, on the side of the West there are, too, many difficulties in adopting the strategy of positive reengagement. On political grounds, there is still insufficient understanding of the depth and scope of changes now taking place in Eastern Europe. There are tendencies to underestimate their importance and even to dismiss them as tactical or cosmetic adjustments rather than symptoms of more fundamental and eventually irreversible process. On economic grounds, the present instability of international monetary system and strong tendencies for narrow regional integration at the expense of more expanded forms of economic cooperation among larger group of countries, create most serious problems. Traditional EEC policy of selfreliance and trade discrimination between members and non-members is loosing its rational justification in view of ever rising costs connected with maintaining inefficient branches and sectors and at the same time makes it more difficult for EEC countries to penetrate other markets, often with very large prospective potential. If these protectionist tendencies vis-a-vis socialist countries prevail in the future, it may well happen that Eastern Europe, if eventually open for international trade, will become a primary area of expansion for fast growing Asian exporters and investors.

The instability of international monetary and financial markets owes much to the erratic monetary and fiscal policy of the United States. One can hope that a restraint put on budget expenditures by Gramm-Rudman law can eventually lead to more stable system—but still, the process of disposing of accumulated dollar surplus on one hand, and reducing foreign debts on the other hand may be long and difficult, again strengthening protectionist mood in many countries.

The process of establishing closer economic cooperation between East and West could be further enhanced by direct involvement of international financial and economic organizations—IMF, World Bank and GATT. Their contribution would greatly facilitate the transition period and reduce the necessary cost of adjustment. To what extent this common effort can be initiated and coordinated depends however largely on political situation. It seems that recent developments in socialist countries—in the Soviet Union in particular—provide a solid ground for long term policy of reestablishment of the East-West cooperation.

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