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EAST CENTRAL EUROPEAN ECONOMIC TRANSITION AND THE WEST

Tamás Réti

I. Introduction

It has now been several years since the first countries of Central and Eastern Europe (CEE) embarked on their transition to market economies. This transformation has proved to be an unprecedented task and a special challenge since there has been no clear and detailed map to guide the way. This paper shows the most general macroeconomic problems of the four successfully reforming countries — the Czech Republic, Hungary, Poland, and Slovenia — and the economic situation of war-devastated Yugoslavia. It then focuses on the changes in foreign economic relations and presents the relationship with the most important trading partner, the European Community (EC).

In 1995, the state of the CEE economies remains diversified. Market reforms and stabilization efforts have proceeded at various speeds, achieving varying degrees of success. Population support for rapid market reforms has gradually dwindled, and the social costs of the transition are likely to gain importance in policy decisions. The role of geographical position, that is, the distance from developed market economies, plays a decisive function and reflects the continuity of some old traditions.

II. Stabilization and Liberalization Measures

At the onset of the transition, these economies had to face some major tasks, namely, (a) going through a process of macroeconomic stabilization, both external and domestic; (b) implementing economic liberalization measures; and (c) introducing major

institutional changes (e.g., the decrease of state involvement in the economy, beginning with property changes, and the emergence of a new private sector). All these measures have corresponded to the so-called Washington consensus, to the recipe suggested by the G-7 countries, and, above all, to the Washington-based international monetary organizations — the International Monetary Fund (IMF) and the World Bank.

The legacy of the Soviet-style economic system was devastating, producing both hidden and open inflation, monetary overhang, excess demand, fiscal deficit, a situation of acute shortage, and a foreign debt crisis created by inefficient and internationally noncompetitive, backward economies. By 1989, it became clear that the socialist experiment had failed; the communist elite was demoralized, and at least a part of this elite determined that it was in its own economic interest not to oppose the radical change to capitalism and democracy.[1]

After holding the first free parliamentary elections, new governments had to select appropriate reform strategies for their nations' conditions. They had to choose a proper pace of stabilization and liberalization measures, that is, between a gradualist/evolutionary approach and shock therapy/big bang.[2]

As a result of these changes, a "shortage economy" has been transformed into a "demand-constrained economy" — a major achievement. A common outcome of both the gradualist or the shock therapy approach was a huge decrease in output in each country between 1989 and 1993. The recession that followed has been compared to the Great Depression of the 1930s in the United States — only worse. The reasons for this recession were multifold. Perhaps the most important was the collapse of COMECON trade, resulting in a switch to dollar-trade and the end of bilateral state trading. In addition, an important factor in the decline was the squeeze on real wages and credit supply, which negatively affected both consumer demand and the business climate. Excessive reductions in aggregate demands and the absence of government assistance to state firms led to a decline in output. In the framework of monetary stabilization, a tight monetary policy reduced government expenditures, and a restraint on wages had a direct negative impact on the level of production. Other reasons for the decline were a reduction in military expenditures and in specific "Soviet-type" areas of

investment. Both of these reductions meant that decline was inevitable.[3]

On the positive side, the progress made in the transition process by the end of 1993 seemed to have put an end to the transitional recession. The economic recovery that began in Poland in 1992 spread to the Czech Republic, Hungary, and Slovenia.

A. Poland

Poland was the first transitional economy to break out of a recession. The Polish shock therapy that resulted in hyperinflation introduced the zloty's internal convertibility, increased external credit-worthiness, and restored external balance. Although the father of the economic program — Leszek Balcerowicz, the Polish Minister of Finance — did not politically survive the first completely free parliamentary election in October 1991, the successive rightist and leftist governments did not make a break with the logic of his original program.[4]

Prior to 1990, increasing the use of hard currency to finance domestic transactions was restraining the government's ability to conduct its macroeconomic policy. The share of zloty-denominated money in the total money supply was only 41 percent in December 1989; this ratio increased to 75 percent by the end of 1991. Polish inflation continued its decline from the triple-digit rates recorded during 1989 and 1990 to 35 percent by 1993. The combination of moderate inflation and beginning recovery forced the Warsaw stock market into action; it recorded a boom in 1993. The boom was in connection with the fact that much of the capital inflow into Poland came as portfolio investments. The dynamic growth of the private sector has compensated for the fall in output resulting from the disappearance of loss-making enterprises in the state sector. The Suchocka government held a firm policy line against excessive wage demands and defended a budgetary stance in line with the IMF's recommendations. As a result of the tight monetary and fiscal policies, great social tensions developed. By autumn of 1994, social pressures and political dissatisfaction led to a shift from a middle-right to a leftist socialist-dominated coalition government.

In 1993 and 1994, the economy produced an impressive growth fueled by a strong export performance and increasing domestic demand, consumption and investment. The role of imports has been considerable in supporting domestic recovery, leading to a strong imbalance in foreign trade. However, the Consumer Price Index appears to be under control, although it was still very high (32 percent in 1994) compared to other transition economies. The central government budget deficit is low; in 1994, it was equal to 2.8 percent of the Gross Domestic Product (GDP).

Despite this good result, the government budget is suffering from structural deficiencies. Financing the growing public debt is a heavy burden. Unemployment remains high—16 percent at the end of 1994—and there are strong regional variations in the unemployment rate. Crisis-struck counties are located in the northeastern section of Poland, where the rate of unemployment nears 30 percent.[5]

It came as some relief that Poland has succeeded in coming to an agreement with its creditors. Debt was reduced to the Paris Club in April 1991 and to the London Club in March 1994. This means that approximately one-half of Poland's foreign debt was forgiven. The most important consequence of debt reduction is that Poland becomes once again a fully rehabilitated member of the international finance community, which, in turn, opens the way to new borrowing on easier terms. The London Club settlement improves its credit-worthiness as well as increasing investors' confidence. This is extremely important since (a) economic recovery requires new investment and (b) the trade balance is already stretched. However, as a result of this debt reduction, Polish payment obligations will increase over time, including both interest payments and amortization. An immediate impact has been a deterioration in the current account and an increased inflow of capital in the form of new credits. Debt reduction was strongly interrelated with the positive assessment of the IMF. Constraints in economic policy have been imposed by IMF conditionality.[6]

B. Hungary

In contrast with the Polish model, the Hungarian economy chose a gradualist program in 1990. The reason for this choice was the lower level of destabilization in Hungary than in Poland. In addition, there existed among the Hungarian economists a disbelief in any "great leap forward" and suspicions about shock therapy. Hungarian economic reforms have been taking place since 1968 without achieving a market economy, which has resulted in a so-called reform trap. Although Hungarian business leaders and other agents of the economy have had experience with a more open business-oriented system and economic liberalization since the 1980s, they rejected radical changes such as a sharp devaluation, a freeze on wage increases, and full liberalization of prices. Whether the Hungarian economy has been better suited to transition as a consequence of these limited but early reforms is doubtful.[7]

The limits of gradualist economic policy, given the loss of Soviet markets and debt service payments, made austerity measures necessary. Declining agricultural subsidies, rapidly growing import competition, and long-lasting uncertainty in ownership changes have been the primary factors behind the heavy decline in output. Despite governmental intentions for a slow and peaceful transition without dramatic hardships, as foreign demand collapsed, domestic demand had to be severely cut. The outcome of this coincidence in 1991 was the biggest drop in the GDP (11.9 percent) in Hungarian history. However, there were some signs of improvement during the following year. Inflation slowed to 23 percent (as projected), the population savings ratio increased to 14 or 15 percent of household incomes, the current account reported a surplus, and the decline in output slowed down.

In order to accelerate positive changes, the government attempted to initiate a forced recovery; consequently, the monetary policy was artificially loosened and the fiscal deficit went out of control. By 1993, output decline continued, although it was already marginal. As a result of the growing fiscal deficit, tensions with the IMF finally suspended the disbursement of the next tranche due under the three-year credit agreement.

One structural problem was connected to the very low level of capital investments, which resulted in a 22-percent real drop in investments between 1990 and 1993. The reason for investment shrinkage can be found in the limited and very expensive credit resources available from state-owned commercial banks who still control much of the banking.[8]

The second difficulty occurred in the external sector. Current dollar exports declined by 17 percent in 1993 while imports grew by 13 percent. A $3.5 billion deficit in the current account emerged not as a sign of an impending economic upturn, but rather as a consequence of export decline. The current account deficit affected the country's credit rating negatively and increased borrowing costs of new credits.

A third structural problem was the privatization of state assets. The Hungarian model of privatization has been fairly similar to the Polish one. In both countries, there has been a mix of centralized and decentralized privatization that gives preference to sale for a real money cost in contrast to asset distribution at no cost. By early 1994, the fourth consecutive year of ownership changes, only 30 percent of the originally state-owned property had been privatized, another 20 percent had disappeared through liquidation, an additional 30 percent would have yet to face privatization, and 20 percent remained in long-term state ownership. Thus, 50 percent of the economy was state-owned and only 30 percent privatized. However, privatized firms and the genuine private sector produced more than half of the GDP and employed 40 percent of the labor force.

By 1994, economic recovery in Hungary was stronger than had been expected. According to preliminary official figures, growth remained at about 2 percent. Also, there was a strong increase in industrial output, exports, and investments. However, the size of external and internal imbalances was higher than had been thought, and the country, as in 1993, consumed about 9 percent more than it produced, thereby increasing its foreign indebtedness. These trends are obviously unsustainable. Under pressure from the International Monetary Fund and the World Bank—who, in September 1994, expressed concern about the country's economic performance, particularly the budget deficit and the level of public spending — the new socialist-lib-

eral government was forced to adopt a harsh austerity program in March of 1995.

The IMF insisted that the country slim down its generous system of social welfare provision, specifically, the child care system, early retirement schemes, unemployment benefits for those who do not finish school, and health care expenses. All of these actions were included in the austerity package elaborated on by the new minister of finance in early March of 1995. So far in 1995, the government and the IMF have failed to reach an agreement on a new standby loan. The government has to address simultaneously the deficit on the current account and the fiscal deficit.[9]

A worrisome trend is that unemployment has continued on a downward course while inflation has risen. The rate of unemployment was 10.6 percent at the end of 1994. Acceleration of restructuring, originating from tightened macroeconomic conditions, is likely to push up the unemployment rate in 1995. Year-on-year inflation slowed down to 19 percent in 1994. As a result of strong devaluation, the introduction of an import tax, and various central price adjustment measures, inflation began to accelerate and may surpass 30 percent in 1995.

C. The Czech Republic

So far, the stability-oriented macroeconomic policy seems to be staying on track in the Czech Republic. On January 1, 1991, the Czechoslovak government launched a major set of reforms that consisted of liberalizing some prices, sharply devaluing the koruna and linking it to Western currencies, introducing a 20-percent import surcharge, and controlling the growth of wages. These radical measures were introduced in the context of a proclaimed restrictive monetary and fiscal policy. They were supplemented by a strong push to speed up the privatization process, attract foreign capital, promote the growth of newly emerging private firms, decrease government subsidies to firms, and, generally, reduce the role of the state in the economy. By applying restrictive macroeconomic policy, the Czechoslovak government succeeded in rapidly extinguishing the inflationary pressure brought about by the sudden liberalization of prices.

The ability to eliminate inflation and bring about some price stability for the next few years was impressive.

From 1991 to 1994, the monetary authorities pursued the goal of maintaining a stable exchange rate that was strongly undervalued in relation to its purchasing power parity. On the negative side, the Czechoslovak economy plunged into a much more severe recession than was originally expected. In undertaking tough measures, the government greatly benefited from the willingness of the population to undergo a painful transition.

The dissolution of the Czechoslovak federation had repercussions on both the Czech Republic and Slovakia, similar to the dissolution of the COMECON trade links. The establishing of border controls, the introduction of separate currencies, and the segmentation of capital markets had a negative effect on trade. The negative consequences were also evident in a decline of output, employment, and direct foreign investment.

The cornerstone of the Czech economic policy continues to be voucher privatization. During the first wave (completed in December 1992), almost 1,500 formerly state-owned firms were privatized; the second wave offered 846 companies to the public. While Poland and Hungary implemented government-managed and decentralized privatization schemes, in the Czech Republic mass-privatization enjoyed priority — currently, approximately 80 percent of the economy is at least partially privatized compared to approximately 30 percent of the Hungarian economy. The state retains majority stakes through the National Property Fund in energy, steel, and telecommunications.

While Czech privatization has been broad, there are some questions regarding its depth. About two-thirds of Czechs participating in the mass privatization entrusted their vouchers to investment funds. The still (indirectly) state-controlled commercial banks manage newly privatized enterprises through their ownership of investment funds. In fact, the Czech architects of voucher privatization created banking ownership. The banks play the dual roles of lender and owner. The separation of their banking and fund management activities creates problems. It seems that the dominance of bank-managed investment funds might be a transitory phase in the privatization process.

Preliminary assessments of the first wave of voucher privatization show that the direct impact of ownership changes has

been rather small. However, management enjoys more independence from the state and works in a fairly stable environment. Funds set up by the big banks are extremely conservative about accepting direct responsibility for the running of privatized firms. Instead, many funds are involved in managing portfolios. Another part of the problem is that funds are limited to a maximum 20-percent share in any firm, which prevents them from gaining control of management.[10]

The Czech economy has several strong points, the most important of which are the balanced budget, a surplus in the current account of the balance of payments, and a constant exchange rate since 1990. A major advantage of the Czech economy is a low level of foreign debt, equal to the currency reserves of the banking sector. The unemployment rate has remained very low compared to other East European countries despite permanent reductions in employment. Finally, the inflation rate is nearing single digits.[11]

The low rate of registered unemployment is not an asset, rather it is a liability in the transformation. Skeptics argue that low unemployment forcefully maintains low wages via regulation and "allows" firms to continue the practice of overemployment. So far, bankruptcies have been few and limited primarily to small companies. But many argue that without changes at the micro level, it is impossible to sustain macroeconomic stability. It is also true that, prior to the political change in 1989, the private sector was almost nonexistent and the service sector underdeveloped. The new private industries and service sector have been able to absorb part of the labor force released by large industries. However, one has to expect future growth in the present unemployment rate if restructuring and modernization in newly privatized firms really begins.

The current Czech economic policy places a high priority on a balanced budget even when overall economic activity is low; however, there have been no radical measures to reduce the size of the central budget. On the other hand, strengthening the banking sector by taking over a portion of bad debts was also an issue of high importance. Various forms of assistance given to commercial banks have increased the public debt, which was equal to 18 percent of the GDP at the start of 1994. The debt-to-GDP ratio has remained constant, and its limited size is an addi-

tional important asset of the Czech transition. Monetary policy maintains credit restrictions as a means to battle inflation. The inflow of foreign currency, in the form of portfolio investments and loans to businesses, increases the quantity of money. It is unclear which shares have been sold outside the country, and it is also unknown whether the major vendors have been private individuals or investment funds.

One of the most difficult economic issues facing the Czech government is the bad financial situation of private companies. In 1990, commercial banks were burdened with a korona (Kc) 126 billion bad debt on loans to private companies. The government transferred about Kc 130 billion worth of non-performing debts from commercial banks to the state's Konsolidacni Banka at a discount. In 1993, the government started debt-clearing operations aimed at reducing the inter-enterprise debts estimated at approximately Kc 160 billion. In most of the cases, the reform was a shift from state subsidies to bank loans that are to be moved to the state-owned Konsolidacni Bank as bad debts. An outcome of this Czech paternalism in bank debt policy is the avoidance of both enterprise bankruptcies and the dismissal of employees. Managers also are unwilling to shed superfluous labor, but in return they expect wage restraint from the unions.

D. Slovenia

The most developed East European economy, Slovenia, gained its political independence from Yugoslavia in June 1991. It had to implement a currency reform in order to introduce its own monetary policy and to rid itself of the highly inflationary Yugoslav dinar. The Bank of Slovenia has used a flexible exchange rate, with the German mark as the main currency of reference. The introduction of a fixed exchange rate of the new national currency, the tolar, to the German mark was not feasible since the country had low foreign reserves and high inflation. The economy has suffered from sharp external shocks such as the loss of the former Yugoslav markets and the interruption of transport and infrastructural links. As a result of the Yugoslav war, sanctions by the United Nations also negatively affected its economy. In order to fight high inflation, a very restrictive mon-

etary policy has been employed, resulting in a shortage of tolars.[12]

The highly export-oriented economy has managed to make up for the loss of markets in the former Yugoslavia by shifting its trade to markets in the European Union (EU). Revival in Western Europe in 1994 revitalized its foreign trade performance. The share of exports and imports compared to the GDP exceeded 112 percent of the GDP in 1994—a clear indication of its openness. The combined effect of increased exports with a growth in tourism and other service revenues has led to a fast rise in foreign exchange reserves, which, in turn, created an upward pressure on the tolar. The buildup of foreign reserves was also achieved through privatization of publicly owned flats. In addition, it was an advantage that the country inherited a comfortable budgetary position. Cuts in transfers to the former federal authorities saved an important part of its traditional current budgetary expenditures.

The economy has been growing since the postindependence recession bottomed out in mid-1993. The economy showed dynamic growth throughout 1994; this will probably continue in 1995. The GDP rose from 1.3 percent in 1993 to 5 percent in 1994. The upswing in production was backed by increased domestic demand as well as the solid performance of investments and exports. Investments grew at a much more rapid pace than in the previous year: gross fixed capital investments in real terms rose from 15 percent in 1993 to 20 percent in 1994. The central government's budget remained balanced. Besides the moderately restrictive monetary policy, the real appreciation of the tolar continued to be an important instrument for driving back inflation. Although the pace of growth in the economy was faster than anticipated, consumer prices slowed down, so the annual rise in retail prices dropped from 32.3 percent in 1993 to 19.8 percent in 1994.

In spite of the tolar's real appreciation, there has been a fast growth in exports, which reached $6.8 billion, while imports came to $7.2 billion. Thanks to favorable developments in tourism and low foreign debt service obligation, Slovenia achieved a surplus in the current account at $478 million in 1994 from $150 million in 1993. Low foreign debt—Slovenia's being $2.3 billion at the end of 1994 — is another major asset in the

transformation process.[13] In 1995, the main goal of monetary policy will continue to be the lowering of inflation and the reduction of very high real interest rates. It is open to question whether Slovenia will be able to sustain export-led growth and implement some form of income restraint together with structural reforms.

Behind the surface picture of a strongly growing economy with financial stability lie substantial unresolved problems. A significant problem is the high level of government expenditure and taxation, which is approximately 49 percent of the GDP. These expenditures and taxes were the basis for major complaints by the business sector. The transformation of socially owned enterprises into private ones has difficulties. Privatization means, in most cases, a form of management or worker buyout. As a consequence, managers of private enterprises have been unable to resist demands for higher wages and are unwilling to invest. High wages, coupled with high government spending, lead to the decapitalization of firms, a loss of competitiveness in their exports, and a further squeeze on employment. In March 1995, negotiations were under way for the first national agreement between social partners (i.e., the government, employers, and employees) that aimed at serious wage restriction in order to decrease inflation and augment competitiveness.

E. Yugoslavia

The economic stabilization program in the small republics of the former Yugoslavia (i.e., Serbia and Montenegro) shows a contradictory picture of the Yugoslavian economy. Dragoslav Avramovich, the governor of the National Bank, instituted anti-inflationary methods. The Avramovich Program rested on two main cornerstones: (a) linking the dinar convertibility to the German mark and (b) the Yugoslav National bank regulation attaching the issue of primary money to foreign currency and gold backing.

These measures resulted in the liquidation of hyperinflation, an end to shortages of goods, increases in the previously low levels of production, and an increased confidence in the national currency on the part of the general population as well as companies putting their stocks on the market. Of the methods used to

counter hyperinflation, it is important to mention that the Yugoslav National Bank operates as a currency board. The primary issue of money has to be completely covered by the central bank's foreign currency and gold reserves. The new "superdinar" was set up to be convertible on the current account transactions with an exchange rate pegged at a ratio of 1:1 against the deutsche mark. An important part of the program is to end the creation of money in order to cover the budget deficit. These positive trends have not lasted, and since the second half of 1994, financial stabilization has been in danger.[14]

According to official data, the "social product" (an alternative barometer of the GNP) in 1994 grew by 6.5 percent, following the 27.7 percent decline sustained in the previous year. The social product in 1994 reached 52 percent of its 1990 level. Industrial output in 1994 rose by 1.3 percent, amounting to 42 percent of the 1990 production level. Within industry, the smallest drop in output came from energy suppliers. In contrast, iron metallurgy slumped to 18 percent of its earlier level, manufacturing of transportation vehicles to 16 percent, and the machine-building industry to 21 percent. On the other hand, the very low output level in the rubber, shipping, textile, construction materials, and electrical machine industries showed a sharp growth beginning in 1994.

Official Yugoslav government statistics contradict the government's own statements on inflation. According to official statistics, consumer prices did not rise after the introduction of the anti-inflation program on January 24, 1994. However, by February, price increases were very high, and in the fourth quarter of 1994, new price rises took place. Deflation lasted from March until August, and the monthly pace of price reductions remained between 0 and 1 percent. Central price regulations came into force in several important areas, such as public services, pharmaceuticals, products with high import content, and excise products. Centrally regulated wage policy is applied to state-owned companies, and the partial payment in kind — introduced during the period of hyperinflation — has been discontinued. However, price increases have continued — in October they grew by 1.4 percent, in November by 7 percent, and in December by 2 percent. The latter did not include the 71.6-percent rise in domestic electricity prices for households. By the

first quarter of 1995, retail prices grew by 16.9 percent compared to December 1994. The above-mentioned figures contradict the government's statement that from March to December 1994, there was zero inflation. The officially published growth in social product also becomes questionable, as figures were, indeed, based on zero inflation.

The average wage level is still abominably low, although net annual earnings during 1994 increased rapidly, rising to 283 dinars in December. However, since the increase in retail prices was even lower, the real earnings of the population started to expand. In addition, workers receive some of their food at their workplace through trade unions. This is an important benefit since prices there are cheaper than in the marketplace. Nevertheless, many people have been forced to sell their foreign currency savings.

By 1994, the government was forced to give up both basic principles of the Avramovich Program — the convertible link between the dinar and the German mark and the link between the issue of money to foreign currency and gold backing. However, after reaching price stabilization by the spring of 1994, the government attempted to promote an upswing in the economy. In order to revive production, it increased credit lending with the Yugoslav National Bank's relaxed credit policy. Earnings began to rise since a significant part of the credits were used for salaries that had fallen behind. Following the revival in domestic demand, money supply was also increased, but the central bank's foreign exchange reserves could not keep pace with this increase. Growth in production and inflow of large quantities of smuggled goods extended demand in foreign currencies. On the free market, the German mark exchange rate had already risen to 1.2 dinars in June 1994, growing to 1.7 to 1.8 dinars by the end of the year. Devaluation has continued; in February 1995, the mark was (unofficially) worth 2 dinars. The internal convertibility of the dinar was discontinued from the middle of 1994, and the government stopped speaking about foreign currency banking of the dinar. As a result of the rapid growth in production costs, the price of basic consumer goods increased, although salaries slowed down. The result was an explosion of social tensions in the form of strikes. The government attempted to mod-

erate this strained situation by printing money. All these factors put financial stabilization at risk by the end of 1994.

A modification of the Avramovich Program was announced in December 1994, a main element of which was a restriction of monetary and fiscal policies. Under this policy, in the first quarter of 1995, the government froze salaries and pensions at their November 1994 level and held credit expansion and money supply to December 1994 levels. Moreover, they reduced the Federation and Republic budgetary expenditures by 15 to 25 percent. In order to slow down the rise in prices, the government called upon producers to return to the prices of the summer of 1994. In the modified Avramovich Program, the stabilization of the dinar and maintenance of its convertibility were no longer mentioned. The amount of freely exchangeable dinars was restricted to 100, but even this limited sum was not available in the banks.

Restrictive measures resulted in a 17-percent decline in the dinar during the first two months of 1995 compared to December 1994, while consumer prices went up by 12.4 percent in January and 1.9 percent in February. The government's attempts to restore price levels were not successful. Tight monetary policy has led to a serious lack of working capital that has affected almost every branch of the economy. Contrary to the general restrictions in budgetary expenditures, no cuts are expected in armament industries. In the interest of limiting imports, the government implemented dramatic import tax increases from 8 to 41.5 percent. There are no official data available regarding the performance of foreign trade or foreign currency reserves in the banking sector since publication of public data ceased in April of 1993, the same time the harsh international embargo measures were put into effect.

The use of nonmarket, state-distributive methods signified that a growing part of the economy has been managed by the state bureaucracy. The Milosevich leadership has been trying to make the population believe that sanctions are soon to be lifted. The new dinar stabilization package, which was initiated in January 1994, was based on low levels of production and standard of living. However, it became clear that the stabilization of the dinar and the functioning of the central bank as a currency board were incompatible with both the widespread black market and the need for growth and restoration in the economy.

Without foreign financial support and with the current international blockade, the revival of the Yugoslav economy from the bottom up cannot be successful. Economic revival also depends on whether or not it will be possible to release the Yugoslav international currency reserves currently frozen in foreign banks. The country remains a constant source of instability in Eastern Europe.[15]

III. Opening up to the West

Important to the transformation process has been an opening up to the West. The prospects for macroeconomic stabilizations are largely dependent on trade relations, foreign debt servicing, direct foreign investments, and the influx of new loans from the West. There is widespread agreement that the success of this transition rests on the ability of these former communist countries to become full-fledged participants in the world economy. Therefore, economic relations with the Western industrial countries have become a matter of great importance. Because of the collapse in the former COMECON trade in 1990, CEE countries suffered a deep recession. Western trade became a major source for economic growth. Simultaneously, the liberalization of trade put pressure on domestic enterprises by way of foreign competition.[16]

Although all countries in the Organization for Economic Cooperation and Development (OECD) have introduced trade liberalization programs since 1989, the steps taken by the European Community have been the most comprehensive. Prior to the political changes of 1989, Central and Eastern Europe had faced considerable trade barriers. Their exports were subject to quantitative restrictions. In addition, they could not benefit from the General System of Preferences (GSP), which were one-sided preferences for commodities granted to less-developed countries by the highly developed market economies. In 1989, CEE foreign trade with the European Community (EC) was between 20 and 35 percent. As a result of the political systemic changes that occurred from 1988 to 1990 in Central and Eastern Europe, their most important Western partner, the European Community, reacted quickly. The EC immediately began promoting political and economic reforms in the CEE countries. As a result,

trade and cooperation agreements have been established between the EC and Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the former USSR. In the framework of these agreements, the European Community provided its partners with the General System of Preferences, which meant eliminating a number of quantitative restrictions and reducing barriers with regard to so-called sensitive goods, such as textiles and steel products. In the case of agriculture, EC trade concessions were rather limited. The major problem with the GSP was that the EC could revoke them at any time it desired.

The next more developed step of the relationship between the European Community and the individual countries has been the conclusion of the Association Agreements. The agreements, which also contain sections on political dialogue and institutional provisions, aim at the establishment of a free trade area by the end of a ten-year transition period. At the end of 1994, after the splitting of Czechoslovakia, the six reforming countries — Bulgaria, Czechia, Hungary, Poland, Romania, and Slovakia — have Association Agreements with the EC. On the EC side, the Agreements consolidate all the previous trade concessions, while laying the groundwork for the complete removal of all trade obstacles (except agriculture). The European Community has attempted to eliminate quotas and phase out import tariffs in a shorter time than the Central and East European countries are required to reciprocate these concessions. The CEE countries are not obliged to reciprocate on a cut-for-cut basis. The above commitments of the EC do not apply to the so-called sensitive sectors that play an important role in CEE exports.[17]

An assessment of trade flows suggests that the EC market is offering a substantial export outlet for the CEE countries. It has been valuable because it coincided with the collapse of the Soviet markets. A fast change in the reorientation of trade from the former COMECON markets has altered the regional composition of trade radically between 1989 and 1994. As a result, approximately 40 to 70 percent of CEE foreign trade occurred with the European Community. This shift has been greatly affected by the unification of Germany, which now includes the former East German trade. The expansion of trade with the EC has, in part, been a genuine success. The six countries' market share in the EC external imports from abroad rose dramatically;

however, it still remained comparatively low. In 1994, only 5 percent of total EC imports originated from those states that enjoy partnership agreements. For example, Sweden, which has a population of less than 9 million, exports about as much to the EC as the six CEE countries, which have a combined population of approximately 90 million. On the other hand, the small countries have achieved some competitive gains, meaning that CEE exports to the European Community grew faster than non-EC competitors. The combined market share of the so-called Visegrad countries (the Czech Republic, Hungary, Poland, and Slovakia) in certain industries or products, such as cement, clay, wooden products, and metal products, is extremely high (52 percent, 37 percent, 26 percent, and 24 percent, respectively). All of these statistics show that, with the exception of a few products, CEE export is marginal, and, in addition, it is rather sensitive to the general economic climate in the West. If a recession occurs, it will have a very negative impact even on this marginal CEE export performance.[18]

The export structure of all CEE countries is fairly similar, although there are some important differences. For instance, the share of agriculture and food is higher in the Hungarian and Polish export, and the ratio of iron and steel is bigger in the Czech export. Despite the Association Agreements, which are, in principle, liberalizing the Western market faster than is required for CEE countries, there was a growing imbalance during the 1993–1994 period. Western exports to the East increased faster than the Eastern exports to the West, resulting in a deterioration in the CEE trade balance. A major role in the comparative advantage of CEE exports is low wage costs.[19]

Evaluating the initial results of the Association Agreements, there is some reason for disappointment on the part of the CEE countries. It now seems clear that the CEE countries had unrealistic expectations concerning the amount of assistance coming from the European Community. Furthermore, it appears that there is a loss of political momentum; specifically, the EC is not as interested in Eastern Europe as it was a few years ago. Eastern Europe no longer represents any political or economic danger to the West; therefore, postponement of membership in the European Union seems less risky. The protectionist features of

the European Community are a major problem for CEE countries.

Ivan Kocarnik, the Czech Minister of Finance, stated in an interview, "They [the European Union nations] advise us on liberalizing everything during the transformation process, and after we have done so, they implement protectionist measures against our exports."[20] According to another leading Czech economist, Vladimir Dlouhy, there is a need for economic reforms in Western Europe that would lead to both the "transfer of a certain part of production to more competitive conditions in Central Europe and [to] structural changes."[21] The official Polish position on concessions is also rather critical. They agree that the antidumping and safeguard clauses of the EU are wiping out the benefits from the concessions in tariffs and quotas. The Slovak government's position emphasizes the importance of the so-called nontariff protection prevailing in Western Europe. These nontariff barriers are employed mainly in the case of sensitive goods (e.g., textiles, clothing, iron and steel, foodstuffs, and agricultural products). This kind of Western protectionism has a very negative effect by visibly increasing deficits in the CEE trade balance. This means that the Western exports are increasing faster than their CEE counterparts. Another part of that problem is connected to the weak protection of the CEE domestic markets. Some economies (e.g., the Hungarian, Polish, and Slovakian) have been giving a priority in their economic policies to anti-inflationary measures, which has led to an appreciation of their local currencies. This revaluation has been detrimental to export performance, but it constrained the inflationary growth and simultaneously pushed up Western imports.

On the side of the EU, there is a clear rejection of this CEE criticism. The European Community's apologists state that their import policies have been liberal, but the major problem is that CEE countries are simply uncompetitive. They argue that free trade is possible between the two regions as fast as the CEE countries can digest it. However, the EC must admit that there are special trade regulations in those areas in which Eastern Europe is more competitive.

This leads us to the question, "Why is there such soft support?" In answering this, one needs to note that the Association Agreements may be aimed at unifying the European Union

trade policy more than at opening its markets. Eastern Europe has a small share in EU foreign trade, and its economies are rather limited in size. The weakness of European Union support can be explained by the small size and uncertainty of CEE markets. It is also important to mention that, as a consequence of the collapse of communism, the East went from a political position of applying pressure to the EU to that of an applicant. It is true that CEE countries are economically unfit to receive instant membership, but they need a timetable and a clear-cut set of requirements or concrete economic performance criteria for the preparation of accession. The so-called Maastricht criteria — which include the elimination of subsidies, budgetary discipline, monetary stabilization, and low inflation — cannot fairly be applied to CEE economies since they are too demanding even for most of the current EU members. The Copenhagen Summit of June 1993 was a real step forward in the relationship as it officially acknowledged that the partners are future members. The Essen Summit held in December 1994 resulted in a decision to prepare a White Paper by the summer of 1995 that would provide some details on the process of joining. When we evaluate the result of the present Association Agreements, it is important to note that internal domestic problems are also obstructing the faster export expansion of the East. The frequent underutilization of export quotas are a result of low CEE nonprice competitiveness, which means poor marketing and low product quality.

The enlargement of the EU raises the question of bringing in the most advanced CEE countries (e.g., the Czech Republic, Slovenia, Poland, and Hungary) as a group or, more likely, in a one-by-one accession. The real per capita income is well below the EU average in all CEE economies with the exception of Slovenia. Since development occurs at different speeds, political consideration may influence the EU to let in the more successful and wealthy reformers. Still, the basic problem is the high cost of subsidization, which is a serious drain on structural, cohesion, and common agricultural policy funds. Certainly, full EU membership is not an issue for every Eastern state, nor is fast membership likely for even a few. However, all the efforts carried out thus far seem to be necessary in order to promote the future integration of the most advanced countries into the European Union.

IV. Conclusion

Economic growth has taken a firm hold in the most reform-oriented Eastern countries. The recovery is fueled mainly by export expansion, although domestic sources of growth — strong advancement in the private sector and acceleration of personal consumption — have been equally important. The significant slow down of inflation emerged regionwide; however, price increases seem to be resistant in those countries where currency devaluations, immense budgetary spending, increases in domestic tax rates, and increased energy prices are contributing to an upward pressure on prices. Because of these factors, current inflation rates are well above those in Western Europe. Prospects for sustainable growth depend on a solution to such structural problems as high unemployment, a fragile fiscal balance, weak asset portfolios of commercial banks, and the poor financial situation of state firms. Despite the economic upturn, levels of employment continue to fall; expansion in private sector employment cannot fully compensate for jobs lost in the state sector. Inflow of direct foreign investment is still lower than expected and is likely to remain so. A further tightening of financial policies in some countries is unavoidable. Reforms in public spending and restructuring health care and pension systems, as well as the limitation of other premature social achievements, are of great concern to each government.

The principle lessons of the transition are not yet final. It seems that the best results have been achieved when there has been an unquestioned commitment by policymakers to the adjustment programs, including a general support from the population as well. In contrast to fast achievements in the areas of stabilization and liberalization, structural reforms have proceeded more slowly. Privatization, enterprise reforms, and fiscal and financial sector reforms are the tasks most difficult to implement. Popular support for comprehensive reforms is essential. The transition from central planning to the market has been more difficult and more time-consuming than many democratic governments anticipated. The dilemma is how to speed up economic recovery while maintaining political stability; clearly, these are interconnected and self-strengthening processes. How-

ever, if this is accomplished, Eastern Europe has a good chance of integrating itself into the developed market economies.[22]

Notes

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