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Paper presented at the Symposium "Vienna - A Spring-Board for Doing Business with Eastern Europe" in Jakarta am 22. Mai 1990

WIFO-Vorträge, 1990, (46)

Economic Situation of Changing East Europe

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1. Economic Causes and Consequences of the Political Reshuffling in Eastern Europe

The last few years terminating the 1980s brought about a remarkable change in the goals of Eastern Europe's reformist movements: attempts to improve on living conditions within the given political and economic system were substituted for changing the system itself. Much of this development was initiated by the *economic backwardness* of Eastern countries: Over the time, people increasingly realized the gap between their demands for a minimum scale of life necessaries and actual accomplishments. In addition, intensifying outward contacts through travelling and telecommunications made people aware of the gap between living conditions in their countries and in the neighboring West. Gradually, this has forced politicians to rethink the role of party influence and economic planning. *Thus, the prospects of never being able to attain a satisfactory economic status may be seen as instrumental for the initiation of political reform in the East block.*

Already many years ago, some room for economic reform was opened in Hungary (1968) and Poland (1981), attempting to find a "third way" between the central-planning and the market approaches. In the wake of Gorbatchev's "Glasnost" and "Perestroika" movements, the mood

for economic reform has spread all over Eastern Europe[1]). The world has since been full of *euphoria* about the potential new contacts and markets.

As seen from a less emotional standpoint, however, only a potential has been opened, and severe *set-backs* can not totally be excluded. Such a more cautious view is backed by the fact that reform movements in individual East block countries are by far not uniform: in some countries, the pressure has risen from bottom; in other countries, foremost in the Soviet Union, the revolution has rather been initiated from the top, and it still is an open question whether eventually this will be grasped and honored by the people.

Accordingly, the economic consequences of the political reforms are expected to differ substantially from country to country. The more advanced Eastern economies, such as those of the GDR, the CSFR and Hungary, may be able, within a reasonable time-span, to catch up with Western economies. For the more backward economies of Bulgaria, Romania and Poland, the outlook is rather bleak.

2. The Current Economic Situation in Eastern Europe

A few figures may highlight the present economic situation of individual Eastern countries as well as the average position of the group. As the sharp distinction between economic blocks is about to vanish, I shall treat Yugoslavia as an "Eastern" country, and the Soviet Union as an Eastern "European" country. If I want to exclude these two countries, I shall talk about the six former "satellite countries" of the USSR – Bulgaria, CSFR, GDR, Hungary, Poland, and Romania.

Excluding for the time being Yugoslavia, the post-war economic system of the other Eastern countries was characterized by:

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[1]) Now possibly also including Albania.

- large-scale *nationalization* of the means of production and distribution,
- institution of a *central planning system* to set prices and wages and to allocate resources among enterprises.

The dominant position of the USSR is obvious from the size of its area and *population,* the latter accounting for some two thirds of the population of the overall group (including Yugoslavia) of 425 million. This is some 100 million persons more than are currently living within the EC. In the former "satellite countries", 50 percent out of a total population of 113 million participate in the labour force; in the EC, that share amounts to only 45 percent.

Income per head in Eastern countries does on average not exceed 50 percent of that in the EC. Some countries, such as the GDR and the CSFR, are much better off and approach 70 to 75 percent of the EC average[2]). Romania, Poland, Bulgaria and Yugoslavia remain below the average of Eastern countries with Romania marking the tail-light.

Average *economic growth* in the first two decades following World War II was in Eastern Europe about as high as in industrial countries (some 5 percent p. a. between 1951 and 1973). It fell short, though, of growth rates in those Western countries that were also rebuilding from the war (e. g., FRG, Japan). The slow pace of economic growth became particularly apparent after 1973 and during the 1980s, when industrial countries better managed to overcome the retarding effects of the oil crises. Up to the beginning of the 1980s, *labour productivity,* e. g., in the USSR, grew about 1 percentage point less than in industrial countries, although the rate of capital formation was almost twice as high. This indicates the rather inefficient deployment

[2]) These calculations are based on purchasing power parities rather than on currency exchange rates. They do not fully account for differences in the quality of goods and services supplied. Other estimates are less favourable. According to the figures quoted in *Kramer* (1990), average Eastern income per head would not exceed 30 to 50 percent of the EC average (which compares with the EC average of the 1950s); the GDR, CSFR and Hungary would be in the range of 50 to 60 percent of the EC average.

The information content of any such comparison is of course limited. In contrast to GDP calculations in Western countries, most of the Eastern countries only publish a "net material product" which disregards the production of services if not closely related to the production of goods; for meaningful international comparison, rough estimates have to be substituted for the missing data.

Table 1

The Economies in Eastern Europe: Basic Figures for 1989

Country[1)]	Population (mill.persons)	Area Size (1,000 km²)	Employment (mill.persons)	Per-capita income (EC = 100)[2)]
Poland	38	313	19	40
Romania	23	238	11	35
GDR	16	108	9	75
CSFR	16	128	8	70
Hungary	11	93	5	55
Bulgaria	9	111	4	45
Subtotal	113	992	56	...
USSR	288	22,401	156	50
Yugoslavia	24	256	10	45
Total	**425**	**23,649**	**222**	**50**
(EC total)	(325)	(2,261)	(145)	(100)

Source: *Deutsche Bank* (1990)

1) Ordering according to size of population.
2) Based on purchasing power parities.

of capital in the USSR (*IMF,* 1990). As in most Eastern countries, growth was "extensive" in the sense that it relied more on increases in factor inputs than in productivity.

In many of the Eastern economies, *production of primary goods* is dominating. The share in total employment of agriculture amounts to 19 percent on average compared with just 7 percent in the EC. Again the GDR (10 percent) and the CSFR (13 percent) exhibit much lower shares, indicating that the manufacturing sector is quite advanced in these countries. Production of energy is much larger than in the EC, but also is per-capita consumption of primary energy.

According to a rough breakdown, the structure of *manufacturing* does not much differ among Eastern countries. Machinery accounts for about a quarter of total manufacturing in any of them, the share of chemistry ranges from 11 percent (USSR) to 20 percent (GDR). In the metal industry, the ranges are from 6 percent (Bulgaria) to 12 percent (CSFR), in the textile and clothing industries from 8 percent (CSFR) to 14 percent (USSR, Romania), and in the food industries from 12 percent (Romania) to 23 percent (Bulgaria).

It has been evident that the *supply* structure of goods and services has for long not matched the preferences of the consuming population. Output of low quality and outdated design has failed to satisfy internal demand, and supply has been limited partly due to production inefficiencies. Goods have been produced according to plan, but have in considerable amounts been unsalable, even at low prices, and have thus resulted in stockpiling.

As a consequence, the competitive position in *foreign trade* has been weak, and Eastern countries have lost market-shares in international markets. In 1970, out of total imports of goods of OECD countries 1.6 percent originated from the "satellite countries". By 1989, this share amounted to just 1.2 percent. The share of the USSR mirrored its importance as an oil exporter: it rose from 1.3 percent at the beginning of the seventies to more than 2 percent a decade later, but fell back to 1.2 percent by 1989. Losses in market shares occurred predominantly in machinery and in the food industry, while, as a rule, markets were gained in raw

Table 2

Economic Growth in East and West

	1985	*1986*	*1987*	*1988*	*1989*
World trade volume	3.6	3.7	5.2	8.5	7.5
Economic growth in the West 1)	3.2	2.7	3.2	4.0	3.2
Economic growth in the East 2)	3.5	4.2	2.6	4.2 3)	3.2 3)

Source: *Stankovsky* (1989)

1) Real GDP growth in OECD countries.
2) Growth of net material product in European CMEA countries (including USSR).
3) Estimate.

Table 3

Primary Producing Sectors

Country[1)]	*Agriculture (percentage share in total employment)*	*Electricity production (bill.kwh)*	*Crude oil production (mill.tons)*	*Primary energy consumption per capita (oil unit tons)*
Poland	28	144	0.1	3.5
Romania	28	70	9	3
GDR	10	119	0.1	6
CSFR	13	81	0.1	5
Hungary	19	30	2	2.5
Bulgaria	19	45	0.3	4.5
Subtotal	...	489	11.5	5
USSR	18	1,720	608	5
Yugoslavia	22	83	3.5	2
Total	**19**	**2,292**	**623**	**5**
(EC total)	(7)	(1,700)	(115)	(3.5)

Source: *Deutsche Bank* (1990)

1) Ordering according to size of population.

Table 4

Structure of Manufacturing Production (1987)

Country[1)]	*Food*	*Textiles*	*Metals*	*Chemistry*	*Machinery*	*Other*
	(Percent of total material product)					
Poland	18	11	11	12	22	26
Romania	12	14	10	16	24	24
GDR	15	9	9	20	26	21
CSFR	15	8	12	14	27	24
Hungary	17	9	8	19	24	23
Bulgaria	23	9	6	14	27	21
USSR	15	14	10	11	24	26
Yugoslavia	15	12	10	14	20	29

Source: *Deutsche Bank* (1990)

1) Ordering according to size of population.

materials and semi-finished goods. It is perhaps interesting to note that the more advanced Eastern countries (GDR, CSFR) lost markets chiefly in more sophisticated product categories (*Stankovsky,* 1990A). The recent reforms in East Europe have not materialized yet in gains of market shares.

The economic performance of Eastern countries has been impaired by the large build-up of external debt which has not been used, to the extent necessary, for productive purposes. To evaluate the *debt situation* properly, net hard currency debt rather than gross debt should be considered. In absolute end-of-1989 figures, Poland's net debt ($ 38 billion) slightly dominates over that of the USSR ($ 37 billion), Hungary ($ 19 billion) following on third place.

More elucidating than absolute figures, however, are debt ratios (measured as the net hard currency debt over foreign exchange receipts from exports of goods and services, expressed in years). According to such figures, Poland (3.2 years) is by far the most heavily indebted Eastern country. Other quite endangered countries are Bulgaria (2.7 years) and Hungary (2.1 years), while the CSFR (0.7 years) and Romania (0 years) are presently not burdened by foreign debt problems.

Eastern Europe is faced with many other problems which are partly related to the debt situation. In this setting it is almost impossible for the Eastern countries to keep pace with even the most heavily polluting industrialized countries in preserving their natural *environments.* The extensive use of lignite coal and inadequate filters in the GDR and the CSFR causes the highest per-capita sulfur dioxide emissions in the world. As a consequence, severe health problems have evolved, aggravated by water pollution and acid-rain-induced deforestation. This actually turns Western investments in Eastern environments more efficient than further marginally improving the environmental situation at home[3]).

[3]) The *ECE* (1990) has estimated that out of the total sulfur dioxide pollution in Austria, only 8.4 percent can be attributed to domestic sources, while 36.4 percent stem from Eastern countries.

Table 5

Market Shares in Foreign Trade with OECD Countries (1989)[1]

Country[2]	*OECD Imports from*	*OECD Exports to*
Poland	0.28	0.24
Romania	0.17	0.04
GDR[3]	0.32	0.28
CSFR	0.18	0.10
Hungary	0.21	0.16
Bulgaria	0.04	0.09
Subtotal	1.20	0.91
USSR	1.16	1.44
Yugoslavia	0.44	0.45
Total	**2.80**	**2.80**

Source: OECD

1) Estimates; in percent of total imports and exports, respectively.
2) Ordering according to size of population.
3) Including trade with West Germany.

Table 6

Imports From the West and Hard Currency Debt (1988)

Country[1)]	*Imports from the West (bill. $)*	*Hard Currency Debt (bill. $, gross)*
Poland	5	40
Romania	1.25	1
GDR	7	21
CSFR	3.5	7
Hungary	4	20
Bulgaria	2.5	10
Subtotal	23	100
USSR	25	52
Yugoslavia	9	18
Total	**57**	**170**

Source: *Deutsche Bank* (1990)

1) Ordering according to size of population.

Table 7

Hard Currency Debt and Debt Ratio (1989)

Country[1)]	*Hard Currency Debt (bill. $, net)*	*Debt Ratio*[2)] *(years)*
Poland	38	3.2
Bulgaria	9	2.7
Hungary	19	2.1
USSR	37	1.4
GDR	13	1.3
CSFR	5	0.7
Romania	0	0.0
Total[3)]	**123**	**1.6**
Yugoslavia	14	0.9

Source: *Deutsche Bank* (1990)

1) Ordering according to size of debt ratios (excl.Yugoslavia).
2) Ratio of net hard currency debt to foreign exchange receipts from exports of goods and services, measured in years.
3) Includes liabilities of COMECOM banks not attributable to individual countries.

In this rough characterization of Eastern economies, negative items dominate. Of course, it should be acknowledged that the political system developed in the Eastern countries also exhibits a number of *positive aspects.* Among those are:

- a high degree of job security,
- very low revealed unemployment,
- low revealed inflation, and
- any pathbreaking successes in basic high-technology research.

However, there obviously has always been hidden unemployment and inflation, and the implementation of *technological progress* into goods to be sold on the market has in general been lagging significantly behind similar processes in industrial countries. A catching-up phase would commence only, if huge investments in computers, information and communications equipment and in consumer electronics were generated.

In summary, the economies of Eastern European countries have significantly fallen behind the performance of Western economies, in spite of a broad raw material base and extensive use of other production factors. Inefficient production and distribution methods were attempted to be overcome by debt financing from abroad, but this turned out largely unsuccessful. Increasing discrepancies between Eastern and Western living standards have resulted in up-risings and the initiation of reformist measures.

3. Next Steps in the Economic Reform Process

Economic reform in Eastern Europe is essentially linked to *political liberalization* and the movements towards democracy. So far it has extended *human rights* in some areas and

conceded freedom of opinion, freedom to travel abroad, freedom for political prisoners, and the plurality of political parties.

Not much has changed yet for the economies, though. The major problem still is the *low level of productivity* which prevents Eastern countries from successfully competing in international markets. It is the result of:

- an obsolete *infrastructure* and production capital stock, representing the technology of the 1950s or 1960s;
- *inconsistent planning* resulting in *bottlenecks* in the supply of material inputs into the production process;
- *lack of sufficient motivation* for employees and managers to increase productivity and to use inputs efficiently and sparingly;
- *lack of a market and price system* which would point at shortages or excess supplies and which could guide supply and demand to approach equilibrium. In a market system, prices tend to inform market participants about prevailing preferences of economic agents, in a centrally planned economy they reflect the preferences of the bureaucracy.

The lack of a sufficient *infrastructure* is indicated by the thinly developed communications facilities. As of the mid-1980s, telephones per 100 persons ranged from 12 to 24 in the six former "satellite countries", which compares with Portugal, the least developed country within the EC. There is also an underdeveloped transportation system. The average hard-surface "road density"[4]) of 2.5 km in the former "satellite countries" falls much behind the 6.4 km of the EC. However, the similarly defined "railroad density" of 0.7 km exceeds the figure of the EC of only 0.4 km (*Hervey,* 1990).

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[4]) The hard-surface "road density" is measured as kilometers of hard-surface roads per 1,000 population.

Targets and conditions for reform

In contrast to traditional stabilization policies pursuing short-term goals, an economic program for any of the East European economies should emphasize *structural developments* over the medium and longer term. Short-term effects, though, will have to be monitored to lessen disturbances along the path from the present situation to the desired final setting of the economy.

Before formulating a reform program, priorities among the many possible economic goals would have to be expressed by politicians. As an obvious *overall target, the standard of living of the population should rise, possibly to Western standards, under socially viable conditions.* Fostering the international competitive position will serve that goal as well as the subordinate target of securing balance-of-payments equilibrium.

Thus, the bundle of medium-term targets to be approached simultaneously may consist of:

- raising the general standard of living;
- improving the international competitiveness of goods and services producing industries;
- reducing disequilibrium in the external sector of the economy;
- avoiding unemployment (other than frictional);
- securing a just distribution of real income rises.

In the course of approaching these goals, numerous changes in the current economic structure will be inevitable. Employing the experience of Western economies, it seems likely that these goals may be attained only under the following *conditions:*

- Central-planning will have to be substituted by decision making on the *market.*

- Bureaucracy will have to recede in favour of *competition.*

- To create a market, the *price system* will eventually have to be liberalized, subsidies eliminated, and *private entrepreneurship* permitted.

- *Incentives* on the firm level will have to be provided to encourage production for the market rather than for an anonymous plan[5]). Institutional monopolies, particularly in the foreign trade regime, must be phased out as soon as possible.

- *Management of the economy* on the microeconomic level should be substituted by management on the macroeconomic level which is not well developed in Eastern countries.

- To foster international competitiveness, *convertibility of currencies* should be aspired at a rather early stage.

- Foreign *debt burden* must be contained, if not reduced.

- Capital inflows from the West should preferably take the form of *direct investments,* and should particularly be directed to improve the infrastructure[6]).

- A *social network* should be established to mitigate the hardships unavoidably linked to structural changes in any economy.

As the *result* of these changes, the allocation of production factors could be expected to react to the development of relative prices to reflect comparative advantages. This would enhance the efficiency of production and would be mirrored by a gradual reduction in the public sector's share in economic activity, and by a step-by-step increase in the private sector's share. However, in spite of advances in market orientation, the share of state-owned enter-

[5]) E. g., decentralized decision making, management success measured in terms of company profit, company profit remaining disposable for company investments, market prices signalling excess demand and supply.

[6]) Including the telecommunications, traffic, and environmental sectors as well as education and retraining.

prises will remain high for many years. Only by and by will existing companies be displaced in favour of modern plants and equipment. Accompanying this, new training facilities will be established or upgraded to retrain employees. In the process of restructuring, the lack of management skills may turn out as a major bottleneck.

Radical or gradual approach?

As the bureaucrats are still pulling most of the strings, it is likely to *take some time* before the recent changes will become effective to improve productivity. The uncertainties as to the final success of the reform movements are still great. In some countries, people may get impatient with the reform process and either call for revolutionary steps forward or even opt for the restauration of the previous system. This holds particularly true for the Soviet Union.

What the optimal way out could be depends much on how the most pressing intermediate problems will be tackled.

One of the open questions to be answered beforehand is whether reforms should be implemented *radically or gradually,* as measured by the speed of reform, its comprehensiveness and sequencing. Since "there is no theory of the transition from a centrally planned to a market economy" (*IMF,* 1990), politicians have to decide between the two approaches according to their subjective weighing of pros and cons of either of them. A radical approach is likely to yield the following advantages:

- a short transition period from the current to the desired structure of the economy, minimizing the period of hardship;
- a short transition also reduces possible action of pressure groups which could water down the stabilization program and imperil its success;

- an extended adjustment period produces "rational" expectations of agents in the economy which also might endanger the success of the program by anticipating and counteracting it.

The likely disadvantages of a radical approach may be summarized as follows:

- Immediate changes will inevitably cause involuntary unemployment.
- Radical changes will negatively affect larger parts of the economy in a more substantial way than in a gradual approach; although the relative advantage of the one or the other approach is almost impossible to measure at the macroeconomic level, the individual hardships will most certainly be more pronounced in the radical approach.
- The adjustment process will be too short as to permit corrections of unforeseen side-effects of the stabilization program or of wrong-proving assessments and forecasts.

Whether or not a radical approach is to be followed seems largely a question to be posed at politicians rather than at economists. Any decision will (explicitely or implicitely) mirror 1. the priorities among the policy goals, and 2. the prevailing institutional and behavioural restrictions.

In most countries a radical approach will politically not be feasible; an exception may be the *GDR* where West German money is to mitigate the socially undesirable effects. *Poland* also is demonstrating that political agreement can be found to implement such an approach. Politicians with limited office-terms may favour a radical approach, as the success of the new system may surface only if implemented with all its consequences. In a step-by-step approach, in contrast, the inadequacies of the old and the new systems may cumulate and jeopardize any desired outcome of the reforms. From this point of view, the optimal approach could be radical in principle, but it would also care to mitigate socially undesired consequences.

Monetary stabilization

Reform plans which eventually aim at improving the competitive position of the economy and the living conditions of the population are in general accompanied by a financial program. It should strive for a consistent evolution of basic financial policy variables such as the foreign debt, the balance of payments, and the budget deficit. An integrated financial program will rest on a number of structural reforms, particularly

- a price reform,
- a monetary and exchange-rate reform, and
- a tax reform.

The two approaches mentioned above can be applied to each of these. A *price reform* may be designed as a once and for all decontrol of all prices, or as a step-by-step policy. A more gradual approach would allow for the differentiation between consumer and producer goods with widely differing income and price elasticities: prices for "luxury" goods (and services) could be freed immediately, while prices for vital goods could remain fixed for some time. After a period set by the program, virtually all prices should be stripped of subsidies and be free to adjust to market forces.

Initial steps have been adopted in many of the Eastern countries. By help of the IMF-monitored stabilization program, Poland is now probably most advanced in this field.

To keep inflation under control as price subsidies are gradually abolished for vital goods, a *price-wage negotiation scheme* will be inevitable to secure real wage increases in the medium term. Temporary reductions in real wages may occur in certain sectors of the economy. Therefore an accompanying social program should care for some redistribution of incomes. This way has been adopted to lessen the possible negative effects of the monetary union between East and West Germany.

A *tax reform* would assist these measures. It could provide for the introduction of a value-added tax, a corporate tax, a property tax, and a progressive income tax.

Reform of the *monetary sector* would comprise

- stabilization of the supply of liquidity to households and corporations;
- a reform of the banking system, including the creation of an independent central bank and independent commercial banks;
- the gradual establishment of a domestic capital market;
- controlling and confining public deficits;
- stabilizing foreign debt;
- gradual abolishment of import restrictions and export subsidies;
- stabilizing the market value of the currency; and as a final step,
- introducing convertibility of the currency.

In the monetary sector, certain measures appear successful only when adopted once and for all. This holds for possible cuts of liquidity overhangs as well as to exchange-rate measures.

With some hesitancy, first steps towards *convertibility* have been taken in almost any of the Eastern countries. This pertains to the more liberal foreign trade regimes as well as to attempts to close the gap between official and market exchange rates. A precondition for convertibility would of course be to eliminate the liquidity overhang of the private sector, a particularly severe problem in Poland and in the USSR.

To finance the restructuring process, massive *capital imports* must be generated by all Eastern countries, and to that end, various forms of financing will have to be cumulated. To

avoid the burden of future debt servicing, as much capital as possible should be raised in form of direct investment – if it is politically feasible in Eastern countries, and not interpreted as selling-off the countries' most valued assets. This should be accompanied by debt-relieving swaps for equity capital (*Fink – Stankovsky*, 1990).

Part of the capital will certainly be raised on financial markets or from international financial institutions, such as the IMF or the World Bank. Any kind of conditional financing should be preferred to non-conditional loans, also in the interest of debtor countries, because 1. it limits the future debt service burden, and 2. it refrains politicians from misusing the proceeds for non-productive purposes. Almost all Eastern countries have by now established some form of relation with the IMF or are already members (such as Yugoslavia, Romania, Poland, and Hungary). Within Europe, many of them will seek OECD and perhaps EC membership.

4. Prospects for Individual Countries: No Common Answer

In contrast to integration efforts in the West (particularly in the EC), cooperation in the East block's COMECON organization[7]) has not resulted in economic impulses for the participating nations. The CSFR – prior to World War II a leading industrial nation – has lost virtually all its international markets. Romania – once an important supplier of agricultural products – is now heavily dependent on food supplies from abroad.

What are the *economic prospects* for individual *countries*? Except for the GDR and perhaps Poland, not much can be said about the timing of reform measures and their likely effects.

It seems clear by now, however, that a radical approach will be enforced in the *GDR*, though it will be lessened in its social effects by massive income transfers from West Germany. Although most of what is now the area of the GDR may for long remain a development region

[7]) Council for Mutual Economic Assistence (CMEA).

within the larger Germany, income levels and household demand will be adjusted upwards, investment in the infrastructure as well as in private plants and equipment will surge and, as a consequence, productivity would rise as desired.

However, several years will have elapsed before in the GDR the positive effects of the economic and monetary union between East and West Germany will dominate over the immediate negative effects. Still, given the "social umbrella" provided by West Germany, the radical approach seems to be without an attractive alternative.

The *CSFR* starts from a similarly advanced economic position, backed by a long (though today somewhat concealed) tradition as an industrial nation. Balance of payments and foreign debt problems are minimal, and the social groups seem quite prepared to adjust to the necessities of a market economy. The new Government seems eager to liberalize the *price system* and introduce *internal convertibility* of the currency until the end of this year. A new *privatization* scheme would convert many of the state-owned enterprises into joint-stock companies, the shares being sold to the general public. A reform of the *banking system* has been started at the beginning of this year by creating a two-tier system of commercial banks and an independent central bank. However, since the CSFR is lacking a generous money dispenser – as the FRG is for the GDR – the immediate adjustment period may last even longer than in the GDR.

Poland is heavily indebted vis-à-vis Western banks, and is currently not in a financial position to regularly service its debt. By the beginning of 1990, it accepted a comprehensive stabilization program to obtain access to IMF credit. Central to the package was the devaluation of the Polish currency in order to gain internal convertibility: the exchange rate of the zloty is now close to the previous black market rate. Other elements of the program are fiscal and monetary discipline, supported by a tax-based incomes policy; trade liberalization, decontrol of prices and reduction of consumer subsidies; strengthening the private sector and establishing a social safety net (*IMF,* 1990). Immediate results of the program have been a reduction in the

budget deficit and in the inflation rate[8]), although at the expense of real production and incomes losses (in the first quarter of 1990: -35 percent). The short-term outlook for the Polish economy is quite bleak, as the process of restructuring will for some years be accompanied by severe income losses. An encouraging medium-term aspect in Poland certainly is that a deeply rooted democratic movement is likely to carry on the reform process regardless of setbacks.

Among the more advanced Eastern countries, *Hungary* has for many years experimented with introducing market elements into its economy. Therefore, Western entrepreneurs find quite experienced partners there, meet a well-trained labour force and a decentralized banking system. The private sector currently contributes already some 15 percent to GDP, another 15 percent may come from the private "black economy" (*Friedländer,* 1990). The most severe drawback from a macroeconomic point of view is the heavy debt burden which now is about to paralyse the restructuring process. *Among all Eastern countries, net debt per capita in hard currencies is highest in Hungary.* Above all, Hungary suffers from an imminent liquidity problem: much of the debt is short-term and creditor banks increasingly become reluctant to prolong their engagements. Hungary desparately needs further official money (most likely from the BIS and the IMF) to preserve its chance of successfully completing the reform process. An *IMF stabilization program* has already been implemented which aims at eliminating the deficit on current account. Part of the balance-of-payments problem stems from liberalizing the foreign exchange regime, including free travelling abroad. However, Hungary seems to be already through the worst part of the adjustment process. Since it also maintains an adequate institutional framework for Western direct investment, it may approach the silver lining earlier than most of the other countries.

In contrast to Hungary, *Romania* has not even established an accepted new political system yet. Politicians have so far been reluctant to abolish the old system of central planning. A devaluation of the currency in February 1990 combined with terminating the two-tier

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[8]) In December 1989, the year-on-year inflation rate amounted to some 640 percent. In the first four months of 1990, monthly inflation was at 88 percent, 24 percent, 5 percent, and 6 percent, respectively (*IMF,* 1990, *Laski,* 1990).

exchange rate system was aimed at stimulating exports and curbing black market dealings (*Barisitz,* 1990). The standard of living is extremely low, partly because of excessive debt repayments in the past. Currently, Romania is not a net debtor of Western countries, and that is of course a promising starting base for an economic take-off in the future.

In *Bulgaria* the debt problem has surfaced lately, as the country in April 1990 announced to discontinue its scheduled debt repayments[9]). Production is concentrated on agricultural products on the one hand and machinery on the other, whereas the share of semifinished products, such as textiles, clothing and metals, is low. Penetration of Western markets is minimal, and stagnant, while imports from the West were increasing before import cuts were enforced in 1989. The resulting shortage in raw materials and investment goods entailed a decline in the net material product at constant prices of about half a percent (instead of a planned increase by 6.2 percent; *Grosser,* 1990). Similar to neighboring Romania, the country is still struggling with its political reform, and no final concept has yet been designed for the overdue economic reform.

As mentioned above, the reform process in the *USSR* seems to be of a different nature compared with those in the previous "satellite countries". Reforms have been initiated from the top of the political and social hierarchy – and it is still an open question whether the population will support the process during a transitional period of significant real income losses. The authorities are leaning towards a gradual approach: after stabilizing the economy by help of the central planning system, market elements would be introduced only in a second step; recently, this approach has been challenged by more radical views. The strength of the Soviet economy lies in its enormous raw material base (crude oil, gold), its comparatively low indebtedness and its scientific potential. Although there seems no imminent debt problem, net debt has increased rapidly and has recently worsened the Soviet Union's credit standing in international financial markets[10]).

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[9]) Interest due is still payed.

[10]) Between September and November 1989, the spread over Libor for dollar-denominated USSR notes rose from 25 to 88 basis points (*Stankovsky,* 1990A).

Yugoslavia has long played a special role in the political and economic setting between East and West. Like Hungary, Yugoslavia long ago opted for permitting certain market elements within the central-planning system, and it has gathered experience with self-governing entities. This experiment of a third way between a central-planning system and a market economy has largely failed. At the end of 1989, the Yugoslav parliament passed a package of reforms with the goal of establishing a full-fledged market system. However, some of the measures are still controversial, and the whole program may run into trouble as the ethnic and social tensions are mounting.

Summing up, one should probably not be too optimistic as to the success of the adjustment process in Eastern Europe. Even if from now on real GDP in East Europe were to grow by 9 percent p. a., average income would only have reached by the turn of the millenium the current average of the EC. *Kramer* (1990) estimates the capital needs for restructuring to be some US-$ 15,000 billion at 1988 prices. If only half of that is considered a realistic amount to be supplied, and only one-fourth of that half is seen to come from Western countries[11]), investments in Eastern Europe of some $ 100 to 150 billion per annum would be required over one to two decades. Such flows can only be expected if capital gains for the investor were likely and transfers of profits were not limited. The EC Commission estimates that only the initiation of the reform processes would require some $ 20 billion to be raised on the international financial markets up to 1992.

As regards the dynamics of the adjustment process, there seems no way to escape real income and production cuts during the immediate future of several years. Thereafter, according to estimates of the EC Commission, real growth may approach rates of 5 to 6 percent p. a. Similarly, inflation will generally surge as a consequence of phasing out subsidies. Exceptions may be those countries that are currently fighting hyperinflation by means of an IMF stabilization program.

[11]) The rest supplied within Eastern countries themselves.

Much of the final result will depend 1. on the speed of reform, 2. on the extent of official Western assistence[12]), and 3. on the investment strategies of Western companies which should take into consideration a rather distant break-even point. The speed of adjustment will substantially differ from country to country. Given the current experience of the GDR, *a more radical approach seems promising if supported by the creation of a social net.*

5. Closing Remarks: Will the Economic Gap Between Eastern and Western Europe Ever Be Bridged?

Before closing, a few remarks are addressed to the *position of Austria* as an intermediator between East and West. Austria has always been a "Western" country with a market-oriented economy[13]). This is documented by Austria's membership in EFTA and its recent application for EC membership.

An evident indicator of Austria's very active bridging position are *joint-venture* activities: Inspite of the smallness of our country, companies from Austria hold the top positions, as measured by the number of projects, in Hungary (200 out of 900 projects) and the CSFR (16 out of 55), second position in Poland (34 out of 500), and they are fourth in the USSR (*Stankovsky,* 1990B). The share of Austria's exports to the East in total exports (9.0 percent in 1989) is significantly higher than for OECD Europe on average (2.8 percent).

On the other hand, Austria has always suffered from its "dead border" vis-à-vis East block countries. That border has now been revived and Vienna has suddenly moved from a geographic outlier to a potential economic center within Europe[14]). Because of close historical links – on ethnic, political and economic grounds – Vienna is well equipped to serve as an

[12]) The EC Commission is coordinating a program of assistence to reform-prone East Europe of 24 Western countries. Assistence has already been extended to Poland and Hungary.

[13]) Though with a rather high share of nationalized industries.

[14]) Politically, Austria has always attempted to avoid the position of an outsider.

Table 8

Joint Ventures in Eastern Countries (1989)[1]

Country[2]	*Total number of joint ventures in East Europe*	*Austrian joint ventures in East Europe*
USSR	1,100	70
Poland	500	34
Romania	5	0
GDR	0	0
CSFR	55	16
Hungary	900	200
Bulgaria	40	10
Total	**2,600**	**330**

Source: *Stankovsky* (1990B)

1) Estimated numbers of authorized projects.
2) Ordering according to size of population.

intermediator for interests in both directions. As a recent example, Austria has granted to Hungary (1988) and Poland (1990) the advantages of the GATT Generalized System of Preferences, a step followed suit by the EC. Investment projects of Austrian and third-country companies in Eastern Europe can well be serviced from Austria, *Austrian know-how* is particularly intense in small company business, services (trade, tourism, financial services, consulting) and environmental technology (*Stankovsky,* 1990B).

What I have termed "Eastern Europe" in my remarks may soon become an economic gravity center called *"Central Europe"*. Although at the outset of Eastern reforms the standard of living is generally very low, *there is much hope that in, say, 10 years from now the former East block countries will have succeeded to compete in international markets; they will also have evolved to be new markets for other contries themselves. This should eventually terminate Europe's political and economic dichotomy.*

Such hope is footed on the traditional *cultural links* of Eastern countries with Western thinking. Some areas of the social and educational *infrastructure* are also well developed. E. g., the number of scientists and engineers per 1,000 population in the GDR, Bulgaria and the CSFR exceeds the figure for West Germany. The literacy rate of 98 percent on average slightly exceeds that of the EC. However, large parts of the economic and managerial infrastructure are obsolete and need to be replaced through heavy investments during the coming years. It would be wishful thinking to suggest that such investments could be undertaken solely by way of private enterprises. Much government money is to flow into infrastructure projects. Only upon this basis can private Western enterprises be expected to invest in plant and equipment.

Most of Western "help" will come in form of financial assistance. However, technical assistance and some debt relief would be needed more than direct financial flows. Among other cooperative gestures, trade liberalization and technology transfers (e. g., ending the COCOM restrictions) would urgently be needed. The final success of the economic reform movements could be jeopardized by political problems, in particular by rising *nationalism,* which might

turn out as a major threat to democratic reforms and improvements in the economic situation. As a *normative conclusion* of my remarks, *the Western community can and should contribute substantially to secure the success of the reforms and to mitigate the negative social effects of economic measures.*

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