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EAST-CENTRAL EUROPEAN ECONOMIES IN TRANSITION

STUDY PAPERS

SUBMITTED TO THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NOVEMBER 1994

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LETTER OF TRANSMITTAL

NOVEMBER 28, 1994

To the Members of the Joint Economic Committee:

I am hereby transmitting for use by the Joint Economic Committee, Congress, and the public a study assessing the economies of East-Central Europe, *East Central European Economies in Transition*. It contains papers prepared at the committee's request by a number of government and private experts.

This study is one of the most important studies in the long history of the committee's economic assessments of countries of the former Soviet bloc. This timely publication provides a basis for review of U.S. policy toward the region. The countries of East-Central Europe have made great strides, but still face considerable obstacles in transforming themselves into democracies and market economies under a rule of law. Western states and international economic institutions have provided a measure of support, and deserve some credit for the success that has been achieved, but it seems clear that assistance programs warrant examination to improve their effectiveness in East-Central Europe and their applicability to other regions.

We are indebted once again to the Congressional Research Service of the Library of Congress for making available John P. Hardt, Senior Specialist in Post-Soviet Economics, assisted by Phillip J. Kaiser, a consultant at CRS. As indicated in Daniel Mulhollan's transmittal to the committee, many others at CRS as well as other government agencies and private analysts contributed to this study and deserve praise. We appreciate the high quality of the submissions of the contributors from the United States, Western Europe, and East-Central Europe. Our previous volumes have not been able to draw on objective contributions from within the region. This is another first.

Richard Giragosian, Professional Staff Member of the Joint Economic Committee, coordinated this effort for the committee. Richard Kaufman, formerly General Counsel, made a sizable contribution in organizing the study. The views contained in the volume are those of the authors and not necessarily those of the Joint Economic Committee or its individual Members.

Sincerely,

KWEISI MFUME,
Chairman.

Hungary's solvency problem was made worse by a law passed in 1992 that required banks to carry greater stocks of capital, and the strict bankruptcy law passed that same year that made much of their debt unrecoverable. An agency similar to the Czechoslovak Consolidation Bank has been used to recapitalize the system, but the government has had to supply additional capital as well. New entrants into the banking system have been encouraged. There is, however, no strategy for corporate governance that will ensure that bank management will staunch the flow of bad debt. The balance sheets of the largest banks remain weak.

Both Kemme and Marrese praise the approach adopted by Poland, although it is too new for its effectiveness to be judged. Banks were permitted to participate in a restructuring program that included the provision of capital for banks that met certain criteria. Among these was the establishment of a department to administer bad loans and submission of a plan for restructuring those loans. These plans can include restructuring enterprises or forcing them into bankruptcy and can involve banks in corporate governance. This makes them an external monitor for the firms, but they may be ill-suited for the task. The Polish approach has managed to recapitalize seven of the nine largest banks and has made it possible for them to shrink their bad-debt portfolio.

DEFENSE CONVERSION

The misallocation of resources in the communist era included enormous expenditures for defense, particularly in Czechoslovakia and Poland, which were among the 10 largest arms exporters in the world. The defense industries of the other countries in the region were minor. The structure of the defense industries in all these countries reflected an allocation of resources determined neither by the market nor by their national interest, but by the needs of the Warsaw Pact. After the communist regimes fell, as Thomas Szayna points out, the demand for arms collapsed as foreign markets disappeared and new defense policies reduced domestic demand for weapons produced in the region. Defense budgets shrank; so did the defense industries in the region.

Differences between the arms industries in Slovakia and the Czech lands made the former more dependent on arms production and contributed to the dissolution of the federal republic. The Czechoslovak government tried to promote defense conversion by providing funds as incentives for enterprises to shift to civilian production. But the effort failed as managers chose to use the funds merely to stave off restructuring or, if they tried to convert, showed too little understanding of a market system and simply tried to substitute civilian goods for military, ignoring such crucial factors as marketability, efficiency, and consumer demand. New policies adopted in 1992—to provide conversion funds only to plants that completely stopped production of arms and removal of the ban on arms exports—seemed to encourage arms production instead.

Most defense enterprises in the region have escaped bankruptcy only through state subsidies. The differing approaches of these countries to defense conversion—unlike Czechoslovakia, Poland chose not to promote it—have had little effect. Many resources stand idle, and true conversion will occur only when the region's economies grow and the market reallocates resources to civilian production.

The arms industries of the countries of East-Central Europe should recover in the next few years, although they are unlikely to grow to their previous size. Defense budgets have bottomed out, and the modification of current arms to make them compatible with NATO weapons should both increase demand for them and make the industries attractive to Western firms.

THE LEGACY OF COMMUNISM

By Bartlomiej Kaminski *

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SUMMARY

The legacy of communism is addressed by examining the disintegration of communism in Central European countries, the nature of economic development under central planning and dependence on the Soviet Union, and the extent to which the disintegration of Stalin's communism created the conditions facilitating the establishment of a viable market economy and democracy. The diversity in evolutionary paths under communism is briefly sketched and discussed from the point of view of inherited obstacles to a smooth transition.

Although communist countries followed similar paths of economic development and have faced in many respects similar problems on the eve of the transition, the institutional evolution from Stalin's model varied significantly among Central European communist countries. Yet, this diversity did not affect the political transition, as they all established unexpectedly quickly viable democratic institutions.

Measured by the extent of departure from the "original" system's economic design, the degree of marketization was the highest in Hungary and Poland, moderate in Bulgaria, and the lowest in Czechoslovakia and Romania. This clearly contributed to a fast pace of transition in the most reformed countries under com-

* Bartlomiej Kaminski is Director, Center for the Study of Post-Communist Societies, University of Maryland, College Park.

munism, but Czechoslovakia's adherence to orthodox planning did not prevent it from rapidly moving to a market economy.

The legacy of communism is addressed in this paper by taking a broad look at the evolution of communism, the nature of communist economic development, and the extent to which this evolution created the conditions facilitating or impeding the establishment of a viable market economy and democracy. The diversity in evolutionary paths under communism is briefly sketched and discussed from the point of view of inherited obstacles to a smooth transition. Although communist countries followed similar paths of economic development and have faced in many respects similar problems on the eve of the transition, the institutional evolution from Stalin's model varied significantly among Central European communist countries. This evolution is reviewed in terms of the impact various developments had on the strength of the state, the rule of law, the autonomy of economic actors (decentralization) and on rights of citizens (sphere of activities beyond the reach of the state, or civil society), and the extent of the private economy. The last section highlights challenges by contrasting the transition to communism with the transition from communism to capitalism.

INTRODUCTION

Every post-communist society is cursed with the legacy of a system that was fundamentally flawed. By linking its ideological legitimacy to rapid development of its industrial base and moving ahead of Western economies, communism conditioned its survival upon achieving this goal or, at least, assuring a rapid improvement in standard of living. By destroying boundaries that set apart economy and polity in modern societies, it assigned to the party-state *direct* responsibility to provide goods and services, generate economic growth and innovation, and to secure efficiency in the use of resources that would guarantee its long-term viability. Short of transforming *homo sapiens* into *homo sovieticus*, the task was impossible to achieve in the environment devoid of institutional arrangements that would channel self-interested behavior into economically beneficial performance. The institutional foundations of communism created a paradox: the only way to improve its performance in economic or political terms was to adopt "alien" institutions or to assign a greater role to those inherited from the precommunist past. In consequence, the evolution of communism consisted in converging toward capitalism—the very system that communism rejected. This was not by design, but of necessity, to reverse deteriorating economic performance and contain domestic discontent.

Communism collapsed under the weight of accumulated economic inefficiencies—its institutional framework did not prevent its demise, and various attempts at reforming it merely contributed to the acceleration of crisis-generating tendencies. Its crisis, as measured by deteriorating economic performance and falling position in the international economic pecking order, began well before its collapse. Its collapse amounted to the rejection of the "party-state" and central planning as mechanisms to coerce, coordinate, and stimulate economic activity. Thus, the most relevant legacy for post-communist countries concerns the absence of market-support-

LETTER OF SUBMITTAL

THE LIBRARY OF CONGRESS,
CONGRESSIONAL RESEARCH SERVICE,
Washington, DC, November 7, 1994.

Honorable KWEISI MFUME
Chairman, Joint Economic Committee
Congress of the United States
Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to submit to you a collection of papers on the situation in East-Central Europe, entitled *The East-Central European Economies in Transition.* The study was directed by John P. Hardt, Senior Specialist in Post-Soviet Economics of the Congressional Research Service, with the assistance of Richard F Kaufman, former General Counsel of the Joint Economic Committee. Many CRS and other Library of Congress personnel, as well as Government and private specialists contributed significantly to the project. In particular, I would like to note that Phillip J. Kaiser coordinated the publication with editing and production assistance from Karen Wirt, Mary Maddox, and John Bartoli.

We trust that the analyses and information contained in this study will be of value to the Joint Economic Committee, as well as the Congress in general, and to the broad audience of students of that region of the world. The views expressed are those of the authors, and not necessarily those of CRS or the Library of Congress.

Sincerely,

DANIEL P. MULHOLLAN,
Director.

CONTENTS

INTRODUCTION: EAST-CENTRAL EUROPEAN ECONOMIES IN TRANSITION

By John P. Hardt and Richard F Kaufman *

The East-Central European states are all undergoing transformation from communism to capitalism. Whether the end results will be liberal democratic governments and free market economies remains to be seen. The available evidence indicates that at this stage of the transitions substantial progress has been made and that the medium-term prospects are good. Although the transformation process is incomplete, the papers in this volume provide the basis for making judgments about what has been accomplished so far and the obstacles that remain.

While the region-wide recession that began prior to the collapse of communism has not yet ended, there are many encouraging signs. Poland, the Czech Republic, Hungary, and Slovakia are leading the region with positive reforms and economic improvements. Largely as a consequence of the removal of price controls and barriers to the entry of new businesses, market forces are giving direction to the economy and private markets have expanded greatly. Overall economic output has been growing in Poland, and to a lesser degree in Romania, and several other countries appear poised to begin their recoveries.

MEASURES OF SUCCESS: A MIXED RECORD

Serious problems remain and any overall assessment depends on the measuring rods of successes and failures. There have been sharp declines in industrial production and increases in unemployment in most countries. High unemployment and inflation rates have been accompanied by a decline in living standards. The growth of private markets and entrepreneurial activity has coincided with greater disparities of income. The expectations that many had for better times have not been fulfilled, and an *expectation gap* hampers efforts to sustain reforms and political stability.

At the same time, analyses of the transition, such as the one done for this volume by Keith Crane, show that much of the costs of change have been offset by benefits not always reflected in the statistics commonly used in public discussions. For example, Crane maintains that while there are many complaints about price increases of consumer goods, items that were in short supply are now more readily available and there is a closer fit between preferences and purchases. Similarly, the declines in industrial production

*John P. Hardt is Senior Specialist in Post-Soviet Economic, Congressional Research Service, Library of Congress. Richard F Kaufman, former General Counsel, Joint Economic Committee, U.S. Congress, is presently Director, Bethesda Research Institute.

have led to gains in welfare because of reductions in inefficient activities and in military expenditures.

Changes in the defense sector exemplify how difficult it is to measure progress during a transitional period. It is generally agreed that military spending by the Warsaw Pact countries diverted resources that could have been more efficiently used for economic purposes. In their efforts to reorder priorities, all East-Central European governments have sharply curtailed military spending. These are positive steps that should lead to more balanced economic development and sustainable growth. But in the short term, reduced military spending has contributed to reduced industrial production and the overall shrinking of the economies of the region.

It is also generally recognized that the widespread economic deterioration and breakdowns that had become endemic to the region are part of the legacy of communism. As Bartolomiej Kaminski points out in his paper, the communist system left the successor governments with misdeveloped and nonviable production capacities. Another author, Harvey Shapiro, writes that "The economic malaise found in Eastern Europe had its roots in decades of resource misallocation that resulted in shortages of consumer goods, decaying infrastructure, and environmental deterioration." Restoring the potential for wealth creation is necessarily a time-consuming process.

If the sharp decline during 1990–1992 can be equated with the Great Depression, the more recent record has been good. In addition to the modest growth noted above, there has been some progress in controlling inflation. Industrial restructuring and privatization are moving forward. David Kemme concludes in his study of privatization issues that remarkable progress has been made in Central Europe in the development of the legal and institutional framework for the transition to a market economy with private property. The consensus among economic experts is that conditions will continue to improve over the medium term, barring any major political problems.

The Politics of Economic Transformation

One of the special features of this volume is the examination of the political issues influencing economic transformation. It is self-evident now that those who expected the transformation process to be a relatively quick one were overly optimistic. Five years after the fall of the communist governments, the countries of the region are still struggling to re-define themselves, to develop appropriate strategies for reform, and to respond to public impatience with the pace of change.

There are important internal and external political factors influencing the region's economic transformation. In several countries, including Poland and Hungary, elections have returned former communist officials to power. Although there is much dissatisfaction with the costs of change, to date there is no indication that publics or government officials wish to block or reverse economic transformation. But given the persistence of high unemployment and inflation, and the potential for political instability, the final outcomes are still uncertain.

The existence of free elections underlines an important fact about the sequence of political and economic change. Valerie Bunce shows in her paper that the transformation of politics first and of economics second in East-Central Europe is the opposite of what happened in the development of capitalism and democracy in the West. Historically, authoritarian rule in western countries was gradually weakened by the rise of capitalism.

The liberalized politics of the region contributes to stresses on economic policies as various interest groups and factions struggle for survival and preferences. The weakness of political parties and the uncertainties that politicians face assure a high degree of sensitivity to public opinion. The continuing debate over "shock" therapy versus more gradual approaches to change is one of many controversies that could result in basic policy shifts.

WESTERN ASSISTANCE

External political factors are, if anything, more complex than the internal ones. Western assistance, trade, and investment are the new focal points of East-West relations, replacing the all-consuming security concerns of the cold war. Unlike the Marshall Plan era of 50 years ago, the United States is not the principal force in this postwar period. The largest share of aid and commercial transactions is from West Europe, which will also be the region's primary market for the foreseeable future.

Western economic assistance policies toward East-Central Europe, while well-intended and not without successes, have been a source of frustration, mixed signals, and disillusion for the recipient countries. According to Robert Hutchings, the West's approach to aid has been haphazard and the duplication of effort is proving to be unacceptably costly for the recipient governments. Both Hutchings and William Schuerch, another contributor to the volume, are critical of the lack of coordination among Western assistance donors. The Group of 24 (G–24) has not provided the strategic coordination that was envisioned and, according to Hutchings, the amount of aid being provided is inadequate. Schuerch is also critical of earlier assertions by U.S. officials that the transitions would require three to five years, after which aid programs could be ended.

In a major report prepared for this volume, Janine Wedel analyzes the U.S. aid program. After examining the political and social impacts, as well as the economic impacts, she finds that the program lacks a coherent, overall strategy and is being implemented in an inefficient manner. U.S. aid is seen by officials in the region as less responsive to local needs and less effective than European Union programs.

AN END TO THE DIVISION OF EUROPE?

Aside from issues related to foreign assistance, Central-East European external relations directly influence the transformation process. A number of authors comment on the strong desire of the Central-East European governments to reintegrate themselves with the West. John Danylyk writes that U.S. policy has aimed at the reintegration of these states into the economic and political structures of the West. The U.S. government has encouraged closer ties between them and West Europe through a variety of mechanisms in order to undo the division of Europe brought about by the cold war. These ties have been slow to develop in the area of economic relations.

Integration is proving to be especially intractable with respect to security relations. Paul Gallis, Julie Kim, and Francis Miko observe in their paper that the integration goal of the East-Central European states was underestimated in the West. They note with some irony that unity has not yet emerged in Europe despite the fact that the military threat that caused its division has disappeared, or so it would seem. The Warsaw Treaty Organization was dissolved three years ago and all former Soviet troops have been removed from the region. But requests by the Central-East Europeans for membership in NATO and the European Union have been rejected, for the present.

Russia represents perhaps the most intractable difficulty. The Central and East Europeans are encouraged by the economic and political reforms in the former Soviet Union, but there is a residual fear of their eastern neighbor that causes them to oppose closer relations between NATO and Russia. At the same time, the West is reluctant to take steps that would signal to Russia that new security arrangements with East-Central Europe are directed against Moscow.

It is apparent that solving the problems that would end the post-cold war division of Europe will not be easy. Many observers believe further delays in resolving the issues that continue to divide East and West could have a negative effect on the transformation process. In view of the passage of time since the collapse of communism in East-Central Europe, one of the questions raised in the volume is whether solutions will be worked out while the momentum still exists for the kind of change the West would like to see.

Past and Present Assessments of East-Central Europe

This volume reflects a significant change in the economic assessments of East-Central Europe provided to Congress over the past 25 years by the Joint Economic Committee and the Congressional Research Service. The change in the approach to the task is consistent with the change in circumstances. Prior efforts were part of the round-robin cycle of cold war economic assessments of the communist world that began in the 1950s when the Joint Economic Committee and the Congressional Research Service initiated the studies of the Soviet economy that came to be known as the "Green Books." Studies of China were added to the series in 1966.

Four years later, in 1970, the first of the studies of Eastern Europe was published in the Green Book series. Subsequently, studies of Eastern Europe were published in 1974, 1977, 1981, 1985–86, and 1989. The 1989 study, entitled *Pressures for Reform in East European Economies*, preceded by one month the fall of the Berlin Wall.[1] The present volume, *East-Central European Economies in*

[1] The titles of the earlier studies are as follows: *Economic Developments in Countries of Eastern Europe* (1970); *Reorientation and Communist Relations of the Economies of Eastern Europe* (1974); *Eastern European Economies Post Helsinki* (1977); *East European Economic Assessment*,

Transition, is the first assessment of the region in the Green Book series since the revolutions in the East-Central European countries.

The reasons for monitoring the economies of East-Central Europe are different now that the cold war is over, and there are better methods available for understanding economic conditions. Although security issues are still relevant, they no longer dominate thinking in the way they did during the cold war. East-Central European policies and the purported results are no longer dictated from Moscow. U.S. intelligence estimates can be viewed in the context of evidence from open sources. Measures of consumer satisfaction and other indicators have replaced measures of military preparedness and threats to Western interests.

Notwithstanding the limitations of official statistics, which do not adequately report private market activities, they are more meaningful today than they were in the past. There is a new transparency to economic activity as a result of the extensive involvement in the region of the multilateral lending institutions and Western business. Scholars and researchers have reasonable access to government officials, business people, and information.

The present assessment was initiated by a formal request from Rep. David R. Obey, then Chairman of the Joint Economic Committee, to the Congressional Research Service requesting its assistance. Some of the papers for the volume were discussed in May 1994 at a conference held at the Woodrow Wilson Center for International Scholars, in Washington, D.C. The conference was co-sponsored by the Joint Economic Committee, the Congressional Research Service, and the Wilson Center. A compilation of statistical material prepared for the conference is included in the volume.

Testimony prepared by the Central Intelligence Agency for the Joint Economic Committee, entitled "Eastern Europe: Reforms Spur Recovery," was presented at a hearing July 15, 1994. It may be viewed as an official U.S. Government assessment against which the analyses in the volume may be compared. This testimony is available from the committee and will be available in the forthcoming hearing report.

Parts 1 and 2 (1981); *East European Economies: Slow Growth in the 1980s*, Parts 1,2 and 3 (1985 and 1986); and *Pressures for Reform in East European Economies*, Parts 1 and 2 (1989).

I. THE TRANSITION TO MARKET ECONOMIES AND POLITICAL PLURALISM

OVERVIEW

By James Voorhees *

In 1989 the countries of East-Central Europe cast aside their communist regimes and began an economic and political transition that in its breadth had no precedent. Countries in Europe, Latin America, and elsewhere had faced many of their problems before, but only one, two, or a few at a time. No country had been confronted with the full array of choices that stood before it. The countries of the region were constrained by the quality of the institutional and human resources left by the communist system (and the pre-communist history of their countries) and by the very process of transformation itself, which threatened to impose costs of inflation, unemployment, and insecurity that were sometimes hard to bear. The authors in this section address the legacy of the old system, strategies used to effect the transformation to a new one, and the costs and benefits of the changes under way in the countries of East-Central Europe.

THE LEGACY OF THE PAST

Communism, in Bartlomiej Kaminski's view, destroyed most of the institutional and organizational diversity of the countries of Central and Eastern Europe. It replaced it with the monopoly of power accorded to the communist party and an economic and political system characterized by the rejection of the market, democracy, and the rule of law. The post-communist governments were left with the difficult task of reconstructing that diversity. They have also had to overcome the most important legacies of the communist era: the absence of the institutions needed to support a market economy and the misallocation of resources stemming from the needs and impulses of central planners rather than the demands of markets.

The inefficiency of a system in which producers faced neither competition nor market-clearing prices was costly. It helped prove the communist economic system unsustainable. Moreover, the planners found that their ability to develop and implement sound plans was limited increasingly by the complexity of the information they required and by the inability of their economy to deliver the material abundance the communist ideology promised.

*James Voorhees is a Consultant with the Congressional Research Service, Library of Congress.

Trade within the Council for Mutual Economic Assistance (CMEA) grew more slowly than trade with the West, a trend that was exacerbated by the falling production of nonrenewable natural resources—including oil—within the Soviet Union. Yet the countries of Central Europe became increasingly marginal in OECD markets and were able to improve their competitive position only in the production of low value-added, resource-intensive goods.

Efforts to reform the communist system were intended to reduce the harm stemming from the absence of the institutions of a capitalist democracy. Countries in the region took essentially three steps before the collapse of communism, though not all reached the second and third steps. First, they modified the mechanism for planning, usually by changing the number and responsibilities of branch industries. Second, they replaced physical commands with financial incentives. Third, some countries created a limited-market environment through such reforms as liberalizing a significant proportion of prices, ending the state's monopoly on foreign trade, and opening parts of the economy to private business. In Hungary and Poland these reforms reached the limit beyond which no improvement in either economic efficiency or governability could be achieved without destroying communism.

The collapse of the communist political order in most of the region was distinguished by an absence of revolutionary movements and the rapid replacement of old political institutions with democratic ones. Moreover, there was a consensus that the communist economies had become inefficient. The new democratic institutions have proved to be remarkably resilient in most of these countries, in part owing to the facade of democratic institutions maintained during the communist era. That resilience may, paradoxically, be another legacy of the communist era.

Other legacies of communism have complicated the work of making the transition to a market economy. An overblown social welfare system forms a large part of the sizable public expenditures in these countries, expenditures that cannot be sustained without either fueling inflation or imposing taxes that would curtail development of private firms and economic growth. The transition cannot be made without an effective state, but the post-communist state has been weakened by the communist system of public finance, which lacked incentives for fiscal responsibility and made everything subject to bargaining rather than to rules that could make public expenditures stable and predictable.

The Sequence and Costs of Reform

Valerie Bunce argues that whereas the West adopted economic reform first in the centuries-long transition to capitalist democracy, and then tried political reform, the countries of East Central Europe have done precisely the opposite. They have tried to liberalize the political system first, and then to transform the economic system and democratize simultaneously. But this sequence was unavoidable, she argues. Political liberalization had to come first, because the communist party's monopoly of political power had to be broken before its monopoly of economic power could be dismantled.

Professor Bunce divides post-communist regimes into three categories. The first category, which includes Poland, Hungary, and the Czech Republic, is characterized by a sharp break with communism, rapid progress toward both democratization and economic transformation, and fewer costs of mixing economic and political reform. The second category is typified by Romania and has the opposite characteristics: a break with communism that was less than complete, slow progress toward democratization and economic transformation, and high costs of mixing economic and political reform. The third category includes Slovakia, Bulgaria, Albania, and, perhaps, Russia. Its characteristics put it between the other two and thus far have resulted in government instability, periodic use of less than democratic procedures, and economic transformation that has been slow, but more rapid than that in Romania.

A comparison of the experience of the countries in the first category with those in the other two suggests that a key issue in the economic and political transformation of these countries is speed. The pace of economic reform correlates highly with pace of political reform. The pace of both economic and political reform depends on the victory or defeat of the communist party in the first competitive elections. A rapid transition will impose fewer costs than slower transitions. In sum, the prospects for creating a capitalist, liberal democracy will be greatest if the transition is rapid.

There are several reasons for this. One is obvious. All else being equal, a country that moves toward capitalism and democracy will get there faster than one that does not. Second, a sharp break from the political past puts into power forces that seek to end the communist system by engineering a transition to its opposite, a capitalist democracy. It also forces the losers (the communists) to change if they want to become competitive in politics. They can then provide needed representation for a part of the public and drain the authoritarian right of support.

A rapid transition imposes fewer costs because it helps solve the political problem of an unreconstructed communist party opposing economic reform. It also creates a political cushion that can shield the new regime from angry publics and anti-democratic politicians. Quick transitions also tend to show results. The faster the reform, the faster the number of people who benefit from it expands and provides support for reform. Moreover, reforms tend to make it difficult for interests opposing reform to coalesce. Lastly, a rapid transition disperses economic resources and creates a propertied class—two steps necessary for the development of democratic politics—more quickly than a slower one.

The costs of the transition in East-Central Europe are significant whether or not it is rapid, but Keith Crane argues, so are the benefits. Many of these benefits have gone to consumers, who have seen the end of most shortages of consumer goods and lower relative prices for clothing, fruits and vegetables, and other consumer goods. The share of household income spent on food has fallen. Other benefits have included increases in exports and greater opportunities to create businesses.

Crane's conclusions echo Bunce's. He finds that output fell least or recovered most quickly in Albania, Hungary, Poland, and Slovenia, the countries that pursued economic transformation rapidly and consistently. But inflation was highest and output fell most sharply in Romania and, more generally, in countries where transformation was pursued more slowly or alternatives to it were sought. In sum, he concludes, the economic transformation of the region is laying a solid basis for sustained growth.

But gross domestic product has fallen in every country in the region. Personal consumption fell in every country except Poland and Slovenia. Unemployment rates have risen to double digits. Inflation soared after prices were liberalized. Privatization has increased efficiency in these economies, but it has also increased corruption.

Many of these costs seem to be temporary, however, and may be necessary results of efforts to correct the misallocation of resources and create the institutions of a market economy. GDP has ceased to shrink throughout the region and signs of growth can be seen in all countries except Bulgaria. Labor markets have come to resemble those of market economies, with similar costs and benefits, and unemployment rates have stabilized. The reallocated industrial labor force is increasing its productivity and wage rates are beginning to rise. Inflation rates in Albania, Hungary, Poland, and Slovenia have fallen from their peak; it remains lowest in the Czech Republic. The increase of exports from the region to the West has been a surprise.

The economic costs of the transition have not reduced the political support for it. Both electorates and parties continue to support it, and no major political party in the region seeks to turn back the clock and reimpose the communist economic system. To Crane, this more than anything else suggests that to the people of Eastern Europe, trying to create a new economic system is cheaper than trying to maintain the old.

Yet the costs of the transition have not been imposed equally in the societies of East-Central Europe. Sharon Wolchik suggests that women in the region have faced many of the same costs and benefits that men have, but in some ways it has made them worse off. They may look on the transition somewhat less favorably.

The gaps between men and women in employment, wages, and political power have narrowed little if at all since the collapse of the communist system. The transition has reduced women's employment almost everywhere but Hungary. Once they become unemployed, women find it harder to get jobs, are more likely to be among the long-term unemployed, and are more likely to stop actively seeking jobs. Because of the continuing differences in wages, women's unemployment benefits are generally lower than those of men.

Traditional attitudes toward women are more clearly expressed now that the ideological commitment of communist regimes to equality has gone the way of the regimes themselves. Women face increasingly open discrimination. For example, job notices frequently differentiate by gender. Women also face limitations imposed by protective legislation. Benefits related to maternity and child care in effect raise the costs of hiring women and make it less likely that firms will do so.

Women continue to have the primary responsibility for children and the household. This has made them less willing or able to increase their qualifications or to put in the time on the job needed to advance in market-oriented enterprises. Moreover, under communism, women were able to use work time to take care of errands and other household duties. Market-oriented firms have less tolerance for absences. As long as women bear greater responsibility for the household, this is likely to reduce their role in the labor force.

They will also feel many of the disruptions of the transition more keenly and immediately than men. Changes such as lower social benefits, the elimination of many factory-subsidized or government-operated child care facilities, and the increase in prices of consumer goods affect women more strongly than men. It is not surprising, therefore, that surveys have shown women to be more concerned about the costs of the transition. Many feel they were better off under the old system. They have, therefore, tended more than men to support parties of the left whose support of democracy may seem doubtful, but whose support of the government's role in providing material security (and of the right to abortion) is not.

PRIVATIZATION AND STRUCTURAL REFORM

According to Stilpon Nestor and Scott Thomas, the achievements of the countries of East-Central Europe in privatizing their economies are unprecedented: no country outside the region has ever privatized as much of its economy as quickly. To accomplish this they had to overcome the absence of the institutions needed for privatization and political inertia stemming from the dependency on the state engendered by the communist system. Had they adopted traditional means, the pace would have been too slow. Had they not tried experimental means, internal privatization would have given the workers and management of state-owned enterprises corporate control at low cost but with few incentives to meet the goals of increasing efficiency or reducing transfers from the state.

Hungary chose a form of privatization that came closest to the traditional. The State Property Agency was formed to regulate and make transparent the internal privatization that was already occurring. Domestic and foreign investors were encouraged to make bids on enterprises and to negotiate directly with the enterprises, rather than the central government. The approach was successful, but too slow by the standards being set in the region. Hungary then adopted a more experimental approach that emphasized speed.

Czechoslovakia and later the Czech Republic privatized largely by transferring ownership to citizens using vouchers that could be invested in enterprises through investment funds. The Polish approach for large enterprises, which has yet to be implemented, is similar, but it includes numerous safeguards against citizens exercising ownership rights directly. However, much of the privatization of large enterprises in Poland has allowed employees and management to acquire ownership.

Once the ownership of an enterprise is transferred from the state, according to Nestor and Thomas, operational restructuring can begin. David Kemme poses a host of new questions that need to be addressed, many of which have to do with corporate governance and the relationships among owners (shareholders), managers, and stakeholders (people who have a nonownership interest in the firm, such as employees and managers).

The Czech Republic, Slovakia, Poland, and Hungary all found ways to provide managers and employees with the opportunity to become shareholders in the newly privatized firms. The responsibility for reconciling stakeholder interests now rests less with the governments of East-Central Europe than with individual private firms.

Firms in market economies have adopted numerous structures of corporate governance, some aspects of which are internal to the firm, such as boards of directors or auditing systems, and some aspects of which lie outside the firm. The latter include the discipline of the markets for products, factors of production, and capital. Privatization and the lowering of trade barriers increasing competition and expanding the private sector, make the discipline of the product and factor markets effective as a means of measuring the performance of management.

To Kemme, however, the capital market is the definitive external monitor: when the interests of owners and the behavior of management diverge, the value of the firm falls and investors can contest control of the firm by threatening to take over the firm and replace its management. This market is as yet too imperfectly developed to serve as a means of external monitoring in the region, and shareholder rights are too ill-defined and ill-tested to make it possible to contest corporate control adequately. Moreover, the thinness of the market for managerial talent means that bad management cannot always be replaced.

Market discipline also requires effective bankruptcy procedures. Poland, the Czech Republic, and Slovakia have been reluctant to establish such procedures because of the potential political cost of bankrupting large enterprises. Hungary, on the other hand, has adopted and enforced stiff bankruptcy laws that have themselves served as important means of both privatization and restructuring.

Kemme also asks what can be done to ensure the financial viability of the enterprise. The easy conditions placed on loans at the beginning of the transition in all the countries of the region produced a stock of loans made to enterprises that cannot be repaid to banks that are already undercapitalized. This has made the stake banks have in enterprises large enough to threaten the solvency of the banking sector. That solvency is also threatened by the flow of dubious loans that banks continue to make.

In his examination of the debt problems faced by banks in the region, Michael Marrese sees no alternative to an expensive, long-term, government-led solution. The governments of these countries were at first reluctant to reach the same conclusion. Now, however, they are all trying to create stable, sound banking systems. As with privatization, each has its own approach to the problem.

Czechoslovakia created the Consolidated Bank to take over much of the debt of the new state-owned commercial banks and provided the banking system with new capital. New banking regulations were adopted that allowed banks to build their reserve funds. Privatization has enlarged the banking sector in both the Czech Republic and Slovakia. The large commercial banks in both countries have also been privatized, and the resulting change in corporate control is intended to help solve the problem of the continuing flow of bad loans. But as Kemme notes, this problem has yet to be solved. Banks in these countries also lack sufficient capital.

ing institutions and the presence of misdeveloped productive capacities.

On the eve of the collapse of their political regimes, all communist countries still had distinctive institutional features setting them apart from other socioeconomic systems. The most important was that their underlying structure was not market- but state-oriented with property rights poorly defined. No matter how reformed the economic system, its core institutions were predicated upon supporting central planning and the bureaucratic mechanism of economic coordination. Their economies were not based on a free interplay of supply and demand, that is, market clearing prices and competition among autonomous actors. They were supply-constrained or shortage economies, to borrow an apt term from Janos Kornai, which in turn shaped patterns of resource allocation driven by "system-specific" criteria. Their productive structures were characterized by overblown and distorted productive capacities in relation to market economies at similar levels of GDP per capita (Winiecki, 1988); small service sectors with nonexistent financial intermediation services; excessively energy-intensive production capacities; an overabundance of machine-producing sectors; technologically obsolete production capacities; and poorly developed export sectors.

STALIN'S MODEL AND ITS SLOW DISINTEGRATION

Despite similarities in the initial institutional design of communism forcefully implemented by Joseph Stalin in the Soviet Union and Eastern Europe,[1] subsequent developments varied across the "socialist camp." In consequence, the initial conditions of the post-communist transformation were different, displaying various proclivities to respond to measures prescribed in transformation-cum-stabilization programs and varying political readiness to accept reforms. This section briefly reviews the outcomes of the evolution under communism in terms of conditions relevant to the transition to a market-based democracy.

The evolution of communism can be grasped in terms of movement away from its initial institutional design, also referred to as a classic model (Kornai, 1992) or pure communism (Kaminski and Soltan, 1989). The defining characteristic of communism, setting it apart from other politico-economic systems, is the unique symbiosis of the state with society and the economy, which I have called elsewhere the fusion principle (Kaminski, 1991). As a result, both politics and economics lose their distinctive features as autonomous and distinguishable spheres. Communism is a step backward in the societal evolution or rather a continuation of earlier political systems dominated by patrimonial bureaucracies and traditional hierarchies while simultaneously professing progress in its ideology and basing its legitimacy on modernization.

The "world" that Stalin had built was an "anti-world." Its institutional design was based on the rejection of three Western innovations: (1) the market as a mechanism of stimulating and coordinating economic activity; (2) democracy as a mode of governance to

[1] The pace and scope of communist takeover varied across Central Europe. The goal was the same: to establish a carbon copy of the system that Stalin built in the 1930s.

mediate between conflicting group and individual interests as well as assuring accountability of the rulers to the ruled; and (3) the rule of law (Rechstaat) subduing the discretional intervention by the state. These three features were underpinned by ". . . an aspiration to total control by a political center backed by an extensive and active repressive apparatus, and a central role of Marxist-Leninist ideology" (Kaminski and Soltan, 1989, p. 373). The simultaneous rejection of three major pillars of a modern society made it a logically coherent construct, as one feature supported the existence of another.[2] Moreover, they created an arrangement putting those in charge beyond political and economic accountability to society writ large, while simultaneously offering them seemingly unlimited powers.

Although the system that Stalin had imposed on Central-Eastern European countries destroyed the three Western social innovations, some institutions survived albeit operating in an alien environment. The elimination of "bourgeois democratic" institutions in Central European countries, however, was never complete even at the outset of the communist rule. To the contrary, for reasons that are irrelevant to this discussion, the facade of Western-style institutions was retained wherever this did not collide with the party-state's aspiration to total control. Communist countries had constitutions—usually very liberal ones incorporating observance of human rights and Montesquieu's separation of powers—although they had no constitutional order and the constitutions were not worth the paper they were printed on. They had parliaments that as a rule acted as a rubber stamp although during periods of upheavals they usually sought to assert some autonomy. They also had mass organizations which—although controlled by the party-state—retained some quasi-democratic procedures and elections (Kornai, 1992). While these were largely irrelevant from the point of political dynamics under communism, their very existence has turned to facilitate the political transition following the collapse of communism (see the heading "The Political Dimension" below).

The paradox of the evolution of communism was that changes (the so-called reforms) introduced were designed to reduce the negative impact of its defining characteristics, i.e., the absence of the rule of law, democracy and markets, on the party-state's capability to govern and generate economic growth. Yet, reform measures, even in the most-reform advanced countries of the region, fell short of generating real democracy and competitive economy. Political and economic reforms in Hungary and Poland in the 1980s reached the limits of what could be done without completely overhauling communism. They reached the point where they could improve neither economic efficiency nor governability without destroying the identity of communism. Market-oriented reforms could not work without markets, that is, price liberalization and competition, whereas political reforms had little meaning when citizens were denied the right to choose their government.

The evolution of communism was characterized by retrenchment from an aspiration to total control, varying by various domains of

[2] For instance, the rejection of the market eliminates the need for a legal framework assuring private property rights. It also introduces rationing based not on effective demand expressed in monetary terms but on administrative management of shortages.

public life and over time. This retrenchment did not follow any clear-cut blueprint and became chaotic in the years preceding the collapse of communism, especially in the former Soviet Union and to a lesser extent in Poland. But everywhere, the departure point of the transition was a crumbling communism, which was markedly different from its pure Stalinist version of the 1950s.

CHANGES IN THE ECONOMIC SYSTEM

The economic pillar of communism was central planning and state ownership. The invisible hand of the market was supplanted by the visible hand of the party-state apparatus. Rationing through markets and prices was largely replaced by administrative allocation, giving special privileges to those in charge of shortages management. The economy became fused with the party-state, and the latter displaced objective economic with subjective political criteria. While competition, profits, and fear of bankruptcy "compelled" firms in a market environment to seek ways of improving microeconomic efficiency, central planning required a strong centralized power to assure compliance of enterprises with norms and tasks detailed in plans. With the growth in information complexity of the economy and its inability to deliver material abundance promised in communist ideology, the capacity of central planners to develop "sound" plans and implement them became more and more limited.

The weaknesses of central planning based on detailed physical allocations became apparent very quickly, although initially in only one country, Poland, were they allowed to surface. In 1956, less than six years after a command economy had been introduced, the Polish official Economic Council argued forcefully in favor of a decentralized model. Similar diagnoses linking disappointing economic performance with the excessively centralized economic system circulated among economists and policy makers in other countries in the 1950s, but then critical opinions were suppressed there. However, beginning in the 1960s, "reforms"—although under different headings—would regularly occupy agendas of communist governments. Their blueprints were never fully implemented and traditional methods of central planning tended to re-emerge. Most countries participated in these cyclical exercises with reform blueprints displaying strong similarities, indicating shared deficiencies in the economic system.

Before the collapse of communist political regimes in 1989–90, changes in the economic system consisted in (1) modification of the administrative mechanism used for the purpose of planning; (2) replacing directive "physical" commands with financial instruments borrowed from the institutional menu of market economies; and (3) creating a limited market environment.[3] Each step represented a different stage in economic reforms, and not all communist countries reached the second or the last step. The administrative modifications usually comprising changes in the number of branch ministries and their responsibilities and in planning procedures dominated in the 1950s and 1960s. The replacement of physical directives by financial instruments within the hierarchical structure of central planning began in the late 1960s with Hungary's New Eco-

[3] For an extensive discussion, see Chapter II in Kaminski, 1991.

nomic Mechanism. Although step (2) implied the reduction in scope and detail of plans, this would not alter the principle of *direct* state intervention into coordinating economic activities. In other words, the economic system remained based on direct controls in contrast to the indirect controls characteristic of state interventionism in market economies.

Reform measures implemented did not result in the shift from a supply-constrained economy, characteristic of command planning, to a demand-constrained economy with market clearing prices. The state largely retained control over entry to various spheres of economic activity. There was little incentive to develop infrastructure for financial intermediation (Polanski, 1992). Some countries reformed their banking sectors by introducing two-tiered structures before the collapse of communism (Bulgaria and Hungary). This change was more in form than substance as the socialist monobank system remained firmly in place. State-owned enterprises (SOEs) continued to operate in a soft-budget environment.

During the last few years before the collapse of communism, the Hungarian and Polish authorities introduced changes effectively overhauling some important components of the central planning system (step 3) and indicating their willingness to move to a market economy. The changes were limited and included, among other modifications, liberalization of a significant proportion of prices, a *de facto* dismantling of state monopoly over foreign trade, introduction of a two-tiered banking system, and opening large sectors of the economy to private business.

Thus, in these two most-reformed countries there had been some movement toward "defusing" the economy from the state. The evolution of the domestic economic system resulted in an increase in autonomy of enterprises, the scope of officially sanctioned private economic activity, growing monetization of the economy, and the use of contracts. In consequence, the traditional, vertical pattern of interaction among state-owned enterprises had been extended to incorporate horizontal links. Concomitantly, this process was accompanied by the introduction of legislative frameworks increasingly recognizing private property rights and introducing some tools of market providence. However, they were used in a non-market environment devoid of competition and market-clearing prices. Hence, this movement was too slow and too narrow in scope to fill in institutional blanks that set central planning apart from a market economy.

While these developments fell short of introducing a full-fledged legislative framework facilitating private business activity or competitive markets, significant inroads had been made in some countries—most notably in Hungary and Poland in the 1980s. Other former communist countries paid only lip service to economic reform measures addressing property rights: the degree of centralization and perseverance of methods characteristic of a command economy (planned materials supply system firmly in place) was significantly higher than in Hungary and Poland.[4] However, on a less positive note, disintegration of central controls spawned a shadow

[4] For a comparative analysis in terms of degree of economic decentralization, see Fischer and Gelb (1991).

economy, lacking legality and allocating goods by patronage and coercion, and contributed to domestic (Poland) and external imbalances (Bulgaria, Hungary, and Poland).

Measured by the extent of departure from the "original" economic design, the degree of marketization of the administrative economic system was the highest in Hungary and Poland, moderate in Bulgaria, and low in Czechoslovakia and Romania. When measured by the extent and duration of public activities not directly controlled by the party-state, Poland stood highest and Romania lowest in 1989. Finally, when the pre-World War II level of development and the time length of the communist rule is taken into account, then Czechoslovakia would join Hungary and Poland as the best structurally endowed countries in institutional terms to cope with the challenge of transition.

THE LEGACY OF MISDEVELOPMENT UNDER COMMUNIST RULE

In addition to the institutional legacies of communism, there is a legacy of production and investment shaped by the allocation of resources responding to needs and impulses of central planners which were in some important aspects different from those generated by markets. The allocation differed from the one which would take place in a market economy, because the institutional features of central planning favored an inward-oriented development strategy focusing on producer goods industries and predicated upon access to cheap natural resources in the Soviet Union.[5] Because of the absence of competition and market clearing prices, effective demand neither constrained supply nor provided stimuli to improve microeconomic efficiency. The latter was responsible for the tendency in these economies to follow the path of extensive rather than intensive development. Because of shortages, central planners accorded preference to the production of raw materials and producer goods and treated exports only as a means to pay for indispensable imports. The administrative/bureaucratic mechanism largely insulated enterprises from international markets.

The full extent of "misdevelopment" can be observed directly only when central planning is replaced by markets—economic actors then become free to choose the product they want (i.e., they not only obtain autonomy but also become subject to a hard budget constraint). Before the collapse of communism, its extent could be gauged through the lenses of foreign trade performance in OECD markets and, indirectly, through comparing their economic growth performance with that of non-communist economies.

The centrally planned economies operated in two distinct environments with different sets of rewards and penalties as well as structures of demand; world markets and the CMEA (Council for Mutual Economic Assistance). Within the latter, transactions were radially patterned around the Soviet Union with Central European CMEA members shipping mainly manufactures in exchange for raw materials and energy from the Soviet Union.[6] This exchange

[5] For an extensive analysis of the relationship between central planning and development, see Kaminski (1991, pp. 78–113).

[6] For instance, the Central-European economies once obtained about 96 percent of their petroleum and nonferrous metals from the Soviet Union.

had two important consequences: first, it allowed them to pursue development strategies with complete disregard for their energy and raw material intensiveness; second, it facilitated and perpetuated wasteful practices of central planning in individual countries—marketing in the Soviet Union was not different from the sellers' domestic market conditions, and firms exporting to the Soviet Union were under no pressure, as they would be in a market economy, to produce more efficiently and to come up with technologically more sophisticated goods. Once their growth rates began to decline, because of accumulating economic inefficiencies, the shifts in trading patterns within the bloc were generally at the expense of trade between the smaller member states and intra-CMEA trade.

Since the 1960s intra-CMEA trade had tended to increase slower than trade with the West. The revalued trade figures, taking into account a substantial devaluation of the transferrable ruble relative to the U.S. dollar, suggest a long-term trend of declining shares of the CMEA in Central European total exports (Pohl and Sorsa, 1992). Nonetheless, in 1990, on the eve of the collapse of the CMEA, the CMEA absorbed 54 percent of Bulgaria's exports, 37 percent of Czechoslovakia's exports, 31 percent of Hungarian exports, 39 percent of Poland's exports, and 24 percent of Romania's exports. Moreover, because of the contracting Soviet output of many nonrenewable natural resources, including oil, beginning around 1988 (the result of neglected maintenance, insufficient capital investment, and excessive exploitation based on outdated technologies), this trend of falling intra-CMEA trade was bound to accelerate independently of political developments that terminated communist rule.

The foreign trade performance of Central European countries in OECD markets revealed some disturbing similarities, indicating a persistent structural economic crisis. First, the competitive position of these countries in Western markets declined significantly in the 1980s, despite the governments' efforts to reverse the declining tendency already present in the 1970s (Poznanski, 1986). Second, the 1980s witnessed a growing marginalization in OECD markets, manifest not only in falling shares in OECD imports but also in large annual fluctuations of exports because of their high vulnerability to swings in Western business cycles. Third, the region's position as a marginal supplier of low value-added resource-intensive products became increasingly apparent throughout the 1980s, reflecting the rapidly expanding technological gap between East and West. The region's competitive position improved only in low value-added, resource-intensive, production (Kaminski, 1993). Taking into account earlier proclaimed goals of catching up and surpassing highly developed Western economies, these were very disappointing developments.

The comparison of per capita incomes in Western and Eastern Europe in 1990 with the interwar period adds credence to the observation that central planning provides inappropriate incentives to economic growth and performance. While most North Western European economies have essentially caught up with the United States, Central European countries fell behind economies at similar levels of GDP per capita in 1938. In 1938 Bulgaria and Romania had per capita income comparable with that in Greece and Turkey; Czechoslovakia with that of Austria and Finland; Hungary and Poland with that of Italy, Spain, and Portugal. As can be seen from data in Table 1, the order changed significantly by 1990. Although one may argue that World Bank estimates of GDP in 1990 are too low (because of undervalued local currencies), per capita income in each Eastern European economy is undoubtedly lower than in their counterparts 50 years ago.

TABLE 1. Per Capita Income, 1938 and 1990, and Approximate Date When Employment in Manufacturing Exceeded Agricultural Employment for Selected Countries

Country	Per Capita GNP in 1990 U.S. dollars		Date Manufacturing Employment Exceeded Agricultural Employment
	1938[a]	1990	
Austria	1,800	19,200	1950
Czechoslovakia	1,800	3,100	1940
Finland	1,800	26,100	1950
Italy	1,300	16,800	1960
Hungary	1,100	2,800	1970
Poland	1,000	1,700	1970
Portugal	800	4,900	1980
Spain	900	10,900	1970
Bulgaria	700	2,200	1970
Greece	800	6,000	1990
Romania	700	1,600	1980
Turkey	600	1,600	1990

Sources: G. Pohl and P. Sorsa, *European Integration and Trade with the Developing World*, The World Bank, Washington D.C., 1992 and *OECD Historical Statistics* and *World Bank Development Reports*, various annual editions.

[a] The figures for 1938 have been adjusted to 1990 prices with the U.S. GDP deflator.

On the other hand, however, although communist Europe largely missed the information and electronics revolution of the 1970s and 1980s, its overall developmental gap vis-à-vis the West is much smaller than that of many developing countries with higher per capita incomes. Many less developed countries have yet to go through the second industrial revolution. Even though skipping some stages of industrial development may be desirable, these countries still have to accomplish a major shift in employment structure in favor of industrial employment. As can be seen from Table 1, Central-Eastern European economies have moved beyond the threshold of urbanization, as measured by the 50 percent share of employment in the agricultural sector. Therefore, they do not face the highly resource-intensive challenge typical of most developing countries implementing costly transitions from rural to urban employment, but they face a politically difficult task of scrapping some of their unneeded productive capacities.

The Political Dimension: Limited Impact of the Communist Past?

The political evolution has also been characterized by *weakening* of the characteristic features of Stalin's system. It can be described in terms of a gradual movement toward some modicum of *Rechstaat* (rule of law) combined with a weak aspiration to total control as well as a weak commitment to ideological principles. It should be noted that communism was born and evolved in different forms in various countries; it was born in the weakest form in Poland and never achieved its stronger manifestation. It had "strong" periods in other countries with considerable "liberalization" in the Hungarian version of *goulash* communism. Although in all countries some rights of free action and autonomy had been granted, they were rather limited and not based on established and rigid principles. The civil society—defined as a domain of political action outside the party-state's control—was not allowed to firmly take root, with the possible exception of Poland in the 1980s.[7]

Although the institutional design of communism was based on the rejection of the rule of law, the legal infrastructure was not immune to change reflecting decaying ideology and search for its substitute—the autonomous law. In contrast to bureaucratic law, which is a systematic instrument of authority, autonomous law—guaranteed by an independent system of law interpretation—is a means ". . . for controlling and limiting authority" (Kaminski and Soltan, 1989, p. 383). Kowalik (1987) has noted the increasing independence of courts after the 1956 Polish October and, more generally, that it was an important aspect of de-Stalinization. Some countries went beyond the stage of slogans and implemented significant institutional changes. While these changes did not meaningfully extend the scope of individual freedom, they had at least created a legal basis for activities carried out previously without a legal basis, thus limiting the scope for arbitrary action by the party-state. Needless to say, a communist state could not evolve toward "constitutionalism"—which implies governance by due process, by forms, and by technicalities in which the form or manner of an action is raised above its end (as opposed to Machiavellianism or Stalinism)—without losing its communist identity. This became possible only with the collapse of communist political regimes.

The pace in this unfinished (under communism) march toward the rule of law was uneven; it began only around 1988 in the former Soviet Union with the "rule of law" theme dominating Gorbachev's reforms and never took off in Ceaucescu's Romania. In Poland, the establishment of the Constitutional Tribunal to curtail the discretion of the Parliament in issuing and interpreting new laws and of the Sejm ombudsman to give citizens some protection against the power abuse represented a significant step toward development of a constitutional order.

Paradoxically, the pre-collapse of political developments had much less significant implications than anticipated for the mode of the communist regimes' breakdown—i.e., the way that communist elites ceded power and democratic reforms were implemented. In

[7] Poland clearly stood out among other former communist countries in terms of the extent to which all pillars of the original institutional design had been weakened or removed before the collapse of the communist political regime in 1989. It was the only country that experienced the revolution, although not in 1989, as many commentators argue, but in 1980–81. While the Solidarity upheaval was a socialist revolution, it had three consequences relevant to the political developments under communism. First, it put to rest all ideological claims of communist regimes. "Socialism" was dropped from the political vocabulary. Second, the disappearance of ideology accelerated the trend toward the rule of law (see above). Third, the regime had to reconcile with, though reluctantly, the existence of alternative political elites, if not an alternative society.

fact, there was surprisingly little variation in their collapse. The basic pillar of the communist political order—monopoly of power—was removed mainly as a result of the pact struck among elites. The exception was Romania where Ceaucescu was executed following an internal coup, and to some extent Czechoslovakia with its "velvet revolution." Hungary followed the Polish "road" of negotiating the pact founding a new political order—its pact was more radical, simply because it was negotiated in a completely different external environment after it had become apparent that Moscow would not resort to Brezhnev's doctrine to preserve communism in Central Europe.

Perhaps the most distinctive aspects of the breakdown of communist power were the conspicuous absence of revolutionary movements and the astounding pace at which democratic institutions replaced previous arrangements. Although one may have expected that countries where political structures had been frozen under communism would have experienced problems, this was not the case during the first stages of the transition.[8] By the end of 1990, all countries of the region had democratically elected governments in place. The system clearly collapsed under the weight of its economic inefficiencies. Full realization of the extent of these inefficiencies, both among the rulers and the ruled, set the mode of its peaceful breakdown.

Democratic consolidation can be gauged by the extent to which political parties are firmly established, viability of democratic institutions measured by smoothness of transfer of power to coalitions (or parties) winning in free elections, and—last but not least—the extent to which political institutions are beyond the direct reach of government. By these measures, political frameworks in many post-communist countries are yet to be tested, while those in the Visegràd group and Bulgaria have proved to be remarkably resilient. Successive post-communist cabinets have observed democratic rules and stayed on a reform course, despite gloomy predictions of Western mass media following each electoral success of former communist parties.

While the web of international agreements signed in the aftermath of the collapse of communist political regimes has been a strong deterrent against authoritarian temptation in Central Europe,[9] the remarkable pace in consolidation of democratic reforms was possible in part thanks to the existence of a quasi-democratic facade in communist countries. Although parliaments, elections, and non-communist parties were redundant under communist rule, they preserved knowledge of democratic procedures and rules. On the eve of the collapse, the infrastructure and knowledge about how to take advantage of new opportunities created by the demo-

[8] This was the case also of the Soviet Union, which disintegrated as a result of nationalist pressures emanating first from the Baltics and then spreading to other republics, including Yeltsin's challenge to Gorbachev's rule in the Russian Federation through 1991.

[9] Central Europeans are dependent on OECD economies in terms of market access and financial assistance. Access to resources of multinational organization has been either explicitly (e.g., European Bank for Reconstruction and Development) or implicitly linked to democratic reforms. The European Association Agreements, signed between the European Union (EU) and Central European countries (Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia), contain numerous clauses compelling East European "associates" to observe human rights in addition to harmonization of their economic regulatory framework in line with that in the EU.

cratic opening was largely in place, which facilitated the political transition.

INITIAL CONDITIONS AND THE TRANSITION TO MARKETS

The task facing post-communist societies of moving to a market-based democracy is riddled with many risks posed by unanticipated developments. These risks vary among post-communist societies, reflecting the attained level of institutional maturity, that is, the degree to which they had developed (quasi) democratic institutions, a (quasi) market-supporting institutional framework, and the level of economic development before the collapse of communism. Developments preceding the breakdown of communist political regimes—marking the beginning of the post-communist transition—have affected the pace of the transition to a market-based democracy.

The task of transforming the inherited economic system boils down to introducing the legal framework, assuring means to enforce it and building other institutions supporting competitive markets. This task is more complicated than the transition from capitalism to communism. A viable market-based economy is a much more complex system in institutional terms than that supporting central planning. The transition from capitalism involves destroying organizational and institutional diversity—always an easier job than creating it. Contrast, for instance, difficulties faced by post-communist countries in establishing capital markets with the ease with which commercial banks were destroyed by a stroke of the pen during the communist takeover of the economy in the late 1940s. In addition, communism suppressed individual freedoms whereas the transition to a market economy takes place in a democratic environment and under economic duress.

The communist pattern of forced growth has depleted developmental potential, so that post-communist governments are left with poorly developed and nonviable production capacities. The problem for post-communist countries is that of restoring the potential for wealth creation—a time-consuming process riddled with a potential for political instabilities—rather than that of wealth distribution as was the case in the period following communist takeovers. It calls for austerity and is unavoidably accompanied by unemployment. Moreover, in order to facilitate state direct management, large units were created no matter whether there were economies of scale. Taking into account that these units have large employment, their restructuring is taxing both politically and economically.

The communist blueprint promised not only full employment but also provision of an entire array of various public services including health care, housing, and education. The post-communist state inherited an overblown social welfare system. Public expenditures, which still account for around 50 percent of GDP in Central European economies, are not sustainable without budget deficits fueling inflation. Although the quality of these services has left much to be desired, termination or even limitation of social transfers would not be politically popular. The alternative to significant cuts in these expenditures is high tax burden imposed on firms and individuals, which hampers development of the private sector and economic growth.

The state, broadly conceived as including all branches of power, has a vital role to play in the process of dismantling central planning. In fact, the paradox of the transition is that the state becomes one of the major—if not the most important—agents of change. The state's project is fourfold: first, to reorganize so as to make it compatible with evolving requirements of the transformation process;[10] second, to construct a bureaucracy that is the key to its capacity to bring about change—provided that the constitutional design is in place; third, to liberate itself from the legacy of public ownership through privatization, as the only way to correct the "soft" budget constraint; and fourth, to supply legal order (including enforcement) supporting competitive markets. No other institution is in position to provide "collective goods" indispensable to implement market-building changes, tame the wasteful rent seeking of special interests, and enhance economic participation by shaping incentives, establishing the rules of social transactions that promote entrepreneurial energies, and encouraging more efficient ways of conducting economic activity.

However, the problem is that, in marked contrast to the communist transition when the state was strong, the post-communist state is weak and poor. This is due to the legacy of communist rule in public finance. The system of public finance was devoid of any incentives to promote fiscal responsibility and was purposefully murky under the administrative economic regime, although at its pure Stalinist version there was some semblance of centrally imposed Gulag-style discipline. Although the traditional system evolved into an unconstrained bargaining regime, money remained passive, that is, it did not suffice to have budget allocations; one had to gain favors of a monopolistic contractor. The belief that everything is subject to negotiations and obtaining access to resources depends only on the bargaining power is hard to eradicate unless new rules are quickly introduced and fully enforced. These old patterns cannot be eradicated at once, and thus the need for transition. In the meantime, however, demand for state expenditures—compounded by its excessive involvement in the provision of services—is accompanied by a fall in revenue because of contracting output, a distorted budget revenue structure based on SOEs, and a narrow tax base. While the post-communist states of Central Europe succeeded in maintaining their core functions and providing basic public goods, this was at the expense of inflation and relatively high taxation. Moreover, once democratic reforms are implemented the state faces constraints related to the necessity of consensus-building among competing political coalitions—a task especially difficult under conditions of extreme economic pressure.

Notwithstanding similarities in the initial conditions faced by Central European countries, there were significant macroeconomic differences due to the uneven pace of the evolution and circumstances immediately preceding the collapse of communism. The pace of disintegration of communism and the extent to which it was controlled by central authorities was different and so were their forms and initial macroeconomic conditions. The Czechoslovak

[10] The major issue to be solved is that decentralization of economic activity (transfer of property rights and development of the private sector) should be accompanied by decentralization of other spheres of public activity. For more detail, see Hicks and Kaminski (1993).

government—adhering to the highly orthodox model of central planning—retained its central control capacity until the communist party crumpled like an empty shell in November of 1989. It inherited neither a sizable external debt—as did Bulgaria, Hungary, and Poland—nor grave domestic imbalance—as did the Polish Solidarity government or the first Bulgarian post-communist government. As a result, Czechoslovakia inherited ". . . the most favorable initial internal and external balance" (Bruno, 1993, p. 23). So did Romania, which, like Czechoslovakia, had one of the most orthodox systems of central planning. Hungarian movement away from communism was controlled through gradual introduction of market- and democracy-oriented measures displaying a significant degree of continuity in development before and after the collapse of the communist political regime. Hungary had a small monetary overhang, but a sizable international debt. Poland initially followed a path similar to that in Hungary, but the authorities had lost control over the economy, as vividly illustrated by a combination of shortages and inflation in the late 1980s. Both external and domestic imbalances were severe. The Bulgarian communist authorities appeared to have full political control over its populace before 1989. Nonetheless, the Bulgarian economy suffered from large domestic and international imbalances.

With the benefit of hindsight, severe domestic imbalances turned out to be neither a blessing nor a curse. In Poland, inflation combined with shortages laid the groundwork for the public's acceptance of radical change in the economic system. Economic problems were blamed not on policies but on central planning, thus offering the Solidarity government a golden, short-lived opportunity to introduce a reform package independently of their social costs. Yet although the Czechoslovak economy did not suffer from severe domestic imbalances, the government introduced a stabilization program along similar lines as in Poland (Bruno, 1993). According to many commentators, it imposed unnecessary austerity on the populace.[11] Nonetheless, both Czechoslovak and Polish programs were effective in terms of price stability and the rapid shift to a demand-oriented economy.

CONCLUSIONS

The transition from communism can be conceptualized as the process of moving away from Stalin's institutional design. This process embraces not only developments after the collapse of communist political regimes, which mark the beginning of the post-communist transformation, but also developments preceding it. Although eonomic reforms did not reverse deteriorating growth performance, they significantly altered the framework of central planning. Yet, even the most reform-advanced countries of the region could not generate real democracy and a competitive economy without destroying the identity of communism. With the benefit of hindsight, they provided a better departure point for the post-communist transition.

It is tempting to assess what post-communist societies inherited from their communist past in terms of assets and liabilities. As for

[11] For additional discussion, see Blejer and Gelb, 1992.

assets, their list is short but significant. It includes close location to highly developed economies of Western Europe and a highly educated work force in comparison to countries at similar level of economic development. Having such a work force has been clearly responsible for the relative abundance of entrepreneurial skills in Central European societies, contrary to earlier expectations.

The liabilites are easily identifiable and their list is long. They include a state's excessive involvement in all domains of public life, revealed in unusually high public expenditures in comparison with market economies at similar level of economic development, as well as inherited productive capacities and organizational structures in need of overhaul, ill-adapted and technologically outdated capital stock, exccessively large units producing significant amounts of needed components in-house to reduce uncertainty associated with supply, transportation networks oriented toward the former Soviet Union, etc. None of these legacies can be overcome instantaneously.[12]

Dealing with these liabilities poses either political or economic problems. The legacy of state financed social action programs encounters strong political resistance, especially once democratic institutions are consolidated. Scarce resources are needed to restructure and privatize enterprises or to replace a monobank with viable financial markets. Depending on the extent to which productive structures were developed that suited only communism, it will take time and money.

Dismantling central planning amounts to a genuine economic transformation that will dramatically change redistribution of incomes and the economic position of various groups in society. The process is riddled with many risks posed by unanticipated responses to various facets of the transformation. It will proceed along an evolutionary path. Simply the task of replacing former institutions with those supporting a market economy is enormous by any standards.

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[12] For discussion of the "desired" pace of transition, see Balcerowicz (1993), Brada (1993), Lipton and Sachs (1990), Murrell (1993) and Poznanski (1992).

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THE COSTS AND BENEFITS OF TRANSITION

By Keith Crane*

CONTENTS

SUMMARY

This paper evaluates the costs and benefits that have accompanied the transition from centrally planned systems to market

* Keith Crane is Director of Research at PlanEcon, Inc.

economies in Eastern and Central Europe. Costs and benefits are evaluated by assessing typical market economy indicators: changes in output, per capita consumption, inflation, unemployment, foreign trade, and improved consumer choice. All the inhabitants of the region have benefited greatly from the disappearance of shortage, greater consumer choice, opportunities for the creation of businesses, and transfers of wealth to the private sector through privatization. Ownership of consumer durables such as automobiles has greatly increased. Very large numbers of people have set up their own businesses. Those countries that have liberalized most aggressively have benefited from improved export performance. However, the transition has also been accompanied by high rates of unemployment, higher rates of inflation, and declines in real incomes and consumption. Frequently, those who are relatively less advantaged have borne the majority of these costs. GDP has fallen sharply, although in most countries declines in consumption have been much less severe. As aggregate output expands in 1994 and beyond, these costs should diminish and the benefits of transition should increase. Furthermore, although many of the costs appear unavoidable, the experience of Eastern Europe suggests that they can be minimized by implementing transition policies as quickly as possible.

INTRODUCTION

Some of the costs of the transition from centrally planned systems to market economies in Eastern and Central Europe have been unavoidable: massive changes in economic systems, true revolutions in the case of Eastern and Central Europe, leave people who lose in their wake. To understand the social and political responses to the transition, these costs need to be identified. However, the transitions have also provided economic benefits. These benefits need to be publicized, so that policymakers have a better understanding of the positive consequences of transition as well.

This paper focuses on *economic* costs and benefits of transition. In so doing, it fails to highlight the improvements in civil and human rights that have resulted from the political revolutions in these countries. Any overall assessment of the costs and benefits of the transition also would need to take these improvements into consideration. Despite the economic dislocations associated with the transition, large majorities in these countries value their new political rights and enjoy exercising the power to choose their leaders as shown by their readiness to vote and replace current leaders. These benefits should not be lightly dismissed.

The paper begins with a brief discussion of the key economic policy measures necessary to transform a centrally planned system into a market economy. It then evaluates economic performance in these countries since the beginning of their transitions. Economic performance is evaluated by looking at typical market economy indicators: changes in output, per capita consumption, inflation, unemployment, and foreign trade. Some additional factors are examined that are especially germane to formerly centrally planned economies, such as consumer choice. This process of evaluation attempts to link economic performance with some of these policies.

The paper concludes with an overall assessment of the costs and benefits of transition.

THE PROCESS OF TRANSITION

All the countries in Eastern Europe, with the exception of a few of the former Yugoslav republics, are in the process of transforming their economies from socialist systems of various types to market economies. The experiences of these countries indicate that to ensure a successful transition from a centrally planned system to a market economy, governments must take the following steps:

1. Liberalize prices
2. Lower barriers to entry
3. Liberalize foreign trade
4. Create a partially convertible currency
5. Control inflation
6. Privatize state-owned assets.

The first five steps operate as a package. Price liberalization immediately provides consumers and businesses with the signals and incentives necessary to create markets. However, to derive full benefits from markets, governments have to dismantle barriers to entry for would-be entrepreneurs so as to ensure a supply-side response to market signals as lower barriers to entry foster competition and force loss-making enterprises to restructure. Most domestic markets in Eastern Europe are too small to permit large numbers of competitors in many industries, however. To provide competition for producers in these sectors, foreign trade must be liberalized. Freer trade requires that importers be able to freely convert domestic currency to foreign currencies so as to make purchases. Consequently, currencies have had to be made convertible for most current account transactions for transition to succeed. Successful stabilization policies have also been an important element of the transition. It becomes difficult to maintain convertibility and impossible to keep exchange rates stable when inflation is high. Markets, especially capital markets, also work less well under high inflation. Consequently, inflation has had to be controlled.

The sixth step, privatization of state-owned assets, is more complicated than the others. The first four measures involve the relaxation or elimination of previous controls, sometimes politically difficult to implement, but administratively simple. Controlling inflation is difficult for most countries; the countries of Eastern and Central Europe have been no exception. In privatization, property rights, formal and informal, have to be transferred from one set of institutions or people to others. As this may entail substantial transfers of wealth and, because socialism has left a legacy of widespread implicit property rights, privatization may be fraught with conflict. Despite these difficulties, privatization is a necessary condition for the creation of a market economy. Most economic assets remaining in state hands have been found to be used less efficiently than those under private ownership. Continued state ownership frequently imposes substantial economic costs as political considerations slow efforts to use assets more efficiently and loss-making enterprises are permitted to drain resources from other parts of the economy.

COSTS AND BENEFITS OF TRANSITION

Broadly speaking, these are the measures the governments need to implement in order to transform their economies. Once these measures have been implemented, they set in motion major economic changes. An assessment of the consequences of these changes for economic performance is presented below.

Economic performance has to be assessed in comparison to some standard. This paper compares performance during transition with that of the past, although cross-country comparisons are interjected. However, the proper standard against which to measure the costs and benefits of transition is the costs and benefits of attempting to maintain the former system, not past performance from a world that no longer exists. If socialism had not collapsed, the economic problems of the former Soviet Union—among them problems of resource exhaustion and declining factor productivity growth—would have made it very difficult, if not impossible, for that country to continue to support its confederates in the former Council for Mutual Economic Assistance (CMEA) through favorable terms of trade, guaranteed markets, and, in the case of Cuba and Mongolia, foreign aid. Although the timing and manner could have been better, the severe shocks suffered by the East European countries in trade with the former Soviet Union were unavoidable. By way of example, countries that have clung to central planning such as Cuba and North Korea have fared very poorly over the past few years. However, in the absence of constructing a counterfactual history, comparisons with past performance are by default the measure used to judge current performance.

CONSUMER CHOICE

Under centrally planned systems the selection of consumer goods available to households was determined in great part through quantitative controls. In some countries, domestic production was driven by plan targets set by government agencies. In all countries, the government apparatus limited import competition through a system of import permits. Major investment decisions were made by the central authorities. These decisions determined the patterns of aggregate output and therefore what was available for consumers. Perverse incentive systems coupled with controlled prices generated shortages throughout the system. These shortages imposed substantial costs on consumers and producers alike that have been well-documented by scholars. [1]

The first step in the transition in these economies was to sweep away this system by liberalizing most prices and imports. The immediate effect of price and trade liberalization was the disappearance of shortages and a dramatic shift in patterns of demand. The disappearance of shortages is one of the most beneficial and startling changes for those who remember the former system, even though it is now treated as a matter of course throughout the region. Their disappearance has made life much easier, especially for women and the elderly who bear the brunt of shopping in the region. For the elderly who are physically unable to spend long peri-

[1] See Janos Kornai, *Economics of Shortage* (North-Holland: New York), 1980.

ods standing in line under harsh weather conditions, the disappearance of shortages has literally provided them with a new lease on life.

The introduction of free markets should also have led to a much better match between preferences and purchases in the region, leading to an increase in consumer welfare for a given level of income. The changes in patterns of composition suggest that this has been the case. Figure 1 shows household consumption patterns in Poland in 1985 and in 1992. Although not identical, changes in household budget expenditures in the other countries in the region have been similar. Some of the changes may be due to increased incomes as per capita personal consumption in Poland was 6 percent higher in 1992 than in 1985 in Poland. Because the increase in real consumption was relatively modest, it can be argued that most of the changes in expenditure patterns were due to increased availability and changes in relative prices.

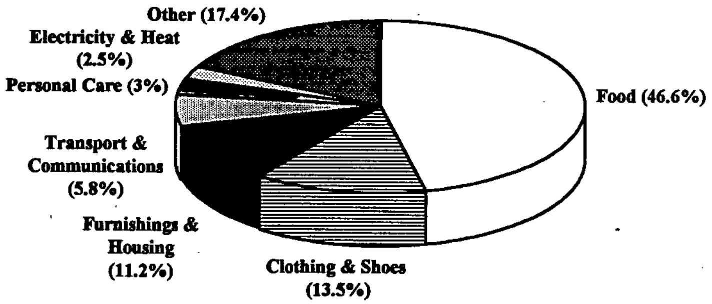
The most striking revelation from the figure is that the share of household expenditures on food has fallen during the transition. This has been the case in Bulgaria and Hungary as well as Poland. Despite the publicity given to price increases for subsidized foods such as bread and meat, the introduction of markets appears to have led to a fall, not an increase, in the relative price of food. In the past, prices on private markets for foodstuffs (which supplied a large share of vegetables, fruits and eggs) were relatively high; the introduction of markets has resulted in declines in the relative prices of these products. Furthermore, the relative price of imported foods has tended to fall. Oranges and bananas, formerly extremely expensive and available only through connections, have become widely available throughout the region. Because of the fall in relative prices, households have been able to reduce the share of their budgets spent on food.

The share of expenditures on electricity and heat, on the other hand, has risen because of increased relative prices. Expenditures on transport and communications, especially on automobiles, have also risen, but relative prices of used Western automobiles have declined. Demand has been price elastic. The number of individuals who own automobiles has risen dramatically during the transition, reflecting the high degree of unsatisfied demand for automobiles in this region (Table 1). In this case the increase in expenditures appears to be due to expanded availability and declining relative prices.

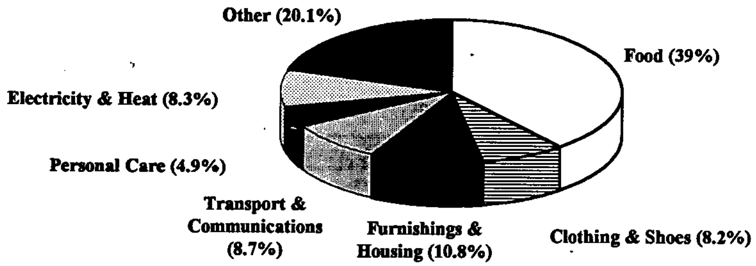
Patterns of consumption are now much more similar to those in Western Europe than in the past. Because individuals are now permitted to use their earnings to purchase what they desire rather than what the state makes available, price liberalization appears to have led to increased welfare for a given level of income.

Why then has price liberalization caused so many complaints during transition? First, price increases on frequently purchased commodities are more noticeable to the average consumer than those on infrequently purchased products such as consumer durables. They have an even more noticeable effect if prices have been frozen for substantial periods of time as was the case in Eastern Europe. Second, because of changes in relative prices and the introduction of markets, connections, the heart and soul of the former

FIGURE 1. Pattern of Consumption in Poland, 1989



Pattern of Consumption in Poland, 1992



Source: Polish Statistical Yearbook (*Rocznik Statistyczny*), various years.

system, have lost much of their value. Under the old system, the key to obtaining many goods and services was personal ties to the retailer or dispenser of the service. For example, the manager of the local meat shop reserved the best cuts for favored customers that performed favors for him in turn. With the creation of markets, these connections lost most of their value, leading to a sharp reduction in one's human capital. Third, nominal prices have risen dramatically in all countries, leading to the perception that everything is more "expensive." Finally, price liberalization has been accompanied by declines in real incomes for many households. For

TABLE 1. Car Ownership in Eastern Europe, 1985–1993

(Number of Cars per 1,000 population)

Country	1985	1988	1989	1990	1991	1992	1993
Bulgaria	121	131	133	137	138	140	142
Czechoslovakia	176	192	197	206	213	221	228
Hungary	135	170	167	187	194	207	217
Poland	98	119	128	138	151	156	161
Romania	39	44	45	47	49	52	53

Source: National statistical commissions of the various countries.

these individuals, everything has become more "expensive," leading to widespread dissatisfaction.

CHANGES IN OUTPUT

GDP by sector of origin has fallen very sharply in every country in the region Europe since the beginning of the transition (Table 2). Reported declines have been as steep as those suffered by the United States during the Great Depression. Albania and Romania reported the severest declines, falls of 42 percent and 37 percent, respectively. Bulgaria and Slovakia experienced declines of about 25 percent; the Czech Republic, Hungary and Poland, falls of about 20 percent. The more Westernized industrial countries have reported the smallest declines in GDP.

TABLE 2. Industry's Contribution to the Decline in GDP in Eastern Europe

Country	Maximum Decline in GDP	Percent of Decline in GDP Due to Industry
Albania	–42.0	47.5
Bulgaria	–25.0	76.7
Czech Republic	–21.1	80.4
Hungary	–18.8	47.9
Poland	–18.2	79.6
Romania	–33.5	73.9
Slovakia	–22.0	92.6
Slovenia [a]	–14.7	57.8

Source: National statistical commissions of the various countries.
[a] 1990 is the first year for which GDP was estimated.

The declines have ended or are ending in all the countries in the region. Poland reported positive growth in GDP in 1992 and strong growth in 1993. The GDP of Albania and Slovenia rose in 1993, while the economies of the Czech Republic and Hungary bottomed out. After the longest recession in the region, the economy of Romania also began to grow again in 1993. With the exception of Bulgaria, all the countries in the region showed signs of growth in the first quarter of 1994. It is striking that those countries that have liberalized prices most quickly and implemented reform policies most consistently have had the shortest recessions.

What accounted for these steep falls in GDP? Among a number of factors, economists have cited declines in domestic demand due to stabilization policies, the fall in intra-CMEA trade due to the collapse of institutional arrangements for trade, and changes in the composition of demand due to price and trade liberalization. This paper argues that price and trade liberalization were the key factors in the decline in GDP.

In those countries that liberalized prices and introduced partial currency convertibility abruptly, most notably Bulgaria, Czechoslovakia, and Poland, stabilization policies contributed to the initial decline in industrial output. Retail sales in these countries plummeted in the quarter after price liberalization. Consumers had prepared for price liberalization by stockpiling goods; retail sales tended to be substantially higher in the quarter preceding price liberalization than in the previous year's levels. As consumers drew down hoarded supplies in the first few months of transition, retail sales fell. Retail sales failed to rebound in part because stabilization policies attempted to brake wage increases. Most governments imposed punitive taxes on wage increases exceeding government set norms, squeezing real incomes and contributing to a decline in domestic demand.

Stabilization policies also contributed to declines in gross investment. Budget deficits financed by money creation have been a major source of inflation in the region. To curb deficits, governments have targeted investment expenditures because they have found it difficult to raise revenues from state-owned enterprises, the traditional source of tax revenues, through profit and other enterprise taxes. Many of these enterprises have been losing substantial sums of money.

Institutional changes have also contributed to the declines in GDP. East European exporters suffered very sharp declines in demand because of the collapse of the CMEA. As this system of trade and clearing agreements fell apart, intra-CMEA trade fell sharply. Some of the declines were due to the breaks in institutional linkages as traditional customers had difficulty in finding ways of making payments. However, much of the decline in export sales stemmed from the same processes reducing demand domestically. Declines in demand for investment goods by the former Soviet republics has been especially devastating for industry because the former Soviet Union was the most important market for every country in Eastern Europe. Once the former Soviet republics were no longer willing to sell raw materials for East European investment goods at unfavorable terms of trade, many manufacturers lost the majority of their sales, and this contributed to the sharp declines in GDP.

A close analysis of changes in the sectoral composition of GDP indicates that changes in patterns of demand were the major factor in the declines. The importance of changes in demand is reflected in the nature of the recession, for these transition recessions have primarily been driven by declines in industrial output due to restructuring. The role of industry in the recessions has been overwhelming. On a net basis, declines in industry have accounted for 50 to 95 percent of the declines (Table 2). Except for the transportation sector and in some instances, construction, the declines in output in industry have been steeper than in any other sector of the economy. In contrast, the service sector has generally grown in these economies during the transition.

Initially, output in state-owned industries fell in all sectors except publishing. However, soon declines began to be differentiated by sector or enterprise. Imports competition was an important factor in declines in output by enterprises producing electronics and low-quality textiles. The East European computer industry has been hard hit as import competition has eliminated many local producers.

Aside from industries that have been hit hard by import competition, the major declines in output have tended to be in investment goods or intermediate goods such as steel used in the production of machinery. Changes in incentives for enterprise managers, especially in regards to investment decisions, have been a major factor in the declines in output of these producers. Sharp declines in the production of investment goods have been a direct consequence of the collapse of central planning and the introduction of markets and the shifts in incentives these changes have precipitated.

Central planning was a highly wasteful system that encouraged enterprises to invest. Since the transition, managers have faced strong pressures to raise revenues and reduce costs so as to pay wage bills and generate resources for modernization. Managers have responded to these pressures by reducing investment expenditures and focusing on raising capital productivity. They have sold off underutilized assets such as trucks and some machine tools. More intensive use by the new owners also resulted in improvements in capital efficiency. When investments have been made, trade liberalization has permitted managers to substitute higher quality imported equipment for domestically produced machinery. Reduced domestic demand also eliminated pressures to expand capacity. A consequence of the change in incentives and government attempts to curb expenditures has been a sharp fall in gross investment in fixed capital (Table 3).

TABLE 3. Declines in Gross Investment in Fixed Capital in Eastern Europe, 1989–1993

(Index: 1989 = 100)

Country	1989	1990	1991	1992	1993
Albania	100	85.8	51.5	40.1	48.3
Bulgaria	100	93.9	65.7	37.4	29.3
Czech Republic	100	106.5	78.0	82.9	76.3
Hungary	100	90.2	79.4	78.1	81.8
Poland	100	89.9	86.2	86.9	89.5
Romania	100	61.7	51.3	47.2	47.6
Slovakia	100	105.3	90.1	80.6	75.4
Slovenie	100	88.0	72.2	62.4	66.5

Source: National statistical commissions of the various countries.

Of these factors (stabilization policies, the demise of the CMEA, and price and trade liberalization), this paper argues that price and trade liberalization have been the most important in the reduction in demand for East European manufactured goods and the consequent sharp decline in industrial output. Stabilization policies such as wage controls and investment cuts did contribute to reductions in aggregate demand in all countries. However, it is difficult to argue that these policies were the primary source of the decline in output because countries such as Bulgaria and Romania that have *not* adopted tight stabilization policies have suffered steeper declines in GDP than other countries. Although it is true that declines in industrial output contribute to higher budget deficits as wage and profit tax revenues from loss making enterprises fail to materialize, nowhere have generous emissions of credits to prop up loss-making enterprises contributed to halting the decline in industrial output except for very brief periods of time. The collapse of the CMEA has disrupted settlements systems, although less so in Eastern Europe. Nonetheless, products in demand such as Russian oil, Lada cars, or Bulgarian wines have continued to be traded. Buyers have found the means to make payment when they have wanted the goods. Sharp shifts in demand, on the other hand, have resulted in the abrupt loss of markets for a number of enterprises while those enterprises that produced goods in demand were able to expand output and reinvest. The current recovery in industrial output across the region reflects growth in output from firms producing goods in demand. Industrial output has ceased to fall as those companies that failed to adapt their production profile to the market have been liquidated.

CHANGES IN REAL INCOMES AND CONSUMPTION

Although reported declines in GDP have been very steep, the composition of the declines in output have mitigated the impact of these declines on personal consumption. In every country except Romania and Slovakia, personal consumption has fallen substantially less than GDP and real wages, according to official figures (Table 4). Per capita personal consumption actually hit all-time highs in Poland and Slovenia in 1993. In Hungary and the Czech Republic, it was down 4.3 and 7.8 percent, respectively, from 1988 when it was at or close to its previous peak. Only in Romania and Slovakia is personal consumption down by close to the decline in GDP.

The key to this anomaly has been sharp declines in inventories and sharper declines in investment than in consumption. Not all of these reductions have been for the bad. Most centrally planned economies invested a larger share of GDP than Western economies. The rate of return on this investment was very low. In the last half of the 1980s, the marginal productivity of capital was negative in a number of East European countries. In comparison to market economies, investments took much longer to complete, the effective rate of capacity utilization was much lower, and product quality was poorer. Reductions in this type of investment and the concomitant production of investment goods appear to have had modest effects on consumer welfare. Reductions in military expenditures are also seen in many countries as contributing to, not reducing consumer welfare. Reductions in waste, especially in the consump-

TABLE 4. Changes in GDP, Real Wages, and Personal Consumption in Eastern Europe, 1988–1992

(Index: 1988 = 100)

Country	1988	1989	1990	1991	1992	1993
Bulgaria						
GDP	100	98.1	89.2	78.7	74.3	71.1
Real Wages	100	101.0	106.4	80.1	85.8	76.7
Personal Consumption	100	101.7	100.1	92.4	85.6	85.8
Per Capita Consumption	100	101.6	99.9	92.3	90.6	90.9
Czech Republic						
GDP	100	104.5	103.2	88.6	82.7	82.5
Real Wages	100	100.8	95.1	70.8	75.0	77.6
Personal Consumption	100	101.5	108.2	82.0	89.4	90.8
Per Capita Consumption	100	101.4	108.1	82.3	90.3	92.2
Hungary						
GDP	100	100.7	97.2	85.6	81.8	82.5
Real Wages	100	100.9	95.8	90.2	89.4	89.6
Personal Consumption	100	100.6	99.4	92.5	90.7	94.3
Per Capita Consumption	100	101.0	100.2	93.5	91.8	95.7
Poland						
GDP	100	100.2	88.6	81.8	83.1	87.0
Real Wages	100	109.0	82.4	82.2	79.9	78.5
Personal Consumption	100	100.4	87.3	93.7	98.6	101.9
Per Capita Consumption	100	100.1	86.7	92.8	97.3	100.3
Romania						
GDP	100	94.2	88.9	77.5	66.9	67.6
Real Wages	100	102.1	107.7	91.6	77.8	69.2
Personal Consumption	100	100.6	108.6	91.6	63.6	93.6
Per Capita Consumption	100	100.1	107.9	91.1	64.3	96.4
Slovakia						
GDP	100	101.4	98.9	87.8	82.4	79.1
Real Wages	100	101.0	106.4	79.4	82.5	76.3
Personal Consumption	NA	NA	100	72.0	74.2	67.5
Per Capita Consumption	NA	NA	100	72.2	74.2	67.3
Slovenia						
GDP	100	99.5	94.8	86.0	80.8	81.7
Real Wages	100	115.5	85.6	76.3	69.5	80.9
Personal Consumption	NA	NA	100	95.2	93.7	103.3
Per Capita Consumption	NA	NA	100	95.0	93.8	103.7

Source: National statistical commissions of the various countries.
NA = Not Available.

tion of bread and other highly subsidized foodstuffs, have limited the declines in welfare.

According to official figures, real wages fell sharply in the first period of the transition, although they have started to improve in some countries after the initial declines. Between 1989 and 1993 real wages reportedly fell by about 25 percent in Bulgaria, the Czech Republic, and Slovakia, by about 20 percent in Poland and Romania, and by 11–12 percent in Hungary and Slovenia. The real wages indexes are calculated by dividing increases in nominal incomes and wages by the consumer price index.

In most countries savings rates rose during transition even though per capita consumption fell less rapidly than declines in real wages. This anomaly indicates that a substantial share of personal incomes was derived from sources other than officially reported wages. Housing, food, and other allowances are not included in wages, but account for a substantial share of income for most households. Tax regulations in Eastern Europe have been such that income paid in the form of allowances has not been subject to income tax or to wage caps. Consequently, enterprises have paid an increasing share of wages in the form of allowances. In Hungary, allowances have provided half of total income. Income generated from private businesses or second jobs has risen dramatically, although much of this is not captured in official statistics. Moreover, most wage surveys focus on the state-owned sector; they fail to account fully for private sector incomes.

Statistical problems have exaggerated the decline in real wages. In the first years of the transition, economists argue that the consumer price indexes overstated inflation. The surveys used to construct the indexes excluded most black market purchases. In some cases, official prices were used to construct the indexes even though the goods pertaining to these prices were unavailable in stores. In the year before transition, many East European governments relaxed wage discipline but failed to increase prices. Consequently, nominal wages rose much more rapidly than the consumer price index even though goods were unavailable. When the transition occurred, the price levels adjusted. However, it made the value of incomes in 1988 and 1989 appear higher than they actually were in real terms.

Nonetheless real wages and, with the exception of Poland and Slovenia, personal consumption have declined in all the countries during the transition. One can argue that the black economy has cushioned some of these declines, but for a large share of the population, real incomes and consumption have declined.

CHANGES IN INCOME DIFFERENTIALS

Price liberalization has affected labor markets as well as other markets. It has resulted in substantial changes in relative wages and increased income differentials. The major change in relative wages has been an increased premium for more highly educated workers outside of higher education. Wage differentials for engineers, managers, individuals with training in finance and accounting, and English language skills have risen. Real wages for unskilled labor have fallen. Unskilled labor has also born the brunt of unemployment. These changes contrast sharply with the more privileged position granted manual labor under the former system and have resulted in considerable resentment among these workers.

A number of countries have attempted to compute poverty lines. According to Bulgarian authorities, 70 percent of households now fall under this line. Elsewhere, the percentage has been in the neighborhood of 30 percent. Because the market basket used to determine this line tends to be dominated by goods that were subsidized in the past, these indicators have some flaws. However, they do reflect some of the deterioration in living standards for lower income groups.

All indicators show that incomes of entrepreneurs, a very small, highly taxed group in the former system, have risen very substantially during the transition. Statistical evidence on the magnitude of increases in income differentials is difficult to obtain as many of the newly wealthy hide a large share of their income for tax reasons. However, sales of luxury goods highlight the existence of this wealth.

GROWTH OF ENTREPRENEURSHIP

Entrepreneurs have responded to the new legal framework and freedoms with alacrity. Every country in the region with the exception of those at war has registered thousands of new businesses (Table 5). Initially, the new businesses have been sole proprietorships operated by families, but increasingly entrepreneurs have been creating limited liability companies as well. The first private firms focused on retailing, services such as automobile repair, and restaurants. Now the focus is shifting to wholesaling, manufacturing, and transportation. These businesses have been responsible for regional job growth. They are also the generators of new wealth.

TABLE 5. Changes in the Number of Private Businesses in Eastern Europe, 1989–1992

Country	1989	1990	1991	1992
Hungary	335,854	422,920	563,215	675,593
Czech Republic	NA	124,455	891,872	979,633
Romania	NA	NA	NA	196,306
Poland	813,500	1,135,500	1,420,000	1,783,900

Source: National statistical commissions of the various countries.
NA = Not Available.

The new entrepreneurs have been concentrated in the capitals and other large cities, but every small town and village has at least a few entrepreneurs who have set up stores or service establishments. The most successful are following a traditional capitalist path of expansion. Owners of a single store are expanding, creating chains. Others are moving backward, up the supply chain, into wholesaling or even manufacturing. Still other entrepreneurs are becoming venture capitalists, providing equity to promising ventures in any field of activity.

In addition to local entrepreneurs, the transition has made it possible for foreign investors to set up companies. With the exception of Albania, every country in the region is host to several thousand joint ventures. Foreign investment flows into the Czech Republic, Hungary, and Poland have been large, over $6 billion in the case of Hungary alone. The entry of these firms into Eastern Europe has contributed to improvements in productivity and the transfer of management and technical skills as they have introduced Western machinery, technologies, and systems into their East European operations.

Lower barriers to entry have been accompanied by lower barriers to exit. Hungary and Poland are subjecting state-owned enterprises as well as private firms to bankruptcy laws. The Czech Republic is also now enforcing its bankruptcy law since privatization has been completed. Bulgaria and Romania have avoided employing their laws, but have begun to liquidate companies. The results of these laws are beginning to show up in statistics. Several hundred state-owned firms have gone bankrupt in both Hungary and Poland.

Transition has led to changes in behavior in state-owned firms as well as in private business. These changes have been forced by *commercialization*, the process of creating limited liability companies from state-owned enterprises. The new companies are no longer run by a ministry, although ministries continue to have a powerful voice. Managers now answer to a board of directors, created when the enterprise is transformed into a state-owned joint stock company. The boards have made the managers both more accountable and more independent. Managers now must produce and report financial results to the board rather than negotiating export or production targets with a ministry. This change has concentrated minds on reducing losses and turning a profit. The result has been extensive restructuring. Subsidiaries have become independent companies, units have been bought out by their managers, and loss-making operations have been closed down. Management systems have been revised. Companies are setting up profit centers and have changed their accounting systems to provide better information as well as to better conform to Western standards. East European firms do not yet operate like their Western counterparts, but their activities are much closer to that standard than they were two years ago.

UNEMPLOYMENT AND THE LOSS OF JOB SECURITY

The reverse side of the growth in private firms and employment has been the reduction in job security and increased unemployment. Transition has been accompanied by large increases in unemployment in all the countries except the Czech Republic. Since the beginning of the transition, unemployment rates have risen from almost zero to double digits (Table 6).

Although high school and college graduates had an inordinately prominent place in the initial group of unemployed, patterns of unemployment are beginning to reflect those in market economies. As in the West, unskilled workers form a disproportionate share of the unemployed. The share of the long-term unemployed in total unemployment has steadily risen. Although job creation has been strong in the private sector, many of the long-term unemployed are less attractive to private sector employers. Inhabitants of one-company towns face some of the most difficult problems in finding new work if key manufacturers close or are forced to downsize. Poor, agricultural regions also have higher than average rates of unemployment. These areas traditionally exported labor (often younger workers) to more prosperous regions. Because the large state-owned enterprises, the traditional employers, reduce their staff,

TABLE 6. Unemployment Rates in Eastern Europe, 1990 through First Quarter of 1994

(Percent)

Country	1990	1991	1992	1993	1994:1Q
Albania	8.7	9	24.9	19.5	NA
Bulgaria	1.6	10.5	15.2	15.8	16.3
Czech Republic	0.8	4.1	2.6	3.5	3.3
Hungary	1.6	7.5	12.3	12.1	12.2
Poland	6.3	11.8	13.6	15.7	15.7
Romania	NA	2.3	8.3	10.2	11.4
Slovakia	1.5	11.8	10.4	14.4	14.5
Slovenia	4.7	10.1	13.4	15.5	15.2

Source: National statistical commissions of the various countries.
NA = Not Available.

young men and women return or stay home, which raises local unemployment rates.

These countries are encountering the same policy problems as West European countries in their efforts to deal with the problem. Initially, unemployment programs were often too broad, including people that had never been part of the labor force. For example, recent college and high school graduates were eligible for unemployment benefits in Poland. These policies raised costs and, in some cases, delayed concentrated searches for jobs. Fraud is another problem. In Budapest, many joke that unemployment means workers are only working two jobs instead of their previous three. The "unemployed" are often active in trading, retailing, and construction.

Labor markets have become more like those in market economies with all the attendant costs and benefits. Jobs are being created by small businesses; large businesses are shedding labor. Unemployment rates are lowest in booming areas such as the capital cities, where small businesses are growing most rapidly and highest in rural areas dotted with declining industries.

INFLATION

Higher rates of inflation have been a hallmark of transition (Table 7). Inflation rates soared after price liberalization and then followed two separate trends. In the cases of Albania, Hungary, Poland, and Slovenia, inflation rates have declined from their previous peaks, although more slowly in 1993. Czechoslovakia and its successor states have generally had the lowest inflation rates, although inflation jumped in 1993. In the case of Bulgaria and Romania, inflation rates have either failed to improve or deteriorated since price liberalization.

Some of the initial price increases were overstated. Market pricing eliminated the discrepancy between black market prices and official prices that existed under central planning. The fall in black market prices following liberalization is not captured in the consumer price indexes. However, the transition has generally been marked by a very substantial deterioration in performance in controlling inflation in every country in the region except Slovenia.

TABLE 7. Inflation Rates in Eastern Europe, 1988–1993

(Annual Rates in Percent)

Country	1989	1990	1991	1992	1993
Albania	0	0	100	226	85
Bulgaria	6.4	26.3	334.0	85.0	72.9
Czech Republic	1.4	9.7	56.7	11.1	20.8
Hungary	17.0	28.9	35.0	23.0	22.5
Poland	251.1	585.8	70.3	43.0	35.3
Romania	0.9	4.2	155.0	213.5	314.0
Slovakia	1.4	10.5	56.0	10.3	23.2
Slovenia	1,306.0	550.0	118.0	201.0	32.0

Source: National statistical commissions of the various countries.

TRADE PERFORMANCE

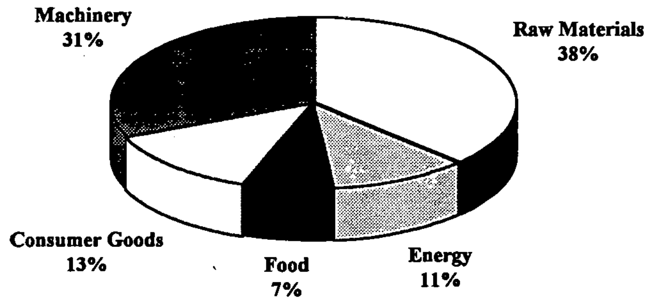
Imports

The centrally planned economies suffered from the most complete trade protection in the world. In general, neither enterprises nor private citizens were permitted to import without permission from the state. Although some countries such as Hungary and Poland had more relaxed systems, trade protection was almost absolute.

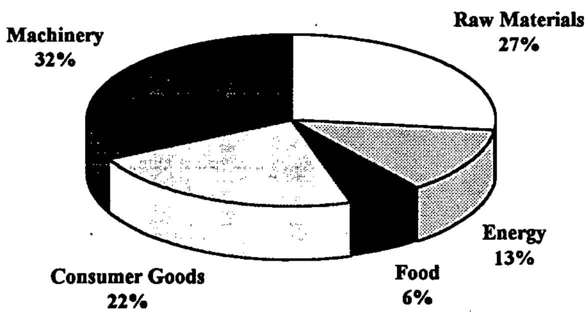
Trade liberalization has permitted a rapid change in the pattern of imports as market forces now dictate trade. The share of consumer goods in total imports has expanded dramatically while imports of raw materials and machinery, the preferences of central planners, have fallen (Figure 2). Restructuring has resulted in a more "West European" pattern of imports; imports of components and subassemblies has increased sharply as the new operations of Western multinationals trade components with the parent company. Domestically owned manufacturers are also increasing demand for these imports as they improve quality and their competitiveness by substituting superior for inferior components. Where Eastern Europe was noted for shoddy consumer goods and lines as recently as four years ago, now every capital city boasts stores with goods identical in quality (and price) to those sold in Munich or Milan. The change in the composition of imports and improvements in quality indicate that imports now correspond much more closely to consumer preferences than in the past.

Despite this rapid change in trade policies, trade liberalization has been only partial. The East European governments continue to employ high tariffs, strict quotas, and other nontariff barriers to trade to protect domestic industries. Hungary has imposed quotas on a number of products, including steel, and charged the Czech Republic and Ukraine with dumping. The Czechs delayed homologating the new Polish FIAT, the Cinquecento, even though it is freely sold in Western Europe. Poland levies a 6 percent "temporary" tariff on top of its normal levies and has some of the highest tariff rates among these countries. These protectionist measures impose all the attendant associated costs on the economy.

FIGURE 2. Hungarian Imports, 1989



Hungarian Imports, 1993



Source: Hungarian Foreign Trade Yearbook, (*Magyar Kukereskedelmi statisztikai Evkonyy*), various years.

Exports

Between 1989, the year of the revolutions, and 1992, exports to the developed West from the northern tier countries have grown over 50 percent (Table 8). The success of most East European countries in increasing exports to the West has been one of the most pleasant surprises of transition. East European manufactures had steadily lost market share in OECD countries since the 1970s. After transition, export growth resulted in substantial increases in market share of 14, 21, and 31 percent, respectively, for former Czechoslovakia, Hungary, and Poland between 1989 and 1992.[2]

[2] Bartlomiej Kaminski, "The Impact of the Market Transition on the Export Performance of Central European Economies," The World Bank, Washington, D.C., 1993.

The driving force behind the increases in exports was manufactures. OECD market share in manufactured imports for these three countries increased 22, 31, and 63 percent, respectively, for these periods. Even in 1993, a year in which import demand fell sharply in Western Europe, exports to this region held up well. Exports to Western Europe rose for every country in the region except Bulgaria, Hungary, and Slovakia in 1993, a year in which German imports, the key East European market, fell sharply. In the first quarter of 1994, exports were up across the region. In short, the transition has resulted in a sharp increase in East European export competitiveness.

TABLE 8. Central and East European Exports to Developed Market Economies, 1989–1992

Value of Trade

(Millions of Dollars)

Year	Bulgaria	Czech Republic	Czecho-slovakia[a]	Hungary	Poland	Romania	Slovakia	Slovenia
1989	1,301.0	NA	4,740.8	4,249.1	6,666.8	4,416.8	NA	NA
1990	1,101.1	NA	5,580.2	5,197.4	9,438.0	2,745.8	NA	NA
1991	902.2	4,413.6	5,655.9	6,921.9	11,029.0	2,040.4	1,452.2	3,061.0
1992	1,478.7	5,570.1	7,494.1	7,516.1	10,263.1	2,052.6	1,924.0	4,418.0

Change in Trade

(Index: 1989 = 100)

Year	Bulgaria	Czech Republic	Czecho-slovakia[a]	Hungary	Poland	Romania	Slovakia	Slovenia
1989	100.0	NA	100.0	100.0	100.0	100.0	NA	NA
1990	89.2	NA	117.7	122.3	141.6	62.2	NA	NA
1991	69.3	100.0	119.3	162.9	165.4	46.2	100.0	100.0
1992	113.7	126.2	158.1	176.9	153.9	46.5	132.5	144.3

Source: National statistical commissions of the various countries.
[a] Czechoslovakian figures exclude trade between the Czech Republic and Slovakia.
NA = Not Available.

INCREASED TRAVEL

A major benefit of transition has been greater freedom to travel. The repeal of travel restrictions was, of course, the major step needed to permit greater travel. However, the introduction of convertibility for households has also been an important ingredient in encouraging more travel. All the countries now permit households to keep convertible currency deposits in local banks and to withdraw this money freely for travel abroad. Coupled with more realistic exchange rates, convertibility has made foreign travel possible for large portions of the population.

PRIVATIZATION

A number of East Europeans have benefited substantially from the transfer of property from the state sector to themselves. Privatization has contributed to efficiency gains. However, it has also been accompanied by corruption and in some instances has not improved competition.

All the countries have adopted a variety of programs to privatize state and cooperatively owned assets. The final shape of the programs appears to have been dictated to a great degree by the type of asset being privatized. For ease of discussion, we divide these into four types:

- Residential property
- Farmland
- Small state-owned enterprises
- Large state-owned enterprises.

The costs and benefits of privatization differ substantially depending on the type of asset privatized. The privatization of residential property has been popular throughout the region. In most cases, occupancy has given ownership rights, although policies designed to restore property to former owners in Bulgaria, the Czech Republic, Hungary and Slovakia have resulted in the transfer of ownership to former owners rather than current tenants in some cases.

The privatization of residential property has generally been seen as beneficial. It has created the basis for a real estate market. The new owners generally have been pleased to gain title and many have begun substantial renovation projects. The municipalities have also been relieved of some responsibility for repairs. Popular opposition to the transfer of ownership has been muted inasmuch as most voters believe that current occupants deserve the right to purchase their dwellings. Citizens also appear to accept that restitution is just.

The privatization of farmland and farms has been pursued on the same basis as residential property. The current employees of state-owned farms and cooperatives are given formal ownership rights; past owners, if unjustly deprived of their holdings, have been partially compensated.

These programs have been burdened with more problems than have programs for the privatization of residential housing. Although privatization has been followed by substantial increases in agricultural output in Albania, output has fallen in Bulgaria, the Czech Republic, and Hungary. The local press complains of declines in agricultural efficiency as equipment purchased to operate on the large fields characteristic of collective farms is poorly adapted to working smaller private farms. Large livestock operations have frequently been dissolved. The disappearance of these operations has made it more difficult to apply modern livestock management techniques. New private farmers have often found it difficult to procure agricultural inputs because of the absence of credit systems and wholesalers committed to serving smaller farmers. Part of the efficiency losses appear to be due to the pace of privatization rather than the actual change in ownership structure. Once title has been transferred, the new farmers are able to tap credit and reorganize production so as to regain some of the efficiency losses.

Smaller state-owned companies have been rapidly privatized through auctions and management- and employee-buyouts throughout the region. The retail sector is now substantially in private hands in every country. Because the new owners often tend to understate results, it is difficult to determine whether value-added has risen, but the general consensus has been that the new private firms and the newly privatized firms operate more efficiently than their state-owned predecessors and that privatization and increased competition have led to great improvements in the quality of services rendered. The transfer of ownership has proceeded swiftly and fairly smoothly. Privatization has created a growing entrepreneurial class of small businessmen, and the successful companies are generating an expanding supply of capital. On the negative side, some of the auctions have been rigged, depriving the state of potential revenues, or unfairly excluding other bidders from purchasing these businesses.

Larger state-owned enterprises are being privatized through a variety of programs that are covered in detail in the rest of this volume. The plethora of programs attests to the continued difficulty in transferring state-owned property to the private sector. The value of most state-owned enterprises has fallen over the past three years as the recession has reduced or eliminated profits and a freer trade regime has revealed weaknesses in cost control and product quality. Governments have been reluctant to cut their asking prices, so sales have been slow. Moreover, privatization is not a cure-all for the ills of these enterprises. The enterprises need to change management practices, streamline staffing, and improve their operations and products. These changes take time, whether the firm is owned privately or by the state. The slow pace of privatization reflects the depth of these problems.

Privatization of large state-owned enterprises has been accompanied by numerous cases of corruption. Government officials, the managers of these enterprises, and buyers have sought to reduce payments to current shareholders, usually the government. The large number of transactions, the sizeable assets involved, and the difficulty in establishing proper oversight have encouraged corruption in this process.

The governments' focus on privatization has also led to neglect of the issue of how to manage enterprises remaining under state ownership. The governments are only just beginning to set up formal procedures, institutions, and criteria for managing these companies under market conditions. Managers of these firms have argued that because the state provides no guidance, it has hampered their efforts to restructure and led to losses in assets and efficiency. Over the next few years, how to manage the remaining state-owned firms effectively will be an ongoing problem.

Privatization of large state-owned enterprises has also provided benefits to East European citizens. In countries with voucher programs, citizens have benefited materially from the transfer of state-owned assets at below market prices. Although theoretically, they also suffer from the decline in the assets of their government, most recipients appear to value the personal increase in wealth more highly than the offsetting decline in government assets. Governments have also been able to reduce financial debts through trade sales of assets to foreign or domestic investors.

Privatization of large state-owned enterprises has also been accompanied by efficiency gains. Quality and labor productivity have increased markedly at Skoda, Tungsram, and FSM, three large companies purchased by Western multinationals. The substantial increases in labor productivity in manufacturing in Hungary and Poland in 1993 (11 percent or more) have been partially traced to improved efficiency stemming from privatization.

HAS THE TRANSITION LAID THE BASIS FOR SUSTAINED GROWTH?

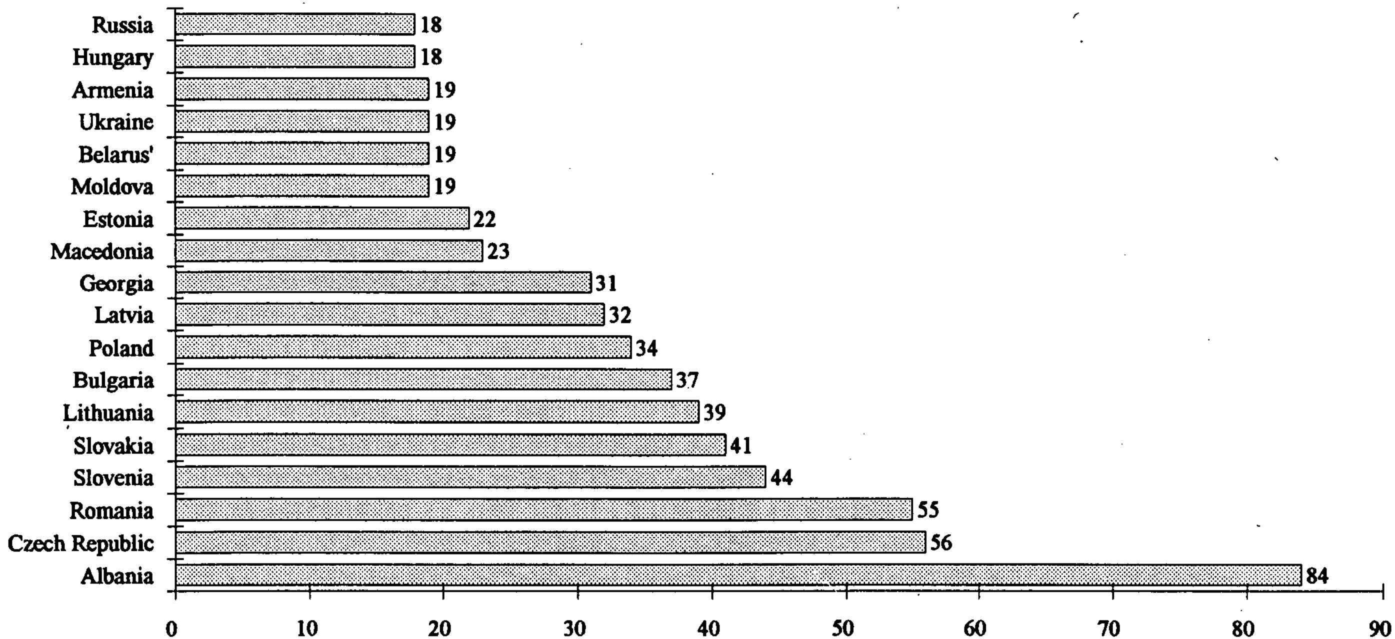
Although the transition has produced a number of benefits, the statistics and the voters indicate that there has been a substantial amount of pain as well. Figure 3 shows percentages of respondents in a large number of countries in the region who feel that life has improved under the new system. As can be seen, most respondents have failed to detect an improvement in their living standards; many feel that their circumstances have declined. If the current upturn is slow and halting and real incomes fail to recover, many would consider transition a failure despite the numerous benefits it has already delivered. The key question, therefore, is whether the transition has laid the foundation for sustained, strong economic growth.

Small, open economies with sensible macroeconomic policies and well-educated labor forces have flourished in Western Europe since the end of World War II. In general, the countries of Eastern Europe have well-educated labor forces. If stabilization policies are effectively implemented, there is no reason that these countries cannot mimic the performance of their West European counterparts. The question is therefore whether current policies have created an environment in which Western Europe's successes can be duplicated in Eastern Europe.

Most forecasters project growth in 1994 and beyond for these countries. PlanEcon is forecasting growth of 4–6 percent per annum for these countries through the end of the decade. The basis for the forecasts is a strong rebound in industrial output and continued strong growth in services. The performance of Hungary, Poland, and Romania in the second half of 1993 show that very rapid growth in industrial output is possible in the region. In the first quarter of 1994, industrial output has jumped in Hungary, Poland, Slovakia, and Slovenia.

The first signs that Eastern Europe is beginning to put its human capital stock to better use have shown up in productivity increases in industry. These have been very strong, running over 10 percent in some countries. The recent increases in industrial output have been accompanied by few increases in the industrial labor force because the surviving companies have been able to increase output without hiring additional workers. In factories where Western investors have installed modern equipment and use Western management techniques, productivity levels are up to 80 percent of West German levels despite relatively low wages. However, many plants are still encumbered with low-quality equipment and

FIGURE 3. Percentage of People Who Believe Life is Better in the Post-Communist Era



Source: Gallup Organization Survey results reported in *Contemporary Sociology*, March-April 1994.

even poorer management systems. As plants continue to adapt, the scope for productivity improvements is great. These increases will generate increases in real incomes or greater industrial output, sustaining the recovery.

Labor markets also seem to be improving in the region. Unemployment rates have stabilized or even declined. In many countries, enterprises have completed the first and second rounds of layoffs. Rapid employment growth in services and the private sector is absorbing the unemployed, especially new graduates. Unemployment continues to be a serious problem in many regions, but there has already been a substantial reallocation of labor. As rates gradually decline, an increase in the number of jobs will help accelerate the recovery.

The decline in unemployment rates is occurring as real wages are beginning to rise. Those individuals fortunate enough to hold onto their jobs are beginning to benefit from more substantial salary increases at a time of falling or stabilized inflation. Increased job security and higher wage packets are feeding through into higher retail sales. As productivity continues to rise, this phenomenon will continue through 1994 and beyond.

The new private firms and the newly privatized firms appear to operate more efficiently than their state-owned predecessors. As the nascent financial markets grow, thereby improving the allocation of investment, and firms become better established, these firms and the economy in general should continue to become more efficient.

Foreign investment inflows have stabilized in Hungary and the Czech Republic and are accelerating in Bulgaria, Poland, and Romania. Past and future foreign investments also lay the foundation for long-term economic growth. Increased capital productivity stemming from these inflows are an additional factor underlying forecasts of rapid growth.

In short, productivity growth, restructuring, increased employment and real wages, privatization, and foreign investment are creating a solid basis for recovery. These factors should lead to strong economic growth over the next several years, something that a continuation of the old system appeared incapable of providing.

CONCLUSIONS

There have been substantial benefits as well as costs stemming from the first stages of transition. Even people with lower incomes have benefited greatly from cheaper relative prices for clothing, fruits and vegetables, and other consumer goods due to price and trade liberalization. Improved export performance, greater consumer choice, opportunities for the creation of businesses, and transfers of wealth to the private sector are other benefits stemming from transition. Lower barriers to entry, trade liberalization, the introduction of household convertibility, and privatization have improved the welfare of large numbers of people.

There have been costs as well. Unemployment, higher rates of inflation, and declines in real incomes and consumption have imposed substantial costs on large numbers of people, frequently on those who are relatively less advantaged. In every country, very large shares of the population have complained of the increased uncertainty, which is partly due to the introduction of markets and partly due to transition itself. The emergence of the threat of unemployment has been an adjustment for most workers. The high inflation rates and much higher crime rates that have accompanied the initial changes have also made life more uncertain. However, as aggregate output expands in 1994 and beyond, the economic costs should diminish, although increased insecurity has become a fact of life.

The restructuring of industry and increased insecurity associated with markets appear to be unavoidable costs of the transition. However, the experience of Eastern Europe suggests that the way to minimize the costs of transition is to implement changes quickly. No country has devised a successful alternative to the policies outlined above. Those countries that have pressed ahead most rapidly and consistently with these policies have suffered the smallest declines in output in the region or are recovering most rapidly (e.g., Albania, Hungary, Poland, and Slovenia). Those that have attempted to devise alternative policies or introduce these measures more slowly (e.g., Romania) have suffered the sharpest declines in output and the highest rates of inflation.

There is, of course, no single figure that measures the net benefit of transition. Individuals in Eastern Europe and abroad must make their own judgments based on their own values. However, despite the electoral losses of parties in power and the manifest discontent with the current situation, East European electorates and political parties continue to support the transition. No major party in Eastern Europe campaigns on a promise to restore the past. This indicator more than any other shows that the costs of transition are regarded as less than the costs of continuing with the previous system.

SEQUENCING OF POLITICAL AND ECONOMIC REFORMS

By Valerie Bunce *

CONTENTS

SUMMARY

Eastern Europe is in transition to capitalism and liberal democracy. The simultaneity of these changes, plus their speed and magnitude, suggest that Eastern Europe is undergoing a process of revolutionary transformation in economics, politics, and thus social structure. Such a transformation is without historical precedent. It also promises to be a long and conflictual process with no guarantees as to the final result.

The approach to revolutionary transformation in post-communist Eastern Europe has been to liberalize politics first and introduce major economic reforms second. This sequencing of political, then economic reform is the opposite from what happened in the development of capitalism and democracy in the West. This reversal of the Western model has introduced a number of tensions between political and economic reform in Eastern Europe. Just as politicians sensitive to the electorate have found it hard to introduce painful economic changes, so the economic costs of the transition have contributed to political instability.

This does not mean, however, that the mixing of political liberalization and economic reform will lead necessarily to the end of the democratic and capitalist experiment in Eastern Europe. Political liberalization enhances in some ways the prospects for economic reform, and the economic reform is central in important ways to democratic consolidation. The mutual benefits of pursuing economic and political reform are most apparent when reforms move rapidly—as the Czech, Polish, and Hungarian experiences illustrate. Where political reform has been slower, however, so has economic reform, and the tensions between the two have been greater. Thus, to the question of sequencing and its impact on the development

* Valerie Bunce is Professor of Government and Director of the Slavic and East European Studies Program at Cornell University.

of capitalism and democracy a second consideration must be added: the pace of the reform process. Faster transitions in politics and economics are advisable, if the concern is to maximize the prospects for capitalist liberal democracy.

The sequencing of political and then economic reforms in Eastern Europe, therefore, produces problems, but does not foreclose the possibility that capitalist liberal democracy will develop.

CAPITALISM AND DEMOCRACY

In the West, the development of capitalism and liberal democracy was a slow process that took place over the course of several centuries. It was a process shaped less by the actions of the state than by the interests of economic and political entrepreneurs. A second characteristic of this process was that it followed a particular sequence; that is, capitalism first and liberal democracy second. There was a logic to this. Capitalism produced over time divisions among elites and a transformation of the class structure. Both processes worked to undermine slowly the basis for authoritarian rule by rendering politics more competitive and by rendering society more pluralistic and more politically active. As a result, the development of capitalism provided important preconditions for the development of liberal democracy.[1]

The development of capitalism and liberal democracy in post-communist Eastern Europe has been very different. First, the process of transformation is revolutionary, not evolutionary. This speaks to the pace and magnitude of economic and political change in Eastern Europe since the collapse of communist party rule in 1989. This also speaks to yet another contrast with the Western experience; that is, the considerable role of the post-communist state (and various international actors and institutions) in orchestrating economic and political transformation. This is not a case, then, of ambling to capitalism and democracy; rather, this is a case of racing to both.

The sequencing of economic and political change has also been very different from what we saw in the West. The end of the single party communist system in Eastern Europe in 1989 ushered in a significant liberalization of politics. This was shown by the rapid expansion of civil liberties, the construction of representative political institutions, and the holding of competitive elections throughout Eastern Europe from 1989 to 1990. What followed was the introduction—albeit in varying degrees—of policies aimed at building a capitalist economic order. Thus, political liberalization preceded the development of capitalism in Eastern Europe.[2] This represents a reversal of the Western pattern—and, indeed, the experience of every country that has undergone the process of democratization.[3]

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[1] This is not to suggest that capitalism leads necessarily to democracy. It depends on the nature of authoritarian rule and when and how capitalism developed. See Barrington Moore, *Social Origins of Dictatorship and Democracy* (Boston: Beacon Press, 1967).

[2] The one possible exception to this generalization is Hungary, where substantial economic reforms took place prior to the termination of communist party rule. See Eva Palocz, "Some Major Difficulties of Economic Transition: Hungary's Example," Paper presented at the International Symposium, "Adam Smith and Economic Development in the Twentieth Century," Paris, May 11–12, 1992.

[3] This is also in contrast to the Chinese case, where capitalism is making significant inroads into the socialist economy, but where politics has remained firmly (as of this writing) in the authoritarian mode of single party communist rule.

Even in the new democracies of southern Europe and Latin America, for example, capitalism was in place prior to the liberalization of the political order.

The many distinctive features of the post-communist transformation introduce an important question that goes to the heart of the transitions now under way in Eastern Europe. Can countries deviate from the Western model and still succeed in building capitalism and liberal democracy?[4] Does the unique sequencing of political liberalization and then economic reform mean that capitalism must be sacrificed for democracy—or vice versa? Even more disturbing, does this mean that both revolutions will fail, and that Eastern Europe in the future will be neither capitalist nor democratic?

Three arguments are made in this analysis. First, the sequencing of political, then economic reform has produced important tensions between the two. Just as political liberalization has complicated the task of economic transformation, so the economic transformation has posed a number of difficulties for the translation of liberalized politics into a consolidated democratic order. Second, this does not mean, however, that hard choices must be made between building capitalism and building democracy. There are in fact ways in which the two processes support each other. Moreover, a slower pace of democratization blocks the development of capitalism, and failure to push through a transformation of the economy seems to work against democratization. Finally, if the goal here is to maximize the prospects for the development of capitalism and liberal democracy, then the optimal combination of economic and political reform is rapid movement on both fronts. While this hardly guarantees that capitalism and liberal democracy will develop and take hold, this approach nonetheless presents a higher probability of success in both areas than the alternatives.

DEFINITIONAL ISSUES

Misunderstandings are common in discussions such as this one that cross disciplinary boundaries. Thus, before addressing the issues at hand, it would be useful to define some key terms and to lay out some basic generalizations. The discussion begins with what is meant by capitalism and the transition to capitalism, democracy and the transition to democracy.

A capitalist economic system is defined by the existence of private ownership and market exchange. Perhaps the most useful way to think about capitalism is to reduce it to the following formulation: capitalism is an economic system that combines uncertain outcomes with certain procedures. The former speaks to competition as the driving force of capitalism and the latter to the existence of

[4] We are concentrating on the relationship between political and economic transformation in this paper. However, it is important to keep in mind that these are not the only areas of transformation in post-communist Eastern Europe. In addition, one must point to a transformation of the state's relationship to the international system, a refiguring of national identities and, in some cases, a redefinition as well of the state and its boundaries. These issues reflect the fact that 1989 was not just the end of the one-party communist system in Eastern Europe. It was also a process of national liberation and a process which led to the end of the cold war international order. All of this assuredly complicates the process of building capitalism and democracy in Eastern Europe. This is especially the case since the issues of nation and state formation, we must remember, were resolved in the West prior to the process of democratization.

institutions that establish the rules of the economic game—in particular, the definition and protection of property rights. Indeed, this is the major way in which politics enters the equation. It is the state and the legal system which define the rules of economic exchange.

How does one move from a socialist to a capitalist economy? While economists disagree on the specifics of this transition (particularly with respect to sequencing, speed, methods of privatization and the need for various forms of compensation), they do concur at the most general level that three sets of policies are involved: (1) macro-economic stabilization (if the economy is in serious imbalance); (2) micro-economic liberalization, and; (3) institutional reform and innovation. The first set of policies can be introduced quickly—if the state of the economy so necessitates and if the politics of the moment so allows. Indeed, it was this convergence between economic need and political capacity that explains the introduction of shock therapy in Poland in 1990.

However, the remaining two policy packages take much longer to implement. They involve enormous technical, political, and social problems in the process of carrying out such programs as the elimination of substantial subsidies to enterprises and consumers, the creation of labor and capital markets, the development of an unemployment infrastructure, the privatization of state-owned enterprises (which account for up to ninety percent of the gross domestic product in Eastern Europe), the development of new private concerns, and the creation of an effective tax system[5]. It is not just that the point of departure for this process—that is, state socialism—offers little that can be recycled in the creation of a capitalist economy; that changes in economic institutions and the creation of new institutions necessarily invite considerable political and social conflict; that all these changes involve not just refiguring but also modernizing the economy; or that there is no historical precedent and thus empirical referent for the creation of capitalism "in a hurry" with state socialism serving as the point of departure. One must also remember that the process of creating the institutions of capitalism took hundreds of years in the West—and under seemingly more favorable economic and political circumstances.

On the political side of the equation, democracy is a form of government that combines rule of law, extensive civil liberties guaranteed by law, representative government, and institutionalized competition for political office. This rather elaborate description can be reduced to its essence by echoing the definition of capitalism presented above. Democracy combines uncertain results—that is, competition—with certain procedures—that is, the existence of established rules of the political game. Without such certainty in procedures, competitive politics would degenerate into a free-for-all. Democracy would be anarchy.

How does one move from the authoritarian politics of the communist system to a liberal political order? There is no widely

[5]This list is even longer and more daunting for those new countries, such as Croatia, Slovenia, Slovakia, and the like, which are operating with new borders as a consequence of the collapse of the federal communist state. For a discussion of the economics of state-building, see Ivo Bicanic, "The Changing Croatian Economy," unpublished manuscript, Washington, D.C., The Woodrow Wilson Center, December 7, 1993.

agreed-upon method—which is hardly surprising, since there are no historical precedents for such a transition.[6] One can, nonetheless, glean certain generalizations about what has to happen if a durable democratic order is to be constructed. One can speak, first, of the expansion of civil liberties and the development of political competition. This process—which is understood as political liberalization—implies the end of a political monopoly and the holding of free, fair and competitive elections. Second, democratic rules of the game must be established. This involves the ratification of a constitution and its elaboration through laws that together specify civil liberties, electoral procedures, the institutional structure of the government (local and national) and the court system and, more generally, the mechanisms by which conflicts are mediated and government is held accountable to the governed. The third set of changes involves the creation of institutions, such as political parties, unions, and interest groups, which are independent of the state and which are crucial in the representation of interests in the process of selecting candidates for political office and making public policy. To this list, we can add a final set of changes: the creation of a democratic political culture. Without public support for democratic institutions and procedures and without public willingness and capacity to participate in politics, democracy is rendered fragile, and crises—political and economic, domestic and international—can more easily derail the democratic experiment.

As we move down this list of necessary political changes, we find tasks that are ever more difficult and ever more time-consuming to carry out. Thus, while the introduction of political competition can take place quickly (as we discovered in Eastern Europe in 1989-1990), the establishment of the rules of the game takes longer—especially if we note that this implies not just rules on paper, but also the willingness and capacity of major political players to abide by these rules and thus struggle for political power within the democratic institutional context. However, it is in the two remaining areas—the development of an organized and politically-influential society and the creation of a democratic political culture—that the process of democratization moves the most slowly. This is particularly the case for the post-communist world, since the long hegemony of the communist party prevented the development of a politically engaged and independent society that valued the democratic method of conflict resolution.

This definitional exercise yields some useful generalizations for the analysis that follows. First, capitalism and liberal democracy are quite similar in their underlying principles. Both are best understood as processes, not outcomes—a characteristic that speaks to their dynamism as well as to the difficulty of identifying when they are "in place." They also parallel each other in featuring competition within the context of established and transparent rules of the game. Indeed, it is this very combination of uncertain outcomes, yet certain procedures that makes both systems fair and ef-

[6] It is important to note that there are many recent cases of transition from authoritarianism to democracy—for example, in Spain, Greece, Portugal and numerous countries in Latin America. However, these cases diverge sharply from the post-communist cases—for instance, in the nature of authoritarianism and in the agenda of transition. Thus, they provide limited guidance for how communist states can and should democratize.

ficient—or at least more fair and efficient than the alternatives. The similarities between the two systems point in turn to their natural affinity with one another—a point that is reinforced by the fact that all democratic orders have been capitalist[7], just as all socialist economies (defined by state ownership of the means of production and central planning) have been authoritarian.

Second, but less often noted, are the similarities in the post-communist context between the transition to capitalism and the transition to democracy. In particular, both involve revolutionary changes. Whereas capitalist democracies feature competition, but procedural certainty, communist systems feature the opposite; that is, guaranteed results, but capricious procedures. The transition, therefore, involves moving a system from one set of underlying principles to an opposite set of principles. This, plus the pace of change, identifies the transition as a revolution. Other parallels are that both transitions feature a two-stage process of liberalization and then construction of institutions; both generate considerable conflict; and both take a long time. Finally, neither process carries any guarantees.[8] We should not be misled, then, by the common phrase, "the transition to capitalism and democracy in Eastern Europe," with its implications of a linear process with predictable results. This phrase speaks more to Western hopes and the rhetoric of elites in the region than to the uncertain reality of the post-communist experience.

Finally, caution must be exercised in characterizing the sequencing of political and economic reform in Eastern Europe. This is *not* a case of democracy first and capitalism second. Rather, it is political liberalization followed by a *simultaneous* process of economic transformation and democratization. This is an important distinction, because it alerts us to the incomplete nature of democracy in the region and to the necessarily combustible interaction between a political system still in formation and an economic system also in flux.

Let us now turn to a discussion of the tensions produced by mixing political and economic reform. The basis for this discussion is the assumption that the goal of the transition is to maximize the prospects for the creation of capitalism and liberal democracy. We will begin by examining how political liberalization complicates the process of economic reform.

TENSIONS BETWEEN POLITICAL AND ECONOMIC REFORM

The effects of political reform on economic reform can be stated succinctly. Political liberalization has created incentives for politicians in Eastern Europe to slow down, if not block the process of economic transformation. To understand why this has happened, we need to focus, first, on the economic transition. The transition to capitalism has asked Eastern European citizenry to do four difficult things: 1) live with a great deal of economic and social uncertainty; 2) undergo significant short-term economic sacrifices; 3) tol-

[7] The reverse, however, is not true. Capitalism—particularly in its heavily protected variant—has often coexisted with authoritarian politics.

[8] If history is any guide, this is particularly the case for democratization. Witness, for example, the durability of capitalism in Latin America as contrasted with the propensity throughout the region over time for alternating between liberal and authoritarian politics.

erate the development of rapidly growing socio-economic inequalities, and; 4) take public officials at their word that the sacrifices of today will lead to substantial benefits in the future. These crosses are very hard to bear in any country, but particularly hard in the post-communist context. This is because of the decline in the standard of living the last ten years of communist party rule (most notably in Poland, Romania, and the former Yugoslavia), and because of the culture created by the communist experience—a culture that tends to view employment as a fundamental right, private property as bad and a relatively egalitarian income distribution as good. Still another problem is that the major beneficiaries of the economic transition have often been the ex-communists, who have used their privileged economic and political position in the old order to become wealthy entrepreneurs in the new order—an outcome that would seem to make a mockery of the revolutions of 1989. Finally, the economic sacrifices of the transition are all the more intolerable in light of the familiarity of the promises politicians are now making; that is, that suffering today will lead to a radiant future tomorrow. The citizens in Eastern Europe have heard that before—and seen the disappointing results.

Not surprisingly, then, the citizenry has responded with anger to the economic costs of the transition. If the state were strong and independent of public opinion, this would be an inconvenience, but not a serious problem. Indeed, this is why many analysts looking at structural adjustment policies in Latin America have argued that such policies are best undertaken by less liberal and more centralized states that can limit public input and political protest.[9] However, in the post-communist context we find weak and accountable states. These states are weak because of the stresses of transition and because of the institutional vacuum left by the departure of the communist party-state. At the same time, these states are accountable (albeit in varying degrees), given the rapid liberalization of politics from 1989 onward. The end result is that angry publics use public opinion, votes, and demonstrations to register their dissatisfaction with the economic transformation, and politicians, ever in search of issues and political support in a liberalized environment, find it easy to respond by championing their cause of opposing the economic reform.

To this must be added three other political pressures working in the same direction: the emergence of a highly critical, but as yet unprofessional media, the absence of a stable base of support for politicians and parties in these new semi-democracies, and the instability of governing coalitions throughout much of the region. These factors remind us that democracy in Eastern Europe is unfinished business. They also explain why politicians throughout the region are unusually sensitive to the public concerns of the moment. In Eastern Europe, then, political rationality—that is, maximization of power in the short-term through courtship of the public—goes against the logic of economic reform—with its emphasis on economic policy-making as a set of long-term and interrelated policies and with its presumption that short-term economic sac-

[9] Stephan Haggard and Robert Kaufman, *The Political Economy of Democratic Transitions*, Part II. (San Diego: Graduate School of International Relations and Pacific Studies, 1993).

rifices from the public are a necessary condition for successful reform.

If the causal arrow is reversed and one examines the impact of economic reform on the process of democratization, equally deleterious effects can result. In producing a large number of angry people, the economic transition threatens to create a mass mobilization against the new regime. This is all the more likely given other aspects of the post-communist experience; that is, the absence of well-established parties that could route political participation into more constructive channels, the presence of fragile and unpopular governing coalitions and, finally, the recent memory of protest as an effective political weapon. Whether mass mobilization represents a threat to the regime and thus to democratization depends on the strength of political institutions, elite commitment to the regime, and the incentives politicians have to play by the new democratic rules. In the post-communist context, all three factors are a problem. Institutions are weak, and the regime is too new and too much the source of controversial actions to have generated widespread elite support. At the same time politicians are seeking ways to build support in a fluid situation. What better way to do this than to defect from the democratic game and respond to the concerns of a large and angry crowd?

However, even if public anger is contained within the democratic framework, it can still imperil the process of democratization. This can happen, first, through the rise of extremist parties. Economic deprivation can lead people to search for scapegoats and politicians to respond by identifying for them the "true" enemy of the people—be it ethnic and religious minorities, the communists, or the International Monetary Fund. Indeed, it was precisely this unlikely collection of culprits that Istvan Csurka identified in his recent political campaign as the cause of Hungary's recent problems. Whether extremist parties can effectively challenge the process of democratization depends, of course, on their electoral appeal. While they have not been able as yet to attract majoritarian support anywhere in the region, they have done reasonably well in recent elections in Romania, "rump" Yugoslavia, and Russia. In Poland, the Czech Republic, Hungary, Bulgaria, and Albania, by contrast, they are at present marginalized political forces.[10]

A related problem is polarization of politics. The economic reform tends to divide society into two camps: those who support it (because of values or interests) and those who oppose it (including communists, who have lost their privileged economic and political position and that segment of the public that is quite vulnerable to unemployment and rising prices). This division can translate into a weak political center and increasingly polarized politics—a hardly surprising outcome in a revolutionary situation. The result is that democracy suffers, whether the governing coalition is dominated by extremist parties or by the center. In either case, governments tend to be immobilized and unstable. This produces an authoritarian temptation, as intra-elite conflict grows, as extremist parties find it easy to circumvent democratic politics, and as citizens begin to

[10] The issue of the ex-communists and their strong political showing of late in Poland, Hungary and the Czech Republic is addressed below. The now renamed socialist parties embrace the goals of the transition and cannot, therefore, be labelled extremist.

resent the weakness of the government, its lack of political influence, and the disorder around them. This is a capsulized summary of the collapse of democracy in Europe between the two World Wars.

Finally, the development of a political culture that supports democracy is undermined by the process of economic transformation. As the economic reform proceeds and people suffer, citizens can begin to link democracy with economic hardship—a linkage which resonates, unfortunately, with the interwar experience in Eastern and Central Europe. While democratization in Germany after World War II was furthered by the correlation in the public mind between democracy and prosperity, then, democratization in Eastern Europe will be undermined by a very different connection; that is, democracy and economic deprivation. This can lead citizens to withdraw support from politicians and from democratic institutions—a trend that is evident, for example, in recent public opinion polls in Hungary, Poland, and Bulgaria.

Thus, the sequencing of political, then economic reforms in Eastern Europe would seem to be a very costly approach to the construction of capitalist liberal democracy. Does it then follow that the new regimes in Eastern Europe have to choose between economic reform and democratization? Worse yet: does this mean that, having already liberalized politics prior to economic reform, the new regimes in the region are now stuck in a process that is likely to compromise the development of both capitalism and democracy? The answer to both of these questions is no. To understand why, one must look more systematically at the patterns of economic and political reform in post-communist Eastern Europe.

AFFINITIES BETWEEN POLITICAL AND ECONOMIC REFORM

There are two generalizations that can be made that apply to the entire region.[11] One is that the political liberalization of 1989 has been followed in *every* case by market-oriented economic reforms. To this observation can be added some other relevant points: namely, that "tight" politics in the communist period always correlated with orthodox socialist economics, that a loosening of politics during communism always went with a loosening of state control over the economy, and, finally, that economic reforms under socialism (as in Hungary, Poland, and the former Yugoslavia) never went so far as to establish the foundations of a capitalist order. If we combine these observations, we arrive at a crucial conclusion: political liberalization in the Eastern European context can be seen as a *precondition* for the transition to capitalism. The political monopoly of the communist party had to be removed before its economic monopoly could be dismantled. In this sense, political reform is an ally in the process of economic transformation.

Another region-wide generalization is that the costs of mixing liberalized politics and economic reform have not produced in any case the abandonment of either the transition to capitalism or the transition to democracy. The worst that has happened—as in Romania—is limited progress, not a reversion to either full-scale

[11] The former Yugoslavia is excluded from this analysis. The economic and political constraints of war place these states in a wholly different situation.

authoritarianism or re-socialization of the economy. This would seem to suggest that the tensions between political and economic reform, while real to be sure, are not sufficient—as yet—to derail the process of either economic or political transition. These tensions have produced, in short, problems and tendencies, not system-defining dynamics.

This could reflect, of course, the fact that these transitions are but four and one-half years old. The survival of the transition, one suspects, speaks to a less time-bound set of points. One is that communist systems collapsed quickly and relatively easily for one very good reason. What had supported them had slowly withered away, and the Gorbachev reforms (which were to arrest this process) provided, in fact, the opportunity for the increasingly precarious foothold of communist power to be revealed to all in the region—and then to the world.[12] The collapse of communism, then, was neither sudden nor superficial. This, plus the introduction of a liberalized economic and political order, means that the new regimes in Eastern Europe lack the raw material needed for a reassertion of either political authoritarianism or socialist economics.

A second factor that has contributed to the durability of the transition is the role of the international community. International institutions have made their preferences clear. They have also created incentives for Eastern European governments to meet their expectations with respect to economic and political reform. Finally, Eastern European publics are very supportive of "joining Europe." Indeed, this is virtually the only issue in Eastern Europe that has generated a public consensus. As such it represents a luxury for politicians: a low-risk position that they can wholeheartedly embrace. Thus, while one might wish for more international support, the fact remains that the international system has helped keep the East European transitions on track. This is in stark contrast to the role of international actors during the calamitous interwar years.

This leads to a final and surprising reason why the transitions in Eastern Europe have survived some difficult tests. That reason is the sheer degree of disorganization that post-communism has produced. This has been seen by most Western observers to be the central problem of the transition and has led some to draw parallels between Eastern Europe today and Germany in the 1930s. However, one must not forget that disorganization characterizes the situation of illiberal as well as liberal forces in the region. Democracy and capitalism can develop not just because there are a large number of democrats and capitalists, but also because those who would oppose such developments are themselves divided and contentious. Indeed, it is precisely this latter conception of democracy and capitalism as a by-product of divided authoritarianism that best explains the evolution of liberal orders in the West.

This leaves two conclusions. There are limits to the costs of liberalizing politics before economic reform. Moreover, there are certain advantages in fact to mixing the two. The question then becomes: under what conditions are the costs the lowest and the advantages

[12] For an elaboration of the slow, but sudden collapse of communism, see Valerie Bunce, "The Empire Strikes Back: The Transformation of Eastern Europe from a Soviet Asset to a Soviet Liability," in *International Organization*, 39 (Winter 1985), pp. 1–46.

the greatest? What seems to matter here is the *pace* of political liberalization and economic reform.

THE ADVANTAGES OF MOVING FAST

The post-communist regimes in Eastern Europe can be divided into three categories. The first—which describes developments in Poland, Hungary, and the Czech Republic—features the following characteristics: (1) a sharp political break with communism (as indicated by the movement of the communists into the opposition following the first competitive elections); (2) rapid progress subsequently on democratization; (3) rapid progress on the economic transformation (as indicated by, for example, the growth of the private sector, the freeing of prices and, in the Polish case, a return to economic growth by 1993), and; (4) fewer of the costs, noted above, of mixing economic and political reform (for example, sabotage of the economic reform, political extremism, and political polarization).

The second model—which Romania best typifies—features a mirrored opposite set of characteristics. The political break with communism was less complete, since communists won the first competitive election (albeit through corrupt practices). At the same time, progress on democratization and the economic reform have been slow, and the costs of the transformation—ranging from disastrous economic performance, 1989–1994, to the empowerment of the political extremes—have been very high. As a result, the transition to both capitalism and democracy has been slow, uneven and compromised.

Between these two extremes lies the more mixed cases of Slovakia, Bulgaria, and Albania (and one might add Russia). In Bulgaria and Albania, for example, the communists maintained political power in the first competitive elections, but subsequently saw their power erode in the face of an increasingly powerful opposition. In the Slovak case, the communists lost to an opposition that advocated (in contrast to every other victorious opposition in the region) a slow transition to capitalism. The end result in all three cases has been governmental instability, periodic indications of less than democratic procedures, and progress on the economic front that is slower than what one sees in Poland, the Czech Republic, and Hungary, but not as limited as what has been seen in Romania.

This topology leaves three important generalizations. One is that the pace of economic reform correlates highly with the pace of political reform. Another is that the pace of the two reforms depends on whether the first competitive elections led to the victory or loss of the communist party. Finally, a rapid economic and political transition seems to generate fewer negative by-products than slower transitions.

Thus, the key issue is speed—in political liberalization, in the transition to capitalism, and in the consolidation of democracy. Political liberalization, then, is an asset, especially if it leads to the victory of the opposition. Combining economic and political reform can also be advantageous—if both proceed rapidly. Finally, if one adds speed to the equation, the contradiction can be resolved to some degree between the problems posed by the sequence of political, then economic, reforms versus the seeming resonance between the two.

This leaves a final question. Why do fast transitions improve the prospects for the development of capitalist democracy? One reason is obvious. All else being equal, moving more rapidly to capitalism and democracy will achieve the results faster than the alternatives. Other, more nuanced explanations can also be given.

First, a sharp break with the political past—as evidenced by the victory of the opposition in the first competitive elections—sets in motion a dynamic that is helpful to both the economic and the political transition. It produces, in particular, a convergence between two facilitating conditions: a strong desire to root out communism and considerable government capacity to carry through on major reforms. The first condition follows from the fact that the opposition is in power and has devoted itself for many years to the project of ending communism as an economic and political system. Since ending this system is one and the same as engineering a transition to capitalist democracy, the stage is set for a rapid transition.

These signals are all the stronger when the new government, as in Czechoslovakia and Poland, enjoyed a large mandate. Any representative government that is blessed with so much political capital is in a position to be quite innovative—especially when power is joined with major problems requiring action.[13] The combination of popularity and accountable government, moreover, means that governments can ask for public sacrifices. They can also assume that they have some time—at least until the next election—to show beneficial results. "Extraordinary politics," then, as Leszek Balcerowicz[14] has put it, creates the policy agenda and the political support necessary for rapid political and economic transformation—at least in the initial flush of victory. Later, political capital atrophies as economic hardship grows and as the issues of the day move from the easy unity provided by anti-communism to the hard divisions generated by the transition. This speaks, of course, to the importance of moving quickly on the economic transition—a point that was not lost on either Leszek Balcerowicz in Poland or Vaclav Klaus in Czechoslovakia.[15]

There is one more advantage to a sharp political break. It forces the more reform-minded communists to reconstitute themselves as social democrats if they wish to be competitive in the new political game. This has three benefits. It gives the losers in the revolutions of 1989 a stake in the new system. This is no small benefit, since one peculiarity of these revolutions was that they did not kill the losers; that is, the communists. Another advantage is that the reconstituted left can provide representation for a segment of the public that would otherwise be disenfranchised. Without their representation, democracy would be a sham, and the possibility would exist for their political incorporation through anti-democratic means. Finally, a viable and democratic left is the best guard

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[13] See Valerie Bunce, *Do New Leaders Make a Difference: Executive Succession and Public Policy under Capitalism and Socialism*. (Princeton, NJ: Princeton University Press, 1981).

[14] Balcerowicz, "Economic Transition in Central and Eastern Europe: Comparisons and Lessons," Annual Lecture of the International Finance Corporation, Washington, DC, Dec. 1, 1993.

[15] As they explained in Mario I. Blejer and Fabrizio Coricelli, *A Dialogue with the Reformers in Eastern Europe: Conversations with Leszek Balcerowicz, Peter Bod and Vaclav Klaus*, Unpublished manuscript, 1993.

against a vigorous extreme right. It drains the right of support without sacrificing the democratic and capitalist project. This is a major reason why one sees a weak extreme right in countries where the reform communists, now socialists have expanded their political power over time (as in Poland, Hungary, and Lithuania). It is also why the victory of these parties in recent elections is a cause for relief, not worry.[16]

Thus, a sharp break with communist party rule produces the optimal conditions for a rapid transition to capitalism and democracy. It creates the desire and the capacity to move quickly on the economic and political front. It is not accidental, then, that there is a high correlation between rapid political and economic transformation, and why the two tend to be preceded by a sharp political break with communist party rule.

But why do rapid political and economic reforms generate fewer negative externalities than more slow-moving transitions? Two reasons have already been offered: they help solve the "communist problem," and they create a political cushion that shields the new regime from angry citizens and anti-democratic politicians. In addition, quick transitions also tend to show results—and show positive results sooner. It is telling, for example, that Poles were happy to see the newly created abundance in their stores in 1990 as a consequence of shock therapy, despite the lack of funds to take advantage of it. It is also relevant that the countries that moved fastest on the economic front show no more economic costs in the first few years of post-communism than their more slowly moving counterparts,[17] *and* they more quickly show indicators of economic recovery.

To this three more considerations can be added. One is that the more rapid the economic and political reform, the faster the expansion of those who benefit from the new order, and the more likely that politics and economics will be shaped by these new interests. This can create a self-propelling dynamic in which two phenomena occur: rapid reform generates pressures for continuing reform *and* the coalition against reform is consequently reduced in size and influence. This can begin to happen precisely when the political "honeymoon" ends, and the consequence is a much-needed boost to the reform process.

The Russian case shows what happens when this dynamic is blocked and when political capital declines without the countering effect of a rapid expansion of vested interests in the new (dis)order. It also points to the importance of a related issue: the need for rapid progress on institutionalization of the rules of the game. Thus, lacking progress on democratization (understood as institution-building) and on the transition to capitalism, Russia features all the costs of the transition—and few of the benefits.

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[16] Another advantage of the socialist "comeback" is that it forces other parties to be more effective organizations and vote-getters.

[17] See, for instance, Balcerowicz, "Economic Transition." However, there is one indicator that is an exception—levels of unemployment. This seems to have had some destabilizing consequences in Poland. See Adam Przeworski, "Economic Reform, Public Opinion and Political Institutions," in Luis Carlos Bresser Pereira, Jose Maria Maravall and Adam Przeworski, *Economic Reforms in New Democracies: A Social Democratic Approach* (Cambridge: Cambridge University Press, 1993), pp. 132–198.

Another factor that reduces the costs of rapid reform is the tendency of such reforms to disorganize interests. With politics, economics, and society all in flux and institutions in the process of being re-defined, if not built from scratch, interests take on an unusually fluid character. Thus, people find it hard to know what they want and how policies enacted will actually affect them. This leaves them uncertain about the positions they should take. It is, therefore, hardly surprising that one sees weak interests, weak parties, and weak interest groups in post-communism.[18] All three feed into each other, and they are symptomatic of the disarray of the transition, particularly when it is rapid. While there are many costs to such fluidity, there is also one advantage. It is difficult in such circumstances for interests to coalesce into strong opposition against reform. In this sense, what economists term "rent-seeking behavior"—that is, the formation of political coalitions against the market—is slow to develop in the transitional context and thus not effective in countering the process of economic transformation. When this is joined with a government willing and able to move full steam ahead on reform, the consequence is reduction of the obstacles to development of capitalism, but without sacrificing democracy in the process through coercive state policies. As a result, the constraints on economic reform are reduced in the crucial early stages of economic transition. Later, interests aggregate, but by that point some are there to champion the reforms. Moreover, the very process of aggregation provides an anchor to democratic politics.

Finally, one must not forget that there are good reasons why all democracies have been capitalist. Capitalism disperses economic resources and creates a propertied class; that is, two familiar preconditions for the development of democracy. More rapid movement on the economic transition, then, could be said to put in place all the faster these building blocks of democratic politics.

CONCLUSIONS

Five arguments are presented in this analysis. First, the collapse of communism in 1989 has been followed by a revolution in politics, economics, and society in Eastern Europe. Second, the transition to capitalism and liberal democracy in this region promises to be a long, difficult, and conflictual process that carries no guaranteed results. Third, the approach to the transition in Eastern Europe—that is, political liberalization prior to the introduction of major economic reforms—is the reverse of the process by which capitalist liberal democracies came into being in other parts of the world. Fourth, the particular sequence of political and economic reform in the region has generated a number of problems that complicate the process of both economic and political transformation. Finally, these problems are less serious when, as in Poland, Hungary, and the Czech Republic, the pace of reform has been rapid: that is, when the initial liberalization of politics has been substantial and when this has been followed by quick movement on the construction of a capitalist and democratic order.

[18] Valerie Bunce and Maria Csanadi, "Uncertainty in the Transition: Post-Communism in Hungary," in *Eastern European Politics and Societies*, 7 (spring 1993), pp. 240–275.

Whether these advantages and disadvantages will seal the fate of Eastern Europe, however, remains to be seen. At best they suggest that the road to capitalism and democracy will be bumpy in all cases, but more hazardous in some than in others.

SYSTEMIC PRIVATIZATION AND RESTRUCTURING IN EAST-CENTRAL EUROPE

By Stilpon Nestor and Scott Thomas*

CONTENTS

SUMMARY

Rapid privatization and restructuring of the vast state-owned assets of post-communist economies is key to every East-Central European government's program for systemic economic reform. The countries of this region—in particular, Poland, Hungary, and the Czech and Slovak Republics—have achieved far more privatization, and more quickly, than anything seen so far in either the developing countries or OECD member countries. It is also true that, with the possible exception of the Russian Federation, the East-Central European countries have been the leaders in privatization from among the post-communist economies of the old Soviet bloc; indeed, the experimental privatization and restructuring methods developed there serve as models to all of those countries.

*Stilpon Nestor is Principal Administrator in the Organization for Economic Cooperation and Development (OECD), Directorate for Fiscal, Financial and Enterprise Affairs; Scott Thomas is Principal Administrator in the OECD's Centre for Co-operation with the Economies in Transition. The views and analysis of this chapter are entirely those of the authors, and do not necessarily reflect those of the OECD.

In this paper the authors review and analyze the East-Central European privatization experience. The first section highlights the objectives of privatization in post-communist economies, the principal privatization strategies that have been pursued, the constraints to their implementation, and the results achieved. The benefits and drawbacks of each strategy are assessed in an effort to come to grips with the "quality," speed, and comprehensiveness of privatization achieved under each. The second section examines the linkages between privatization and enterprise restructuring, addressing issues related to the institutional framework of the latter, including bankruptcy and the development of secondary markets for debt and equity. Conclusions are drawn in the final section.

SYSTEMIC PRIVATIZATION

Although the collapse of the old Soviet empire in East-Central Europe was swift and decisive, its replacement with a new order proceeded much more slowly than had been hoped for in the early, euphoric days. The peoples of the former Soviet-bloc satellites embraced the precepts of democracy and capitalism with alacrity. But the next stage, of making the transition from central planning to market economies, proved unexpectedly harsh. Partly, these countries faced adverse developments beyond their control. Their oil import costs increased dramatically, as Russia began requiring payment in hard currencies, and at world market prices. Their trade links, especially those with the former Soviet Union, all but collapsed. Some faced very high debt burdens incurred by previous regimes in part to avoid having to make systemic economic reforms. Others inherited convulsive economic and financial crises.

But beyond these difficulties, it quickly became apparent that the transition from central planning to capitalism would require wholesale transformation of the basic underlying fabric of the economy, and in particular, of the role of the public sector in that economy. It also meant having to shut down a great deal of unsuitable productive capacity, leading to declining output and loss of privileges, jobs and income, while subjecting the surviving enterprises to market prices and competition, and weaning them from government subsidies. The sheer scale of the needed economic restructuring itself was daunting. With the possible exception of Hungary, in 1989, state sectors in East-Central Europe constituted 90 percent or more of industry. On conservative estimates, one-third of these enterprises were insolvent, or would require major financial restructuring to survive.

Privatization of these vast holdings, seen as the best means to enforce market discipline and promote efficiency and productivity, became the centerpiece of the economic transformation programs in every country. The reformist governments elected after the withdrawal of the Soviet Union committed themselves to very ambitious targets for divestiture of state holdings—often promising to privatize 50 percent or more of industry in a matter of two or three years. Constraints included ill-defined property rights; large extant state-sector liabilities and contingent liabilities; scarcity of domestic and foreign savings in proportion to the enormous size of the assets that authorities wanted to privatize in such a short period;

and the inability of economic systems to absorb quickly large numbers of laid-off workers. Besides these constraints, the legal and institutional infrastructure necessary to facilitate de-statization and privatization had to be created from whole cloth, as did the laws, regulations, and institutions in related areas such as corporate law, accounting, contracts, competition, banking and finance, social safety net, bankruptcy, and liquidation of assets.

Perhaps the most difficult constraint to overcome was the political inertia engendered by state-sector dependency. In East-Central European countries, characterized by comparatively successful economic stabilization policies, authorities increasingly subjected both state and private enterprises to market forces and financial constraints. With a large proportion of state enterprises effectively insolvent, however, and with dramatic declines in output resulting from imposition of the "hard budget constraint"[1] on enterprises, pressures to delay or derail privatization programs were enormous. Despite this, much has been achieved, as the authors review in detail below. Nonetheless, the striking thing politically is that in three of the four East-Central European countries, reformist governments have been replaced by alliances of reformed socialists with roots in the old regimes, partly because it was perceived that they would move forward more slowly on privatization.

PRIVATIZATION OBJECTIVES AND CONSTRAINTS

In OECD member countries, and developing countries, increasing the efficiency of public enterprises has always been one of the primary goals of privatization, as has maximizing revenues from sales of the enterprises, and increasing future tax revenues (or reducing subsidies).[2] Sale or liquidation of public assets to the highest bidder is usually acknowledged to be the best means to accomplish these goals, because the buyer will look to maximize the profitability of a purchase by ensuring enterprise efficiency and competitiveness, which in turn will allow it to become a net revenue generator for the state. In the post-communist economies, however, a variety of experimental forms of privatization have evolved, many of which have little or nothing to do with sale to the highest bidder. Instead, privatization can mean lease or gift of the enterprise to workers and management. It can mean auctioning of shares in enterprises to citizens in exchange for vouchers that they receive for free or for a nominal fee. It can mean government allocation of shares in enterprises to government-sponsored mutual funds run by government-contracted managers. Or it can mean "spontaneous" privatization, in which authorities effectively close their eyes while the nomenklatura pick off the best bits.

Clearly, these various forms of privatization cannot all have the same objectives, other than the broadest one of achieving some form of ownership transfer. They most certainly have quite different implications in terms of the "quality" of privatization produced, a subject defined and discussed in more detail below. Authorities in every reforming post-communist country want to increase enterprise efficiency and reduce net transfers to the state

[1] On the concept of a "hard budget constraint" see Kornai (1990).
[2] For a review of the goals of privatization see Nellis (1994).

sector. But reformers have been increasingly attracted to experimental and systemic forms of privatization in part because they promised speed: Indeed, if pursued at the pace typical in Western industrial economies, or developing countries, where case-by-case divestitures have been the rule, privatization of the huge public holdings of the post-communist economies would require half a century or more.

Traditional privatization methods, with some notable exceptions, have produced disappointing results, at least as compared with the initial expectations of reformers in post-communist economies. This is partly because the scale of the divestiture that would be required in the old Soviet bloc, which in 1990 contained an estimated 100,000 medium- and large-scale state-owned enterprises, simply was beyond the absorptive capacity of domestic savings in those countries, if the enterprises were to be sold quickly at their nominal book values. The hope that foreign investors would fill this gap has not been realized. The reticence of foreign investors probably has derived from the amount of systemic economic restructuring yet to be accomplished, and the fear that the investment- and trade-friendly policies that had been implemented could be rolled back. And, of course, domestic investors have been constrained by many of the same considerations of political risk that have applied to foreign investors. Thus, reformers were increasingly faced with either retaining most production and employment within the public sector for the foreseeable future, or implementing some experimental means of distributing ownership to citizens at large. In fact, even this choice was illusory, because the inherited status quo of public ownership was simply unsustainable.

Instead, in the absence of rapid privatization by other means, effective corporate control tends to be ceded progressively to management and workers in the enterprises themselves, at zero or nominal prices. If this is not accompanied by the transfer of clear ownership rights, enterprise insiders are given strong incentives to "strip" the company's assets through sales for personal gain, or to "decapitalize" the plant by failing to reinvest income. Even if property rights are transferred to insiders, there is often an inherent conflict between employee interests and the necessity of restructuring enterprises to enhance profitability or of liquidating them so that their resources can be more profitably utilized elsewhere, both of which are likely to imply substantial layoffs. And, given the predominance of the state-owned enterprises in these economies, there is always an incipient danger that key enterprise management and worker concerns may combine to compel highly inflationary credit and wage increases, while forestalling implementation of other forms of privatization and increased competition.

In fact, it has always been the case that an important goal of privatization, often unstated officially but usually understood, is to reduce the control of labor unions and other interested factions, like the bureaucracy itself, in respect to the enterprises (and industries) being privatized. By resorting to privatization, governments tacitly acknowledge their inability to stand up to interested factions by making painful corporate decisions that go against those factions. This mixes political economy into the equation. The goal of privatization, in this view, is to substitute new, private owners whose interests are concerned solely with efficiency and profitability, for the old, debilitating alignment of self-interested bureaucrats with factions internal to the enterprises themselves. In the process, it is hoped, a new class of private owners will emerge that will form a constituency that favors market-oriented reform.

Speed is considered essential for two reasons. First, under state ownership, the interests of the managers and employees of each enterprise usually are the only ones voiced within the political system, because no other concentrated interests exist. Minimization of management and employee resistance with general subsidies, as was done in Germany, is understood to be simply unaffordable.[3] Instead, at least in theory, quick and massive ownership transfer may counterbalance the interests of enterprise management and workers, by creating a new interest group composed of private share owners. By making the ownership transfers as quick as possible, and (sometimes) allocating minority shares to employees in each enterprise as a sweetener, government officials hope to circumvent opposition to privatization from workers facing possible unemployment. Usually mass ownership transfer programs assume that difficult decisions about layoffs, management changes, asset liquidation and new investment are to be made by the new owners, or by investment funds acting on behalf of those owners. Second, rapid privatization could be an imperative if economic reform is to be sustained, since backpedalling on credit and fiscal restraint to the gargantuan state sector could put at risk macroeconomic stability itself. Again, at least in theory, this could be avoided by privatizing quickly and massively, thus removing the prior claim that state enterprises have been able to exert on the allocation of society's resources.

PRIVATIZATION METHODS AND RESULTS

The concept that the goal of privatization is as much political as it is economic is essential to understanding the polyglot of forms and methods of ownership transfer currently being employed in post-communist economies. In short, with respect to the large, industrial enterprises, three broad approaches emerge, two of which are planned and the third arrived at almost by default.[4] These are traditional or case-by-case privatization, of the sort known in Western economies; rapid and massive privatization by distributing ownership virtually free to the citizenry at large; and, finally, allowing workers and management from within the enterprises in effect to inherit them at minimal or zero cost. East-Central European privatization programs usually embrace one or several permutations of these forms.

Traditional Privatization

The traditional approach stresses enterprise sales on a case-by-case basis. This approach works best in economies in which the public sector is overshadowed by a predominant private sector,

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[3] The German strategy, and its cost and relevance to other post-communist economies, is reviewed in Thomas (1993).

[4] Small-scale privatization of retail and service outlets is not addressed in this paper, although it is usually a bright spot in privatization in post-communist economies. For a description of this process see Ceska et. al. (1993).

which can absorb redundant public-sector labor. Privatization receipts can enhance macroeconomic stability, both in terms of contributions to the government budget and to inflows of foreign direct investment. Yet sometimes governments are persuaded to strip away viable assets for subsequent privatization, leaving behind nonviable assets, nonperforming loans, and contingent liabilities, all with eventually negative budgetary repercussions.

The principal means of traditional privatization are trade sales and public offerings. The former category consists of sales through public closed tenders, direct sales to specific investors and, in the case of smaller enterprises, auctions. In auctions, price is usually the only determinant, although participation in auctions of small-scale enterprises may be limited to domestic bidders. In the case of tenders for larger enterprises, privatization authorities usually require the submission by offerors of a business plan, including specific intentions regarding future employment and investment. Direct sales result from direct negotiations with a single bidder. Finally, public offerings entail sales of enterprise shares in capital markets, initially one of the prime methods recommended by Western consultants with experience in public enterprise divestures in OECD member countries like the United Kingdom.

Results of traditional privatization approaches have been modest in comparison to the vast size of the state sectors in these countries, but in some ways these results have been highly significant. The public offerings approach has been most disappointing: Poland has privatized majority stakes in a total of eleven enterprises, and Hungary in eight using this route (from an initial pool of more than 8,000 medium- and large-scale enterprises in Poland and 1,800 in Hungary). Trade sales have been more successful. Poland has utilized trade sales to divest some 100 state enterprises, with proceeds amounting to $460 million. In the Czech Republic, more than 300 medium- and large-scale enterprises have been sold through trade sales.[5] Finally, to date, the Hungarians have managed more than 600 trade sales, representing approximately one-third of state-sector assets, in the process attracting large inflows of foreign investment.

Although all East-Central European governments have promulgated policies designed to attract offers from strategic, and especially foreign, investors along traditional privatization lines, the Hungarian program was the one that adhered most closely to traditional or case-by-case privatization as a national strategy. From the outset, Hungarian authorities explicitly rejected privatization through free distribution of shares, except for compensation of former owners and their heirs. In the early years, numerous "spontaneous" privatizations of medium-scale enterprises had occurred, initiated by enterprise management and workers in tandem with outside investors, and not by central government officials. Negative political reaction against such deals was addressed by the establishment of the State Property Agency, which attempted, instead of prohibiting the approach, to regulate it and make it transparent. The idea was to encourage bids from outside investors, domestic or

[5] In the process of "unbundling" the large enterprise combines (discussed below), the number of medium- and large-scale state enterprises grew to more than 5,200. See Mladek (1994).

foreign, and direct negotiations with enterprises, rather than with the central government. The so-called self-privatization program was one example of this approach. Under this program, around 130 foreign and domestic consulting firms were empowered to privatize a block of 800 medium-sized state enterprises, with compensation to be based on success fees, without any further government review other than full disclosure. Although later abandoned as having achieved only marginal success, this approach resulted in the privatization of about 170 enterprises by the end of 1992.

Despite what would be considered astounding progress in any other region, Hungarian authorities became concerned at the slowing pace of privatization (their goal in 1990 was to privatize 50 percent of state industrial assets by the end of 1993). Especially important, foreign investment had accounted for about 70–80 percent of the total revenues from privatization through the end of 1992, but it was doubtful that this pace could be maintained, because many of the best assets had already been sold.[6] The government began promulgating less traditional means of pumping up domestic demand for ownership of state-owned enterprises (SOEs)—and in the process, the Hungarian program began to converge toward the more experimental approaches under way in other East-Central European countries, which emphasize speed over sales receipts. In particular, authorities introduced lease/buy-out schemes analogous to those implemented in Poland (reviewed below). Potentially significant price discounts were achieved through subsidized interest rates—with long grace periods and terms—to facilitate purchase by management and employees of the enterprises in which they worked. In addition, the government began offering no-interest loans to citizens to buy enterprise shares on offer through the stock exchange.

Mass Ownership Transfer[7]

The second approach to privatization attempts rapid transfer of ownership in hundreds or thousands of medium- and large-scale state enterprises to citizens at large, using vouchers. Usually the principal goal is to improve corporate control, and thereby management, worker productivity and market competitiveness, by transferring these responsibilities to the private sector.[8] Within the heading of "mass" privatization, one can discern two broad approaches, usually referred to as "top-down" versus "bottom-up." The program implemented in Czechoslovakia in 1992, and by the Czech Republic in 1993–94, epitomizes the latter approach. Branch ministries, outside investors, and management of medium- and large-scale enterprises were given fixed periods to come up with privatization proposals, which could include trade sales, management/employee buy-outs or inclusion in the voucher privatization program. As mentioned above, this resulted in some 300 large enterprises being sold in trade sales, mostly to foreign investors. Then majority stakes in some 1,800 medium- and large-scale enterprises were

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[6] Hungarian officials reported in 1992 that the pace of direct foreign investment matched 1991 levels, but that "greenfield" investment accounted for a rising proportion of the total.

[7] For a comprehensive review of mass privatization techniques see Lieberman (1994).

[8] Other goals, more political in nature, may include equitable distribution of ownership and (discussed later in the section) attempts to empower political economic factions which stand to benefit, as opposed to lose, from the transition to open and transparent market economies.

passed to private citizens via sequential voucher bidding rounds. The program was indeed quick, although it proved to be one of the bones of contention between the two Republics, which finally led to their mutual agreement to part ways. Although the Czechs proceeded with a second wave of 860 voucher privatizations, to complete the divestiture of more than two-thirds of state industry by October of 1994, the Slovaks appear to have rather dramatically backpedalled.

Although the transfer of ownership to private hands in the Czech Republic has been very rapid, it is too early as of this writing to discern the benefits of the process in terms of microeconomic reform. Nonetheless, initial fears that voucher privatization would simply disperse ownership widely among the population thereby reducing the chances of establishing effective corporate control, appear largely to have been unfounded. To the contrary, about 50 percent of the vouchers bid by citizens were invested through just 10 of the 420 newly formed private investment funds, giving rise in the Czech Republic to concerns about untoward concentration of ownership in the hands of a few funds, which will presumably become the principal arbiters of the fate of much of the economy. How that control will be exercised is unclear, especially for enterprises that are sustaining losses. The next stage in establishing corporate control, and restructuring the privatized enterprises, will depend heavily on the efficiency of capital markets, bankruptcy laws, and liquidation procedures (discussed in the next section).

In contrast, as proposed but still not implemented 4.5 years since its conceptualization, the Polish mass privatization program is the model "top-down" mass privatization approach. Outside managers are to be selected by government tender to administer large, closed-end mutual funds to which portfolios of shares in some 400 large-scale state enterprises have been allocated in fixed proportions by lottery; the first Supervisory Boards of the funds will be appointed by government. No fund is to receive an outright majority, but one fund is to be selected to be the "core investor" in each enterprise, with 33 percent of its shares. In exchange for their vouchers, citizens will receive shares in the mutual funds, but will not be allowed to bid directly for shares in the enterprises themselves. The idea is to attempt to put into place a framework for corporate governance, and a track record of mutual fund portfolio profitability, before allowing direct citizen trading in enterprise shares. As a political sweetener, enterprise employees are to receive a 20 percent stake at no cost; other proportions have been allocated to public sector employees and pensioners. Government itself will retain a 30 percent stake, in effect retaining considerable ultimate leverage. The outside managers hired to run the funds will be compensated in part by "success" fees based on fund performance.

Unfortunately, implementation of the Polish program has been delayed for years by fierce political opposition, partly because of parliamentary haggling over intricate share allocation rules, but also perhaps because the program has built in so many checks and balances against citizens exercising direct ownership rights in the enterprises themselves, the average Pole seems to have lost interest in seeing the program implemented. It is also true that the decision by Polish authorities to give management and workers a veto over their inclusion in the program, rather than to require all enterprises either to find an outside buyer or be included wholesale in the program (as in the Czech and Slovak program), created a focal point for enterprises to voice their opposition within the bureaucracy which may have proved insurmountable.

Internal Privatization [9]

If traditional privatization proves too slow, and mass ownership transfer programs are not implemented, the alternative, unless the state is to retain ownership for the indefinite future, is progressively to cede control of the industrial enterprises to internal factions. This is referred to as internal privatization. In reality no East-Central European country pursues such a privatization method as a primary strategy. Instead, the best description of what is happening is that governments, faced with political pressures to recognize the effective ownership claims of enterprise management and workers, and hoping to privatize state sectors quickly, have instituted programs and regulatory procedures that recognize and attempt to make the best of internal privatization.

The problem is that when management and workers, often with the government as a silent partner, retain overweaning influence over enterprise decisions, all but the most confident of outside investors will pause. And there is little likelihood of improved management, and money for new investment, if outside investors cannot be persuaded to chip in a substantial stake. If internal factions gain effective control of the enterprise without actual ownership rights, they may strip the assets of the enterprise over which they have gained control, or neglect plant maintenance, to pay for increased wages, benefits, and short-term profits while undermining long-term viability. In addition, there is often an inherent conflict between employee interests and the necessity of restructuring to enhance profitability, and this may lead to continuing pressures on the state to continue subsidizing enterprises after they are privatized.

On the other hand, if the process is regulated and structured to pass ownership rights to internal factions in a market-oriented and transparent manner, and management is able to operate with sufficient autonomy from workers, internal privatizations can result in an effective structure of corporate governance. [10] With this in mind, and responding to pressures from management and workers, government programs have evolved to regulate internal privatization. These typically are designed with the intention of attracting outside investors, or maximizing the stake that internal factions must put up as part of the bid, while attempting to limit fraud and abuse. Programs may be instituted to lease enterprises to management and workers with the option later to turn the lease into a direct government loan. Preferential loans or loan guarantees may be offered. [11]

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[9] On this subject see *OECD* (1994a), with a special feature on management/employee buy-outs.

[10] One condition necessary for effective corporate control to result in this case is the imposition by governmental authorities of a "hard budget constraint."

[11] It seems reasonable to conclude that, as described, regulation of internal privatization will cause it to resemble more traditional forms of privatization, and that this will in the end slow the process considerably.

Although all four East-Central European countries have promulgated programs to regulate and/or facilitate internal privatization, the Polish case serves as an interesting example of one of the more market-oriented buy-out programs. Despite considerable emphasis at first on traditional privatization, and years of tinkering with plans for mass privatization, the most prevalent divestiture route has been a regulated form of internal privatization. Some 650 privatizations of medium-sized enterprises have occurred to date through the so-called privatization-through-liquidation program. Of these, about three-quarters have been leases to management and workers, requiring 20 percent down payment on book value, and carrying the option to buy into a direct loan. The remainder have been direct purchases, also typically by management and workers, or asset sales, often at a substantial discount. In reality, there may be little difference between leases and discounted purchases via this route, because the threat of government foreclosure, should the lessee or borrower fail to meet scheduled payments, may have little credibility.

SPEED VERSUS "QUALITY" OF PRIVATIZATION

The need for speed in privatizing the state sectors inherited from the communist regimes in East-Central Europe derives from several sources, but may be summarized as follows. The job itself is enormous, and there is a severe paucity of domestic or foreign savings available to accomplish it in a reasonably short period if reliance is placed on traditional methods. The alternative is not the status quo, but progressively to cede control of enterprises to workers and managers at nominal or no cost, and to risk asset stripping, enterprise de-capitalization and continued subsidization of loss-making enterprises. This gives rise to the interest of authorities in implementation of experimental forms of privatization, which promise quicker, and more systemic, results.

But the characteristic feature of the more experimental forms of privatization which have arisen in post-communist economies—such as mass or internal privatization—is that political objectives often dominate economic ones. If any form of privatization other than sale to the highest bidder is used, some form of nonmarket ownership distribution is implied. One result is that officials must concern themselves with the "quality" of privatization—that is, the extent to which it is likely to result in desirable microeconomic reform. A privatization outcome exhibiting high "quality" under circumstances of non-market methods of asset divestiture might be summarized as follows. Decisions about restructuring of finances, management, and production, and worker layoffs, plant closures, and so on, are better made by outside owners with sufficient concentration of ownership to be able to enforce corporate control. Or, if insiders prevail, they should not be held "hostage" to the search for government subsidies, either direct or through quasi-public banks, to palliate workers in the enterprise and thereby retain their position.[12] Instead, the sole basis for decisions should be prof-

[12] This argument is put forward by Boycko et al., (1994). Again, one way to alleviate this concern would be to impose a hard budget constraint on enterprises, although this may be difficult to achieve politically if the majority of enterprises are potentially so held "hostage."

itability of asset usage, as compared with all alternative uses, meaning that the new owners will shut down unprofitable activities. The legal and institutional infrastructure covering such things as bankruptcy and liquidation must be in place and effective to facilitate carrying out such decisions. More broadly, "market incentives" must apply, so that, for example, any transitional subsidies are directed to workers and not to the enterprises and their owners. In addition, if vouchers or sharp price discounts are employed, authorities may wish to encourage the prospective new owners to risk at least some of their own savings as part of the acquisition process, possibly in the context of a business proposal that includes a program for new investment following privatization; perhaps facilitated by some innovative financing schemes, or the ability to match voucher bids with cash bids in auctions of enterprises or enterprise shares.[13]

Most important, enterprise shares should be tradeable. In all experimental forms of privatization, officials expect, or hope, that a "post-privatization" round will occur, in which newly acquired shares are sold to outside investors, in effect consolidating corporate control. Even in countries in which the privatization process has been virtually dominated by internal factions, authorities are keen to encourage share trading in the post-privatization phase. The hope is that workers, managers and other shareholders will sell off their shares to outside concerns whose sole interest is profitability; and that banks and other creditors will force insolvent debtor enterprises to liquidate unprofitable assets, or in the extreme, into bankruptcy. Indeed, as is discussed in detail in the following section, the latter route may well become a key element of efforts to foment microeconomic reform in the post-communist economies.

SYSTEMIC RESTRUCTURING

LEGAL RESTRUCTURING

Unless enterprise assets are to be liquidated directly by the state, in general, prior to privatization, public enterprises must be transformed legally into limited-liability corporate units autonomous from their founding ministries ("corporatized"). This has several outcomes that are key to the privatization and restructuring process. First, legal restructuring is a clear prerequisite to sales of enterprise shares, which are necessary for traditional privatization through public share offerings to be carried out. More important, under several of the experimental privatization routes, a steady supply of corporatized enterprises is needed, so that their shares can be exchanged for vouchers in voucher auctions.

Legal restructuring also is an opportunity for the state to "unbundle" the enterprise, which under central planning often was an amorphous conglomeration of unrelated activities. The typical large-scale manufacturing enterprise, for example, would be responsible not only for its principal product lines, but would also provide its employees—and sometimes the whole town—with serv-

[13] Although not reviewed in this report, such matching voucher/cash bidding programs have been successfully employed in Lithuania. See Semeta (1993).

ices such as health care, nurseries, schools, sports facilities, and so on. Breaking up these large industrial combines into smaller units, and either transferring them to appropriate municipal or central authorities, or privatizing them separately, is an essential element of the legal restructuring process. In addition, of course, the process of unbundling is extremely important in that it allows the creation of saleable business units from the socialist-era industrial behemoths.[14]

It is worth noting that East-Central European countries have approached quite differently the question of whether legal restructuring, or "corporatization," should be voluntary or mandatory. In effect, corporatization involves the re-assertion of property rights by central authorities, in the form of privatization ministries or agencies, at the expense of existing stakeholders such as the founding ministries, enterprise management and workers.[15] Proponents of mandatory, mass corporatization of state enterprises argued early on that it was necessary to avoid lengthy and protracted negotiations, firm-by-firm, with workers and managers over the terms of privatization. And mass corporatization was, in effect, what was carried out in the Czech and Slovak Republics in respect to all of the enterprises that went through the voucher privatization process. It may have been considerably easier there, because Czechoslovakia under the prior regime had always adhered quite strictly to central planning, which strictly limited the claims of stakeholders other than the central government.

The previous regimes in Poland and Hungary, by way of contrast, had attempted to introduce socialist reforms, which created stakeholders among founding ministries, associated banks, enterprise management, and workers. Perhaps as a result, in these countries, "corporatization" was left to the volition of the enterprises themselves. In Hungary this has meant that each enterprise is effectively corporatized as it is privatized, a practical solution given its more traditional privatization program. In Poland resistance to corporatization became one of the means for insiders to forestall privatization, and in particular, inclusion in the mass privatization program. The result is that, of some 8,000 medium- and large-scale state enterprises inherited from central planning, only 700 have been corporatized to date; and the government is again reviewing the question of mass corporatization of 5,300 enterprises.

FINANCIAL RESTRUCTURING AND INSOLVENCY PROCEDURES

One of the most acute problems faced by reformers in all of the post-communist countries was the bad financial condition of a large proportion of state enterprises. Many were already heavily indebted; others began sustaining severe losses, and accumulating unsustainable debt levels, when market pricing and competition were initiated, and markets in the old Soviet bloc dried up. Quasi-public sector commercial banks at first continued supplying unse-

[14] Reformers also believed initially that anti-trust actions would be key to promoting competition in the post-communist economies, due to the preponderance of monopolistic and monopsonistic structures of the previous system. But, at least in the industries subject to competition with imports, anti-monopoly actions proved much less critical following sweeping trade liberalization.

[15] On the advantages of corporatization as such see Jones (1991).

cured credits to their traditional clients. When financial discipline was imposed through tighter monetary and bank supervision policies, some enterprises continued delivering products to their traditional clients, accumulating large "inter-enterprise" debts in lieu of payment, expecting their banks again to bail them out with soft loans. Significant inter-enterprise debt payment arrears accumulated in almost every country, and in those countries where they were monetized by central banking authorities, they contributed to rapidly accelerating inflation.

In short, the transformation from central planning to market economies created a banking crisis in virtually every post-communist economy. The difference between this crisis and those experienced in OECD or developing country economies, however, is that virtually all of the bad loans had been made to public enterprises. This was to complicate privatization efforts enormously. In the following sections a taxonomy is presented of the principal policy tools used to deal with these debt problems, alongside assessment of their implications and effectiveness. Three such tools have emerged: comprehensive pre-privatization restructuring of enterprise balance sheets; systemic solutions to the bad debt problem; and insolvency procedures.

SYSTEMIC PRE-PRIVATIZATION RESTRUCTURING

Although it was the model followed in most OECD and developing countries for preparing enterprises for privatization, the scale of the public sector in post-communist economies by and large has precluded pre-privatization restructuring. The only country that has pursued this approach at the enterprise level is Germany following unification; and without the West German economy behind it, it would have been unthinkable.[16] The other countries of East-Central Europe could not afford such a comprehensive internalization of restructuring costs. They did, however, carry out pre-privatization balance sheet restructuring in certain large enterprises. In the Czech Republic, for example, this exercise has been undertaken by the National Property Fund (NPF) on a much larger scale than is generally assumed. In Hungary, apart from the 100 companies participating in the debt consolidation program (discussed below), another 160 very large companies (with a cumulative value of more than $10 billion) have been transferred to the State Holding Company, which is responsible for their pre-privatization restructuring, including financial support. Poland has adopted a number of such pre-privatization restructuring schemes, with mixed results.

BAD DEBT AND INTER-ENTERPRISE ARREARS

Authorities in all post-communist economies have had to come to grips with the bad-debt problem because of its implications for liquidity of the banking system and hence for economic stability. The traditional approach to resolving such banking crises is to encour-

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[16] Prior to any privatization transaction in Eastern Germany, the German Treuhandanstalt wrote off the enterprise's old debts and, in addition, took over substantial environmental, social or other liabilities and potential liabilities. Moreover, the Treuhandanstalt underwrote current operational costs for all enterprises until their privatization. This, of course, was costly, too costly for any other post-communist country: the Treuhand's accumulated deficit since it commenced operations was around DM 300 billion in 1993. On the "bad debt" approach in the case of the former GDR see Plessing (1993).

age bankers and borrowers to work out as much of the bad debt as possible first, then cut all the bad debt that can be identified out of the banks' portfolios. An autonomous public entity receives the bad loans, and these are settled through direct negotiation with or bankruptcy of the borrowers. The banks are then recapitalized. The concern, of course, is that the banks may get used to being bailed out in this manner, creating a moral hazard for them to continue making bad loans.

This more traditional approach was the one followed by the Czech and Slovak Republics and Hungary. Consolidation Banks were created in both Republics in 1991, under the former Czechoslovakian government, which took over a large chunk of bad loans from the nation's quasi-public commercial banks. The latter received in exchange 5-year government bonds. A second round of Czech bank re-capitalization took place in 1992, with the recipient of the bad loans in this case being the National Property Fund, the statutory recipient of privatization income. On the enterprise/debtor side, in addition to the pre-privatization financial restructuring mentioned above, several schemes were enacted to work out (or "net out") inter-enterprise debts, with very little success, mainly because of a lack of clear incentives for the enterprises, which participated on a voluntary basis. In Hungary, a similar approach was adopted with the establishment of the Hungarian Investment and Development Company (HID), which took over most bad debt from the commercial banks' balance sheets, replacing it with 20-year treasury bonds. The job of enterprise restructuring was addressed by the adoption in the beginning of 1992 of a severe bankruptcy law (discussed below). In Poland, by way of contrast, the banks were "capitalized" first, and then charged with working out their bad loans directly with borrowers. Banks were given a set of incentives to either restructure their debt or exchange it for equity in insolvent firms and then capitalized in proportion to their presumed nonperforming assets.

One difficulty with the traditional approach [17] to systemic financial restructuring is that it accomplishes restructuring primarily on the creditor side, rather than the debtor side, in effect "de-coupling" the two, and leaving large portfolios of bad loans to public or recently privatized enterprises in the hands of public entities. In the Czech Republic most of the enterprises concerned are already privatized or in the final steps of their privatization, so the government is in the unenviable position of having either to liquidate the insolvent companies itself or re-nationalize them through debt-for-equity swaps, presumably preliminary to their re-privatization following restructuring. In the Hungarian case, the current bankruptcy law makes it very difficult to avoid insolvency proceedings. However, about 100 large, loss-making state enterprises have been effectively shielded from the latter in the context of the loan consolidation scheme (the Hungarian bad-debt approach). The responsibility for privatization of these companies has been transferred from privatization authorities to the entity holding the bad debts (the HID), a result which might actually make their privatization

[17] Fries and Lane (1994) underline the advantages of the traditional approach, at least regarding the banking sector.

more difficult.[18] Of course, the drawback of the alternative policy, of ex-ante capitalization of the banks, is that it increases moral hazard, since the actual bad debts can only be known after the actual restructuring occurs (*if* it occurs). The policy places the restructuring burden on the banks, and it could make them effectively responsible for corporate control of a large number of enterprises, which might considerably complicate bank supervision. However, from the point of view of enterprise reform, this approach might have some distinct advantages, as discussed in the next section.[19]

INSOLVENCY PROCEEDINGS[20]

One of the often-overlooked means of privatizing state assets, as opposed to state enterprises, is through bankruptcy of insolvent enterprises and liquidation of their assets. Indeed, in market economies, insolvency proceedings—bankruptcy and re-organization provisions—are the main tool for imposing financial discipline on enterprises. Hungary has been the first East-Central European country to employ this tool in a major way. New, and somewhat draconian bankruptcy legislation came into effect in early 1992. Since then a large number of enterprises, with aggregate production representing close to 10 percent of GDP, have entered insolvency proceedings. The bankruptcy law has been very effective in lowering inter-enterprise arrears. It also has been a major privatization method: approximately 500 large enterprises have undergone insolvency procedures and their ownership (in the form of assets or as going concerns) has been transferred to the private sector.

The Hungarian bankruptcy law is one of the strictest among market economies, and is the most strict among post-communist economies. It makes insolvency proceedings mandatory for the debtor on the basis of a very narrow liquidity test. While it does allow for a period to negotiate a settlement agreement with debtors, it requires creditor unanimity for the acceptance of any reorganization plan and is therefore strongly biased against reorganization in favor of asset liquidation. Amendments to soften the quasi-automatic triggering of bankruptcy procedures and the liquidation bias have been introduced recently by the Hungarian government.[21]

The Czech approach has been radically different. The government delayed implementation of the bankruptcy law until the first wave of privatization was completed and, even after the law took effect, exempted from its scope companies undergoing privatization within the second wave. The logic of the Czech (and Slovak) mass privatization scheme was that it transferred politically difficult questions such as dealing with insolvent enterprises to the private sector. But even though the bankruptcy law became applicable to privatized enterprises in September 1993, very few bankruptcy procedures were initiated.[22] The cause of this phenomenon seems to be twofold: on one hand, as mentioned, the Consolidation Bank con-

[18] See Nestor (1993).
[19] For further details concerning this approach, see van Wijnbergen (1994).
[20] For a review of different legislative approaches see Nestor (1994).
[21] See Miszei (1993) for further analysis of the costs and benefits of the Hungarian law.
[22] See Brom and Orenstein (1994).

trols a large chunk of bad enterprise debt and the National Property Fund is a minority—but often controlling—shareholder in a large number of troubled companies. These entities may be reluctant to initiate bankruptcy proceedings for political reasons. On the other hand, there seems to be a reluctance on the part of dominant creditors (commercial banks) to initiate bankruptcy proceedings. This behavior may be related to the fact that several banks are still controlled by the National Property Fund; furthermore, they frequently are at the same time major shareholders in many companies, via the investment funds that they control.

Poland has followed an approach that could be termed two-track. Early on it adopted a bankruptcy law that is applicable to both private entities and state enterprises. In contrast to the Hungarian one, the Polish law is triggered by a very lax insolvency test; it leaves outside the scope of reorganization a number of important state claims, such as tax and social security payments, thus making creditor-led restructuring unattractive.[23] While a number of bankruptcy proceedings were initiated during the three years of its implementation, the law has not substantially affected state enterprises. The second track of the Polish approach addressed precisely the problem of the state enterprises. In the first place, specific provisions existed for the liquidation of state-enterprise assets by the founding ministries; these provisions have been applied with some success to smaller enterprises. The most important measure to this effect was introduced as part and parcel of the arrangements regarding the bad-debt problem. Through the bank-led "reconciliation" procedure, creditors that hold 50 percent or more of the outstanding debt of an insolvent enterprise (almost always banks), become responsible for adopting a reorganization plan or liquidating the company. A distinctive feature of the reconciliation procedure is the existence of direct incentives for reorganizing insolvent enterprises rather than closing them and liquidating their assets. One of the most important of such incentives is the inclusion of state claims in the debt-reduction process.[24] The approach seems to have been successful in restructuring a number of larger state enterprises since August 1993.

From a comparative point of view, there seems to be a trade-off between the effective implementation of bankruptcy provisions and the adoption of a rapid mass privatization program. Countries that have followed a more traditional "sales" approach to privatization have been forced to introduce insolvency procedures at an earlier stage as an alternative way of enforcing market discipline on companies that had not yet acquired private ownership structures. Where mass privatization has been the norm, however, imposing such constraints on state enterprises could have caused considerable delays and generated additional transaction costs during their privatization. Instead, application of insolvency procedures in this case generally has been left to the "post-privatization" phase.[25]

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[23] See Miszei (1993).

[24] See Van Wijnbergen (1994) for a more thorough exposition of the Polish reconciliation procedure.

[25] An interesting alternative approach to bankruptcy in transitional economies has been proposed by Aghion et al. (1992). However, the review of this proposal goes beyond the scope of the paper.

OPERATIONAL RESTRUCTURING AND CORPORATE GOVERNANCE

The third and, in the long-run, probably most important category of restructuring entails the transformation of enterprise activities in such a way that the enterprise can be profitable in an open market economy. Under "operational restructuring" one may include changes in the product line, managerial structure, market strategy, or productivity of a single firm. From a policymaker's perspective, these changes can only be implemented if individual firms are subject to a market incentive structure. Apart from the financial discipline issues discussed in the previous section, the most important set of incentives relevant to restructuring is related to the governance of firms.

There are five types of institutions that can perform the "principal" function of supervising the "agents," or managers, in the process of enterprise restructuring: the state, private owners, institutions in the capital markets, non-bank financial institutions, and banks.[26] Each of these forms of exerting corporate control is discussed in turn in the sections that follow.

State Ownership

Since systemic preprivatization restructuring on the German model is unaffordable, it is generally agreed in the post-communist context that operational restructuring should be left to the new private owners, following enterprise privatization. This has a certain logic to it economically, in any case: Government bureaucrats are the least well placed for deciding or controlling the future course and strategy of commercial firms, or choosing those that will succeed or fail. Nonetheless, in reality, as mentioned above, all East-Central European governments have assumed responsibility for a number of large state enterprises considered "too sensitive to fail" and not ready to be privatized. In the Czech Republic the National Property Fund, apart from providing financing, has adopted a very passive role in the companies it still controls through majority or minority stakes—although in some sectors such as coal, active restructuring programs have been adopted. In Hungary, the State Holding Company is planning to undertake considerable restructuring prior to the (partial) privatization of its portfolio. In Poland, a number of enterprise restructuring schemes have been adopted that emphasize the involvement or management by private agents and the inclusion of incentives for the privatization of the state enterprises concerned.

"Real" Private Owners

The ownership structure generally to be desired, from the standpoint of enhancing corporate control, is one in which a strategic investor or group of investors gains control of the enterprise. Under such "closed" circumstances, agency costs are drastically reduced and corporate governance is exercised directly and with few obstacles. This is the ownership structure implied by trade sales to out-

[26] One should also include two important sources of discipline for corporate managers: product markets and the competitive pressures they exert on the firm; and the market for corporate managers (which in the case of the East-Central European countries is obviously not developed). For background on agency and transaction costs approaches to the theory of the firm, see Williamson (1985), and Jensen and Meckling (1976).

side strategic investors, although it may result from bottom-up voucher privatization or even, under certain conditions, insider privatization. It is to be stressed, however, that the more experimental, and rapid, forms of privatization typically leave the majority of enterprises with no strategic investors. In this case, nonetheless, the establishment of corporate control may be effected subsequent to the privatization itself through exchanges of enterprise shares in secondary markets.

Capital Markets

In addition to providing the means to consolidate corporate control post-privatization, secondary markets (along with asset markets, in the case of liquidation) also represent the main exit route for incumbent (or immediate post-privatization) share owners. And, of course, capital markets can also play a central role in financing enterprise development. Equity markets—both formal exchanges and over-the-counter markets—have developed with unexpected speed in the East-Central European countries. Despite recent corrections, Poland and Hungary have seen their markets grow impressively during the past 18 months, although the number of shares traded is quite low. This is mainly due to the influx of foreign fund capital seeking promising emerging markets. Growth of equity markets is in itself an important source of financing operational restructuring of companies, but its corporate control function seems thus far to be limited in these two countries.

In the Czech Republic the situation is quite different. In the aftermath of the first mass privatization wave, more than 1,000 companies find their shares traded, and there are many more to come following the second voucher wave in 1994. Few are listed in the Prague Stock Exchange (PSE), but most are traded in the PSE unlisted market and the rival RM-S Exchange.[27] The market is characterized by low liquidity and important information asymmetries; these problems are compounded by the fact that most block trades (that is, the market for corporate control), take place outside the exchanges. This idiosyncrasy is directly related to voucher privatization: alongside the multitude of small voucher-holders turned stock-holders, a number of huge financial intermediaries emerged in the form of voucher investment funds that control important blocks of company shares and are thus the main players in the market for corporate control. The existence of such a large gray market, given the relative size of the players, is probably unavoidable and not necessarily negative. However, it is important that price-sensitive information from these transactions be made public.

In all of the post-communist economies, greater emphasis should be placed on the establishment and effective functioning of takeover mechanisms, which are essential for corporate governance purposes and represent the main exit path for investors—large and small. Indeed, given the extensive reallocation of resources that should follow privatization in most cases (with the exception of trade sales to strategic investors), the smooth functioning of takeover markets is of much higher importance in East-Central Europe

[27] See Triska (1994).

than in OECD countries. Corporate legislation regarding proxies, closed employee ownership arrangements, or protection of minority shareholders should take account of these needs related to the form and peculiar nature of the transition from central planning.

Corporate debt markets, in contrast to equity markets, have been slow to emerge and, given the traditional predominance of banks as lending institutions in continental Europe, might never become prominent in enterprise financing. Nonetheless, an important "window of opportunity" seems to be open to them during the transition period; it is related to the solution of the bad-debt problem. Instead of becoming the means for equity acquisition by creditor banks, debt can be made convertible, securitized and sold in a secondary market for corporate control. This solution has already been envisaged in the context of the Polish arrangements; it seems to be a possible answer to concerns related to state ownership and control of banks (especially in the Czech and Hungarian cases). Secondary markets for such debt might be the missing link for "re-coupling" the "de-coupled" banking and enterprise restructuring policies..

Investment Funds

The role of investment funds is predominant in any country that has implemented mass or voucher privatization. The ten largest voucher investment funds in the Czech republic control approximately 50 percent of the equity privatized against vouchers. Being the main players in the emerging market for corporate control, the funds are confronted with a fundamental conflict of functions: they are at the same time mutual investment institutions, which should therefore preserve at all times a highly liquid asset structure; as well as holdings, required under the circumstances to play an important role in corporate governance of the newly privatized enterprises.

The regulatory solution to this conflict given by the Czech government in 1992 was, in the long run, inadequate. Funds were not permitted to acquire more than 30 percent of the equity of a single enterprise, while no more than 10 percent of their assets could be invested in one single company. These were on one hand insufficient measures from the point of view of shareholder protection. On the other hand, they created additional costs for exercising corporate control by the Funds, which, given the present low liquidity of the market, are the only plausible "principals" in the corporate control equation. Still, the light-handed regulatory approach of the state did make sense in the first and highly uncertain phase of voucher privatization; anecdotal evidence suggests that funds are becoming active in corporate governance, despite the legal constraints.[28]

Apart from voucher funds, a number of venture funds with mainly foreign capital are slowly becoming active in the corporate con-

[28] In the longer term, more clear cut regulation might need to be adopted that would draw the line between open-ended (that is, passive-investment), variable-capital funds requiring strict liquidity provisions; closed funds with publicly traded shares, requiring high transparency but minimal regulation as to the size and quality of their equity holdings; and venture-type funds that, in principle, should not require any additional regulation. There need not be any restriction on the control side of these funds (i.e. the recipient of fee or equity-based income from the operation of several funds might be a single entity/investment company), as long as there are clear regulatory walls between them and their detailed accounts are made public.

trol market, especially in Hungary and Poland. However, their presence currently is of only marginal importance in the overall restructuring process. Finally, pension funds are being capitalized with privatized enterprise shares in both Hungary and the Czech Republic. These institutions have a potential of becoming important players in the market for corporate control, as was the case in Chile and more recently in the United States. It is still too early, however, to expect results; in any case, given the high risks and volatility of East-Central European emerging markets, it might be unwise to encourage high exposure to individual company risk during their current nascent phase.

Banks

Finally, the role of banks in exercising corporate control has stirred lengthy discussion. The debate has sometimes centered on whether to adopt an Anglo-Saxon "specialized" banks approach or a continental "universal" model. In reality, the question has been answered in practical terms: East-Central European countries have adopted a "universal" approach to banking. This does not necessarily mean that banks are free to hold as much equity as they want. In Hungary, the banks' equity shareholdings are limited to 15 percent of the warranty capital for commercial banks and 40 percent for investment banks; banks can hold no more than a 51 percent share in nonfinancial firms. In the Czech Republic and Slovakia equity exposure is limited to 25 percent of their capital while individual company holdings have to stay below 10 percent, beyond which point a prior consent is required by the Central Bank. Poland has a 25 percent cap on equity exposure.

A distinction should be made here between two issues that are often blurred. The first concerns the role of the banks in corporate governance; it corresponds to their position as the main providers of debt financing to enterprises. The second issue addresses the desirability of the banks becoming large holders of equity in commercial firms. In the context of the first issue, there seems to be ample scope for an adequate degree of control to be exercised. If a company predominantly relies on debt and, therefore, bank financing—as seems to be the case in Poland and Hungary—banks will be in a position to obtain seats in its supervisory board, and hence exercise their governance functions. Yet where the capital structure of companies is equity-oriented, as might be the case in the Czech Republic, assuming the unlisted markets develop at their present pace, banks will justifiably have a smaller role in corporate governance. There is no reason for any special privileges to be accorded to the banks in terms of corporate control, assuming that the legal framework for secured transactions is properly functioning. Indeed, such a bias might discourage strategic investors, who are by definition the most appropriate "principals," from buying into companies and, in general, might create rigidities in the equity-based market for corporate control.

Substantial equity exposure of banks that are at present state-owned or controlled may have negative consequences. It seems that Polish-type approaches to bad-debt restructuring might well result in large bank equity holdings, for example. Bank supervision might become more complicated, since bank asset structures will become

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more risky and less liquid. From a corporate governance point of view, there is a conflict of incentives between debt and equity holders, especially regarding the level of risk each of these categories of stakeholder is willing to bear. Banks might become captive to enterprises in which they are major shareholders by subordinating their creditor interests to shareholding considerations. In the Czech Republic, where banks indirectly (through control of investment funds) control a sizeable part of privatized equity, the slow implementation of the bankruptcy law seems to be partly caused by this type of incentive conflict. A solution to these problems might be found in combining the existing caps on banks' equity holdings with a strict regulatory separation of the equity-based activities from their lending activities.[29]

CONCLUSIONS

Each of the East-Central European countries has implemented a distinct strategy for privatization of medium- and large-scale public enterprises. The Czech Republic has implemented, and should complete by the end of 1994, mass privatization using vouchers. The Slovak Republic, too, has privatized a large proportion of its holdings in this manner, and plans to continue the process. In both these cases, however, restructuring or liquidation has largely been postponed until the post-privatization stage. Most medium- and large-scale privatizations that have been accomplished in Poland, on the other hand, have been internal privatizations, principally management/worker lease/buy-outs. But most of the medium- and large-scale enterprises inherited from central planning still remain in state hands; the question of how these assets are to be restructured or liquidated has not yet been determined, although it is clear that the state will play a much larger role in Poland than that envisioned, for example, in the Czech Republic. Hungary, in contrast, has pursued the more traditional approach of selling viable enterprises to the highest bidder, although more recently this strategy has been modified to offer subsidized lease/buy-out options, and zero interest rate loans for the purchase of enterprise shares, to increase citizen participation in the privatization process. It is also true, however, that Hungary has liquidated nearly as many enterprises as it has wholly privatized, an indication of just how important liquidation may be as a means of privatizing public assets.

Thus, in East-Central Europe, as in the post-communist economies generally, the methods used and the progress achieved in privatizing most of each country's economy have varied widely. The process has been one of multiple and sometimes conflicting objectives, disappointment at the lack of interest on the part of foreign investors, at times severe political gridlock in program implementation, and experimentation with forms of privatization that sometimes have yielded mixed results, both in terms of speed and "quality" of the privatization achieved. In some countries, the transfer of ownership to private hands has proceeded very rapidly, whereas in others it has been slow, at least in comparison to initial expectations. In the former case, for the most part, the establishment of

[29] This approach is outlined in Blommestein and Spencer (1994).

effective corporate governance, and restructuring of finances, management, work forces and productive assets, all have been left to the "post-privatization" stage, which is still in the initial phase. Where privatization has been slower, of course, the state remains responsible for a vast number of enterprises, over which insider factions strive to gain effective control. In both cases, the state will remain a key player in bankruptcy and liquidation of the assets of many large, loss-making enterprises. Bankruptcy and liquidation, whether initiated by the state or by creditors, has become one of the more important routes to achieving privatization of state-sector assets. Imposition of the "hard budget constraint" appears to be a necessary, if not sufficient, condition for effective enterprise restructuring or liquidation to occur; although it is difficult to sustain politically. Nevertheless, considerable potential for macroeconomic instability arises from demands for continued subsidization, in one form or another, of loss-making state-sector enterprises. This adds particular urgency to the need to substitute new, private owners for the old, debilitating alignment of bureaucrats with factions internal to the enterprises themselves.

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POST-PRIVATIZATION ISSUES IN CENTRAL EUROPE

By David M. Kemme*

CONTENTS

SUMMARY

Privatization of state-owned enterprises and the growth of indigenous private sector firms has greatly changed the structure of the economies of the Czech Republic, Hungary, and Poland. With successful privatization, a host of new issues has appeared. Appropriate representation of stakeholders, those who stand to gain or lose from the change in disposition of an enterprise or are affected by the activities of an enterprise, was critical as privatization took place and remains critical after privatization. Further, with the change in ownership, corporate governance issues familiar to market economies (agency problems in particular) are beginning to arise. This paper focuses on the linkages among ownership changes, the development of new forms of corporate governance, and the creation of new dominant shareholders, mainly institutions such as investment funds or commercial banks.

After a short introduction, the second section examines general corporate governance issues in a comparative framework. The third section discusses the recognition of stakeholders in the former centrally planned economy and the need to convert stakeholder interests into ownership interests to advance privatization efforts. Both small and large privatization efforts in the Czech Republic, Hungary, and Poland are briefly reviewed in this context.

*David M. Kemme holds the Chair of Excellence in International Economics, at the Wang Center for International Business, University of Memphis.

As enterprises are privatized, the principal-agent problem, aligning the interests of shareholders (the principals) and managers (the agents) at the lowest possible cost, becomes a critical issue. The fourth section reviews the mechanisms for solving the principal-agent problem in the Central European context. While the market for corporate control is the ultimate monitor of corporate governance, it requires a rather well-developed capital market. Policymakers in Central Europe are then faced with the need to provide a means to ensure alignment of management and shareholder interests while stock markets develop. One solution is to promote dominant shareholding by an intermediary such as a commercial bank or investment fund.

The fifth section discusses the development of the corporations and the evolution of dominant share holding in each country. As a result of the lenient lending policies of state-owned commercial banks during the early transition period, the banks have inadvertently acquired an excessive stake, through lending, in enterprises that are not viable under current conditions. The accumulated bad debt has required the recapitalization of the banking system and, as a result, commercial banks and investment funds have converted these stakes into ownership interests in the enterprise sector through debt restructuring and debt-for-equity swaps. Thus, intentionally or not, financial intermediaries are evolving into the dominant shareholders necessary to ensure corporate oversight on behalf of a larger group of dispersed shareholders.

The last section concludes by noting that whether or not the recapitalization of the banking systems and the assumption of corporate oversight by financial intermediaries has solved either the bad debt problem or corporate governance problems depends, first, on whether there has been a change in the operational behavior of banks in evaluating the creditworthiness of loan clients, i.e., whether banks now lend solely on economic criteria and, second, on whether they are successful in monitoring the effectiveness of the management of the companies they influence through dominant ownership.

INTRODUCTION

The transition to a market economy with privately owned firms requires the transformation of individual state-owned enterprises into a new corporate form. This process has been ongoing in Central Europe for the past three and a half years. Three issues have emerged: how best to transfer the legitimate interests of stakeholders into shareholders' (or ownership) interests; what the appropriate corporate governance structure of the newly created larger private companies should be; and, as a result of ensuring the financial viability of the enterprise during the transition via liberal bank lending, how best to recapitalize the banking system and restructure the enterprises to induce a change in operational behavior of both the banks and the enterprises. Policymakers in Central Europe have devoted enormous energy to these issues with a significant measure of success. Nonetheless ongoing privatization efforts, enterprise restructuring, and bank recapitalization continue to lead the policy agenda. To understand why, it is first necessary to examine the fundamental issues of corporate governance.

CORPORATE GOVERNANCE

In the traditional centrally planned economy, enterprises were created and owned by a "founding body," usually a ministry or other government agency. The enterprise operated in accordance with a central plan provided by the state planning commission. The planning commission represented the interests of the government or society as a whole, the ultimate owners of the state enterprise. Managers were provided with a detailed plan, and objectives and incentive schemes were constructed to ensure enterprise managers and workers did their utmost to meet plan targets. The targets were typically output goals and various indicators of efficient or "appropriate" use of inputs. Although profits may have been an indicator of performance, profits or enhancing the value of the enterprise were rarely the most important target for managers. Rather, enhancing the political or negotiating power of the manager within the planning system was more important.

For the last three decades economic reforms were undertaken in Eastern Europe that introduced more market incentives and gave managers more flexibility in managing the enterprise. Nonetheless, there were no real changes in ownership. In both the modified centrally planned economy and the more traditional centrally planned economy the incentive problem persisted: how to ensure that enterprise managers operated in accordance with the central plan, rather than in pursuit of their own objectives. In fact, it may be argued that in the modified centrally planned economy (like Hungary, and to some extent Poland) the incentive problem worsened in the late 1970s and 1980s, as enterprise managers had to respond in some degree to both market forces and plan indicators. Thus, the issue of control of the enterprise remained paramount.

In the market economy the counterpart of the enterprise is the business corporation. While neoclassical economic theory treats the firm essentially as a production function in a profit-maximizing environment, here it is more appropriate to view the firm as an organization or governance structure. In the United States these organizations are chartered under state laws, while in other countries they are chartered under federal laws, with the purpose being to undertake activities benefiting both the shareholders and society as a whole.[1] In general, corporations are of perpetual life and the liability of shareholders is limited to the equity invested. The modern corporation is the result of decades of innovations in organization that minimize transaction costs. The purpose of the corporation as an economic entity—dealing primarily with economic outcomes—is quite different from a political body with multiple constituencies typically seeking compromise solutions.[2] As a result the

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[1] The state granting of a legal charter for profit-making business activities and simultaneous pursuit of public policy objectives has a long history. For example, the East India Company, the Massachusetts Bay Company, the Hudson Bay Company, and others were chartered joint stock companies that also pursued the state's objectives in colonization. Further, in the United States private corporations were employed to shift the construction of economic infrastructure to the private sector. *The Business Lawyer*, vol. 46 (November 1990), p. 241.

[2] See Williamson (1981) for a review of the literature on the origins of the modern corporation. In particular he emphasizes the firm as a socially beneficial agent that economizes transaction costs rather than a socially harmful monopolizing agent. The significant organizational innovations he emphasizes are "the development of line-and-staff organization by the railroads; selective forward integration by manufacturers into distribution; the development of the

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governance structure is also quite different. Rather than a system of one person having one vote, an individual may hold hundreds or thousands of votes, proportional to the economic interest in the corporation. The corporate charter stipulates not only the purpose and tasks of the corporation, but also the basic governance structure that may vary significantly from firm to firm. The flexibility provided by the corporate form of organization, and in the United States the greater flexibility in organization from state to state allows for remarkable institutional innovation depending on the environment and business tasks at hand.[3]

Viewing the firm as a governance structure allows the reader to focus on the organization, which theoretically should minimize transaction costs. Rather than focus on organization theory in all of its dimensions, this paper will center on issues that each corporation, whether in a market or a transition economy, must resolve: the reconciliation of shareholder interests and stakeholder interests,[4] and solving the principal-agent problem assuring the alignment of owners' interests and management behavior. In addition, another issue faced by enterprises in transition economies is the capitalization (or recapitalization) of enterprises in order to maintain viable economic processes, preserve wealth, and otherwise minimize the costs of transition to a market economy with private property. This may occur before, during, or after privatization.

Often corporate governance structures are characterized as having inside monitors (as in the German lead bank case or the Japanese keiretsu system) or outside monitors (as in the United States with outside directors on the executive board). Alternatively, governance structures may be viewed as relying on market monitoring or on institutional or legal monitoring mechanisms.[5] In fact, most systems contain all elements. Below this paper touches on several different aspects of the corporate governance problem, but does not suggest that any one system or element is necessary or sufficient.

Stakeholders to Shareholders

For the publiclyheld corporation the owners are usually readily identifiable shareholders.[6] The interests of shareholders are represented by the economic returns of the corporation and are proportional to the number of shares the individual (or institutional)

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multidivisional corporate form; the evolution of the conglomerate; and the appearance of the multinational enterprise" (p. 1539).

[3] Whether or not there should be a federal corporation law replacing state laws has been debated for decades. The general argument in favor of state-level regulation is that it allows greater institutional variety, thus promoting corporate efficiency and increasing shareholder welfare. Further, it is unlikely that regulation at the federal level would better monitor corporate management behavior in areas where the market for corporate control fails. See Kostel (1993).

[4] Shareholders typically have a clearly defined ownership claim to the residual income of the firm and other assets. The term "stakeholder" emphasizes that some interests in the corporation, ownership or otherwise, are not necessarily legally defined but depend on tradition, custom, and social and economic organization. See Honore (1961) and Koopmans and Montias (1985) for a discussion of property rights.

[5] "Market monitoring" refers to pressures not only from the capital market (changing valuation of the firm), but also pressures from both product and factor markets.

[6] This paper focuses on problems of large, state-owned enterprises, their governance, and privatization. Newly created small and medium private firms are not discussed, although they play an important role in the transition process. To some extent the government's role in the corporate governance debate is lessened as small, closely held private enterprises displace the activities of the large, state-owned enterprises.

shareholder owns.[7] Stakeholders, however, are other individuals or groups in society who have a nonownership interest in the activities and well-being of the corporation. Examples of stakeholders are the employees, managers, retirees, creditors, suppliers, and customers of the corporation. In addition, the community in which the corporation operates and, in some cases society as a whole, may be considered stakeholders. In the transition economies, occupants of state-owned residential housing and previous owners of nationalized property may also be considered stakeholders of certain types of property.[8] The stakeholders' interests in a market economy are often indirect and not represented by ownership claims on the assets or income of the corporation. However, the corporation's activities do have an impact, economic or otherwise, upon the well-being of the stakeholder.

In the transition economy establishing legitimate stakeholders' interests is even more problematic because ownership of the enterprise itself is ambiguous. Initially it may be argued that all state-owned enterprises are owned by society as a whole; yet there are no shares and no clear way to identify the size of an individual's interest. Equity arguments would then lead to a privatization program that distributes shares widely across society as a whole without charge on a more or less equal basis. However, some individuals may have not only an ownership interest, but also an additional stake in the enterprise as employee, manager, retiree, customer, supplier or even next door neighbor. Whether or not certain stakeholder interests should be converted into ownership interests has been at the heart of privatization debates in the transition economy. Generally there appears to be two groups of stakeholders, employees and managers, which have received some degree of ownership rights. To the extent that the state pension funds receive shares of state-owned enterprises during the privatization process, current and future retirees represent another recognized stakeholder group.

The so-called small privatization programs in each country provided an opportunity to convert a stakeholder interest to an ownership interest by allowing employees or managers the first opportunity to participate in auctions of small retail and service establishments. The large privatization programs differ by country but often allow some mechanism for employee and management participation, thus allowing the conversion of stakeholder interests to ownership interests.[9]

Large-scale privatization in both the Czech and Slovak Republics consists of auctions, public tenders, direct sales, conversion to joint-stock companies with an offering to the public through voucher points, transfers from federal ownership to municipalities, pension funds and banks, and restitution to previous owners.[10] The first wave of the voucher privatization program (which accounted for

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[7] This is highly simplistic. The corporation may issue a number of different types of shares or securities with various voting, conversion, or dividend privileges.

[8] In the case of residential housing in the transition economies, occupants of state-owned housing almost universally received some ownership rights to their dwelling, even if it was simply a right of first refusal for the purchase of the residence.

[9] For a thorough review of privatization issues in Eastern Europe see Bornstein (1992).

[10] See Mann (1993) for a discussion of the legal aspects of privatization and foreign investment in the Czech Republic.

28.6 percent of all enterprises and 89.1 percent of the book value of enterprises privatized) allowed both wide distribution of shares and also some opportunity for insider participation.[11] Well over a thousand individual state-owned enterprises participated in the first wave of voucher privatization by offering a majority share of ownership to the public at large.[12] Individuals received shares in a multiple-round auction participating directly or through an intermediary (an investment fund) that obtained the voucher points of the individual and then purchased shares of firms with the points on behalf of the individual. A minority interest in each firm was typically retained by the employees, management, the founding body, or other government agency.[13] In effect not only did society as a whole have the opportunity to obtain an ownership interest in the enterprise, but also some members of society, certain stakeholders, were able to convert their special interests into ownership interests. This was a major part of the campaign platform of Vaclav Klaus and has proven an effective way of creating a new social group with capital ownership interests.

The Hungarian approach does not provide a voucher-type mechanism for wide distribution of shares without charge, as in the Czech and Slovak cases, but the stakeholder interests of certain groups and society as a whole have been recognized. The State Property Agency was created in 1990 to manage the privatization process, which to date has six components:[14]

1. *Centrally initiated privatization* included the "pre-privatization" program (8,695 outlets were transferred to private hands by July 31, 1993), the first privatization program (20 large companies valued at Ft70 billion) and the second privatization program (22 companies, still under way).

2. The *enterprise-initiated self-privatization* program allowed 700 small and medium-sized enterprises to seek buyers. By September 1993, 228 enterprises had been sold, mainly to Hungarian buyers and often to employee groups.

3. The *employee partial ownership* program allows employees to acquire shares with preferential loans, installment payments, and tax allowances. By July 1993, 24 enterprises had been sold under this program, predominately in agriculture and food processing.

4. *Privatization via leasing* allows entrepreneurs with little or no capital to acquire firms in full after the entire leasing fee is paid. A pilot program was successfully concluded in 1992, and the state Property Agency has decided to initiate a second program.

5. *Compensation through vouchers* is a program designed to compensate individuals for damages resulting from the nationalization of private property. Vouchers can be used to purchase property,

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[11] The voucher program was only a part of the large privatization program. Of 4,238 large state-owned enterprises, approximately 1,210 were privatized as part of the voucher program; 351 were sold via auctions, 316 via public tenders, 969 via direct sales, 1,175 via unpaid transfer (primarily to municipalities, pension funds, and banks) and 217 as restitution to original owners. A second wave of voucher privatization is in progress. See Table 2 of The Vienna Institute for Comparative Economic Studies (1994).

[12] Also see Adam (1994) for further discussion.

[13] About 62 percent of the shares of joint stock companies participating in the voucher program was offered in exchange for vouchers. 16 percent remained with the National Property Fund; 11 percent was unpaid transfers; 4 percent was held for restitution cases; and 3 percent was sold outright (The Vienna Institute for Comparative Economic Studies, p. 19).

[14] See *National Bank of Hungary (1993)*, pp. 101–105, for additional details.

stocks, or arable land, any of which becomes available during the course of the government's privatization programs.

6. The *small investor shareholder* program is designed to distribute shares, or the opportunity to purchase shares, as widely as possible. Under the program, individuals may purchase up to Ft100,000 of stock with up to five years to pay, interest free.

Overall the privatization efforts in Hungary are rather eclectic, but the underlying themes are clear. The ultimate ownership structure should be similar to that of a modern market-type economy. The value of state-owned enterprises should be preserved, if not enhanced, during the process and if necessary foreign participation that brings management or technical expertise should be welcomed. As a corollary to maintaining or enhancing the value of the enterprise, the revenues generated by privatization should also be maximized. Although most proceeds will be used to reduce internal state debt, some are earmarked to enhance the privatization process, in part by funding privatization loan facilities. Finally, the results should increase competition in the domestic market place and increase the number of domestic shareholders.

These are reasonable goals for any privatization plan and for the most part are being achieved. In 1993 the State Property Agency sold assets generating Ft77.9 billion (about $800 million) for the state budget, about a third in convertible currency. To date nearly 9,000 small enterprises and 494 larger enterprises have been privatized.[15] During 1994 or 1995 the activities of the State Property Agency are likely to be consolidated with the State Holding Company to handle the assets of the 160 largest companies, accelerating their privatization. Plans are also under way to at least partially privatize public utilities.

In Poland the privatization program is also rather eclectic in nature and is administered by the Ministry of Privatization, established by legislation in July of 1990.[16] The small privatization program was similar to that of Hungary and the Czech and Slovak Republics. Large privatization efforts have some interesting differences. The privatization efforts of the Ministry may now be broken into two components: *privatization through liquidation* and *mass privatization*. Privatization through liquidation allows the assets of a state-owned enterprise to be transferred, through a lease with an option to buy, to private owners. The state-owned enterprise may be formally dissolved (e.g., in the case of bankrupt enterprises) or may continue to operate in a reduced capacity privatizing only part of its assets.[17] The recipients of the assets typically consisted of a management group, or management and workers, of the state-owned enterprise. Thus, stakeholders are receiving ownership rights through this form of privatization. Large privatization in Poland has met with mixed success. Several enterprises have been privatized through initial public offerings and foreign direct investment, and a program of mass privatization is under development.

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[15] *PlanEcon Review and Outlook for Eastern Europe*, June 1994, p. 121.

[16] Note that in Poland, as in Hungary, some spontaneous privatization took place before government agencies were in place and formal efforts were implemented. For the most part these activities were relatively insignificant.

[17] Of 1,474 firms in the process of liquidation at the end of 1992, 52 percent were actually dissolved. See Slay (1993), p. 53.

The program of mass privatization, designed to offer wide distribution of ownership to Polish citizens, has met with repeated delays but appears to be moving forward. In May 1993 the formal plan along with two groups of firms to be included was approved by the Suchocka government. The third group of 105 firms has been awaiting approval since May of 1994 and Prime Minister Pawlak has requested additional data before approving them.[18] In any event, approximately 400 enterprises that converted to joint stock companies are in the program (although the exact number is not yet fixed, about 10 percent of existing state-owned enterprises will be included). Approximately 60 percent of the shares of the companies will be distributed to adult citizens with accounts in an investment fund. The remainder will be retained by employees (20 percent) or the Treasury (for state employees, pensioners and contributions to social insurance funds).[19] The program provides for the distribution of shares with only a nominal charge, as in the Czechoslovak case, but the method is slightly different. In the Czechoslovak program individuals received points for a nominal fee and bid for shares of companies with the points. The ultimate book value attained varied by individual depending upon the individual's choices. The individual assumes the market valuation risk immediately. In the Polish case 15 professionally managed national investment funds (analogous to holding companies or mutual funds) will begin managing the shares of the enterprises. The shares of the companies will be distributed to the investment funds and then after a short period (perhaps a year) each participating individual will receive an equal number of shares of each investment fund for a nominal fee. Thus, every individual receives an equal amount of the book value of the enterprises being privatized. Only after trading in investment fund shares and individual company shares actually begins will the individual assume the market risk.

For the most part the privatization processes in each country have maintained a rather strict dichotomy: private versus public (or state-owned) property. However, in a market economy the rights and claims entailed in ownership may be separable and distributed to various individuals, agencies, and organizations through legal instruments such as franchises, leases and mortgages. From a public policy standpoint in Eastern Europe, it is now more appropriate to focus on particular property rights rather than an ill-defined bundle of rights termed "private ownership." Where various forms of limited ownership have been employed the privatization process has been more rapid. Stakeholder interests of particular groups can be recognized more easily without necessarily granting full and complete ownership rights.

While there is often no clear legal basis for stakeholder claims, or a legal obligation to accommodate the interests of stakeholders, the nature of the socialist planned economy required that these interests be addressed during the transition process. For those stakeholder interests that have not been converted into some form of ownership interest the government has, in effect, transferred the responsibility of accommodation to the newly formed privately

[18] *RFE/RL Daily Report*, August 5, 1994.
[19] See Adam (1994) and Blaszczyk and Dabrowski (1993).

owned company. The reconciliation of shareholder interests and stakeholder interests in the transition economies now is similar to that of a market economy. It is not likely that the competing interests of all groups can be accommodated. For example, when management must close or relocate a production facility, shareholders, customers, and society as a whole may benefit if the action results in a more efficient use of resources. Employees, and perhaps the community, will clearly object to the decision, however. These stakeholders' interests must be accommodated by means of a social safety net (e.g., unemployment compensation schemes) and the political process. While institutions are being created to address stakeholder issues a quickly emerging issue is the common problem of ensuring that managers of the newly created firms act in the interest of new owners, or shareholders.

SHAREHOLDER INTERESTS: THE PRINCIPAL-AGENT PROBLEM

In a market-type economy the modern corporation is rarely owned by an individual or family. In the classic Berle-Means model of American corporate governance the owners of the corporation are atomistic shareholders with neither the ability nor the information necessary to supervise the managers of the firm.[20] The missing link between owners and managers is the means of governing the managers to ensure they pursue the interest of the shareholders—to increase the value of the shares—rather than pursue their own agenda or the agenda of some nebulous group of stakeholders. The critical issue in the corporate governance debate then is simply how to minimize the costs of aligning the interests of the managers (agents) with the interests of the shareholders, the owners of the firm (the principals). This is the principal-agent problem in corporate governance.[21] The institutions designed for maintaining this alignment of interests vary from country to country.

In the United States share ownership is typically widely dispersed. It is rare that more than 5 percent of the shares of a major public corporation are owned by any individual or institution.[22] Nonetheless, there are several institutional mechanisms for minimizing the agency costs associated with maintaining the alignment of manager and owner interests. Internal to the organization, the Board of Directors of the corporation is chiefly responsible to shareholders for the actions of management. The burden of monitoring management performance typically falls upon the independent, or outside, directors.[23] Usually, but not always, the chairman of the

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[20] See Berle and Means (1932).

[21] There are many different principal-agent problems—for example, ensuring that supervisory boards or other institutions designed to represent stakeholders and owners in dealing with management actually carry out the wishes of stakeholders.

[22] For example, Roe (1993) in Table II and Table XIII examines ownership and voting rights in German, Japanese, and American firms. In the United States, at IBM, General Motors, and Exxon the largest shareholder owns in each case less than 1.5 percent of the shares. Further, the top five shareholders, in each case owns less than 6 percent of the shares. This ownership pattern is not unusual for the largest American corporations. In Germany and Japan, however, ownership is more concentrated and relatively few shareholders (or nominees) exercise greater control and therefore may more effectively monitor corporate management.

[23] It is difficult to classify the independent or outside directors as either internal or external monitors. They are internal monitors because they have access to sensitive "inside" information not generally available to shareholders or the public. They are external or outsiders because they are not part of the corporate management, and therefore represent shareholders only. In

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board of directors and the chief executive officer are different individuals, with the chairman of the board monitoring the activities of the chief executive officer on behalf of shareholders. To the extent that independent directors see themselves as serving the chief executive officer of the corporation rather than the shareholders, the effectiveness of the independent directors in this monitoring function will be diminished. Nonetheless, there are numerous examples of discord within corporate boards that result in significant changes in management and operational behavior of the corporation.

Critical to utilizing the board of directors as an internal monitoring body is the incentive scheme for both the management and the board. Typically management is rewarded on the basis of firm performance, as measured by accounting data such as revenue, profits, sales, and so forth; whereas board members typically have stock ownership positions or options which reflect corporate performance. However, in the Central European context there is no baseline to measure performance of management; accounting systems are not yet sophisticated enough to report performance accurately; conditions exogenous to the firm may have a greater impact upon performance than managerial decisions; stock markets do not necessarily reflect the value of the firm; and stock options are not yet available to serve as incentives for board members.

A second internal monitoring device may in fact be the supervisory board often found in European corporations.[24] This board represents the interests of stakeholders (employees in particular) rather than solely shareholders. The role of labor on these boards varies from country to country. In Belgium workers have information rights only; in Germany 50 percent of the board members must be labor representatives; in France one-third of the members of the supervisory board must be labor representatives and up to one-third of the members of the management board may be; whereas in Greece, Italy, Portugal, Spain and the UK there are no legal stipulations. In some cases the supervisory board has authority to veto nominees to the management board and also possesses other oversight functions.[25] These potential oversight activities may also provide benefit to shareholders as stakeholder and shareholder interests coincide. An example of coincidence of interests may be found in the area of executive compensation. Further, high-level employee representation may make difficult restructuring decisions more palatable to workers and minimize the costs of restructuring—to the benefit of shareholders. Restructuring issues are critical in the case of transition economies.

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fact, though, they may easily become associated with the board and higher-level management of the company in general, thus becoming less independent.

[24] For example, in Germany there are two forms of corporate organization. The first is the limited liability corporation (GmbH) requiring only shareholders and the executive directors. The GmbH may be established voluntarily by the shareholders or may be required by the German Co-Determination Law (if the firm exceeds 2,000 employees). The second form is the AG (Aktiengesellschaft), designed to raise large amounts of capital. The AG has a two-tiered board, a management board and a supervisory board, with the management board having responsibilities similar to the executive directors of the GmbH. The supervisory board, among other responsibilities, appoints members of the management board, controls the business conducted by the management, and represents the company in legal matters.

[25] In Germany the responsibilities of the supervisory board may include recall and appointment of the executive board, oversight of business conduct, approval of executive compensation, and approval of major investment decisions.

A third internal monitoring device is the auditing and information systems of the firm. The reporting pathways of internal audit and routine management information, as well as shareholder access to appropriate information, is critical. External auditing serves as a means of validating information for the benefit of the boards and shareholders, but the burden of accurately monitoring the activities of the management depends upon the shareholders themselves.

Regardless of the internal monitoring systems the market economy corporation is also subject to external monitoring. This process includes both legal and institutional systems and the ultimate monitor, the discipline of the marketplace. In Central Europe external monitors in the form of outside directors, supervisory boards, and independent auditors are being put into place. (All are novel ideas.) The legal and institutional framework has also changed dramatically in Central Europe. New legislation detailing bankruptcy procedures, banking reform, securities issuance, and mechanisms to regulate the capital market and enforce anti-monopoly regulations, tax and accounting provisions, and so forth are in place. However, the regulatory environment is essentially untested and enforcement is problematic at best.

While the institutions remain interested, the discipline of the market is emerging as an effective monitor of managerial performance. Product and factor markets are becoming competitive for two reasons. First, there has been a rapid expansion of the private sector through privatization and new firm creation and, second, the opening of the domestic marketplace to foreign competition has effectively taken place in nearly all markets. However, the factor market that is most important for corporate governance is the market for managerial talent, which is rather thin in Central Europe. In this marketplace corporate boards monitor management behavior and replace management in cases of poor performance and reward management in cases of good performance. In a market economy this market often functions inefficiently and in Central Europe this market is underdeveloped at best.

The definitive external monitor, however, is the capital market, or the market for corporate control. When this market perceives a divergence between the interest of the shareholders and managerial behavior the market value of the firm declines. The firm then becomes vulnerable to a hostile takeover and attendant major changes in management. The market for corporate control, though, assumes an efficient capital market and relies on the ability of interested parties to make tender offers, wage proxy fights, engage in hostile takeovers, and leveraged buy-outs, or at least threaten to do so. The important factor is that corporate control is at least contestable. Typically in a market economy control is contested when the internal monitoring systems and other external monitoring systems fail. Privatization processes in Central Europe have wrenched control of enterprises from one group of managers and channeled it to another, but not through a market process. Whether or not the new group of managers, representing new owners, operating with a different set of monitoring systems, has a greater likelihood of success in operating in the transition environment is an open question. For cases in which the enterprise is not yet privatized or the government retains a significant share, it is critical that the government or dominant owner retains the right to replace the directors.[26]

In any event, the discipline of these markets is effective only if the firm has an efficient exit mechanism, i.e. effective bankruptcy regulations. This is particularly problematic in Central Europe. There has been a general reluctance to initiate bankruptcy proceedings in Poland and the Czech and Slovak Republics due to the uncertainty of the nature of the problems of the firm and the social costs of closing large, state-owned enterprises. This differs from Hungary where bankruptcy proceedings were initiated nearly automatically once certain conditions existed.[27] In many cases the governments have extricated themselves from the painful political decisions of forcing large, state-owned enterprises into bankruptcy by privatization or transferring ownership to local government authorities or other government agencies. For example, in the Czech case a large portion of enterprises likely to be insolvent or face bankruptcy proceedings is owned by the National Privatization Fund or the Consolidation Bank. Similarly, the Hungarian Investment and Development Company, as the owner of large blocks of bad debt of numerous unprofitable large state-owned enterprises, has taken over the privatization of these enterprises.[28] Both these agencies must restructure and privatize the problematic enterprises (or liquidate them), all the while continuing to subsidize them. Although the process has been depoliticized, the final disposition of hundreds of essentially bankrupt enterprises is yet to be determined.

The market for corporate control in Central Europe will remain imperfect until the capital market is more fully developed, including better-defined shareholder rights. Shareholder rights are usually stipulated in the body of corporate law and articles of incorporation or in listing requirements of the stock exchange, which require firms to adopt certain corporate governance principles. From the shareholders' perspective it is important to have the ability to extend their reach over decisions made by the management board at a relatively low cost. To do so, rules for conducting proxy voting and putting issues before shareholders, having access to shareholder mailing addresses, and so forth, are important. Shareholder suffrage is an issue that has not yet been addressed in detail in Central Europe.

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[26] If the enterprise is not privatized it is important that it be "commercialized" or "corporatized." That is, the enterprise is reconstituted as a free standing legal entity, independent of the branch ministry or original founding body. The government remains the owner of the corporation and controls it via appointment of the board of directors, but it is not involved in daily operations. This does not necessarily harden the budget constraint of the enterprise, but is a first step in doing so and facilitates privatization of the corporation.

[27] There were two particularly onerous conditions which made the original bankruptcy law virtually unworkable. First, if a company failed to meet any of its financial obligations (regardless of the size of the obligation) within 90 days, it was required to file for financial reorganization or liquidation. And second, financial reorganization of the debtor company then had to be approved unanimously by all creditors (see Mizsei (1993) for further discussion). Parliament amended the law in September 1993, discontinuing mandatory bankruptcy filings and eliminating the requirement of unanimous agreement of creditors (*National Bank of Hungary Monthly Report*, July 1993, p.21).

[28] This involves approximately one hundred large state-owned enterprises. In the meantime bankruptcy actions have been undertaken for 2,972 incorporated firms from the beginning of 1992 (when the bankruptcy law became effective) until the end of September 1993. Half of these firms had fewer than 21 employees. (*National Bank of Hungary Monthly Report*, October 1993, p.9).

Because shareholder rights are ill-defined and untested (and in the case of the Czech and Slovak Republics and Poland ownership is likely to remain widely dispersed for firms privatized via vouchers or mass privatization) policymakers must provide a means of contesting corporate control during the transition period without adversely affecting the development of the capital market and the market for control. The natural solution is to seek dominant shareholders, such as institutional investors like banks, mutual funds, insurance companies, or retirement funds, either foreign or domestic. This approach is compatible with the continued development of the stock markets.

Many argue that in Japan and Germany the concentration of ownership increases oversight effectiveness. The corporation has a dominant owner that effectively controls the operations of upper management. This control is further enhanced since a principle source of capital for the firm's operation is frequently the dominant shareholder. The shareholder (often a bank) then has a strong interest in minimizing lending risk and assuring profitability (proper management from the shareholders' point of view) of the activities of the corporation. It is unclear, however, whether corporations with concentrated ownership, or a dominant owner, are more efficient overall than firms with dispersed ownership, but ownership and control is contestable in a well-developed capital market. For example, many newly created private banks in Poland were created by state-owned enterprises and municipal governments simply to ensure a continued source of funding during the transition period. The cross-ownership of the bank and the enterprise could lead to a wide range of perverse behavior. [29]

Further, it should be emphasized that in Central Europe the managerial talent of the dominant shareholder is not necessarily greater than the original management team. In Poland and Hungary, in particular, banks are reluctantly taking on equity interests in many bankrupt or near bankrupt firms through debt-for-equity swaps. The workout departments of the banks then take on significant oversight responsibility with no particular managerial expertise other than foreign advisers. Concentrated ownership by Central European banks then is in part out of necessity, and in part designed to insure that control is at least one step further away from the political vagaries of a government ministry. Increasing the distance between the firm and the government bureaucracy is one accomplishment of banks holding dominant positions in corporations. In the end the market for corporate control that a well-developed capital market provides appears to be the critical element in minimizing agency costs and should be promoted; but the dearth of managerial talent in the region is a barrier yet to be overcome.

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[29] Coffee (1991) relates perverse behavior by Japanese main banks. For example, the lead bank may lend at below market rates with an implicit quid pro quo, the purchase by the borrower of shares of the bank stock to support the stock price. Or, the borrower may pay an above market rate with the presumption that the bank will stand by the firm if it faces difficulties in the future. Maximization of shareholder value or minimizing agency costs appears to be a secondary interest at best.

THE DEVELOPMENT OF THE CORPORATION IN CENTRAL EUROPE

While there are many different forms of private ownership in the transition economy, most state-owned enterprises will assume the form of the joint stock company or limited liability corporation as part of corporatization and privatization. In Hungary the Act on Economic Associations (January 1989) and the Law on Transformation (May 1989) provide the basis for establishing new domestic and foreign companies as well as the transformation of state-owned entities into new forms.[30] These legal entities, commercial companies, include joint stock companies that tend to be majority state-owned and limited liability companies that are majority privately owned (Webster 1993a, p. 21). Smaller non-legal entities include sole proprietorships, enterprise work partnerships (VGMKs), business work partnerships (GMKs) and other partnerships (PTTs and BTs).[31] The growth in commercial companies and the smaller nonlegal entities has been extremely rapid, whereas the number of state enterprises and both large and small cooperatives has predictably declined. The number of incorporated firms increased from 5,091 in 1989 to 42,211 in 1991, and the number of registered individual entrepreneurs increased from 186,291 in 1989 to 300,000 in 1991.[32] The number of incorporated firms reached 69,400 by the end of 1992 and 82,000 by September 1993. Similarly, the growth in unincorporated entities and registered individual entrepreneurs continued, reaching over 91,000 and 676,200, respectively, by the end of September 1993.[33]

The Hungarian Company Law provides the mechanism for establishing the structure of corporate governance while State Security Surveillance approves initial public offerings, licenses and supervises brokers, enforces listing and disclosure rules, oversees capital adequacy requirements for brokers and dealers, and enforces prohibitions on insider trading. Companies have significant leeway in determining the structure of shares (common, preferred, dividend bearing, registered, and bearer) and the internal governance structure of the firm. Legal requirements and regulations governing shareholder participation, proxy contests, and the rights of shareholders are not well developed, however.[34] The Budapest Exchange was one of the first in Eastern Europe, established in December 1987, and individuals gained the right to hold shares in 1989. The Securities Act of March 1990 provided for the first public offerings, and the market has grown rapidly. Market capitalization expanded by five times in 1993 alone, reaching $4.6 billion by year end.[35] Nonetheless, the capital market is not efficient due to asymmetric information, poor settlement practices, lack of liquidity, and infrequent trading. While there is an automatic matching and trading system in place, only one side of a transaction may be posted (either a buy or a sell, not a bid and ask) and it is claimed that price

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[30] See Grey, Hanson and Heller (1992) for details.

[31] For details see Webster (1993a), p. 20–21.

[32] Webster (1993a), p. 22.

[33] *National Bank of Hungary Monthly Report*, October 1993.

[34] For example, there is no provision for nominees in proxy contests; foreign shareholders may have different rights than domestic shareholders (depending more on the foreign country's laws); and requirements governing accessibility to shareholder lists and the provision of information to individuals contesting company actions are ambiguous at this time.

[35] *PlanEcon Review and Outlook for Eastern Europe*, June 1994, p. 120.

manipulation is relatively easy. Thus, the market for corporate control as a means of external monitoring is probably not feasible at this time.

In Poland the Law on Economic Activity (January 1989) enabled individuals to establish private firms more easily and the resurrection of the Commercial Code of 1934 provided corporate forms, the limited liability company and joint stock companies.[36] The number of firms increased rapidly: incorporated firms increased from 11,693 in 1989 to 45,077 in 1991 and to 86,530 by March 1994. The number of unincorporated firms including sole proprietorships increased from 813,500 in 1989 to 1,420,000 in 1991 and to 1,783,900 by the end of 1993.[37] While the number of firms has increased dramatically, the number of publicly traded companies is small.

The Warsaw Stock Exchange reopened on July 2, 1991, in close cooperation with the Society of French Exchanges and patterned after the Lyon Stock Exchange. All of the legal regulations concerning securities and market operations (essentially the 1934 Commercial Code, the Trust Funds and Public Trading in Securities Act, 1991, and the Articles and By-Laws of the Exchange and follow-on regulations) conform to EC standards.[38] There were 21 companies with an average capitalization of about 41 trillion zloty (about $2 million) trading as of December 1993, and 25 companies trading in June of 1994. Interest in participating on the part of individuals has increased dramatically as there were over 280,000 investment accounts opened at brokerage houses by the end of 1993.[39] Individuals may be anticipating the mass privatization program that promises to bring a substantial number of companies to the stock exchange.

The establishment of private enterprises was legalized in the Czech and Slovak Federal Republic by the Entrepreneurial Law of April 1990 and the existing commercial code was amended to provide for the establishment of limited liability companies, joint stock companies, and partnerships. In January 1992 a new, comprehensive commercial code was put in place. As in Hungary and Poland private sector growth was extremely rapid. From about 100 registered companies (limited liability, joint stock, and registered "physical" persons) in 1989, there were 11,600 in 1990 and 39,000 in 1991. The number of sole proprietorships increased from 8,200 in 1989 to 381,300 in 1990 and to 1,175,000 in 1991.[40] While the number of newly created firms has slowed, the number of large state-owned enterprises privatized with shares traded is much larger in the Czech and Slovak Republics than in other countries as a result of the voucher privatization program. As of June 7, 1994, there were 790 companies listed on the Prague stock exchange and 876 unlisted companies.

Although the Prague market suffers from the same problems as the Budapest and Warsaw exchanges, it appears to be developing more rapidly. In each country the capital market will eventually provide for the contestability of corporate control necessary for effi-

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[36] See Grey, et al. (1991) for details.
[37] Webster (1993b) p. 19 and *PlanEcon Review and Outlook for Eastern Europe* (1994), p. 28.
[38] See *The Banking System in Poland* (1993), chapter 2, for details regarding prospectus information, listing requirements, and so forth.
[39] *Warsaw Stock Exchange Quarterly Bulletin*, no. 4 (1993), p. 3.
[40] See Webster and Swanson (1993), pp. 20–21, for details.

cient corporate governance, but it does not yet. In the meantime in each of the countries the financial performance of both private companies and remaining state-owned enterprises has become a critical issue. In each country bank lending has allowed the continued operation of many nonviable enterprises. As a result, banks have become an interested stakeholder in the enterprise sector to such an extent that the solvency of the commercial banking system is threatened. Thus, while corporate governance issues remain paramount, they have become closely linked with the viability of the banking system.

CAPITALIZATION AND RECAPITALIZATION OF BANKS AND ENTERPRISES

In each of the transition economies a combination of events, from institutional changes to macroeconomic forces, has forced hundreds of state-owned enterprises into positions of insolvency if not formal bankruptcy. Also, during the early stages of transition in each country state-owned enterprises received bank loans to continue operating rather than the direct budget allocations of the past. As enterprises began to respond to market forces, some managed to shed labor,[41] or otherwise alter their input and product mix, to restore cash flow and regain credit-worthiness. Nevertheless, hundreds have been unable to repay loans granted in a lenient lending environment by the newly created state-owned commercial banks. The capital position of the banking systems, undercapitalized when created, deteriorated rapidly, necessitating recapitalization. The Czech Republic, Hungary, and Poland have therefore undertaken extensive and sometimes innovative bank recapitalization programs.[42]

In the Czech Republic there have been three programs to improve the capital base of the banking system. First, the Consolidation Bank was created in March 1991 by the Ministry of Finance and the Central Bank to take "perpetual credits" for inventories from the balance sheets of the newly created commercial banks. This operation affected only two banks, Commercial Bank—Praha and the General Credit Bank—Bratislava. About Csk110 billion, 20 percent of the banks' assets, were transferred to the Consolidation Bank. Then, in a follow-on operation, the banks transferred at a negotiated discount "bad" loans on a case-by-case basis to the Consolidation Bank, which was charged with recovering them. The second program was one of direct recapitalization of the same two banks taken in October 1991. Csk50 billion, approximately 8 percent of all bank credits at the time, was infused into the banking system. Csk12 billion was destined to augment the banks' own capital and Csk38 billion was for the direct write-off of nonperforming loans. The National Privatization Fund provided the funds for both the operations of the Consolidation Bank and the recapitalization. The third program consisted of netting out mutual enterprise arrears by Commercial Bank-Praha, and later other institutions, until mid-1993.

[41] Recent estimates indicate that state-owned enterprises in Poland have decreased employment by nearly 30 percent of the pretransition work force.

[42] Other East European countries have as well. See Saunders and Sommariva (1993) for a detailed discussion of bank restructuring issues in Eastern Europe.

These operations addressed the stock of bad debt existing at the time transition began and that which accumulated early in the process. However, it is clear that the flow problem—the true bad debt problem—has not been addressed. Table 1 below provides data on risk credits,[43] for December 1992 to December 1993. Both the absolute magnitude of risk credits and the risk credits as a proportion of total credits have expanded. At this point it does not appear that bank lending practices or central bank regulatory policies have fully addressed either the adverse selection or moral hazard problems.[44] Total reserves and loan loss provisions on risk credits have increased, however, indicating that at least the opportunity cost of poor lending is increasing. Ultimately only the continued privatization of the banks and the demonstration effect of a significant bankruptcy will induce both banks and enterprises to alter behavior sufficiently to overcome the moral hazard problem.

TABLE 1. Credits, Risk Credits, and Reserves in the Czech Banking System, Selected Dates, 1992–1993.

Item	December 1992	June 1993	December 1993
Credits (Billions of Czech Korunas)	567.8	615.0	672.2
Risk Credits.			
Billions of Czech Korunas	109.2	133.6	159.8
Percentage of total	19.2	21.7	23.8
Reserves and loan loss provisions			
Billions of Czech Korunas	29.9	37.5	57.0
Percentage of risk credits	29.4	28.1	35.7

Source: Hrncir (1994), Table 1. Similar data are presented in Hrncir (1993) Table 3, but the latest source is considered more reliable as bank auditing and classification has improved. Above reserves are general reserves against losses, not required or excess operating reserves. Loan loss provisions are reserves earmarked against specific loans.

While the banks are being recapitalized in the Czech Republic, they have nominally little formal interest in the corporate governance of the enterprise sector. However, as a result of the voucher privatization scheme, investment funds are emerging as dominant owners, and these funds tend to be founded, owned, and operated by banks.[45] Investment funds are limited because they can devote no more than 10 percent of their capital to any one company and can hold no more than 20 percent of the shares of a single company. While a single fund may hold a maximum of 20 percent of

[43] According to Czech methodology, before 1994 risk credits were temporarily illiquid claims, substandard, doubtful, and nonperforming loans. As of 1994 the risk credits classification includes doubtful loans, nonperforming loans, nonstandard loans, and other classified credits. The data in Table 1 use the pre–1994 definition of risk credits. See Hrncir (1993, 1994) for further details.

[44] Opportunism is responsible for economic agents acting unreliably, and both adverse selection and moral hazard are special cases of opportunistic behavior. Adverse selection may be thought of as an ex ante insurance screening problem and moral hazard an ex post insurance condition. See Williamson (1981) for a brief discussion in the context of the behavioral assumptions for the analysis of the organization of the modern corporation.

[45] There are more than 200 investment funds, but of the 10 largest, 8 were founded and operated by investment companies attached to the large banks or insurance company.

a company's shares, that position is usually sufficient to gain a seat on the management board and actively participate in the management of the company. The funds then act not only as an interested owner on behalf of their shareholders, but also unofficially as a representative of one of the company's creditors—the bank that also owns and operates the fund. Thus, the investment funds have quickly assumed an important intermediary role similar to the German lead bank.

In Hungary the government began a credit consolidation program in 1992 in which bad debt was swapped for long-term government bonds. Financial institutions participating either had to be partially state-owned or have a capital adequacy ratio of less than 7.25 percent. Only debt incurred before September 30, 1992, was eligible for consolidation. Fourteen banks and sixty-nine savings cooperatives participated in swapping Ft104.9 billion of bad debt into Ft80.3 billion of government bonds.[46] The government created the Hungarian Investment and Development Bank (HIDB) to manage the bad loans. It functioned much like the Czech Consolidation Bank. In December 1993 a second and "final" bank recapitalization and debt consolidation program was announced. About 25 percent of the banking system's loans were deemed to be problematic. The new program will recapitalize the state-owned banks by about Ft320 billion (approximately $3 billion).[47] In the meantime the HIDB has continued to participate in enterprise restructuring and assisting banks by purchasing some Ft40 billion in problem debt of 56 companies and intends to buy the debt of another 20 to 30 companies,[48] bringing them up to 4 percent BIS standards. Again, as in Prague, the bank recapitalization programs appear to be successful in temporarily solving the stock problem. Whether or not there will actually be a change in the operational behavior of the state-owned banks and enterprises is an open question.

In Poland a recent bank recapitalization and enterprise restructuring operation may serve as a model for recapitalization in other transition economies. The program takes a decentralized approach and forces banks to play a major role in enterprise adjustment. In 1991 the nine large, state-owned commercial banks originally derived from the state bank were audited by Western accounting firms and their portfolios split into performing and nonperforming assets based on newly adopted BIS standards. To some extent it was argued that the nonperforming loans were inherited and the banks should not be obligated to incur losses from them. Regardless of the validity of the argument, the restructuring program (based on the Act on Financial Restructuring of State Enterprises and Banks, February 3, 1992, as amended) was initiated March 19, 1993, with a deadline for completion of March 31, 1994.[49] Thus most of the program's activities have just concluded. The program required that participating banks be at least 50 percent state-owned, have audited financial statements conforming to international accounting standards, establish a separate portfolio for

[46] Data are from National Bank of Hungary (1993), pp. 83–87. Csaki (1993) also describes the consolidation program in detail.
[47] *PlanEcon Review and Outlook for Eastern Europe*, June 1994, p. 120.
[48] Ibid., p. 120.
[49] See "Act on the Financial Restructuring of State Enterprises and Banks . . ." (1993) for complete details.

loans classified as "doubtful" or "loss," create a separate department in the bank for administering these loans, and present a plan for restructuring these loans to the Ministry of Finance. Only when these conditions were met did the individual bank become eligible for recapitalization. An important aspect of the program is that banks had to develop, in conjunction with the debtors, a plan for restructuring the loans (or the enterprises) prior to bank recapitalization. Thus, enterprise restructuring and bank recapitalization occurred simultaneously.

Seven banks took part since two, Bank Slaski S.A. (Katowice) and Wielkopolski Bank Creditowy S.A. (Poznan) were privatized in the meantime. Wielkopolski Bank was recapitalized at the time of its privatization and Bank Slaski required no additional capital at the time of privatization. Two other banks with severe problems, the Savings Bank (PKO-BP) and the Agriculture Bank (BGZ), are still in the process of recapitalization and restructuring.[50] The program was implemented in two distinct steps. First, the seven banks were recapitalized up front to 12 percent BIS standards, receiving from 1.3 to 1.9 trillion zloty each of fresh capital.[51] Second, the law provided a "bank conciliation procedure," which enabled banks to restructure enterprise debts without initiating court procedures.

This procedure has a number of unique features. First, it generally avoids the court system (which is not prepared to handle huge numbers of bankruptcy proceedings or contentious debtor-creditor arguments) unless there is an appeal by another creditor. Second, the procedure provides *in pari passu* treatment of tax obligations with other creditors thereby eliminating special treatment for government obligations.[52] Third, restructuring and privatization may be part of the conciliation agreement. Banks are required to establish "difficult loans divisions" or "workout departments" both to administer the conciliation agreements and to participate in the management of debtor companies if appropriate. If privatization is involved, the Ministry of Privatization must convert the enterprise into a Treasury-owned registered company or transfer the assets to a registered company in consideration for an equity position within 30 days. Fourth, only creditors holding 50 percent of the debtor's liabilities must agree to the conciliation arrangement. This also expedites the agreement. Although other creditors may appeal to the courts within 30 days, the courts have generally not been receptive to altering the original agreements.

Table 2 illustrates the four options available under the program that banks could employ to cleanse their loan portfolio. First, they could enter into a conciliation agreement which greatly reduced the holding of the bank, but also eliminated a large part of the indebtedness of the enterprises. For most enterprises, bank debt was only

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[50] BGZ is organized as a cooperative and has not yet changed its legal form. It has been partially recapitalized. A program for reorganizing BGZ is being prepared and will be presented at the next session of the Parliament. It is likely that it will take on the function of a central bank for the 1600 rural cooperative banks which will then be consolidated, restructured and recapitalized. The portfolio of PKO-BP has been separated into mortgage loans and commercial loans. The commercial loan component of the portfolio has been recapitalized at the 8 percent level.

[51] See *The Banking System in Poland* (1993), p.46, for the participating banks and exact amounts recapitalized.

[52] Standard bankruptcy procedures in Poland leave enterprise obligations to the government intact, whereas conciliation procedures require the government to share in the debt write-off.

a small part of total indebtedness, which included state and local tax arrears, and interenterprise payables. It is estimated that bank debt was about 20 percent of total indebtedness, with the remainder tax arrearages and interenterprise debt.[53] Second, they could sell debt of enterprises, typically at 20 to 25 percent of face value. Third, the enterprise could be liquidated or forced into formal bankruptcy proceedings. And fourth, the enterprise may repay or resume servicing the loan. Regardless of the option taken, most debt was written off. Belka (1994) notes that one of the seven banks reports (anonymously) that in its bad-loan portfolio 62 percent of the debt was written off; 30 percent was exchanged for equity; and 8 percent was rescheduled as a result of activities undertaken during the program. Thus, for many of the participating enterprises the program simply amounted to a write-off of nearly all debt obligations and a debt-for-equity swap.

TABLE 2. Polish Loan Conciliation Program, Total for All Seven Participating Banks, May 1994.

(Millions of Zloty)

Action, Initiated or Completed	Number of Loans	Principal	Interest	Total
Conciliation or court agreement	198	6,104,115	1,473,216	7,577,331
Sale of claim	94	624,924	273,158	898,082
Liquidation or Bankruptcy	171	1,456,820	530,645	1,987,465
Repayment (rescheduled)	109	3,260,307	253,463	3,976,648
Sub-total	572	11,446,166	2,530,482	13,976,648
Cash repayment (immediate)	201	1,580,137	141,781	1,721,918
Total	773	13,026,303	2,672,263	15,698,566

Source: Ministry of Finance and National Bank of Poland, September 1994.
Notes: Value of loans are for loan classifications "doubtful" and "loss" as established by audits of the participating banks as of December 1991. Actions undertaken are as reported initiated or completed by May 1994.

While the full impact of the program remains to be determined, there are a number of positive results currently evident. First, the government is relieved of the responsibility of operating a large number of problematic enterprises. Nearly 200 medium to large enterprises thought to be viable have been restructured and may continue operations on a firmer financial footing (at least for the time being), while about 135 nonviable enterprises have been forced into bankruptcy, and 35 more have moved into liquidation. Second, participating commercial banks have been recapitalized and relieved of an onerous debt portfolio. At the same time, these banks have taken on a new responsibility—participating in the governance of the restructured enterprises—and have acquired a new problem, continued monitoring of enterprise performance. And, third, commercial creditors have realized the previously unrealized losses on

[53] Note that the debtor cannot restructure arrearages on social security contributions, unpaid wages, and personal income taxes when the debtor is the withholding agent. See the Restructuring Act for details. Also see Belka (1994) for further discussion.

inter-enterprise credits. While the market value of inter-enterprise debt was always questionable, it may be that the write-off of inter-enterprise credits in some cases could be sufficient to cause a second wave of bankruptcies.

The program in Poland has addressed two critical interrelated problems: bank recapitalization and enterprise restructuring. The immediate solution, as in the Czech and Hungarian recapitalization programs, has addressed the stock problem as banks are recapitalized and enterprises restructured. It is unclear whether the flow problem has been solved; i.e., whether there will be a change in bank lending behavior. The Polish program has gone a step further. By directly involving banks in the corporate governance of the restructured enterprise, there will be an additional monitor of the firm's activities. However, it would be incorrect to assume that the banks are truly capable of efficient oversight. They have little experience in monitoring credit activities, i.e., whether these enterprises were capable of repaying loans in the first place. They have no experience in monitoring equity performance, identifying problematic managerial behavior, or actually participating in corporate governance.[54] The perverse behavior of Japanese banks should not be ruled out, because old personal and political linkages in Poland are strong and there remains a dearth of managerial talent at the enterprise level.

CONCLUSIONS

Overall, Central European policymakers have made remarkable progress in developing the new legal and institutional framework for the transition to a market economy with private property. The privatization of large, state-owned enterprises is forcing a close examination of corporate governance issues. Dominant shareholding as a means of resolving the principal-agent problem may be one solution. State-owned commercial banks lent heavily to enterprises during the early transition period with little real knowledge of enterprises' long-term economic viability. As enterprise performance deteriorated, so did the commercial banking industry's loan portfolio. As a result of enterprise restructuring and bank recapitalization, commercial banks acquired the position of dominant shareholder in Poland and Hungary. In the Czech Republic investment funds acquired dominant shares of many of the enterprises privatized in the voucher privatization program.

These recapitalization and restructuring programs are critical, but the bad-debt problem has both stock and flow dimensions. The programs have apparently solved the stock problem. Whether the flow problem has been solved is an open question. Commercial banks must refrain from continued lending to nonviable enterprises, on the one hand, and must exercise effective control over the management of companies that they influence by means of dominant shareholding, on the other. Essentially, only the continued privatization of commercial banks and the demonstration effect

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[54] At one major bank visited, there were 17 people employed in the Problem Loan Division to monitor 276 companies with an indebtedness of about $150 million. Close attention was paid to 138 of the companies with indebtedness of more than Zl 1 billion (about $50,000), whereas the others were transferred to the branch offices.

of major bankruptcies are likely to induce the necessary changes in behavior at the operational levels of banks and enterprises.

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BANKING SECTOR REFORM IN CENTRAL AND EASTERN EUROPE

By Michael Marrese *

CONTENTS

SUMMARY

This paper focuses on the intertwined insolvency of banks and enterprises in the former Czech and Slovak Federal Republic (CSFR), Hungary, and Poland in the late 1980s and early 1990s. In the best of all possible situations, bank and enterprise restructuring should be achieved and a systemic banking crisis avoided with simple bank provisioning and individual loan recovery efforts and without government intervention. However, if the net worth of formerly state-owned banks is, or at least is widely perceived to be, highly negative, then government involvement in solving the stock and flow problems of bank and enterprise restructuring is inevitable. This has been the case in Central and Eastern Europe. The unrecoverable loans which the newly formed commercial banks inherited from the monobank have constituted the root of the stock problem. The flow problem has been connected to all factors that have allowed bank management that is not prudent to remain in place.

The reason to resolve the stock problem as quickly as possible is that corporatization of enterprises and banks should be implemented along with hard budget constraints. Enterprises are likely to face such constraints only when the chief financiers, the banks, demand timely payment. The banks will impose hard budget constraints on enterprises only if bank management is convinced the

*Michael Marrese is a Senior Economist with the Russia Division, European II Department, International Monetary Fund.

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state will not subsidize its own mistakes nor will funnel financial assistance directly to enterprises.

The effectiveness of enterprise and bank restructuring depends on how the authorities contribute to the recapitalization of banks and influence the incentives of bank and enterprise managers. If the authorities possess full information, they could solve the problem of determining the optimal combination of liquidation-restructuring, privatization, and government-funded recapitalization. Instead, the authorities are faced with the need to estimate the market value of each bank's loan portfolio without knowing the private sector's willingness to invest in the debt-ridden companies or buy their bad debt. Under these circumstances, the Polish solution appears quite reasonable, namely evaluation, by reputable outside auditors, of each major state bank's portfolio of loans to determine the extent to which each bank will be recapitalized before bank-initiated restructuring-liquidation of enterprises begins in earnest. Then as long as the recovery agency, whether centralized or decentralized, faces an incentive structure based on recovered loan repayments and on the value of the equity obtained in exchange for debt forgiveness, the stock problem should be under control. To remedy the flow problem, all the ingredients of hard budget constraints and effective corporate governance must be present.

However, this "reasonable" approach has rarely been implemented. Moreover, in selecting quite diverse policies, authorities in these various countries have tended to ignore two key insights into the problem, namely, (1) a comprehensive strategy—requiring expensive and long-term support, including privatization and involving both banks and enterprises and all of their claimants—is required to clean up the balance sheets of banks and enterprises; and (2) a normal audit rarely identifies the bad-debt problem because the loans of insolvent clients had often been rolled over and the interest capitalized. Thus, the scope of the problem is recognized only after the recovery agency has taken control of banks and exhaustive audits have taken place; and the losses from the bad-debt problem tend to be underestimated by large magnitudes in order to prevent panic.

INTRODUCTION

The countries of Central and Eastern Europe made their initial commitments to become full-fledged market economies in 1989–1991. At that time, their banking systems were lacking:

- A high degree of solvency in the sense that most large banks had balance sheets filled with bad loans, and many enterprises were burdened with nonrepayable debts;
- Traditions, incentives, and institutions to mobilize savings effectively and to allocate loanable funds based on collateral and ability to repay;
- Market-oriented accounting systems;
- A payments/clearing system that allowed for rapid processing of interbank and other financial transactions;
- A regulatory framework that monitored the soundness of banks' loan portfolios and set prudential rules for banks; and

- A noninflationary environment with stable tax and financial laws and regulations that would be attractive to business and banking.

The confluence of these factors and the asymmetry of information that permeates banking[1] made it necessary for governments and central banks to become involved in the creation of new institutions, regulations, and incentives, and in the recapitalization of banks.

This paper focuses on the intertwined insolvency of banks and enterprises, acknowledging that to resolve this problem would require the simultaneous cleaning of the balance sheets of banks and enterprises, the privatization of banks and enterprises, and the creation of effective banking supervisory authorities.[2] This bad-debt problem is examined, as are the macroeconomic and institutional conditions of the former Czech and Slovak Federal Republic (CSFR), Hungary, and Poland in the late 1980s and early 1990s. The policies these countries use to untangle the bad-debt problem are reviewed. The bad-debt experience of Austrian banks in the 1920s–1930s and Spanish banks in the 1970s–1980s is also described. The paper's main findings are summarized in the conclusions.

THE BAD DEBT PROBLEM

One can reasonably ask whether bank restructuring can be achieved and a systemic banking crisis avoided with simple bank provisioning and individual loan recovery efforts and without government intervention. The answer in Central and Eastern Europe has generally been no for two reasons. First, the negative net worth of large formerly state-owned (and generally still state-controlled) banks was so highly negative that adequate provisioning would have put those banks at a substantial competitive disadvantage in attracting fresh capital because new banks would not be burdened with the cost of provisioning for a portfolio of inherited bad debt.[3] Therefore, erecting barriers to entry would have been necessary if governments were to avoid subsidizing bank recapitalization.

Second, even if the negative net worth of large banks was small *in the eyes of bank owners* relative to the difference between the banks' true market value and the balance sheet value (say, due to undervaluation of the client base and branch network), those investors who share the held belief that substantial enterprise restructuring is inevitable might not believe the owners' (namely, the government's) perception of market value. Such asymmetry of information could push the government to subsidize recapitalization schemes and initiate centralized loan workout programs.

The bad-debt problem that is the subject of interest here exists when: (1) the banks' clients, predominately enterprises, are not able to meet their loan obligations in a timely manner; (2) resched-

[1] For instance, depositors and investors rely on information provided by banks to evaluate a bank's soundness. Regulatory agencies monitor the content and accuracy of bank-supplied information.

[2] Brainard (1991a).

[3] Net worth was negative in the following special sense: before bank/enterprise restructuring and assuming that loans would have been classified correctly.

uling of most of these nonperforming loans and the capitalization of uncollectible interest payments will not improve the probability of repayment, rather improved prospects for repayment will come about only through enterprise restructuring (which also encompasses liquidation); (3) the share of non-performing loans in banks' portfolios is so large relative to the banks' ability to provision against such losses that bank managers perceive that provisioning alone will not solve the problem; (4) banks refuse to initiate massive enterprise restructuring in order to hide their own insolvency; and (5) society is worse off because banks, in rolling over bad loans and capitalizing uncollectible interest payments and thereby not revealing their own financial weakness, prevent better management from gaining control of enterprises and/or the banks themselves.

This characterization of the bad-debt problem reflects Central and East European circumstances because nonperforming loans have been widespread, and provisioning coupled with individual bank recovery efforts has not solved the problem; enterprise restructuring has been recognized as crucial to improved economic efficiency;[4] and bank managers, on their own, have been reluctant to initiate restructuring of enterprises, perhaps out of concern for their current and future employment opportunities or in the face of pressure from local government officials who wish to avoid short-term regional unemployment. Therefore, banks have been slow in promoting more effective resource allocation and utilization, and the authorities have been unwilling to let banks fail.

Misallocation and misutilization have been particularly serious given the shortage of domestic capital for investment purposes and the financial needs of the growing private sector. In addition, the spread between bank deposit and lending rates has tended to be greater than otherwise as financially weak banks (which usually have conducted most lending to businesses) have attempted to improve their balance sheets through higher profits,[5] but the resultant higher lending rates may discourage creditworthy borrowers (leading to adverse selection due to a deterioration in the pool of applicants) and encourage the remaining borrowers to embark on riskier but potentially higher-payoff endeavors (perhaps creating moral hazard).[6] Consequently, cleaning up the balance sheets of banks is an important precondition to economic restructuring.

The following example with two state enterprises and their bank illustrates the bad-debt problem. Enterprise A has net worth of −200, with liabilities to the bank and enterprise B of 400 and assets of 200. Assume creditors initiate liquidation of A. If A, during its liquidation, is able to amass 200[7] and to pay its creditors in proportion to their claims, then B would receive 50 and the bank

[4] As evident from the attention given to privatization.

[5] Taxing the nonfinancial sector through large spreads can be maintained over time only in the presence of barriers to entry in the banking industry.

[6] Sundararajan and Baliño (1991, p. 6) describe moral hazard as the risk associated with three types of borrower behavior: a change in business strategy, relative to that revealed when applying for the loan, that increases the probability of default in an effort to increase the probability of a high return; failure to use the cash flow associated with the loan to service the debt; and pledging the asset as collateral to another creditor. As borrowers consider the costs of refinancing the loans they have already obtained, an increase in the spread between loan and deposit rates may encourage them to alter their current business strategy in a way that increases the probability of default. Also see Brainard (1991a), Buch (1993) and Várhelyi (1993).

[7] This assumes that A would first remove its deposits of 120 from the bank and gain 80 from the sale of its physical assets.

150. As a result B and the bank are insolvent with a net worth of –40 and –10 respectively.[8]

Balance Sheet Book Values Before Restructuring

Enterprise A

Assets		*Liabilities*	
Bank deposits	120	Trade credit from B	100
Expected value of physical assets	80	Bank credit	300
		Net worth	–200
Total assets	200	Total liabilities	200

Enterprise B

Assets		*Liabilities*	
Trade credit to A	100	Bank credit	100
Bank deposits	280	Unpaid taxes	300
Expected value of physical assets	30	Net worth	10
Total assets	410	Total liabilities	410

Bank

Assets		*Liabilities*	
Loan to A	300	Deposits of A	120
Loan to B	100	Deposits of B	280
Reserve requirements	20	Net worth	20
Total assets	420	Total liabilities	420

Numerous combinations of the following three approaches could solve this bad-debt problem. Notice that in the first two approaches, net creditors and the "original" owners incur all the direct costs of reversing the insolvency (though distribution of burden-sharing could vary greatly), while in the third case taxpayers also bear the direct costs.

The first is to encourage the bank to provision against A's nonperforming loans and A's creditors to engage in loan recovery by initiating liquidation procedures and/or debt-equity swaps. The government is likely to follow such a noninterventionist path only if three conditions hold: (1) the government perceives that A's liquidation would not seriously damage the rest of the economy; (2) the government realizes that its knowledge of enterprise A is not superior to that of A's creditors; and (3) the expected liquidation value of A is greater than the value from either continued operation or privatization.

Notice that in the example if the bank sets aside its entire net worth (20) against nonperforming loans, the bank would still be forced to close. Moreover, if the government would seek to recover all of the unpaid taxes from B, B also would face liquidation or government ownership. Therefore, one condition for bank provisioning and creditor loan-recovery efforts to be the sole means of solving

[8] B would have assets of 360 and liabilities of 400. The bank would have assets of 270 (150 from A, a loan of 100 to B, and 20 in reserve requirements) and liabilities of 280 (deposits of B).

the bad-debt problem is that the magnitude of the unrecoverable debt is less than creditor net worth.

Liquidation of large-scale enterprises has occurred infrequently in Central and Eastern Europe precisely because it is difficult to estimate the ensuing ramifications on creditor enterprises and on banks. This difficulty is related to confusion over property rights and uncertainty over how bankruptcy laws will be implemented.[9] At the same time, provisioning alone has not been the sole means of recapitalizing banks because the magnitude of the bad-debt problem has been too high relative to the net worth of heavily indebted banks.[10]

The second approach, privatization, increases a company's value whenever the new owners have better managerial skills and greater access to technology, international markets, and financial resources than the former owners. However, given the magnitude of the bad-debt problem and asymmetry of information, new owners have been unwilling to assume the full amount of past debts, therefore privatization has involved significant debt forgiveness. More generally, net creditors, former owners (namely, the federal government, local authorities, management and employees) or taxpayers bear the direct cost of any debt forgiveness that accompanies privatization.

The third approach is to set up a centralized government recovery agency or decentralized recovery departments (usually in those banks with a significant amount of bad assets) to determine which firms should be recapitalized and which firms should be liquidated.[11] This approach is often hailed as a means of making the bad-debt issue transparent, but transparency will be realized only when incentives are present to encourage banks to reveal accurate information about the soundness of their loan portfolios and to engage in loan recovery via restructuring or debt-equity swaps. A centralized recovery agency may offer less conflict of interest in the sense that the ties between problem banks and problem borrowers have been broken and may save on administrative costs relative to the decentralized approach.[12] However, the decentralized method could, in theory, take advantage of the knowledge that banks have of their customers.

Another consideration is whether a centralized recovery agency would have the mandate to offer new loans. A debtor's incentive to repay is likely to be higher when the recovery agency is able to offer future financing. However, the recovery agency may not have enough expertise to make such judgments. One possible solution is

[9] See Mitchell (1993) for a discussion of why creditors in Central and Eastern Europe may have been reluctant to initiate liquidation procedures. See Abel and Gatsios (1993) for a discussion of the costs and regulations that surround both liquidation and reorganization of firms and for a description of the dilemma of implementing bankruptcy regulations in Central and Eastern Europe.

[10] Too high in the sense that competition from banks not encumbered with nonperforming loans would prevent heavily indebted banks from sustaining a large enough spread between lending and borrowing rates or earn sufficient profit from banking services to provision adequately and in a timely manner.

[11] The difficulties in establishing the market value of loans amid circumstances which precipitate a banking crisis make implementation of this third approach quite a delicate matter. See footnote 15 below referring to Germany's costly experience in setting up a centralized recovery agency.

[12] In a country with few commercial banks and a scarcity of banking expertise, those who staff a centralized recovery agency might well be the same people who made the loans in the first place.

to establish a centralized recovery agency with no capability of extending new loans, but with an incentive structure based on recovered loan repayments and on the value of the equity obtained in exchange for debt forgiveness.[13]

In the third approach, the money for recapitalization of the bank and enterprises A and B would come from government revenue, privatization proceeds, and/or the sale of government bonds. This approach would be attractive when government knowledge of the bank and enterprises A and B is superior to that of the potential buyers of these entities.[14] However, if bailout money is distributed in the absence of proper incentives (such as penalties to current owners and managers) to discourage banks from classifying their good loans as bad ones, then the direct costs of ameliorating the bad-debt problem would increase sharply.[15]

In each of these approaches, the government is forced to accept a good deal of the burden, which during the 1990s has had some merit in Central and Eastern Europe because prior to that time these governments did not enforce budget constraints on state-owned enterprises. Therefore managers made relatively weak efforts to reduce enterprise debt, believing that unpaid debt would either be forgiven or rolled over and the associated interest payments would be capitalized. At the same time, profit-oriented commercial banks did not exist. Enterprises simply received loans from departments of the monobank, which had almost no incentive to initiate bankruptcy proceedings.

So in the late 1980s, when a country's monobank broke up into a central bank responsible for monetary policy and banking supervision and newly formed state-controlled commercial banks which received a portion of the monobank's loan portfolio, both a stock and a flow problem existed. The stock problem involved those enterprises that could not repay their bank loans, leaving such enterprises little room to restructure and burdening the state-controlled banks with loans they did not initiate. The stock problem would have been difficult to solve quickly because of its magnitude.[16]

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[13] Sundararajan and Baliño (1991, p. 32) discuss the pros and cons of a centralized recovery agency in light of the experience of the Philippines, Spain and the United States. Fries and Lane (1994, pp. 7–9) examine the decentralized versus centralized resolution strategy in light of experience in both industrial and developing countries.

[14] However, this weakens the government's fiscal position to "the extent to which the government implicitly guarantees deposits in state banks, which usually account for most of the private sector's claims on the public sector." See Fries and Lane, 1994, p. 5.

[15] The modalities of the German monetary unification during April-June 1990 increased the costs of the bad-debt problem in the former German Democratic Republic.(See Brainard, 1991a, and Friederich, 1992, pp. 3–7). In April, all commercial accounts from Eastern Germany's central bank were moved to a newly created Eastern German recovery agency, the Kreditbank. Then Kreditbank's personnel and branch offices were transferred to two joint ventures with two Western German commercial banks as partners. The remaining shell consisted of Kreditbank's portfolio of commercial loans, where no attempt was made to distinguish good from bad loans. Kreditbank had no authority to issue new loans, so Eastern German enterprises had no strong incentive to repay. The Bonn Government recognized this moral hazard and, in August, announced a one-year moratorium on the servicing of this corporate debt. However, the de facto loss of most of these commercial loans was not the only cost because enterprises in Eastern Germany were not subjected to Western audits and the ownership of enterprise assets was not clarified, which hampered the two joint-venture banks from making loans in Eastern Germany. Also see OECD (1991a).

[16] At the end of 1991 the estimated ratio of nonperforming loans to total loans was 55 percent in the CSFR, 50 percent in Hungary, and 40 percent in Poland. The costs of removing all of these nonperforming loans, as a percent of GDP, were estimated to be, respectively, 5.6, 5.4, and 6.5. See Thorne (1993), table 5, p. 977.

The flow problem has had two dimensions. On the one hand, the still state-controlled banks have exhibited insufficient care in offering loans to solvent enterprises. The original stock problem has become more serious to the extent that these loans were more imprudent than would have occurred under a fully reformed banking system. On the other hand, "insolvent" enterprises not only had their bad loans rolled over and the interest capitalized, but also received new loans in the hope that a fresh injection of funds would prevent default.

If the stock problem and the flow problem are independent of one another, then efficiency considerations would dictate that the stock problem be solved immediately so that state-controlled banks could compete with new private banks on an even playing field. Conceptually, this could occur via a one-time bond issue to recapitalize the banks (thus spreading the bailout costs over several generations, all of whom would benefit from a sound banking system) or a one-time inflation tax (thus penalizing net savers for the bad-debt problem).

However, there are several potential problems with the assumption that the stock and flow problems are independent. First, improved efficiency may only occur once managers of state-controlled banks have been replaced and enterprises have been restructured; which are lengthy processes during which time the costs of the flow problem should not be ignored. Second, there is no clear delineation between bad and good loans. Therefore, the prospect of an immediate overall bailout, unless accompanied by appropriate incentives, may encourage borrowers who can repay to claim they cannot, as occurred in the former German Democratic Republic after unification (see earlier footnotes). Third, an overall bailout might lead economic agents to believe that such bailouts will be forthcoming in the future, thus significantly worsening the flow problem. Fourth, distributional consequences of compensation to former owners, privatization, property rights, fiscal federalism, and the social safety net[17] suggest that a one-time solution to the stock problem—in which those who were responsible would bear no special share of the cost of cleaning up the situation—may well be socially unacceptable.

Initial Conditions[18]

The CSFR, Hungary, and Poland approached the bad-debt problem in contrasting ways partly because at the end of 1989 these countries faced vastly different macroeconomic pressures and banking structures. The CSFR had a relatively light foreign-debt burden and a government budget deficit of only 0.8 percent of GDP. It also had not altered its monobank system and therefore confronted a stock problem that was perceived to be entirely the responsibility of the federal authorities. Hungary confronted a huge foreign-debt and a government budget deficit of 2.5 percent of GDP. It established a two-tier banking system in January 1987 by allocating, along industry lines, loans from the National Bank of Hungary's

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[17] Blommestein, Marrese, and Zecchini (1991, p. 11). More generally, see OECD (1991a, 1991b, 1991c).

[18] Statistical information in this section is from OECD publications and PlanEcon Reports.

portfolio to three new commercial banks. Hungary therefore had to contend with the stock problem that was ignored when the commercial banks were established, together with the flow mistakes that were made during the ensuing three years. Poland had to deal with the worst macroeconomic situation—high and accelerating inflation, an unrepayable foreign debt, and a government budget deficit of 6.0 percent of GDP. Moreover in 1988, Poland formed nine state-owned regional commercial banks and distributed loans to them—both good and bad—from the National Bank of Poland's portfolio. Consequently, Poland also had to deal with both stock and flow problems, but had fewer resources than Hungary with which to correct the situation.

Despite these differences, the three countries faced a number of common negative external shocks—namely, the temporary rise in oil prices associated with the Gulf War, the shortfall in Soviet oil deliveries during 1990 and 1991, the collapse of trade with the Soviet Union due to the Soviet liquidity crisis, and the end of the CMEA—which may have been more devastating to the banking system than the mistakes made before 1990.

THE BANK RESTRUCTURING STRATEGIES OF CSFR, HUNGARY, AND POLAND

THE CZECH AND SLOVAK REPUBLICS

The CSFR authorities approached bank restructuring fully aware that the central government's practice of ad hoc "extra" taxation of enterprises had by the end of 1989 placed an untenable debt burden on enterprises.[19] Nonetheless, the authorities were slow in realizing that they would have to play a dominant financial role in the rescue of both enterprises and the yet-to-be-established banks.

On January 1, 1990, the State Bank of Czechoslovakia allocated its commercial loans to three banks—the ongoing Investicni Bank, and the newly established state-owned Komercni Banka Praha (KB) for the Czech Republic and Vseobecna Uverova Banka Bratislava (VUB) for the Slovak Republic. Not only were the capital-to-asset ratios of these banks very low, but more than 40 percent of KB's and VUB's outstanding loans were revolving inventory credits to enterprises at negative real interest rates. After a year of debate between the two new commercial banks and the Ministry of Finance, KB and VUB were allowed to "improve" their balance sheets by transforming the fixed 6 percent interest rate on revolving inventory credits into short- and medium-term credits at 20–24 percent. However, this policy simultaneously weakened the ability of the enterprises that owed these credits to repay them.[20]

As a result, indebted enterprises protested vehemently, which prompted the government to establish a Consolidated Bank that in June 1991 took over two-thirds of the revolving inventory credit (CSK 110 billion (Czechoslovak korunas) or $3.66 billion; note that all U.S. amounts are at exchange rates prevailing at the time) from

[19] Before the CSFR began its transformation, the government frequently imposed additional levies on highly profitable enterprises. In return, the enterprises received revolving inventory credits with indefinite maturity at a 6 percent annual interest rate. Vojtisek (1993), p. 70.

[20] Vojtisek (1993), pp. 69–70.

KB and VUB.[21] This allowed KB and VUB to reduce the book value of their assets, thus improving their capital-to-asset ratios. Simultaneously, the Consolidated Bank granted enterprises more favorable terms on their existing loans, namely an eight-year maturity at 4 percent over the bank discount rate (equal to 13 percent in June 1991), compared to the earlier short- and medium terms at 20–24 percent. While the interest burden on enterprises was lowered, they remained overindebted.[22]

Until becoming a universal bank, the Consolidated Bank only managed the transferred loans, did not issue new credit, and had no reserves to cover defaults. Even though this situation created a moral hazard for firms, a good part of the first two installments were paid to the Consolidated Bank in January and June 1992 (the remainder of these installments was covered by the National Privatization Fund).[23]

While the 1991 transfer of two-thirds of revolving credit to the Consolidation Bank did not eliminate the bad-debt problem,[24] there have been no other transfers of bad loans from KB and VUB to the Consolidated Bank. Rather, banks have used their profits to strengthen their balance sheets, and have benefited from the following measures taken by the Ministry of Finance:

- In 1991 banks were given CSK 50 billion ($1.67 billion) of state bonds with a five-year maturity at 2 percent above the discount rate, 25 percent going to increase bank capital and 75 percent to write-off pre–1990 loans to enterprises. The bonds were purchased with receipts from the National Privatization Fund.
- Subsidies were provided to banks to offset the losses associated with the fixed rate loans for housing and for newly married couples the banks inherited when the two-tier system was formed.
- New banking regulations were implemented that have allowed banks to build reserve funds before taxation.[25]

Data from KB (which in January 1993 became the largest commercial bank in the Czech Republic) and VUB (which became the largest commercial bank in the Slovak Republic) show a steadily declining "doubtful loans/total asset ratio" (from 0.50 at the beginning of 1990 to 0.20 at the beginning of 1993) and improved capital adequacy.[26] In addition, KB's ownership structure was transformed due to the voucher privatization program so that by early 1994 investment privatization funds held 41.7 percent of all shares, the Czech National Property Fund held 29.3 percent, and the Slovak National Property Fund held 14.7 percent.[27] Therefore, the strategy consisting of removal of a sizeable share of bad loans, an

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[21] Vojtisek (1993), pp. 70–71.
[22] Vojtisek (1993), p. 71.
[23] Vojtisek (1993), p. 71.
[24] As of the end of September 1992, 8.7 percent of all loans were classified as "suspicious" (the next to the-lowest loan classification) and 11.9 percent as "non-performing" (the lowest classification). See Vojtisek (1993), pp. 71–72. Also see the discussion below of the Czech and Slovak governments injection in January 1994 of $135 million into their jointly owned foreign trade bank.
[25] Vojtisek (1993), pp. 72–73.
[26] Vojtisek (1993), p. 73. Note that KB and VUB accounted for about 45 percent of all outstanding loans at the beginning of 1993.
[27] "Czech Republic: Banking Sector," Oxford Analytica News Service, April 18, 1994.

injection of new capital, new banking regulations, and voucher privatization (described below) seems to have been successful in solving a large part of the original stock problem and in attracting new ownership that should have an incentive to avoid flow problems.

While the large, partly state-owned banks still hold the predominant share of banking system assets, new entrants have arrived. By spring 1994, 60 commercial banks were operating in the Czech Republic, four of which were foreign.[28] At the end of 1993, the Slovak Republic had 18 domestic banks, 10 branches of foreign banks, and 6 representatives of foreign banks.[29]

However, it is still too early to say that the banking systems in the Czech Republic and the Slovak Republic are sound, partly because financial supervision and capital adequacy need to be improved. For instance, the United States Securities and Exchange Commission uncovered in March 1994 a scheme by Banka Bohemia (a middle-size Czech bank) to sell $1.18 billion in worthless securities.[30] Once alerted, the Czech Central Bank immediately placed its own administrator in the bank, then froze Banka Bohemia's deposits on April 14, 1994, because corporate customers had withdrawn their deposits in light of the ongoing investigation.[31]

Four other signs indicate continued weakness in the Czech and Slovak banking sectors. In January 1994, the Czech and Slovak governments injected Kcs 4.05 billion (Czech korunas; about $135 million) into their jointly owned foreign trade bank, Ceskoslovensko Obchodni Banks (CSOB) and transferred Kcs 40 billion ($1.34 billion) of bad and doubtful loans from CSOB into two new recovery units to be funded and managed by CSOB. In addition, CSOB wrote down a number of its loans. These measures gave CSOB a capital adequacy ratio of 6.25 percent as of January 1994.[32] In addition, KB's capital adequacy ratio has remained below the international standard of 8 percent and it has voiced interest in a new share issue.[33] Moreover, as of April 1994, at least 18 of the Czech Republic's 60 banks had not met the new proposed minimum capital requirement announced by the Czech National Bank in January 1994.[34] Finally, the largest three banks in the Slovak Republic had capital adequacy ratios, which though improving, were still below the 8 percent standard at the end of 1993.[35]

The Czech and Slovak authorities realized that both the banking system and enterprises must be reinvigorated with new entrants and with the privatization of the existing commercial banks. There-

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[28] In 1993 the foreign banks were responsible for 3.2 percent of all credits. On the whole, the Czech authorities have been reluctant to encourage substantial foreign involvement in banking. See "Czech Republic: Banking Sector," Oxford Analytica News Service, April 18, 1994.

[29] According to the National Bank of Slovakia, foreign banks held 12 percent of the charter capital in the commercial banking system.

[30] The Banka Bohemia notes were described as "bank guarantee" and "prime bank guarantee" and were being sold by Banka Bohemia's foreign partners in Britain, Germany, Switzerland, and the United States. See *Financial Times*, April 26, 1994.

[31] "Czech Republic: Banking Sector," Oxford Analytica News Service, April 18, 1994.

[32] The Czech government, which owns 73 percent of CSOB, provided $100 million of the new capital, while the Slovak government, with 26 percent of the shares, contributed $35 million. See *Financial Times*, January 5, 1994.

[33] The EBRD has expressed interest in buying as much as 20 percent of KB's shares from the Czech National Property Fund. "Czech Republic: Banking Sector," Oxford Analytica News Service, April 18, 1994.

[34] The proposal is to raise the minimum capital requirements from Kcs 300 million ($10 million) to Kcs 500 million ($17 million).

[35] All in the range of 6.33–7.33 percent.

fore, both a portion of the shares of Investicni Banka, KB, and VUB and the shares of many Czech and Slovak firms were privatized through the CSFR investment voucher scheme. The first wave of voucher privatization had the following characteristics:

- During October 1991 through January 1992, 8.5 million out of an eligible 10 million people purchased vouchers for the equivalent of $35 per person (about one week's salary).
- Voucher holders then either invested indirectly through one of 480 government-approved privatization investment funds or kept the vouchers in order to bid directly for shares of firms.
- Privatization investment funds and individual voucher holders next used their vouchers to bid for shares of 1,491 firms.
- During 1993, investment funds, the largest of which were owned by banks, took control of much of industry in the newly independent Czech and Slovak Republics.

As a complement to voucher privatization, portions of over 200 enterprises—most of which also were part of the first wave of voucher privatization—were sold directly to foreigners during 1992 and 1993.[36] Finally, registration for the second wave of voucher privatization in the Czech Republic began on October 1, 1993. In total, more than 6 million adults (about 90 percent of those eligible) participated, and bidding for shares in some 770 companies was to begin in March 1994.

In the Czech Republic a bankruptcy law was introduced in April 1993. However, this law did not trigger the anticipated wave of bankruptcies, apparently because banks feared that such bankruptcies would create a spiral of related bankruptcies which would inflict too much harm on the entire economy. Moreover, commercial banks have been profitable due to new lines of business related to privatization, investment banking, and their own equity acquisitions.

HUNGARY

The Hungarian authorities, under much more budgetary pressure than the Czech and the Slovak authorities, initially were reluctant to allocate funds from either the state budget or privatization receipts to solve the bad-debt problem. Rather, from January 1987 until the introduction of the New Banking Law on December 1, 1991, the Hungarian approach to the bad-debt problem (which resided primarily in the balance sheets of the Hungarian Credit Bank, the Commercial and Credit Bank, and the Budapest Bank—the three largest commercial banks) was to allow banks to retain a large percentage of their high profits in order to build reserves. Since the government held a controlling interest in these banks, it could ensure that dividends would be low. Yet, this policy and the regulations concerning the setting aside of reserves did not enable banks to build up enough reserves to cover their bad debts (see below). One sign of this trend is that bad debt as a percentage of

[36] Drábek (1993), pp. 6–7.

total bank assets rose from 2.6 percent at the end of 1990, to 4.1 percent at the end of 1991, to 11.4 at the end of September 1993.[37]

Hungarian authorities first intervened directly in mid-1991 with the establishment of a 10.5 billion forint guarantee ($140 million) to cover some of the bad debt that the three largest commercial banks inherited before 1987. These three government-controlled banks were also told to moderate dividends for the next few years in order to build reserves and to pursue a restrained investment policy in order to improve their capital/asset ratio.

As noted above, the bad-debt problem became much worse from the end of 1991 onward. While this is partly due to the recession in Western Europe and the sharp fall in trade with the newly independent countries of the former Soviet Union, the New Banking Act (adopted in November 1991, effective December 1, 1991) and the New Bankruptcy Law (effective on January 1, 1992, though the automatic trigger mechanism came into force in April 1992) contributed greatly to the growth in bank insolvency during 1992.[38]

The New Banking Act required financial institutions to classify their outstanding loans into four categories—standard, substandard, doubtful and bad.[39] Banks were obliged to establish provisions for 100 percent of bad loans, 50 percent of doubtful loans, and 20 percent of substandard loans, with accumulation of reserves for all the bad loans and half of the doubtful and substandard loans within three years. At about the same time, the New Bankruptcy Law required, under threat of criminal prosecution, a firm to initiate bankruptcy whenever any of its debt became overdue by more than 90 days. During 1992, 4,231 companies filed for bankruptcy and about 10,000 applied for liquidation (roughly half of liquidation applications were rescinded).[40] Partly due to the impact of these two pieces of legislation, the full statutory provisions of the banking system rose almost 200 percent during 1992, and the largest three commercial banks faced solvency problems.[41]

As a result of the increase in bad debt during 1991 and 1992, a government recovery agency was established in December 1992. This recovery agency exchanged newly issued 20-year government consolidation bonds for bad assets (loans) from banks.[42] The recovery agency has had the right to sell these assets or become involved in restructuring the enterprises unable to repay their obligations.

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[37] Nyers and Lutz (1993), p. 62. These ratios are based on the accounting standards that applied at the time, with one category of bad debt prior to December 1, 1991, and four categories thereafter. See footnotes 1 and 2 in Nyers and Lutz (1993), p. 68, for these definitions.

[38] Bonin (1994), p. 106, argues that these two legislative acts were partly attributable for commercial bank reluctance to finance new business during 1992.

[39] Substandard loans involve substantial sectoral risk, but are otherwise collectable; doubtful loans are associated with borrowers who have been in arrears for more than 60 days or have suffered losses for each of the two preceding fiscal years; and bad loans are associated with borrowers who have been in arrears for more than 360 days or are in the midst of financial reorganization or liquidation. See Nyers and Lutz (1993), p. 68.

[40] *National Bank of Hungary Monthly Report*, January 1993, p. 7, as reported in Bonin (1994), p. 116, footnote 4. The number beginning restructuring or liquidation in 1992 was more than 10 times the corresponding 1991 figure, Bonin (1994), p. 107.

[41] Bonin (1994), p. 116, footnote 5, reports that before the recapitalization described below in the text, the capital adequacy ratio of Hungarian Credit Bank had fallen to 2.2 percent, Commercial and Credit Bank to –7.0 percent, and Budapest Bank to –8.5 percent.

[42] The exchange was based on centrally determined prices that equalled 50 percent of the nominal value of certain pre-December 1991 loans; 80 percent of the nominal value of qualified loans issued between January 20, 1992 and September 30, 1992; and 100 percent of the nominal value of loans to state enterprises identified by the State Property Agency. See Nyers and Lutz (1993), p. 66.

Through this government recovery agency, the state spent 100 billion forints ($1.3 billion) in 1992 and 40 billion forints ($410 million) in 1993 to recapitalize the banking system.[43]

Yet these additional measures proved insufficient.[44] On December 13, 1993, the Hungarian government announced a two-stage 140 billion forint recapitalization scheme for 10 Hungarian commercial banks. During the first stage, in December 1993, eight Hungarian banks, including the three largest, traded bad assets and bank equity for 114 billion forints (roughly $1.1 billion) to reach a zero percent capital adequacy ratio from negative capital equivalent to about 15 percent of their risk-weighted assets. In the second stage, scheduled to occur during the first half of 1994, those eight banks and two others will sell other bad assets for an expected 30 billion forints ($290 million) and thus raise their capital adequacy ratios to at least 4 percent.[45] Including the expected purchase of bad debt in 1994, gross Hungarian government involvement in resolving the bad-debt problem over the years has totalled about 325 billion forints (roughly $3.54 billion).[46] While the number of bankruptcies and the high rate of unemployment have been signs that Hungary's enterprise sector has undergone significant restructuring, Hungary's approach to the bad-debt problem has been criticized for two major reasons: failing to replace bank management or at least requiring an improved business plan from current bank management as a component of the recapitalization schemes; and the absence of a sensible corporate governance strategy for those managing the transferred bad debt.

With respect to the privatization of both commercial banks and enterprises, the Hungarian authorities encouraged new entrants at a very early stage. In the banking field, 36 financial institutions were operating as of June 30, 1991, 15 of which were partly or fully foreign-owned. Also Hungarian privatization has been based on the principle of selling assets, and not "giving them away" through a voucher scheme. A significant portion of state assets has been sold, with foreign investment playing an important role in these sales.[47] However, as of the end of 1993, Hungary's three largest commercial banks had not been able to attract investor interest because of their weak balance sheets.

POLAND

Poland, the country with the fewest resources to devote to the bad-debt problem, has been the slowest to introduce its strategy, in part due to the time required to garner international financial assistance to cover the costs of the bank restructuring program.[48] In

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[43] *Financial Times*, "Hungary to Bail Out 10 Banks," December 17, 1993.

[44] Bonin (1994), p. 108, makes the point that the Hungarian Ministry of Finance retained the right to levy a stabilization tax of up to 50 percent on the interest income generated by the consolidated bonds, therefore the amount of recapitalization was much less than the face value of the issued bonds. He concludes that this recapitalization program was not successful.

[45] *Financial Times*, "Hungary to Bail Out 10 Banks," December 17, 1993.

[46] Gross in the sense that the government received bad assets that have a positive market value and has the option of imposing the stabilization tax mentioned in footnote 40.

[47] See OECD (1991b), pp. 107–127, and Marrese (1992) for a summary of early Hungarian strategy toward and progress with privatization.

[48] Bonin (1994), pp. 109–114, Chopra (1994), pp. 20–22, and Vinton and Slay (1994), pp. 22–30, outline this strategy. The G24 has provided money to finance bank recapitalization (from the unused $1 billion currency stabilization fund established in 1990), and the World Bank has extended a $350 million loan for industrial restructuring projects.

October 1991 the legal status of Poland's nine large state-owned commercial banks was transformed into that of joint-stock banks 100 percent owned by the Polish Treasury. In addition, Polish authorities allowed a particularly wide spread to develop between borrowing and lending rates. This spread served as a source of profit and allowed banks to roll over troubled loans and capitalize the interest payments. Meanwhile, some enterprise restructuring occurred due to the forced downsizing of many state enterprises. However, from mid-1991 onward it became clear that seven of Poland's nine large banks were in serious trouble when many state enterprises were unable to service existing debt because of the 1990–92 recession and the tendency to make new loans to insolvent, deeply indebted customers in the hope that a fresh injection of capital would turn their situations around.[49,50]

The December 1992 decision of the National Bank of Poland to instruct each of the nine large Polish banks to set up a "bad-loan recovery department" and the Law on the Financial Restructuring of Enterprises and Banks, approved by the Sejm in March 1993, signaled the beginning of the Polish effort to recapitalize banks. The Law on the Financial Restructuring of Enterprises and Banks, includes the following provisions:

- State-owned banks (footnote below) received 15-year restructuring bonds to cover loan consolidation. The distribution of the bonds was based on loan portfolios at the end of 1991, with loans classified by outside auditors as "substandard," "doubtful," and "lost," being recapitalized at 20 percent, 50 percent and 90 percent, respectively. Therefore, the scale and distribution of recapitalization was fixed before the actual workout of the loans began.[51]
- The bad-loan recovery departments of commercial banks and the Industrial Development Agency have been entrusted to remove bad debts from the banks' portfolios and undertake Chapter-11 type restructuring procedures against the bad debtors. A bank's restructuring proposal must be accepted by all creditors whenever it is approved by creditors holding at least 50 percent of the firm's debts. Thus small creditors no longer were an obstacle to enterprise restructuring. In addition, an enterprise's arrearages to the state budget are automatically

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[49] Slay (1992), and Chopra (1994), p. 20).

[50] Loans rated "doubtful" (overdue for 3–6 months) or "loss" (overdue for more than 6 months) accounted for 10 percent of all of the loans of the nine major state-controlled banks in mid-1990, 20 percent in mid-1991, and between 30 percent and 60 percent at the end of 1992. These figures are based on audits by an international accounting firm and should be treated with caution since BIS methodology was not completely followed and, more important, rolling over bad loans was a common practice in Poland. See Wyczanski and Zebrowski (1993), p. 80.

[51] The Polish government spent Zl 21 trillion during 1993 to improve the capital adequacy ratios of Polish banks. Zl 11 trillion ($560 million) in restructuring bonds for recapitalization was transferred to seven (Wielkopolski Bank Kredytowy and Bank Slaski had already been privatized) of the nine largest commercial banks in September 1993. In December 1993, another Zl 10 trillion (roughly $469 million) went to the state bank holding a large portion of all Polish savings deposits (Powszechna Kasa Oszczednosci, PKO) and to the agricultural credit banks (Bank Gospodarki Zywnosciowej, BGZ). For 1994, another Zl 19 trillion has been allocated for recapitalization of the banking system, most of which has been earmarked for PKO and BGZ. Vinton and Slay (1994, pp. 27–28).

reduced by the same extent as is agreed to in the restructuring procedure.[52]

- In return for the restructuring bonds, each recapitalized bank agreed that within a short time period (from September 1993 to the end of March 1994, extended to the end of April) it either would liquidate or restructure all its borrowers with bad debts, or face possible takeover by the central bank. Restructuring requires the bank's acceptance of an enterprise-devised coherent business plan.
- To stimulate enterprise privatization, claimants holding at least 30 percent of a state enterprise's debt have the right to exchange their debt for equity.[53]

Although the deadline at the end of 1994 to implement this law has expired, it is still too early to reach any firm conclusion about its effectiveness. Nonetheless, results as of the end of March indicated that the seven recapitalized banks were able to conclude restructuring agreements that covered roughly one-half of the value of their bad-debt portfolio, and for which debt forgiveness was rather high. At the same time, progress with respect to liquidation was quite modest as these seven banks collected less than 0.2 percent of the face value of the loans they offered for sale.[54]

One of the mainstays to Poland's strategy to recapitalize banks has been privatization including active participation by strategic foreign investors. Several banks in Poland have already been privatized, though only one foreign commercial bank had participated by spring 1994. The first one occurred in the summer of 1992 when 47.5 percent of the shares in Bank Roswoju Eksportu were sold in a public offering. Then in 1993 the European Bank for Reconstruction and Development took a 28.5 percent stake in one of the nine large banks, Wielkopolski Bank Kredytowy, while employees received 20 percent, the Ministry of Finance 30 percent, and the public divided up the rest. In December 1993, ING Bank of the Netherlands purchased 25.9 percent of the shares of Bank Slaski (Poland's third largest commercial bank) at the price established in the November 1993 public offering of 30.1 percent of the Bank Slaski's shares.

With respect to enterprise privatization, Poland initiated a multifaceted approach in late 1990 that eventually saw state enterprises privatized via leasing, liquidation, sale to private investors, employee shareholding, and voucher auctions. By the end of December 1992, some 1,600 state enterprises were privatized, which according to World Bank sources represent about 20 percent of total output and 12–15 percent of industrial output. In 1993, the Privatization Law was modified in order to accelerate the privatization process. Up to the spring of 1994, foreign interest in investing into large Polish firms has been modest because of Poland's record

[52] Restructuring outside the context of this program requires the approval of creditors holding at least two-thirds of the firm's debt and does not encompass any reduction in arrears to the state budget, Vinton and Slay (1994), pp. 23–24.

[53] While exchanging bad loans for bad bank shares may not seem attractive, Polish banks have increasingly been engaging in debt/equity swaps as a means of retrieving some value from non-performing loans ("Poland: A Need for Capital," *Central European*, February 1993, p. 36).

[54] Vinton and Slay (1994), pp. 31–32.

of macroeconomic and political instability and the much delayed restructuring of Poland's commercial bank debt.[55]

Austrian and Spanish Experience with Bank Restructuring

Unsustainable accumulations of bad debt have occurred for various countries throughout history. In this section, case studies are presented of Austria in the 1920s and 1930s, and Spain in the 1970s and 1980s.

Aurel Schubert (1992) describes the 1931 collapse of the Viennese Credit Anstalt, one of the biggest bank failures in history. He notes that the direct causes of the collapse were the hyperinflation of the 1920s, which eliminated the capital base of Austrian banks, and the depression of the late 1920s. In addition, the problem was made more serious by the absence of bank supervision, poor accounting practices, a laissez-faire economic philosophy, and government resources that were inadequate to engineer a panic-free cleanup of bank and enterprise balance sheets.

The Austrian government's strategy in handling the bad-debt crisis greatly exacerbated the situation. The government believed that if so-called successful banks took over failing banks and not too many enterprises went bankrupt, the economy would eventually hit an upswing and the problem would be solved. So the government put pressure on Credit-Anstalt in late 1929 to rescue the second largest bank in Austria, which itself had earlier taken over several mid-sized Viennese banks.[56] At the same time, the government encouraged Credit-Anstalt to prop up crumbling businesses.[57] When the collapse of the Credit-Anstalt was initially announced, reported losses equalled about 7 percent of deposits, while final estimates of the losses equalled over 50 percent.[58]

The Spanish banking crisis of the 1970s occurred because banks allocated an imprudently large share of their loan portfolios to their affiliated business groups on the basis of corporate connections rather than on the basis of risk/return criteria. In addition, some banks made highly speculative real estate loans. Once bankers realized the weakness of their balance sheets, they engaged in costly attempts to attract new deposits, thus aggravating their predicament.[59]

Upon recognizing the seriousness of the bad-debt problem, the Bank of Spain in 1977 set up a recovery agency designed to reverse the illiquidity of the troubled banks. The recovery agency took over ownership of illiquid banks, replaced management, and continued to operate them. However, the recovery agency had no means of injecting new capital into these banks. So in 1980, a Fund was established to both manage troubled banks and restore their capital base.

The cost of cleansing a bank's balance sheet was borne by the central government, the banking system at large, and the original shareholders of the troubled bank. The cleansing process involved

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[55] Poland's London Club arrangement was signed on March 11, 1994. Poland received up to 45 percent debt forgiveness on its $13.2 billion in commercial debt, and payment will be over a 30-year period.
[56] Schubert (1992), p. 3.
[57] Schubert (1992), p. 3.
[58] Schubert (1992), p. 6.
[59] Juan (1993).

taking over an insolvent bank, writing off a portion of the debt, and dismissing the management responsible for the accumulation of bad debt. Then the aim of the Fund became the sale of the restructured bank to the highest bidder in a process marked by disclosure of the carefully examined bank's balance sheet to a select group of potential buyers.[60] The process was considered to have been implemented successfully.

CONCLUSIONS

In the best of all possible situations, bank restructuring should be achieved and a systemic banking crisis avoided with simple bank provisioning and individual loan recovery efforts and without government intervention. However, if the net worth of formerly state-owned banks is, or at least is widely perceived to be, highly negative, then government involvement in solving the stock and flow problems of enterprise and bank restructuring is inevitable. This has been the case in Central and Eastern Europe. The unrecoverable loans which the newly formed commercial banks inherited from the monobank have constituted the root of the stock problem. The flow problem has been connected to all factors that have allowed non-prudential bank management to remain in place.

The fundamental reason to resolve the stock problem as quickly as possible is that corporatization of enterprises and banks should be implemented along with hard budget constraints. Enterprises are likely to face hard budget constraints only when their chief financiers, the banks, demand timely payment. The banks will impose hard budget constraints on enterprises only if bank management is convinced the state will not subsidize its own mistakes nor will funnel financial assistance directly to enterprises. However, an immediate resolution to the stock problem is unlikely[61] and may not be desirable because the time-consuming process of examining a firm's assets, liabilities, and business strategy is often a necessary step in the firm's future access to outside financing.

The effectiveness of enterprise and bank restructuring depends very much on how the authorities contribute to the recapitalization of banks and influence the incentives of bank and enterprise managers. If the authorities possess full information then, they could solve the general equilibrium problem of determining the optimal combination of liquidation/restructuring, privatization, and government-funded recapitalization. Instead the authorities are faced with the need to estimate the market value of each bank's loan portfolio without knowing the private sector's willingness to invest in the debt-ridden companies or buy their bad debt. Under these circumstances, the Polish solution appears quite reasonable, namely evaluation, by reputable outside auditors, of each major state bank's portfolio of loans to determine the extent to which each bank will be recapitalized before bank-initiated restructuring or liquidation of enterprises begins in earnest. Then as long as the recovery agency, whether centralized or decentralized, faces an incentive structure based on recovered loan repayments and on the

[60] See Juan (1993) for a much more detailed account.

[61] Unless a country (as in the case of Germany) decides to have taxpayers cover most of the medium-term costs and does not make an effort to distinguish good loans from bad loans.

value of the equity obtained in exchange for debt forgiveness, then the stock problem should be under control. To remedy the flow problem, all of the ingredients of hard budget constraints and effective corporate governance must be present.

However, countries have rarely, if ever, been able to implement this "reasonable" approach to the stock and flow problems in a short amount of time, and generally have chosen diverse policies to deal with the issue of bad debt. The CSFR and later the Czech and Slovak authorities have avoided bank-led restructuring/liquidation and have instead relied on government-funded recapitalization and modest dividends (implicit transfers of profit from the state-controlled shareholders), along with voucher privatization and new entrants to address the bad-debt problem. The Hungarian authorities initially hoped retained earnings would be enough to repair banks' balance sheets, and only reluctantly began to channel government resources into bank recapitalization. The turning point in the Hungarian strategy occurred in 1992, when banks were forced to initiate bankruptcy procedures and to provision for all non-standard loans on a massive scale. Only after this had occurred did the Hungarian authorities engage in substantial levels of government-funded recapitalization. Nonetheless, privatization of troubled banks has not yet occurred in Hungary. The Polish authorities delayed addressing the bad-debt problem for several years, then put forward a rather elegant plan which has involved substantial government-backed recapitalization, promises of several years of additional government-backed recapitalization, and a strong commitment to involve strategic foreign investors in the restructuring of Poland's nine largest banks. In return for new injections of capital, recovery departments within banks have been given the role of restructuring/liquidating bad assets. Foreign participation in the privatization of banks has been modest thus far.

The experience of all the countries examined in this paper offer a number of insights into solving the bad-debt problem that should be relevant for most economies in transition:

- A comprehensive strategy, including privatization and involving both banks and enterprises and all of their claimants, is required to clean up the balance sheets of bank and enterprises. This suggests a time- and negotiation-intensive process. Yet most governments initially refuse to acknowledge this.
- Bank restructuring requires expensive and long-term support (in the Spanish case, the process lasted seven years), that could include the sale of government bonds to soften the contemporaneous budgetary cost of the bailout. This suggests that it may be much too early to judge the "success" of Central and East European strategies to solve the bad-debt problem.
- Since the banking system as a whole benefits from the restructuring of troubled banks, solvent banks may be encouraged to contribute to the costs of restructuring through the purchase of long-term bonds as in the case of Spain.
- A normal audit rarely identifies the bad-debt problem because the loans of insolvent clients had often been rolled over and the interest capitalized (all countries). Thus, the scope of the problem is generally only known once the recovery agency has

taken control of the bank and an exhaustive audit has taken place.[62]

- There always is a tendency to underestimate the size of losses from the bad-debt problem in order to prevent panic (all countries).
- There is a need to enforce the use of stringent and comprehensive accounting and auditing rules.
- Bad assets should be separated from good ones.
- An expected cleansing of the books of banks and enterprises may increase the incentive of borrowers to stop repaying their debts and may reduce bank efforts to recover their assets (the German Democratic Republic, Hungary, Poland, Austria). Thus, those responsible for insolvency should be replaced and the rescue should be structured as a one-time event.

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[62] In Austria the final estimates were over 7 times greater than the initial estimates. Aristobulo de Juan noted in February 1992 at an OECD Seminar on Bank Restructuring in Central and Eastern European Countries that the actual losses connected to Spanish restructuring were twenty times the initial estimates.

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DEFENSE CONVERSION IN EAST EUROPE

By Thomas S. Szayna *

CONTENTS

SUMMARY

The collapse in demand for East European armaments led to a shrinking of the defense output in those countries by 1993 to only a fraction of its size in 1987. The process entailed the release of substantial resources from the defense sector. The recession that accompanied the economic transition process depressed the domestic demand for alternative civilian products. As a result, the civilian sector has utilized only some of the resources released from the defense sector, while the rest have been idled. Only future economic growth and market mechanisms of allocation of resources stand to truly "convert" the currently idle resources.

THE PRE–1989 SITUATION

Until the ouster of communist regimes from power in the former non-Soviet Warsaw Pact (FNSWP) states, the arms industries in these countries contributed to the military effort of the Warsaw Pact and served as a component of Soviet dominance over the region. Soviet authorities directed and coordinated the whole military economic effort within the Warsaw Pact through the various Warsaw Pact and CMEA (Council for Mutual Economic Assistance) channels. The entire setup ensured weapons standardization and interoperability among the military services of Warsaw Pact countries and strengthened the operational viability of the Warsaw Pact forces. Since the structure and development of the armaments industries in the various FNSWP states stemmed from the Soviet-outlined Warsaw Pact military doctrine, the output and the division of labor among the arms industries of the FNSWP states reflected Soviet interests. In terms of end products, the arms indus-

* Thomas S. Szayna is a researcher with the International Policy Department, RAND, Santa Monica, California. The author would like to thank Jeff Simon of the National Defense University for helpful comments on a previous version of this paper.

tries in the FNSWP states produced mainly Soviet armaments under license, domestically designed variations of Soviet armaments or, in limited cases, indigenously-designed armaments (though often dependent on Soviet components).[1] Only Romania, following its distancing from the Warsaw Pact in the 1960s, manufactured some weapons based on West European licenses. In terms of components of larger weapons systems, the various FNSWP countries specialized along sectoral lines, with most of the products exported to the USSR rather than to other FNSWP states.

Although Czechoslovakia and Poland developed extensive armaments industries, the two countries concentrated on specific weapons types and neither of them could provide for all its defense needs. For a variety of reasons, ranging from technological constraints in the FNSWP countries to residual Soviet distrust and penchant for secrecy, the FNSWP arms industries did not manufacture the latest Soviet armaments. Generally, the FNSWP arms industries manufactured end products a generation behind the latest Soviet weapons, with license production starting when the given weapons system already neared the end of its production cycle in the USSR. The pattern appears deliberate and aimed at securing spare parts for armaments already in service (made easy by the Soviet practice of improving tried designs rather than building new ones from scratch). The objective was also to provide modern but not the latest armaments as exports to "deserving" clients among the developing countries while freeing the Soviet industry to concentrate on more advanced models of weapons systems.[2]

THE COLLAPSE IN DEMAND

As the Warsaw Pact began to unravel and then fall apart, the defense industries of the FNSWP countries experienced first a drop in size and then a dramatic contraction. As of 1994, the contraction has reached such proportions that only a fraction of the previous defense manufacturing capacity has remained. In the space of six years, from 1987–1993, the defense industry in the FNSWP states has gone from its historic high point and a significant force in world arms production to a position of little relevance. The reasons for the contraction stem mainly from the collapse in demand (both foreign and domestic) for arms manufactured in the FNSWP states. This collapse in foreign demand followed the disappearance of the most important markets—most of all the USSR and the German Democratic Republic (GDR)—and the inability to find new ones in the post-cold war situation of a glut on the international arms market. The collapse in domestic demand stems from the fundamental economic transition that all individual FNSWP countries have embarked upon and which has led to a reallocation of funds away from defense and in support of the transition process. That transition and reallocation, combined with the disappearance of the need

[1] For a profile of the FNSWP countries' defense industries, see Shelley Deutch, "The Non-Soviet Warsaw Pact Defense Industries: An Overview," Joint Economic Committee of Congress, *Pressures for Reform in the East European Economies, vol. I* (Washington, D.C.: United States Government Printing Office), October 20, 1989, pp. 171–186.

[2] For an ex-insider's account of some of the Soviet dealings with the FNSWP countries in the defense industry realms in the Warsaw Pact era, see Michael Checinski, *A Comparison of the Polish and Soviet Armaments Decisionmaking Systems*, R–2662-AF, RAND, Santa Monica, California, January 1981.

on the part of the FNSWP countries to follow Soviet wishes regarding the orientation and outfitting of their armed forces, as well as a common suspicion of the military in the FNSWP countries as an institution associated with the old regimes, has led to a severe contraction in the outlays for the military, with procurement suffering the most.

The collapse in demand has had a varied impact upon the economies of the FNSWP states. The states with the largest arms industries have experienced the biggest problems, though country-specific political and economic characteristics have worsened or ameliorated some of the impact. As the largest of the FNSWP arms manufacturers, Czechoslovakia suffered the most, and factors specific to that country have worsened the problems stemming from the collapse in demand. In fact, the problems of the Czechoslovak defense industry became a symbol of the increasingly divergent Czech and Slovak economic aspirations that led to the breakup of Czechoslovakia at the end of 1992. Poland's arms industry, ranked second among the FNSWP states, experienced a proportionally smaller impact than that of Czechoslovakia because of its lesser importance within the Polish economy as a whole and because of different governmental policies. The other FNSWP countries had substantially smaller arms industries than Czechoslovakia or Poland. While the problems of the defense industry became an issue at the local level, the other states have not felt any significant impact at the macroeconomic level based on the troubles of the defense industry itself.[3]

CONVERSION OF THE DEFENSE INDUSTRY

CZECHOSLOVAKIA

At its high point in 1987 the Czechoslovak arms industry accounted for almost 3 percent of the country's total industrial production and 11.3 percent of its heavy industry production. The defense sector employed directly 73,000 workers and another 50,000–60,000 indirectly.[4] Altogether the defense sector employed 1.5 percent of the work force. Exports accounted for most of the output of the Czechoslovak defense sector, with only 22.4 percent of the output earmarked for the Czechoslovak armed forces. Of the 77.6 percent of the products exported, about 75 percent went to the other Warsaw Pact members (most of all to the USSR) and 25 percent went to the various Soviet client states among the developing countries. According to the U.S. Arms Control and Disarmament Agency (ACDA), the share of arms exports in total Czechoslovak exports stood at 8.4 percent in 1987 (down from its high of 12.6 percent in 1985; in 1988 the ratio went down to 6.2 percent and in 1989 to

[3] For an early overview of the probable costs of the transition and their impact on the defense industries in the FNSWP states, see Keith Crane, *The Economic Implications of Reductions in Military Budgets and Force Levels in Eastern Europe*, N-3208-USDP, RAND, Santa Monica, California, 1991.

[4] These numbers became inflated for political reasons in 1990–92. The figures given here come from the Czechoslovak Ministry of Defense. Yudit Kiss, "Lost Illusions? Defense Industry Conversion in Czechoslovakia, 1989–92," *Europe-Asia Studies*, vol. 45, no. 6, (1993), p. 1046.

6.1 percent).[5] In the mid- and late-1980s, Czechoslovakia ranked among the world's ten largest arms exporters in the world.

The arms industry in Czechoslovakia had a regional dimension, with important differences existing between the structure of the arms industry in the Czech lands and in Slovakia. Most of all, the relative importance of the defense sector in these economies differed. Slovakia, with approximately one-third the population and territory of Czechoslovakia, accounted for 60.6 percent of the Czechoslovak arms production in 1987.[6] Whereas arms production constituted less than 2 percent of the total industrial output in the Czech lands, it amounted to 5–6 percent in Slovakia.[7]

Another difference centered on the different product lines of the arms industries. The arms industry in the Czech lands, geographically concentrated in central and eastern Bohemia and throughout Moravia, produced mainly aircraft and avionics, electronics, radar equipment, specialty explosives, small parts, and components for armored vehicles made in Slovakia.[8] The arms industry in Slovakia, dispersed throughout the republic but especially important in northwestern (the Vah river valley) and south-central regions, produced mainly heavy weapons, such as tanks and other armored vehicles, artillery systems, and ammunition.[9] Based on this difference in the type of arms production, the enterprises engaged in arms manufacturing in Slovakia had a lower rate of diversification (they depended more on their arms production) than the enterprises engaged in arms production in the Czech lands. Finally, the most important arms plants in Slovakia differed in size from those in the Czech Republic. As products of the Stalinist industrialization drive, the Slovak arms factories resembled their cousins in the USSR, with the work force often in the thousands and entire towns built around the plants and dependent on them for livelihood.

The collapse of demand for the products of the Czechoslovak arms industry reduced it by 1992 to approximately 17 percent of its 1987 size. The biggest contraction took place in 1991, when the arms industry (already one-half of its 1987 size) shrunk again by half. The contraction of the arms industry in Slovakia took place faster than the similar process in the Czech lands; in 1992, the Slovak arms industry fell to about 10 percent of its 1987 size. Employment in the defense sector in Slovakia fell to 14.1 percent of its 1987 levels. The trends have continued since the gaining of sovereignty by Slovakia, decreasing the output to about 5 percent of their peak levels. According to Slovak spokesmen, the heavy machinery defense enterprises only manufactured some spare parts in 1993 as part of their defense sector production.[10]

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[5] *World Military Expenditures and Arms Transfers, 1991–92*, U.S. Arms Control and Disarmament Agency (ACDA), p. 102.

[6] Oldrich Cechak, Jan Selcsovsky, and Milan Stembera, "Czechoslovakia: Reductions in Arms Production in a Time of Economic and Political Transformation," in Herbert Wulf (ed.), *Arms Industry Limited* (New York: Oxford University Press), 1993, p. 240.

[7] Ales Capek and Gerald W. Sazama, "Czech and Slovak Economic Relations," *Europe-Asia Studies*, vol. 45, no. 2 (1993), p. 225.

[8] For a list of the arms production facilities in the Czech Republic, see *Defense Conversion and Arms Transfers: The Legacy of the Soviet-Era Arms Industry*, National Security Planning Associates, Inc., Cambridge, Mssachusetts, and the Institute for Foreign Policy Analysis, Inc., Washington, D.C., June 1993, pp. 61–63.

[9] For a list of the arms production facilities in Slovakia, see Ibid., pp. 64–67.

[10] Igor Kosir, "Industrial Restructuring and Defense Conversion in Slovakia," paper presented at the NATO Economic Colloquium on Economic Developments in Cooperation Partner Coun-

The relaxation of tensions and the prospects for a comprehensive arms control agreement in Europe in 1987–89 began the slide in the fortunes of the Czechoslovak arms industry. The incorporation of the GDR into the German Federal Republic in 1990 and the drop of Czechoslovak arms exports to the USSR and the FNSWP states to negligible levels as a result of the introduction of hard currency payments in trade (and then the falling apart of CMEA) amounted to the disappearance of a market for almost 60 percent of the products of the Czechoslovak arms industry. The adaptation of Czechoslovak arms sales policies to Western guidelines on arms exports put a stop to sales to such traditional major Czechoslovak clients as Iraq, Iran, and Libya.[11] Sales to other traditional clients, such as Syria, also came under pressure. With the old markets no longer available and a glut in the international arms market precluding any substantial new markets, Czechoslovak arms exports in 1992 declined to about 20 percent of the 1987 figure. By 1991 most of the arms exports (approximately 70 percent) went to the developing countries, a complete reversal of the pattern prevalent during the Warsaw Pact years.

The regaining of sovereignty by the FNSWP states, the disintegration of the Warsaw Pact, and the fundamental realignment of Czechoslovak security policy away from its previous anti-NATO orientation and toward a prospective NATO membership led to the abandonment of the heavy, offensive-oriented military in favor of a lighter, defensive, territorially oriented force. The reorganization has meant a sharp downturn in the domestic need for many of the types of armaments produced in Czechoslovakia. In addition to all of the above, the need for outlays to safeguard the disruptions accompanying the economic transition process acted as powerful motivating forces in favor of decreasing the defense budget. In real terms, the 1992 Czechoslovak defense budget fell to less than half of the 1989 defense budget. More important for the defense industry, procurement took the brunt of the cuts in defense outlays. From constituting 34.8 percent of the defense budget in 1989, procurement fell to 4.4 percent of the defense budget in 1992,[12] making any domestic purchases virtually a moot point. Finally, the CFE-dictated (Conventional Forces in Europe treaty) cuts in arms stipulated that Czechoslovakia destroy more than 1,000 tanks, armored combat vehicles, and artillery pieces. The conditions hardly favored further procurement.

The specific makeup of the leadership that came to power in Czechoslovakia following the ouster of the communist regime contributed to the decline in fortunes of the Czechoslovak defense industry. Having origins in the dissident group "Charter 77," and exemplified best by Vaclav Havel, the new leadership had strong pacifist tendencies. Motivated by idealism and embarrassed over the previous role of Czechoslovakia as a supplier of arms to some of the

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tries from a Sectoral Perspective, Panel 3: Industrial Restructuring and Defense Conversion, Brussels, June 30-July 2, 1993.

[11] Richard T. Cupitt, "The Political Economy of Arms Exports in Post-Communist Societies: The Cases of Poland and the CSFR," *Communist and Post-Communist Studies*, vol. 26, no. 1, (March 1993), pp. 87–103; and Paul Henri Laurent, "Czech and Slovak Arms Sales Policy: Change and Continuity," *Arms Control*, vol. 14, no. 2, (August 1993), pp. 151–180.

[12] Evamaria Loose-Weintraub, "Appendix 9A: Military Expenditures in the Central and East European Countries," *SIPRI Yearbook 1993: World Armaments and Disarmament*, Oxford University Press, 1993, p. 404.

world's terrorists and rogue regimes, the new leadership made it a government policy to stop completely Czechoslovak arms sales and switch the Czechoslovak arms industry's production to civilian output. Although the policy of fully stopping arms exports proved short-lived and, in any event, never became fully implemented, the issue became a symbol for some Slovak political figures (associated mainly with the Movement for Democratic Slovakia and the Slovak National Party) who used it to portray the alleged Czech indifference to Slovak concerns. This indifference supposedly was shown through the greater negative impact of the economic transition process on Slovakia than on the Czech lands. The political appeals on this basis proved effective, leading to the success of opposing political movements in the Czech lands and in Slovakia in the June 1992 election, which then led to the split of the country into two sovereign states at the beginning of 1993.

In reality, structural economic reasons, such as a greater dependence of Slovak industry on imports from CMEA countries and a lower general efficiency, caused a greater degree of economic hardship—and especially unemployment—in Slovakia than in the Czech lands. Undoubtedly, the structure of the Slovak defense industry caused it to suffer relatively more than the Czech defense industry but, despite the claims of some Slovak politicians, the troubles in the defense sector contributed in only a minor way to the disruptions in Slovakia.[13] In any event, the troubles of the defense industry in Slovakia stemmed from the drop in demand for its products in the post-cold war conditions; the policy of stopping arms sales marginally worsened the troubles but it did not create them.

The Czechoslovak government attempted to aid the conversion process by introducing incentives at the microeconomic level. The most important incentives included the provision of substantial funds in the budget to assist individual enterprises in the switch to civilian production. The 1990 budget allocated $40 million (of which Slovakia received $28.33 million); the 1991 budget allocated $50 million ($40 million to Slovakia); and the 1992 budget allocated $33 million ($26 million to Slovakia).[14] The funds covered three groups of conversion projects: extending already existing civilian production lines, creating new production lines to complement already existing civilian production, and attempting to find new market niches by creating completely new production lines. While a number of successes at the factory level came out of the conversion projects, the process overall proved unsuccessful. Most of the defense plants cut back on their defense production but the cutbacks often came as a result of the work force becoming idle rather than as a result of switching production to civilian output.[15]

Although factors internal to enterprises, such as lack of expertise in marketing and inappropriate capital stock, contributed to the failure, factors related to the fundamental transition process appear as the dominant reasons. The enterprise managers, accustomed to quantitative measures of output and conditions of high

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[13] The unemployment rate in central Slovakia consistently remained below the average for all of Slovakia from 1990–92. See Sharon Fisher, "The Slovak Arms Industry," *RFE/RL Research Report*, vol. 2, no. 38 (September 24, 1993), pp. 34–39.

[14] The last communist government in Czechoslovakia also appropriated $22.5 million in 1989 for conversion, all of it earmarked for Slovakia.

[15] Kiss, "Lost Illusions," p. 1054.

priority, previously had been insulated completely from dealing with the uncertainties in the civilian sector. They were fearful of privatization, uncertain of the way the economic reforms would affect them, and often hovered on the brink of bankruptcy. Many of them used the conversion funds as a temporary reprieve to prevent badly needed restructuring and to keep a semblance of production going. Allegations even arose that some firms used the conversion funds to continue their military production.[16] The conversion process relied on enterprises to submit project proposals for conversion, but the enterprise managers had little if any understanding of the market conditions in which they had to operate. Consequently, enterprise managers seem to have focused on the technical feasibility of conversion and ignored the crucial dimensions of marketability, efficiency, and appeal to consumer taste.[17] In other words, the enterprise managers approached the conversion process as simply substituting civilian goods for the military output, still thinking in terms of a planned economy.

Besides the basic difficulty of trying to address the issue of conversion at the microeconomic level (and attempting to do so while relying on enterprise managers accustomed to thinking in terms of the planned economy), structural problems related to the nature of the industry worsened the situation in Slovakia. Data on problems of the U.S. defense industry suggests that plants engaged in the production of tanks and tank components find it most difficult to switch to civilian production, because of inappropriate capital stock. In contrast, aerospace, engineering and scientific instruments, and even some types of explosives producers find it much easier to adapt the existing capital stock to civilian production.[18] The regional dimension of the Czechoslovak arms industry, with the heavy machinery producers located largely in Slovakia and the aerospace and communications equipment plants mainly in the Czech lands, meant that the industry in the two parts of Czechoslovakia faced different problems of adaptability. The large size of the major Slovak arms manufacturers, with their attendant built-in inefficiency, only magnified the difficulty of adjusting to civilian production on the part of Slovak arms enterprises. In turn, the large size of the plants and their dominant position in certain towns in Slovakia made the troubles of the arms manufacturers a political problem that politicians in the new democratic conditions in Czechoslovakia had to address.

Amidst the growing controversy surrounding the process and an increasing Czech-Slovak political antagonism over it because of the greater relative effect of the phase-out of the defense industry on Slovakia, the Czechoslovak policy changed in early 1992 so that only plants that fully stopped military production would receive conversion funds. The move represented a blow to the enterprises planning a more gradual phase-out of defense production. The switch in policy placed the whole process in question, since the few successful cases of conversion at the plant level came in the enter-

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[16] Kiss, "Lost Illusions," pp. 1052–55; *Defense Conversion and Arms Transfers*, pp. 50–56.

[17] Thierry Mallaret, "The Economic and Social Aspects of the Regional Dimension of Defence Conversion," paper presented at the CSCE Conflict Prevention Seminar on the Conversion of Military Industry to Civilian Production, February 1992.

[18] *The Economic Effects of Reduced Defense Spending*, Congressional Budget Office, February 1992.

prises that increased civilian production alongside a declining but continuing defense production.[19] The move also caused greater difficulties for the Slovak arms manufacturers because of their greater problems in switching to civilian production. In addition, in a seemingly contradictory move, the Czechoslovak government eased up on the earlier ban on arms sales, a move that seemed to encourage continued arms production. The whole question became moot with the division of Czechoslovakia into two states.

The rapid downturn in the arms industry in the two states that emerged from Czechoslovakia has largely stabilized and, within a few years, it seems likely to recover gradually and partially to a level of about 10–20 percent of its peak size. The arms industries of both countries will continue their different orientations and will need to rely heavily on exports to sustain them. The Czech arms industry already has found specific market niches (for example, L-39 jet trainers) and the forming of ties among the major Czech defense enterprises (the RDP Group) seems to have increased its strength as a domestic lobby group.

The prospects for Slovak arms industry seem worse than for its Czech counterpart, since little foreign direct investment in the Slovak enterprises that had engaged or still engage in arms production has materialized so far despite the fact that, since independence, the Slovak government has introduced a number of policies designed to assist in the process of switching of production lines (e.g., tax and debt relief, credit guarantees). Unlike their Czech counterparts, Slovak enterprises may renew cooperative ties with Russian firms in a limited manner following the current hiatus.[20] Any potential success by the Slovak arms producers probably will come as part of cooperative schemes between Slovak enterprises and those in the other FNSWP states, especially in the Czech Republic and Poland (though substantial domestic political impediments stand in the way of such cooperation in all countries concerned).

POLAND

In 1989 the Polish arms industry accounted for about 2.5 percent of the country's total industrial production. The output of 128 enterprises accounted for most Polish arms production. Estimates regarding the level of employment in the defense sector vary widely, though it seems to have employed directly about 75,000 workers.[21] According to the Arms Control and Disarmament Agency (ACDA), the share of arms exports in total Polish exports had declined to 3.0 percent by 1989 from its high of 12.4 percent in 1986, 10.7 per-

[19] This is not surprising because enterprises find it much easier to pursue incremental conversion strategies (changing minor product functions to attract new customers or changing several product functions to amend current production for new uses) than to follow total conversion strategies (replacing all present customers or pursuing a total product overhaul). Avraham Shama, Christian Aubert, and Timothy L. Meuret, *The Price of Peace: Defense Conversion Strategies*, the Robert O. Anderson School of Management, Albuquerque, New Mexico, 1993.

[20] Whereas the Czech leadership categorically rejects any cooperation with Russian arms manufacturers in the future (stemming from the current Czech government's determination to do nothing that could impede its integration with NATO), the Slovak leadership views potential future cooperation with Russian defense firms in a more pragmatic manner. Brigita Schmognerova, "Conversion of the Military Industry in the Slovak Republic," *Slovakia*, vol. 1, no. 1 (1993), p. 20.

[21] *Defense Conversion and Arms Transfers*, p. 72.

cent in 1987, and 8.6 percent in 1988.[22] According to Polish figures, exports accounted for just over 50 percent of the output of the Polish defense sector in 1988–89. About two-thirds of the arms exports went to the other Warsaw Pact states, and especially to the former USSR. In the mid- and late-1980s Poland ranked among the top ten arms exporters in the world (usually just behind Czechoslovakia). The Polish arms industry produced a wide array of end products, ranging from major land weapons (tanks, armored vehicles, artillery), to aircraft (transports, jet trainers, helicopters), and naval units (patrol and landing craft). Ammunition, missile components, radar, and electronics completed the profile of the industry. The Polish arms industry lacked any regional concentration, though Silesia and southeastern Poland tended to dominate in the industry's geographical distribution. Except for a few cases, most of the enterprises engaged in arms production had a high rate of diversification.

The collapse of demand for the products of the Polish arms industry reduced the size of the Polish arms output by 1991 to about 20 percent of its size in 1988 (its peak year); the share of the arms industry in the total industrial production fell to just over 1 percent.[23] Apparently the downward trend bottomed out in 1992–93 so that the arms industry comprised about 18–20 percent of its 1988 size. By 1991 employment fell by almost half to about 40,000 directly engaged in the production of end products. Just as in the case of Czechoslovakia, the collapse of the intra-Warsaw Pact arms sales amounted to the disappearance of a market for over 50 percent of the products of the Polish arms industry. Similarly, the adaptation of Polish arms sales policies to Western guidelines on arms exports pulled the plug for most of the Polish markets among the developing countries. The inability to export arms to Iraq proved especially damaging to the Polish arms industry, and arms exports declined to about 5 percent of the 1987 levels.[24] The importance of the developing countries as a market for Polish arms has grown, though it seems to have done so at a lower rate than it did for Czechoslovak arms.

Just as in the case of Czechoslovakia, a fundamental realignment of Polish security policy and the adoption of a new defensive strategy entailed a change in the force structure of the Polish military toward a lighter and defensive-oriented force. The reorientation has caused problems for the Polish arms industry, though not to the extent that it did in Czechoslovakia because of the greater diversification and the relatively lesser reliance on heavy land weapons systems by the Polish arms manufacturers. In real terms, the 1992 Polish defense budget fell to just under half of the 1989 defense budget, and it has stayed at that level since that time. From constituting 22.7 percent of the defense budget in 1989, procurement fell to 12.0 percent of the defense budget in 1992.[25] The fall in procurement resulted in the domestic demand falling from 43–46 percent of the Polish arms industry's output in 1988–90 to 10–15 per-

[22] *World Military Expenditures and Arms Transfers, 1991–92*, p. 120.

[23] Maciej Perczynski and Pawel Wieczorek, "Poland: Declining Industry in a Period of Difficult Economic Transformation," in Wulf, *Arms Industry Limited*, p. 226.

[24] ACDA figures used here differ greatly from some of the Polish figures.

[25] Weintraub, "Military Expenditures," p. 409.

cent by 1991. Nevertheless, the fall in procurement took a proportionally smaller, more gradual—and thus gentler—form than it did in Czechoslovakia.

Conversely, the CFE Treaty-dictated reductions in the number of major land weapons had a proportionally greater impact on Poland than on Czechoslovakia. Altogether, the Polish military will need to destroy more than 1,000 tanks alone in order to comply with the treaty; the total number of tanks, armored combat vehicles, and artillery destined for a phase-out numbers more than 2,000. The figures show the level of militarization of Poland under the communist regime but the numbers also entail substantial expenditures in the defense budget toward the destruction of the weapons systems. The expenditures amount to an additional constraint on procurement.

Unlike the post-communist Czechoslovak government, the Polish post-communist leadership had no pacifist tendencies and did not treat arms trade as an activity that needed to stop completely. The different backgrounds and orientations of the new Polish leadership, as well as an overall different attitude toward the military in Poland and in Czechoslovakia (and especially the Czech lands) explain the different outlooks. The new Polish leadership took a detached view toward the problems of the defense industry. The fact that much of the Polish arms industry had a high degree of diversification and that enterprises engaged in production difficult to adapt to civilian production (heavy machinery and shipbuilding in the Polish case) represented a small portion of the overall arms industry made the issue less prominent. Only a series of scandals regarding the covert attempts by Polish arms makers to sell arms to countries affected by arms embargos, a wave of strikes at defense enterprises, the specter of massive bankruptcies, and the elimination of most of the Polish arms manufacturing capability motivated the government to establish a framework for future arms production in Poland.

Under the provisions of a defense industry restructuring plan adopted in May 1992, the state will own 21 enterprises (11 of them engaged in spare parts production and maintenance of existing weapons) judged as critical to the defense of the country. Another 18 defense enterprises will have majority state control.[26] The rest of the arms industry (more than 100 enterprises) will become privatized and will engage in defense production according to market criteria, though the enterprises will receive preference in procurement for the Polish armed forces. The slower-than-expected pace of privatization in Poland appears to have delayed the implementation of the plan.

Because of the lesser importance of Poland's arms industry to its economy, the government did not promote conversion as a policy, but treated the problems of the arms industry simply as one of the manufacturing sector's adjustment to the new market conditions. The effect of such "brutal conversion" has not differed much from that of Czechoslovakia; some enterprises managed to increase their

[26] For a full list of the enterprises and the initial plan, see Perczynski and Wieczorek, "Poland: Declining Industry," pp. 228–233; for the outlines of the final plan see *Report on the State of National Security: External Aspects*, Polish Institute of International Affairs, Warsaw, 1993, pp. 114–123.

share of civilian production while most have foundered and looked for state support. A few have attempted to engage in illegal arms exports.[27] Because of the Polish arms industry's lesser importance to the Polish economy and the lack of an ethnic dimension to the problems of the defense industry in Poland, the issue did not result in major political problems (though some political organizations, especially the Confederation for Independent Poland, have attempted to use the issue for their own political agendas).

The guaranteed survival of a portion of the Polish arms industry has stabilized the situation. Just as in the case of the Czech and Slovak states, the Polish arms industry should recover partially during the next few years, probably ending up at about 30–35 percent of its peak (mid-1980s) size by the late 1990s. The Polish arms industry will have to rely on exports to offset its R&D costs. A number of weapons, such as the thoroughly revamped and upgraded Polish T–72 tank (renamed the PT–91), a new armored personnel carrier, light helicopters, jet trainers, and radar may achieve some success on the international market. Cooperation with U.S., French, Swedish, and South African firms has already given the Polish arms industry greater competitiveness.

HUNGARY, BULGARIA, AND ROMANIA

The arms industries of the other three FNSWP states—Hungary, Bulgaria, and Romania—played only a minor role within their national economies and a distinctly minor role in the Warsaw Pact military economic effort.

Hungary produced some armored vehicles but most of its defense sector consisted of telecommunications and electronics components exported to other Warsaw Pact arms manufacturers, especially the USSR. Except for two cases, none of the large Hungarian enterprises relied for more than 50 percent of its share of output on defense production by 1989.[28] According to ACDA, the share of arms exports in total Hungarian exports declined to 0.8 percent in 1989 (from 2.5 percent in mid-1980s).

Bulgaria's arms industry produced armored vehicles, artillery, small naval craft, and some electronics components. Bulgaria's arms exports in 1989 amounted to twice the Hungarian arms exports that year (a substantial share of which went to the developing countries), though the share of arms exports in total Bulgarian exports declined to 1.0 percent (from 3.5 percent in 1987).

Romania, the maverick within the Warsaw Pact, produced the full range of armaments, even more so than Poland or Czechoslovakia. Often consisting of obsolescent designs, most of the Romanian arms production supplied the Romanian military. Romania's arms exports amounted to 0.7 percent of its total exports in 1989 (down from 2.0 percent in 1987). Fitting in with its special status within the Warsaw Pact, Romanian arms manufacturers cooperated in the production of equipment with French, British, Yugo-

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[27] Anna Sabbat-Swidlicka, "Poland's Arms Trade Faces New Conditions," *RFE/RL Research Report*, vol. 2, no. 6, (February 5, 1993), pp. 49–53.

[28] Tibor Palankai, "Economic Problems of Conversion in Hungary," Serge Sur, (ed.), *Disarmament Agreements and Negotiations: The Economic Dimension*, United Nations Institute for Disarmament Research (Brookfield, Vermont: Dartmouth), 1991, p. 60.

slav, and Soviet firms. All of the minor FNSWP arms producers manufactured small arms and ammunition of various caliber.

The collapse of the Warsaw Pact markets virtually forced the Hungarian arms manufacturers out of business. Comprising altogether 25–30 enterprises (some of which were involved in maintenance and support functions), the output of the Hungarian arms industry declined by 1993 to about 15 percent of its 1988 levels. The fact that Bulgarian arms manufacturers have not suffered the same fate as those in Hungary seems related more to the lag in Bulgarian economic reforms and continued state support than to anything else. The loss of Warsaw Pact and Middle Eastern markets especially affected the Bulgarian arms makers. By early 1994, the Romanian arms industry had shrunk to about half its size in 1989. The small reliance of the Romanian arms manufacturers for exports has sheltered them from the extreme effects that the other FNSWP states have experienced.

The defense budgets in Hungary, Bulgaria, and Romania have followed a trend similar to that in Poland and Czechoslovakia. The smallest drop seems to have occurred in Romania, due in part to the already lower levels of the defense burden in Romania than in the other FNSWP states prior to 1989. Procurement too has followed the same trends. In Hungary and Bulgaria, procurement dropped to under 10 percent of the defense budget by 1992 (from about 20 percent in 1989 in Hungary and, in a spectacular dive, from about 60 percent in 1989 in Bulgaria),[29] in Romania procurement dropped to 25 percent of the defense budget (from over 60 percent in 1990). The drops put a stop to any major weapons purchases in Hungary and Bulgaria and greatly reduced the level of procurement in Romania.

THE EXTENT OF CONVERSION

The output of the defense sectors in all of the FNSWP states has declined to only a fraction of their size in the mid-1980s, with the output of the two main arms producers—Czechoslovakia (now the Czech Republic and Slovakia) and Poland—declining to less than 20 percent of their peak size. The drop might have continued even further had the FNSWP countries not tried to stabilize the downfall and keep a semblance of minimum-defense industrial base intact.

While the process that took place in the FNSWP states has succeeded in reducing greatly the previous over-capacity of the manufacturing sector devoted to armaments production, it did so by partially reallocating the resources from the defense to the civilian sector and by partially leaving idle other resources made redundant by a lack of demand for arms. The recession that accompanied the economic transition process depressed the domestic demand for alternative civilian products and caused the idling of part of the resources released from the arms sector. The recession in the EC countries, as well as the existence of trade barriers, depressed foreign demand. Conversion, understood in the broad, macroeconomic sense of an industrial transformation entailing the reallocation of

[29] Weintraub, "Military Expenditures," pp. 407, 411, 413; Information from the Romanian Ministry of Defense.

resources from the defense sector in favor of civilian production, thus has taken place partially in the FNSWP states. The experience in these countries reinforces the idea that an expanding economy eases defense industry conversion (and all forms of economic restructuring in general). Only future economic growth and market mechanisms of allocation of resources stand to truly "convert" the currently idle resources.

The same outcome occurred in countries that pursued specific policies to promote conversion, understood as product substitution (Czechoslovakia),[30] as well as in countries that allowed market forces to take their toll on the defense industry and treated the problems of that industry as one aspect of the problems affecting the manufacturing sector in general (Poland). Currently, almost all enterprises that had engaged in arms production teeter on the brink of bankruptcy; they stay alive largely because of government subsidies. Although government spokesmen justify the continued provision of subsidies as stemming from national security reasons, domestic political pressures undoubtedly play a large role.

OUTLOOK

The restructuring of the arms industries of the FNSWP states has entailed painful adjustments but it also presents some opportunities in the long run. The opportunities may come as part of their increasingly closer ties to the EU and NATO. All of the FNSWP countries have adopted full EU and NATO membership as their goal. As part of the Partnership for Peace (PFP) process, the militaries of these states will become more compatible with the NATO militaries. Rather than entailing the procurement of major weapons systems (not feasible on a large scale because of budgetary problems), compatibility generally will entail the modification and modernization of existing weapons. Upgraded, Western-based equipment in avionics and communications equipment will provide for interoperability, while standardization of gun caliber and ammunition will provide for a measure of compatibility. Selective improvements in the mechanical realm, such as upgrading armored vehicles with better engines and transmissions, will improve the ability of FNSWP armored vehicles to keep up with NATO units and will further the compatibility of the FNSWP militaries with those of NATO. Increased effectiveness of FNSWP states' weapons, obtained, for example, through better fire control mechanisms, also falls in the area of compatibility.

The modification of existing FNSWP weapons in order to increase their interoperability with arms used by the NATO militaries will entail substantial cooperation between the defense firms in the FNSWP countries and those in the Western countries. Lower

[30] The conversion measures adopted in Czechoslovakia seemed based on an understanding of conversion as the reallocation of *existing* manufacturing capacity from the military to the civilian sector. In itself, such an understanding seems based more on political criteria of avoiding unemployment rather than on economic rationale based on efficiency, since allocation of resources for new capacity may turn out more efficient than switching existing capacities. Erik Dirksen, "Industrial Policies in Central and Eastern Europe?," paper presented at NATO Economic Colloquium, Economic Developments in Cooperation Partner Countries from a Sectoral Perspective, Panel 3: Industrial Restructuring and Defense Conversion, Brussels, June 30–July 2, 1993. For a similar line of thought and recommendations for U.S. policy, see: Steven W. Popper, *Conversion of Arms Industries in Central Europe*, (Testimony before the Permanent Subcommittee on Investigations, United States Senate), P-7729, RAND, June 1991.

costs in the FNSWP countries make co-production and licensing arrangements attractive and provide these countries with the only viable short- and mid-term procurement prospects.

The long drop in the defense budgets in the FNSWP states seems to have bottomed out. Although all these countries have delayed any but the most critical improvements to their arsenals during the past few years, their emergence out of the recession should entail some increases in their defense budgets. As part of this process, the funds allocated for procurement also should increase from their present minimal levels. The Polish budget may show signs of such a recovery as soon as 1996. The others should follow the trend by 1997–98. In any event, the domestic arms industries in all FNSWP states should begin to show signs of recovery within 2–3 years. Because of the severe current budgetary problems in the FNSWP states, a need has emerged on the part of the U.S. and NATO to stimulate cooperation in the defense industry realm as part of the PFP process by "jump-starting" it. The jump-start could take the form of credits for selective improvements in areas of mutual concern, such as air defense or for assistance in the equipping of rapid deployment units currently forming in the FNSWP states that could then cooperate as part of NATO peacekeeping forces. Such improvements would have economic as well as security benefits to all parties concerned.

Ideally, the evolving process of cooperation between the remaining arms manufacturers in the FNSWP states and Western firms (U.S., French, Swedish, South African, and Israeli firms, among others, already have demonstrated their interest) should create a further division of labor among the FNSWP states, this time based on efficiency and comparative advantages rather than Soviet interests. The Czech Republic, Poland, and perhaps Hungary should gain in this process, though Slovakia, Romania, and perhaps Bulgaria also may prove attractive for certain types of arms production. However, the arms industries of the FNSWP states seem unlikely to come anywhere near their previous large size. The much lower level of arms production seems more applicable to the size and the technological levels of these countries under market conditions.

GENDER ISSUES DURING TRANSITION

By Sharon L. Wolchik *

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TABLES

SUMMARY

The economic changes that have followed the end of communist rule have been a mixed blessing for women. Although certain groups of women have benefitted, many women have suffered increased hardship and new difficulties in carrying out both their economic and domestic roles since 1989. In addition to being at greater risk for unemployment in all countries but Hungary and more likely to live in poverty, women also face new competition from men, increased demands for better performance, and more open discrimination at the workplace. The impact of the decline in production and drop in the standard of living that occurred in all of these countries immediately after the end of communist rule and still characterize economic life in many states, complicated women's tasks of providing for the daily needs of their families and compounded the stress many women and members of their families felt as the result of rapid change and continued uncertainty in many areas of life. Many of the social benefits women received dur-

* Sharon L. Wolchik is Director of the Russian and East European Studies Program and Professor of Political Science at The George Washington University. The author thanks Dr. Liba Paukert and Minister Karel Dyba of the Czech Republic for their help in providing information on employment trends and Nancy L. Meyers, Kevin Jernegan, and Nancy L. Mendrala for their assistance.

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ing the communist era have decreased or been eliminated. Single mothers and older women have been particularly hard hit by these changes.

In both the labor force and the home, traditional attitudes concerning gender roles have resurfaced and serve to legitimize gender inequality. As during the communist period, political factors, including women's limited representation among political leaders and the nature of transition politics, also contribute to the different impact of the economic transition on men and women. The failure to take women's particular perspectives into account in economic and social policy-making in turn has had important political repercussions.

Economic recovery and the growth of the private sector may lead to the creation of new jobs for women and increase the standard of living of families. However, economic recovery alone will not lead to greater equality between men and women. As in other developed economies, change in the extent of gender equality in the workplace and the home will depend on political as well as on economic factors.

INTRODUCTION

The economic transitions that have followed the collapse of communist governments in Central and Eastern Europe have had a profound impact on the economic opportunities and living standards of all members of these populations. On the positive side, the end of central control of economic activities and the re-creation of a private sector have brought new opportunities for individuals to found their own businesses or work for privatized or newly established private enterprises. The opening of these economies to Western investment has also created the possibility of working for international companies. Similarly, the opening of borders has meant that citizens of these countries can now travel abroad to increase their skills and establish contacts; they can also work abroad. For those with the skills, education, and personal characteristics needed to take advantage of these new opportunities, the move to the market has brought many benefits. Far larger groups of individuals have benefitted from the opportunity to practice their professions or work in their occupations free from the political interference that often occurred during communist rule. From the perspective of consumers, the shift to the market and increase in imports eliminated the shortages that were a chronic feature of many of these economies and increased choice.

The move to the market has also had many less positive aspects, however. Increased levels of unemployment have been perhaps the most visible of these. The end of state subsidies to inefficient enterprises and privatization have also changed working conditions and created new expectations of workers and employees. Austerity measures have been accompanied by both reductions in many services and benefits previously provided by the state, and by an increase in economic hardship for many families. These features were particularly noticeable in the years immediately after the end of communism. Although, as other chapters in this volume argue, levels of consumption increased in many countries and several have demonstrated solid signs of recovery, the situation of those at the bottom of the social hierarchy continues to be very difficult throughout the region. Income differentials have increased and with them the gap between social groups.

The move to the market has had different impacts on different groups in Central and Eastern Europe. Young, well-educated, urban dwellers have been better able to take advantage of the opportunities created by economic change; older, less educated people have experienced more of the hardships. There are also important differences in the impact of the move to the market on men and women. As the pages to follow illustrate, many women as well as men have benefitted from the economic changes since 1989. However, large groups of women, particularly older women, those who head single parent households, and those who lack the education and skills needed to make their way in the market, have experienced largely negative consequences. Many of these have been evident in the work place itself, as women face new pressures to perform, the very real possibility of unemployment, and more open discrimination than in the past. Given the uneven pattern of gender role change that took place during the communist period and women's continued responsibility for the home and children, the burden created by the increased cost of living and decreases in social welfare and social services has also fallen disproportionately on women.

Political factors, including the limited role women play in the exercise of political power and other aspects of transition politics, as well as popular and elite attitudes toward gender roles compound the impact of these changes. The failure to take women's particular perspectives into account in economic and social policy-making in turn has important political repercussions

Women's situation at work and in the family, in both the communist and post-communist periods, have been shaped by the economic policies of the leaders of these countries. Women's opportunities have also been influenced by the leadership's approach to gender issues and by popular values and perceptions of gender roles.[1]

WOMEN AND THE LABOR MARKET

In Central and Eastern Europe, the impact on women of the shift to a market economy has been conditioned by gender role patterns developed under communism. Despite important differences in the levels of development of the countries in the region at the outset of the communist period, gender roles changed in similar ways across the region. Although there were differences in the extent of such changes within countries, changes in gender roles did not differ consistently by level of economic development, previous cultural and religious traditions, or earlier educational levels across the region. Change was greatest in the areas of women's educational access and labor force participation. Even in these areas, however, important gender differences remained. There was far less change in gender roles in the political realm, where women were well-represented in symbolic governmental positions but virtually excluded from the effective exercise of political power, or in the family,

[1] Because of war and disruption in parts of former Yugoslavia, the successors to that country will not be considered.

where theoretical support for gender equality was not reflected in actual behavior.[2]

There were many commonalities in women's economic activities across the region during the communist era. These included: (1) high levels of women's employment, (2) a considerable degree of gender segregation by sector, (3) significant gender differences in wages, and (4) women's exclusion from most positions of authority in the economy.[3]

The high levels of women's employment outside the home that prevailed throughout the region before 1989 were one of the more striking aspects of economic life in Central and Eastern Europe during the communist era. Differences in the levels of women's labor force participation in communist and non-communist countries were greater in the 1950s and 1960s than in the 1970s and 1980s, when large numbers of women in the United States and the non-communist countries of Europe began to work outside the home. However, levels of women's participation in paid employment, particularly women with young children, increased more quickly and remained higher at the end of the communist era in the communist world.[4]

As Table 1 illustrates, women comprised from 38 to 50 percent of the labor force toward the end of the communist period. For much of that period, women's participation in the labor force was higher in the more developed countries in the region (the German Democratic Republic (GDR), Czechoslovakia, Poland, and Hungary), than it was in the Balkan countries, with the exception of Bulgaria. However, women's proportion of members of the socialized labor force increased substantially in Albania and Romania in the 1970s and 1980s.[5]

The relatively low levels of women's employment in Yugoslavia illustrate the impact of both economic policies and political factors

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[2] See Sharon L. Wolchik, "Ideology and Equality: The Status of Women in Eastern and Western Europe," *Comparative Political Studies* 13:4 (January 1981), pp. 445–76; and Sharon L. Wolchik, "Women and the State in Eastern Europe and the Soviet Union," in Sue Ellen Charlton, Jana Everett, and Kathleen Staudt (eds.), *Women, the State and Development* (Albany: SUNY Press, 1989), pp. 45–65.

[3] See Barbara W. Jancar, *Women under Communism* (Baltimore: John Hopkins University Press, 1978); Alena Heitlinger, *Women and State Socialism: Sex Inequality in the Soviet Union and Czechoslovakia* (Montreal: McGill-Queen's University Press, 1979); and Sharon L. Wolchik and Alfred G. Meyer (eds.), *Women, State and Party in Eastern Europe* (Durham: Duke University Press, 1985) for an overview of these trends during the communist era. See also Liba Paukert, "The Changing Economic Status of Women in the Period of Transition to a Market Economy System: the Case of the Czech and Slovak Republics after 1989," in Valerie M. Moghadam (ed.), *Democratic Reform and the Position of Women in Transitional Economies* (New York: Oxford University Press, 1993), pp. 248–79; Monica Fong and Gillian Paull, "Women's Economic Status in the Restructuring of Eastern Europe," in Valerie M. Moghadam, (ed.), *Democratic Reform and the Position of Women in Transitional Economies* (New York: Oxford University Press, 1993), pp. 217–47; Sharon L. Wolchik, "Women and Work in Communist and Post-Communist Central and Eastern Europe," and Hedwig Rudolph, "Women's Labor Market Experience in the Two Germanies," in Hilda Kahne and Janet Giele (eds.), *Women's Work and Women's Lives: The Continuing Struggle Worldwide* (Boulder: Westview Press, 1992), pp. 169–86 and Jacqueline Heinen, "The Reintegration into Work of Unemployed Women: Issues and Policies," in *Unemployment in Transition Countries: Transient or Persistent?* (Paris: Center for Cooperation with the Economies in Transition, OECD, 1994), pp. 311–333 for analyses that span the communist and post-communist periods.

[4] See Wolchik, "Ideology and Equality", pp. 445–76; Hubner Maier and Rudolph, "Women's Employment in Central and Eastern Europe: Status and Prospects," in Georg Fischer and Guy Standing (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Social Policy Implications* (Paris: OECD, 1993), pp. 213–40; Fong and Paull, pp. 302–26; and Paukert, pp. 248–79, for a comparison of activity rates.

[5] See Table 6.1 in Sharon L. Wolchik, "Women and Work," p. 121, and Fong and Paull, pp. 220–221, for a discussion of the problems that cross national comparison of women's labor force participation encounters.

on levels of women's employment. The devolution of responsibility for economic decision-making to the republics and the far greater autonomy given individual industrial enterprises contributed to lower levels of women's employment, as hiring and other decisions that affected the composition of the labor force were the responsibility of managers of individual enterprises rather than of central officials. Such decisions were also influenced by considerations of profitability sooner than they were in other states in the region. There was thus less pressure on women to enter the labor force or on enterprises to hire women. Women were also hardest hit by the unemployment that accompanied Yugoslavia's move to market socialism.[6] Within Yugoslavia, there were important regional differences in women's participation in paid employment that corresponded to development levels and cultural traditions.

TABLE 1. Women as a Percentage of the Labor Force in Central and Eastern Europe, 1989–1994

Country	1989	1990	1991	1992	1993	1994
Albania	46.7	45.1	46.7	NA	NA	NA
Bulgaria	50.2	49.6	49.6	NA	NA	NA
Czech Republic	45.5	44.3	43.3	44.2	46.6	47.5[a]
GDR	48.9	NA	NA	NA	NA	NA
Hungary	46.0	45.5	48.5	49.2	48.5	48.7
Poland	45.7	45.7	46.1	47.3	NA	46.3[a]
Romania	37.7	38.8	42.8	42.3	NA	NA
Slovakia	45.5	44.7	44.3	NA	NA	46.1[a]
Yugoslavia	38.3[b]	41.6	39.6	NA	NA	NA

Sources: Compiled from: Ministria e Ekonomise, Vjetari Statistikor I Shqiperise, Tirana, 1991, p. 79; Natsionalen Statisticheski Institut, Statisticheski Gogishnik na Republika B'lgariia, Sofia, 1990, p. 105 and 1991, p. 71; Federální Statistický Úřad, Český Statistický Úřad, Slovenský Statistický Úřad, Statistická ročenka České A Slovenské Federativní Republiky, Prague, 1991, pp. 192–93 and 1992, p. 198; Český Statistický Úřad, Statistická ročenka České Republiky, Prague, 1993, pp. 179–80; Központi Statisztikai Hivatal, Statisztikai Évkönyv. Budapest, 1992, p. 51; Központi Statisztikai Hivatal, Statisztikai Havi Közlemények, no. 1 (December 1993), Budapest, 1994, p. 12; Központi Statisztikai Hivatal, Statisztikai Havi Közlemények, no. 5 (April 1994), Budapest, 1994, p. 13; Glówny Urzad Statystyczny, Rocznik Statystyczny, Warsaw, 1993, pp. 115–16; Directia Centrala de Statistica, Anuarul Statistic al Romaniei, Bucharest, 1990, p. 116, 1991, p. 109, 1992, p. 140, and 1993, p. 165; Savezni Zavod za Statistiky, Statistichki Godishnak Yugoslaviye. Belgrade: 1992, pp. 417–18; Fong and Paull, p. 220; Sue Hastings and Martha Coleman, "Women Workers and Unions in Europe: Analysis by Industrial Sector," (ILO: Geneva), 1992, p. 41; Wolchik, "Women and Work," Table 1; Information received from L. Paukert, July 1994.

[a] First quarter figures.
[b] 1986.
NA = Not Available.

Women's labor force participation rates are perhaps a better indicator of the extent to which paid employment outside the home was an accepted part of women's lives by the end of the communist period. As Fong and Paull note, the proportion of all women of work-

[6] See Silva Meznaric, "Theory and Reality: The Status of Employed Women in Yugoslavia," in Sharon L. Wolchik and Alfred G. Meyer, eds., *Women, State and Party in Eastern Europe* (Durham: Duke University Press, 1985), pp. 214–220; and Susan L. Woodward, "The Rights of Women: Ideology, Policy and Social Change in Yugoslavia," in Sharon L. Wolchik and Alfred G. Meyer, eds., *Women, State and Party in Eastern Europe* (Durham: Duke University Press, 1985), pp. 234–256.

ing age who were economically active ranged from a low of 53.4 percent in Yugoslavia in 1989 to a high of 86.3 percent in Albania in 1990.[7] Approximately 57 percent of women age 15 and older were employed in Poland, and 62 percent in Czechoslovakia;[8] 80 percent of women of working age were employed in Romania in 1989 and 71.7 percent in Bulgaria in 1987. Within Yugoslavia, women were far more likely to be employed in the more developed northern republics.[9] In the GDR more than 90 percent of women between the ages of 15 and 60 were employed.[10] These rates were considerably higher than those of women in OECD countries, which raged from 37.6 percent in Ireland to 72.8 percent in Norway. Women's rates approximated those of women in formerly communist countries of Europe only in Finland, Norway, and Sweden.[11]

Another significant difference in patterns of women's economic activity in formerly communist and non-communist European countries is the very high proportion of women in the main childbearing ages (from 20–35) who were employed. From 60 to approximately 93 percent of women in these age categories were employed in Bulgaria, Czechoslovakia, Hungary, Poland,and Romania in the late 1970s and 1980s[12]

In part, women's entry into the labor force reflected the official commitment of communist governments to women's equality and steps taken to eliminate barriers to women's employment to achieve that goal. However, much of the impetus came from the labor-intensive strategy of economic development that was a key feature of the economic policies associated with the Soviet model of economic development, political change, and social transformation. Since women were the main labor reserve, numerous measures were adopted to mobilize them to join the labor force. These included propaganda campaigns that urged women to contribute to building socialism and a better future for their families by entering paid employment. More important, wage scales were structured in such a way that two incomes became a virtual necessity for families. An economic system that lacked mechanisms to measure labor costs, ideological commitment to full employment, and demographic policies that provided easy access to abortion in most countries also contributed to high levels of women's employment.

Women's influx into the labor force did not lead to equality in the workplace during the communist era. Although women entered a far wider range of occupations than they had previously, most women workers and employees continued to be concentrated in low-priority sectors of the labor force that had lower than average wages.[13] In a recent analysis, Francine D. Blau and Marianne A. Ferber found levels of occupational segregation by major occupa-

[7] Fong and Paull, p. 219.

[8] The authors note that the activity rates for Poland and Czechoslovakia appear lower than they are because these rates include economically employed women as a proportion of the population age 15 and older rather than of the working-age population only (Fong and Paull, p. 218). See Paukert, pp. 254–258, for further discussion of the Czechoslovak case.

[9] Fong and Paull, p. 219.

[10] Rudolph, p. 181.

[11] Fong and Paull, p. 218.

[12] Hubner, Maier, and Rudolph, p. 215.

[13] See Walter D. Connor, *Socialism, Politics and Equality* (New York: Columbia University Press, 1979) and essays in Wolchik and Meyer.

tional groupings in Bulgaria, Czechoslovakia, Hungary, Poland, and Yugoslavia to be somewhat less than in most advanced industrialized nations.[14] The authors note, however, that the categories used were very broad and in all likelihood did not capture the real extent of gender-based occupational segregation.[15]

Women's educational patterns contributed to this situation and women's educational levels increased substantially. By the end of communist rule, the educational levels of young women were higher than those of men in many countries in the region.[16] However, this increase in women's educational attainments did not reduce occupational segregation or other aspects of gender inequality in the labor force, because girls and women continued to choose and be channeled into very different kinds of educational specializations than those of boys and men. At both the secondary and higher levels, girls and women entered a broader range of educational specialties than before the communist era. More girls and women entered vocational and technical fields; however, most studied subjects that were either traditionally thought to be appropriate for women, or that became feminized under communist rule. At the higher level, most women studied humanities, the arts, and education as well as medicine. Most of these women then entered branches of the labor force in which their earning potential was limited. In Bulgaria, for example, where women accounted for 68 percent of all specialists in 1989, 60 percent of all women specialists worked in the areas of teaching, medicine, culture and arts, and the services.[17]

The preponderance of girls among students in general secondary institutions (gymnasia) also had repercussions in the labor force. These schools served primarily to prepare students to enter higher education. However, large numbers of their graduates, and particularly their female graduates, did not go on to further study. Many women therefore entered the labor force without either the credentials that higher education would have provided or the practical skills that vocational education might have given them. Many became unskilled or semi-skilled workers.

Occupational segregation by gender in turn helped to account for the fact that the gap in wages between men and women failed to close. The proportion of women employed in different sectors of the economy changed as these economies became more developed. However, most women continued to be concentrated in areas such as education, retail trade, medicine, and the service sector, as well as

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[14] Francine D. Blau and Marianne A. Ferber, "Women's Work, Women's Lives: A Comparative Economic Perspective," in Hilda Kahne and Janet Z. Giele (eds.), *Women's Work and Women's Lives in Modernizing and Industrial Countries* (Boulder: Westview Press, 1991), p. 34.

[15] Ibid, p. 33.

[16] See Wolchik, "Women and Work;" Weil, p. 285; Anna Titkow, "Political Change in Poland: Cause, Modifier or Barrier to Gender Equality," in Nanette Funk and Magda Mueller (eds.), *Gender Politics and Post-Communism* (New York and London: Routledge, 1993), pp. 253–256; and Fong and Paull, p. 228.

[17] From information in Georg Fischer and Guy Standing, "Policy Issues of the Emerging Labour Markets of Central and Eastern Europe," in Georg Fischer and Guy Standing (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Social Policy Implications* (Paris: OECD, 1993). See Hildegard Maria Nickel, "Women in the GDR and the New Federal States," in Nanette Funk and Magda Mueller (eds.), *Gender Politics and Post-Communism* (New York and London: Routledge, 1993), pp. 139–141, for a discussion of factors that influenced these patterns.

in light industry. Far smaller numbers of women worked in higher priority areas such as mining and heavy industry. [18]

These patterns in turn were reflected in the continued disparity between men's and women's wages. Wage differentials were in general low during the communist period. However, although there were not great differences by education or skill levels, there were important differences by gender. Women's wages ranged from 25 to 30 percent less than men in the late communist period. [19]

The low representation of women in leading economic positions contributed to the persistence of gender-based wage differentials. Despite the dramatic increase in women's proportion of the labor force, women continued to be underrepresented in leading economic positions. Women's share of leading positions was greatest in heavily feminized areas of the economy, such as education and medicine, as well as in light industry, but even in these areas the relatively few men who worked in these fields had a much greater chance of holding leading functions. [20]

THE POST-COMMUNIST PERIOD: GENDERED UNEMPLOYMENT

In the period immediately after the end of communist rule in Central and Eastern Europe, many women as well as men reacted against the approach to gender issues that prevailed during communism. They also reacted against the fact that the state had appropriated the goal of women's equality. In contrast to the situation in many West European countries and the United States, women's equality was not a goal chosen by women themselves, but rather imposed from above in these societies. Citizens were told that women were equal, but they experienced the dislocations that occurred as a result of the uneven pattern of gender role change that took place under communist rule. Many thus rejected the goal of gender equality itself after 1989 when it became possible to openly question previous policies.

This rejection was particularly evident in the area of labor force participation. Many men and women, as well as public officials, clearly felt that levels of women's employment were too high during the communist era. This perception was shared by many women activists, who noted that women should be free to choose whether they would be economically active outside the home. The new ability of church and other conservative groups to be active politically after 1989 reinforced these perspectives.

Ample survey research conducted during the communist era indicates that women were to some extent ambivalent about their employment. Many women indicated that they worked mainly for eco-

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[18] Wolchik, "Ideology and Equality;" Connor, chapter 6; Jancar, pp. 13–19; Heitlinger, pp. 149–53; Marilyn Rueschemeyer, "Women in the Politics of Eastern Germany: Dilemmas of Unification," in Marilyn Rueschemeyer (ed.), *Women in the Politics of Postcommunist Eastern Europe* (Armonk: M.E. Sharpe), 1994, p. 91.

[19] Alena Nesporova, "The Czech and Slovak Federal Republic: Labour Market Trends and Policies," in Georg Fischer and Guy Standing (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Social Policy Implications* (Paris: OECD), 1993, p. 87; Fong and Paull, pp. 228–29; Paukert, pp. 268–71; and Iskra Beleva, Daniela Bobeva, Silvia Dilova and Asen Mitchkovski, "Bulgaria: Labour Market and Social Policy Implications," in Georg Fischer and Guy Standing (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Policy Implications* (Paris: OECD), 1993, p. 60.

[20] See Wolchik, "Politics, Ideology and Equality;" Jancar; Heitlinger; and Harry G. Schaffer, *Women in the Two Germanies: A Comparative Study of a Socialist and Non-Socialist Society* (New York: Pergamon Press), 1981.

nomic reasons. However, a sizeable number indicated that they would continue to work even if it were not necessary for their family's well-being. These attitudes were especially prevalent among younger, better educated, urban professional women.[21]

Similar patterns are evident in the post-communist period. Although the idea of working fewer hours, having more time to devote to their families, or leaving the labor force entirely continues to have a certain appeal to many women in the eastern part of Germany, for example, a survey conducted in 1990 found that only 3 percent thought "housewife" was an ideal job.[22] Similarly, although a substantially larger proportion of women in Czechoslovakia (76 percent) indicated that they worked primarily for economic reasons compared to women in an earlier study in Belgium, France, Germany, Italy, and the Netherlands (40 percent), slightly less than a third (28 percent) of married women indicated that they would stay at home if their husbands' salaries permitted this.[23] However, while certain groups of women would thus continue to work in any case, many see a situation in which a male's wage would be sufficient to support a family as ideal.[24]

In fact, of course, there is little opportunity in the current situation for most women to realize this ideal. The impact of the transition to the market on the standard of living, the liberalization of prices, and the closing of unprofitable enterprises and pressures on others, including large state industries to be more efficient in their use of labor and other inputs, have all created a situation in which two incomes are as necessary as during the communist era to maintain an adequate standard of living. Uncertainty about what lies ahead also increases the need for women's employment.[25]

In practice, the shift to the market has led to a decrease in women's employment in many countries in the region. As with other information concerning labor force statistics at present, there are problems in ascertaining real levels of women's unemployment. It is also difficult to obtain comparable data across countries on levels of women's unemployment.[26] Nonetheless, information from a variety of sources indicates that women are indeed more likely to be unemployed than men in all of these countries except Hungary (see Table 2). Only in Hungary, where women accounted for approximately 41.6 percent of all those who were unemployed in mid-

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[21] See Renata Siemienska, "Women, Work and Gender Equality in Poland: Reality and its Social Perception," in Sharon L. Wolchik and Alfred G. Meyer (eds.), *Women, State and Party in Eastern Europe* (Durham: Duke University Press), 1985, pp. 312–14; Schaffer, pp. 67–68; Jancar, pp. 181–84; Hilda Scott, *Does Socialism Liberate Women?* (Boston: Beacon Press), 1974, pp. 117–21; Wolchik, "Women and Work" for references to studies illustrating these tendencies.

[22] Marilyn Rueschemeyer, "Women in East Germany: From State Socialism to Capitalist Welfare State," in Valetine M. Moghadam (ed.), *Democratic Reform and the Position of Women in Transitional Economies* (New York: Oxford University Press), 1993, p. 85.

[23] Paukert, pp. 260–61. See also Heinen, p. 316.

[24] See Fischer and Standing, "Policy Issues of the Emerging Labour Markets of Central and Eastern Europe," in Georg Fischer and Guy Standing (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Social Policy Implications* (Paris: OECD), 1993, p. 43, for the results of a survey of working women carried out in Bulgaria in 1989 that illustrates this tendency.

[25] See Valerie Bunce and Maria Csanadi, "Uncertainty in the Transition: Post-Communism in Hungary," *East European Politics and Society*, vol. 7, no. 2 (Spring 1993), pp. 240–275.

[26] See Fischer and Standing, pp. 10–11, for a discussion of these problems.

1991,[27] and 41.3 percent in 1992,[28] was women's proportion of the unemployed lower than their proportion of the labor force. In the Hungarian case, the lower level of women's unemployment reflects the fact that much of the unemployment that occurred in 1989 and 1990 resulted from the closing of enterprises in heavy industry with predominantly male labor forces.[29] In Slovakia, where women comprised a substantially higher proportion of the unemployed than of the labor force in 1992, women's proportion of the unemployed decreased somewhat to approximately equal their share of the labor force in the first quarter of 1994.

TABLE 2. Women as a Percentage of Those Unemployed in Central and Eastern Europe, 1990–1994

Country	1990	1991	1992	1993	1994
Bulgaria	65.2	54.5	53.1	52.0	NA
Czech Republic	NA	57.4	58.0	56.3	58.0[a]
Former GDR	NA	58.1	63.3	62.3[a]	64.6[b]
Hungary	40.2	41.6	41.3	41.5	43.5
Poland	50.9	52.6	53.4	53.2	NA
Romania	NA	59.5	60.6	58.0	NA
Slovakia	NA	52.0	51.0	42.0	45.0

Sources: Compiled from Natsionalen Statisticheski Institut, Statisticheski Gogishnik na Republika B'lgariia, Sofia, 1992, p. 50; Bundesanstalt für Arbeit, Presse Informationen, no. 37 (June 7, 1994), Nürnberg, 1994, p. 2; Statistisches Bundesamt, Statistisches Jahrbuch, 1993, p. 130; Központi Statisztikai Hivatal, Statisztikai Havi Közlemények, no. 5 (April 1994), Budapest, 1994, p. 17; Glówny Urzad Statystyczny, Rocznik Statystyczny, Warsaw, 1992, p. 108; 1993, p. 122; Directia Centrala de Statistica, Anuarul Statistic al Romaniei, Bucharest, 1992, p. 141; 1993, p. 169; Heinen, p. 314; Anna Szczepanska, Poland, Selected Data. (Warsaw: Section of Topical Publications, Analysis and Aggregate Statistics Division, Central Statistical Office, 1993), p. 9; Information received from L. Paukert, July 1994.

[a] Second quarter.

[b] May, 1994.

NA = Not Available.

In 1991 women accounted for approximately 60 percent of the unemployed in the Czech Republic and approximately 52 percent in Poland and Slovakia. Women's percentage of the unemployed increased slightly between 1991 and 1993 in Poland and eastern Germany, while remaining more or less constant in most of the other countries for which information is available (See Table 2).

The impact of increased unemployment on women has been particularly great in the eastern part of Germany, where unemployment rates increased radically very quickly after the demise of the GDR. Women accounted for nearly 60 percent of the officially registered unemployed in 1991 and 1992. Women's unemployment increased by almost eleven times between June 1990 and July 1992, while that of men increased by six times.[30] Perhaps more telling

[27] Központi Statisztikai Hivatal, *Statisztikai Havi Közlemenyek*, no.5 (April 1994), p. 17; Fischer and Standing, p. 13.

[28] Központi Statisztikai Hivatal, *Statisztikai Havi Közlemenyek* 5 (April 1994), p. 16.

[29] Hubner, Maier, Rudolph, p. 233; and Heinen, p. 314.

[30] Dr. Ute Kretzschmer, Commissioner for Labor and Women, Senate of Berlin, *East Germany: Women and Employment Under Change*, Paper presented as part of the conference "Can They

is the decrease in the number of employed women in the eastern regions of Germany. There was an absolute decrease of 1.565 million economically active women between late 1989 and mid 1992. As a result, women's activity rates fell from 91 percent to just over 50 percent.[31] Women's share of the employed in firms operated by the Treuhand decreased particularly rapidly; in the course of 1991, for example, it fell from 40 to 34 percent.[32] Women's share in other areas in which they predominated in the economy also dropped rapidly. In 1989 women accounted for 70 percent of those who worked in commerce, 60 percent of those in light industry, and 42 percent of those working in electrical technology and electronics. By late 1991 their proportions had decreased to 52 percent of the labor force in commerce; 46 percent in light industry; and 31 percent in electrical technology/electronics.[33]

As Table 3, which presents male and female unemployment rates, illustrates, the number of men and women affected by unemployment varies considerably within the region. Levels are lowest for both men and women in the Czech Republic and highest in Bulgaria among those countries for which data are available. In 1992 differences between men and women were highest in the former GDR and also substantial in Poland and Romania. Women's rates of unemployment were lower than men's in 1992–1994 in Hungary and in 1993 in Slovakia.

TABLE 3. Unemployment Rates of Men and Women in Central and East Europe, 1991–1994[a]

Country	1991	1992	1993	1994
Bulgaria	9.5/11.5	18.7/19.0	NA	NA
Czech Republic	NA	4.8/ 5.4	3.0/4.5	NA
Former GDR[b]	8.1/11.1	12.6/21.8	11.0/19.6	12.8/23.2
Hungary	NA	14.6/12.5[c]	12.6/ 8.9	12.8/ 8.7
Poland	9.2/11.2	11.9/15.5	NA	NA
Romania	NA	6.3/10.5[d]	NA	NA
Slovakia	NA	NA	NA	13.6/13.0

Sources: Compiled from Bundesanstalt für Arbeit, Presse Informationen, no. 10 (Feburary 8, 1994) Nürnberg, 1994, p. 2; no. 9, (February, 5, 1993), p. 2; no. 7, (February 5, 1992), p. 2; no. 30, 1991 (June 6, 1991), p. 2; World Labor Report, 1994 (ILO, Geneva, 1994); Központi Statisztikai Hivatal, Statisztikai Havi Közlemények, nos. 2–3 (January-February, 1994), Budapest, 1994, p. 12; Központi Statisztikai Hivatal, Statisztikai Havi Közlemények. no. 5 (April, 1994), Budapest, 1994, p. 13; World Labor Report, 1993 (ILO, Geneva, 1993); Paukert, p. 249; Information received from L. Paukert, July 1994.

[a] The first number in each cell is for men; the second number following the diagonal (solidus) is for women.

[b] Statistics for January 1 of each year.

[c] *Statisztikai Havi Kozlemenyek*, 1993, p. 6 gives these figures as 11.4 and 8.2.

[d] *Romanian Statistical Yearbook*, 1993, p. 169 gives these rates as 8.4 and 10.7.

NA = Not Available.

Build a State Without Us? - Women and German Unification," at the Goethe House, New York, April 1993.

[31] Ibid., pp. 1–2; this figure includes women who were studying or in training for their occupations.

[32] Ibid., p. 3.

[33] Ibid., p. 3.

In addition to facing a greater risk of unemployment in most countries in the region, women also face unequal treatment once they become unemployed. Women's unemployment benefits are generally lower than those of men, as the result of the differences in men's and women's wages. In Hungary, for example, women's benefits in 1990 and 1991 were approximately 70 to 75 percent of men's.[34] Minimum thresholds limit differences based on previous earnings in most cases, but women are estimated to receive an average of 15 percent less in benefits than men.[35]

Women also have a more difficult time finding new jobs once they become unemployed. In the eastern part of Germany, for example, almost twice as many unemployed men as women (21 percent, compared to 11 percent), began working again between November 1990 and March 1991.[36] Although women comprise the majority of those who are unemployed, they account for only approximately 40 percent of those who have found new jobs through official offices or labor bureaus in eastern Germany.[37] Similar trends are evident in Poland, where job openings are differentiated by gender by employment offices.[38] In the early 1990s, the ratio of unemployed to vacancies was considerably higher for women than for men. In December 1990, for example, there were 14 unemployed men per vacancy, but 40 unemployed women per vacancy. By June 1991, there were 21 men per vacancy and 74 women.[39]

Women also appear to be more numerous among the longer term unemployed, and may be more likely than men to become discouraged workers, i.e., those who no longer actively seek jobs.[40] Gender differences in this regard appear to vary considerably by country, however. Differences in this respect were minimal in Hungary and the Czech Republic in the early 1990s; in Slovakia, however, 9 percent more women than men were classified as long-term unemployed.[41] In Romania, women also accounted for a majority of those seeking jobs in 1992. However, their proportion of such persons (54.0 percent) was 10 percentage points lower than their share of the total unemployed.[42] Many of the difficulties women face in being reemployed also reflect the increase in open discrimination against women in the labor force, changed expectations and demands at the workplace, and the resurgence of traditional views concerning gender roles. Some women who lose their jobs may welcome a chance to take a respite from the stresses of managing both work and family. However, women's decisions in this regard may also reflect the fact that there are generally far fewer positions offered for women and a realistic evaluation of the likelihood that they will find new employment.

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[34] Hubner, Maier, and Rudolph, p. 233.
[35] Heinen, p. 321.
[36] Kretzschmar, p. 3.
[37] Ibid.
[38] Heinen, p. 329.
[39] Marek Gora, Irena Kotowska, Tomasz Panek, and Jaroslav Podgorski, "Poland: Labour Market Trends and Policies," in Georg Fischer and Guy Standing (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Social Policy Implications* (Paris: OECD), 1993, p. 145.
[40] Hubner, Maier, and Rudolph, p. 233.
[41] Heinen, p. 315.
[42] Ibid.

Gender Differences in the Private Sector

As the private sector increases in the region, women's participation in private business activities clearly will have a major impact on gender differences in income, employment, and economic well-being. As was the case with women's participation in the second, or unofficial economies during the communist era, it is difficult to assess the extent of women's participation in the re-creation of the private sector in Central and Eastern Europe. These problems are particularly great in examining women's share among new entrepreneurs, as most official sources do not differentiate business owners by gender. In former Czechoslovakia and now the Czech and Slovak Republics, where the voucher method has been used, women have participated in large numbers in mass privatization programs. However, public opinion surveys conducted in a number of these countries in the early 1990s indicate that women tend to be less favorable than men to the privatization of state enterprises.[43]

Despite these reservations, women have entered the emerging private sector as employees and owners. Information on the gender distribution of those workers and employees in the private sector in Poland, for example, indicates that women comprised 45.8 percent of all workers and employees in the private sphere in 1989; 45.3 percent in 1990; and 46.1 percent in 1991.[44]

It is more difficult to know how many women have become owners of new private businesses. Women in Poland, for example, accounted for 30 percent of employees in the private sector. They accounted for 20.5 percent of owners and owner-families in 1991.[45] However, it is likely that many of the women in the latter category are auxiliary or helping family members. Women accounted for 16.6 percent of those employed in the private sector in the Czech Republic in 1990, 35.2 percent in 1991, and 35.9 percent in 1992.[46] Women comprised 22.5 percent of employers in 1991.[47]

According to Fong and Paull, 32 percent of those who owned or worked in new small enterprises were women in the early 1990s in Hungary.[48] In 1990 women owned 1.11 percent of all Hungarian registered private firms.[49]

Many women appear to be hesitant to take the risks involved in becoming entrepreneurs. Surveys conducted in Bulgaria in the early 1990s found, for example, that very few (6–10 percent) of the women surveyed were interested in starting their own business.[50] These attitudes undoubtedly reflect the perceived risks and difficulties that face those that try to set up private businesses in the

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[43] James R. Millar and Sharon L. Wolchik, introduction to *The Social Legacy of Communism*, by James R. Millar and Sharon L. Wolchik (eds.). (Cambridge: Woodrow Wilson Center Press with Cambridge University Press), 1994, pp. 1–28.

[44] From information in Glówny Urzad Statystyczny, *Rocznik Statystyczny 1992* (Warsaw: Glówny Urzad Statystyczny), 1992, p. 6.

[45] Gora, Kotowska, Panek, and Podgorski, p. 136.

[46] Czech Statistical Office, 1994.

[47] Federální Statistický Úřad Ceský Statistický Úřad Slovenský Statistický Úřad, *Statistická ročenka České A Slovenské Federativní Republiky 1991*, Prague, 1991, p. 415.

[48] Fong and Paull, p. 37.

[49] Fong and Paull, p. 237.

[50] See Dobrinka Kostova, "The Transition to Democracy," in Valentine M. Moghadam (ed.), *Democratic Reform and the Position of Women in Transitional Economies* (New York: Oxford University Press), 1993, p. 105; and Beleva, Bobeva, Dilova, and Mitchkovski, p. 43, for references to these studies.

area.[51] Many of the men and women surveyed by the International Labor Organization (ILO) in Czechoslovakia in the early 1990s, for example, felt that most people did not have the experience required to establish a private business. Many, (including approximately equal proportions of men (84 percent) and women (81 percent), feared the stress associated with private business or saw the private sphere as "too risky as a main job" (77 percent of men and 69 percent of women).[52]

Popular attitudes concerning gender roles and women's aptitudes also contribute to this hesitation. Nearly half of both men and women surveyed in Czechoslovakia in 1991, for example, felt that becoming an entrepreneur was an activity mainly appropriate for men and that women should "only be helping" in business ventures.[53]

However, as Paukert notes in a discussion of this issue in Czechoslovakia, there was a rapid increase in both the proportion of women working in private businesses and in the willingness of women to start small businesses between 1991 and 1992 in that country. Thus, although almost a third of women surveyed in early 1991 wanted to conduct private business part time while keeping their other jobs, by early 1992, 12 percent of the female labor force (compared to 15 percent of the total labor force) were in small private businesses, compared to 3 percent in such businesses in February 1991. Intentions to start a small business also increased from 4 to 10 percent. As in the survey discussed above, however, many of the women who wanted to start businesses or worked in small businesses wanted to be "family helpers" rather than solo owners.[54] Women's reluctance to become entrepreneurs is likely in turn to increase gender differences in wages as the private sector and overall income differentials increase.

Working Conditions and Changes in the Workplace

In addition to facing the threat of unemployment, workers and employees in Central and Eastern Europe also face new demands and new conditions at the workplace. Many of these, such as the need to work more efficiently, improve one's skills, work longer hours, and contribute to an enterprise's profitability, affect men as well as women. However, there are also ways in which women are particularly affected by these new demands and challenges. As Nickel notes in a recent study of the impact of privatization on women in the former GDR, changes in the nature of work and in the kinds and levels of expertise required of employees and workers put many women at a disadvantage. This factor is particularly evident in many of the spheres in which women predominated, such as services.[55] Because women see themselves and are seen by others as having primary responsibility for the day-to-day care of the household and children, many are not as willing or as able as men to increase their qualifications or put in the time needed to advance in market-oriented enterprises. These pressures to improve

[51] See Paukert for a discussion of these obstacles.
[52] Paukert, p. 274.
[53] Paukert, p. 275.
[54] Paukert, pp. 274–75.
[55] Nickel, p. 144.

performance at work are greatest in private enterprises. However, reorganized state enterprises also must now give more attention to their ability to compete and thus expect more of their workers and employees.

Pressures for higher performance in the workplace also affect women in other ways. During the communist era, for example, most women worked full time. However, surveys done in Czechoslovakia in the late 1980s indicated that, although virtually all the women surveyed worked full time, few complained about the length of the workweek. In part, there were few complaints because women and their superiors all took for granted the fact that women would use working time to take care of many errands and other issues necessary for their households.[56] Women were also able to stay home with sick family members and miss work to attend to the needs of the family without great penalties. Mothers in Hungary for example, worked an average of 50 percent of normal working hours due to such absences and other legally allowed time off.[57] Such behavior is less likely to be tolerated in private enterprises and in state enterprises that must be concerned with profit. In the more competitive atmosphere of the market then, the lack of change in gender roles in the family is likely to have more adverse effects on women's roles in the labor force than it did during communism, when guaranteed employment and state ownership led to less concern with efficiency and good performance.

Discrimination in the Workplace

In addition to pressures for better performance, women appear to be facing increasingly open discrimination at the workplace. A certain amount of discrimination based on gender clearly existed in all these countries during the communist period. Women were routinely assigned, for example, to the lower end of wage categories for which their education and experience qualified them, and often received lower wages than men at comparable skill and qualification levels. They also faced certain informal barriers to employment in particular jobs and occupations, in addition to those from which they were barred by protective legislation. However, legal prohibitions of discrimination against women prevented many openly discriminatory practices from taking place.

With the end of communist rule and the backlash against the idea of gender equality, women have been subjected to increasingly open forms of discrimination. These range from being paid lower wages than male colleagues to being subjected to degrading requests. Job advertisements frequently differentiate by gender, for example. Employers seeking engineers, technicians, and managers often specify that they are seeking male candidates; women, on the other hand, are specifically sought for clerical, secretarial, or sales positions. Advertisements for women often also include requests for "young, attractive, and agreeable" candidates. There are many reports of older saleswomen losing their jobs as shops privatize, for example, to be replaced by younger, presumably more attractive,

[56] Paukert, p. 261.
[57] As reported in Fong and Paull, p. 235.

women.[58] Women also report being asked to wear short skirts, and high heels, or, in certain cases, to provide sexual favors for customers and clients.

These abuses appear to be most prevalent in the private sector. As Paukert notes, the small private sector is known for failing to observe legal norms and regulations concerning treatment of many categories of employees.[59] Direct violations of wage legislation and other government policies are thus likely to affect relatively small numbers of women at present. However, the new permission those who disagree with the goal of gender equality feel to voice their opinions, and the consensus that women are a secondary part of the labor force, appear to be having an effect in enterprises still in state hands.

Although evidence is once again largely anecdotal, many foreign businesses active in the region appear to be contributing to the increasing discrimination evident in the private sector. Many seek young men for managerial positions and are willing to hire young women, even those with comparable levels of higher education and skills, largely in clerical roles. The attractiveness of salary scales geared to Western economies and opportunities to travel are evidently enough to induce many young women to accept these positions, which are far below those for which they are qualified. There is some evidence that foreign firms engage in certain more blatantly discriminatory practices in these countries that they would not attempt in Western Europe or the United States.[60]

In addition to the resurgence of traditional gender role preferences, particularly on the part of men, in the post-communist period, there are two aspects of the elites' approach to women's issues under communism that contribute to these practices. These include measures that prohibit women from entering certain occupations lest they or their unborn children suffer harm, and legal provisions concerning pregnant women and the mothers of small children. Much of the protective legislation that prohibits women from working in occupations deemed to pose unacceptable health risks remains in place. Although these prohibitions may benefit certain groups of women, they prevent all women, including those who do not intend to have children or who are beyond the child-bearing and nursing years, from working in occupations that produce higher incomes than many of those in which women are concentrated.[61]

Reproductive policies also contribute to discrimination against women employees. The pronatalist measures introduced in most of these countries in the 1960s and 1970s included generous maternity and child care leaves, maternity and child care allowances, and guaranteed return to one's job. Several of these countries have replaced maternity leave with parental leave, which theoretically allows men to stay at home with newborns or young children. However, due to the gender differences in incomes discussed above, in almost all families it is the woman who takes advantage of these

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[58] See Maria Ciechocinska, "Gender Aspects of Dismantling the Command Economy in Poland," in Valerie M. Moghadam (ed.), *Democratic Reform and the Position of Women in Transitional Economies* (New York: Oxford University Press), 1993, pp. 302–303.

[59] Paukert, p. 259, p. 171.

[60] See Weil, p. 293, for a discussion of parallels to the actions of transnational corporations in less developed parts of the world.

[61] Fong and Paull, p. 242.

policies. Given the perception that reproduction is women's responsibility, these costs are often viewed as costs of women's employment. In market conditions, policies designed to make it easier for women to be both mothers and workers (without a radical change in the gendered division of labor within the home) may in fact work against women. This situation arises particularly in the case of young, childless women, whom many employers are hesitant to hire for fear that they will have to bear the costs associated with their eventual childrearing.[62]

Women also face increased competition from men at the workplace. This situation is particularly evident in those areas of the economy, such as tourist services, banking, and financial management, that were previously highly "feminized" and had low average wages but now bring high salaries, contact with foreign companies and hence opportunities for useful business contacts, and job mobility.[63] The influx of men into what are now more prestigious, better remunerated jobs may thus vitiate the advantages that women's previous work experience, training, and the existence of "female role models in the occupations" might be thought to carry for women as the service sector and light industries become more important.[64] Changes in production processes, which require workers and employees to retool and the introduction of new technologies, may also favor male workers and employees.[65]

Information concerning the composition of the labor force in the Czech Republic and Poland, two of the countries that have moved most quickly to implement market reforms and privatize, illustrate the shifts that are occurring. In the Czech Republic, where the proportion of the labor force employed in tourism nearly doubled between 1989 and 1991, women's proportion of the labor force dropped from 76.8 percent to 60.6 percent. Women's share of those employed in another rapidly expanding area, banking, decreased by 1 percent during this period.[66] In Poland, women's proportion of those employed in finance and insurance decreased by 2.5 percent from 84.5 to 82.0 between 1989 and 1991; total employment in this sector increased from 148,900 people to 166,700 people during this period. Women's share of those employed in communal administration and communal services on the other hand increased. In the area of communal administration and community services where total employment decreased from 205,700 to 172,500 people, women's proportion of the labor force increased from 42.8 percent to 44.1 percent. Women's share of those employed in industry, which employed 28.5 percent of all working women in 1989 and 26.9 percent in 1991, decreased from 37.2 percent to 35.8 percent, as the

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[62] Renata Siemienska, "Women and the Transition in Poland," Paper presented at a conference entitled "Women and the Transitions in Latin America and Central/Eastern Europe," Berkley, California, December 1992.

[63] See Rueschemeyer, "Women in East Germany: From State Socialism to Capitalist Welfare State," for a discussion of this factor in the eastern part of Germany.

[64] Fong and Paull, pp. 232–33.

[65] Paukert, p. 264.

[66] *Statistická ročenka České A Slovenské Federativní Republiky 1990*, (Prague, 1990), p. 192; Český Statistický Úřad *Statistická ročenka České Republiky 1993* (Prague, 1993), p. 197. See also Paukert, pp. 263–268.

total number of those employed in this area decreased from 4,016,300 to 3,155,600.[67]

Women also predominate among those who work part-time. Women in Poland in 1991, for example, accounted for 50.7 percent of those who worked less than full time.[68] The largest portion of women in this category, (26.8 percent) were employed in education; 14.5 percent were employed in industry. Although many women welcome the new opportunities to work part-time, part-time workers tend to be marginal members of the labor force who receive lower wages and fewer benefits.

The impact of these factors is reflected in the continuing gap in men's and women's earnings. In Poland, women's average monthly earnings were 74.8 percent those of men in material production and 83.0 percent in non-material branches of the economy in 1991. Earnings differed by educational levels for both men and women; however, women earned less than men at all educational levels as well as in all age groups.[69] In the Czech Republic women earned an average of 76.4 percent of men's average monthly wages and salaries in June 1994.[70] In Hungary women's earnings in 1990 ranged from 55 percent of those of males in the mining industry to 89.1 percent of those of males in the construction industry.[71]

THE IMPACT OF THE TRANSITION ON GENDER ROLES IN THE FAMILY

To this point, this discussion has focused on the different impact that the transition to the market has had on men and women as workers. Due to the uneven pattern of gender role change that occurred under communism, women have also borne the brunt of the impact of the transition on the family. Because women continue to be responsible for most of the work needed to maintain the family and secure its needs on a daily basis, they have felt the disruptions caused by decreases in social services, increased prices of many of the necessities of life previously subsidized by the state, such as food, housing, education, and medical care, and new patterns of supply and demand. The difficulties women have faced in this area in turn have repercussions on their labor force participation and advancement.

Many of the social benefits women received in connection with childbirth and rearing under communism have been retained or even extended in the new systems. In Czechoslovakia and Poland, for example, maternity leave was changed to parental leave that can be used by men or women.[72] Many of the special provisions for single mothers have been kept, and several states have banned the firing of single mothers. However, in many cases these benefits are less attractive than they were during the communist era. High inflation rates in the early transition stage reduced the economic value of many social benefits. Some women also hesitate to use them due to fear that they will lose their jobs or suffer negative consequences once they return from leave. A study conducted in

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[67] Glówny Urzad Statystyczny, *Rocznik Statystyczny 1991* (Warsaw: Glówny Urzad Statystyczny, 1991), p. 98; *Rocznik Statystyczny 1992*, p. 102.
[68] *Rocznik Statystyczny 1992*, p. 102.
[69] Gora, Kotowska, Panek and Podgorski, pp. 164–65.
[70] Czech Statistical Office, July 1994.
[71] Központi Statisztikai Hivatal, *Statisztikai Évkönyv 1991* (Budapest, 1992), p. 9.
[72] See Fong and Paull, pp. 238–39, and Paukert, p. 269.

Poland in 1991, for example, found that one-third of women surveyed decided not to take leave for fear that they would lose their jobs.[73] Certain benefits, such as children's allowances, have been eliminated or linked to the family's income for the first time.

The situation of older women is particularly precarious. Although efforts have been made to increase pensions to take the economic changes into account, the purchasing power of pensioners has decreased, and many find themselves in poverty. This situation is particularly common among those pensioners, who are generally women, who receive survivorship benefits.[74] Surveys conducted in Poland in 1990, for example, found that 35 percent of all pensioners indicated that their income was not enough even for the cheapest food; an additional 31 percent indicated that their income allowed them to purchase food but not clothing.[75]

As Ciechocinska notes, factories and workplaces played an important role in distributing goods and services to the population under communism.[76] With privatization and the closing of plants, economic enterprises no longer serve such an important welfare function. Change in this respect has been particularly evident in the area of child care. The closing or downsizing of factories has led to the elimination of many factory-subsidized child care facilities. Since local governments also have very scare resources, many child care facilities operated by these governments have also closed. Others continue to exist, but have raised their fees. In this situation, many families cannot afford to use their services. There are similar problems for most families with the private child care facilities that have begun to operate in these countries.[77] Problems in finding adequate care for their children are particularly great for single mothers and those who have large families. Difficulties in finding affordable child care are one of the factors that have led to a decrease in the labor force participation of young women in the main childbearing ages in many of these countries.[78] Families have also had to deal with increased costs for higher education and felt the impact of reduced public spending on health care.

Women have also faced the need to deal with the impact of austerity measures, unemployment, and other economic changes on their families' standards of living. As the result of price liberalization and reductions in state subsidies, the incomes of many families decreased dramatically during the early phase of the transition from communist rule. Although some families, particularly those in private business or those in which family members worked for foreign corporations, saw their incomes increase dramatically, most families faced the need to stretch the family budget even further to meet the family's basic needs. Recent improvements in economic performance in a number of countries in the region suggest that this pressure on families may soon recede. However, for many

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[73] See Heinen, p.316, and Ciechocinska, p.319.

[74] Georghe Raboaca, "Romania: About Market Trends and Policies," in Georg Fischer and Guy Standing, (eds.), *Structural Change in Central and Eastern Europe: Labour Market and Policy Implications* (Paris: OECD), 1993, p. 136.

[75] Gora, Kotowska, Panek, and Podgorski, pp. 157–58.

[76] Ciechocinska, p. 303.

[77] Heinen, pp.317–18. See Ciechocinska, pp.316–20, for a discussion of these trends that began before 1989 in Poland.

[78] Heinen, p.317; Fong and Paull, p. 240.

women the need to provide for their families with reduced resources will continue to be a fact of life for some time.

Women's lives have also been complicated by changes in the organization of consumption and services. The impact on women of privatization of retail trade and increased imports has varied to some extent within the region. In many countries, where shortages and long lines were a daily feature of life during communist rule, the new availability of a wide variety of products has been a positive change for women, who continue to do most of the shopping for their families. In others, however, such as the Czech and Slovak Republics, or the eastern parts of Germany, where such problems were not as severe, the impact of price liberalization and new availability of goods has been less positive. Although there is a far wider assortment of goods on the market, many are too expensive for most families. Faced with the need to stretch their families' budgets as far as possible and with increased prices for basic goods, particularly in the early period of the transition, women also must now spend additional time comparison shopping.[79] Women have also seen the disruption of the informal networks they developed to obtain what their families needed.

The transition from communist rule has also brought social and psychological costs. The need to deal with uncertainty and change in all areas of life has affected men as well as women. However, it is often women who must find ways to satisfy the needs of family members under changed conditions. Because women still perform much of the kin work of the family, they also bear a disproportionate share of the burden of dealing with the emotional and psychological impact of the transition on family members. All of these factors take time and energy and further limit the attention women can give to their economic roles.

Gender Differences in Politics and Their Impact on Inequalities in the Market and Within the Family

As the preceding pages illustrate, the end of communist rule has been a mixed blessing for women. Although certain groups of women have benefitted, many women have suffered increased hardship and new difficulties in carrying out both their economic and domestic roles since 1989. In addition to being at greater risk for unemployment in all countries but Hungary and more likely to live in poverty, women also face new competition from men, increased demands for better performance and higher skill levels, and more open discrimination at the workplace. The impact of the decline in production and drop in the standard of living occurred in all these countries in the period immediately after the end of communist rule and still characterizes economic life in many women's lives. The tasks of providing for the daily needs of their families has become more complicated, and the stress many women and members of their families feel has been compounded as the result of rapid change and continued uncertainty in many areas of life. In addition, many of the benefits that women received as the result of social legislation enacted during the communist era have decreased or been eliminated. Even those that remain, such as mater-

[79] Interview with Dagmar Burcsova, chair of the Czech National Council, 1991, Prague.

nity benefits, often are a disadvantage for women, for they have led many employers to be reluctant to hire women.

As in the other areas discussed in this paper, the impact of these factors is becoming increasingly differentiated. With the growth of income differentials and social inequality, the extent to which women face serious problems in these areas varies. However, although women in higher income groups face less immediate problems than the majority of women at lower income levels, single mothers, or women in poverty, they also feel the impact of the patterns of gender role relations that are emerging in the post-communist period. In both the labor force and the home, traditional attitudes concerning gender roles have resurfaced and serve to legitimize gender inequality. Given the increasing tendency to identify women primarily with their domestic roles, a tendency that has its roots in the pro-nationalist policies and political and economic crises of the communist period,[80] discrimination based on gender and economic inequality are likely to increase.

Political factors also contribute to the different impact of the economic transition on men and women, just as they did during the communist period. Despite the official commitment of communist governments, gender equality was a low-priority goal throughout the communist period. Policies that affected women were most often determined by their relationship to other, higher-priority policy issues. Women's economic as well as domestic roles were influenced profoundly by public policies adopted by the elites, including those designed first to further industrialization and later to reverse the declining birth rate. Although women were well represented in the symbolic, governmental elites, they were rarely found in positions of real political power. They also faced the same restrictions on independent activities outside the framework of official institutions as other citizens.[81]

With the end of communist rule, women as well as men gained the opportunity to speak out openly on political issues, form groups to articulate their interests, pressure political leaders on issues of concern to them, and run for political office. However, women continue to be marginazlied from the exercise of political power. The women who hold national elected or appointed offices resemble their male colleagues more closely than their communist predecessors did in terms of social background and education. However, they are very few in number. Given the widespread reaction against the pattern of gender role change that occurred under communism and, in many cases, against the goal of gender equality itself, it has been very difficult for the few women who hold political office to push for attention to women's particular needs or take steps to counteract the backlash against gender equality.[82]

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[80] See Wolchik, "Women and the State," pp. 44–65;, and Renata Siemienska, "Women and Social Movements in Poland," *Women in Politics* 6, no. 4 (Winter 1986), pp. 5–36.

[81] Heitlinger; Jancar; Wolchik, "Ideology and Equality;" for the case of the Soviet Union, see Gail Lapidus, *Women in Soviet Society: Equality, Development, and Social Change* (Berkeley: University of California Press), 1978.

[82] See Barbara Einhorn, "Democratization and the Women's Movement in Central and Eastern Europe: Concept of Women's Rights," in Valerie M. Moghadam (ed.), *Democratic Reform and the Position of Women in Transitional Economies* (New York: Oxford University Press), 1993, pp. 48–74, and Sharon L. Wolchik, "Women and the Politics of Transition in Central and Eastern Europe" in Valerie M. Moghadam (ed.), *Democratic Reform and the Position of Women in*

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As in the communist period, most male leaders, as well as many female leaders, either do not support the goal of gender equality or see it as a goal that can only be pursued vigorously once the presumedly more essential tasks of the transition are completed. In this situation, it is very difficult for women's needs to be addressed adequately or for measures that would foster gender equality or address some of the growing inequalities discussed above to be adopted. Many women have joined new or newly reorganized trade unions. However, neither these nor the many new women's organizations that have formed throughout the region since 1989 have emerged as effective advocates for women.

There are also other aspects of transition politics that work against action to promote gender equality. Among the most important of these are the tendency for political leaders to focus on issues of high politics to the neglect of local and social issues; the limited contacts and incentives that exist to link political representatives to their constituencies; and the economic and political factors that have relegated social policies to a secondary concern.[83] Unrepresented among political decision makers and ignored for the most part by political officials, women have had few avenues to get their concerns onto the political agenda.

This neglect of issues of particular concern to women and failure to address the impact on women of the shift to the market is one of the factors that has contributed to the resurgence of support for parties whose commitment to the market is somewhat in doubt. Numerous public opinion surveys conducted in the region since 1989 demonstrate that women tend to be more concerned about the negative impacts of the shift to the market, more fearful of unemployment, and less favorable to privatization than men. Many women clearly applauded the end of communist rule. However, despite the increase in consumption documented elsewhere in this volume in many countries, many women continue to feel that they and their families were better off under the old system than under the new. Although it is difficult to assess the impact of this factor, some of the social pathologies, such as increases in crime, pornography and other graphic uses of sex, and violence against women that have been prominent features of the transition, contribute to this view. Women have also been more likely than men to want the state to continue to provide a high degree of material security for citizens and play a substantial role in buffering the impact of the shift to the market.

As the results of the elections of 1992 in Slovakia and Poland and of 1993 in Hungary indicate, women tended to support parties of the left to a somewhat greater degree than men. In all of these cases, particularly in Slovakia and Poland, women's rejection of center right parties also reflected their concern over efforts to limit their reproductive rights. However, fears of economic hardship and the perception that the government was not addressing the popu-

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Transitional Economies (New York: Oxford University Press), 1993, pp. 29–47. See the essays in Marilyn Rueschemeyer (ed.), *Women in the Politics of Postcommunist Eastern Europe* (Armonk: M.E. Sharpe), 1994; see also the essays in Nanette Funk and Magda Mueller (eds.), *Gender Politics and Post-Communism* (New York and London: Routledge), 1993.

[83] Wolchik, "Women and the Politics of Transition in the Czech and Slovak Republics," in Marilyn Rueschemeyer (ed.), *Women in the Politics of Postcommunist Eastern Europe* (Armonk: M.E. Sharpe), 1994, pp. 3–28.

lation's economic and social needs also contributed to the victory of the left. Ironically, then, the neglect of women's issues and the increase in gender inequalities since the end of communist rule in Central and Eastern Europe have contributed to bringing political parties to power whose commitment to democratic government may be doubted.

FUTURE PROSPECTS

The extent of gender equality in the workplace and the home will continue to reflect both economic and political factors. Women's labor force opportunities and their levels of unemployment will depend in large part on overall economic trends and performance. In the long run, economic recovery and the growth of the private sector may lead to the creation of new jobs for women who have lost their jobs as the result of changes in the structure of the economy and the streamlining of the retail and service sectors in which women predominate. Positive economic trends may also create a situation in which it is feasible for some women who would like to stay out of the labor force to care for their families. Similarly, greater economic prosperity may ease the economic burden on families and women in particular. However, in the near-future, most women are likely to continue to be under considerable pressure to contribute to the family's income by working outside the home. Women are also likely to continue to face higher levels of unemployment, increased discrimination, and inequality at the workplace and difficulties in satisfying the day-to-day needs of their families.

Economic recovery will not in and of itself lead to greater equality between men and women in the workplace or at home. As the experiences of women in developed economies that have never experienced communist rule illustrate, prosperous market economies are compatible with a good deal of economic and other inequality. Change in the gender roles in the workplace and in the family thus will depend on political as well as on economic factors. It may be that male political leaders will be more willing or better able to give serious attention to measures to reduce gender inequalities once economic issues become less pressing. However, it is far more likely that such issues will remain unvoiced and that women's particular concerns will remain low-priority matters until women themselves organize to articulate their interests, pressure political leaders and economic decision-makers to take action on issues of special concern to them, or run for political office in greater numbers.

As noted above, there are numerous impediments to such actions at present. Many women as well as men feel that politics is an area of activity that is not appropriate for women, and there is very little interest in feminism. Most of the numerous women's groups that have formed in these countries since the end of communist rule explicitly renounce any identification with feminism; most also focus on what their members perceive to have been women's neglected maternal roles. Many deny that they are political, despite the fact that they sponsor lectures and workshops on public issues. Nonetheless, these groups provide a forum for women to articulate their interests that may develop into more explicit efforts to lay claim to public attention and resources for women's issues in the future.

There are also women's business groups and explicitly feminist groups in each of these countries. At present, these groups are very small, have few resources or members, and are confined to the largest cities. However, support for these groups and interest in issues related to gender equality can be expected to grow in the future. As women gain more experience with more open discrimination and the workings of a market economy, they may become more aware of the need to organize to protect their own interests. Continued contact with the ideas and goals of women's groups in other developed societies will also increase the numbers of women who support such actions. Young, highly educated, urban women, who also have the greatest amount of contact with outside groups, are particularly likely sources for such recruits, as they experience the difference in their own economic opportunities and those of their male classmates.

As the varied history and success of women's movements in other developed societies illustrates, the impact of these groups on public policies and public perceptions of gender roles is difficult to predict. However, in many societies, the growth of a women's movement and the election of more women to public office have led to positive changes in women's opportunities. In the meantime, women in these societies will continue to be constrained by public perceptions of gender roles that tolerate and reinforce gender differences and inequality in the opportunities and experiences of men and women. These perceptions can be expected to create special problems for women in both the workplace and the family.

II. WESTERN ASSISTANCE AND INTEGRATION

OVERVIEW

By George D. Holliday*

About five years have passed since Western governments and multilateral agencies began to provide substantial assistance to the countries of East and Central Europe to assist their transition to market economies. Their efforts have been widely criticized, both by officials in the region and by many independent observers in the West, as insufficient and even niggardly. For a variety of reasons, the aid effort has not lived up to the expectations of many who were caught up in the euphoria of the 1989 revolutions. Nevertheless, the cumulative value of aid—balance-of-payments support, stabilization assistance, debt relief, humanitarian aid, concessionary trade credits, and technical assistance—is substantial. The size of the effort and the apparent need for large additional sums in the future suggest the need for assessing the effectiveness of Western assistance efforts.

As they reflect on the successes and failures to date, aid donors and recipients have begun to ask whether a new strategy, or new emphasis, is needed in the future. After a prolonged recession, some of the aid recipients have begun to experience the first signs of economic progress—economic growth, reduced unemployment, reduced inflation, and other important steps toward integration into the world economy. The kinds of assistance that are needed to help sustain such economic progress may be quite different from what was needed at the beginning of the transition.

How effective has Western aid been, and what kinds of aid should be emphasized in the future? The authors of the papers in this section provide useful insights on both questions.

ASSESSING THE EFFECTIVENESS OF WESTERN AID PROGRAMS

Most of the authors suggest that the Western aid effort has resulted in some notable successes. The signs of economic recovery in some countries in the region are attributed, at least in small part, to Western assistance. It is important to emphasize that the successes are primarily due to decisions made, and burdens borne, by people in the region. Nevertheless, several of the authors suggest that Western assistance, particularly financial and technical assistance from the international financial institutions, played an important role in macroeconomic stabilization. As Aziz Ali Mohammed

*George D. Holliday is a Specialist in International Trade and Finance with the Economics Division of the Congressional Research Service, Library of Congress.

notes, the progress made by countries like the Czech Republic and Poland, which persevered in implementing programs supported by the international financial institutions, stands in contrast with the problems being experienced by countries that did not.

There are significant disagreements among the authors who assess the bilateral (primarily the U.S.) aid programs. U.S. programs have emphasized private sector development, rather than public projects, such as infrastructure and environmental developments. They also emphasize direct assistance to private firms and non-governmental organizations. Robert Hutchings and also John Danylyk suggest that the U.S. focus on private sector development has been highly successful. Hutchings praises the speed and flexibility of this aspect of the U.S. aid effort and its success in building public-private partnerships. The American Enterprise Funds, he says, proved particularly successful in strengthening the private sector.

Janine Wedel assesses the reaction of recipients of U.S. aid programs and finds they have had mixed results. U.S. Agency for International Development (AID) programs have sometimes worked poorly, she says, because of inadequate input from recipients and lack of coordination with domestic government agencies. She cites the example of AID's "Indefinite Quantity Contracts," which assist countries in the region with privatization. She maintains that they have not been coordinated adequately with government agencies that have responsibility for privatization. She finds that the recipients of the programs are often suspicious of the motives of private contractors hired by AID, and that sometimes the contractors are accused of conflicts of interest. Other U.S. programs, Wedel finds, have worked well. Programs that involve long-term resident advisers who work in the host country for several years, she says, have been particularly successful. One example is the Treasury Department's Financial Sector Technical Assistance Program, which advises on taxation and budget matters. Wedel concludes that the best assistance programs balance the need for donor oversight and decisionmaking with the need for participation and input from aid recipients.

William Schuerch relates that key Members of Congress have criticized the focus of U.S. aid programs and the way they have been administered. While there was widespread support for the programs' private sector emphasis, he says, some Members urged that more attention be given to public sector institution building. Schuerch also notes that there was substantial disagreement between Members on the House Appropriations Committee and Administration officials on administering AID programs from Washington. Some Members were highly skeptical of the Bush Administration's idea that programs could be run responsibly from Washington without AID staff in the field, and insisted that AID assign more specialists to posts in the recipient countries.

The authors find a number of other shortcomings in the Western aid effort. Hutchings criticizes the proliferation of U.S. programs, the diffusion of scarce resources, and the unwillingness of the U.S. Government to join the international financial institutions and other countries in providing essential balance of payments support. Schuerch is critical of the early management of the European Bank for Reconstruction and Development and of the lack of coordination among Western assistance donors. Several of the authors note that, while efforts at macroeconomic stabilization have had some successes, Western assistance has not stimulated an adequate supply-side response. George Assaf finds that there has not been enough attention to the "regeneration of the industrial base."

A NEED FOR NEW APPROACHES?

A key to future growth of the economies of the region is increased investment to expand and modernize production facilities. In their present conditions, the economies of East and Central Europe cannot generate sufficient domestic savings to meet their investment needs. They must, therefore, attract foreign savings to fill the gap. Most transition countries remain almost totally dependent on official sources for financial assistance, and official flows have not been adequate. In fact, as Harvey Shapiro shows, there were net outflows of official loans from Eastern Europe to Western governments during 1990–1992 largely because of loan repayments. Shapiro and Mohammed note that the international financial institutions (the International Monetary Fund, World Bank, and the European Bank for Reconstruction and Development) made large, positive contributions, but their resources are also limited. They are concerned about the risks in less stable countries and about general overexposure in the region. Moreover, budgetary problems are likely to constrain bilateral lending.

Mohammed estimates that the East European countries will require about $20 billion a year for the next several years. Some of this will continue to come from the international financial institutions. A substantial portion is likely to come in the form of debt relief by official creditors. A large portion, perhaps as much as half, Mohammed says, must come from private capital flows.

Thus, there is a need to improve access to private sources of capital—either borrowing in private markets, or attracting private direct investment. Only three countries, Poland, Hungary, and the Czech Republic, have had much success in doing so, according to Shapiro. Foreign lenders and investors are wary of domestic instability, poor economic performance, and inadequate legal, commercial, and governmental institutions. Several authors suggest ways to stimulate private financial flows. They emphasize technical assistance to make the domestic environment more attractive to foreign owners of capital, new efforts by Western governments to promote flows of private capital, and improved market access in the West for exporters from the region.

Assaf concludes that there must be a second phase of transformation, in which the focus of Western aid shifts from macroeconomic stabilization to structural reform aimed at removing rigidities at the microeconomic level. He proposes a shift in emphasis from capital to technical assistance. Key elements of the second phase, he says, will be assistance with privatization and private sector development, industrial restructuring, promotion of foreign direct investment, and development of social safety nets. To promote reforms at the microeconomic level, Assaf says, there needs to be massive amounts of know-how transfer, particularly transfers of market-based economic skills and Western business experience.

He identifies two important mechanisms for such transfers—expansion of official technical assistance programs and increases in foreign direct investment.

Janine Wedel has a different view. She notes that Poles and Hungarians, who are among the most advanced in the economic transition, have requested more capital assistance and less technical assistance. She suggests that the need for technical assistance has declined as domestic technical capabilities have improved.

Several authors suggest ways in which Western governments can promote flows of private capital to the region. Danylyk describes some of the existing U.S. programs—bilateral investment treaties, the Overseas Private Investment Corporation (OPIC), the Trade and Development Agency, and the Export-Import Bank—that have played a role in promoting investment flows and trade credits to the region. Roberta Waxman-Lenz explains the growing role of limited recourse project finance in expanding the flow of credit to the region. In such financing arrangements, the lender relies on the revenue streams of a project for repayment rather than having recourse to a public entity if the project fails. Limited recourse project finance, she says, is one means of meeting the increased demand for financing in the region for high-risk projects requiring large amounts of capital. The Export-Import Bank and OPIC, she suggests, have an important role to play in providing such financing for Central and East European countries.

Another important way to promote flows of financial capital to the countries in transition is to open Western markets to exports from the region. Improved market access, according to Hutchings, is the single most important means of nurturing the private sector. Promoting exports from the region will not only expand hard currency earnings, but will also stimulate increased foreign investment. Western countries have a mixed record. Danylyk notes that they have taken some important steps to open their markets. The U.S. Government has extended most-favored-nation treatment and made some exports from the region eligible for duty-free treatment under the Generalized System of Preferences. The European Union (EU) has concluded association agreements, which promise eventual free trade with countries in the region. At the same time, however, both the United States and the European Union have placed new restrictions on Eastern exports of "sensitive" products, such as agricultural products, textiles, and steel.

Remy Jurenas' discussion of developments in the agricultural sector in East and Central Europe illustrates a central paradox of Western assistance to the region: while Western governments have been active in extending credits for agricultural exports and providing technical assistance to Eastern agricultural producers, they have sometimes been less willing to bear the costs of integrating those producers into Western markets. Jurenas notes that countries in the region view their comparative advantage in producing certain agricultural products as critical to generating the earnings needed to redress balance-of-payments problems. Agricultural exports, however, have faced the biggest barriers in Western markets. The EU association agreements, for example, left in place many restrictions on agricultural exports from the Eastern association countries. Eastern exporters have also faced stiff competition due to EU and U.S. subsidies to some agricultural exports. According to Jurenas, Western protectionism has led some policymakers in the region to question how serious the Western countries are in integrating their economies into world markets. Given the constraints on official aid programs, improved market access may offer one of the more promising approaches to helping the countries in transition in the future.

FIVE YEARS AFTER: REFLECTIONS ON THE POST-COMMUNIST TRANSITIONS AND WESTERN ASSISTANCE STRATEGIES

By Robert L. Hutchings *

CONTENTS

SUMMARY

Five years after the democratic revolutions in Central and Eastern Europe, it is clear that the transition to stable democracy will be longer, harder, and more complex than was assumed during the heady days of 1989. Progress will be neither uniform nor orderly, as the relatively straightforward tasks of the initial phase of post-communist transition have given way to the more differentiated, intensely political, structural transformations of these political, economic, and social systems. The revolutions have just begun.

Western assistance strategies need to be retooled to reflect the lessons that have been, or should have been, learned from these five years of post-communist experience. Western assistance should try to affect systemic, not just piecemeal, reform in critical sectors, targeting the main barriers to economic growth and the longer-term requirements of democratic civil society. Above all, Western assistance must be embedded in a larger strategic plan for integrating Central and Eastern Europe into a larger democratic community. The essential new agenda—increased assistance, improved market access and accelerated entry into Western institutions—should be seen not as a matter of foreign aid but as a strategic imperative toward a secure post-cold war order in Europe.

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*Ambassador Robert L. Hutchings was special adviser to the Secretary of State, 1992–93, with responsibility for the U.S. assistance program for Eastern Europe.

The December 1993 Russian elections provided a dose of "shock therapy" to Western governments and the international financial institutions. The ascendancy of national extremist forces and the flight of leading reformists from the Russian government, together with the deepening economic crisis in Ukraine, raised fresh concerns about the prospects for the post-communist transformations and the efficacy of Western assistance strategies. The instinctive, and quickly rescinded, call of the U.S. government and others for "less shock, more therapy" was both wrong analysis and wrong policy, but it expressed the sentiment of many ordinary citizens, not only in Russia but also among the emerging democracies in Central and Eastern Europe. Indeed, the strong showing of former communists in the most recent Polish and Hungarian elections serve to remind that the transition to secure democracy is not yet assured, even among the more advanced countries of Central Europe.

These post-communist agonies should prompt a stock-taking of the lessons learned five years after the revolutions of 1989 and the five-year record of U.S. and other assistance efforts in Central and Eastern Europe. These lessons necessarily proceed from ongoing reconsideration of the transitions themselves. Given the limited resources the West has so far deployed in support of the Central and Eastern European transitions, Western assistance will continue to be important but marginal to the efforts made by these countries themselves. Humility, not condescension, is the proper frame of mind with which to reassess Western assistance strategies.

THE NATURE OF THE POST-COMMUNIST TRANSFORMATIONS

Five years after the revolutions of 1989, much of Central and Eastern Europe remains mired in recession, with rising unemployment and social tensions threatening the political consensus behind these painful transitions. There have been spectacular successes as well: a dynamic new private sector in Poland, now accounting for more than half of Gross Domestic Product; an upsurge in U.S. and other Western investment in the Czech Republic; and an impressive expansion of Hungarian trade with new partners in the West. In the Balkans, progress has been more halting and uneven, owing partly to the economic and political spillover of the conflict in the former Yugoslavia. Despite these strains, Bulgaria, Albania, and Romania largely have maintained their commitment to free market democracy under very difficult circumstances. The Baltic states, too, are making steady progress despite the many problems associated with the withdrawal of Russian troops and the disruption of traditional trade relations. Almost all the countries of the region successfully controlled inflation, privatized small businesses, and encouraged the growth of a new private sector.

Yet social discontent has grown, owing partly to the fact that these transitions inevitably generate new inequalities among the populations at large as well as regionally. The diamond-shaped socioeconomic structure one associates with advanced industrial democracies, with small upper and lower classes and a large middle class bulge, will be years in the creation. Instead, these countries have pyramidal socioeconomic structures, with a vast and resentful underclass and a small but conspicuously wealthy group at the top. Lacking the social welfare benefits that the East Germans acquired as a result of unification with a prosperous Federal Republic, the rest of Central and Eastern Europe has little capacity to redress these burgeoning social and economic inequalities and the political dangers associated with them. Absent external underwriting of costly social safety net programs, the only available answers are to be found in streamlining existing welfare systems and particularly in promoting rapid economic growth and job creation. This will take time.

The most obvious generalization from the experiences of the past five years is that building stable democracy on the ruins of communist rule will be longer, harder, and more complex than was assumed during the heady days of 1989 and early 1990. This is partly explained by external events over which these countries had no control—the collapse of the East German and Soviet markets, the impact of sanctions against Iraq and Serbia; but the basic explanation springs from the inherent difficulties and complexities of the internal transformations themselves.

THE RETURN OF HISTORY

The superficial similarities of the revolutions of 1989—spiralling public demonstrations leading to the swift and (except for Romania) peaceful capitulation of the existing regimes—disguised the much more complex and differentiated forces at work in the region. So did the commonality of the first phase of political and economic transformation: preparing the legal and political ground for the first round of free elections, establishing the constitutional foundations for democratic rule, and embarking, under the guidance of the International Monetary Fund, on programs of macroeconomic stabilization, whether of the "shock" or gradualist varieties. These early steps were necessarily led from above by the new democratically elected governments, with little public debate or involvement, and with a speed of implementation that obscured the protracted, painful economic and social transformations still to come. The revolutions had just begun.

Thereafter began the much more variegated, intensely political, structural transformations of the political and economic systems, each with its own logic born of specific national circumstances. These patterns, which David Stark has termed "path dependence,"[1] have ethical as well as practical implications. Stalin once said that fitting communism to Poland was like trying to saddle a cow, but he tried nonetheless. The results of this imposition of the Soviet model were unfortunate, even by Stalin's own standards (which were not overly constrained by ethical considerations). By the same token, those now responsible for Western assistance programs would be well advised to adjust their strategies to fit the country-specific patterns of transition rather than try to impose a "one size fits all" model on a region fast returning to its historic diversity. Assistance should continue to be conditioned on real progress toward market democracy, but within those limits, flexibly conceived, it should be adapted to the programs chosen by elected

[1] David Stark, "Path Dependence and Privatization Strategies in East Central Europe," *East European Politics and Societies*, vol. 6, no. 1 (Winter 1992) pp. 17–54.

officials in these countries. They, after all, are the ones subject to democratic accountability by their electorates.

There is, consequently, little point in trying to judge these transitions against some ideal measure, as in "Country X has to get 'back on track' with reform." The track metaphor is too unilinear, as is the notion of "transition," which implies movement from one fixed point to another, "post-transition" destination. The post-communist transitions inevitably are messy, intensely political processes, unlikely to conform to prescriptions hatched in Western social science laboratories. Nor should one country's achievements be used as the standard for another: Slovak politicians rightly object when their economic program is measured by a Czech yardstick. Indeed, a quick glance at the approaches toward privatization in Poland, Hungary, the Czech Republic, and Slovakia show how varied their approaches are, despite the considerable convergence of their ultimate goals.

"DEMOCRACY, MARKET, EUROPE"

From the Baltics to the Balkans, this was the rallying cry, with "Europe" meaning not only integration with a prosperous, secure West but also replication of Western Europe's postwar success in overcoming destructive nationalism. The transformations therefore are simultaneous political, economic, and social revolutions. Ralf Dahrendorf put it succinctly: "The issue is how to establish the constitution of liberty and anchor it firmly. The heart of the problem lies in the incongruent time scales of the political, the economic, and the social reforms needed to this end." Dahrendorf stresses the inevitable social backlash, as passage through the "valley of tears . . . will always take longer than the lifetime of the first parliament and . . . engender a degree of disillusionment which will threaten the new constitutional framework along with the new economic reforms."[2]

Yet it would be an error to conclude that the political, economic, and social revolutions are too difficult to be pursued simultaneously. It may even be true, as Samuel Huntington argued, that public disillusionment is not only inevitable but salutary, in that "the lowered expectations it produces are the foundation of democratic stability."[3]

There are, of course, examples of authoritarian political systems with free market economies. Chun Du-Hwan's South Korea and General Pinochet's Chile are two examples commonly adduced. Yet for virtually all Central and Eastern European countries, the "Korean model" is not what is being espoused or pursued by the existing governments and relevant political elites. Their aspiration is democracy *and* the market. The alternative, and the danger, is authoritarianism pure and simple, not some new "model" that combines political authoritarianism and economic liberalism. It is probably true that this model is inherently flawed, containing the seeds of its own destruction, in that free market systems inevitably generate internal pressures toward an eventual loosening of authori-

[2] Ralf Dahrendorf, *Reflections on the Revolution in Europe* (New York: Times Books, Random House, 1990), pp. 78 and 84.

[3] Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman and London: University of Oklahoma Press, 1991), p. 263.

tarian rule. This is certainly true for contemporary Central and Eastern Europe, whose populaces are not likely to shoulder the responsibilities of free market economic development if their hard-won political liberties are denied.

THE POLITICAL-ECONOMIC-SOCIAL NEXUS

In this sense, it is reassuring that "democracy, market, Europe" remain inseparable aspirations for most of the new Central and Eastern European leaders and the standards to which they are held by their own publics. Political, economic, and social change cannot be separated or pursued sequentially: suspending the economic transformation in order to consolidate democratic rule or suspending democracy to pursue painful economic reform measures are recipes for achieving neither.

One paradox of the post-communist transitions was that the new, democratically elected governments were obliged to create the conditions for their own demise. Replacing the intrusive role of the state in social, economic, and political life was among their most important tasks, yet it required an exceptional concentration of governmental authority to destroy the old command system and replace it with less intrusive, regulatory government. They had, in short, to amass power in order to dispose of its excesses. The economic monopoly of the state had to be broken for democracy to take root, just as democratic legitimacy (and a measure of governmental efficiency) were required for structural economic transformation.

The Polish sociologist Jadwiga Staniszkis cited a former Industry Minister as saying, "I represent interests that do not exist yet."[4] It is a thought worth contemplating. The Minister did not say the interests were not yet articulated; he said they did not even exist. Of course, something related to "industrial interests" could be identified, but they amounted to the bureaucratic, monopolistic interests of a substantially unreformed managerial class, not those of an economically vibrant industrial sector manifesting themselves in ways conducive to market-based economic competition. To be real in this sense, industrial interests have to be backed by social and economic power; to be politically relevant, they have to be accompanied by a devolution of power and creation of new avenues of political participation.

To take another example: most of the countries of the region have political parties that could be called "liberal" in the European sense of the term. Yet how can a European-style Liberal party exist without a politically active entrepreneurial class wielding real economic power? Without these social and economic foundations, "parties" are more political "clubs" organized around a set of personalities and political orientations, a consideration that may explain why the "liberals" in Central and Eastern Europe found so little support in recent elections.

PRIVATIZATION AND "MARKETIZATION"

In the economic realm, privatization of large-scale state enterprises is of course essential, but this process is not likely to produce

[4] Jadwiga Staniszkis, *The Dynamics of The Breakthrough in Eastern Europe: The Polish Experience* (Berkeley: University of California Press, 1991), xii.

wealth or new jobs. Nor should privatization, especially large-scale privatization, be equated with "marketization." Western attention has been overly focused on this issue, to the exclusion of others that are as important for the transition to a market economy—and more important for economic progress in the near term.

If the swift and orderly privatization of large state-owned enterprises were the measure of progress toward a market economy, all these countries have failed and indeed were doomed to fail from the beginning. Yet those countries that have successfully pursued the essential requirements of market reform—price liberalization, macroeconomic stabilization, currency reform, foreign trade liberalization, small-scale privatization, and private sector promotion—have *not* failed, despite their meager progress toward large-scale privatization.

In the longer term, it is essential—for democracy as well as a market economy—to reduce the state's economic monopoly; thus a rational plan for mass privatization must be part of a longer term (say, decade-long) strategy of economic restructuring. (Here again is the paradox of government's crucial role in managing the economic transformation in a way that reduces its own role in managing the economy.) Meanwhile, the problems of large state-owned enterprises are not likely to be solved but only managed, so that they do not jeopardize the overall transition. Subsidies need to be reduced in order to control inflation and free up scarce resources for critical investments; industrial and financial reform must be pursued together so as to avert the banking system crisis that has plagued Poland and others; labor and welfare programs need to cushion the inevitable "downsizing" lest social discontent produce an antidemocratic political backlash.

With a rational program of mass privatization, a few of these large firms will find foreign purchasers, others will be able to increase efficiency and carve out new and profitable lines of production, and many, perhaps most, will slowly wither away as workers leave semi-voluntarily for better prospects in the real private sector. In short, the most that can be expected is a rational, long-term plan that attracts foreign investment, introduces market discipline, and constrains subsidies, while managing and cushioning the attendant social costs. Even that limited agenda will prove hard to fulfill.

Meanwhile, the new private sector will continue to generate economic growth and provide new jobs; and it will be imperative to nurture this sector, so that fledgling small businesses can prosper and expand beyond services into light manufactures and other productive sectors. Improved access to Western markets is the single most important step, one which will also stimulate increased foreign investment. Creation of new capital markets is also crucial, requiring financial reform and bank privatization as well as the creation of private pension funds and other new sources of indigenous capital.

Western assistance efforts need to concentrate greater attention on private sector growth and, to put it bluntly, engage in less posturing about ambitious agendas in such areas as social welfare, environmental remediation, and infrastructural renovation that the West has no intention of funding. All these areas are critically important, yet the majority of the financing will have to come from state budgets in the region. If the West, including the international financial institutions, will not provide sufficient financing for major infrastructure or environmental projects, it should do more to help these economies grow so that local funding becomes available. By the same token, Western assistance is likely to be more successful in helping create new jobs than in trying to support social welfare programs for mass numbers of unemployed.

At the same time, Western assistance was never meant to support economic development alone. While most Western resources have been devoted to economic restructuring, this was more the means to an end, with the ultimate goal being a stable democracy. In the United States, the original enabling legislation did not contain the word "economy" in its title. It was called the Support for East European *Democracy* (SEED) Act, which means that all U.S. assistance programs are meant to promote democracy.

CIVIL SOCIETY AND THE "DEMOCRATIC DEFICIT"

As the Polish historian Adam Michnik argued early on, "the victory of freedom has not yet meant the triumph of democracy":

> Democracy is something more than freedom. Democracy is freedom institutionalized, freedom submitted to the limits of the law, freedom functioning as an object of compromise between the major political forces on the scene. [5]

Since those words were written in late 1990, Michnik's country has had two presidents, six prime ministers, and, for most of the period, a cacophony of voices in a parliament fragmented among nearly 30 political parties.

In Poland and elsewhere, there was a fairly consistent pattern of political evolution after the revolutions of 1989. The broad-based democratic coalitions of that year held together long enough to oust the communists, win the first free elections, and form the first governments. Then they splintered, giving way to a proliferation of parties with no roots, organized around prominent personalities whose aversion to compromise (the old us/them mentality being hard to shake) made it hard to form stable ruling coalitions. Meanwhile, public apathy and impatience created pressures for greater governmental coherence through expanded presidential authority, electoral reform (with barriers to representation by the smaller parties), or a combination of both. The former communist parties, benefiting from their greater internal discipline, tended to hold together better than the fractious center and right in elections held since 1993. (As one commentator put it with regard to the 1993 Polish elections, the ex-communists graduated to the first grade of electoral politics, while the post-Solidarity parties were in political kindergarten, refusing to put aside differences and forge electoral alliances.)

These patterns, natural enough for the early stages of democratic development, are not cause for despair. They do point to an inevitable tension between democratic legitimacy and governmental effi-

[5] Adam Michnik, "The Two Faces of Eastern Europe," *The New Republic* (November 12, 1990), p. 23.

ciency, however. Because of Poland's electoral reforms (under the so-called "little Constitution") that erected barriers to political representation, some 30 percent of the Polish electorate was effectively disenfranchised in 1993—i.e. their parties or candidates did not win seats because they failed to pass the electoral threshold. This may have been a reasonable price to pay for a less fractured parliament, but there was a price to be paid—a "democracy deficit," as it were—nonetheless.

New democracies, as Huntington observed, face an inevitable dilemma: "lacking legitimacy they cannot become effective; lacking effectiveness they cannot develop legitimacy.[6] Political maturation is part of the solution. Just as the ex-communists learned that political cohesion helped them to electoral victory, the parties of the center and right may also learn the art of political compromise and fare better the next time around. Parties are likely to have greater staying power and broader bases of support if they merge or ally with like-minded parties. Political maturation and parliamentary reform may also help legislatures become more efficient, even with a potentially unwieldy number of political parties.

Over the longer term, the key to secure democracy is civil society. The building, or rebuilding, of democratic civil society requires economic empowerment and democratic devolution, as well as the cultivation of all the institutions and habits that go into making democracy work from the bottom up.[7] It is encouraging that Poland, Hungary, and the Czech Republic have assigned high priority to public sector reform, by which they mean not just the rationalization of public administration but, for want of a better term, the democratization of public policy: devolution of power to lower levels, rebalancing legislative and executive authority, and, above all, enhancing public participation in the policy process. This entails the creation and nurturing of private voluntary organizations (PVOs), nongovernmental organizations (NGOs), and other intermediate institutions that were levelled under the Stalinist *Gleichschaltung* four decades ago.

Western assistance also needs to attach greater priority to this task by promoting legal and regulatory reforms that reduce barriers and provide incentives (including tax incentives) for PVO/NGO development and focusing on such key areas as education, particularly secondary education; media, particularly electronic media; and the legal system, particularly the creation of a strong and independent judiciary. President Clinton's proposal, announced in Prague in January 1994, for a series of "Democracy Networks" is a modest but welcome step toward promoting indigenous, self-sustaining PVOs and NGOs in Central and Eastern Europe.

Civil society, to repeat, is not just an adjunct of democratic and market development; it is integral to the overall process of post-communist transition. This judgement proceeds from an awareness, as Giuseppe Di Palma put it, "that civil society and the market are

[6] Huntington, *The Third Wave*, p. 258.

[7] Bronislaw Geremek, "Postcommunism and Democracy in Poland," *The Washington Quarterly* (Summer 1990), p. 129, set this task—what he called "building local democracy from the bottom up"—among the highest priorities for Poland's post-communist transformation.

vital to democracy—that there can be no democracy without a civil society, and no civil society without a market.[8]

U.S. AND OTHER WESTERN ASSISTANCE STRATEGIES

The aspirations to "democracy, market, Europe" formed the basis of Western assistance strategies: emergency aid for the immediate tasks of the transitions toward democratic rule, sustained technical and financial assistance for creating the foundations of market-based economic systems, and multilateral efforts to support the integration of these economies into the broader European and global economy. To coordinate these activities, G–7 leaders, at their summit in Paris in July 1989, proposed a mechanism for "concerted Western action" that became the Group of 24 industrialized democracies (G–24) under the chairmanship of the Commission of the European Community.

The common assumption during the heady days of 1989 was that a three- to five-year burst of external assistance—balance of payments and structural adjustment support from the international financial institutions, bilateral technical assistance programs coordinated through the G–24, and facilitation of foreign trade and investment—would propel these countries toward integration into the global economy. This assumption proved much too optimistic, and Western assistance efforts had to adjust to the longer term challenges of post-communist transformation.

Given the modesty of Western financial assistance to date, it is important to be clear about where and how Western support can make a difference. Aside from the example of our own economic and political success, the most important thing Western assistance can do is to encourage the Central and Eastern European governments to pursue policies that will promote continued democratic and free market development. In other words, the West should provide economic incentives, technical assistance, and political suasion to help them pursue the policies they should be following anyway. Beyond that, Western assistance should try to affect systemic, not just piecemeal, reform in critical sectors and to focus maximum attention on those areas (financial sector reform, for example) that are the chief obstacles to economic recovery and growth.

EVOLUTION OF THE U.S. ASSISTANCE PROGRAM

Since the inception of the SEED (Support for East European Democracy) program, the U.S. assistance effort has passed through three main phases. In 1989 and 1990, the priority was on "targets of opportunity," with a premium on getting programs up and running as quickly as possible. It was politically essential to do so—to show U.S. engagement and support at that critical moment. In 1990 and 1991, the U.S. put in place the "building blocks" of the program: the American enterprise funds, dozens of partnership programs, and large regional contracts in areas such as privatization assistance. Although more systematic than phase one, the stress was still on speed and flexibility of delivery. Then, beginning in 1992, the U.S. worked out, in close consultation with each govern-

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[8] Giuseppe Dc Palma, "Why Democracy Can Work in Eastern Europe," *Journal of Democracy*, vol. 2, no. 1 (Winter 1991), p. 28.

ment in the region, detailed country strategies that set priorities, established objectives, and lent greater predictability and transparency to the U.S. assistance effort. This evolution in the U.S. approach paralleled a similar pattern in the EC PHARE program, which went further, however, in devolving responsibility to the Central and Eastern European governments themselves.

The focus of the U.S. program has been on economic growth and private sector development, whereas the EC's preference has been for "social market" programs in public infrastructure, industrial restructuring, and social welfare. In truth, the difference between the two perspectives is more pragmatic than philosophical. The U.S. approach, shared to some extent by the British, had nothing to do with "Reaganomics" or "Thatcherism." It derived from the view that the United States should do what it can to help these countries produce wealth so that they can make their own choices. Since no one in the West was about to underwrite social safety nets, finance major infrastucture projects, or clean up the environmental devastation, the United States wanted to help these countries develop as quickly as possible the financial wherewithal to address these problems themselves. This, we believed, was preferable to promulgating grandiose plans without providing any external resources toward their realization.

The particular strengths of the U.S. program have been its reliance on grant assistance, rather than loans or lines of credit, its speed and flexibility, and its success in building public-private partnerships. The American Enterprise Funds proved particularly successful in energizing private sector development in the region and blazing trails for private investors, both foreign and domestic, to follow. Health care and utilities partnerships, linking U.S. institutions with counterparts in Central and Eastern Europe, also achieved considerable success. Other programs, such as legal assistance through the American Bar Association's Central and East European Legal Initiative (CEELI), relied on pro bono, or private voluntary, assistance supplemented by modest governmental outlays for travel and accommodations.

One of the weaknesses of the U.S. effort has been the proliferation of programs, some quite marginal, and the consequent diffusion of scarce resources. Certainly the greatest failure has been U.S. unwillingness, owing partly to the legal constraints imposed by credit reform, to join the international financial institutions and other G–24 countries in providing essential balance-of-payments support. (U.S. leadership in providing a $200 million grant as its share of the Polish Stabilization Fund is a notable exception.)

Another strength of the U.S. program in its first three years was its organization under the direction of the then Deputy Secretary of State. Unless a political and strategic imperative is imposed at that level, assistance programs, particularly those involving market-opening and investment promotion measures, will be no match for powerful economic agencies with countervailing interests. Similarly, high-level direction is needed to supply the strategic urgency that is rarely found among traditional assistance agencies, which are accustomed to long-term developmental projects. With the demotion of the program within the Department of State in 1993, its overall effectiveness and coherence predictably declined.

By the same token, effective programs need the active engagement of multiple agencies, including those charged with advancing commercial interests. The U.S. program involves some 18 separate agencies, each providing unique perspectives and expertise. The Departments of Labor and Energy, for example, mounted programs that could not be replicated either in government or the private sector. Of course, the participation of so many agencies underscores the need for overall policy coordination, which is best supplied by the Department of State.

LESSONS FROM THE MARSHALL PLAN?

The Marshall Plan offered little in the way of a model: it was, as George Kennan himself stressed, directed at the very specific problems associated with post-war reconstruction in Western Europe,[9] almost none of which applied to the post-communist states of Eastern Europe. The main problems they faced—creation of a new private sector and managerial class, mass privatization of thousands of state enterprises, and establishing the foundations of democratic civil societies—were not the work of a few years, no matter the scope of external assistance.

Post-communist dilemmas are not those of underdevelopment but of severe, sometimes bizarre, "mis-development." The Central European countries in particular had highly educated populations, skilled work forces, and existing, albeit decrepit, industrial bases, which meant that well-targeted external assistance often could achieve wonders by helping open up the inherent potential of these economies and societies. On the other hand, the legacy of some four decades of communist misrule has meant that everything needs to be changed in one way or another, and everything is related to everything else. Progress will be neither uniform nor orderly: some changes may be implemented from the top down, others will proceed from the bottom up in the helter-skelter of daily efforts to make things work. Central ministries in Budapest or Warsaw may think that the reform of public administration will have to await elaboration of a comprehensive, country-wide program, but it is at least as likely that public sector reform will be driven by innovations of local governments in response to immediate economic and social pressures.

The inaptness of the Marshall Plan analogy and the unprecedented character of post-communist transformation had the perverse effect of forestalling among Western governments a serious, ongoing review of the appropriate levels of Western assistance. (It also prejudiced subsequent debate over aid to Russia and the other states of the former Soviet Union, as Western governments settled on similarly insufficient levels of support.) While assistance on the scale of the Marshall Plan would not have yielded a commensurate increase in the probability of success in Central and Eastern Europe, nor appreciably reduced the social pain of transition, a strong case could have been made for a substantial expansion of Western assistance. Such an increase was not forthcoming or even seriously debated in the United States or in Europe.

[9] George F. Kennan, *Memoirs 1925–50* (Boston: Little, Brown and Company, 1967), pp. 352–53.

There are at least three respects in which the Marshall Plan offers lessons worth applying in Central and Eastern Europe. First is the strategic priority that should be attached to the task: support for this region, like postwar Western Europe, is a matter of European stability and security. Second, the responsibility for devising economic recovery programs should rest with the peoples and governments concerned, not with international bureaucrats. Third, promotion of regional cooperation should be a conscious goal of foreign assistance. While there is no need for strict conditionality to promote regional institution-building, Western assistance should actively promote cooperative efforts such as the Visegrad process among Poles, Hungarians, Czechs, and Slovaks. If there are those in Prague hoping to outrace their neighbors into the European Union, they should be given to understand that membership in Western institutions entails responsibilities that begin with one's immediate neighborhood.

INTERNATIONAL COORDINATION

The G–24 has proved useful as a forum for assessing progress in the region, reinforcing conditionality, and setting priorities, but it has not supplied the kind of strategic coordination of assistance envisioned at its inception. The haphazard nature of Western approaches was acceptable during the initial phase of the post-communist transitions, when Central and Eastern European governments were disorganized and when a degree of experimentation was inevitable, but the continuing duplication of effort and competition among G–24 countries is now proving unacceptably costly for Central European governments whose own reform programs have become more sharply focused.

Rather than create yet another international bureaucracy, the best solution may be to focus on limited but sharply defined areas where coordination is most urgently needed: first, improved strategic coordination among the major bilateral and international donors, and second, strengthened operational coordination "on the ground" for major projects involving multiple donors. At the strategic level, relations are already improving among the EC Commission, the United States, the OECD (Organization for Economic Cooperation and Development), and the IMF and World Bank. Oddly, EC member countries, notably Germany, tend to be much less inclined to coordinate their activities with others. At the project-specific level, a good model of coordination is to be found in the Environmental Action Plan agreed upon at the April 1993 Lucerne meeting, in which G–24 countries and the East and Central Europeans worked out a common environmental agenda that set priorities and established realistic objectives.

Finally, international coordination can help sustain support for these transitions even as the priorities of Western governments wander. In this regard, the G–24 process and the EC Commission's leadership thereof continue to be important.

LEVELS OF WESTERN ASSISTANCE

The very upheavals that had brought freedom to these countries also created new conditions prejudicial to their success. As Lech Walesa foresaw the day after the opening of the Berlin Wall, Poland "would pay the price" for the fall of the Wall because of Germany's preoccupation with its internal problems.[10] More than that, U.S. and West European preoccupation first with German unification, then with the Gulf War and a fragmenting Soviet Union, served to erode Western support for Eastern Europe's economic and political transitions, even as the collapse of East German, Middle Eastern, and Soviet markets deprived the East European economies of essential foreign trading partners. Additionally, a Western recession, aggravated by the high cost of German unification, constricted Western markets and fueled new protectionist measures against East European products. This was hardly the 1920s, but neither was it an international economic environment conducive to economic recovery and growth.

Based on their evolutions to date, it appears likely that assistance needs will remain roughly constant among the more advanced countries of Central Europe (albeit with shifting emphases) for another 2–3 years, followed by a gradual phasing down. The rest of the region is much harder to forecast, but it is clear that needs will continue to rise before they begin to taper off, with the net result that it will be some years before the overall assistance needs in the region diminish substantially. Meanwhile, U.S. assistance to Central and Eastern Europe remains at the 1990 level of $400 million per year, roughly the amount the U.S. once spent on Costa Rica alone. Originally intended for three countries in Central Europe, it is now stretched to cover more than a dozen from the Balkans to the Baltic, with a combined population of some 135 million. Other G–24 countries have not done much better: the most recent G–24 "scoreboard" estimate of nearly $50 billion vastly exceeds the assistance actually delivered to date.

Assessing "how much is enough" is a subjective business, but the minimum requirement would be a doubling of total Western assistance, to be sustained at least through the end of the decade. This would allow sustained support for the more advanced countries of Central Europe while also meeting the rising needs elsewhere in the region. Additionally, there is an urgent need for a one-time infusion of support for the countries neighboring the former Yugoslavia, whose efforts toward building stable democracy have been dangerously jeopardized by the effects of sanctions against Serbia (and, before that, Iraq). U.S. humanitarian aid to Bosnia in 1993 totalled more than $400 million; a similar amount for neighboring countries could avert a widening of the conflict and obviate the need for even greater costs later. Western governments should at least observe a kind of "democratic tithe": for every ten hours spent on the conflict in the former Yugoslavia, at least one hour should be devoted to the state of democratic development among its neighbors. This would also help to superimpose a democratic logic over the pernicious Balkan "wisdom" that peace can be achieved by consolidating and segregating ethnic nations and building high walls between them, with "blue helmets" patrolling the perimeters.

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[10] Comment made to Chancellor Kohl on November 10, as cited in Horst Teltschik, *329 Tage: Innenansichten der Einigung* (Berlin: Siedler Verlag, 1991), p. 16.

THE STRATEGIC IMPERATIVE

History has shown more than once this century that the countries of Central and Eastern Europe exert an influence on world affairs disproportionate to their intrinsic power and importance. Two world wars and one cold war had their origins in this region; now, the bloody disintegration of what was Yugoslavia seems a portent of a wider violence that may characterize post-cold war Europe.

The sine qua non for European security is the establishment of stable democracy on the ruins of communist rule; without this, nothing the Western allies do will have much chance of building a viable post-cold war order in Europe. Indeed, if the West closes its doors and fails to provide essential assistance, the resulting economic dislocations and sense of abandonment will be a breeding ground for what Vaclav Havel has called the "post-communist nightmare" of authoritarian ultra-nationalism,[11] with dangerous implications for the cohesion and stability of the Western democracies as well.

The war in ex-Yugoslavia, along with dangerous trends in Russia and elsewhere, argue for new, countervailing integrative measures, lest even the most auspicious post-communist transitions fall victim to the forces of fragmentation now on the loose. The strengthening of the CSCE (Conference on Security and Cooperation in Europe), NATO's new "Partnerships for Peace," and the European Union's Association Agreements were useful but insufficient steps in that direction. The next must involve much larger judgments about the future of Europe and the transatlantic community. The two most crucial steps would be a firm commitment by the European Union to early accession by the new democracies of Central Europe, according to a clear timetable and set of conditions, and similar efforts by the North Atlantic Alliance to infuse the "partnership" program with substantive content, aiming toward eventual full membership by these same countries (leaving aside for now the possibility of additional new members at some future date). For NATO, such a goal need not and should not be publicly stated, lest it generate an unwanted backlash farther east.

Renewed commitment to the success of the new (or aspiring) democracies of Central and Eastern Europe is not the only task for the Western community in the post-cold war world, but it is among the essentials and is integral to a grand strategy toward a secure new order. It does not require an unacceptable investment of leadership or resources. For all the difficulties these countries face, conditions are much more auspicious than in 1945 or 1919. There is no large external threat on the near horizon. A prosperous, democratic, and integrated Western Europe is a magnet and point of reference. The United States has not retreated across the ocean. There is a functioning, if sluggish, global economy. European and transatlantic institutions, to which these countries can adhere, already exist. Virtually all the countries of the region are oriented, albeit with differing levels of commitment and capacity, toward building secure democracy; many have achieved substantial success

[11] "Address by Vaclav Havel, President of the Czech Republic, at the George Washington University, Washington, April 22, 1993," press release of that day by the Embassy of the Czech Republic.

already. It would be a bitter legacy of the long struggles of this century if the U.S. preoccupation with the conflicts arising from the ashes of communist rule diverted the United States from a uniquely auspicious opportunity to integrate this region into the broader community of democratic stability.

THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS

By Aziz Ali Mohammed*

CONTENTS

SUMMARY

Macroeconomic stabilization and structural reform are both essential to sustain and reinforce each other for success in economies in transition. Resumption of growth and progress against inflation in countries that persevere in implementing programs supported by the Bretton Woods Institutions stand in contrast to the intensifying problems in countries where programs stalled due to the lack of persistent application. The gradualist approach has clearly not succeeded.

Two issues are of critical importance to the future success of Bretton Woods Institution programs: the installation of social safety nets to protect the most vulnerable elements of the population and the provision of credit to emerging enterprises.

INTRODUCTION

This paper looks at the relations of the countries of East-Central Europe with the Bretton Woods Institutions (BWI) during the 1989

*Aziz Ali Mohammed is Director, Washington Center for Policy and Research and retired staff and Executive Board Member, International Monetary Fund.

through mid-1994 period; it is thus a partial update of a previous Joint Economic Committee study paper that examined relations with these two agencies (and with the General Agreement on Tariffs and Trade) in an earlier period.[1]

The countries covered are Albania, Bulgaria, Czechoslovakia and its two successor states[2] (the Czech Republic and Slovakia), Hungary, Poland, Romania, the Socialist Federal Republic of Yugoslavia (SFRY) and its successor republics,[3] of which three—Croatia, the Former Yugoslav Republic (FYR) of Macedonia, and Slovenia—are already members of the BWI while the other two—Bosnia-Herzegovina and the Federal Republic of Yugoslavia (Serbia/Montenegro)—have not as yet completed arrangements for succession to membership. With the exception of Albania, which is eligible for International Development Association (IDA) assistance, all the other states are World Bank borrowers; for the same reason, Albania is the only member in the region that has obtained International Monetary Fund support from the Enhanced Structural Adjustment Facility (ESAF), its concessional facility.

IMF AND WORLD BANK GROUP ACTIVITIES

While Yugoslavia is an original member, its last credit transaction with the IMF was a standby arrangement in March 1990, which became inoperative later that year; Romania, Hungary, and Poland became members before 1989 but only the former two had received any financial assistance in earlier years (see Table 1).

The World Bank Group has had a long relationship with SFR Yugoslavia, with as many as 90 loans to that country for cumulative lending operations of $6,115 million, of which about $2 billion remain. These loans are being re-allocated among the successor states, and new operations in them remain at an exploratory stage, except for Croatia and Slovenia, which obtained their first loans in FY 1994.[4] Romania became a member as far back as 1972; however, lending was discontinued in 1982 and the country prepaid $1.8 billion in 1989. Contacts were resumed in 1990 and new loans totalling $1,176 million have been approved since then. Hungary became a member in 1982 and cumulative commitments to it amounted to $3,370 million (in 31 operations) plus six co-financing

[1] "Reform and Membership of the Planned Economies in the GATT, the IMF and the World Bank," Jozef M. van Brabant and Paul Marer, vol. 2, titled *Pressures for Reform in the East European Economies* (study papers submitted to the Joint Economic Committee, 101st Congress, 1st Session). U.S. Government Printing Office, Washington, 1989.

[2] The shares of the two successor states in the IMF quota of Czechoslovakia were fixed at 69.61 percent and 30.39 percent for the Czech Republic and the Slovak Republic, respectively, and the same shares applied to their assets and liabilities in the IMF.

[3] The shares of the successor states in IMF assets and liabilities of SFRY were determined as follows: Bosnia-Herzegovina (13.20 percent); Croatia (28.29 percent); FYR Macedonia (5.4 percent); Slovenia (16.39 percent) and FR Yugoslavia (Serbia/Montenegro) (36.52 percent). In the World Bank Group, each successor state assumed debt service responsibility for Bank loans benefitting borrowers on its territory in accordance with an interim agreement on debt apportionment reached with the Bank as a condition of membership. Croatia and Slovenia are current on debt service payments on loans approved when these republics were part of SFRY and the loans continue to disburse. Loans to the other successor republics with an aggregate principal outstanding of $2,497 million were in nonaccrual status on June 30, 1993, of which $772 million was overdue; as of that same date, overdue interest and other charges on these loans totaled $509 million.

[4] References to fiscal year (FY) in the case of the World Bank refer to the year ending June 30; the IMF fiscal year ends April 30.

TABLE 1. East-Central European Countries' Relations with the IMF

(Millions of SDR)[a]

Country	Date of Membership	Quota	Fund Credit Outstanding, End of Year					
			1989	1990	1991	1992	1993	4/30/94
Albania	10/15/91	35.3	—[d]	—[d]	—[d]	-9.7	21.6	30.1
Bulgaria	9/1/90	464.9	—[d]	—[d]	289.9	428.9	459.9	599.4
Czech Republic[b]	1/1/93	589.6	—[d]	—[d]	—[d]	—[d]	780.7	639.0
Slovakia[b]	1/1/93	257.4	—[d]	—[d]	—[d]	—[d]	405.2	388.7
Czechoslovakia	9/20/90	847.0	—[d]	—[d]	917.9	1,121.5	—[d]	—[d]
Hungary	5/1/82	754.8	347.1	231.7	880.2	875.8	896.3	859.4
Poland	6/1/86	988.5	—[d]	357.5	596.6	596.6	497.7	810.0
Romania	12/1/72	754.1	—[d]	—[d]	565.8	750.9	750.9	750.9
Yugoslavia[c]	Original	613.0	522.2	327.9	214.8	142.5	77.4	77.4
Croatia[c]	12/14/92	261.6	—[d]	—[d]	—[d]	—[d]	26.5	NA
FYR-Macedonia[c]	4/21/93	49.6	—[d]	—[d]	—[d]	—[d]	2.8	14.8
Slovenia[c]	12/14/92	150.5	—[d]	—[d]	—[d]	—[d]	8.5	7.2

Source: IMF, *Annual Report*, various years, and IMF, *Survey*, various years.

[a] SDR (Special Drawing Rights) is an IMF unit of account; its valuation in dollars at the end of each year was 1989 (1.3142); 1990 (1.4227); 1991 (1.4304); 1992 (1.3750); 1993 (1.3736); and in April 1994 (1.4214).

[b] Czechoslovakia, an original member, left in 1954; it rejoined as the Czech and Slovak Federal Republic in 1990 and was succeeded by the Czech Republic and the Republic of Slovakia on 1/1/93.

[c] The Socialist Federal Republic of Yugoslavia (SFRY) ceased to be a member effective 12/14/92, and two of its successor states—Croatia and Slovenia—became members on the same date; FYR of Macedonia joined 4/21/93; Bosnia-Herzegovina and the Federal Republic of Yugoslavia (Serbia/Montenegro) have not completed arrangements for succession to membership to date.

[d] No transactions in this year.

NA = Not Available.

operations (B-loans for $132 million) and a partial guarantee for a Eurobond issue ($200 million). Poland became a member in 1986 but has built up a loan portfolio of about the same size as Hungary in only 18 operations, indicating the much larger amounts provided per loan transaction for sectoral adjustment and debt-support operations. All the other countries have operations beginning in FY 1991 or later following the launching of major economic restructuring programs (Table 2).

The BWI have worked closely together to facilitate the transition of the countries in the region from centrally planned to market-oriented economies. The IMF, in accordance with its mandate, has taken the lead with policy advice and financial support for macroeconomic stabilization programs and trade, payments and exchange reforms; it has also furnished technical assistance in its prime areas of specialization, namely, central banking, clearing and settlement mechanisms, tax administration and expenditure control, and financial statistics in addition to coordinating such assistance from national sources, especially central banks. Its role as "gatekeeper" for Paris Club debt operations has meant an intensive involvement in arranging debt and debt service reduction operations, as in Poland. Finally, it has played a significant agency role for the G–7 industrial countries in developing the framework for estimat-

TABLE 2. East-Central European Countries' Relations with the World Bank Group

(Millions of Dollars)[a]

Country	Date of Membership	Capital as of 6/30/94		Loans Approved/Fiscal Year						Total[b]
		Sub-scribed	Paid in	1989	1990	1991	1992	1993	1994	
Albania	10/15/91	10	4	—[c]	—[c]	—[c]	41(1)	45(4)	47(5)	133
Bulgaria	1/1/91	629	37	—[c]	—[c]	17(1)	250(1)	178(3)	148(2)	593
Czechoslovakia	9/20/90			—[c]	—[c]	450(1)	246(1)	—[c]	—[c]	696
Czech Republic	1/1/93	425	36	—[d]	—[d]	—[d]	—[d]	—[c]	80(1)	80
Slovakia	1/1/93	220	18	—[d]	—[d]	—[d]	—[d]	—[c]	115(2)	115
Hungary	5/1/82	971	58	345(3)	366(3)	550(3)	200(1)	413(4)	129(2)	2,003[b]
Poland	6/1/86	739	62	—[c]	781(9)	1,440(13)	390(3)	900(3)	146(1)	3,657
Romania	12/1/72	484	31	—[c]	—[c]	180(1)	650(3)	120(1)	401(3)	1,351
Yugoslavia, SFR	Original	529	46.5	198(2)	692(7)	300(1)	—[c]	—[c]	—[c]	1,190[b]
Croatia	2/25/93	155	14	—[d]	—[d]	—[d]	—[d]	—[c]	120(1)	120
FYR Macedonia	4/21/93	29	2.5	—[d]	—[d]	—[d]	—[d]	—[c]	40(1)	40
Slovenia	2/25/93	85	5	—[d]	—[d]	—[d]	—[d]	—[c]	80(1)	80

Source: World Bank, *Annual Report*, various years, and press releases FY94.

[a] With the exception of Albania, which only received IDA credits, all other loans were made by the World Bank. Figures in parentheses refer to number of loans and credits approved during the year.

[b] Totals refer to 1989–1994 period only. Cumulative commitments from date of membership to end of fiscal year 1994 amount to $3,635 million for Hungary and $6,115 million for Yugoslavia through 2/25/93 when membership was terminated.

[c] No transactions in this year.

[d] Not member states of the World Bank at the time.

ing the exceptional financing needs of individual members and catalyzing external assistance from other sources in tandem with extending its own financial support. (Appendix Table A–1 lists the financial arrangements entered into by countries of the region with the IMF since 1989).

The World Bank Group has provided technical assistance and financial support while conducting an intensive policy dialogue on a broader set of structural reform issues in such diverse areas as price and other incentive systems, enterprise reform and privatization, the dismantling of state monopolies on foreign trade and production, the construction of better-targeted social safety nets, and the installation of legal frameworks for the emerging private sector. While traditional project financing has been available to the "older" members, it has begun only recently to provide the same for the others, following their adoption of structural reforms; these operations are being focused on rehabilitation of infrastructure, the protection of environment and natural resources, and the improvement of basic health and other social services. Finally, the Bank has mobilized and coordinated long-term external assistance for the region, notably by setting up a consultative group for Bulgaria and Romania and participating in donor meetings for Albania. (Appendix Table A–2 lists World Bank loans made to or guaranteed by the governments of member countries since FY 1989).

POLICY ISSUES FACED

Most countries in the region have completed at least three years of their transition; while their experience is quite diverse, there are sufficient elements of commonality to permit the drawing of some conclusions, even if tentatively. All of them registered serious declines of output and investment in the first stage of transition; their inflation rates spurted in the immediate wake of price liberalization and exchange rate depreciations and open unemployment began to appear as the state-sector contracted. While a part of the deterioration can be discounted as reflecting deficiencies and biases in the standard statistical systems inherited from socialist days,[5] much of it was inevitable in the transition from patterns of production and trade dictated by central planning to those determined predominantly by market-driven demand. There is no gainsaying, however, the vast social distress and growing income disparities that have accompanied the transformation process.[6]

One school of thought attributes these social and economic costs to the "shock therapy" programs undertaken with the support of the international financial institutions[7] and involving the rapid lib-

[5] See note on "Measurement of Aggregate Output in Countries in Transition" in IMF *World Economic Outlook* (May 1994) (pp. 80–81). Also "Macropolicies in Transition to a Market Economy: A Three-Year Perspective"—Leszek Balcerowicz and Alan Gelb, Annual (World) Bank Conference on Development Economics, Washington, D.C., April 28–29, 1994.

[6] The World Bank Report for FY 1992 notes that "A central part of current reforms is the move towards market-determined prices, wages and employment. An inevitable result is a widening distribution of earnings and income, including rising unemployment and increased poverty."

[7] In responding to this criticism, the Managing Director of the IMF noted:

"To those who say that the IMF is advocating shock therapy, I would ask: who will have suffered the more severe and prolonged shocks—the people of Poland, the Czech Republic, and the Baltics, where growth has resumed and inflation is being brought under control,

Continued

eralization of prices and trade, a sharp restriction of credit growth and reduction of fiscal deficits, and the introduction of strict wage controls and large currency devaluations (except in Hungary). However, this is at best a partial explanation for the consequences of multiple crises that afflicted countries in the first stage of the transition. These crises included (1) the inability of nascent market structures to substitute suddenly for the central administrative machinery in the allocation of materials and funds for current production and investment; (2) the breakdown of the trading system of the Council for Mutual Economic Assistance (CMEA) on which much production depended for imported inputs (especially subsidized inputs like energy and primary commodities) and for export markets;[8] (3) the rapid influx of consumer goods, including subsidized agricultural products from Western countries (often financed by short-term credits on commercial terms); (4) the injection of vast uncertainty regarding ownership rights following the announcement of plans for the restitution of property and the privatization of state enterprises, to name but a few of the shocks that hit the region simultaneously or in quick succession.

What is perhaps remarkable is that several countries in the region have begun to surmount this collectivity of problems (Table 3). Growth has resumed in Poland and Albania (albeit from a very low base in the latter case) and might be reemerging in the Czech Republic and Slovakia. Inflation, which had risen sharply immediately after price liberalization and massive exchange rate depreciations, has been brought under control; in Poland it has declined to an *annual* rate of around 30 percent, from an average *monthly* rate of 18 percent in 1989; it has been lowered to single digits in the Czech Republic, since the initial macroeconomic situation in former Czechoslovakia was never as unbalanced as in most other countries of the region. Some progress on the inflation front has also been made in Hungary, Slovakia, and Slovenia.

In two countries—Bulgaria and Romania—weaknesses in implementation following the first stage of the reform process resulted in intensifying domestic and external imbalances as programs went off-track; however, the approval of stand-by arrangements as well as purchases under the IMF's Systemic Transformation Facility (STF)[9] in April and May 1994 suggest a renewed determination to

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or the people of those countries where undiscipline and gradualism have brought hyperinflation or the threat of it? There is no shock more cruel than prolonged recession, hyperinflation, and economic disorder. In fact, if there are shocks anywhere they are there, and in the legacy that the countries in transition have inherited, not in the policy strategies supported by the Fund."

(Address by M. Camdessus entitled "Progress in the Economies in Transition in Central and Eastern Europe: The Roles of Policies and External Assistance," (European Institute Forum, IMF, Washington, D.C. February 14, 1994.)

[8] A striking example, though by no means an exceptional one, is provided by Bulgaria. Prior to 1990, about two-thirds of its exports were directed to countries within the CMEA area, with almost three-quarters of these exports going to the former Soviet Union. As a net energy importer from other CMEA countries, obtained at subsidized prices, the collapse of the CMEA led to a sharp increase in Bulgaria's import costs.

[9] The Systemic Transformation Facility (STF) was established in April 1993 to help members experiencing balance of payments needs resulting from severe disruptions in traditional trade and payments arrangements. Such needs could be manifested by (1) a sharp fall in total export receipts on account of a shift from a significant reliance on trading at nonmarket prices to multilateral, market-based trade; (2) a substantial and permanent increase in net import costs, due to a shift toward world market pricing, particularly for energy products or (3) a combination of both. Access to the STF is limited to no more than 50 percent of quota and financing is provided in two disbursements: half to be disbursed at the outset and the remainder within 12

bring their programs of macroeconomic stabilization and structural reform back on track. Their experience as well as cross-country evidence from other transition economies suggest that the debate on the relative merits of gradualism versus shock therapy is settling in favor of the latter; this of course does not contradict another finding, namely, that the process of structural reform in a number of areas cannot be telescoped in time. This creates a problem of synchronization where the earlier phase of macro-stabilization is not quickly reinforced by progress on the structural front, in such areas as fiscal systems, banking reform and financial regulation, the restructuring of state-owned enterprises, labor market reforms, and making effective the legal framework for private sector development, to name a few of the institutional changes that are essential for consolidating the stabilization of the economy.

EXTERNAL FINANCE

Another necessary, but by no means sufficient, condition for successful outcomes is external assistance. Here the role of the BWIs has been crucial, both in providing funds from their own resources and in mobilizing other sources of bilateral and multilateral finance, including debt relief. The onset of the transformation process in the region was accompanied, as noted earlier, by the collapse of the CMEA trading arrangements, resulting in sudden changeover to world market prices and hard currency settlements; the breakdown of the interstate payments system reduced credit to finance trade imbalances. The large terms of trade losses and the disintegration of established trading patterns created immediate external payments problems; at the same time, most governments were moving rapidly to liberalize their trade and payments regimes (while depreciating their exchange rates) as the quickest way of correcting their highly distorted domestic price systems and forcing domestic monopoly producers to adjust to market forces. The introduction of currency convertibility on current account also required foreign exchange support of fairly large magnitude, especially in cases where the sequel to an initial depreciation was the pegging of the exchange rate to serve as a nominal anchor to calm inflationary expectations. Finally, it was recognized that heavily indebted countries could not begin to bring their fiscal imbalances under control until their external debt obligations were reduced, especially in the wake of exchange rate devaluations that suddenly raised the domestic currency counterpart of their debt-servicing payments.

The BWIs were chosen to organize the effort to mobilize financial and technical support, working closely with the OECD (G–24) grouping.[10] The first step was to make estimates of the balance-of-payments gap, and since the amounts required were apt to exceed

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months after the first purchase, depending on continued cooperation with the Fund and policy implementation, satisfactory progress toward agreement on an upper credit tranche arrangement, articulation of a quantified financial program and progress in mobilizing financing from other sources. The STF is a temporary facility, to be in effect through 1994 (but likely to be extended). Access to the STF is additional to that under the Fund's customary facilities.

[10] At an earlier stage, the European Community had gone ahead by committing a loan of $1 billion to Hungary; this initiative was absorbed into the G–24 framework.

TABLE 3. Countries in Transition: Output (GDP)[a] and Consumer Prices (CPI)[b]

(Annual Percentage Change)

Country	1989		1990		1991		1992		1993	
	GDP	CPI	GDP	CPI	GDP	CPI	GDP	CPI	GDP	CPI
Central Europe	0.4	135.5	−7.0	158.2	−12.7	121.9	−8.3	145.1	−1.4	128.0
Albania	9.8	NA	−10.0	NA	−27.7	35.5	−9.7	225.9	11.0	85.0
Bulgaria	−0.5	6.4	−9.1	23.9	−11.7	333.5	−5.6	82.0	−3.5	72.8
Croatia	NA	NA	NA	NA	NA	NA	NA	NA	1.4	1,516.4
Czech Republic	NA	NA	NA	NA	NA	NA	NA	NA	0.5	20.8
Former Czechoslovakia	4.5	1.4	−0.4	10.8	−15.9	59.0	−8.5	11.0	NA	NA
Hungary	−0.2	17.0	−3.5	28.9	−11.9	36.4	−4.5	23.0	−1.6	22.5
FYR of Macedonia	NA	NA	NA	NA	NA	NA	NA	NA	−15.2	244.0
Poland	0.2	251.1	−11.6	585.8	−7.6	70.3	1.5	43.0	4.0	35.3
Romania	−4.3	0.9	−7.4	4.7	−15.1	161.1	−13.5	210.3	NA	−256.0
Slovak Republic	NA	NA	NA	NA	NA	NA	NA	NA	−3.6	23.2
Slovenia	NA	NA	NA	NA	NA	NA	NA	NA	−6.0	22.9
Former Yugoslavia	0.8	1,257.7	−7.5	584.0	−17.0	270.0	−34.0	6,142.6	NA	NA

Source: International Monetary Fund, *World Economic Outlook*, (May, 1994).

[a]Data for most countries refer to real net material product (NMP) or are estimates based on NMP. For many countries, figures for recent years are staff estimates and should be interpreted only as indicative of broad orders of magnitude because reliable, comparable data are not generally available. In particular, the growth of output of new private enterprises or of the informal economy is not fully reflected in the recent figures.

[b]For some countries, figures for recent years are staff estimates and should be interpreted only as indicative of broad orders of magnitude because reliable, comparable data are not generally available.

NA = Data not available.

the capacity of the two institutions to provide from their own resources, the next step was to determine how best to fill the gap through a combination of debt relief, exceptional financing from official bilateral and other multilateral sources, and residually from private capital flows. Poland was the first test-case for the BWI's agenda, involving a complex operation that combined current account financing with a debt relief operation and the arrangement of a stabilization fund to underwrite the adoption of an exchange rate for the zloty pegged to the U.S. dollar (the 1 billion dollar fund was not drawn upon).

Programs adopted for other countries have typically tied official support to IMF-sponsored programs, with disbursements linked to successful completion of IMF program reviews. Loans by Japan have been provided as cofinancing of World Bank structural adjustment loans, with disbursements subject to the conditionality attached to those loans. In 1993, Japan agreed to provide parallel funding to IMF standby programs as well.[11] The application of conditionality by the BWIs has thus proved to be the catalytic element for international financial assistance and is likely to continue to be so used, especially in the face of strong pressures that are emerging in some countries to attenuate the transformation process.

Also significant is the share of financing coming from the BWIs. During the 1991–93 period as much as $8 billion (out of a total of $11.6 billion from official sources) was provided by them (of which $5.1 billion was from the IMF) with the G–24 countries contributing $2.9 billion (the majority by the European Union) and other international institutions, $0.7 billion.[12] Another $12.4 billion has come by way of debt relief, from private and official creditors, mainly for Bulgaria and Poland. It is interesting to find that private capital flows of $17.4 billion exceeded original IMF estimates of $14.2 billion, primarily in the form of direct foreign investments (DFI) and bond placements.

Assuming a deepening of the transformation process, there will continue to be a large external financing requirement, especially as investment outlays gather momentum. Allowing for a gradual buildup of foreign exchange reserves to match rising trade and service flows and for the meeting of scheduled amortization payments, the transition economies outside the former Soviet Union are expected to need about $20 billion a year for the next several years. Private capital flows can be expected to rise in line with growing private investment opportunities, assuming rigorous pursuit of good economic policies; perhaps as much as one-half of the financing requirement can be funded by foreign private investors through both portfolio and direct investment. Some countries will require debt relief from commercial creditors and while those needing official debt relief have already received it through the Paris Club, more might be forthcoming on comparable terms from other official creditors. This would still leave an unfilled gap of $5–7 billion a year to be met from official bilateral and multilateral sources.

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[11] IMF, *World Economic Outlook* (May, 1994), p. 76, fn. 67.

[12] Totals are for Central and Eastern Europe plus the Baltics.

The exposure of the World Bank Group can be expected to keep rising as its disbursements on project-type loans reach a peak several years after loans are approved. There is a question whether the IMF, which disburses balance-of-payments assistance much faster, and is repaid over a shorter period of time, can maintain an annual disbursement level much higher than that of the 1990–93 period. If private flows were not to rise as assumed and/or if direct official support from bilateral sources proves insufficient, a greater burden will necessarily fall on the BWIs. A somewhat higher level of IMF support is envisaged by decisions taken at the Naples Summit to raise access limits and extend the STF. Also planned is an SDR allocation; most countries in the region were not members of the IMF when the last allocation was made in 1981.

There is a question of risk if the Balkan situation fails to stabilize; already overdue obligations are accumulating for two of the successor states of SFR Yugoslavia that have not completed their membership arrangements and are responsible for 49.72 percent of IMF claims on that former member. Indeed, the issue of risk is looming even larger because a geographic concentration of lending may be taking place for a group of countries (including the former Soviet Union) that is simultaneously engaged in a highly complex process of sociopolitical and economic transformation. Some innovative types of underwriting arrangements by the major shareholders may well be called for to enable the BWIs to enter into much larger future commitments without courting undue risk.

OTHER PENDING ISSUES

The BWIs are involved with the region's members in a range of other issues, of which two have a significant impact on the outcome of the programs currently receiving BWI support. These relate to the construction of social safety nets and the provision of adequate credit to new firms.

SAFETY NETS

The social protection arrangements in the pretransition period were extensive, providing for old age, disability, and survivor pensions; health care; work injury benefits; sick pay; family allowances; and maternity benefits. Many of the benefits were administered by the state-owned enterprises, including vacations at company facilities, housing, child care, access to subsidized goods; in-kind benefits and cash transfers (family allowances) were often more important in household budgets than wages. In the immediate aftermath of the launching of reform programs, many of these arrangements either needed to be curtailed or realigned to the requirements of a market-based environment, e.g., provision had to be made for unemployment compensation. While direct consumer subsidies were reduced, cash benefits tended to expand; these frequently proved wholly insufficient to offset inflation, leading to severe hardship for the old, the unemployed, and the unskilled. Under these conditions a certain backlash has been inevitable and poses a real threat to the sustainability of the reform process unless better-targeted social safety nets are quickly put in place to protect a minimum level of subsistence. The BWIs have been conscious of the urgency of the issue but the task of installing a replacement for the earlier arrangements has proved to be far more complicated than earlier envisaged. It remains nevertheless one of the highest priority issues for the future.

REFORM OF FINANCIAL INSTITUTIONS

A large portfolio of bad debts has accumulated with the region's banking systems in the wake of the deterioration in the financial condition of most state-owned enterprises; the volume of nonperforming loans is estimated to range up to 40 percent of total bank credit. This not only undermines efforts to restructure existing enterprises but is a barrier to the provision of credit to new firms, especially small ones. While a number of options for dealing with the bad debt problem are being tried out by countries in the region,[13] the urgency of keeping emerging private enterprises afloat grows sharper with the passage of time.

CONCLUSIONS

This paper has discussed the role of the BWIs in facilitating the transition process in member countries of East and Central Europe. Macroeconomic stabilization and structural reform have both proven essential to sustain and reinforce the other. Resumption of growth and progress against inflation in countries like the Czech Republic and Poland that persevered in implementing BWI-supported programs has contrasted with the intensification of problems in countries like Bulgaria and Romania where programs stalled for lack of persistent application. The gradualist approach has clearly not succeeded. The BWIs have provided substantial resources in the 1990–93 period and are committed to additional support; however, they need to be protected against the growing risks of geographical concentration of their exposures. Two issues, among many, are identified as being of critical importance to the future success of BWI programs: the installation of social safety nets to protect the most vulnerable elements of the population and the provision of credit to emerging enterprises.

[13] See "Dealing with the Bad Debt Problem in Transition Economies," by Sanjay Dhar and Marcelo Selowsky in *Finance and Development*, June 1994, pp. 44–47.

TABLE A–1. Arrangements Between East-Central European Member Countries and the IMF, 1989–Mid-1994

(Millions of SDR)

Country	Type of Arrangements	Approval Date	Expiration Date	Amount Approved	Amount Drawn[a]
Albania	ESAF[b]	07/14/93	07/13/96	42.36	16.94
	SBA[c]	08/26/92	08/25/93	20.80	13.13
Bulgaria	SBA[d]	04/11/94	03/31/95	69.74	23.25
	STF[e]	04/11/94	NA	116.22	116.22
	SBA	04/17/92	04/16/93	155.00	124.00
	SBA	03/15/91	03/14/92	279.00	279.00
Czech Republic	SBA	03/17/93	03/16/94	177.00	70.00
Slovakia	STF[e]	07/27/93	NA	64.35	64.35
Czechoslavakia	SBA	01/07/91	04/03/92	619.50	619.50
		04/03/92	02/02/92[f]	236.00	36.00
Hungary	SBA	09/15/93	12/14/94	340.00	56.70
	EFF[g]	02/20/91	09/14/93	1,114.00	557.24
	SBA	03/14/90	02/20/91	159.21	127.37
	SBA	05/14/88	06/30/89	265.35	215.35
Poland	SBA	03/08/93	04/08/94	476.00	357.00
	EFF	04/18/91	03/08/93	1,224.00	76.50
	SBA	02/05/90	03/04/91	545.00	357.50
Romania	SBA[h]	05/11/94	12/10/95	131.97	37.71
	STF	05/11/94	12/10/95	188.53	188.53
	SBA	05/29/92	03/38/93	314.04	261.70
	SBA	04/11/91	04/10/92	380.50	318.10
SFR Yugoslavia	SBA	3/16/90	09/15/91	460.00	65.70
	SBA	06/28/88	6/27/89	306.00	122.40

Source: IMF *Survey*, various issues.

[a] Refers to amount at expiration or cancellation of arrangement except for current arrangements dating from 5/31/94.

[b] Enhanced Structural Adjustment Facility (at concessional interest rate of 0.5 percent and repayable over 10 years).

[c] Standby arrangement (market interest rate; repayable 3–5 years).

[d] The SBA is combined with a first drawing of SDR 116.22 million under the Systemic Transformation Facility (STF); a second STF disbursement of SDR 116.22 million will be available provided that progress continues to be made in implementing the program supported by the SBA.

[e] A second drawing under the STF can be made within a 12-month period provided the country continues to make progress in implementing the agreed reforms.

[f] Cancelled prior to original expiration date of 04/02/93.

[g] Extended Fund Facility covering the three-year period ending 02/19/94; cancelled concurrent with approval of new standby arrangement.

[h] A first purchase of SDR 188.525 million under the STF was approved together with the possibility of a second purchase of equal amount following completion of first program reviewed under the SBA.

TABLE A–2. Transactions Between East-Central European Member Countries and the World Bank Group, FY 1989–FY 1994

(Millions of Dollars)

Country	Purpose	Approval Date	Maturities	Amount
Albania	Critical Imports	06/25/92	2002/2032	41.1
(IDA Credits)	Agricultural Sector Adjustments	06/24/93	2003/2033	20.1
	Transport Project	05/20/93	2003/2033	18.0
	Technical Assistance for Economic Reform	05/13/93	2003/2033	4.0
	Rural Poverty Alleviation	02/23/93	2003/2033	2.4
Bulgaria	Technical Assistance for Economic Reform	06/27/91	1997/2008	17.0
	Structural Adjustment	08/01/91	1996/2008	250.0
	Private Investment and Export Finance	06/24/93	1998/2010	55.0
	Telecommunications [a]	04/13/93	1997/2010	30.0
	Energy	03/09/93	1997/2010	93.0
Czechoslovakia	Structural Adjustment	06/26/91	1996/2006	450.0
	Power and Environment Improvement	05/29/92	1997/2007	246.0
Czech Republic	Transport and Telecommunications	09/09/93	1998/2008	80.0
Slovakia	Transport and Telecommunications	7/15/93	1998/2010	55.0
	Rehabilitation of Economy	11/30/93	1998/2010	60.0
Hungary	Third Industrial Restructuring [a]	02/07/89	1994/2004	140.0
	Second Transport Project [a]	03/30/89	1994/2004	95.0
	Energy Development and Conservation [a]	05/11/89	1994/2004	110.0
	Financial System Modernization	04/26/90	1995/2005	66.0
	Structural Adjustment	06/20/90	1995/2005	200.0
	Integrated Agricultural Export	06/20/90	1995/2005	100.0
	Second Telecommunications Project	10/09/90	1996/2006	150.0
	Human Resource Development	03/28/91	1996/2006	150.0
	Second Structural Adjustment	06/19/91	1996/2006	250.0
	Enterprise Reform Loan [a]	05/26/92	1997/2007	246.0
	Product Market Development [a]	07/13/92	1998/2008	100.0
	Road Project	12/22/92	1998/2008	90.0
	Health Services and Management	04/20/93	1998/2008	91.0
	Pensions Administrations Health Insurance	04/20/93	1998/2008	132.0
	Tax Administration Modernization	07/08/93	1998/2013	29.0
	Environment and Natural Resource Protection	02/17/94	1999/2014	100.0

TABLE A–2. Transactions Between East-Central European Member Countries and the World Bank Group, FY 1989–FY 1994—Continued

(Millions of Dollars)

Country	Purpose	Approval Date	Maturities	Amount
Poland	Agro-Industry Export Development [a]	02/06/90	1995/2007	100.0
	Industrial Export Development [a]	02/06/90	1995/2007	260.0
	Environment Management	04/24/90	1996/2007	18.0
	First Transport (general)	05/01/90	1996/2007	8.0
	First Transport (railways) [a]	05/01/90	1996/2007	145.0
	Energy Resource Development [a]	06/05/90	1996/2007	250.0
	Structural Adjustment Loan	07/31/90	1996/2007	300.0
	First Telecommunications Project [a]	04/23/91	1996/2008	120.0
	Employment Promotion	06/04/91	1996/2006	100.0
	Privatization and Enterprise Restructuring	06/11/91	1996/2008	280.0
	Financial Institutions Development	06/11/91	1996/2008	200.0
	Agricultural Development	06/11/91	1996/2008	100.0
	Heat Supply Restructuring and Energy Conservation (general) [a]	06/26/91	1996/2008	75.0
	Six Heat Supply Restructuring (regional) [a]	06/26/91	1996/2008	265.0
	Health Services Development	05/07/92	1996/2009	130.0
	Private Enterprise Development [a]	05/07/92	1997/2009	60.0
	Housing Project	06/28/92	1996/2009	200.0
	Roads Project	03/09/93	1998/2010	150.0
	Agriculture Sector Adjustment Loan	05/04/93	1997/2010	300.0
	Enterprise/Financial Sector Adjustment Loan	05/04/93	1998/2010	450.0
	Forestry Development	07/29/93	1998/2015	146.0
Romania	Technical Assistance and essential Imports	06/25/91	1997/2006	180.0
	Health Rehabilitation	10/01/91	1997/2008	150.0
	Structural Adjustment Loan	06/02/92	1998/2009	400.0
	Private Farming and Enterprise Support	06/11/92	1998/2009	100.0
	Transport Project	04/13/93	1998/2010	120.0
	Education Reform	04/05/94	1999/2014	50.0
	Petroleum Sector Rehabilitation	04/05/94	1999/2014	175.6
	Industrial Enterprises Support, Export Finance	05/19/94	1999/2014	175.0
Yugoslavia	Seventh Railway Project	05/23/89	1995/2004	138.0
	Water Supply and Sewage	05/23/89	1995/2004	60.0
	Second Structural Adjustment Loan	04/12/90	1995/2005	400.0
	Six Highway Sector (regional) [a]	06/20/90	1995/2005	292.0
	Thermal Power and Lignite Mine Development (central station)	06/25/91	1995/2005	300.0
Croatia	Emergency Reconstruction	06/21/94	1999/2001	120.0
Slovenia	Enterprise and Finance Sector Adjustment	07/19/93	1998/2008	80.0

Source: World Bank, *Annual Report*, various years, and press releases for FY 1994.
[a] Loans guaranteed by the state; the borrower is typically a project/regional entity or the country's central bank.

U.S. COMMERCIAL, POLITICAL, AND SECURITY RELATIONS

By John T. Danylyk *

CONTENTS

SUMMARY

U.S. policies toward the countries of Central and Eastern Europe aim to ensure their rapid and irreversible transition to democratic societies with market-based economies, and ultimately to build a more secure Europe. The scale of assistance required to support this historic transformation demanded an international pooling of resources—human, technical, and financial—and the coordination of efforts by the United States and its allies to avoid duplication and improve efficiency. As the countries shedding their communist mantles grew in number, the assistance programs of the United States and its allies evolved—as they learned from mistakes and grew in size and complexity.

From the beginning, the United States vigorously championed the cause of the Central and East European (CEE) countries—pressing its allies, especially the EC and its members, to open their

*John T. Danylyk is Chief of the Markets in Transition Division, Office of Economic Analysis, Bureau of Intelligence and Research, U.S. Department of State. The views in this paper are those of the author and do not necessarily reflect the position of the U.S. Government or the Department of State.

markets to the CEE states and to accept them more readily into the greater community of Europe and the world. The United States also moved ahead with its own unilateral program of economic assistance, the "SEED" program and its unique Enterprise Funds. The United States also moved quickly to liberalize its trade regimes vis-à-vis the CEE states and proceeded with a number of other initiatives to promote U.S. trade and investment with the region.

U.S. efforts to promote the security of the CEE countries—which felt adrift since the collapse of communism in Europe and were troubled by the turbulence in the former Yugoslavia and unsettled conditions in the former Soviet Union—evolved from promoting closer relations with largely political and economic organizations such as the Organization for Economic Cooperation and Development (OECD) and the Conference on Security and Cooperation in Europe (CSCE) to the contemplation of full membership in NATO. This latter goal has been advanced significantly with the launching in January 1994 of the U.S.-inspired Partnership for Peace. The United States also has developed bilateral security relations with most of the noncombatants in the region, particularly with the Visegrad countries—the Czech Republic, Hungary, Poland, and Slovakia.

U.S. Objectives: Promoting Democracy and Market Reforms

The collapse of communist rule in Central and Eastern Europe, which began in Poland in 1989 and quickly spread throughout the region, presented the United States and other democracies with an opportunity to help the fledgling CEE governments build democratic, market-based systems and to strengthen the security of a wider Europe. The challenges were welcome but daunting. The political and economic transformation of the former Warsaw Pact countries required institution building on a monumental scale, for which there was no precedent. Five years later, scholars and other experts are still debating reform strategies, particularly their proper sequencing and the relative merits of shock therapy and gradualism.

U.S. and other world leaders did not have the luxury of time to conduct exhaustive and lengthy inquiries to develop the ideal transition model; indeed, that book is still being written. Rather, they had to act fast under very uncertain and increasingly worrisome circumstances. Growing political and economic disarray in Gorbachev's Soviet Union—the single largest trading partner for each of the Central and East European (CEE) countries—already disrupted trade, and raised serious questions about the region's economic security. These problems were exacerbated in 1990 by the collapse of the trading mechanism of the Soviet-led Council for Mutual Economic Assistance (CMEA) and the Gulf War.

THE MULTILATERAL FRAMEWORK

At the beginning, U.S. and other world leaders recognized that the scale of assistance required to support the political and economic transformation of the CEE countries would require the pooling of resources and coordination of efforts, including those of the

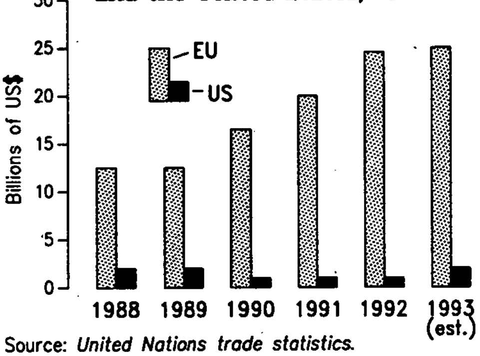
International Financial Institutions (IFIs), to avoid duplication and improve efficiency. In July 1989 President Bush and other leaders at the annual G–7 Economic Summit in Paris agreed to coordinate Western assistance to Poland and Hungary (then the only CEE countries experiencing a democratic transformation) and chose the European Community (EC) Commission to coordinate the process. The EC Commission then convened a series of meetings of the 24 interested countries (the Group of 24, G–24) that were also attended by representatives from the International Monetary Fund (IMF), the World Bank, the Paris Club of official bilateral creditors, and the Organization for Economic Cooperation and Development (OECD). At its first meeting in August 1989, the G–24 established working groups on food aid, management training, environmental issues, market access and trade, and investment. These had been identified as priority areas in consultations with the governments of Poland and Hungary.[1]

The revolutions spread across Central and Eastern Europe from Czechoslovakia's "velvet" revolution to Romania's bloody one. Other CEE states thus were brought into the program, underscoring the economic necessity of the multilateral approach and highlighting Europe's leading role. Indeed, the CEE states saw themselves as eventual members of the EC (now the EU, or European Union). Hungary submitted its application to join the EU on April 1, 1994; Poland followed on April 8.[2]

The focus on the EU by the CEE states was only natural. Besides their geographic location, most of their "noncommunist" trade has been with the EU (see figure 1). And the compliment has been returned, with most of the aid commitments to the CEE states during 1990–92 coming from the EU and EU members: $30.8 billion, or 44 percent of total aid commitments. The IFIs extended another $20.0 billion, or 28 percent of the total (see figure 2).

Figure 1

CEE Exports to the EU and the United States, 1988–93



Source: *United Nations trade statistics.*

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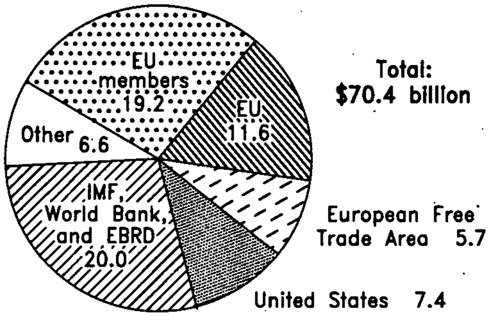
[1] U.S. Department of State, *Focus on Central and Eastern Europe*, no. 19 (July 18, 1990), p. 1.
[2] United States International Trade Commission, *International Economic Revue*, "The European Union Anticipates Four New Members" (May 1994), p. 11.

Included among the IFIs is the new European Bank for Reconstruction and Development (EBRD, established May 29, 1990). The EU member nations and two EU institutions hold 53.7 percent of the capital stock, while the United States holds 10 percent. Under the bank's charter, major U.S. objectives were achieved: lending will be directed (at least 60 percent) toward the private sector; and bank programs are to have a strong environmental focus.[3]

Figure 2

Aid Commitments to CEE Countries, 1990–92



Source: *G–24 statistics.*

U.S. UNILATERAL PROGRAMS

The SEED Program

In November 1989 the U.S. Congress passed the Support for East European Democracy Act (the "SEED" Act), which authorized the U.S. government to provide financial support to the CEE countries. The same legislation created a Coordinator for SEED activities in the Department of State. The SEED program was developed as a regional program, without specific country allocations. This allowed for flexibility to shift resources quickly to address the fast-changing situation in the region.[4] The principal U.S. objectives under the SEED program have remained constant:

- Development of a market economy and strong private sector.
- Development and strengthening of institutions necessary for sustainable democracy.
- Improvement of the basic quality of life in selected areas.

U.S. policy also has as its goal the reintegration of the CEE states into the economic and political structures of the West, as befits their history and values, and the development of friendly relations with the United States. The progress made by the states toward these goals determines their eligibility for U.S. assistance.

[3] U.S. Department of State, *Focus on Central and Eastern Europe*, no. 17 (June 22, 1990), p. 1.
[4] U.S. Department of State, *SEED Act Implementation Report, Fiscal Year 1993*, January 1994, p. 5.

Similar criteria have been adopted by the 24 donor nations, which coordinate their assistance through the G–24 mechanism.[5]

Accordingly, U.S. SEED assistance focused at first on Poland and Hungary, which were furthest along the road of political and economic reform. Czechoslovakia was added to the "priority" list in 1990,[6] and Bulgaria in 1991. Romania, at first limited to humanitarian assistance and aid for democratic institution-building, began receiving assistance for economic restructuring in FY1992. U.S. assistance to Albania followed a similar pattern. SEED funded programs in privatization, banking, and financial services were priorities for Yugoslavia in FY1992, but were reduced following the outbreak of hostilities in June 1991 and then suspended in December 1991. Non-SEED funds remained available for humanitarian aid and democratic initiatives. In FY1993 new economic restructuring programs were initiated in Slovenia and the former Yugoslav Republic of Macedonia. The Baltic states, never formally recognized by the U.S. government as part of the Soviet Union, also have been added to the SEED program, though they are outside of the scope of this paper.[7]

Keeping the SEED program fine-tuned to meet the particular conditions in a given country has been a constant challenge. Within the second year of the program, it became clear that political instability in some of the CEE countries was more serious than anticipated, as was the virulence and staying power of resurgent nationalism. Accordingly, greater emphasis was placed on democracy-building and quality of life programs for FY 1992.[8]

Also for FY1992, to deal with the lag between macroeconomic and microeconomic reforms, notably, the absence of a supply-side response to an otherwise remarkably successful stabilization program in Poland, the United States urged all the countries of the region to accelerate the pace of privatization and the creation of truly competitive market conditions. The United States also placed greater emphasis on Enterprise Funds. These funds were the flagship of the SEED program (see figure 3) for stimulating the private sectors in Poland, Hungary, and Czechoslovakia.[9]

Established in Poland in 1989, in Hungary and Czechoslovakia in 1990, and in Bulgaria in 1991, Enterprise Funds represent a bold experiment for delivering assistance to the developing private sectors in the region. They are private U.S. corporations authorized by Congress and staffed by experienced business managers. Their primary function is to make loans to, or investments in, small and medium-sized businesses in which other financial institutes are reluctant to invest; they also attract outside capital. The Enterprise

[5] Ibid. and U.S. Department of State, *Dispatch* (reprint), vol. 2, no. 16, "Priorities of U.S. Assistance to Central and Eastern Europe," statement by Ambassador Robert L. Barry before the Senate Appropriations Committee, April 16, 1991.

[6] Separate programs for the Czech Republic and Slovakia were established following the breakup of the Czech and Slovak Federal Republic on January 1, 1993.

[7] *Dispatch*, op. cit., and *SEED Act Implementation Report*, op. cit., pp. 61–66 and 112.

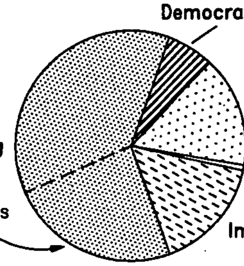
[8] *Dispatch*, op. cit.

[9] Ibid.

Figure 3

SEED Assistance to CEE Countries by Type

Cumulative Obligations, FY 90 – FY 93



Source: *US Department of State, SEED Act Implementation Report Fiscal Year 1993, January 1994, Chapter VII, p.21.*

Funds additionally provide technical assistance for private sector development in the host country.[10]

In the fourth year of the SEED program, the need for greater country-specific emphasis became even more apparent. For example, while Poland, Hungary, and the Czech Republic had made great progress in their reform programs and had attracted significant amounts of foreign investment, they still differed greatly in their approach to and speed of reform. To better adapt the SEED program to local realities, the role of the USAID offices in the region was clarified and strengthened (AID is the primary implementing agency for the SEED program and all SEED funding is transferred through it), and host country involvement was enhanced. To ensure flexibility and efficiency of operations, regional programming has been retained.[11]

The SEED program was envisaged as a temporary program to help the CEE countries through the difficult transition to democracy and a market economy. Reflecting the relative success of Poland, Hungary, and the Czech Republic in making this transition, the United States in FY1994 will begin winding down the SEED programs in those countries and gradually shift resources to the Southern Tier CEE countries, such as Bulgaria and Romania, which still have a long road to travel (see figure 4). Careful monitoring will be required, however, to assure that SEED assistance is not withdrawn prematurely.[12]

New initiatives announced by President Clinton in January 1994 while in Prague include:

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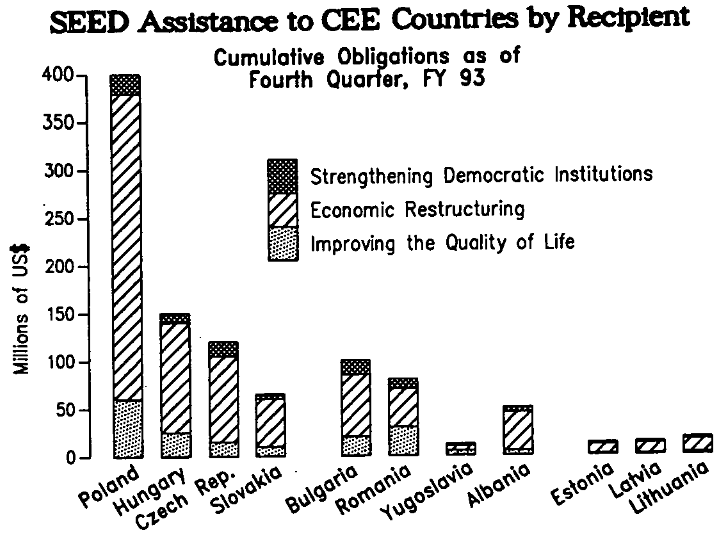
[10] U.S. General Accounting Office, *ENTERPRISE FUNDS, Evolving Models for Private Sector Development in Central and Eastern Europe*, GAO/NSIAD–94–77, March 1994, pp. 2–4. This GAO report also provides a detailed critique of the accomplishments and growing pains of the Enterprise Funds.

[11] *SEED Act Implementation Report*, op. cit., pp. 3–6.

[12] Ibid.

Figure 4



Source: *US Department of State, SEED Act Implementation Report Fiscal Year 1993, January 1994, p. 7.*

- Shifting efforts to the development of longer-term democratic practices, including strengthening and developing non-governmental institutions in the region that contribute directly to democracy building (e.g., human rights organizations and advocacy and watchdog groups).
- Placing greater emphasis on SEED activities in the social safety net to help alleviate "reform fatigue" among populations in the region.
- Looking for ways to use SEED funded assistance, together with other donors and the IFIs, to promote regional infrastructure improvements and cooperation.

In addition to President Clinton's initiatives, new Enterprise Funds are to be added to the SEED program during FY1994 for Romania, Albania, and the Baltic states. [13]

Trade and Investment Initiatives

Enhanced market access for CEE exports and increased foreign investment are critical to economic recovery and the success of market reforms in the region. Accordingly, the United States has supported requests by Poland and Hungary for reaccession to the General Agreement on Tariffs and Trade (GATT) despite lingering bilateral problems. [14] The United States also supports the applica-

[13] Ibid., pp. 8–9.

[14] With Poland, the problems relate to Polish tariff differentials, including the better-than-MFN treatment provided to the EU under Poland's Association Agreement with the European Union. The United States intends to use Poland's GATT reaccession negotiations to press for

Continued

tions by Bulgaria and Slovenia for GATT membership. With the approval by Congress in November 1993 of the restoration of MFN for Romania (which had been renounced in 1988 by former dictator Nicolae Ceausescu) all the CEE countries are considered to be in compliance with the freedom of emigration and human rights provisions of the Jackson-Vanik Amendment to the Trade Act of 1974. Additionally, all CEE countries have been extended benefits under the generalized system of preferences (GSP) regime in the U.S. market. GSP status allows a wide variety of CEE goods to enter the United States either duty-free or at tariff rates substantially below the most-favored-nation (MFN) rate, increasing their price competitiveness in the U.S. market. [15]

To promote U.S. private investment in the region, the United States has concluded bilateral investment treaties with most of the CEE states. As of mid-May 1994, the treaty with Poland was still not in force. An unresolved issue delaying agreement with Hungary is that government's request to be permitted to take unilateral discriminatory measures for up to ten years to protect infant industries or industries undergoing restructuring. [16]

The Overseas Private Investment Corporation (OPIC) has been playing a major role assisting U.S. companies in the region. Its finance department operates like an investment bank, customizing and structuring a complete financial package for each project. Other OPIC services include political risk insurance and sponsorship of missions of U.S. businessmen to explore investment opportunities. OPIC provided almost $1.4 billion worth of investment assistance during FY1991–93. OPIC is committed to provide another $250 million in loan guarantees and insurance in FY1994. [17]

The U.S. Trade and Development Agency (TDA) is actively encouraging the U.S. private sector to participate in rebuilding the infrastructure of the CEE countries while at the same time targeting those host country priority projects for grant assistance that create trade opportunities for U.S. firms. The TDA funds a mix of activities, including feasibility studies that—given political and economic uncertainties in the area—U.S. companies would be unwilling to underwrite without government support. The TDA also is starting to work more closely with the U.S. Enterprise Funds to advance U.S. joint-venture investments. [18]

The Export-Import Bank of the United States (Eximbank) provides a variety of short and medium-term insurance programs and medium and long-term loan/guarantee programs to facilitate the exports of U.S. goods and services. The Eximbank programs supplement commercial financing and insurance. [19]

Table 1 shows the status of a wide range of trade and investment relations of the United States with the CEE states.

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a permanent solution. With Hungary, the problems relate to inadequate patent protection, particularly for pharmaceuticals.

[15] *SEED Act Implementaion Report*, op. cit, pp. 3–6, 8–9, 249–252, and *The Financial Times*, "Polish Tariffs Biased to the EC, says U.S.," May 15, 1992.

[16] *SEED Act Implementation Report*, op. cit., pp. 3–6.

[17] Ibid., pp. 254–255.

[18] Ibid., pp. 258–260.

[19] Ibid., p. 256.

TABLE 1. Status of U.S. Trade and Investment Relations in Central and Eastern Europe

Item	Albania	Bulgaria	Czech Republic	Slovakia	Hungary	Poland	Romania
GATT	Observer Status	Observer Status	Yes	Yes	Yes	Yes	Yes
IMF/IBRD	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Most Favored Nation	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Trade Agreement	Yes	Yes	Yes	Yes	Yes	NA	Yes
Investment Agreement	No	Yes	Yes	Yes	Pending	Not yet in force	Yes
U.S. Trade and Development Agency (TDA).	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Generalized System of Preferences (GSP).	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Overseas Private Investment Corporation (OPIC).	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Export-Import Bank	TCID only [b]	TCID only [b]	Yes	Yes	Yes	Yes	TCID only [b]
JCC/JEC or JTC [c]	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Business Councils	No	Yes [a]	Yes [a]	Yes [a]	Yes [a]	Yes [a]	Yes [a]
Double Taxation Treaty	No	Pending	Yes	Yes	Yes	Yes	No

Source: U.S. Department of Commerce, updated May 17, 1994.
[a] U.S. Chamber of Commerce.
[b] TCID is trade credit insurance.
[c] Joint Commercial Commission, Joint Economic Commission, or Joint Trade Commission.

POLITICAL AND SECURITY ISSUES

The political and economic integration of the CEE countries with the West did not keep pace with the disintegration of the Warsaw Pact and its ancillary structures. As a result, the elected leaders of these countries felt early on that they had been cut adrift, particularly as they realized that neither NATO nor the EC would provide a secure "home" in the short run. In response, U.S. policy has been to strengthen the entire web of East-West relationships. Accordingly, the United States:

- Encouraged the development of closer ties between the CEE states and the European Community and the European Free Trade Association.
- Favored new institutional arrangements in the Conference on Security and Cooperation in Europe (CSCE) that would bring legislators from the CEE states into closer contact with legislators from North America and Europe.
- Encouraged closer consultative ties between the CEE states and NATO through liaison relationships proposed by President Bush at the London NATO summit in 1990. (President Clinton sought even closer ties with his proposal for a Partnership for Peace in 1993.)
- Pushed to create a new status in the OECD for those CEE countries striving to make the transition to a market economy, and ultimately OECD membership for those countries that qualify. [20]

INTEGRATING CENTRAL AND EASTERN EUROPE WITH THE WEST

The United States has been a forceful advocate of integrating the CEE countries with the rest of Europe, but at a pace that reflects each country's interest and capabilities. Perhaps most symbolic is the future accession of these countries to the OECD, which would formally bridge the division of Europe that Stalin imposed in 1947. Because of pressure from Moscow, the government of Czechoslovakia reversed its decision to participate in the July 1947 conference on the Marshall Plan; the government of Poland also abandoned its plans to participate. Accordingly, these countries (and perhaps others in the region) did not become members of the Organization for European Economic Cooperation (OEEC), which was established in April 1948 to administrate the Marshall Plan for economic recovery in Europe and was succeeded by the OECD in December 1960. Instead, the CEE countries joined the Council for Mutual Economic Assistance (CMEA), established in January 1949 by Stalin as the USSR's counter to the Marshall Plan.

The four Visegrad countries currently have "Partners in Transition" (PIT) status in the OECD, which on June 8, 1994, endorsed plans to open membership negotiations with them. [21] As of June 1994, Bulgaria, Romania, and Slovenia were still seeking PIT status. Association with the OECD opens another avenue of technical assistance to advance market reforms; membership signifies that

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[20] *Dispatch*, op cit., and *Focus on Central and Eastern Europe*, "Conference on Security and Cooperation in Europe," April 22, 1991.

[21] *The Washington Post*, "U.S., Allies Closer to Forging Special Ties with Russia," June 9, 1994.

they have met certain minimum standards on important issues such as capital movements and investment regimes and other legally binding liberalization codes, especially regarding equal treatment for foreign-owned enterprises. Progress in these areas also would mean that CEE OECD members are that much closer to meeting requirements for EU membership.

The United States also has been promoting the security interests of the CEE countries through the Conference on Security and Cooperation in Europe (CSCE). Established during the cold war as a way to promote dialogue and decrease tensions between East and West, the CSCE deals with a broad range of concerns—from economic cooperation, human rights, and military security to the environment and media relations—in what became known as the "Helsinki Process." As it evolved in the post-cold war period, the CSCE began to explore the use of a number of operational tools to help the CSCE work together with NATO, the EC, and other international bodies to defend human rights and manage the unprecedented changes underway in Europe. In 1990 a CSCE secretariat was established in Prague, and the Office for Democratic Institutions and Human Rights [22] was established in Warsaw. The civil war in the former Yugoslavia has become an early test for the CSCE's new role in crisis management and "preventative diplomacy," with Hungary, Bulgaria, and Romania hosting sanctions monitoring missions. [23]

FORGING NEW SECURITY RELATIONS: PARTNERSHIP FOR PEACE

The Partnership for Peace (PFP), an initiative of President Clinton and adopted by the North Atlantic Council at its January 10–11, 1994, Summit session, builds on the foundation of the North Atlantic Cooperation Council (NACC), which was created by NATO in November 1991. PFP offers Europe's new democracies the best preparation for eventual NATO membership, and the United States is commited to helping them achieve this goal. [24]

NACC was designed as a forum for consultation and cooperation on security and related issues between NATO countries and the governments of the CEE countries, the Baltic states, and the newly independent states of the former Soviet Union. [25] PFP goes much further. It offers permanent facilities at NATO Headquarters to the Partners in order to improve their working relations with NATO and to facilitate closer cooperation, including: joint planning; joint military exercises; participation with NATO forces in peacekeeping, search and rescue, and other humanitarian operations. [26]

By the end of June 1994, 21 countries had signed the Framework Document (see Table 2). Two of Europe's neutrals, Finland and Sweden, are among the 21 signatories. The Framework Document is a public text, common to all Partners, which sets out the objec-

[22] It was originally called the Office for Free Elections.

[23] *Dispatch*, vol. 3, no. 52, "Fact Sheet: Conference on Security and Cooperation in EUROPE (CSCE)," December 28, 1992, pp. 915–916.

[24] *Dispatch*, vol. 5, no. 31, "The Importance of American Engagement," statement by Secretary of State Christopher on July 28, 1994 before the House Foreign Affairs Committee, August 1, 1994, p. 519.

[25] *Dispatch*, vol. 3, no. 52, op. cit., "Fact Sheet: North Atlantic Cooperation Council (NACC)," p. 935.

[26] U.S. Department of State, *Dispatch Supplement*, vol. 5, Supplement no. 1, "Partnership for Peace: Invitation and Framework Document," January 1994, pp. 5–6.

tives of the Partnership and the goals and values that underpin it: the preservation of democratic societies; their freedom from coercion and intimidation; and the maintenance of the principles of international law. Next, the Partner must submit a Presentation Document, which addresses the various political and military aspects of the Partnership: steps to promote transparency in defense planning and budgets, and to ensure democratic control of defense forces. A third step is the development of individual Partnership Programs between NATO and each Partner, setting out a range of PFP activities specific to that country.[27]

TABLE 2. States that Have Signed the Partnership for Peace Framework Document

Date	Country	Official	Title
26 January	Romania [a]	Teodor Melescanu	Foreign Minister
27 January	Lithuania [a]	Algirdas Brazaukas	President
2 February	Poland [a]	Waldemar Pawlak	Prime Minister
3 February	Estonia	Juri Luik	Foreign Minister
8 February	Hungary [a]	Géza Jeszensky	Foreign Minister
8 February	Ukraine [a]	Anatoly Zlenko	Foreign Minister
9 February	Slovakia [a]	Vladimir Mečiar	Prime Minister
14 February	Bulgaria [a]	Zhelyu Zhelev	President
14 February	Latvia	Valdis Birkavs	Prime Minister
23 February	Albania	Sali Berisha	President
10 March	Czech Republic [a]	Vaclav Klaus	Prime Minister
16 March	Moldova	Mircea Snegur	President
23 March	Georgia	Alexander Chikvaidze	Foreign Minister
30 March	Slovenia	Janez Drnovšek	Prime Minister
4 May	Azerbaijan	Geidar Aliyev	President
9 May	Sweden [a]	Baroness of Uglass	Foreign Minister
9 May	Finalnd [a]	Heikki Haavisto	Foreign Minister
10 May	Turkmenistan	Boris Shikmuradov	Deputy Prime Minister
27 May	Kazakhstan	Kanat Saudabaev	Foreign Minister
1 June	Kyrgyzstan	Askar Akayev	President
22 June	Russia	Andrey Kozyrev	Foreign Minister

Sources: *NATO Review*, vol. 42, no. 3, June 1994, p. 6, and *Daily Report Central Eurasia*, FBIS–SOV–94–121, June 23, 1994, p. 3.

[a] These countries have also submitted Presentation Documents as of June 6, 1994.

U.S. BILATERAL PROGRAMS

The United States also has developed bilateral security relations with virtually all of the noncombatants in the region, particularly with the four Visegrad countries. The overarching aim of U.S. policy is the promotion of regional stability through democratization of the CEE armed forces; expansion of contacts between CEE armed forces and Western (especially U.S.) militaries; and the reorientation of the CEE militaries to defensive postures and to promote their interoperability with NATO and U.S. forces. Transfers of U.S. defense articles and services have been minimal to date. Bi-

[27] *NATO Review*, no. 3, June 1994, "Building a Partnership for Peace," p. 5.

lateral working groups meet annually with the Visegrad countries and Romania for consultations on regional security, defense relations, and security assistance. All of the region's noncombatants participate in the U.S. International Military Education and Training (IMET) program. The United States also assists regional countries to develop national export control regimes for sensitive technologies and military goods and services. Finally, there have been the traditional military-to-military contacts, including ship visits to maritime states, air shows, and visits of high-ranking defense officials.[28]

THE RELEVANCE OF PROJECT FINANCE FOR COUNTRIES OF THE FORMER SOVIET UNION AND EAST-CENTRAL EUROPE

By Roberta J. Waxman-Lenz*

CONTENTS

SUMMARY

Policymakers and corporate leaders are seeking ways to direct financial flows to the developing economies of East-Central Europe and the former Soviet Union. From a geopolitical perspective, the stability of this region—both political and economic—depends on creating an economic web that connects the states of the former Soviet Union and East Central Europe with the more developed countries and with each other. From a business perspective, this region has great potential, with low labor and production costs and largely untapped markets. The economic development of this region can contribute to the growth of the world economy; and conversely, stagnation or economic instability in this region could lead to political imbalances that lead to further economic decay.

*Roberta J. Waxman-Lenz is a Financial Economist with the U.S. Export-Import Bank. The content and ideas in this paper are solely those of the author and in no way represent those of the Export-Import Bank.

Project finance structures have a significant role to play in addressing the financing needs of East-Central European and former Soviet countries over the next several decades. This paper explains the mechanics of project finance transactions, describing the elements that must be analyzed and the risks that are being taken. It then places this type of financing in the broader context of alternative forms of financing, and clarifies the unique role project finance has begun to play in the region. It explores why demand for project finance has grown and continues to grow. This background establishes the framework for understanding the relevance of limited recourse project finance for these countries, and for understanding further developments that will enable such deals to be carried out in this region.

Project finance transactions depend on the revenue streams of a project for repayment of borrowed funds. Because there is no *pro forma* structure that can be used each time a project finance deal is designed, transactions typically take at least a year for final approval and for disbursement of funds to begin. Analysts review the elements of a transaction to determine how best to compensate for the risks involved and construct a bankable structure. Six categories of risk examined include: political risk, uncertainties associated with the legal/regulatory environment, project risk, reliability of financial flows, cross border risk, and pricing risks.

Project finance combines several advantages that set it apart from other forms of financing. Lenders include multilateral organizations, bilateral agencies, and commercial institutions. However, when any one of these entities lends on its own, using traditional financing tools, it usually does not have the flexibility allowed by a project finance structure. Specifically, project finance allows a great deal of latitude in crafting an appropriate structure to address the particularities of a country, an enterprise, or a specific project, thus better accommodating higher-risk environments such as those found in East-Central Europe and the former Soviet Union. Risk may be mitigated for each party by employing a combination of financial instruments (such as an escrow account, a syndicated credit facility, or hedging through use of derivatives), and by apportioning the risk among several participants.

Another advantage project finance has over traditional financing structures is that it facilitates the mobilization of large amounts of capital for a single project by enabling several institutions—public and private—to participate. The International Finance Corporation has estimated that countries in the East-Central European and former Soviet region are likely to spend roughly $28 billion a year during the 1990s to upgrade their infrastructure. The bulk of the capital for these projects may well come from project finance transactions. Project finance lends itself to such finance-intensive projects as those in the oil and gas sector in Russia, Kazakhstan, and Uzbekistan, for example, and large-scale highway projects in Poland, Hungary, and the Czech Republic. Renovating a port in one of the Baltic countries might be another project best structured as a project finance deal because of the large amount of capital necessary.

A word of warning: project finance should not be viewed as a panacea to the financing needs of this region for two significant reasons. First and foremost, the success of a project finance transaction is contingent upon a functioning and reasonably consistent legal and regulatory system; and legal systems in the majority of the countries of this region are incipient at best. A creative engineer of a project finance transaction should be able to overcome some of the inconsistencies in the legal system that are found in most developing countries. However, there is a limit to how much assurance one can receive from any transaction structure unless applicable laws and regulations are relatively predictable and transparent.

Second, while project finance is particularly suited to large-scale projects, smaller projects are best financed through other means. The greater the risks involved, the more complicated the structure may be, thus consuming more staff time and extending the period from design to disbursement. The labor and time-intensive nature of this form of financing inclines most institutions to opt for larger-scale projects to justify the substantial investment of time required.

Development of the economies of East-Central Europe and the former Soviet Union requires huge capital inflows that necessitate the expansion of the modes of financing applied. As the countries in this region develop legal and regulatory structures that enable financing, project finance structures are expected to be utilized more frequently.

INTRODUCTION

The growth and development of the states of East-Central Europe and the former Soviet Union hinge on adequate financial flows entering this region. Certainly the domestic economic and political reforms under way in some of these countries establish the foundation for further progress; but without investment and trade financing, the economic progress achieved by these countries cannot be sustained. And without economic gains that are tangible to the populace, social and political stability is soon undermined. Western financing—from multilateral institutions, bilateral lending agencies, commercial banks, and investors—can spur the growth of small and large enterprises and facilitate development of industries, natural resource extraction, and the service sector to act as engines of growth in a transition away from centrally planned systems.

One form of financing, limited recourse project finance, is growing in significance in all regions of the world. Because of its unique characteristics, particularly the flexibility allowed in structuring transactions, it is able to play a role in meeting the increased demand for financing of high-risk projects requiring large amounts of capital. The lender relies on the revenue streams of a project for repayment rather than having recourse to a public or private entity if the project fails. While use of project finance has expanded most rapidly in Southeast Asia, many of the same elements that make it attractive in this region apply to countries of East-Central Europe and the former Soviet Union. As the process of privatization accelerates in developing nations, as governments seek to finance their growing infrastructure needs, and as lenders search for ways to mitigate risk in higher-risk regions, this lending and investment structure will become more widely utilized by the finance community.

Institutions that have traditionally provided this form of financing in higher-risk regions (e.g., the International Finance Corporation, the World Bank, and the European Bank for Reconstruction and Development) can no longer meet the growing demand. Each of these institutions has noted the increased number of serious inquiries for such transactions—transactions that are extremely labor- and time-intensive. Thus there is a need for these institutions to expand their activities and for other lending and investment institutions to develop their expertise in this area and become more involved.

This paper explains the mechanics of project finance transactions, describing the elements that must be analyzed and the risks that are being taken. It then places this type of financing in the broader context of alternative forms of financing, and clarifies the unique role project finance has begun to play in the East-Central European and former Soviet Union region. It explores why demand for project finance has grown and continues to grow. This background establishes the framework for understanding the relevance of limited recourse project finance for countries in this region and further developments that will enable such deals to be carried out in the area.

DEFINITION OF LIMITED RECOURSE PROJECT FINANCE

Project finance transactions rely initially on the revenue stream generated from a project for repayment of loans and investments. A non-recourse project finance transaction typically does not allow lenders and investors to turn to sovereign or private entities for recourse should the project fail. In most cases, engineers of a financing transaction will establish contracts that allow some recourse to other parties should the earnings of a project be inadequate to meet repayment requirements. This is referred to as limited recourse project finance, where financial flows from the project are the expected source of payment; yet if problems arise, participants seek compensation from sovereign or private entities associated with the transaction. This manner of securing a loan or investment thus differs greatly from that entailing a sovereign guarantee—where the sovereign entity is primarily responsible for payment on a company's default—or a private guarantee—where an already existing company would be held responsible for payment of the loan.

Since the loan is secured by the expected earnings of the project, extensive analysis must be undertaken to determine the project's viability. It may be useful to contrast this form of analysis with those that are carried out in connection with sovereign or private transactions. For sovereign transactions, the analyst seeks to determine the willingness and ability of a government to repay its debt, and examines such risk elements as the country's repayment history and its current debt burden. The balance-of-payments situation indicates the ability of the country to generate foreign exchange for debt repayment. The macroeconomic situation is also reviewed, including such elements as the economic policy plans of the country, growth in output, and inflation. All these factors are viewed in light of the political stability of the country.

For a transaction with a private entity, the balance sheet of the company acting as guarantor of the transaction is used to assess the entity's creditworthiness. The strength of a company is judged by its debt/equity ratio, its cash flows, and net income, among other criteria. The analyst must be able to evaluate the health of the company by its financial statements, plans, and projected sales, and the effectiveness of its management.

In contrast, limited recourse project finance lies on the more complicated end of the scale of lending transactions, requiring an assessment of the country risks listed above as well as the viability of the specific project. Assessing the viability of the project requires analysis of the timing of the payment streams that will flow from the project. It also requires an understanding of the technical aspects of the project, i.e., the equipment necessary, location of the plant, market for the goods being produced, etc. Moreover, the analyst's job is further complicated by the often unstable macro- and microeconomic environments that characterize most of the developing countries where limited recourse project finance may be used. More specific discussion of the risks that must be examined are presented below.

ANALYSIS OF A PROJECT FINANCE TRANSACTION

Limited recourse project finance deals typically take at least a year for final approval and for disbursement of funds to begin; they often require several years before that to develop. This is because each transaction is unique. Generalizations can be made about projects in the same sector in different countries, or in the same country in different sectors. However, there is no *pro forma* structure that can be used each time a project finance deal is designed. The complexities of analyzing such a deal are manifold and often involve coordination among several investors and lending institutions. Project finance requires a multidisciplinary approach and relies upon technical specialists knowledgeable about the particular sector of the project, economists covering the country, lawyers acquainted with the legal system and regulatory environment, as well as the loan officer.

Analysts of a project finance deal review all elements of a transaction to determine the best way to compensate for the risks involved and to design a bankable structure. They consider factors ranging from the commercial strength of the project to the reasonableness of the time frame proposed. Six categories of risk must be examined: political risk, uncertainties associated with the legal/regulatory environment, project risk, reliability of financial flows, cross-border risk, and pricing risks.

Political risk pertains to the possibility that a government might overrule or undermine production agreements made by the enterprise. Lenders must take into account the possibility that a government might nationalize an enterprise and appropriate revenue streams from the project (especially if the government is having budgetary or balance-of-payments difficulties). Revenue could be appropriated indirectly by the government unexpectedly raising tax rates, setting new tariffs, or fixing prices.[1] Along these lines, lenders may also face transfer risk—another type of political risk—the possibility that the government could determine that funds associated with the project can no longer be repatriated.[2] One way of addressing potential government interference is to have the government sign agreements delineating the parameters of its involvement. Alternatively, a project analyst might propose establishing a special project entity from which neither the government nor the original enterprise would have access to financial flows.

Another form of political risk stems from the behavior of firms that continue to rely on government capital injections to keep them afloat or even to serve as a major source of financing. Such dependence could result in a situation that, in financial circles, might be referred to as "moral hazard." Enterprises that believe the government will step in to bail them out if they run into financial difficulties may act fiscally irresponsible, hence the "moral hazard." Since the mechanism for bankruptcy is not yet established in several East-Central European and former Soviet Union countries, and the government has a history of supporting weak enterprises, these enterprises may not take seriously the possibility that they could go out of business. In this case, the government creates or perpetuates an environment that encourages enterprise mismanagement and fiscal irresponsibility. Expected revenue streams from the project would then likely be inadequate to meet agreed payments, and if the government did not step in, which it has no commitment to do in a project finance transaction, the project would go into default.

A second and one of the most significant issues in analyzing a project finance transaction is determining the stability and reliability of the *legal infrastructure and regulatory environment*. In order to ensure that financial flows from the transaction are used to repay the loan as agreed, the applicable laws and regulations must be predictable, and preferably "transparent." The unpredictable nature of doing business in Russia is a case in point. A report prepared by Bankers Trust and Daiwa Europe for a Russian company refers to "the abrupt cancellation of export licenses in December 1991, forced currency conversion, and the...surprise imposition of export taxes" as elements that have made Western oil companies wary of investing in Russia.[3] The erratic nature of these policy changes exemplifies the difficulties that foreign investors and lenders face in trying to arrange a transaction in such countries as Russia.

A third category, *project risk*, focuses on the quality of the equipment being used in production, the quality of labor, the location of the plant—including weather conditions affecting the company's

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[1] As an example, the indefinite nature of tax laws in the oil and gas sector in Russia has caused foreign investors great concern. The Russian government has modified the rules governing the rate of excise tax on consumers of natural resources four times since ratification of the law on underground resources in February 1992. Ben Edwards, "How to Finance Projects in Risky Countries," *Euromoney* (January 1994), p. 86.

[2] Some lending institutions, such as the IFC, are willing to take payment in local currency, but this should *not* be considered a form of taking local currency risk. For example, in Hungary, the IFC has borrowed forint on the local currency market, on-lent to a Hungarian project, and expected repayment in forint from revenues generated by project goods being sold on the domestic market. Some private companies may also accept payment in local currency if they expect to be reinvesting in the country for some time. McDonald's fast-food restaurant is one such example in Russia.

[3] Edwards, "How to Finance Projects in Risky Countries," p. 86.

productive capacity—and the transportation potential or whether easy access to foreign markets is available. Lending institutions considering project finance deals in the East-Central European and former Soviet Union region tend to insist that a strong foreign partner be involved to provide assurance that the project will be well managed and to enable technology and knowledge transfer.

Fourth, the *reliability of financial flows*—whether the proposed production schedule is realistic and will generate the intended repayment stream—is a crucial element. *Cross-border risk* is also a major consideration in project evaluation, entailing assessment of the risk of transporting goods across other countries to the final market destination.[4] *Pricing* of the product to be sold in foreign markets is a sixth element that must be evaluated in a project finance deal.

Some types of projects lend themselves more readily to financing in these unstable environments. For example, an executive director at Lehman Brothers has pointed out that price risk can be mitigated in oil projects—more so than deals involving mining mineral resources—because there is a great deal of flexibility in utilizing the oil derivatives markets. A lender can hedge against price changes in the oil market, thereby safeguarding against potentially volatile oil prices.[5] This structure is limited to commodities for which derivatives markets exist, and therefore cannot currently be extended to many sectors in the former Soviet Union and East-Central European markets.

Examination of the above six risk categories is meant to enable an analyst to develop a structure that compensates for the risks of a project finance transaction. However, in some cases careful analysis reveals that a transaction is simply not viable and no amount of creativity can mitigate the risks of a project. A principal advisor to the World Bank's finance and private sector development group, Anthony Churchill, stated in a recent speech, "No amount of financial engineering will produce gold from straw....unless the basic market, institutional, and regulatory structures are such that an investment will produce adequate returns relative to risks, the financial resources will not be forthcoming."[6] The implications for countries in the East-Central European and former Soviet Union region should be clear: that there are more emerging markets and projects to finance than there is financing available; thus only those governments that create an environment conducive to foreign investment and project lending will attract the financial flows necessary for further development and growth.

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[4] A project finance deal considered by the U.S. Export-Import Bank entailed the transport of oil from Kazakhstan across Russia and Belarus. The possibility that transport across these two countries could be held up by changes in tariff laws or by inter-governmental policy disagreements was one consideration in determining whether repayment from project revenues was likely.

[5] Bankers Trust arranged such a structure in October 1993, using a $12-million facility backed by crude oil derivatives as a hedge for about 2 million barrels of crude oil. Edwards, "How to Finance Projects in Risky Countries," p. 88.

[6] Ibid., p. 89.

A Role for Project Finance in East-Central European and Former Soviet Union Countries

As noted above, the East-Central European and former Soviet Union region presents a greater number of risk factors than most other developing regions, which explains, in part, why project finance has begun to fill a particular niche in financing for this region. As can be seen in Table 1, this form of financing has a combination of advantages that give it a role distinct from other forms of financing. The three elements that set it apart from other types of financing include the risk element, potential transaction amounts, and flexibility in structuring transactions.

TABLE 1. Alternative Forms of Financing

Type of Financing	Risk Element	Transaction Amounts	Flexibility in Structuring
Multilateral Lending	Medium	High	Low
Conventional Bilateral Trade Finance [a]	Medium	Medium	Medium
Commercial Bank Lending	Low	Low	Medium
Direct Foreign Investment	High	Low	Low
Portfolio Investment	High	Low	Low
Project Finance [b]	High	High	High

[a] Based on sovereign or private sector repayment guarantee.
[b] Project lenders include multilateral agencies, export credit agencies, and commercial lenders.

THE RISK ELEMENT

One of the primary barriers to financial flows into this region is the high risk element, which deters the participation of private investors and lenders. Without the guarantee of an export credit agency or a government investment institution, or co-financing with a multilateral agency, private companies typically prefer providing loans or equity to countries that have more stable economic, political, and legal environments. Thus, direct foreign investment flows and commercial bank lending to this region are relatively limited. In the few countries of this region where stock exchanges have been established and allow for foreign participation—primarily the Czech Republic, Hungary, and Poland—this form of equity inflow remains minimal compared to other sources of financing because of the relatively high risk involved.

In contrast, export credit agencies (ECAs) and multilateral agencies are able to take greater risks (shown as "medium" in the table) than private sector institutions because of the government backing they have and because their debt is considered senior to that of the private sector. Yet even ECAs may hesitate—for a variety of reasons—to take a sovereign guarantee in some of these countries. A country may have become a new nation state only recently, and may have no repayment history by which to evaluate the willingness of this country to repay debt. Or perhaps a country's ability to obtain foreign exchange (for debt repayment) is severely hampered by the difficulties involved in extracting newly discovered natural resources and transporting them to hard currency markets.

Trade patterns among member states of the former Council for Mutual Economic Assistance (CMEA) also complicate analyses of repayment prospects from these countries.[7] Specifically, since the deterioration of the CMEA trade system beginning in 1989, member nations have not yet established a new payments system. Former CMEA countries agreed that as of January 1991, they would trade at world market prices and make payments in convertible currencies; however, when payment difficulties arise—as will often occur—these countries resort to barter arrangements. While this enables them to obtain necessary products, it decreases their access to foreign exchange, thereby potentially limiting their ability to repay foreign exchange debt.

Due to these complications, a sovereign guarantee might be considered inadequate. However, various lending instruments combined in a project finance structure can lower the level of risk. Lending agencies use such "enhancements" as purchase agreement securities or collateralization structures to mitigate the risk of high-risk transactions.[8] Project finance thus provides another source of financial flows to countries that are generally limited in the financing they receive.

POTENTIAL TRANSACTION AMOUNTS

Multilateral institutions provide traditional (non-project finance) loans typically in the mid- to high-level range of transaction amounts, and are pivotal in meeting the financing needs of countries in the East-Central European and former Soviet Union region. Although multilateral agencies continue to develop programs to assist countries in the region, they increasingly find that they cannot process loans and disburse funds fast enough. In short, on their own they are not designed to meet, nor can they be expected to meet, the exorbitant financing needs of this region.

Project finance has a role to play in filling this gap and can be viewed as a complementary form of financing to that offered by the international financial institutions. Its structure allows for the mobilization of large amounts of capital for a single project by enabling several institutions—public and private—to participate. The amounts lent or invested by each institution may be in the low- to mid-level range of around $50 million to $150 million. Nonetheless, taken together, the investments and loans can amount to a sizeable financing package, in some cases several billion dollars. An example of a particularly large-scale project finance transaction still under way entails development of a gas condensate field in Nigeria. Total financing for this project finance transaction amounts to almost $900 million and involves more than twenty participants.

Project finance thus lends itself to such finance-intensive projects as those in the oil and gas sector in Russia, Kazakhstan, or Uzbekistan, for example, or large-scale infrastructure projects in

[7] The CMEA was founded in 1949 by the Soviet Union as a means of keeping East Bloc countries in its economic orbit and facilitating trade among these nations. Members included Bulgaria, the Czech Republic and Slovakia (then Czechoslovakia), Hungary, Poland, Romania, the Soviet Union, and Yugoslavia.

[8] The World Bank discourages governments from pledging public assets as collateral against deals carried out with other institutions through a clause in its lending agreements known as the negative pledge clause. For a discussion of this clause and its relevance to lending in the East Central European and former Soviet countries, see Appendix A.

Poland, Hungary, or the Czech Republic. (The importance of project finance for large infrastructure projects is discussed in Appendix C.) Renovating a port in one of the Baltic countries might be another project best structured as a project finance deal because of the large amount of capital necessary. However, while the potential is there to involve several institutions and companies in multi-billion dollar project finance transactions, many deals are not of such magnitude, most falling in the medium- to high-level range of transaction amounts.

It should be noted that project finance structures are generally not used for small-scale transactions, and the minimum transaction size is often about $50 million. The labor and time-intensive nature of this form of financing causes most institutions to opt for the larger-scale projects, thereby justifying the substantial investment of time required. The analysis of such deals is usually quite extensive and complex. In addition, as discussed below, the greater the risks involved, the more complicated the structure may be, thus consuming more staff time and extending the period from design to disbursement.

Thus project finance should not be viewed as a panacea to the considerable financing needs of this region. While it is particularly suited to large-scale projects, the time—and thus potential cost—often makes it too expensive for institutions to process projects regarded as too small. (Of course, each institution makes its own determination as to what constitutes "large enough," and whether some other aspect of a deal makes it worthwhile to pursue regardless of size.)

FLEXIBILITY IN STRUCTURING A TRANSACTION

Architects of project finance deals often utilize a mixture of financial instruments to design a bankable project. Unlike most other forms of financing, project finance allows for a great deal of flexibility in crafting an appropriate structure to address the particularities of a country, an enterprise, or a specific project, thus leaving more leeway for accommodating higher-risk environments such as those found in East-Central Europe and the former Soviet Union. Risk may be mitigated for each party by apportioning it among several participants and by employing a combination of financial instruments such as an escrow account, a syndicated credit facility, or hedging through use of derivatives, among many other options.[9]

In arranging financing for a private entity (as opposed to a project), commercial banks and trade finance institutions may also utilize financial instruments to secure a deal. However, the ways in which they structure the tools for a private transaction and how they combine these tools is typically more standardized and thus more constrained than for a project finance transaction. For example, the revenue stream from a project finance transaction can be packaged in a multitude of ways to strengthen the creditworthiness of a transaction. Peter Nevitt explains concisely the broad array of

[9] For an extensive description of the various instruments available when structuring a project finance transaction, see Chapter 11 of Peter K. Nevitt 's publication entitled *Project Financing*. Peter K. Nevitt, *Project Financing* (London: Euromoney Publications, 1989, fifth edition), pp. 63–79.

possibilities open to project finance analysts in his Euromoney publication:

> The objective is to package and combine the undertakings of various parties interested in getting a project built in such a way that no one party has to assume the credit responsibility for the project, while at the same time providing a combination of guarantees and undertakings which, when viewed together, will constitute a bankable credit. If a single strong credit (such as a government agency) will provide a strong guarantee, the task of structuring the transaction as a project financing for the remaining sponsors is much easier. The combinations of entities, guarantees, instruments and borrowings are limited only by the ingenuity of the architect of a project financing and the acceptability of the structure to investors and lenders.[10]

Thus, there is room for much creativity in devising a framework for a project finance deal in a relatively risky environment, as opposed to most other forms of financing that typically have a set structure within which they must work.

INCREASING DEMAND FOR PROJECT FINANCE IN EAST-CENTRAL EUROPEAN AND FORMER SOVIET UNION COUNTRIES

It should come as no surprise that the demand for project finance has increased substantially in the 1990s. Beyond the enormous demand for infrastructure development worldwide, the immense financing needs of the energy sector in Russia necessitate that financial institutions expand their project finance activities. (Estimates place Russia's financing needs for simply maintaining current oil production levels at more than $40 billion over the next six years.)[11]

Those who work in the field are not able to quantify the total increase in value or volume over the past decade. However, the International Finance Corporation (IFC), which has been involved in project finance transactions in developing countries longer than any other institution, reports significant growth in projects financed over the past ten years. They cite an "explosion in demand" for project finance transactions since 1990, and expect activity will double over the next year.[12] In 1984, sixty-two IFC projects were approved, bringing total financing for that year to $700 million; by 1993, the number of projects approved has tripled, requiring financing of almost $4 billion, of which roughly 20 percent is being used to finance projects in the East-Central European and former Soviet Union region.[13]

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[10] Nevitt, *Project Financing*, p. 7.

[11] To stabilize oil production in Russia at the 1993 level of about 350 million tons per year, it is estimated that $50 billion would be necessary from 1993 to the year 2000. Analysts suggest that about $40 billion of this can be generated by the Russian oil sector itself—from production and export. That leaves $10 billion in foreign financing that would be required to maintain current levels of production.

[12] The IFC was established in 1956 to facilitate private sector investment. It provides loans and makes equity investments to finance project finance transactions.

[13] This 20 percent refers to financing approved in fiscal 1993 for projects in the Europe division, including those in the following countries: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovenia, Turkey, and Ukraine. Financing approved for this region—including that on IFC's account and associated syndications and underwriting—totaled $784 million out of total IFC financing approved for the year of $3,936 million.

Another indication of increased demand for project finance is the expansion in the number of serious inquiries that export credit agencies have received over the past three to five years. While none of the agencies has data to quantify this increase, several speak of stepped-up pressure from the exporting and banking community for a more aggressive approach to supporting project finance transactions. In response, these ECAs are restructuring their project finance capabilities. For example, the British ECA, ECGD (Export Credits Guarantee Department), distributed questionnaires to exporters and bankers in September 1993 to ascertain ways in which ECGD could make its project finance services more accessible. This agency reports struggling to manage demand for project finance since starting its project finance program in 1988. Along the same lines, KfW (Kreditanstalt fur Wiederaufbau), an agency associated with the German ECA (Hermes), is considering forming a group specifically focused on project finance.

The U.S. Export-Import Bank (Ex-Im) has historically played a role in financing projects where the obligor was a sovereign financial or credit institution. However, Ex-Im is now responding to shifting demands as sovereign governments move from taking on obligations for infrastructure to allowing the private sector to participate. As of early 1994, Ex-Im received serious inquiries for project finance transactions totaling over $8 billion.[14] In response, Ex-Im established a project finance division in June 1994 to help U.S. exporters compete in these growing markets in developing countries.

The Overseas Private Investment Corporation (OPIC) is another U.S. government institution responding to increased demand for project finance transactions. It was established in the 1970s to encourage U.S. investment abroad by providing project financing and political risk insurance that would cover such business hazards as inconvertibility, war, and expropriation in markets lacking private sources of financing. In 1993 the limit placed on financing per transaction was raised from $50 million to $200 million, partially to address the tremendous financing requirements of the energy sector in Russia.

OPIC's total financial commitments (direct loans and investment guarantees) expanded from $110 million in 1984 to $415 million in 1993, an increase of almost four times in the past decade. Demand now far exceeds these levels, and as a result, OPIC activity is expected to grow concomitantly. Commitments for Eastern Europe and the former Soviet Union were minimal until 1990, starting at 17 percent of total commitments, and increasing rapidly to more than 40 percent of the total by 1993. In 1994 commitments for the former Soviet states alone are expected to reach almost $1 billion.

Some of these projects entailed providing equity and loans. Others provided technical assistance. These figures can be contrasted with financing approved in fiscal 1992 for this region of $465 million out of total IFC financing approved of $3,226 million, or 14 percent of the total. This shows a 22 percent increase from 1992 to 1993 in total financing approved, and almost a 70 percent increase in financing for the region. The International Finance Corporation, *Annual Report 1993*.

[14] These cases do not include those associated with the Oil and Gas Framework Agreement, which could cover over $1 billion in transactions in the first year. More information on the Oil and Gas Framework Agreement can be found in Appendix B.

The Relevance of Project Finance for East-Central European and Former Soviet Union Countries

Project finance transactions are especially complex in the countries of the former Soviet Union and East Central Europe because of the rapidly changing landscape. New laws and shifting power structures must constantly be navigated, particularly in the states of the former Soviet Union. Of course, the degree of legal and structural stability varies across the region, and a greater number of precautions must be taken in analyzing transactions in those countries that lack a stable environment.

Moreover, much of the basic information required for project analysis in East-Central European and former Soviet Union countries cannot be supplied or is unreliable. For example, a sponsor who has been in existence less than two years would not be able to present the three years of independently audited financial statements and annual reports typically required. Historical price and volume data and statistics on past product demand would also be unavailable. On top of this, future prices are unpredictable due to extreme fluctuations in inflation rates; and countries of the former Soviet Union continue to experience trade shocks from other former Soviet Union countries with the introduction of new currencies, shifting tariff laws, and the erratic introduction of trade barriers. East-Central European economies are also buffeted by severe trade shocks as they attempt to reorient their trade toward the West and to reestablish trade links with their eastern partners. Since each of these elements can rarely be viewed as reliable in the current environment, forecasts must contain several scenarios based on widely varying assumptions concerning price changes and plans for sourcing inputs and marketing outputs.

A distinction must be made between two groups of countries in the region of East-Central Europe and the former Soviet Union: the northern tier Central European countries versus the area comprising the southern tier East European countries and the former Soviet states. Specifically these are the Czech Republic, Hungary, Poland, and Slovakia, although economies in transition have progressed far enough in the stabilization and structural reform of their economies that a sovereign guarantee may be considered an acceptable risk.[15] Yet, even where a sovereign guarantee is a viable option, project finance provides another source of financing in a region where foreign capital is inadequate.

Another sign that the northern tier countries have achieved a more advanced stage of economic and financial development is that a few companies in these countries are being selected for project finance deals without a Western joint venture partner. Some lending institutions have found that a few select enterprises in these countries have developed enough of an understanding of the importance of good management techniques, development of marketing strategies, and maintaining accounts according to international stand-

[15] Note that Moody's and Standard & Poors place the Czech Republic and Hungary in their investment grade and speculative grade categories, respectively. The others have not been rated by these institutions.

ards that they are considered strong enough on their own merit. This development has taken place only over the past two years.[16]

Countries in southern tier Eastern Europe and the former Soviet Union are in the early stages of transition away from centrally planned economies, a transition that entails drastic changes in economic policy, development of new institutions, and restructuring of enterprises. As these governments work to stabilize their economies, they are confronted with several seemingly contradictory challenges. While they seek to limit the trade deficit, they must import adequate capital goods to facilitate economic growth. While they seek to limit the budget deficit, they must be responsive to the demands of the populace for adequate welfare programs so as to maintain social stability. While they seek to limit monetary emissions to bring down inflation, they must moderate the number of enterprises they allow to go bankrupt for fear of escalating unemployment. Many of the trade-offs confronting these countries are ones addressed by most governments. However, for economies in transition the challenges are magnified since the decisions these governments make are against the backdrop of starting from scratch and building entirely new institutions while dismantling an obsolete and decaying system.

For these reasons, the economies in transition are viewed as being high-risk economies for lending institutions. Lending institutions question the ability of these countries to find the means to gain the hard currency to repay their debts since these governments tend to focus their resources on constructing a new economic and institutional structure. Lending institutions thus seek alternative means of mitigating their risk when financing projects in these countries, that is, alternatives to accepting a sovereign guarantee.

A paradox must be pointed out in this context for those countries defined to be at a high level of sovereign risk. If a country is at such a high risk level that a lending agency does not feel comfortable taking a sovereign guarantee, how can a project within that country be less risky than the risk of the country itself? This question highlights the basic issues addressed by country risk analysis.

When analyzing the riskiness of financing a project with a sovereign entity as obligor, the principal questions being asked are those of the willingness and ability of a country to repay its debt. The fundamental question is whether the country will have adequate revenue to repay any debt it incurs. If the answer is no, or of a highly questionable nature, the follow-up question in this context should be, how then would a private entity be able to gain the revenue it needs to repay its debt? And, if this private entity *were* able to gain the revenue to repay its debt, what assurances are there that a revenue-starved sovereign entity would not determine that the private entity's revenue should be taxed at a higher rate so as to fill government coffers? This question is particularly relevant for the countries of the former Soviet Union, where questions

[16] According to staff at the IFC, this applies only to a few companies in the Czech Republic, Hungary, and Poland.

of ownership and control rights recur among "private" owners, local governments, and the federal government.

It has been argued that governments in these countries are not likely to appropriate the revenue stream of a private entity or project because the government would want to ensure that future project financing continues to flow into the country. If guarantees from the government are obtained to ensure against interference with the project itself or the revenue generated from the project, then the government's financial strength typically need not be factored into the equation. However, some elements assessed in a sovereign deal still come into play for a project finance transaction—such as the country's political stability and the development of a legal/regulatory framework.

In the states of the former Soviet Union and some Central European countries there are several risk elements that call into question the premise that risk can be mitigated by a limited recourse project finance structure. Some forms of project finance, namely those involving collateral and other enhancements, may be necessary. Probably the most significant element of risk is the continued instability of the legal/regulatory infrastructure. Foreign businesses and lending agencies simply cannot rely on the legal/regulatory system or consistent business practices. Specifically, the following six elements must be addressed to create an environment that encourages investment and credit flows:

- Clearly defined property rights and a system for registering and enforcing established ownership;
- A clearer definition of a "privately held" company, since in many of these countries, even entities that are majority owned by the state and rely on the state for financial support are referred to as private;
- Commercial laws, including provisions for bankruptcy and modes of enterprise liquidation;
- Laws governing the banking system, which define the role of and restrictions on financial institutions;
- Consistent taxation laws that specify tax liabilities on all forms of enterprises (locally owned, joint stock, limited liability), and to whom these taxes must be paid; and
- Use of accounting principals that meet international standards.

Because of the lack of transparent rules in these areas in several East-Central European and former Soviet Union countries, there is no guarantee that some level of government will not intervene in a transaction and change the rules at any time, even once a contract has been signed. As discussed above, this has occurred repeatedly in some of these countries in connection with investments and joint ventures. To some extent government interference can be attributed to the transition through which these countries are going. Old systems are being or have been dismantled, and new institutions and infrastructures are being developed. Governments and private entities need time to shape new roles for themselves.

In this vein, the Czech Republic, Hungary, and Poland set a good example for the other transition economies. Over the past three years laws concerning ownership rights and foreign investment taxation have been clarified. Moreover, the private sector composes a large share of these economies, particularly in the Czech Republic and Poland. (The Czech Republic developed its private sector through voucher privatization, and Poland through a process of local investor purchases of most state-owned companies.) Management methods and structures have also evolved so that lending institutions can rely on local companies without a Western partner for assurance of repayment in a project finance transaction.

On the other hand, if foreign governments do not see the value in encouraging financial flows and establishing a consistent business environment, their systems will remain the quagmire that tends to deter the very investments and know-how so necessary for economic development. Until these issues have been addressed, greater precautions must be taken in structuring project finance deals in the states of the former Soviet Union and East-Central Europe. The Oil and Gas Framework Agreement is one example of an arrangement that uses some of the elements of a project finance structure to compensate for a high-risk environment. (A brief summary of this agreement is provided in Appendix B.)

CONCLUSION

The huge financial needs of the countries of East-Central Europe and the former Soviet Union for development of their economies demands an expansion of the modes of financing applied. Given the infrastructure needs in the region—including telecommunications, transport, and extraction of energy resources (oil, gas and coal)—and the limited capacity of the public sector to address this deficiency, project finance should be a relevant source of financing. However, even innovative architects of project finance structures are likely to be severely hampered by inconsistent laws and shifting lines of authority in the states of the former Soviet Union and some of the East-Central European countries. As the countries in this region develop legal and regulatory structures that enable financing, project finance structures are sure to be utilized more frequently.

APPENDIX A.

THE WORLD BANK NEGATIVE PLEDGE CLAUSE

The World Bank negative pledge clause has been an issue for lending institutions involved in transactions in the former Soviet Union. This clause, included in each loan document signed between a member country and the World Bank, discourages governments from pledging public assets as collateral against deals carried out with institutions other than the Bank. The Bank, for its part, lends against a sovereign guarantee only; it does not require collateral. The negative pledge clause is meant to deter countries that receive loans from the Bank from taking loans senior (given priority in repayment) to those extended by the Bank. The reasoning is that if the Bank allowed a borrowing country to pledge some of its assets to other lenders—creating a loan that was senior to that of the World Bank—the quality of that country's guarantee would be diluted, which would ultimately diminish the Bank's standing in the capital markets.

Though not stated explicitly, there is also an economic principle underlying this World Bank requirement. Namely, the World Bank extends loans to facilitate the implementation of an economic program designed for a particular country. To receive the Bank's funds, a country must take certain prerequisite actions and show its progress in certain reform areas. If a country could simply turn to other lending institutions for loans when it is averse to the conditionality imposed by the World Bank, the Bank would lose its ability to enforce program requirements. Establishing an equal and ratable (proportionally commensurate) position for any loans provided to the government by other institutions allows the World Bank to maintain a position of influence over the policy actions of a government.

This restriction does not affect transactions with private entities that can pledge nonpublic assets as collateral (and to which the Bank is proscribed from lending). Complications arise when an entity is quasi-private, that is, it is partially government-owned and run, and thus assets pledged by the entity are often at least partially government-owned. This is often the case for potential deals in the former Soviet Union, where virtually all assets were historically publicly owned, privatization is in its early phases, and the larger enterprises—especially those in the oil and gas industry—are mostly quasi-private or government-owned.[17]

Project finance deals in this region—if they entail pledging of public assets—have thus been limited by the World Bank pledge clause. Since it was realized that the pledge clause could impede private foreign investment inflows to this region, the Bank determined that a carefully worded waiver of this clause could continue to ensure its standing while enabling much-needed capital inflows. The basic premise of the waiver is that "if a project [in a country receiving a waiver] generates additional foreign exchange earnings, in excess of any debt servicing requirement, both the country and

[17] The World Bank defines public assets as "assets of an entity owned or controlled by, or operating for the account or benefit of a member country or subdivision." See "General Conditions Applicable to Loan and Guarantee Agreements," January 1, 1985.

its external creditors benefit." Thus in mid-December 1993, the World Bank Board approved a policy that allows for waiver of its pledge clause for countries meeting certain criteria.[18] The policy is designed to address financing needs of countries in transition to market-oriented economies, and applies almost exclusively to countries of the former Soviet Union since one of the necessary conditions for receiving a waiver is that a country's assets be at least 75 percent state-owned. A year-end 1993 World Bank document states the other conditions a country must meet to be eligible for a waiver.

Thus far, three countries of the former Soviet Union have applied for and received waivers of the pledge clause, including Russia, Uzbekistan, and Kazakhstan. Russia's receiving a waiver enabled the U.S. Export-Import Bank to implement its Oil and Gas Framework Agreement (discussed in Appendix B). A waiver was necessary since this agreement involves public assets of Russia being pledged as security for repayment. The security for repayment in this case is in the form of assignment of contracts for hard currency sales of oil produced by Russian production associations.

[18] The World Bank, "IBRD Negative Pledge Policy with Respect to Lending for Investment Projects," policy paper R93-199, December 14, 1993, p. 2. The negative pledge clause could be waived on a project-by-project basis prior to implementation of this new policy. The new policy allows a country that meets specific conditions to be granted a general waiver.

APPENDIX B.

THE OIL AND GAS FRAMEWORK AGREEMENT

The Oil and Gas Framework Agreement was signed in July 1993 by the U.S. Export-Import Bank to facilitate the export of U.S. oil and gas equipment, technology, and services to Russia. It is designed to assist Russian oil producers and refiners in revitalizing their existing operations, with the basic premise that this sector can serve as the engine of growth for the economy, boosting export revenues and facilitating continued industrial production.[19] At the same time, Ex-Im Bank must be able to meet its statutorily mandated requirement of finding reasonable assurance of repayment. Since the economic and political situation in Russia creates an environment of high risk for lending, Ex-Im is not looking to the sovereign guarantee of the Russian Federation, but instead relies on foreign exchange revenues generated by existing oil and gas production.[20]

This structure incorporates some elements of traditional project finance structures—in particular, a security arrangement involving the deposit of hard currency proceeds from the sale of oil into an off-shore collateral account. However, while the underlying assumption is that the exported equipment will increase production and revenue levels, transactions under the Framework Agreement are secured from the sale of existing oil and do not depend on expected revenue streams. Thus, under the Framework Agreement, Ex-Im bank is not actually taking the traditional "project" risk associated with project financing.[21]

[19] It is estimated that tens of billions of dollars in financing will be required simply to keep Russia's oil production at its current levels. As it is, oil production in this country has already dropped markedly over the past five years, declining almost 40 percent from 1988 levels of 11.4 million barrels per day to about 7 million barrels per day in 1993.

[20] The Framework Agreement was signed by Ex-Im Bank and the Ministry of Fuel and Energy, the Ministry of Finance and the Central Bank of Russia, and became operative in December 1993. This agreement provides assurances to Ex-Im Bank that the Russian government and the Central Bank will enable deals to go forward, and will monitor transactions once funds have been disbursed. "Handbook for Users of Financing Under Eximbank's Oil and Gas Framework Agreement," unpublished, February 1994.

[21] In December 1993, the Ex-Im Bank signed a project incentive agreement with the Russian Ministry of Finance and Central Bank, enabling the Bank's support of projects in Russia on the more traditional limited recourse project finance basis. This arrangement is designed to facilitate projects in all sectors in Russia, including the energy sector, and gives Ex-Im sufficient assurances regarding the legal and political environment to allow it to take the "project" risk.

APPENDIX C.

INFLUENCE OF INFRASTRUCTURE DEVELOPMENT ON GROWTH OF PROJECT FINANCE

The need for financing of infrastructure projects in emerging economies has driven the expansion of project finance capabilities of finance and credit institutions over the past three to five years. The IFC has estimated that developing economies are likely to spend greater than $200 billion a year during the 1990s to upgrade their infrastructure.[22] This includes power generation, transportation networks, and telecommunication linkages.

Infrastructure needs have been addressed historically by governments based on the premise that the state could minimize costs by providing services (such as waste management and electricity) on a large scale to the public. The economic rationale bolstering this viewpoint was that economies of scale would result in greater efficiency.[23] This kind of advantage can be gained in some situations, but recent analysis has shown that competition—even in infrastructure activities—tends to result in lower costs to consumers and more efficient management than government control allows.[24]

The amount of financing needed for infrastructure projects alone is so large that commercial and private institutions now involved in infrastructure development will not be able to meet the growing demand—particularly in emerging markets, where risks tend to be greater than those commercial banks would choose to cover.

Prospects for Private Infrastructure in Various Regions

(on an annual basis)

Asia	$75 billion
Latin America and the Caribbean	$36 billion
Eastern Europe and the Former Soviet Union	$28 billion
Africa	$ 5 billion
Middle East	$2–5 billion

Source: Everett J. Santos, International Finance Corporation, "International Infrastructure Projects: Innovative Financing Techniques," May 1993.

[22] Lecture by Everett J. Santos, Director of Investments at the International Finance Corporation, entitled "International Infrastructure Projects—Innovative Financing Techniques," presented at the American Conference Institute in New York, May 17–18, 1993.

[23] A good example might be a bus system owned by the municipal government that can service the whole city rather than each district having its own bus company. The former allows for one maintenance crew that can service all buses for the city—at a lower total cost than having separate maintenance crews for each district bus company.

[24] Everett J. Santos, "International Infrastructure Projects." This lecture discusses the three economic keystones that previously favored government financing and management of infrastructure projects—public goods, natural monopolies, and externalities—all of which are now considered inadequate reasons for maintaining government control. The report promotes competition among private entities to "protect consumer interests...[and promote] sustainable management and planning systems." For further discussion of this shift in economic perspective, see the written version of this lecture.

Infrastructure projects are, of course, only one area to which project finance is particularly suited. Thus multilateral institutions such as the World Bank, IFC, the European Bank for Reconstruction and Development, and the Asian Development Bank must position themselves to take on more of this kind of financing, and bilateral agencies such as Overseas Private Investment Corporation and Ex-Im Bank and other export credit agencies must retool to meet the growing demand.

TECHNICAL ASSISTANCE TOWARD RESTRUCTURING AND PRIVATIZATION IN CENTRAL AND EASTERN EUROPE

By George B. Assaf*

CONTENTS

SUMMARY

It has been nearly four years since the countries of Central and Eastern Europe began the unique and historic process of transformation from a command to a predominantly competitive market-based economic system. Two years ago the former Soviet Union made initial steps in the same direction. While real achievements have been made by most of the countries involved, the process has not yet delivered the hoped-for significant reorientation and restructuring of industrial structures and major improvements in economic performance and overall growth. In fact, the initial euphoria that characterized the early days of transformation has given way to guarded optimism and realization of the daunting challenges that are still to be met. While few experts and observers in the region would argue that the trend toward democracy and market-oriented economies is reversible in Central and Eastern Europe, most would admit that the process is going to be much more difficult, far more complex, and take far longer than they expected. And, recent events in the Russian Federation and the republics of the former Soviet Union have pointed out that the process of reform there is far from assured.

The first stage of the transformation prices—the macroeconomic reforms, comprising particularly early price liberalization and stabilization reforms—in many of the countries of the region appear

*Dr. George Assaf is Industrial Development Officer with the Europe Programme, Country Strategy and Programme Development Division, United Nations Industrial Development Organization (UNIDO). The views expressed in this paper are those of the author and do not necessarily reflect the views of the UNIDO secretariat. The author expresses his gratitude to Paul Wiedemann, Michael Davidsen, and especially Lech Kurowski for comments on a previous version of this paper.

to have been successful. But in all, this first stage of the transformation process has been accompanied by sharp drops in output, persistent medium level (the range of 20 percent) inflation, the emergence of budget deficits, and large increases in unemployment. And, the hoped-for overall regeneration of industry and achievement of industrial competitiveness has not yet taken place.

It is now clear that the success of the transformation of the region will depend on more than macroeconomic reforms. The regeneration of the industrial base, an essential element of a country's development, will require the development of an integrated macro-micro policy framework with concerted, enterprise-targeted policy measures and institutional and other support. Clearly too much was expected too soon of macroeconomic reforms across the region. There now must be a second phase of the transformation in which focus has to incorporate the removal of the rigidities at the micro level and greater integration of the macroeconomic framework with the microeconomic measures to induce an appropriate supply response. Key elements of this second phase of the transformation process will be privatization and private sector development and industrial restructuring. For this second phase to be successful, large-scale but targeted support from the international community will be required. So far, adequate support from the international community has not been forthcoming. This paper addresses the issues concerning the technical assistance needs of the region and the development of an appropriate international response.

THE CURRENT SITUATION

After two years of sharp economic contraction in Central and Eastern Europe (over 20 percent), 1992 saw a bottoming out of the drop in output in the former Czech and Slovak Federal Republic and Hungary, while Poland registered growth in its GDP estimated at 0.5–2.0 percent. In 1993 the upturn is expected to continue in Poland (2 percent) and begin in Hungary (0–3 percent) and the Czech Republic (1–3 percent).[1] Much of the economic fortunes of Hungary, Poland, and the Czech Republic will depend on the economic performance of Western Europe, particularly Germany, which is now moving into recession (GNP is expected to contract 1.5 to 2 percent in 1993). As a result of the split of the country and decreased trade, Slovakia will experience continued contraction (–3 percent). In Slovenia, the downturn is expected to bottom out this year.

Bulgaria and Romania continued to experience severe contractions in their economies in 1992 of 22 percent and 15.4 percent respectively. 1993 is expected to be more moderate, but the trend will continue to be downward. Albania is in a critical situation as the poorest country in Europe and will see little improvement without massive amounts of outside assistance.

The republics of the former Soviet Union have seen some of the sharpest drops in output and income across the region, especially the five Central Asian republics (Kazakhstan, Kyrgystan,

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[1] *Economic Survey of Europe 1992–93*, The Economic Commission for Europe, Geneva and New York, 1993, p. 3–2. Data for 1994 are not available at the time of writing and 1993 data and economic tendencies have yet to be confirmed. However, present indications are that 1994 data will largely confirm the expectations mentioned above.

Tajikistan, Turkmenistan, and Uzbekistan). While contractions in 1991 were more modest, inconsistencies in the reform program and the collapse of trade among the republics together with the unrestricted printing of rubles and extension of credits to failing enterprises led to sharp increases in the money supply, hyperinflation (an average of 1,750 percent for the year) and large drops in output in 1992 (18.5 percent for the Commonwealth of Independent States, CIS, as a whole).

The Baltic states too experienced a sharp contraction of economic activity in 1992, ranging from 28 percent in Estonia to 43.9 percent in Latvia. The ambitious transformation programs the three countries chose after declaring their independence in fall 1991 were constrained by the collapse of trade with the rest of the former Soviet Union, the unreliability of the supply and erratic increases in the price of Russian Federation oil and gas, upon which they are highly dependent. Of late, there have even been abrupt stoppages in energy supplies due to the somewhat strained relationship between the Baltic states and the Russian Federation.

The brunt of the recession has been borne by industry. Over the 1989–92 period, industrial output across the region as a whole declined more than 40 percent. In many of the countries, industrial output is now at 1975 levels or below.[2] It must be noted, however, that these figures might be somewhat overstated due to the undermeasurement of activity in the private sector.

Several factors have been cited as the cause of the fall in output across the region, including distorted economic structures inherited from the past, implementation of radical economic reforms and the collapse of trade between members of the Council for Mutual Economic Assistance (CMEA), in 1991 the loss of major input and output markets resulting from the disintegration of the Soviet Union, change to world energy prices or "dollarization" of prices and volatility of energy supply, tight monetary conditions leading to severe credit crunches across the region (particularly in Poland), and the shift in demand from domestic goods to Western imports. While these factors are important and have contributed to the collapse in output, individually none of them is a sufficient explanation for what has occurred. In fact, there are good grounds to believe that they have acted as a mask for more fundamental problems inherent to the region: micro-level rigidities and structural imbalances, particularly inefficiencies at the enterprise level, which have resulted in an anemic supply response to the incentives that should have been induced by macroeconomic reforms. It is now clear that macro reforms can do little by themselves for the industrial inadequacies such as those so characteristic of the command economies: lack of entrepreneurial skills and a thriving private sector, inadequate technology, a lack of managerial and supervisory personnel, and a shortage of financial institutions capable of ensuring the proper monitoring of enterprise performance. They also can do little to directly ensure adequate accounting, management information, and quality control systems. These are the real bottlenecks to the economic development of the countries of the region. Clearly micro-focused industrial policy closely coordinated to the macro re-

[2] Ibid., p. 3–7.

forms will be needed to attack these structural weaknesses at the industry and enterprise level. Without such coordination, the risk arises of throwing even the best enterprises into bankruptcy and causing severe economic disruptions.

The countries of the region need to develop economic governance. They need to build the institutions to support market reforms. This is the most difficult task they will have to do and will take the longest time. It must include development of a diversified and efficient financial sector with functioning capital markets; the development of an independent central bank; a broad-based system of taxation (probably a VAT and a consumption tax) as an alternative to dependence on the revenue generated by large state-owned enterprises, and good collection practices to limit tax avoidance. The countries also need to establish a broad-based stable legal framework with a long-term perspective to define, distribute, and adjudicate property rights.

In many countries bankruptcy laws need to be put in place or enforced in order to force insolvent enterprises to close rather than have the banks continue to roll over bad loans or the enterprises force borrowing from suppliers. Of course, the difficult social dislocations caused by closures must be directly addressed. Recent experience in the region shows that the failure to address these social issues has stalled and even derailed the transformation process. Nonetheless, to date, tight monetary conditions have not forced the efficient reallocation of resources because of these "soft budget constraints."[3] Only once they are tightened will enterprises have the incentive to become efficient and the second stage of reform have the desired results.

Without a secure legal framework, private enterprise cannot develop and foreign direct investment will not take place. There is also an urgent need to develop and upgrade physical and market infrastructure—ports, roads, transport systems, telecommunication systems—and networks of supporting services and intermediate product industries, to build up clusters of competitiveness and thereby attract foreign direct investment.

WHY ASSISTANCE?

Why should the industrialized countries lend assistance to the Central-East European and former Soviet Union region? Many will argue that technical assistance should be reserved for developing countries that are truly in need and not for countries such as the Russian Federation that possesses great mineral wealth. But, assistance to the Central-Eastern Europe and the former Soviet Union region may be as critical to the security of Eastern Europe as its defense capabilities were during the cold war period. The future of a good deal of the region, especially the Russian Federation, is now precariously balanced, not assured. It is clearly in the interest of the West that the reform process press forward and not reverse. All efforts should be made to remove the bottlenecks and facilitate a widespread distribution of the benefits of reform as quickly as possible in order to maintain public support and keep in

[3] See Martin Raiser, "Old Habits Die Hard, A Note on the Nature of the Crisis in Central Eastern Europe," *INTERECONOMICS*, July–August 1993.

check the political power of the vested interest groups that are trying or will try to reverse the reform process.

But most important, if aid is not given, and given quickly especially in the former Soviet Union, there is the risk of:

- Major political and social disruption;
- A reversal of the reform process;
- Local conflicts developing into larger wars and perhaps nuclear confrontation;
- Mass East to West migration.

Foreign assistance to the economies in transition can take several forms: balance-of-payments support aimed at removing hard currency constraints and financing critical imports; stabilization assistance geared toward stabilizing the exchange rate and foreign currency reserves; humanitarian assistance (food and medical emergency); and technical assistance which provides infrastructural support, institution development and capacity building, and, particularly, training and policy advice. It is this last form of assistance that will be a dominant requirement to properly support the second stage of the transformation process.

After 40 to 70 years of life under a command economy, there are few people in the region who have the skills required to implement the transition and political and economic reform. There had been little or no hands-on experience with Western business practices and methods before 1989. The economies of Central-Eastern Europe and the former Soviet Union were geared toward production, and all measures of success were based on quantities of output, not profit. Enterprises were large and overly integrated. And they were overstaffed. Entrepreneurship and innovation were not encouraged or rewarded. Risk taking and the acceptance of responsibility also were not rewarded by the system. And due to the organization of the economy and the political sensitivities, there was little in the way of support institutions to encourage private enterprise and lend support to entrepreneurs.

Because of the lack of these market-based economic skills and Western business experience, to compete effectively in the new environment regional managers and government officials overseeing the reform process will require massive amounts of know-how transfer (training and advice) as well as financial transfers. Know-how transfers can be achieved in two major ways: through foreign direct investment whereby the investor provides the know-how as well as the cash to an enterprise, and technical assistance from bilateral and multilateral donors.

Studies by several of the international financial institutions and individual development scholars have identified numerous needs in the region from policy advice on creating an environment conducive to free enterprise, to devising restructuring plans for individual enterprises. A conference of high-level Central-East European and former Soviet officials in Vienna in October 1992[4] and information

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[4] UNIDO, *Seminar on Industrial restructuring in East European Countries*, Final Report, Vienna, October 1992.

collected by the OECD Register,[5] which monitors East-European and former Soviet country requests for assistance and the efforts being made by donors, indicates that the countries themselves believe that such technical assistance is needed to help them devise and implement their reforms. The conclusions of participants in the Vienna seminar confirmed that there are four broad areas of need at the policy level:

- Overall policy advice on the concept and design of industrial policy in general—restructuring policies in particular, privatization strategies, and investment promotion issues.
- Assistance for the establishment of necessary institutions in executing the policies—including assistance to those few private sector organizations that do exist, setting up support systems for databases, market information, industrial statistics, and the establishment of a consulting mechanism between public and private sector associations.
- Assistance for the integration of environmental aspects into industrial policy.
- A wide range of training programs.

At the enterprise level the conference participants identified the following areas of need:

- Financial, production, operations, and physical restructuring.
- Programs for conversion of production from military to civilian uses.
- Domestic and foreign investment promotion activities.
- Identification and penetration of export markets.
- Provision of appropriate technologies including cleaner production, energy-efficient methods, and environmentally benign technologies.
- Training programs in market-based management techniques and tools.

Direct requests for assistance from UNIDO also confirm awareness of these needs. In the 1980s the majority of UNIDO assistance to the Central-East European and former Soviet Union region was the transfer of technology (67.9 percent) and training (17.3 percent). In the 1991–1993 period, however, there have been far fewer technical and operational projects, 7.6 percent, while investment promotion has risen from 4 percent to 7.2 percent. UNIDO has also seen a large jump in the number of requests for industrial restructuring projects, which now account for 56 percent of the dollar amount of assistance given and 46.1 percent of the number of projects undertaken. Most of these projects involve enterprise restructuring, 33.2 percent in dollar terms and 26.9 percent in the number of projects.

Reflecting the past structure of the region and political sensitivities, UNIDO has seen very few requests at the institutional level to date. As the transformation process progresses, however, the demand for institutional development support from UNIDO is expected to rise as it should for other providers as well.

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[5] OECD, *Overview of the Humanitarian and Technical Assistance to the Newly Independent States of the Former Soviet Union*, Paris, July 1993.

The OECD Register shows a similar pattern of needs to those indicated in the Vienna seminar. For the former Soviet countries, for example, assistance requests have been primarily aimed at the energy sector, enterprise restructuring and privatization, the design of comprehensive reforms, and the financial and food sectors. To date, the majority of assistance given to these same countries, according to the Register, has centered on nuclear safety and the energy sector, enterprise restructuring and privatization, food production and distribution, telecommunications and transportation, and the financial sector. Relatively little assistance is provided for health and the development of trade and investment.

ASSISTANCE IN THE SECOND STAGE OF TRANSFORMATION: THE INTEGRATED MICRO POLICY FRAMEWORK STAGE

The task ahead for the international community in helping Central-Eastern Europe and the former Soviet Union is great. Funds must be mobilized in an environment of recession in the Western driver economies of Germany, Japan, and the United States when budget makers are already being pressured by increasing deficits and other competing interests. Thus, it is vitally important that what limited funds are available be put to the most effective use and that assistance is coordinated and prioritized to limit duplication and waste.

In the context of the broader macroeconomic framework, donors also must reassess the focus of their programs to take into account the need for micro-level reforms. As noted, focus must now turn to this second stage of transformation and target the enterprise level, address the issue of distorted incentive structures, and create an environment in which private enterprise can flourish. Attention and efforts must therefore address the key issues of privatization, promotion of foreign direct investment and private enterprise, industrial restructuring, and the development of adequate social safety nets.

PRIVATIZATION

Privatization is a major instrument of the transformation, and particularly, the restructuring process. Indeed, one of the first reform tasks the Central-East European and former Soviet countries have undertaken is the redefinition of the role of the state and promotion of the private sector. For most, this involves the widespread transference of ownership from state to private hands. In the region, privatizing the economy also will mean the development of new small and medium-sized enterprises. Increasingly government will have to play the role of facilitator rather than regulator, and a more competent and skilled bureaucracy will be necessary.

On the policy level the issues to be addressed are not easy. What should be privatized? How fast? Should foreigners be allowed to participate? To what extent? How can the process be safeguarded from the nomenklatura to ensure that they cannot take unfair advantage of their positions to profit from transformation? To what extent should workers, management, and the general populace be allowed to participate? At what price?

Institutions to support the process must be developed and those regulating it (the state property agencies and ministries) will look to acquire the skills to do so properly. Support may also include public education programs to promote the process and lend it popular backing, and the design of public programs to ameliorate its negative effects.

At the enterprise level, the mechanics of privatization also must be understood. Proper enterprise valuations must be prepared and audits performed. Even for those enterprises that receive infusions of foreign management and know-how, enterprise directors and management must be trained in the workings of a market economy and its business methods and concepts. It also will be important to develop restructuring plans.

Although small-scale privatization—particularly in the retail and services sector (shops, restaurants and so on) appears to have progressed well—it is not without problems in many countries. In Lithuania, for example, the current failure of almost 50 percent of privatized businesses within six months of privatization might be alarming evidence of inadequate preparation of the privatization process in terms of the proper writing and evaluation of business plans, the vetting and even preparation of prospective buyers. Many countries are now being forced to consider how the privatized businesses will be run and by whom in order to ensure successful privatization.

In general there has been great disappointment in the speed with which the privatization of large enterprises is taking place in much of the region. In many cases, particularly in Poland, the privatization of large enterprises has been fraught with delays or has been side-tracked. Not only have there been political delays over such issues as who should be permitted to participate in the process, but part of the reason for the lack of speed has been the difficulty involved in readying large enterprises for the process. Performing adequate valuations and devising business plans have been particularly difficult. There is, therefore, a particular and pressing need for international assistance to kick-start the large-scale privatization process in terms of the policy framework and also the numerous instruments and types of privatization schemes (mass privatization vouchers, shares, public offering, financial intermediaries, and so on). Given the difficulties in privatizing large-scale state-owned enterprises, many will remain in the pubic sector for some time. Increasingly, the countries of the region are considering or taking action to increase the competitiveness and efficiency of state enterprises in the intermediate period before ultimate privatization. This has been done, apparently successfully in China's reform process. China has greatly increased the profitability and efficiency of these enterprises—usually without resorting to full-scale privatization—by gradually turning them into semi-private enterprises. The government has done this in a number of ways. It has introduced auctions for top managerial posts where potential candidates have to submit bids that promise minimum performance targets for the future. It has given state-owned enterprises greater autonomy over production decisions and allowed them to retain a greater proportion of the profits they generate.

Many countries also have to find a way to remove a major obstacle that prevents qualified domestic managers and entrepreneurs from participating in large-scale privatization due to lack of funds. A number of innovative approaches could be considered, none of which is perfect. Consideration could be given to auctions with cash and noncash bids.[6] These auctions would allow appropriately qualified entrepreneurs to bid cash and also promises of income from future profits. The problem here is how to evaluate the array of cash and noncash bids that will be presented. Clearly a committee with relevant expertise to vet bids—probably provided or certainly assisted by the international community—would be needed. In addition, leasing state-owned enterprises could be tried in some form.

In terms of the speed of the privatization process, it is important to stress that if the underlying institutional framework creates a competitive environment, the degree or speed with which privatization is carried out may not be critical. If the free entry and exit (working bankruptcy legislation) of firms is permitted, then a competitive environment can be established even if some large enterprises remain in state hands in the near term. However, it is important to point out that privatization is not the panacea of all ills. In a significant number of countries, privatization has yet to achieve the desired results. Among other things, this has occurred because privatization has not been properly incorporated into the broader framework of industrial restructuring and overall private sector development. Also, in many countries, privatization will require far more than the simple transfer of state-owned property to private entrepreneurs. Successful privatization is not merely change of ownership. The ultimate goal of privatization should be increased competition and efficiency. To ensure that there are long-term efficiency gains to an economy following privatization, it is important that past monopolistic privileges are not simply transferred to new owners. This will generally require the development of a competitive market environment with supporting institutions and infrastructure, the promotion of new businesses and entrepreneurship, and the creation of an appropriate and stable legal framework conducive to such activity. As mentioned earlier, the large-scale redundancies that may result from rehabilitation or privatization are key considerations that also must be addressed. Small- and medium-scale industries—both new and existing—may need to be promoted more vigorously to provide an outlet for redundant workers and a major source of job creation. In all of the above, the international community needs to build or strengthen its assistance.

THE ROLE OF FOREIGN DIRECT INVESTMENT

Privatization alone will not ensure the successful transformation of the economies of the region. Massive amounts of restructuring and new technology will be required. The savings of the region will not be enough to finance this, even when combined with the aid flows to the region. As a result, the promotion of foreign direct investment is given major attention by all the countries of the region.

[6] See Patrick Bolton and Gérard Roland, "Privatization Policies in Central and Eastern Europe," *Economic Policy* vol. 15 (October 1992), pp. 275–311.

Not only does foreign direct investment bring in the needed funds for purchasing new machinery and equipment and updated technology, it brings in the knowledge of the workings of a market economy and access to new markets. These are some of the most important elements required for the success of the region.

In response to the opening up of their economies since 1989, there has been a significant increase in the flow of investment to the Central-East European and former Soviet countries. Cumulative foreign direct investment in Hungary, the country to first initiate reforms encouraging foreign investment, reached $4.5 billion at the end of 1992, one-third of which was from the United States. Over the same period, the Czech Republic saw $1.59 billion invested; Slovakia, $229 million; Poland, close to $2 billion; Romania, $560 million; Bulgaria, $94 million; and Slovenia, $100 million. The republics of the former Soviet Union saw total foreign direct investment in the neighborhood of $9 billion, the majority of which has gone to the Russian Federation. If investment in the oil sector takes place as hoped, the Russian Federation could see $6 billion invested over the next ten years in that sector and Kazakhstan, a staggering $24 billion. In contrast, foreign direct investment to one developing country, Mexico, was $17 billion in 1991.[7]

The primary reason for foreign direct investment in Central-Eastern Europe and the former Soviet Union is to establish domestic market share. This is followed by tapping the regional market, low-cost sourcing, and tapping the European Union market.[8]

Recent studies by UNIDO and the Commission of the European Communities have found that potential investors to the region expect to face many obstacles and difficulties including a lack of both physical and service infrastructure, uncertain property rights, inadequate financial information on which to value a target enterprise, and a lack of sufficiently trained personnel.[9] But the most critical areas of concern are the economic and political outlook of the country for investment and the existing regulatory and legal framework, especially investment protection laws. Looking to establish a market share, investors are concerned about the prospects for growth, employment, inflation and the other factors that will effect domestic purchasing power and social unrest.

Quite expectedly, potential investors are also wary of political uncertainty and areas of potential turmoil or open hostilities.[10] And they look for a proper functioning, predictable and stable legal environment. Investors need the reassurance that their investments will be adequately protected by a legal framework that is sufficiently comprehensive and, most important, enforced. It is not just the presence or absence of relevant laws that are the key de-

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[7] United Nations Development Program (UNDP), Human Development Report 1992, p. 69.

[8] Economist Intelligence Unit (EIU), *Foreign Investment in Eastern Europe and the CIS*, 1993, London, 1993, Chap. 1.

[9] UNIDO, *Foreign Direct Investment in Central and Eastern European Countries*, PPD.210, 16 June 1992.

[10] Companies surveyed in the EIU study said their biggest concern about investing in the former Yugoslavia was political outlook. In contrast, it was ranked as the ninth (of eleven) greatest concerns for Hungary, which had experienced one-and-a-half years of a stable, democratically elected government at the time of the survey (July-August 1992). EIU, *Foreign Investment in Eastern Europe and the CIS*, London, 1993, Chap. 2.

terminants of investment, but rather how these laws are implemented and interpreted.

A further hindrance to foreign direct investment in the region is finding a suitable partner or target enterprise in which to invest. Most foreign investors in the region would like to join forces with a domestic entity when making their first investment in a country. Most are of the opinion that the local partner can bring a knowledge and expertise of the local environment to the venture that the foreign investor cannot easily provide. Locating a partner and assessing his financial position remains extremely difficult, however.

Several international agencies, especially UNIDO with its worldwide network of Investment Promotion Service (IPS) offices, are in the position to help the countries of this region promote inward investment flows as "honest brokers," neutral bridges between the technical, managerial, and financial resources of foreign investors and the development potential offered by the countries of the region.

Technical assistance also should be focused to help governments ensure that they have created an environment that is conducive to attracting investment by helping to strengthen or create the institutions necessary to support the process and assisting in the generation of specific investment opportunities. Assessments of the existing climate for investment and foreign perception of that climate can be taken and recommendations made of where governments should focus their attention and initiate change.

Assistance can be given to hold investment forums in which potential foreign investors are invited to review investment projects and negotiate directly with the local parties involved. Investment promotion forums provide a proven catalyst for foreign direct investment and help alleviate the often heard complaint of the difficulty of finding suitable partners in the region. Agencies can help in the preparation of project proposals and prescreen the various projects offered by the host country.

Foreign investment should not be the only concern, however. In the long run it is the domestic investor who will play the largest role in the process of transformation. Governments and the international agencies lending them support must also work to develop the domestic investor base. Capital markets must be created and encouraged and legislation put in place to encourage savings and investment by private individuals.

PROMOTION OF THE PRIVATE SECTOR

While foreign direct investment will play a crucial role in the transformation of these economies, it is only part of what is required. Most important, the development of the private sector, particularly in the form of small and medium enterprises, must be encouraged. The most important source of economic growth in the region is likely to be new businesses, especially small and medium-sized ones. Large-scale industries rely on smaller enterprises heavily for subcontracting networks and supplies of essential inputs and services. They also form the nucleus for future industrial growth since they are the most flexible and responsive sector to the external challenges in a changing market economy.

One of the major structural flaws of these former command economies is the lack of small and medium-sized enterprises and support industries on which large-scale industries rely, which are so prevalent in the West and in the Asian newly industrialized countries (NICs) and so important for building up competitiveness and attracting foreign direct investment. Development of small and medium-sized businesses is an important way to alleviate much of the dislocation and unemployment problems resulting from the transformation of the region. Such small and medium enterprises account for the majority of employment in developed economies, 70 percent of the employment in Western Europe, and 67 percent in Japan; they create 98 percent of all new jobs in the United States.[11]

Giving the private sector a lead role in industrial development must not be seen as requiring a minimal role for the state. On the contrary, it presupposes an efficient and competent government machinery with qualified capable staff to work closely with the private sector. In order for small and medium-sized businesses to develop and flourish, the macroeconomy must be in a state of relative stability, to the extent that interest and inflation rates and trade as well as foreign exchange policies are not causing distortions. The legal framework and tax and labor policies also must allow for the easy entry of new entrepreneurs and encourage their growth. Prices must be able to be freely set, and there must be free access to inputs, including imports. It is also important that infrastructure, especially telecommunications and banking services, be adequate. Governments of the region must carefully analyze existing legislation and policy and change it where necessary to see that it encourages and not hinders the development and success of small and medium enterprises.

Promoting the development of the private sector, particularly through the encouragement of small and medium enterprises, is one of the most important areas where international institutions and bilateral donors can play a role. International institutions such as UNIDO and the EBRD can offer critical help in the initial policy review by the governments of the region to help them assess existing legislation and policy and to develop a coherent strategy for the encouragement of small business growth. They can advise and support legislative, planning, and executive bodies in their efforts to develop a sustainable environment conducive to promoting the growth of small and medium enterprises by advising on the formulation and implementation of strategies to facilitate the access of these enterprises to financial, technical, and technological resources.

At the institutional level, agencies can support the development of both public and private sector institutions that promote entrepreneurship and small and medium enterprise development such as nongovernmental organizations (NGOs), trade associations, and ministries. At the enterprise level, they can aid in the encouragement of these enterprises through the enhancement of entrepreneurship and facilitating access to information and essential re-

[11] European Bank for Reconstruction and Development (EBRD), Paper for the closed session of the Board of Governors, "Small and Medium Enterprises," London, 14 April 1993.

sources (finance, marketing, and technology). Several agencies and donors are also in a position to provide valuable training assistance to entrepreneurs.

It is interesting to note that the EBRD has placed new emphasis on the encouragement of small and medium-sized enterprises. They consider themselves best suited to provide financial advice and assistance in locating financing, and make grants to local institutions to help defray the costs of technical assistance from outside consultants. This new emphasis by the EBRD presents a good potential for a fruitful partnership arrangement with other international institutions and NGOs.

RESTRUCTURING AND INDUSTRIAL REHABILITATION

Existing industry in Central-Eastern Europe and the former Soviet Union is currently facing severe difficulties. The transition from a command to a competitive market economy, and from regulated CMEA trade to liberalized trade and prices has resulted in many industries being cut off from traditional sources of raw materials and supplies, a loss of markets, and sharply declining domestic demand. Above all, the reduction or suspension of government subsidies, coupled with competition from imports, has revealed an extremely low level of product competitiveness and shortcomings in production processes and enterprise structures. Some industrial sub-sectors such as those that were primarily supplying goods to the CMEA markets have been particularly affected. The efforts to pave the way for industrial rehabilitation and recovery will require policy reforms, subsector restructuring programs, privatization, foreign direct investment, modernization of enterprises, technology and skill upgrading, and retraining in technical skills and management practices.

Whereas the choice of speed and sequence of required policy reforms has been the subject of great debate, there has been little disagreement about the need to support the restructuring process with specific measures and assistance. Without restructuring, many enterprises in the region will not be viable, and none of the countries in the region is in a position to absorb high levels of unemployment. Political stability in the region is too fragile to withstand the heightened social pressure that would result. At the same time, however, plant closure should be a part of an industrial rehabilitation strategy. Restructuring should avoid reestablishing previous conditions for inefficient production and establish instead a new basis for viable production and overall growth. Any restructuring strategy needs to combine an understanding of both macroeconomic forces (the policy and institutional environment) and the real problems at the enterprise level.

The region will want to approach its industrial restructuring at national, regional, and enterprise levels. A policy must be devised in each of the countries, tailored to its specific needs, to analyze the strengths and weaknesses of the existing structure of the industrial sector and employment patterns and target the encouragement of subsectors in which it has a comparative advantage. Consideration of the regional distribution of industry and employment as well as the encouragement of the distribution of the benefits of transformation on a more balanced geographical basis are being emphasized by those beginning the process.

Declining performance and eventual bankruptcy of some industrial enterprises are inherent features of a dynamic industrial development process. However, this also can be an indication of inadequate economic/industrial policies and other shortcomings in the economic environment or the result of abrupt changes in key parameters—such as the abrupt loss of input and output markets, and increases in the price of previously subsidized energy inputs—particularly in international markets. Introducing new industrial policy measures, drawing up special structural adjustment programs at the sectoral and subsectoral levels, and building up greater resilience in industry are among the major problems that many of the countries are addressing.

International organizations can help accelerate this process through support and advice at national and regional policy levels, helping to devise a "vision" of likely investment requirements and anticipated closures, and in aiding the establishment or strengthening of institutions.

Analytical country reports on the overall competitiveness and policy framework of the industrial sector can be prepared to identify subsectors in need of rehabilitation. This sectoral approach has been tried extensively in Poland. Subsector development prospects can be assessed and program proposals drawn, and programs can be developed for building up industrial services, including consulting and financing. An analysis of the human resource base can be made and training programs developed in the areas of skill shortage. Guidelines can be drawn to improve industrial standardization, quality control, technology development, and environmental protection to meet international requirements.

A word should be said about the relationship between restructuring, and privatization. Should privatization precede restructuring or vice versa? There is no universally applicable answer to this question. The answer will depend on the country, its stage of development and subsector or industry concerned, and most important, the individual enterprise in question. For example, in the Czech Republic and the former East Germany the approach is that there should be no restructuring prior to privatization, whereas Poland and some of the other Central-East European and former Soviet countries have generally recognized the need for some restructuring prior to privatization. However, there is now a growing consensus that organizational and operational restructuring should be left to new owners. By organizational restructuring it is meant that restructuring that focuses on the structure of enterprises, departments, internal hierarchies, manpower, and management structure. Operational restructuring refers to production processes, technology issues, sources of materials, products, marketing, and informational systems.[12] Nonetheless, individual enterprises may want assistance in devising plans for restructuring before privatization. In many cases, such preprivatization intervention will be necessary, if only to keep them going long enough to find a private in-

[12] See W. Richard Frederick, "Enterprise restructuring in the context of privatization: Background and Issues Paper," *OECD Advisory Group on Privatization*, Fourth Plenary Session, Prague, 29 September–1 October, 1993.

vestor. This preprivatization assistance generally includes legal restructuring (the transformation of state-owned enterprises into limited liability or joint stock companies), and creating viable core business units by breaking up combines and spinning off noncore activities or social services. In some cases, financial restructuring will be required in order to make an otherwise viable enterprise attractive to private investment. However, with the exception of former East Germany, this has been found too costly for most Central-East European and former Soviet states governments. Many enterprises would be viable were it not for heavy debt-servicing requirements. In countries where industries are highly vertically integrated, large monopolistic enterprises often will need to be split up, and horizontal specialization pursued prior to privatization. It is considerably more difficult to demonopolize or split up large enterprises and introduce the required structural changes after privatization than before it.

In several countries a focus on the specific problems of military conversion will also be appropriate and critical to their transformation, particularly the Russian Federation, Ukraine, and Slovakia.

Finally, the international community can assist the Central-East European and former Soviet states governments and their nascent private sectors by providing support for preprivatization restructuring activities to ascertain the commercial viability of enterprises, assess core assets, value assets, spin-off noncore assets at the enterprise level. These international institutions can also offer preprivatization intervention to restructure enterprises that will not be attractive to private investors in their current state. Useful postprivatization assistance can also be given, particularly in terms of training and capacity-building programs to strengthen the institutional framework and introduce cleaner, more environmentally harmonious and energy-efficient technologies. "Model restructurings" of selected enterprises can also be undertaken and the experience used to draw lessons for other similar enterprises that also need to be restructured. The dissemination of lessons learned can be accomplished through in-country restructuring workshops.

In the context of industrial restructuring, because of the past distribution of economic growth and investment, which neglected many regions and the closing of dominant facilities in other "one-enterprise" regions, Central-Eastern Europe and the former Soviet Union in particular is in need of appropriate regional development programs. Structural change in this region should be seen not only as a general problem of the given national economy but as a set of specific problems characteristic of the different regions within a country. It is expected, and indeed already becoming evident, that governments in the region will need to build up active regional development policies to support industrial restructuring and privatization. Indeed, many of the international donors are increasingly becoming involved in regional development programs and can assist in the encouragement of more balanced regional development in Central-Eastern Europe and the former Soviet Union by first conducting surveys of the current and required institutional and administrative framework for economic restructuring and development, and then preparing analyses of the resource base (including agricultural production for industrial development) as well as of the structure and performance of industry in individual regions/provinces to ascertain structural weaknesses, development prospects, and constraints. They also can assess the need for rehabilitating and modernizing industrial enterprises and identify industrial activities that need to be phased out, including a determination of the general technological status of current industry in terms of productivity, energy consumption, environmental effects, and so on, and the need to upgrade technologies. Increasingly, specific attention must be paid to the environmental and employment effects of restructuring.

On this basis, donors can be of assistance in identifying investment projects in connection with rehabilitation, modernization, and diversification of existing enterprises, and in identifying and facilitating investment in new opportunities for industrial activities. And, they can assess the existing and required institutional infrastructure and administrative framework for regional development, as well as assist in the design of appropriate institutional approaches (including possible industrial zones, "incubators," and science parks). They also can conduct studies to assess the viability of establishing and operating Regional Development Corporations. [13]

SOCIAL SAFETY NETS

One of the major accomplishments of the socialist system in Central-Eastern Europe and the former Soviet Unon was the relatively equal distribution of income (in the mid-1980s Eastern Europe as a region had a Gini co-efficient [14] of 25.4 versus 31.4 for Western Europe and 32.6 for the United States.) [15] Guaranteed employment and low-wage differentials were key reasons for this. The transition to a market economy—particularly widespread industrial restructuring—with high differentiation in wages and no job guarantees is certain to lead to a shift in income distribution. Open unemployment has already increased significantly, from an average across the region of zero, to an average close to 15 percent (excluding the former Soviet Union). There is also an alarming concentration of unemployment in particular regions and towns. For example, in Poland, regional differences in unemployment are considerable, with areas around Koszalin, Suwalki, and Olsztyn having unemployment rates of between 24–26 percent. Currently, the Northeast of the country suffers from a 22 percent unemployment rate. Also, many more people will be put out of work in the restructuring process as inefficient enterprises are allowed to go bankrupt and entire industries are found to be uneconomic when subsidies are removed. The uneven nature of the existing distribution of industry will make the effect of such closings even more disruptive. Certain segments of society will also be more vulnerable than others. Those

[13] UNIDO, *Toward Regional Developing in Central and Eastern Europe*, PPD.217, 19 February 1992.

[14] A Gini co-efficient is a measure of the relative degree of inequality in a country. Zero is total equality, 100 is total inequality.

[15] World Bank, *The Transformation of Economies in Central and Eastern Europe*, (Washington, D.C.: 1991), p. 53.

on fixed incomes are particularly hurt by rising prices; older workers will find it far harder to adjust to new work practices or develop new skills in what are the high job-growth areas of marketing and finance; and women and children will be effected as child care facilities, traditional at most Central-East European and former Soviet enterprises, come under the new heading of inefficient ancillary activities and are closed or spun-off into separate, fee-charging, enterprises.

The recent Russian, Lithuanian, and Polish election results may be to a significant extent a reflection of the growing social discontent caused by high unemployment rates. In order to prevent the widespread outbreak of social unrest, the governments of the region must attempt to redefine or build up the social safety net, unbundling the economic and social roles previously assigned to enterprises; equalize the distribution of the benefits of transformation; and protect those who are the most vulnerable to its adverse effects. A system of adequate social security, including unemployment insurance and old age and disability pensions, must be devised to replace the former social welfare system.

Several international institutions such as the International Labor Organization (ILO), United Nations Development Program (UNDP), and the World Bank are in a position to directly address the general problems of poverty and unemployment through development and support of social safety net programs. Others, such as the United Nations Industrial Development Organization (UNIDO) and the Organization for Economic Cooperation and Development (OECD), also can be of assistance by helping the governments of the region assess what the effects of industrial policy and transformation will be and devise a scheme to ameliorate the most negative ones. For example, industrial studies that identify enterprises to be restructured or closed could also identify groups of employees and geographic areas to be the most effected. From this, the need for retraining and job creation programs can be pinpointed.

Along with helping to identify the areas of need, technical assistance also can support the development of such institutions as retraining centers and technical schools. Support to new business development and small and medium-sized enterprise promotion will also help to create jobs for those displaced due to the transition. This may be the most important aspect for the success of the social safety net concept and ultimately for the success of the transformation process.

In fact, most of the areas in which donor organizations can offer assistance and support to the process of industrial development will help indirectly in the alleviation of poverty and the easing of the adverse effects of the transformation process.

The Problem of Financing Technical Assistance

It is often not recognized that a switch from capital to technical assistance may be more beneficial for the Central-East European and former Soviet Union countries at the present time.[16] At the same time, it is relatively easy to point out the critical need in the

[16] It should not also be forgotten that technical assistance also provides new opportunities for donor country consulting firms, private and commercial banks, not to mention law firms.

region for technical assistance from the international community, as evidenced by the requests received by the OECD Register, and requests directly to the various providers. It is, however, much more difficult to suggest where the money might be found to fund needed technical assistance. There are clearly limited resources available and a reluctance on the part of Western nations, many of which are facing recessions at home, to provide the necessary funds. But, as mentioned earlier, the nations of the West must recognize that it is in their own self-interest to help these countries and the challenge is to develop an immediate and substantial program of assistance. As reported by Mr. Michel Camdessus, Managing Director of the IMF to members of the U.S. Congress, the IMF is projecting an achievable growth rate for the states of the former CMEA of 4 percent in the medium term. This compares to a decline in income of 17 percent in 1991–92. To put this in perspective, if the rate had been achieved in the CMEA countries, it would have meant a global growth rate of almost 2 percent in 1992 instead of the actual rate of 1.4 percent. This is the equivalent of an annual income increase of $20 billion per annum. Thus the success of these countries before the end of the 1990s could make the difference between prosperity and recession in many regions of the world, particularly in the developing counties. And as noted earlier, without foreign assistance, the risk is run that the reform process will halt if not reverse with severe consequences to global security, income, trade growth, migration, unemployment, and political instability.

Besides a limited amount of funding available due to the existing recessions in many of the major Western economies, there has not been a good match between the assistance demanded and the assistance offered. For example, the OECD Register points out that for the six former Soviet republics for which they have information on requests, technical assistance requests total $412 million while assistance offered totals only $274 million. In addition to this shortfall, there has been a problem in the coordination of efforts. The Register shows that donors are not providing $189 million in aid in particular areas requested, while in other areas they are offering $56 million more than the recipient countries themselves estimate they need to implement reforms.

It is thus important not only to find new sources and methods for financing the assistance needed, but to use what is offered as effectively as possible. Assistance must be tailored to the individual needs and stage of transformation in each of the countries. Some donors are taking a "regional" approach to their assistance programs and are viewing the Central-Eastern European and former Soviet Union region as one unit. While this may be a good approach for some problems such as environmental damage, it can be a problem for others. Within such broad regional frameworks, it is extremely important that individual country strategies are considered.

As pointed out in the OECD Register, it is also critical that donor countries and institutions coordinate their activity. With the needs of the region so much greater than the funds available, it is important not to allow continued overlap and duplication. Donors need to create a workable coordinating body within the framework of the G–7 and the broader G–24 that will track country assistance needs and target assistance offered, and, importantly, evaluate and monitor assistance programs. The existing OECD Register and the establishment of a G–7/G–24 policy committee could form the framework for essential coordination. This body could work closely with the recipient governments to assess their needs and develop individual country strategies which funding would then be targeted to meet.

As the Institute for East-West Studies argued in its important 1990 paper,[17] there also may be a need for a body made up of recipients and donors (bilateral and multilateral agencies) on a full partnership basis that would strengthen coordination and enhance and deepen Western assistance to the region. Such a body might be chaired by the EU, as the largest donor to the region, and receive support from the existing G–24 Coordination Unit or a reformulated G–7/G–24 policy committee. Such a body would operate in the same manner as the Organization for European Economic Cooperation in implementing the Marshall Plan and thus:

- Coordinate, manage, and target assistance.
- Make recommendations to improving assistance procedures.
- Coordinate assistance with the national reform programs.
- Help to mobilize resources.
- Maintain a comprehensive database of assistance needs, disbursements, and effectiveness.

Under such a coordinated program as suggested above, the various aid agencies and international financial institutions would have particular areas of concentration in their assistance. For example, the IMF would be primarily responsible for balance-of-payments and exchange rate stabilization policies. The World Bank would focus on enterprise restructuring and the EBRD on developing Enterprise Restructuring Funds, based on the U.S. Enterprise Fund model, small and medium enterprise promotion, and private sector development. The UN too would play a role with each of its agencies concentrating on particular areas of concern such as UNIDO offering advisory services on industrial policy development and industrial restructuring and providing subsector technical expertise; the ILO providing training and human resource development; United Nations Conference on Trade and Development (UNCTAD) advising in the area of trade policy and the OECD, World Bank, United Nations Environment Program (UNEP), UNIDO, United Nations Economic Commission for Europe (UNECE), and World Health Organization (WHO) addressing environmental issues as proposed in the recent Environmental Action Program for Eastern Europe.

In order to ensure a minimum waste of funds, conditionality criteria should be established and each country's meeting of those criteria closely monitored. If any country gets too far away from its goals, assistance is then discontinued until the reform process is back on track.

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[17] Institute for East-West Studies, European Studies Center, "Beyond Assistance: Report of the IEWS Task Force on Western Assistance to Transition in the Czech and Slovak Federal Republic, Hungary and Poland," May 1992, pp. 67–68.

CONCLUSION

The major challenge facing the countries of East-Central Europe and the international community is how to sustain moves toward democracy and at the same time design and successfully implement an economic reform program. The reform program should accelerate transformation to a market economy but avoid being undermined by economic and political problems due to the failure of the microeconomy to respond swiftly and appropriately to the large-scale macroeconomic changes taking place. The road ahead for the Central and East European countries is uncertain and precarious, but with greater commitment from the countries themselves and support from the international community, the transformation to democratic market economies with viable competitive structures can be realized.

INVESTMENT NEEDS AND FINANCIAL FLOWS

By Harvey Shapiro *

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TABLES

SUMMARY

When the communist regimes were turned out of office in 1989 questions immediately arose regarding what kind of assistance was required to transform these economies systemically into market directed systems. Some argued that the Eastern European needs were more technical than financial. Nonetheless, Eastern European expectations of Western financial flows were high.

Western governments reacted quickly to the 1989 "revolutions" and by May 1990 the G–24 had made aid commitments totaling $8.5 billion to Hungary and Poland. By the end of 1992, the total had increased to $37.4 billion and three countries (Bulgaria, Czechoslovakia, and Romania) were added to the list of recipients. However, despite the euphoria over the ending of the cold war, Western governments, facing competing domestic and foreign demands for their resources, failed to provide the full amount of fi-

*Harvey Shapiro is Director, Eurasia Service, The WEFA Group.

nancing they had initially promised. In fact, there was a net outflow as Eastern European debt service payments exceeded G–24 disbursements.

In contrast, the new flow of funds from the International Monetary Fund, the World Bank, and the European Bank for Reconstruction and Development was positive, in part because there were negligible debt service payments during this period. But the flows were constrained somewhat because of difficulties the Eastern European governments encountered in negotiating reform programs that satisfied IMF requirements and in adhering to the targets in them. The annual flow of foreign direct investment began to grow rapidly after 1991, largely to Czechoslovakia, Hungary, and Poland.

The headway that these countries have made combined with the relatively modest amount of financial assistance they received again poses the question of the relative significance of these flows in the transformation process.

INTRODUCTION

The revolutions of 1989 turned the communist regimes in Eastern Europe out of power and ended the intense ideological conflict between competing economic and political systems that had been taking place during much of the twentieth century. The economic situation in each of the Eastern European countries was largely responsible for the unexpected political implosion that occurred. There was little economic growth in the region, and in one country, Poland, per capita income in 1989 ($1,890) was more than 9 percent lower than it was five years earlier.[1] Poor economic performance reinforced the beliefs throughout the area that centrally planned economies could not function satisfactorily and that the only alternative was to move to a market-directed system. The overriding issue was how to bring about the change.

The efforts to transform the Eastern European economies that essentially began in 1990 with the Polish "big bang" approach were unprecedented.[2] While considerable experience had been accumulated since 1917 on how to convert from a "capitalist" to a socialist economic system, there was neither an existing body of knowledge based on accumulated experience nor a developed body of thought to provide guidance on moving in the other direction. However, there appeared to be a consensus on one aspect of the effort, namely that it would require Western economic assistance. This view was reflected in a Library of Congress report that noted "most experts agree that Western support will be extremely helpful, if not essential, if the Eastern European countries are to succeed in their transitions from centrally planned to market economies."[3]

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[1] The World Bank, *Historically Planned Economies, A Guide to the Data, 1993 Edition* (Washington, D.C.), December 1993, pp. 188–189.

[2] Hungary had been experimenting with economic reform since 1968 when it began implementing its "New Economic Mechanism." The efforts were piecemeal and halting and, until the mid-1980s, the reforms were directed more toward making the socialist system function better than toward altering its basic nature.

[3] Francis T. Miko, Karen Donfried, and Curt Tarnoff, *Eastern Europe: U.S. and International Assistance from 1989 to 1992*, Congressional Research Service, Library of Congress, CRS Report 92–801 F, October 30, 1992.

INVESTMENT NEEDS

Questions immediately arose regarding what kind of assistance these countries needed. The region is industrialized and, although income levels were lower than in the West, they were above most of those in the Third World. Its problems did not appear to arise out of a shortage of saving and investment. In fact, "Historical rates of saving and investment in the region are not low by international standards."[4] In 1986 the savings and investment rate (as a percentage of GDP) in Hungary, Poland, and Yugoslavia averaged 31.7 percent and 31.0 percent, respectively. The comparable figures for industrial countries (20.7 percent and 19.9 percent, respectively) and developing countries (24.0 percent and 23.0 percent, respectively) were substantially lower.[5]

The economic malaise found in Eastern Europe had its roots in decades of resource misallocation that resulted in shortages of consumer goods, decaying infrastructure, and environmental deterioration. This line of thought suggested that the Eastern European needs were more technical than financial. Nonetheless, Eastern European expectations of Western financial flows were high.

INITIAL RESULTS

In part, Eastern European hopes for financial assistance were probably kindled by the prompt reaction of the United States to the revolutionary changes that occurred in 1989. President Bush quickly scheduled a trip to Poland and Hungary and, during his July 1989 visit, announced aid programs for both countries, including $125 millon in private enterprise funds and other assistance. One month later, bills were introduced in the Congress to increase aid authorizations to $1.2 billion over the next three years. The FY1990 Appropriation Act (P.L. 101–167) provided a total of $658.9 million for various economic assistance programs for Poland and Hungary. This was followed by The Support for East European Democracy (SEED) Act (P.L. 101–179), which authorized $930 million for FY1990-FY1992. And, on December 27, 1989, President Bush announced that the United States was providing $500,000 in emergency aid to Romania through the International Red Cross and an airlift to provide medical supplies worth $250,000.

The 1989 Economic Summit took place in Paris in July immediately after President Bush's trip to Poland and Hungary. Afterward other bilateral and multinational assistance programs were announced for Eastern Europe. By May 1990, less than one year after Poland became the first Soviet bloc country to hold a free election of a noncommunist legislature, the G–24 governments reported aid commitments totaling $8.5 billion for Poland and Hungary.[6] Five countries: Germany ($2.885 billion), Japan ($1.403 billion), the United States ($675 million), Italy ($657 million), and France ($581 million) accounted for nearly 73 percent of the total amount that had been committed. Grants and loans ($3.601 billion)

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[4] *Financing Eastern Europe, A Study Group Report*, (Washington, D.C.: The Group of Thirty), 1991, p. 12.

[5] Ibid., p. 12.

[6] United States General Accounting Office, *Eastern Europe, Donor Assistance and Reform Efforts*, Report to the Chairman, Committee on Foreign Relations, U.S. Senate, and Committee on Foreign Affairs, House of Representatives, November 1990, p. 13.

and export credits and project loans ($3.936 billion) accounted for more than 88 percent of the total.

SUBSEQUENT DEVELOPMENTS

More than four years have passed since the communist regimes were removed from office. They have been difficult years. Output has fallen sharply, unemployment has grown rapidly, and inflation has remained high in all countries regardless of whether they followed the Polish example and adopted the "big bang" (i.e., shock therapy) approach or chose to proceed at a slower pace (Table 1). Furthermore, two countries, Czechoslovakia and Yugoslavia, cease to exist. Czechoslovakia has evolved peacefully into two countries, the Czech Republic and the Slovak Republic, while a civil war erupted in Yugoslavia in June 1991 as the country fragmented. Yet at the end of the period there were some grounds for optimism. GDP has increased in Poland, the Czech Republic, and Romania; unemployment has declined (albeit marginally) in Hungary; and, except in Romania, the rate of inflation is declining.

Except for Yugoslavia, the economic difficulties that were experienced throughout the region were cushioned in varying degrees by Western financial flows. Western economic aid and investment flows to Yugoslavia were impeded by the civil war and internationally imposed sanctions.[7]

GOVERNMENTAL ASSISTANCE

Commitments

The increase in financial commitments provided by the G–24 since their initial burst of enthusiasm for Poland and Hungary has been modest. By the end of December 1992, the total increased to $37.4 billion, including $14.9 billion in grants,[8] despite the addition of three more countries (Bulgaria, Czechoslovakia, and Romania) to the list of recipients.

Six countries accounted for almost 75 percent of the total (Germany, $10.7 billion; U.S., $7.1 billion; Japan, $3.2 billion; France, $2.3 billion; Canada, $2.3 billion; and Austria, $2.3 billion). Nearly $11.6 billion, or about 41.6 percent of the assistance provided by these six countries, was grant aid. The proportion of grants to the total aid provided by each of the G–24 members ranged between 79.1 percent (Denmark) and none (Portugal).

In contrast to these commitments, Eastern Germany actually received public transfers from the Federal Republic of Germany of DM140 million (including DM75 million from the German Federal

[7] On November 8, 1991, economic sanctions were applied to Yugoslavia during the EC summit in Rome. On December 8, 1991, the EC foreign ministers limited them to Serbia and Montenegro. The sanctions included suspending the EC agreement with Yugoslavia on trade cooperation, dropping Yugoslavia's name from the general list of preferences, and suspending Yugoslavia's participation in the PHARE (Economic Reconstruction Aid for Poland and Hungary) program.

On May 27, 1992, the EC imposed a trade embargo on Yugoslavia. Three days later, the U.N. Security Council adopted similar sanctions. The Security Council tightened the sanctions on April 17, 1993, when, among other actions, they froze Yugoslav financial assets held abroad; impounded all Yugoslav trucks, vessels, aircraft, and rolling stock found abroad; and prohibited the shipment of goods to or through Yugoslavia (except for humanitarian supplies).

[8] OECD, April 1993 G–24 Scoreboard.

TABLE 1. Output, Unemployment, and Consumer Prices in Eastern Europe, 1990–1993

Country and Measures	1990	1991	1992	1993[a]
Bulgaria				
GDP (% change)	–10.7	–16.7	–7.7	–7.5
Unemployment, December (%)	1.6	11.9	15.6	16.4
Consumer Prices (% change)	70.4	405.0	79.5	63.9
Czechoslovakia				
GDP (% change)	–1.1	–15.9	–7.1	[b]
Unemployment, December (%)	1.0	6.6	5.1	[b]
Consumer Prices (% change)	10.0	57.9	10.8	[b]
Hungary				
GDP (% change)	–4.3	–10.2	–4.5	–1.0
Unemployment, December (%)	1.7	7.5	12.3	12.1
Consumer Prices (% change)	28.9	35.0	23.0	22.5
Poland				
GDP (% change)	–11.7	–7.8	1.5	4.0
Unemployment, December (%)	6.1	11.4	13.6	15.7
Consumer Prices (% change)	585.8	70.3	44.3	37.6
Romania				
GDP (% change)	–7.5	–13.7	–15.4	1.0
Unemployment, December (%)	[c]	4.8	9.6	10.2
Consumer Prices (% change)	5.1	165.5	211.2	295.4

Sources: Various official sources.
[a] Preliminary estimates.
[b] Czechoslovakia ceased to exist at midnight, December 31, 1992.
[c] The government first began collecting unemployment statistics in July 1991.

government and DM25 million from the German Federal Labor Office) in 1991 and DM152 million (including DM89 million from the federal government and DM24 million for the Federal Labor Office) in 1992.[9]

Debt Relief

The G–24 total included more than $10 billion in debt relief which Poland and Bulgaria obtained from the Paris Club. In March 1991, Poland and its Paris Club creditors agreed to a two-stage plan that would cut in half Poland's outstanding debt obligations to Western governments (about $28 billion in 1990). During the first three years there would be a 30 percent reduction in the net present value, including an 80 percent reduction in interest payments. Another 20 percent would be written off in the fourth year upon successful completion of the IMF Extended Fund Facility program, which was approved in April 1991. The United States, unilaterally, went further and provided additional debt relief that, upon final implementation, would result in "an overall debt reduction of 70 percent in real terms of the original principal."[10]

Bulgaria unilaterally suspended debt service payments to its Western creditors in March 1990. On April 17, 1991, Bulgaria's

[9] Deutsche Bundesbank preliminary estimates.
[10] *International Finance*, Annual Report of the Chairman of the National Advisory Council on International Monetary and Financial Policies to the President and to the Congress for Fiscal Year 1991, p. 20.

TABLE 2. Net Public and Publicly Guaranteed Private Loan Disbursements, 1990–1992

(Millions of Dollars)

Country and Measures	1990	1991	1992	Total
Bulgaria				
Disbursements	35	9	–21	23
Guarantees	–47	30	–41	–58
Net flows	–12	39	–62	–35
Czechoslovakia				
Disbursements	–40	31	281	272
Guarantees	891	12	–761	142
Net flows	851	43	–480	414
Hungary				
Disbursements	–4	334	91	421
Guarantees	–457	–297	–685	–1,439
Net flows	–461	37	–594	–1,018
Poland				
Disbursements	–87	–91	–80	–258
Guarantees	–18	223	21	226
Net flows	–105	132	–59	–32
Romania				
Disbursements	19	44	198	261
Guarantees	7	31	126	164
Net flows	26	75	324	425
Net flows for 1990–1992	299	326	–871	–246

Source: The World Bank, *World Debt Tables, 1993–1994*, vol. 2, Washington, D.C., 1994.

Paris Club creditors agreed to reschedule 100 percent of medium- and long-term principle and interest payments falling due between April 1, 1991, and March 31, 1992, as well as existing arrearages on medium- and long-term debt as of March 31, 1991, over ten years, including a six-year grace period. They also rescheduled 75 percent of Bulgaria's short-term debts. These debts are to be repaid over a six-year period beginning September 30, 1992.[11]

Loan Disbursements

As Table 2 indicates, actual official bilateral assistance fell far short of commitments during this period as direct and indirect (i.e., private loans with government guarantees) loan disbursements (both net of repayments) fell far short of commitments during this period. In fact, there was a net outflow from Eastern Europe to the West. In Bulgaria, Poland, and Hungary the cumulative net flows were negative because of the amortization of previous loans. In the final year shown in the table (1992), only Romania was a net recipient of Western official and officially guaranteed loans.[12]

[11] On December 14, 1992, the Paris Club creditors agreed to reschedule Bulgaria's 1992 debt service obligations to them for 10 years including a six-year grace period. The Bulgarian Parliament ratified this agreement in July 1993.

[12] These figures do not include Eastern European interest payments and therefore overstate the net financial flows to the region.

IMF FINANCING

Each member of the IMF has a quota, expressed in Special Drawing Rights (SDRs), which determines the limits of its ability to "borrow" from the Fund. The Fund lends money to member countries to meet balance-of-payments needs by selling the currencies of other members or SDRs to the borrowers in exchange for their own currencies. Members must subsequently repay these loans by repurchasing their currencies with the currencies of other members or SDRs.

TABLE 3. Net Use of IMF Credit, 1990–1992

(Millions of Dollars)

Country	1990	1991	1992	Total
Bulgaria	0	396	197	593
Czechoslovakia	0	1,256	287	1,543
Hungary	–157	887	–6	724
Poland	485	327	0	812
Romania	0	774	261	1,035
Total	328	3,640	739	4,707

Source: The World Bank, *World Debt Tables, 1993–1994*, vol. 2 (Washington, D.C.), 1994.

There are two Fund "facilities" that member countries can draw upon for general balance-of-payments financing (i.e., the credit tranche and the extended fund facilities) and several others for specific purposes (e.g., the Compensatory and Contingency Financing Facility, the Buffer Stock Financing Facility, the Supplementary Financing Facility, etc.).[13] The two general balance-of-payments facilities are subject to an annual limit of 68 percent of quota and a cumulative limit of 300 percent of quota net of scheduled repurchases. Purchases under the compensatory and buffer stock facilities are excluded from these limits. Member countries must repurchase their currencies that were sold to the Fund under credit tranche drawings within three to five years and within four and a half to ten years under the extended fund facility.

During the 1990–1992 period the five Eastern European countries listed in Table 3 made extensive use of the IMF's financing facilities, obtaining $4.7 billion as a result of purchases totaling $5.6 billion and repurchases of $0.9 billion. Hungary ($0.7 billion) and Romania ($0.2 billion) accounted for nearly all of the repurchases.

Poland, Hungary, and Romania were not able to fully utilize credits that had been approved because of difficulties in meeting performance targets under IMF standby arrangements. In 1992 the Fund suspended a three-year, SDR1,114 million extended arrangement facility it had approved for Hungary on February 20, 1991,

[13] The compensatory and contingency financing facility provides financing to member countries, especially primary producing countries experiencing balance-of-payments problems because of export shortfalls that are temporary and due to factors largely beyond the country's control. It also provides contingency financing for Fund-approved adjustment programs. The buffer stock facility was established to help members finance buffer stocks of primary products. The supplemental financing facility provides assistance to members facing balance-of-payments problems that are large in relation to their economies and Fund quotas.

because the government failed to meet the mutually agreed budget target. The unused balance totaled SDR556.77 million. Similarly, Poland also lost its IMF programs in 1991 and 1992 because of its inability to meet budget deficit targets. By the end of February Poland had drawn only SDR76.5 million from the three-year SDR1,224 million extended fund facility that had been approved on April 18, 1991. On March 8, 1993, the Executive Directors of the IMF approved a one-year SDR476 million standby for Poland. None of the funds had been drawn by the end of the year. Finally, Romania lost the last SDR52.34 million of a one-year SDR314.04 million standby that expired in April 1993 because of failure to meet performance targets.

There have also been delays in obtaining IMF assistance because of delays both in negotiating reform programs (i.e., performance targets) that are acceptable to both parties and in subsequently obtaining the necessary approvals from parliaments and the Executive Directors of the IMF. For example, Romanian negotiations with the IMF regarding a new standby agreement were broken off in July 1993, reportedly because of unresolved differences regarding the budget deficit and interest and exchange rates. They were resumed later in the year and a Memorandum of Agreement was signed in December. The Parliament had not acted by the end of January 1994.

WORLD BANK LENDING

Between 1990 and 1992 the World Bank disbursed $2.4 billion in nonconcessional loans to the five Eastern European countries listed in Table 4. The majority of the disbursements took place in the last two years as loans began to emerge from the pipeline. Typically it takes about 33 months for the Bank to identify, process, and have its Executive Directors approve a prospective loan before disbursements can begin. And, on average, it takes six to nine years to issue the funds for a project.[14]

TABLE 4. IBRD Loan Disbursements in Eastern Europe, 1990–1992

(Millions of Dollars)

Country	1990	1991	1992	Total
Bulgaria	0	58	92	150
Former Czechoslovakia	0	200	131	331
Hungary	268	397	317	982
Poland	54	349	343	746
Romania	0	3	211	214
Total	322	1,007	1,094	2,423

Source: The World Bank, *World Debt Tables, 1993–1994*, vol. 2, (Washington, D.C.), 1994.

In 1990 only Hungary and Romania had been members of the World Bank for more than six years and had begun repaying old loans. During this three-year period Hungary repaid $367 million.

[14] The World Bank, *The World Bank and International Finance Corporation* (Washington, D.C.), April 1986, p. 35.

In contrast, Romania did not make any repayments because it had few outstanding debt obligations in 1990. In 1984, Romanian President Nicolae Ceausescu cancelled an IMF standby arrangement because he found the conditions accompanying it intolerable and vowed to pay off Romania's external debt as quickly as possible to eliminate what he believed to be unwarranted foreign interference in the country's internal affairs. He largely succeeded before he was overthrown and executed in December 1989. (Romania's long-term foreign debt declined from $5.7 billion in 1985 to $0.2 billion in 1989.)[15]

The Bank has also delayed scheduled disbursements for Romania. In July 1993 it withheld the last tranche ($150 million) of a $400 million structural adjustment loan because of Romania's failure to meet reform pledges. The Bank will release the funds when the Parliament approves the terms of a new standby agreement (see above).

THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

The EBRD "is the first *post-cold war* institution; the first international institution created after—and indeed as a result of—the end of the cold war."[16] According to the institution's first president, the EBRD was created very quickly, in less than a year, because there was an urgent need to help the Eastern European countries "in their transition to democracy, the market economy and social justice."[17] It began operations in 1991.

Operations began slowly, with only 14 projects being approved in 1991, and then accelerated to 51 projects in 1992, the first full year of operations. The number of projects approved in 1993 was nearly 78 percent larger than in the previous year and the financing committed to them nearly doubled, to ECU1.8 billion. (About 21 percent of the projects and 31 percent of the bank's commitments during this period were for the republics of the former Soviet Union.)

Between June 25, 1991, when the first project was approved and December 31, 1993, the EBRD approved a total of 156 projects and committed ECU2.8 billion (about $2.5 billion) to them (Table 5). However, only ECU0.6 billion (about $0.6 billion), or nearly 20 percent of the funds the bank committed were actually disbursed during this 31-month period.

PRIVATE INVESTMENT

After a slow start, private foreign investment flows to Eastern Europe began to accelerate, growing from $0.4 billion in 1990 to $3.4 billion in 1992 (Table 6). The total for the three-year period exceeded $6.3 billion.

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[15] The World Bank, *World Debt Tables, 1993–1994*, vol. 2, (Washington, D.C.), 1994, p. 374.

[16] Speech by Jacques Attali, the President of the European Bank for Reconstruction and Development, at the September 22, 1990, meeting of the Bretton Woods Committee in Washington, D.C.

[17] Attali, ibid.

Direct Investment

The investment funds were not uniformly distributed among the countries in the region. Nearly 97 percent of the total went to Czechoslovakia, Hungary, and Poland.

TABLE 5. EBRD Commitments and Disbursements, 1991–1993[a]

Item	1991[b]	1992	1993	Total
New projects approved (Number)	14	51	91	156
Financing approved (ECU million)	406	1,094	2,276	3,776
Financing committed (ECU million)	86	946	1,794	2,826
Financing disbursed (ECU million)	0	122	435	557

Source: EBRD announcement, March 9, 1994.
[a] These figures include 32 projects in the republics of the former Soviet Union with commitments totaling ECU897.96 million.
[b] Nine months of operations.

Foreign investors were undoubtedly attracted to these countries by their promising economic prospects. Significantly, these are also the countries that moved quickly to implement stabilization and systemic transformation programs. Poland in 1990 and Czechoslovakia in 1991 adopted the "big bang" approach. Hungary started three years before Poland and moved somewhat slower but essentially followed the same approach.[18]

Foreign investors may have been deterred from investing in Bulgaria and Romania by the unstable political conditions in both countries. Bulgaria is currently governed by a minority nonpartisan government that is supported by the party representing the country's ethnic Turks and the post-communist party. It survived four votes of no-confidence in the Parliament in 1993. The Romanian government is headed by a former communist official who has to cope with a militant labor force that has already forced one prime minister out of office. In contrast, foreign investors do not appear to have been discouraged by the unstable political situation in Poland.[19]

Similarly, foreign investors may have been deterred by the civil war in Yugoslavia and the possibility that it could involve the neighboring countries. It has already adversely affected their economies. In May 1993, the Bulgarians estimated that the U.N. sanctions had cost them $1.8 billion since they were imposed and would cost another $1.9 billion during the remainder of the year. At the end of June, the Hungarians announced that they had suffered $645 million in foreign trade losses, additional transit costs,

[18] In 1987 Hungary embarked upon a three-year program that included significant structural reforms progressively liberalizing the domestic price system, expanding the scope for private enterprise, and reforming the tax and banking systems. In January 1990 77 percent of consumer prices and 75 percent of producer prices were set free.

[19] Poland has had six prime ministers (including Waldemar Pawlak, who was in office on two separate occasions), five governments, four national elections, and two presidents since the communists were turned out of office in 1989.

and foregone transit revenues as well as tens of millions in ecological damage from increased road traffic. There was a reported $1.3 billion in direct losses and $7.6 billion in indirect losses from lost import and export contracts, services, import taxes, and tourism. Nonetheless, Hungary was the largest recipient of foreign investment in the region.

TABLE 6. Foreign Direct and Portfolio Investment in Eastern Europe, 1990–1992

(Millions of Dollars)

Country and measures	1990	1991	1992	Total
Bulgaria				
FDI (net)	4	56	42	102
Portfolio	0	0	0	0
Czechoslovakia				
FDI (net)	207	600	1,103	1,910
Portfolio	0	0	31	31
Hungary				
FDI (net)	0	1,462	1,479	2,941
Portfolio	150	0	34	184
Poland				
FDI (net)	89	291	678	1,058
Portfolio	0	0	0	0
Romania				
FDI (net)	0	40	77	117
Portfolio	0	0	0	0
Totals				
FDI (net)	300	2,449	3,379	6,128
Portfolio	150	0	65	215

Source: The World Bank, *World Debt Tables, 1993–1994*, vol. 2, (Washington, D.C.), 1994.

Finally, foreign investors may have been deterred by the existence of unresolved debt problems in Bulgaria and Poland. While both countries successfully negotiated debt relief agreements with their Paris Club creditors in March and April of 1991 (see above) they have been unable to conclude similar agreements with their Western bank creditors despite continuing discussions with them since then.[20] However, annual foreign investment into Poland increased rapidly during this period.

Portfolio Investment

Very little of the foreign investment was in the form of portfolio investment. This can largely be attributed to the limited progress by all countries in privatizing the large state enterprises that dominated economies of the former centrally planned economies. In Poland, for example, the first privatization law was passed in July 1990. By February 1992, when Prime Minister Olszewski acknowledged that the program was moving at a sluggish pace, 1,258 enterprises had received permission to be privatized; only 198 had

[20] In November 1993 Bulgaria's Western bank creditors reportedly agreed in principle to a 50 percent reduction in the $9.3 billion they are owed.

completed the process. It is doubtful that Poland will meet its initial goal to privatize half of the state owned industry by 1994.

In contrast, the Czech Republic began later but is moving much faster than Poland to sell off its large state-owned firms. As a result of two waves of "voucher privatizations" in 1993[21] and 1994, about 80 percent of the economy will be in private hands by the end of 1994. However, while the opportunities for foreign portfolio investment in the Czech Republic will be substantially greater in the future, the relatively late start of the voucher program has inhibited foreign portfolio investment up to the present. After being closed for 50 years, the Prague Stock Exchange officially reopened on April 6, 1993, but no shares were traded because there were none available.

At the other extreme are Bulgaria and Romania. In the spring of 1993, the Bulgarian government decided to follow other Eastern European countries and launch a mass privatization voucher program. However, the necessary legislation did not reach the Parliament until September 1993 and is not expected to pass until early in 1994. In September 1993 the head of the Romanian privatization agency stated that only 1 percent of the equity of the 6,280 companies that had been earmarked for privatization had been sold off despite clauses in the 1991 privatization law that required the government to sell at least 10 percent of state-owned equity annually.[22]

CONCLUSIONS

The Eastern Europeans have clearly been disappointed with the amount of the financing they have received from the West to help systemically transform their economies. With the exception of Hungary, they have been unable to borrow in Western capital markets, largely because of the lingering effects of their external debt problems and the uncertainties created by existing domestic instability. And, despite the euphoria over the ending of the cold war, Western governments, facing competing domestic and foreign demands for their resources, have failed to provide the full amount of financing they had initially offered. In fact, there was even a net outflow in the lending accounts as, during the first three post-communist years (i.e., 1990–1992), Eastern European debt service payments on loans that had been previously provided or guaranteed by Western governments exceeded the total disbursements from new official loans and loan guarantees.

The net flow of borrowed funds from the international financial institutions (i.e., the IMF, World Bank, and the EBRD) however, was positive, in part because there were negligible debt service payments during this period. And, the annual flow of foreign direct investment into the region grew rapidly after 1991. However, these flows were not uniformly distributed among the various countries. Poland, Hungary, and Czechoslovakia received the majority of the funds, obtaining 96 percent of the foreign direct investment, 85

[21] Citizens paid 1,000 koruna (about $35) for a book of vouchers worth 1,000 investment points. After registering the coupon booklets with the Federal Finance Ministry, these points can be traded for shares in specific companies or for mutual fund shares.

[22] World Equity and the International Finance Corporation, *Privatization in Emerging Markets*, London, United Kingdom, December 1993, pp. 34 and 35.

percent of the World Bank's disbursements, and 65 percent of the net credits provided by the IMF. They received nearly 78 percent of the funds approved by the EBRD in 1991–1993.

The concentration of foreign direct investment in these three countries is particularly worth noting. Unlike the financing provided by governments and the multilateral financial institutions that are influenced to some extent by political and strategic considerations, private investment decisions are predominantly based on economic factors. Thus, the commitment of these funds is an indication of business approval of the steps taken by the three countries to stabilize and transform their economies and represent a "vote of confidence" in their economic prospects.

Finally, there is the question of the significance of external financial assistance in the transformation process. Undoubtedly, it can "ease the pain" which, in turn, will politically facilitate the reform efforts. Foreign investment can bring know-how and technology that can enhance a country's economic prospects. It can provide an alternative, to a limited extent, for domestic savings. But it is doubtful that financial assistance can be a substitute for appropriate domestic policies.

The Polish and Czech economies have emerged from their recessions and are growing. They have done so with little external financial assistance. While commenting on the Polish and Czech accomplishments, among other factors, IMF Managing Director Michel Camdessus has suggested that "The progress made by these countries . . . has not been fortuitous. Nor can it be attributed mainly to external assistance. In each case, what underlies it is the resolute implementation of comprehensive and rigorous policies of macroeconomic stabilization and structural reform."[23]

On the one hand, the flow of foreign investment will accelerate as economic conditions improve. This will further enhance economic prospects in recipient countries. On the other hand, countries having little success attracting foreign investment will, quite likely, also be unsuccessful in being able to borrow from private capital markets and will be forced to rely largely on official lenders for external financing with the inherent frictions (i.e, performance targets that meet with foreign approval) which that involves. And, because they are forced to rely on such lenders, these countries will have to be careful to avoid the debt service problems that plagued most of the Eastern European countries in the 1980s.

AGRICULTURE AND FOOD IN CENTRAL AND EASTERN EUROPE

By Remy Jurenas *

CONTENTS

TABLES

* Remy Jurenas is a Specialist in Agricultural Policy, Congressional Research Service, Environment and Natural Resources Policy Division, at the Library of Congress.

SUMMARY

The economic transition process in the Central and Eastern Europe (CEE)[1] countries has started to bring about fundamental change in most of their agricultural and food sectors as well as pressures to mitigate some of the adverse consequences associated with sectoral reform. The changes vary significantly between countries, reflecting differences attributable to the impact of communist-era economic policies, the pace of land reform, and the privatization of agricultural input supply, food processing, and food distribution enterprises. Nevertheless, agriculture and food in this region still accounts for a large portion of economic activity and employment. As a result, many observers contend that the adaptation of farm enterprises, the new class of private farmers, and agribusiness to sectoral and macroeconomic reforms and policies is crucial to the success of the overall economic transition process.

U.S. agricultural exports to CEE have fallen sharply since their 1978–1981 peak. Since 1989, U.S. government programs, used in part to ease food supply problems associated with the transition in Albania, Romania, and Poland, have accounted for a third of all U.S. farm exports to the region. As reforms in these countries take hold and income growth resumes, the composition of U.S. agricultural-related exports is expected to slowly shift from mostly bulk commodities toward higher value foods to satisfy growing consumer demand for American goods and toward commodities that support CEE agribusiness efforts to compete in world markets. Among these will be U.S. exports of farm inputs, food processing and packaging equipment and machinery, breeding stock and technology, and commodities that are further processed into finished products for export.

Western countries and the multilateral development banks active in CEE have played a role in the transformation under way in the agricultural and food sectors. They have provided food aid, technical assistance, resources for structural reforms, and capital for investments in much-needed infrastructure and in newly created and privatized agribusiness enterprises. U.S. firms have taken advantage of existing U.S. government programs to explore and invest in agricultural input and food processing enterprises in order to gain increased access to the region and to the neighboring markets of the former Soviet Union.

In the interim, CEE governments face key decisions on the future direction of their agricultural sectors. Policymakers are seeking increased access to Western European markets for certain competitively priced food products. At the same time, CEE farmers are pressuring them to protect their markets against the surge in food imports from the European Union (EU) and to adopt other measures to prevent a further fall in farm profitability. In addition, differing views have emerged on what near-term CEE agricultural

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[1] Albania, Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, the former Yugoslavia, and the three Baltic States: Estonia, Latvia, and Lithuania. In this paper, references to CEE countries include the Baltics, unless otherwise stated.

policy should be as these countries aspire to join the EU. Should policy be guided by the objective to maintain the region's comparative advantage in some commodities, or by efforts to increase state support to closer match EU's higher level of agricultural assistance? Either way, experts foresee that the region could turn into a surplus grain producer by late in this decade, and become a more active player in world commodity markets.

AGRICULTURE AND FOOD IN THE ECONOMIC TRANSITION

AGRICULTURE'S PLACE IN THE CEE ECONOMIES

The agricultural sector historically has accounted for a significant portion of overall economic activity and employment in most CEE countries. Though varying between countries, agriculture's share of gross domestic product (GDP) and of total employment in the region in recent years is much larger than that of the EU and the United States (Table 1). In 1993, agriculture was most important in Albania (where it accounted for 41 percent of GDP), followed by Romania (21 percent), Lithuania (20 percent), and Latvia (14 percent). Similarly, almost half of the labor force in Albania was employed in agriculture. In Romania, agriculture accounted for 32 percent of all employment, followed by Poland (27 percent), Lithuania (19 percent), Latvia (18 percent), and Bulgaria (17 percent).

Because of agriculture's importance, many observers believe that the overall success of the economic transition to free markets in the CEE countries will depend on the response of the agricultural and food sectors to the macroeconomic and sectoral reforms set into motion in the early 1990s.

REFORMS AND THEIR IMPACT

With a population of almost 135 million, the CEE region (including the Baltics) is a major producer of grains, oilseeds, dairy and meat products, vegetables, and fruit. Both farm production and agribusiness in these countries during the post-World War II era were largely subject to central economic planning by governments. Their plans dictated output targets and directed the allocation of supplies and output without much regard for prices. The farm production sectors in most countries were organized into large collective and state farms, and were supported heavily by state subsidies intended to boost output and cover income shortfalls. However, private agriculture remained important to total production in Poland and the former Yugoslavia. Throughout the CEE, agribusiness (input suppliers, the commodity procurement system, and food processing enterprises) generally operated as monopolies. By the late 1980s, per capita consumption levels for many food products stood near, or surpassed, those in Western Europe. This was due largely to generous state subsidies that artificially maintained demand by keeping consumer food prices low. During the 1970s and 1980s imports of grain and oilseeds covered production shortfalls arising from poor weather and supplemented output to maintain domestic consumption and fulfill food export commitments to other communist-bloc states.

TABLE 1. Agriculture's Share of Gross Domestic Product (GDP) and Employment in Central and Eastern Europe, the Baltics, the European Union and the United States: 1993 Compared to 1989

(Percent)

Country	Share of GDP		Share of Employment	
	1989	1993 [a]	1989	1993 [a]
Albania	32.5	40.8	47.0 [b]	NA
Bulgaria [c]	11.0	10.4 [d]	18.1	17.4 [d]
Czech Republic	6.3	4.5	9.4	6.5
Slovak Republic	6.6	5.5	12.2	10.3
Hungary	15.5	8.9 [d]	17.2	8.1
Poland	11.8	6.5	26.4	26.9
Romania	14.2	21.0	28.2	32.2
Yugoslavia (Former)	11.0	NA	22.6	NA
Estonia	17.5	8.0	12.9	15.4 [d]
Latvia [e]	20.2	14.2	16.0	18.4
Lithuania	26.5	20.0	17.6	19.0
European Union [c]	3.1	2.8 [b]	6.9	5.8 [d]
United States	1.5	1.2	2.7	2.6

Sources: Organization for Economic Cooperation and Development (OECD), *Agricultural Policies, Markets and Trade: Monitoring and Outlook 1994, In the central and eastern European countries (CEECs), the New Independent States (NIS), Mongolia and China*, June 1994, Annex Table I.8, p. 226; European Commission (EC), *The Agricultural Situation in the Community 1993 Report*, 1994, pp. T/22, T/102; EC, *The Agricultural Situation in the Community 1991 Report*, p. T/20; U.S. Department of Agriculture, Economic Research Service, *World Agriculture: Trends and Indicators, 1970–91*, p. 568; U.S. Department of Commerce (DoC), Economics and Statistics Administration (ESSA), Bureau of Census, *Statistical Abstract of the United States 1993*, p. 393; DoC, ESSA, Bureau of Economic Analysis, *Survey of Current Business*, August 1993, p. 58; March 1994, p. S–9; and July 1994, p. 56.

NA = not available
[a] Preliminary
[b] Refers to 1991 data
[c] Agriculture includes forestry
[d] Refers to 1992 data
[e] Agriculture includes hunting, forestry and fishing

The momentous political changes in Central and Eastern Europe in 1989–91 prompted new, popularly elected governments to start dismantling state control over the economy and introduce some market-oriented policies intended to spur economic growth. In the agricultural and food sectors, governments slashed subsidies paid to farms and consumers, reorganized the socialized farm structure (by transfering ownership to newly created independent units or distributing land parcels to farmers), and began to break up the monopolistic agribusiness enterprises. The extent of change that has occurred in these sectors varies throughout the region, reflecting each country's unique historical experience, its level of economic development at the beginning of the transition process, the speed with which governments have introduced macroeconomic reforms and launched privitization initiatives, the ability of governments to implement policy changes, and the political reaction of farmers and others affected by these changes.[2] These factors and the impacts of policy changes have led observers to draw distinctions among the CEE countries on where their agricultural and food sectors stand in the economic transition process. The northern countries (Hungary, Poland, the Czech Republic, and Slovakia) have moved the furthest in introducing market-oriented policies, compared to the southern countries (Albania, Bulgaria, and Romania) where progress has been slower. The Baltic States (Estonia, Latvia, and Lithuania), which produced surpluses of meat and dairy products for sale to the rest of the Soviet Union, lag behind other CEE countries in the level of agricultural technology employed and in their understanding of market principles. The Baltics' unique situation will likely mean a longer transition process for their farm and food sectors.

Policy Reforms

One of the key measures used by CEE governments to reduce large government budget deficits in order to achieve macroeconomic stability were reductions in subsidies paid to farms and consumers. Historically, these accounted for an increasingly larger share of state budget expenditures. The elimination of production and input subsidies occurred with the removal of the government-set prices that farms received for the commodities they sold. No longer obligated to sell commodities at these fixed prices, farms became free to market their output at prices that more closely reflected supply and demand conditions. At the same time, governments eliminated subsidies paid to food processors and also price controls that had kept retail prices of many food products paid by consumers low. Without subsidies and price controls, food processors and marketers began to pass on to consumers the higher commodity prices they paid farms. With families and individuals now spending a much larger portion of household income for food purchases, overall demand for food has fallen sharply.

In dismantling state control over agriculture and granting individuals an ownership stake in the reform process, CEE governments have initiated various forms of agrarian land reform. These include: (1) restitution programs (granting those who lost farmland during the collectivization period the right to reclaim land that they had owned in the pre-communist era), (2) restructuring programs (transforming existing state and collective farms into cooperatives or joint stock companies), and (3) comprehensive land distribution (granting parcels of land to those agreeing to farm it, with full rights to rent and sell at any time).

To inject competition into and increase efficiencies in the agribusiness sector, governments plan, or have started, to break up the state-owned farm input supply, commodity distribution and marketing networks, as well as food processing monopolies. Some gov-

[2] Details on recent agricultural and food sector developments in individual CEE countries are found in: (1) Organization for Economic Co-operation and Development (OECD), Centre for Co-operation with the Economies in Transition, *Agricultural Policies, Markets and Trade: Monitoring and Outlook 1994—In the Central and Eastern European Countries (CEECs), the New Independent States (NIS), Mongolia and China*, pp. 11–142, June 1994; (2) Abraham Avidor and Roger Mireles, "Agricultural Trade Policy and Trade for Central and Eastern Europe," U.S. Department of Agriculture (USDA), Foreign Agricultural Service, August 1994, 40 pp.; and (3) USDA, Economic Research Service, *Agricultural Policies and Performance in Central and Eastern Europe, 1989–92*, February 1993, FAER No. 247, 72 pp.

ernments are slowly privatizing agribusiness enterprises by selling them to existing management and employees and investors, including foreign firms seeking a marketing foothold in the region. More prevalent throughout CEE has been the trend to start up small-scale private agribusiness enterprises.

Early in the transition, some CEE countries (e.g., Poland) liberalized trade in agricultural products by allowing unrestricted imports of food products. These imports, though expensive, boosted food supplies available to consumers and helped eliminate food rationing. The surge in imports, though, prompted protests from domestic producers about increased competition and the lower prices received for their output.

Impact of Reforms

Thus far, both farmers' and consumers' responses to the reforms have resulted in dramatic changes in the CEE's agricultural and food sectors. The most significant trends have been sharp declines in agricultural output and food consumption, and a drop in agricultural employment.

The agricultural sectors have experienced much difficulty in adjusting to the reforms. Producers have faced rapidly rising prices for needed inputs (farm machinery and equipment, fuel, seed) relative to the prices they now receive for the commodities produced. Though higher input prices reflect the high inflation rates experienced in most countries, they also reflect the lack of competition among input suppliers, which still command near-monopoly status. More importantly, farm prices have not kept pace with the rate of inflation; as a result, the terms of trade for the agricultural sector have worsened during the transition.

Farmers have also complained about the lack of access to affordable credit. High nominal interest rates (reflecting high inflation rates) and continued uncertainties about land reform in some countries have meant that banks are reluctant to lend to farms or individuals not having clear title to the most important collateral they can offer: farmland. Moreover, credit institutions specializing in serving the particular needs of agriculture are not yet fully developed.

The collapse of trade with the Soviet Union and other CMEA (Council for Mutual Economic Assistance) partners in 1991 proved devastating to those CEE countries that had played an important role in exporting their agricultural surpluses, reflecting their economic specialization in the communist bloc's trading relationships. In response, the CEE countries have tried to redirect their agricultural exports toward Western Europe and other nearby markets such as the Middle East. Though the former Czechoslovakia, Hungary, and Poland did negotiate market access to the EU market starting in 1993 for certain food products (together with steel and textiles, in which they possess a comparative advantage), actual sales have fallen short of expectations. CEE agricultural trade relations have been further exacerbated by increased competition from subsidized EU commodity and food exports to the region. As a consequence, many CEE governments have begun to reimpose restrictive import policies to address the concerns of the powerful farm-and rural-based political parties that are now critical to creating and maintaining viable government coalitions.

The various reforms have had a mixed effect on consumers. The chronic food shortages experienced by urban residents in some countries during the 1980s disappeared. This occurred as food prices were liberalized, then rose sharply, and as food consumption fell. Also, diets changed in response to food price increases. Per capita consumption of dairy and meat products has declined in most of these countries as retail prices have soared. Consumers shifted away from meat and dairy products toward purchasing less expensive bread products, fruits, and vegetables. In turn, this reduced aggregate farm demand for feed grains and protein meals vital to livestock and dairy production.

Taken together, continued uncertainties associated with land reform, low levels of farm profitability, the fall in domestic food consumption, the impact of the severe 1992 and more localized 1993 droughts, and the loss of historically important export markets contributed to a 20 percent drop in gross agricultural output for Central and Eastern Europe (excluding the Baltics) between 1989 and 1993. The declines in the agricultural sectors in the three Baltic States were more severe, with output falling 40 percent during this period. All countries recorded declines in output, with the sharpest falls in Estonia (–44 percent), Lithuania (–39 percent), Latvia (–37 percent), and Hungary and Bulgaria (each with a drop of about 34 percent) (Table 2). A sizable decline in those working in agriculture also accompanied the severe contraction in output. Agricultural employment in Hungary, Bulgaria, the Czech Republic, and Slovakia fell by about one-third between 1990 and 1992. Much of the decline was due to the restructuring of the large collective and state farms, and decisions by farm workers to take advantage of employment opportunities in other economic sectors. By contrast, farm employment rose by 13 percent in Romania, spurred by the return of farmland to former owners.[3]

CEE'S TRADE IN AGRICULTURAL COMMODITIES AND FOOD PRODUCTS

OVERVIEW OF AGRICULTURAL TRADE FLOWS[4]

During 1983–1992, the CEE region (excluding the Baltics) has run an agricultural trade surplus of close to $600 million per year. Annually agricultural exports averaged $6.2 billion, while agricultural imports averaged $5.6 billion. This trade surplus has declined in recent years, reflecting increased imports early in the transition period and the more recent fall in exports due to the widespread 1992 drought.

For three countries in the region (Albania, Bulgaria, and Hungary), sales of agricultural commodities and food products generate sizable export earnings. Agricultural exports in recent years have represented 20 to 25 percent of the total merchandise exports of

[3] United Nations, Economic Commission for Europe, *Economic Survey of Europe in 1993–1994*, May 1994, Table 3.4.2, p. 85.

[4] Data presented in this section are derived or taken from the "Time Series for SOFA'93" data diskette included with: United Nations, Food and Agriculture Organization, *The State of Food and Agriculture 1993*, 1993.

TABLE 2. Change in Gross Agricultural Output in Central and Eastern Europe and Baltics, 1989 to 1993

(Percent)

Country/Region	Change in Output from 1989 to 1993
Central and Eastern Europe	–20.4
Albania	–9.4
Bulgaria	–34.0
Czech Republic	–21.8
Slovak Republic	–28.4
Hungary	–34.5
Poland	–13.4
Romania	–0.9
Yugoslavia (Former):	
Bosnia-Herzegovina	NA
Croatia [a]	–21.7
Slovenia	–14.6
FYR of Macedonia	–15.2
Yugoslavia (FR)	–22.2
Baltic States	–40.1
Estonia	–43.6
Latvia	–36.7
Lithuania	–38.9

Sources: OECD, *Agricultural Policies, Markets and Trade: Monitoring and Outlook 1994, In the central and eastern European countries (CEECs), the New Independent States (NIS), Mongolia and China*, June 1994, Annex Table 1.3, p. 221; United Nations, Economic Commission for Europe, *Economic Survey of Europe in 1993–1994*, May 1994, Table 3.2.2, p. 63.

NA = not available.

Note: Derived from published data.

[a] Change from 1989 to 1992.

Hungary and Bulgaria. Though the value involved is much smaller, Albania's agricultural exports accounted for close to one-third of total exports in recent years. For the region as a whole, agricultural exports represented an average of 10 percent of total exports.

In 1992 CEE agricultural exports totaled almost $5.4 billion, or 12 percent of merchandise exports. Exports of meat and dairy products represented 26 percent of all agricultural exports, followed by fruits and vegetables (21 percent) and live animals (12 percent).

The region's agricultural imports in 1992 were $5.1 billion, almost 12 percent of total imports. Imports of cereals accounted for 14 percent of all agricultural imports, followed by fruits and vegetables (14 percent), and meat and dairy products (11 percent).

With the collapse of the CMEA in 1991, CEE's agricultural trade now is largely transacted in convertible currencies, having shifted to Western Europe and the Middle East. Some barter trade still occurs with the former Soviet Union and Middle Eastern countries. Also, commodity assistance (in the form of food shipments and feed for livestock) from Western nations, particularly the EU and the United States, were particularly important to Albania, Romania, Poland, and Bulgaria in the early years of the transition and accounted for sizable shares of their agricultural imports.

U.S. AGRICULTURAL TRADE WITH CENTRAL AND EASTERN EUROPE: TRENDS AND POLICIES

U.S. agricultural trade (exports plus imports) with the CEE region has declined since the late 1970s. The U.S. trade balance in agricultural products has been in surplus most years, but has also declined, primarily as a result of the sharp fall in U.S. agricultural exports to the region. In the late 1970s U.S. policymakers viewed CEE as an expanding export market for U.S. agriculture. In recent years, however, the main U.S. government objective has been to assist these countries handle the chaos and uncertainties brought about by the economic and political transition. As part of the U.S. response, U.S. Department of Agriculture (USDA) agricultural export programs were tapped to help some countries secure or purchase agricultural imports to cover shortfalls in food supplies due to either periodic droughts or upheavals in their agricultural and food sectors. Also, to help the CEE countries facilitate their economic growth, the United States increased access to its market by reducing tariffs and granting limited trade preferences on imports (including some agricultural products).

U.S. Agricultural Exports

The CEE's importance as a market for U.S. agriculture has declined since the mid-1970s, when the region's easy access to credits (from both commercial lenders and the USDA) helped to fuel a surge in CEE agricultural imports. To satisfy growing consumer demand for meat and dairy products, CEE policymakers in many countries embarked upon ambitious programs in the 1970s to import feed grains, soybeans, and soymeal to foster expansion of their livestock and dairy sectors.

With the Polish government's imposition of martial law in 1981, and the subsequent U.S. imposition of trade sanctions, U.S. farm sales to Poland—the most significant market in the region—fell sharply. As most countries in the region struggled to service debts taken on during the 1970s, U.S. agricultural exports to the CEE declined from a 1979–1981 annual average of $1.6 billion to a 1985–1989 average of $400 million per year. Similarly, U.S. agricultural sales to the region as a share of total U.S. agricultural exports worldwide declined from 4 percent to 1 percent. U.S. agricultural exports accounted for about two-thirds of total U.S. exports to the region in 1979–1981; by the late 1980s, farm exports represented only about one-third (Table 3).

TABLE 3. U.S. Agricultural Trade with Central and Eastern Europe (CEE), 1976–1993: Trade Turnover, Trade Balance, Exports, and Imports

Calendar Year	Agricultural Trade Turnover (exports plus imports) (Million $)	Agricultural Trade Balance (exports minus imports) (Million $)	Agricultural Exports (Million $)	Share of U.S. Agricultural Exports to CEE (Percent)	Agricultural Export Share of All U.S. Exports to CEE (Percent)	Agricultural Imports (Million $)	Share of U.S. Agricultural Imports from CEE (Percent)	Agricultural Import Share of All U.S. Imports from CEE (Percent)
1976	1,149.0	598.5	873.7	3.8	61.4	275.2	2.5	27.7
1977	862.2	292.6	577.4	2.4	46.8	284.8	2.1	28.3
1978	1,319.2	591.7	955.5	3.3	55.5	363.7	2.5	27.0
1979	2,011.4	1,304.8	1,658.1	4.8	67.8	353.3	2.1	26.2
1980	1,955.9	1,331.6	1,643.8	4.0	62.9	312.2	1.8	22.7
1981	1,720.3	1,162.9	1,441.6	3.3	63.8	278.7	1.6	17.5
1982	864.4	409.0	636.7	1.7	49.4	227.7	1.5	20.1
1983	971.8	443.7	707.8	2.0	53.6	264.1	1.6	19.7
1984	889.4	367.3	628.4	1.7	52.5	261.1	1.4	13.5
1985	677.5	151.3	414.4	1.4	31.5	263.1	1.3	13.3
1986	687.9	58.2	373.1	1.4	31.0	314.8	1.5	15.7
1987	736.9	64.3	400.6	1.4	35.5	336.3	1.6	15.2
1988	780.8	147.1	464.0	1.3	35.6	316.8	1.5	13.7
1989	649.1	4.3	326.7	0.8	22.9	322.4	1.5	16.0
1990	872.6	202.2	537.4	1.4	32.0	335.2	1.5	17.7
1991	546.6	–77.7	234.4	0.6	14.9	312.1	1.4	18.7
1992	651.4	–16.5	317.4	0.7	15.7	333.9	1.4	20.9
1993	720.7	142.9	431.8	1.0	18.3	288.9	1.2	15.3
Addendum: Central and Eastern Europe including Baltic States								
1992	737.4	65.2	401.3	0.9	18.4	336.1	1.4	20.7
1993	783.3	200.9	492.1	1.2	19.3	291.2	1.2	15.0

Sources: U.S. Department of Agriculture (USDA), Economic Research Service (ERS), *Foreign Agricultural Trade of the United States* published calendar year reports from 1977–1983 and 1993, and database; USDA, Foreign Agricultural Service (FAS), Trade & Marketing Analysis Branch, unpublished BICO reports; DoC, International Trade Administration, *U.S. Foreign Trade Highlights* reports for 1987 and 1993; DoC, ESSA, Bureau of Census and Bureau of Economic Analysis, press release CB-94-98, "U.S. International Trade in Goods and Services: Annual Revision for 1993," Exhibit 13, pp. 17–20.

Note: Data exclude trade with the former East Germany from 1976 to 1990.

TABLE 4. U.S. Agricultural Exports to Central and Eastern Europe (CEE) and Baltics, by Country, 1989–1993

Country	Calendar Year (Million $)						Share of Total (Percent)	
	1989	1990	1991	1992	1993	Total, 1989–93	Excluding Baltics	Including Baltics
Albania	0.0	1.2	9.1	25.2	28.8	64.4	3.5	3.2
Bulgaria	129.6	8.0	34.7	5.3	26.2	203.9	11.0	10.2
Czechoslovakia	16.8	22.7	20.7	19.6	15.7	95.4	5.2	4.8
Hungary	5.6	34.5	13.5	11.7	10.6	75.8	4.1	3.8
Poland	58.2	89.2	39.3	106.7	196.5	489.9	26.5	24.6
Romania	60.7	220.4	74.0	94.7	101.8	551.6	29.9	27.7
Yugoslavia	55.8	161.4	43.2	54.3	52.1	366.7	19.8	18.4
Subtotal, CEE	326.7	537.4	234.4	317.4	431.8	1,847.8	100.0	92.8
Estonia	NA	NA	NA	32.6	29.9	62.4	NA	3.1
Latvia	NA	NA	NA	26.0	11.7	37.7	NA	1.9
Lithuania	NA	NA	NA	25.3	18.7	44.0	NA	2.2
Subtotal, Baltics	NA	NA	NA	83.9	60.3	144.2	NA	7.2
Total	NA	NA	NA	401.3	492.1	1,992.0	NA	100.0

Sources: USDA, ERS, Foreign Agricultural Trade of the United States database; USDA, FAS, Trade and Marketing Analysis Branch, unpublished BICO reports.
NA = not applicable

TABLE 5. U.S. Agricultural Exports to Central and Eastern Europe (CEE) and Baltics: U.S.-Government Supported, By Program, and All Other Commercial Sales, Actual Fiscal Years 1989–1993, Programmed and Estimated for Fiscal Year 1994

Agricultural Exports: Supported, by Program, and All Other	Fiscal Year (FY) (Million $)						Share of Total, FY89–93 (Percent)	FY94 (Million $)	
	1989	1990	1991	1992[a]	1993[a]	Total, FY89–93		Programmed Activity[b]	Estimated Exports[c]
Total Exports	350.6	475.4	306.0	274.3	543.9	1,950.2	100.0	NA	335.0[d]
Food Assistance, by Program									
P.L. 480, Title I	0.0	29.1	0.0	1.6	69.5	100.1	5.1	29.1	29.1
P.L. 480, Title II	0.0	0.0	0.0	2.3	46.6	48.9	2.5	63.5	63.5
Section 416	0.0	102.6	57.1	34.9	36.8	231.4	11.9	11.3	11.3
Food for Progress	0.0	0.0	0.0	16.6	44.3	60.9	3.1	12.4	12.4
Subtotal, Food Aid	0.0	131.7	57.1	55.4	197.2	441.3	22.6	116.2	116.2
Commercial Sales, by Program									
GSM–102 Export Credit Guarantees[e]	22.5	7.4	6.9	44.0	60.1	140.8	7.2	133.0	14.5
Export Enhancement Program (EEP)[f]	6.6	3.5	5.5	19.0	55.7	90.3	4.6	NA	2.1
Subtotal, Commercial Sales	29.1	10.9	12.4	62.9	115.8	231.1	11.8	133.0	16.6
All Other Commercial Export Sales	321.5	332.8	236.5	156.0	230.9	1,277.8	65.5	NA	202.2
	Percent								
Share of U.S. Agricultural Exports to CEE and Baltics Supported by U.S. Government, by Type of Program:									
Food Aid Programs	0.0	27.7	18.7	20.2	36.3	22.6	—	—	34.7
Export Credit Guarantees	6.4	1.6	2.2	16.0	11.1	7.2	—	—	4.3
Export Subsidies (EEP)	1.9	0.7	1.8	6.9	10.2	4.6	—	—	0.6
Share Supported by All Programs	8.3	30.0	22.7	43.1	57.5	34.5	—	—	39.6

Source: USDA, various publications and databases of Economic Research Service and Foreign Agricultural Service.

NA = not applicable.

[a] Includes CEE and Baltic States starting in FY 1992.

[b] In the case of food aid programs, refers to programmed commitments; in the case of credit guarantees, refers to allocations (as of September 9, 1994).

[c] In the case of food aid programs, refers to agreements actually signed; in the case of credit guarantees, refers to exporter applications received requesting use of guarantees (as of September 9, 1994).

[d] USDA's agricultural export sales forecast for Eastern Europe, published in *Outlook for U.S. Agricultural Exports*, August 26, 1994, adjusted by CRS to include a projection for exports to the Baltic States.

[e] Includes some export sales made with the use of EEP export subsidies

[f] Derived by CRS using FAS-provided data. EEP export subsidies were also used in FY 1989–1993 with GSM–102 export guarantees to support an additional $45 million in export sales. To avoid doublecounting, these sales are included under "GSM–102 Export Credit Guarantees" (above) as part of the $140.8 million total shown for the FY 1989–1993 period. In FY 1994, an estimated additional $1.7 million in EEP-subsidized sales are included under estimated GSM–102 program activity.

Since 1989, U.S. farm exports to CEE have fluctuated widely (illustrated by the high of $537 million in 1990 and the low of $234 million in the following year). The agricultural export share of total U.S. exports to the CEE has continued to fall, to an average of 20 percent in the 1990–93 period (Table 3). Romania and Poland have accounted for more than half of U.S. farm exports to the region since 1989 (Table 4). The top U.S. exports were grains and feeds (42 percent of all farm exports to the region), animals and products (23 percent) and oilseeds and products (18 percent).

Since late 1989, the U.S. government has offered a variety of food aid and credit resources to CEE countries to enable them to secure needed commodity imports, cope with rapid political change, and adjust to the shocks of introducing reforms in their agricultural and food sectors. U.S. aid supplemented aid also offered by the EU, Canada, and other countries. During this period, U.S. food aid and export assistance programs have facilitated one third of all U.S. agricultural exports to the CEE (Table 5 provides details by program). [5]

U.S. food aid worth $441 million accounted for 23 percent of U.S. agricultural shipments to CEE countries in fiscal years 1989–1993. USDA and the U.S. Agency for International Development (USAID) extended $341 million in grant food aid under the section 416 surplus donations, Food for Progress programs, and P.L. 480 Title II programs. In addition, USDA extended $100 million in long-term concessional credits under the P.L. 480 Title I program.[6] Both Poland and Romania accounted for half of U.S. food aid shipments; Albania's share was 13 percent.

U.S. commercial sales of commodities and food products to the CEE have been supported by USDA's agricultural export credit guarantee and export subsidy programs. Guarantee-assisted exports accounted for 7 percent of all U.S. agricultural exports in FY 1989–FY 1993. USDA, concluding that some countries were sufficiently creditworthy to access such assistance, extended $141 million in GSM–102 short-term credit guarantees to the former Czechoslovakia, the new Czech Republic, Hungary, Romania, the former Yugoslavia, and more recently, Slovenia.[7] GSM–102's objective is to maintain and expand commercial agricultural exports to countries not able to secure normal trade financing for such pur-

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[5] Because these programs are administered on a fiscal year basis, comparisons are made to fiscal year rather than calendar year agricultural export data.

[6] Section 416(b) authorizes USDA to donate Commodity Credit Corporation (CCC)-owned surplus commodities, as needed and available, to fill short-term deficits in foreign countries. Food for Progress (FFP) involves donating CCC-owned or purchased commodities to countries that agree to enhance their private agricultural sectors. Title II of P.L. 480 (administered by USAID) makes available emergency food donations, with a large portion funneled through private voluntary organizations. Title I of P.L. 480 provides for commercial sales of U.S. agricultural commodities using long-term concessional credits extended by the CCC. Loans carry maximum repayment terms of 30 years, and interest is charged at below-market rates. Title I is intended to serve as a market development tool to facilitate U.S. export sales to countries without the financial resources to purchase needed agricultural commodities.

[7] GSM refers to the Office of the General Sales Manager in the Foreign Agricultural Service, which administers all of USDA's export programs. In issuing credit guarantees to participating commercial banks, the CCC agrees to make payments only if, and when, a foreign buyer's bank defaults (does not repay its loans on schedule). By reducing lender risk, these CEE countries were able to obtain commercial bank financing at near market interest rates, when they might not otherwise be eligible for such financing or must borrow at much higher rates. GSM–102-backed export sales are repaid within three years.

chases. Romania accounted for 58 percent of USDA-guaranteed sales to the region; the former Yugoslavia's share was 30 percent.

The Export Enhancement Program (EEP) has subsidized sales of wheat, rice, and barley to Czechoslovakia, the Czech Republic, Poland, Romania, Slovenia, and the former Yugoslavia, primarily to meet EU export competition in these markets. In FY 1989–FY 1993, EEP-supported exports (excluding those subsidized sales made also using credit guarantees) to the CEE totaled $90 million, and accounted for almost five percent of all U.S. agricultural exports to the region. Poland accounted for two thirds of such EEP-subsidized sales; the former Czechoslovakia's share was 20 percent.[8]

U.S. Export Outlook

Most observers do not expect CEE to be a major export market during the 1990s. This view is reflected in policy-level remarks made by Secretary of Agriculture Michael Espy in late 1993, when he stated that the United States should "retarget" its farm trade to focus more on "emerging markets" in Asia and Latin America rather than just concentrate on "emerging democracies" in Eastern Europe and the former Soviet Union.[9] This redirection in USDA focus, together with the projection that the CEE will become self-sufficient in grains by late this decade, will likely mean that the level of U.S. agricultural exports will be driven more by the need to cover production shortfalls that may arise in individual CEE countries, and by U.S. decisions made to ensure continued support of their economic and political reform process. USDA technical assistance efforts in CEE, nevertheless, aim to enhance future trade ties. USDA's Foreign Agricultural Service foresees that "competitively priced U.S. products that support CEE farm development, hard currency export earnings, and greater diet diversity" will represent future growth opportunities for U.S. agriculture.[10]

U.S. Agricultural Imports

Food imports from the CEE historically have accounted for only 1 to 2 percent of total U.S. agricultural imports—averaging about $300 million annually over the last decade. The agricultural import share of total imports from the region has varied over time—falling through the 1980s before rising again through 1992 (Table 3). Since 1989, the top exporters of agricultural products to the U.S. market were Poland, the former Yugoslavia, and Hungary, which together accounted for 80 percent of U.S. food imports from the region (Table 6).

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[8] The EEP's purpose is to challenge other countries' use of unfair trade practices, including export subsidies, and to make U.S. farm exports more price competitive in targeted foreign markets. To accomplish this, USDA makes CCC-owned surplus commodity stocks or cash available to U.S. agricultural exporting firms to permit them to offer foreign buyers lower prices. The United States instituted EEP particularly to counter the EU's practice of subsidizing its wheat and other agricultural exports and to prod the EC to negotiate the contentious agricultural export subsidy issue in the just-completed General Agreement of Trade and Tariffs' multilateral trade negotiations. USDA's targeting of selected CEE countries responds to the EU's extensive use of export subsidies to expand and maintain its market share in the region.

[9] Summary of an excerpt of a Knight Ritter Financial story filed on Espy's speech to the Commonwealth Club of California in San Francisco, October 29, 1993.

[10] Avidor and Mireles, "Agricultural Trade Policy," p. 2.

TABLE 6. U.S. Agricultural Imports from Central and Eastern Europe (CEE) and Baltics, by Country, 1989–1993

Country	Calendar Year (Million $)						Share of Total (Percent)	
	1989	1990	1991	1992	1993	Total, 1989–93	Excluding Baltics	Including Baltics
Albania	2.7	1.5	3.1	3.0	5.2	15.5	1.0	1.0
Bulgaria	23.0	22.6	24.3	67.4	67.2	204.5	12.8	12.8
Czechoslovakia	7.8	12.1	16.7	20.0	19.9	76.5	4.8	4.8
Hungary	75.8	86.5	98.9	64.9	59.2	385.3	24.2	24.1
Poland	127.8	125.6	75.8	77.0	75.0	481.1	30.2	30.1
Romania	9.7	2.4	1.8	2.2	3.8	19.9	1.3	1.2
Yugoslavia	75.6	84.5	91.5	99.6	58.6	409.8	25.7	25.7
Subtotal, CEE	322.4	335.2	312.1	333.9	288.9	1,592.6	100.0	99.7
Estonia	NA	NA	NA	0.7	0.4	1.1	NA	0.1
Latvia	NA	NA	NA	0.3	0.4	0.7	NA	0.0
Lithuania	NA	NA	NA	1.1	1.6	2.7	NA	0.2
Subtotal, Baltics	NA	NA	NA	2.2	2.3	4.5	NA	0.3
Total	NA	NA	NA	336.1	291.2	1,597.1	NA	100.0

Sources: USDA, ERS, Foreign Agricultural Trade of the United States database; USDA, FAS, Trade and Marketing Analysis Branch, unpublished BICO reports.
NA = not applicable.

U.S. tariffs on all imports from all CEE countries have been lowered or eliminated, in order to facilitate their exports to the U.S. market and to promote economic growth in CEE. Agricultural imports from the CEE now benefit from most-favored nation (MFN) tariff status, which commits the United States to extend to the CEE countries the same low tariff rates applied to imports from almost all other countries in the world. Also, some food products qualify to enter duty free from all CEE countries under the Generalized System of Preferences (GSP). Under the GSP, the United States gives preferential tariff treatment on designated product categories to eligible countries in order to further their economic development.

Related Export Activities

The U.S. government also supports agribusiness exports to CEE. The U.S. Department of Commerce in its 1994 country-marketing plans for Poland, the Czech Republic, Hungary and Bulgaria, identified "food processing and packaging as one of the top export sectors for U.S. companies."[11] This trade opportunity reflects growing demand by food manufacturing firms in the CEE for modern equipment and machinery to increase productivity and sufficiently improve the quality of processed food products, in order to sell into export markets and meet rising domestic consumer preferences for high-quality products. To support this export potential, the U.S. Agency for International Development in 1991 extended a grant to two trade associations for projects designed to open the CEE market to the U.S. food and beverage industry.

FOREIGN INVESTMENT IN AGRIBUSINESS AND FOOD SECTORS

In some CEE countries privatization programs have already transferred, or are in the process of transfering, the ownership of state-owned commodity distribution and food processing enterprises to existing management and employees, or to domestic and foreign investors. Some view progress in breaking up, and privatizing, the agribusiness sector, as critical to overall efforts to place ownership of assets into private hands, and to inject price competition into the agricultural input and food sectors.

CEE leaders have placed much emphasis on the role of foreign investment in providing the capital and technology needed to improve overall economic productivity and to enable the region to integrate with, and compete, in world markets. Most observers agree that the region's agricultural and food sectors have the potential to be more productive and more visible players in world markets. Consequently, Western agribusiness firms are participating in the privatization process through investment in some food processing, distribution and marketing enterprises. The perceived advantages of investing include the region's low cost of agricultural commodities and other raw materials, access to skilled labor, relatively low wage levels, and its location as a base to penetrate the large market represented by the former Soviet Union and possibly the Middle East. Western firms (i.e., multinationals such as Nestle, the

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[11] U.S. Department of Commerce, International Trade Administration, Eastern Europe Business Information Center, *Eastern Europe Business Bulletin*, October 1993, p. 1.

large French firm BSN) investing in CEE countries also recognize the potential for food sales in the region arising from increased consumer demand as income growth is expected to resume later this decade. These advantages and the sales potential, in turn, are likely to increase the demand for locally produced commodities, and could have a positive impact on the farm production sector.

To take advantage of this potential, prospective foreign investors have expressed considerable interest in exploring and establishing joint ventures, partnerships, marketing agreements, and other business relationships with private and cooperative participants in CEE countries. Some CEE governments have actively encouraged foreign investment in the to-be-privatized food enterprises, because of the lack of sufficient local capital to transfer ownership to the private sector. Western European firms are the most active investors in agribusiness and food processing enterprises thus far. Firms from Japan, Korea, and the United States are also starting to stake positions. To leverage private sector investment in the agribusiness and food sectors in the CEE, U.S. and other Western governments, together with the multilateral development banks, are supporting the privatization process and new start-up enterprises with loans and equity investments (see "Lending and Equity Investment in Agribusiness and Food Sectors" below).

Western Assistance for Market Transition in CEE Countries' Agricultural and Food Sectors

Since late 1989 Western nations (including the United States) and international lending institutions have been involved in easing the economic transition under way in the agricultural and food sectors of the CEE countries. Among the resources they have provided are technical assistance, support for the introduction of systemic reform and related projects intended to improve the infrastructure vital to the functioning of market mechanisms, and lending or investing in selected privatized enterprises. Each form of assistance has supported both micro-level activities targeted toward the emerging private sector, as well as enabling CEE governments to address macro-level objectives essential to functioning agricultural and food markets. Typical micro-oriented projects have ranged from helping private farmers address small-scale production and marketing problems to taking an equity stake in a food processing firm that produces high-quality products, enabling it to take advantage of export opportunities. Macro-level activities include support for the creation of commodity futures markets (critical for the transparent determination of agricultural prices) or funding agricultural sector adjustment loans. Table 7 summarizes the different types of assistance the U.S. government and other institutions have offered to support the agricultural and food sectors' transition process in the region.

TABLE 7. Western Support (Excluding Food Aid and Food Credits) to Agricultural and Food Sectors in Central and Eastern Europe and Baltics, by Type: 1990 to 1993[a]

Program and/or Organization	Year[b] (million $)					Share of Total Resources Extended to CEE, by Program or Organization (percent)
	1990	1991	1992	1993	Total, 1990–93	
	Technical Assistance and Training					
U.S. Government, By Agency						
U.S. Agency for International Development (USAID): Restructuring Agriculture and Agribusiness Program	4.2	16.7	25.6	23.2	69.7	5.4
U.S. Department of Agriculture (USDA): Emerging Democracies Program	NA	0.2	3.7	2.4	6.2	31.6
Other Bilateral						
European Union: PHARE's[c] Agricultural Restructuring Program	NA	NA	NA	NA	471.9	11.5
	Systemic or Structural Support					
U.S. Government, By Agency						
USAID: Agricultural Sector and Related Programs	0.0	10.0	16.0	19.3	45.3	3.5
Multilateral Banks						
World Bank:						
International Bank for Reconstruction and Development (IBRD)	200.0	100.0	100.0	400.0	800.0	9.7
International Development Agency (IDA)	NA	NA	0.0	22.4	22.4	26.2
Subtotal, World Bank					822.4	9.9
	Investment and Trade-Enhancing Activities					
U.S. Government, By Agency						
Export-Import Bank of the United States (EXIM)[d]	0.0	14.6	1.6	1.7	17.9	2.8
Overseas Private Investment Corporation (OPIC)	5.7	106.1	84.2	0.0	196.0	13.7
U.S. Trade and Development Agency (TDA)	0.0	0.6	0.8	0.2	1.6	5.1
Enterprise Funds[e]						
Bulgarian-American	NA	NA	NA	NA	2.0	80.3
Czech- and Slovak-American	NA	NA	NA	NA	8.4	27.9
Hungarian-American	NA	NA	NA	NA	11.7	30.7
Polish-American	NA	NA	NA	NA	16.4	7.9
Subtotal, Enterprise Funds					38.5	13.8
Multilateral Banks						
European Bank for Reconstruction and Development (EBRD)	NA	41.6	106.2	196.6	344.4	7.8

TABLE 7. Western Support (Excluding Food Aid and Food Credits) to Agricultural and Food Sectors in Central and Eastern Europe and Baltics, by Type: 1990 to 1993[a]—Continued

Program and/or Organization	Year[b] (million $)					Share of Total Resources Extended to CEE, by Program or Organization (percent)
	1990	1991	1992	1993	Total, 1990–93	
World Bank: International Finance Corporation (IFC) ...	0.3	0.0	0.0	2.0	2.3	0.3

Sources: USDA, FAS, "Emerging Democracies Program: Projects and Activities," October 25, 1993; U.S. Department of State, "SEED Act Implementation Report, Fiscal Year 1993," January 1994; Annual reports of the World Bank, the four Enterprise Funds, TDA, OPIC, EXIM, and EBRD; European Commission, Phare Information Office, *What is Phare? A European Union initiative for economic integration with central and eastern European countries*, June 1994.

NA = not applicable or not available

Note: Amounts shown represent obligations, commitments or approvals. Actual disbursements or expenditures through 1993, though, are lower for most of these identified programs and institutions. Amounts for the most part do not include assistance extended to discrete agricultural- and food-related projects under programs taking a broader focus nor investments made through financial intermediaries to agricultural and food enterprises. For many investments, resources made available were used to leverage cofinancing from other sources.

[a] The programs and institutions shown do not include all those providing agricultural- and food-related support in the region. Others (for which data was not readily available) include bilateral assistance programs administered by the British, Canadian, German governments, among others, and other multilateral institutions (i.e., the United Nations Development Program (UNDP) and the Food and Agriculture Organization (FAO)).

[b] Fiscal year for U.S. Government agencies and Enterprise Funds (October to following September) and for World Bank institutions (July to the following June), calendar year for EBRD and EU's PHARE program. Fiscal year data is presented for the year in which it ends (i.e., 1993 represents the 12-month period ending in September 1993).

[c] Poland and Hungary Assistance to the Restructuring of the Economy, created in 1990 to assist both countries achieve market economies based on private initiative and expanded by 1993 to cover most countries in the region.

[d] Refers only to direct loans, long-term guarantees and war chest grants. Excludes intermediary loans, medium-term guarantees, working capital guarantees, and short- and medium-term export credit insurance.

[e] Capitalized with Congressionally-appropriated funds provided by the U.S. Agency for International Development. Does not include resources extended under various technical cooperation programs to agricultural and food sectors.

TECHNICAL ASSISTANCE AND TRAINING

The United States has extended technical assistance and training to support the agricultural reform process in most CEE countries and has supported exploring potential opportunities to market U.S. agricultural commodities, food products, farm inputs, and food processing machinery to the region. USAID has focused on assisting the emerging private sector, while USDA has targeted resources to help create public institutions able to support the functioning of more open market systems. The EU, other Western countries, and multilateral development banks active in CEE have also offered similar technical assistance, frequently integrated with their trade promotion and lending activities.

USAID obligated $115 million in FY1990–FY1993 (9 percent of the near $1.3 billion in foreign aid funds made available for the

CEE) to support the agricultural transition process.[12] To fulfill the U.S. priority to assist these countries develop competitive, market-oriented economies, USAID's "Restructuring Agriculture and Agribusiness Project" has targeted assistance toward private farmers and new farm cooperatives created from the process of restructuring and reorganizing the former collective and state farms. Project objectives are to link CEE cooperatives with their U.S. counterparts, to train cooperative managers at U.S. universities in business management skills and cooperative organization, to place agribusiness managers as interns with U.S. agribusinesses, and to involve U.S. cooperatives and private agribusinesses in providing technical assistance to agribusinesses throughout the region in ways that help develop business opportunities for U.S. firms. For example, Land O'Lakes has sponsored training courses in privatization, cooperative development, dairy breeding and reproduction, dairy processing, agricultural marketing, and input systems in most CEE countries. The American Cooperative Enterprise Center's efforts to encourage joint ventures and trade has resulted in a feed manufacturing and distribution joint venture involving 12 Hungarian cooperatives and a large U.S. soybean processing firm. A training program sent experienced U.S. volunteers (under the Farmer-to-Farmer Program) to most CEE countries to assist farmers and agricultural enterprises increase commercial opportunities through better production, farm management, and marketing. Other USAID programs have tapped the expertise of U.S. accounting firms to assist CEE governments with the details of privatizing food enterprises.

The USDA committed $6.2 million in FY 1991–FY 1993 to share U.S. agricultural and agribusiness expertise with the CEE countries in ways that also promote near-term U.S. commercial opportunities. Activities undertaken under USDA's Emerging Democracies Program[13] have: (1) assessed agricultural development needs and market opportunities in the region, and (2) offered technical assistance (i.e., training, business matchmaking, policy advice, and related activities) that emphasizes promoting private marketing systems in targeted countries and helping U.S. exporters and agribusiness investors explore opportunities in the short to medium term. Technical assistance projects (administered by USDA agencies but funded by USAID), among others, have helped: (1) Poland and Bulgaria develop private farmer-oriented extension education services; (2) Poland and Hungary to draft new cooperative laws and create marketing information services; (3) all CEE countries develop credit institutions to serve agricultural sectors' needs; and (4) sponsor food marketing workshops in several CEE countries.

Similarly, the EU's Poland and Hungary Assistance to the Restructuring of the Economy (PHARE) Program made available $472 million in 1990–93 to assist in CEE agricultural restructuring and reform. Initial efforts developed reform strategies and policies, and

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[12] Funds were authorized by the Support for Eastern European Democracy (SEED) Act of 1989 (P.L. 101–179), as amended, and funded in each subsequent year's foreign operations appropriations act. The $115 million does not include resources made available to assist in the privatization of food enterprises and distinct agricultural and food-related activities supported under other AID programs in the region that are implemented with a broader focus in mind.

[13] Authorized under section 1542 of the Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101–624), as amended, and funded by USDA's Commodity Credit Corporation.

supplied the inputs needed to maintain food production levels. PHARE support has since shifted to implementing these strategies through assistance for restructuring and privatizing state enterprises and farms, developing rural finance mechanisms, developing land reform and registration systems, strengthening and training in rural banking services, establishing independent rural cooperatives, and providing market information and forecasting systems for major commodities. One PHARE project in Romania to support agrarian reform has involved a mix of studies, experts, training, and equipment to modernize the land registry system, provide legal advice, and establish a land information system. [14]

SYSTEMIC SUPPORT

The World Bank, USAID, and other Western nations have provided resources to support systemic policy reforms in some of the agricultural sectors in the region and have intervened to help governments address potential food supply problems. Since FY 1990, the World Bank has approved $822 million in agricultural loans (to facilitate policy adjustments or to support the establishment of new marketing infrastructures) for Hungary, Poland, Romania, and most recently Albania. World Bank loans address more systemic problems, by integrating technical assistance with financial resources to help reform institutions and legal systems, which is critical if agricultural sectors are to adapt to a more market-oriented environment.

USAID has used its foreign aid program in the CEE to inject assistance into the agricultural sectors of Albania, Bulgaria, and Romania when problems arose that required a quick response. In FY 1991, USAID extended $10 million in macroeconomic support to Bulgaria's agricultural sector; the local currency generated by this grant was used to operate the government's land reform offices throughout the country. USAID funded a similar $10 million program in Romania, where proceeds from the sale of soybean meal and other input imports is supporting the land titling effort. In FY 1992–FY 1993 USAID participated in an $18 million project to alleviate fertilizer supply bottlenecks experienced by Albania's agricultural sector. This package of commodity and technical assistance, together with improved price incentives, enabled farmers to increase production by 15 percent in 1992. [15]

LENDING AND EQUITY INVESTMENT IN AGRIBUSINESS AND FOOD SECTORS

The U.S. government and multilateral development banks have assisted Western and local businesses to explore and take advantage of emerging trade and investment opportunities in CEE countries.

The U.S. government has encouraged U.S. firms to particularly explore investment possibilities in, and to assist in developing, the agribusiness and food sectors of CEE countries. Support has been

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[14] European Commission, Phare Information Office, *What is Phare? A European Union inititative for economic integration with central and eastern European countries*, June 1994, pp. 7, 8, 14.

[15] U.S. Department of State, Office of the SEED Program Coordinator, "SEED Act Implementation Report, Fiscal Year 1993," January 1994, pp. 60–61, 72.

in the form of grants, loans, and seed equity capital extended by U.S. agencies and the USAID-funded Enterprise Funds charged with helping the emerging private sectors in four CEE countries.

Since 1989, the U.S. Trade and Development Agency (TDA), the Overseas Private Investment Corporation (OPIC), and the Export-Import Bank of the United States (EXIM) have supported U.S. agribusiness to explore investment and trade opportunities in the CEE. The TDA since FY 1990 has approved $1.6 million to assist the U.S. private sector participate in rebuilding the agricultural infrastructure in the CEE by helping firms target priority projects that in time create trade opportunities in the region. Activities funded include feasibility studies, orientation trips to the United States to introduce project sponsors to U.S. technology and expertise, project briefings at major U.S. trade shows, conferences, and technology training. TDA in FY 1993, for example, provided a small grant to a U.S. consultant to assess a proposal made by a joint venture for a feasibility study for a potato processing facility in Estonia. After certain issues were addressed, TDA made a $177,500 grant to the Estonian Ministry of Agriculture for a detailed feasibility study carried out by a U.S. firm. The study looked at the problem of how to reduce the high rate of potato spoilage and improve the quality of potatoes delivered for processing. Issues addressed included potato supply, marketing, and prospective financing for a plant that would process french fries for McDonald's, dehydrated potato flakes, and products using lower-quality potatoes.[16]

OPIC provides U.S. firms with loan guarantees and political-risk insurance to support the process of privatization, market reform, and democratization in CEE countries. Since FY 1990, OPIC has extended $196 million (largely insurance coverage) to back agribusiness investments in the region made by 14 U.S. companies. The largest transaction ($90 million in insurance) covered Sara Lee Corporation's privatization of coffee, tea, and spice processing and distribution in Hungary. OPIC insurance and a guarantee also backed investments in Poland made by Basic American's privatization of a potato processing plant, by Gerber in a baby food manufacturing facility, and by PepsiCo in a snack foods and candy production line. In Czechoslovakia, OPIC insured Teepak's investment in a facility manufacturing sausage casing. With funds received from USAID, OPIC also extended grants to U.S. firms exploring investment opportunities. As examples, OPIC is assisting in a project involving the production and marketing of apple juice concentrate in Hungary, and another dealing with processing and marketing corncobs for fiber.[17]

The EXIM (Export-Import) Bank facilitates exports of U.S. goods and services by providing medium- and long-term direct and guaranteed loans to supplement those available from commercial lenders to U.S. firms. Since FY 1990, EXIM has financed $17.9 million in three agribusiness-related exports and services, all to Poland. The largest transaction ($14.6 million) represented a loan guarantee approved to support Constar, Ltd.'s and Epstein Engineering

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[16] Based on project descriptions provided by TDA, August 1, 1994.

[17] OPIC, Annual Reports for Fiscal Years 1990, 1991 and 1992; U.S. Department of State, *Ibid.*, p. 126.

Export Ltd.'s provision of engineering, procurement and construction management for a meatpacking plant.[18]

Enterprise Funds, funded by USAID but operating as private U.S. corporations, are promoting the development of free enterprise and entrepreneurship by making available seed capital for joint ventures and other investments. Through FY1993 Funds active in Bulgaria, the Czech and Slovak Republics, Hungary, and Poland had extended $38.5 million in loans and equity investments in local agribusiness and food-related companies.[19]

In all countries, Funds' policies reflect decisions that eligible projects in the agricultural and food sectors are to be treated as priorities for investment. For example, the Hungarian-American Enterprise Fund channeled capital to a financial intermediary (Mezobank) to operate a small-scale lending program to agriculture, and took a 6 percent equity stake in the privatized Pick Sausage Company (a leading meat processor and producer of fresh pork and beef products, sausages and salami, with exports accounting for about half of total sales). The Polish-American Fund made equity and lending investments in two farm-based cold storage and meat processing facilities, in Sando Company Ltd. (a cooperative that grades, packs, and sells apples for the domestic and Western European markets), and in Mostostal Panel Company (a manufacturer of insulated panels used in constructing food processing plants and refrigerated warehouses for food storage). The Czech and Slovak American Fund has financed a few bakeries, the Kansas City-based AgManagement Inc.'s joint venture with a Slovakian farm cooperative to breed beef cattle, and JAMI (a small Czech manufacturer of a small, multi-purpose agricultural machine used as a plow, cultivator and brush cutter), among others.

Since 1991 the European Bank for Reconstruction and Development (EBRD), created to support the transition to democracy and market economies in the region, has placed $344 million in loan and equity investments in 22 agribusiness and food sector projects in CEE. EBRD involvement includes: (1) loans to six banks in Hungary, Romania, and the Slovak Republic to be used to extend medium- and long-term financing to private small- and medium-sized enterprises in the agricultural sector, (2) loans to establish and upgrade wholesale agricultural markets in Bucharest and Budapest, and (3) equity investments in a Czech sugar processor, in Fusion Investment Company (involved in joint ventures in Hungary and Czechoslovakia with local franchises of U.S. fast food firms), and in Cokoladovny (a major Czech producer of chocolates and biscuits, with other equity being provided by Nestles and BSN).[20]

OUTLOOK FOR AGRICULTURAL PRODUCTION AND FOOD CONSUMPTION IN THE CEE

Many experts foresee that the reforms introduced into this region's agricultural and food sectors will enable Central and Eastern Europe to become completely self-sufficient in grain production and

[18] EXIM, Annual Reports for Fiscal Years 1991, 1992 and 1993.
[19] Based on a review of the annual reports that the four Funds have issued since their creation.
[20] EBRD, Annual Reports for 1991, 1992, and 1993.

a player in world grain trade by the end of the decade. Two factors are expected to account for these developments: a further decline in grain consumption, and the region's potential to increase its agricultural productivity. The significant and still continuing decline in food consumption, particularly of animal and dairy products, is expected to substantially reduce the region's need to import wheat and coarse grains (unless there is a severe drought). Also, with CEE crop yields relatively low compared to Western Europe (with a similar climate and soils), the potential exists to boost yields and sharply stimulate production as policy reforms (particularly those allowing for private ownership of land) take hold, farmers and agribusiness pay increased attention to price signals, and imported technologies are introduced, among other contributing factors. Many view Western governmental assistance to CEE's agricultural and food sectors, together with foreign direct investment in the food sector, as a means of improving and introducing the needed infrastructure for more efficient farm production, commodity storage and transportation, food processing, and product distribution and marketing. Critical to the success of this effort will be the development of technical, entrepreneurial and managerial skills among those involved throughout the entire food production and marketing chain.

Lower food consumption, expected increases in agricultural productivity and efficiency throughout the food chain, and the resumption of economic growth in many CEE countries are expected to turn the region into a net grain exporter by late this decade. A World Bank forecast indicates that these trends will allow the region to export 1.6 million metric tons (MMT) of grain by the year 2000, rising to 3.6 MMT by 2010 (compared to 13.7 MMT of grain imports in 1980).[21] A more detailed analysis projects that by 2000, Hungary, Romania, and the former Yugoslavia would become exporters of wheat and corn; Poland and the Czech Republic, though, would continue to import corn.[22] Another report, though, views the sharp fall in agricultural output since 1988 as impairing "the considerable capacities for farm and food production in Poland, Hungary, and Bulgaria in particular."[23] Should the more optimistic scenario emerge, shifting from being a net importer to a net exporter would likely affect the detailed terms of CEE countries' accession to the EU (particularly in the negotiations on the agricultural provisions associated with full membership) and future world grain trade flows (discussed below).

POLICY ISSUES

FUTURE CEE GOVERNMENT POLICIES TOWARD AGRICULTURAL AND FOOD SECTORS

Becoming slowly aware of their countries' potential for increased agricultural productivity, CEE policymakers are torn between real-

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[21] The World Bank, International Economics Department, *The World Food Outlook*, by Donald O. Mitchell and Merlinda D. Ingco, November 1993, p. 189.

[22] *Agra Europe*, "Eastern Europe To Be 'Net Grain Exporter by 2000'," March 18, 1994, p. M/13.

[23] Julie Wolf, "Report Proposes Eastern Europe Adopt Farm-Support System Similar to EU's," *Wall Street Journal*, June 17, 1994, reporting on a study prepared for the EU Commission by Henri Nallet and Adrian van Stolk.

izing this longer-term objective and seeking in the short term to support and maintain the economic resources and labor devoted to agriculture. Most agree on the objective to become self-sufficient in grain production and reduce the need to spend scarce foreign exchange for commodity imports. Three alternative agricultural policy prescriptions have surfaced in this debate—each posing different implications for the overall economic reform process. Sometimes policies suggested or adopted in the interim are made with an eye toward attaining membership in the EU later this decade or early in the twenty-first century.

Policies that support the agricultural and food sectors' transition toward a more free market orientation (particularly liberalizing both domestic and foreign trade), some argue, would contribute to overall economic stabilization and increased growth. With relatively low production costs due to fertile soils and low wage rates, some maintain that Hungary, and in time Bulgaria and Romania, might develop agricultural sectors sufficiently productive to meet domestic food needs and efficient enough to be competitive in exporting agricultural commodity surpluses and processed food products. Western involvement (supported by governments and multilateral lending institutions or undertaken by private firms) in those food sectors being privatized acknowledges this potential, as decisions to invest are frequently based on plans to also sell food products into export markets, primarily in Western Europe.

Others advocate raising barriers to food imports and adopting features of the EU's Common Agricultural Policy (CAP) to ensure the financial viability of their agricultural sectors. Initial decisions to significantly reduce state involvement in, and support of, agriculture, are now criticized as having created severe problems (particularly for producers). In turn, the influence of agrarian interests has increased (following recent elections) to the point that some coalition governments can only be created and maintained with the support of agrarian parties, which seek to use their enhanced political position to address these concerns. To protect domestic producers from competition brought about by a surge in imports, a large portion subsidized by the EU, Poland among other countries has imposed import levies (i.e., tariffs equal to the difference between the lower subsidized imported product price and the domestic price) on selected food products. Also to bolster farm income, some countries have introduced intervention (state purchase) and minimum support prices.

With most CEE countries seeking eventual membership in the EU, some argue that producers should be supported by guaranteed commodity prices that closer match CAP's much higher farm prices. The only question in their minds left to settle is whether or not to match EU's support levels. However, concern exists that temporary measures introduced to respond to the sector's problems in adjusting to reforms may become fixed features of agricultural policy. Observers point out this would place increasing financial burdens on national budgets, create unintentional problems in gaining future EU membership, and undermine the agricultural sectors' potential to be competitive in world markets.

Others, primarily Western observers, argue that governments that seek to address rural issues (particularly the social safety net tied to the socialized agricultural sector) should directly intervene with special programs rather than rely on raising commodity prices to boost income. More emphasis should be placed on aggressively pushing for the breakup and privatization of the agricultural input monopolies as a way to inject some competition, with direct cost benefits to producers.[24]

CEE AGRICULTURAL EXPORT ISSUES

CEE policymakers view access to Western markets, particularly the EU market, for their food products as vital to transforming and making their agricultural and food sectors increasingly responsive to market forces. With a history of exporting their agricultural surpluses to the former Soviet Union and other communist bloc countries, these countries still view their comparative advantage in producing certain agricultural products as critical to generating the earnings needed to recapitalize their economies and to service existing foreign debt. From the CEE perspective, the association agreements that the EU began to implement in early 1993 with the Czech Republic, Hungary, Poland, and Slovakia have had limited impact in opening up the protected EU agricultural market. In turn, some CEE policymakers are now questioning how serious the EU is in integrating economically and politically with its eastern neighbors.

Hungary and the Czech Republic, in particular, have also faced stiff competition due to EU and U.S. subsidies in selling their grain to potential export markets. In response, the Czech Republic and Hungary have felt compelled to subsidize exports of their grain surpluses—another tool employed to support farm income. Concern over both market access to the EU, and its use of export subsidies in third-country markets, have further contributed to calls for CEE governments to become more interventionist and active in supporting their domestic agricultural and food sectors.

The possibility may exist for some of these CEE countries to exploit sales opportunities created by the General Agreements on Tariffs and Trade (GATT) 1994 Agreement on Agriculture. With the EU and the United States required under the Agreement to reduce their use of export subsidies by 36 percent in volume terms by the year 2000, CEE countries may find openings to make export sales of wheat and other commodities in nearby markets in which the EU and United States had earlier subsidized sales.[25]

IMPLICATIONS FOR U.S. AGRICULTURAL EXPORTS AND AGRIBUSINESS

U.S. economic interests in the agricultural and food sectors in CEE countries are expected to be limited compared to the potential foreseen in the higher-growth emerging countries of Latin America and Southeast Asia. Increasingly, U.S. agricultural exports to Central and Eastern Europe will likely be driven more by growth in consumer disposable income than by the need to cover produc-

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[24] Discussion paper prepared for OECD's Ad Hoc Group on East/West Economic Relations in Agriculture, early 1994.

[25] For one detailed analysis of the effects of the GATT Agreement on CEE agricultural policies and trade, see "Future Prospects for Central and Eastern European Agricluture" by Daniel J. Plunkett and Douglas Maxwell, in USDA, Economic Research Service, *Europe Situation and Outlook*, WRS-94-5, October 1994.

tion shortfalls that occur, implying a change in the mix of U.S. agricultural exports.

Still uncertain are the possible impacts on the flows of U.S. agricultural exports worldwide due to policies that CEE governments may adopt to support their agricultural sectors, and the outcome of CEE negotiations to join the EU. Some foresee that if CEE policies move in the direction of reflecting higher EU grain support prices (even with GATT and CAP reforms), thus stimulating production, U.S. exporters would face increasing competition in selling wheat, oilseeds, and other commodities.

The economic transformation taking place in the CEE, nevertheless, may offer lucrative investment opportunities to U.S. agribusinesses (particularly commodity processors and food manufacturers) that take a long-term perspective. This would enable them to take advantage of the region's large consumer market, and perhaps more important, to strategically position themselves to penetrate the markets of the former Soviet Union at an appropriate time.

U.S. AID TO CENTRAL AND EASTERN EUROPE, 1990–1994:
An Analysis of Aid Models and Responses

By Janine R. Wedel*

CONTENTS

*Anthropologist Janine R. Wedel is a MacArthur Fellow and Associate Research Professor at George Washington University, currently affiliated with the Woodrow Wilson International Center for Scholars. This paper is based on the author's fieldwork on the topic over four years, including five months in 1994 in Central and Eastern Europe and Russia; four months in the major recipient nations during 1991–92; and a 1989–90 Fulbright year in Poland.

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SUMMARY

This paper is concerned with understanding the conditions under which effective U.S. aid can be rendered to Central and Eastern Europe. Because the story of grant aid to the region is as much a story of political and social impact as it is of economic impact, the paper first examines the social and political features of aid, its historical context, and changing recipients' responses to it. Second, it reviews U.S. assistance agendas. To explore the components of a successful aid program, various programs are examined for overall strategy and timeframes, location of decision-making, the nature of contracting procedures, degree of recipient input, donor relationships with recipient governments, the degree of donor concentration on "independent" and "private" sectors, and cooperation and coordination with other donors. Finally, two technical assistance approaches are reviewed, plus two models for aiding the "private" or "independent" sector that have been followed in U.S. aid efforts in the region.

The paper concentrates on aid responses and models in Poland, Hungary, and the former Czechoslovakia because after four years of operation, an analysis of key programs is warranted, and since these states were considered the most likely to succeed among the countries in transition, it is important to examine how the assistance has worked. If the aid process is not understood, the problems in these countries might be repeated in regions regarded as less developed and which had less previous exposure to the West. It is also important to understand why and in what areas aid to Poland, Hungary, and the Czech Republic has been effective, so that these productive approaches might be adapted to new aid situations.

Of the two technical assistance approaches examined, one generally has been well received among the recipients and the other has met with mixed response, due to the possibilities and drawbacks inherent in them. The approach with mixed results has been problematic because it is inherently politicized and because its setup lends recipients little flexibility and input. The more effective model is built around long-term resident advisers and institutional support that are integrated into and requested by host institutions.

With regard to independent and private sector aid models, it is important for donors to consider the specific and changing conditions of recipient countries. One model analyzed is the donors' sup-

port of Eastern European nongovernmental organizations (NGOs). Although NGOs can play productive roles, they may not be fully designed to be the "building blocks" of democracy that the donors envision. Four factors identify how the second model, the U.S. Enterprise Funds providing support to small and medium businesses, will work under the varying financial conditions of the many recipient countries.

Although, following a phase of frustration and resentment, Poland, Hungary, and the Czech Republic have begun to make better use of Western assistance (or decided to limit its use), it is by no means certain that this will be duplicated in countries whose aid experiences are just getting under way or are being stepped up, and where the stakes are higher and the potential for chaos greater. In these nations, frustration and resentment may last years longer and have even greater political and social repercussions. Or the nations may not develop the kinds of adaptations favorable to the West. If we have learned anything, it is that there must be a balance between donor decision-making and recipient input with significant oversight from donors.

UNDERSTANDING THE AID SCENARIO

This paper looks at the conditions under which effective U.S. aid can be rendered to Central and Eastern Europe. Since 1989, the United States has obligated nearly $1.5 billion under the Support for East European Democracy (SEED) Act to the nations of the former Soviet bloc to promote democracy and a market economy.[1] In authorizing aid to Poland and Hungary, SEED outlined a wide range of grant aid programs, from privatization and economic restructuring to programs in environment and agriculture. The paper concentrates on priority U.S. grant aid programs, which are administered through the Agency for International Development (AID) rather than on export credits, macrostabilization assistance, or loans. The focus is on the Visegrad countries of Poland, Hungary, and the former Czechoslovakia. These nations received the most donor attention, at least initially.[2]

It is important to examine aid responses and models in Poland and Hungary for two reasons. First, after four years of operation, an analysis of key programs is warranted. Although much attention has been paid to the donor side, aid projects tend to look different in the field than in donors' reports. Second, because Poland, Hungary, and then-Czechoslovakia were considered the most likely to succeed among the countries in transition, it is important to examine how the assistance has worked in these "model" countries.[3] If the aid process is not understood, the problems in these nations might be repeated and even exacerbated further south and east in Bulgaria, Romania, and Albania, and in Russia and Ukraine because these countries generally are regarded as less developed and

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[1] U.S. Agency for International Development, "U.S. Assistance for Central and East Europe: FY 90–94 Obligation Summary as of 31 March 1994," May 1994.

[2] Poland, which has received almost half of the assistance, receives the most aid in the region, while Hungary receives the second largest amount, *SEED Act Implementation Report: Fiscal Year 1993* (Washington, DC: United States Department of State), Jan. 1994, p. 7.

[3] U.S. assistance is slated to be scaled down in Poland, Hungary, and the Czech Republic, *SEED Act Implementation Report: Fiscal Year 1993*. (Washington, DC: United States Department of State), Jan. 1994, p. 6.

had less prior exposure to the West. It is also important to understand why and in what areas aid to Central and Eastern Europe has been effective, so that these productive models might be adapted to new aid situations.[4]

The story of grant aid to Central and Eastern Europe is as much a story of *political and social impact* as it is of *economic impact.* The economic impact of aid presents issues of serious concern, but economic factors cannot be isolated from a whole host of other vital issues.[5] The author, a social anthropologist, is concerned with these other issues. Grant aid and the technical and people-to-people assistance that constitute much grant aid are closely linked to political and social issues and therefore call for in-depth analysis.

There have been no significant studies that measure the *economic* impact of *grant aid* on recipients in Central and Eastern Europe.[6] Notwithstanding donors' policy statements and "transition" reports featuring charts with funding levels, expenditures must not be confused with economic results.

The social and political aspects of aid cannot be ignored because many of the donors' approaches to aid imply substantial political and social transformation. This is a marked departure from aid policies to the Third World. Changing the very nature of recipient institutions is a goal of aid to Central and Eastern Europe (whether explicitly stated or not), but is often not a goal of aid to the Third World. Aid to India, for example, tends to be couched in terms of efficiency and economic growth, not in terms of institutional change. In addition, in Central and Eastern Europe donors have had a greater sense of urgency. Many in the West argued that there was only a short-lived "window of opportunity" to affect change and spoke of the need to move quickly to fill the political-economic vacuum created by the collapse of the Soviet bloc.

The different nature of the Central and Eastern European aid effort led to the restructuring of the aid community itself. The shift in donor attention to the former Soviet bloc has prompted a major change in the priorities, resources, and personnel commitments of donor organizations. For example, the donors have created new entities and mechanisms to handle Central and Eastern European aid that are separate from those that manage Third World aid.[7] In the

[4] There are many factors on the recipient side that might enter into recipients' responses to aid. In addition to exposure to and experience in the West, these include the developmental starting points of the countries; different reform courses undertaken; extent to which there was a grass-roots, wholesale transformation that attempted to replace one system with another; and the size of the aid presence in the recipient country. (This list was conceptualized together with David A. Kideckel, who has researched the topic in Albania and Romania.)

[5] The classic anthropological model that informs this research is the study of the relationship between an organization's policies (in this case, those of a donor agency) and the implementation and effects of those policies on their recipients.

[6] Measuring the economic impact of most grant aid, notably technical assistance, would be extremely difficult. Constructing a simple causal relationship between aid and some specified economic outcome (such as the number of Western aid-paid technical advisers in a country and the number of companies that are being privatized), would be equally problematic. Many variables enter into the privatization picture, among them the political environment of the recipient country and the political and economic interests of parties to the privatization process such as ministry officials, factory managers, and employees, and new entrepreneurs. Furthermore, measuring the effectiveness of privatization by simply counting the number of factories privatized also is questionable. Privatization has come to be seen in the international aid community as a measure of "success" in itself, as shown, for example, in donor reports that cite the sheer number of firms that have been converted without regard to the economic effectiveness or the political or social consequences of the conversion.

[7] In Germany, the Bundesministerium fur Wirtschaft handles aid to the more developed countries of the former Communist bloc, while the Ministerium fur Wirtschaftliche Zusammenarbeit

United States, some 35 federal agencies, many never before active overseas, are working in the aid effort.[8] The United States created the Assistance Coordination Group, a body chaired by the State Department and charged with coordinating the aid effort. The Office of the Coordinator for U.S. Assistance to the New Independent States was later established to handle assistance to the former Soviet Union. AID also created new entities to manage aid to the region, currently known as the Bureau for Europe and the New Independent States. The donors' heightened sense of urgency, however, may have led to overpromising and to frustration on the part of the recipients.

THE HISTORICAL CONTEXT OF AID TO POLAND, HUNGARY, AND FORMER CZECHOSLOVAKIA: CHANGING RECIPIENT RESPONSES

The author's research, which entailed extensive interviews with aid principals during 1991–92 and the spring and summer of 1994, has identified the following three phases in recent aid history in Poland, Hungary, and former Czechoslovakia.[9]

PHASE 1: EUPHORIA AFTER THE COLLAPSE OF COMMUNISM, 1989–1990

On a popular level, Eastern Europeans brought an idealized view of the West and naive understanding of foreign aid to their expectations of what the West could do for them. The late Rita Klimova, former Czechoslovak ambassador to the United States, characterized her country's expectations at the time: "People imagined the United States to be a kind of rich Soviet Union." What she meant was, "We expected to have a relationship of dependence, as with the Soviet Union, but with a lot more cash coming our way."[10]

These expectations were fed by the flood of visitors from the West conveying their interest in the region and their willingness to help. The misleading information that circulated in the press in 1990–91 also fueled these expectations. In Poland, news circulated that the West was sending billions of dollars in aid to Poland without qualifying that this included export credits and loans that would have to be repaid. And many people in the region did not understand that much of the grant aid allocated was for technical, not capital, assistance, and that advisers, not money, would be sent. (It is important to keep in mind that, unlike in Central and Eastern Europe, three generations of Third World aid recipients

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is responsible for Third World aid and the less developed countries of Eastern Europe and the former Soviet Union. In the United Kingdom, Britain's aid to the new countries is handled jointly by the Overseas Development Agency (ODA), the government's foreign aid agency, and the Foreign Commonwealth Office, the agency responsible for foreign affairs. The European Union created a wholly separate PHARE program (Poland-Hungary Aid for Restructuring the Economy) to manage Eastern European assistance.

[8] *Eastern Europe: Status of U.S. Assistance*. General Accounting Office, Feb. 26, 1991, Appendix 1.

[9] Interviews included key officials most directly involved and knowledgeable about the aid process in these countries. The officials interviewed work at the core institutions of foreign assistance coordination and monitoring—in Poland, the Council of Ministers; in Hungary, the Ministry of International Economic Relations (Assistance Coordination Secretariat) in the Czech Republic, the Ministry of the Economy (Centre for Foreign Assistance); and in the Slovak Republic, the Ministry of Foreign Affairs (Department of Foreign Assistance). Other aid principals interviewed include officials who deal with aid in the ministries of privatization, industry, finance, and environment who receive consultants and/or funds. Typically, one or two, at most three, officials manage aid in a particular agency or division.

[10] Janine R. Wedel, "The Unintended Consequences of Western Aid to Post-Communist Europe," In *Telos*, no. 92 (summer 1992), p. 132.

have worked with donors and, to the extent possible, tailored aid to their purposes.) All this paved the way for the difficult second phase.

PHASE 2: FRUSTRATION AND RESENTMENT, BEGINNING IN 1991–1992

Aid outcomes suffered not only from the recipients' unrealistically high expectations and misunderstandings about the type of aid that would be sent, but also from the donors' often unfulfilled promises.

Many people in the region began to wonder where the money went. As Poland's chief coordinator of foreign assistance, Minister Jacek Saryusz-Wolski, lamented: "When people in Poland hear that billions of dollars come to Eastern Europe, they expect that Poland gets one-half or one-third of that money . . . Very often people ask us what happened to it."[11] In 1992 Polish President Lech Walesa articulated the growing resentment when he spoke at the European Parliamentary Forum in Strasbourg, charging, "It is you, the West, who have made good business on the Polish revolution. . . . The West was supposed to help us in arranging the economy on new principles, but in fact it largely confined its efforts to draining our domestic markets."[12]

Similarly, Hungary's chief aid coordinator, Minister Bela Kadar, stated: "The public learns from official statements that the Western world has transferred resources on the order of $40 billion to $70 billion so far, to promote transition in the post-communist countries. One has to ask, where have all these billions gone?"[13] In fact, there was a considerable gap between donors' allocations and actual disbursements in the region. In 1992 only an estimated 11 percent of the committed monies actually had been disbursed.[14]

The hundreds of "first meetings" with Westerners also led many Polish, Hungarian, and then Czechoslovak officials to conclude that the West was delivering far less than promised. The pendulum swung from an initial open-arms welcome to foreigners to the opposite reaction: "Foreigners don't understand our conditions." Officials in Warsaw, Budapest, and Prague complained that their concerns were ignored despite the presence of American government aid bureaus in these cities and numerous fact-finding missions from the West. Polish officials responsible for aid coordination were unable to obtain reliable information about how much U.S. assistance was being spent on particular projects, although the local AID office was just several blocks away.[15] At about the same time the U.S. General Accounting Office (GAO) reported that in Hungary many assistance transactions, including those of the United States,

[11] Janine R. Wedel, "Beware Western Governments Sending Gifts," *The Wall Street Journal Europe* (Jan. 14, 1992).

[12] Blaine Harden, "Poles Sour on Capitalism," *The Washington Post*, Feb. 5, 1992.

[13] Bela Kadar, "Where Have all the Dollars Gone?", *Transition: The Newsletter about Reforming Economies*, Transition Economics Division Policy Research Department, The World Bank, vol. 4, no. 5, June 1993, p. 5.

[14] Average disbursement rates for nine G–24 countries and the EU were 11 percent for total committed assistance to Central and Eastern Europe (Raymond Barre, William H. Luers, Anthony Solomon and Krzysztof J. Ners, *Moving Beyond Assistance* (New York: Institute for East-West Studies), 1992.

[15] Janine R. Wedel, Congressional testimony, Hearing before the House Subcommittee on Europe and the Middle East of the Committee on Foreign Affairs, April 7, 1992; and General Accounting Office (GAO), *Poland and Hungary: Economic Transition and U.S. Assistance*, May 1, 1992, p. 34.

occurred without the knowledge of the Hungarian government's assistance coordination unit.[16]

Indeed, some consultants who came to the region stirred up resentment both among people without any direct experience with aid consultants and among officials with much direct experience. As Czech aid coordinator Pavel Rozsypal expressed: "The salaries paid to foreign assistance contractors advising government ministries are widely known by Czech officials to be stratospheric in local economic terms—it is known, for example, that European Union (EU) PHARE advisers (under the EU's Poland-Hungary Aid for Restructuring the Economy program to aid Central and Eastern Europe) are paid six times more (and upwards) than the Ministers they are paid to assist. This of course causes a certain level of cynicism on the part of the local beneficiaries regarding just who is the intended beneficiary of foreign assistance; criticisms in this regard are widely circulated in Czech government offices."[17]

Early on, Poles dubbed the consultants the "Marriott Brigade" because they tended to stay at Warsaw's pricey new five-star Marriott hotel.[18] Polish aid official Marek Kozak went so far as to suggest that the main benefit derived from the Marriott Brigade was not the expertise they provided, but the hard currency they contributed to the local economy.[19] Perceptions of Western acquisitiveness and arrogance may have been exacerbated by the fact that major donors, notably the United States, the EU, and Great Britain, have tended to use for-profit accounting firms to carry out their agendas in priority areas such as privatization. Especially in the early stages of aid delivery, these consultants seemed more likely to cause resentment than the less conspicuous professors or city managers from the West whose aid projects may have been quietly successful and whose personal styles were seen as more acceptable.

The disillusionment was often mutual. Although few U.S. officials expressed frustration in public, they sometimes denigrated the recipients in private ("they just can't handle it" or "they have no sense of democracy"). When recipients perceived such attitudes, the cultural divide widened and led to the third phase of the relationship.

PHASE 3: REALITY CHECK—RECIPIENTS ADAPT AS EXPERIENCE WITH DONORS GROWS

During trips to Poland, Hungary, and the Czech Republic in 1994, the author followed up on previous interviews with aid coordination officials in those countries. What was observed was an evolution of knowledge, experience, and expertise. Officials are better skilled at working with the donor community and are more realistic about what aid can and cannot do for them. In some cases they have concluded that the costs of working with a program in

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[16] GAO, ibid.

[17] Letter to Janine Wedel from Pavel Rozsypal, director of the Centre for Foreign Assistance of the Ministry of the Economy, Aug. 2, 1994.

[18] A number of articles appeared in the Polish press criticizing the "Marriott Brigade" (e.g., Jacek Kalabinski. "The Marriott Brigade in Action," *Gazeta Wyborcza* (June 21, 1991); and Jacek Kalabinski, "The Misfortune of the Marriott Brigade," *Gazeta Wyborcza* (Oct. 18, 1991).

[19] Janine R. Wedel, "The Unintended Consequences of Western Aid to Post-Communist Europe," *Telos*, no. 92 (summer 1992), p. 133.

terms of timing and meeting donor requirements do not justify the benefits, and they have decided not to use the program.

A related development is the blurring of donor and recipient personnel. Whereas previously it was possible to detect "who is who" by nationality, language, and style, now consulting groups, including accounting firms, are hiring more local citizens and expatriates who speak Polish, Hungarian, Czech, and Slovak. Donors also have recruited some formerly high-level Eastern European officials: The Polish-American Enterprise Fund hired a former deputy minister of privatization and a former undersecretary in the ministry of industry and trade to be vice presidents. Marek Kozak, a Polish aid coordination official who two years earlier criticized Western aid efforts, now heads a new initiative for the EU.

Recipient officials seem better at identifying their needs and more selective about foreign (and local) advisers. As Salvatore Pappalardo, an American consultant in Poland, observed: There were "a lot of carpetbaggers early on. . . . At this stage of the process Poles are more aware of the things they know and, most importantly, of the things they don't know. They've learned to clarify their needs."[20]

One result is that the Czech government has decided to use a minimum of foreign assistance and has even refrained from relations with the World Bank. In a speech at the World Bank, Prime Minister Vaclav Klaus explained that, "After three years of relatively successful fundamental systemic transformation of the Czech economy and society my experience tells me that the role of external factors in this process is relatively small and that the reform begins and ends at home."[21] Zdenek Drabek, former aid coordinator of the former Czechoslovakia, further elaborated: "Many Czechs now proudly believe that Westerners have little to teach us, to show us, to advise. . . . The attitude has been essentially that we don't need the money."[22]

Another result is that the Poles and Hungarians have requested more capital assistance and less technical assistance.[23] This generally has not been forthcoming from bilateral donors; indeed, the limited funds allocated may not go far in capital assistance projects. Regardless of whether much of the technical assistance rendered has been effective, a natural progression has occurred. As Poles, Hungarians, and Czechs have developed their technical assistance capacities, the need for foreign aid-sponsored technical assistance may have diminished.[24] Responding at least in part to political considerations following a Copenhagen summit in June 1993, the EU is beginning to supply more capital assistance to finance trans-European network projects in the form of railway lines,

[20] Interview with Salvatore Pappalardo, April 13, 1994.

[21] See Vaclav Klaus. "Foreign Aid for a Postcommunist Country-Experience and Prospects." Speech before the Bretton Woods Committee, World Bank, Washington, D.C., Oct. 15, 1993.

[22] Interview with Zdenek Drabek, July 7, 1994.

[23] Interviews with Pawel Samecki, Director of the Bureau for Foreign Assistance, the Polish Council of Ministers, April 29, 1994, and with Agnes Nadhazi and Kornel Kovats of the Hungarian Ministry of International Economic Relations, April 27, 1994.

[24] This view has been offered by a number of donor and recipient officials, as well as in an OECD report on technical assistance, "Comparative Assessment of Key Technical Assistance to the Partners in Transition and Four New Independent States of the Former Soviet Union," (Organisation for Economic Co-operation and Development, Paris), 1994, pp. 6–7.

roads, and border infrastructure.[25] As one EU official explained, "Investment finance is more visible to the public. That's one of the reasons we're going into it. . . . [Investment] can be "seen and touched."[26]

Although Poland, Hungary, and the Czech Republic appear to be adapting, it is by no means certain that this experience will be duplicated in countries whose aid experiences are just getting under way or being stepped up. In these nations, Phase 2—frustration and resentment—may last years longer and have even greater political and social repercussions. Or the nations may not develop the kinds of adaptations favorable to the West.

U.S. ASSISTANCE AGENDAS IN PERSPECTIVE

U.S. bilateral aid is one of many programs present "on the ground" in Eastern Europe. Since 1989, the world's wealthy nations of the G–7 have committed nearly $35 billion in aid to help Central and Eastern European nations.[27] All programs have emphasized, to a greater or lesser degree, the privatization and economic restructuring of state-owned enterprises and private-sector development. Although the programs have many similarities, individual donor nations differ in a number of areas and reflect the donors' different political and strategic agendas, levels of experience with Eastern Europe, and cultural strengths. The EU's PHARE program is the largest in size.

The programs warrant examination in these crucial areas: (1) overall strategy and timeframes; (2) location of decision-making; (3) the nature of contracting procedures; (4) degree of recipient input; (5) donor relationships with recipient governments; (6) the degree of donor concentration on "independent" and "private" sectors; and (7) cooperation and coordination with other donors.[28]

OVERALL STRATEGY AND TIMEFRAMES

The SEED legislation that authorized U.S. aid to Eastern Europe established some 25 priority areas and called upon the expertise of up to 35 Federal agencies. This encouraged the compartmentalization of aid into a number of isolated areas. The legislation did not consider how the expertise of all these agencies, many of them never before active overseas, was to be coordinated within the recipient countries (the State Department was given only a nominal "oversight and coordination" role). Moreover, while U.S. assistance was designed as short-term, a long-term commitment was called for if the United States was to have a real impact on the region.[29] Al-

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[25] Interviews with Klaus Schmidt and Andrew Rasbash of the EU Delegation in Poland, April 7, 1994 and April 22, 1994, respectively; and interviews with John Kjaer and Pierre Mirel of the PHARE program in Brussels, May 4, 1994. The "Conclusions of the Presidency" document, Copenhagen June 21–22, 1993, Brussels, European Union, p. 14, states: "Part of the resources under the PHARE programme may be used for major infrastructural improvements."

[26] Interview with Klaus Schmidt of the EU Delegation in Poland, April 7, 1994.

[27] Of this, some 42 percent is grant aid. These figures, which are based on the April 1993 G–24 Scoreboard, cover the period January 1990 to December 1992. *SEED Act Implementation Report: Fiscal Year 1993.* (Washington, DC: United States Department of State), Jan. 1994, p.278.

[28] In addition to consulting published and unpublished works, as cited, this section is based on interviews with donor and recipient officials.

[29] This view is shared by other analysts of Central and Eastern European aid, including the GAO (*Poland and Hungary: Economic Transition and U.S. Assistance*, p.30–31) and the Insti-

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though it is difficult to find aid programs in the region that have been models of foresight and strategy, one might have expected that European programs would be more realistic from the outset because the Europeans had previous involvement in the region and the donors generally made longer-term commitments.

LOCATION OF DECISION-MAKING

The extent to which input from field representatives is integrated into critical decisions at donor headquarters may affect the allocation of resources and the coordination and integration of programs. Washington has been the center of assistance decision-making, creating many coordination, implementation, and political problems. Initially AID field representatives had no signature authority in disbursing funds and served only as advisers to the American ambassador of the recipient country and providers of information to Washington AID. Because AID representatives in Eastern Europe generally had little authority, decision-making often was delayed and the flow of information impaired.[30]

Washington-based management changed somewhat in early 1993 following congressional direction that authority be delegated to the field "in order to avoid planning and contracting in Washington for specific activities without the concurrence of the people in the field who have more intimate knowledge of the particular country . . ."[31] Although the number of AID field representatives has since grown, and these representatives appear to have more input into approving and designing projects than in the past, they still are not charged with the authority of field "missions" established for Third-World aid.[32] An evaluation of AID privatization projects in Central and Eastern Europe commissioned by AID independently concluded that: "The AID field office should have the ability to authorize funding of policy/program assistance, and/or at a minimum the flexibility to amend authorized funding. The lack of this local authority has, at times, held up host country requested assistance, especially in Poland."[33]

By contrast, the British and the German resident representatives in Poland say they have significant input into aid decisions and veto authority.[34] It may help that each program has only one official who handles aid in the recipient country. While this system makes decision-making more efficient, it can also lead to a loss of

tute for East West Studies (*Moving Beyond Assistance*. NY: Institute for East West Studies, June 1992).

[30] Janine R. Wedel, congressional testimony (Hearing before the House Subcommittee on Europe and the Middle East of the Committee on Foreign Affairs), Apr. 7, 1992. In addition, GAO reported the following: "A U.S. official in Poland told us that decisionmakers in Washington did not seek advice on projects from in-country staff, even though these staff members have first-hand knowledge of the country's conditions and monitor U.S. assistance efforts. In some cases, decisionmakers in Washington have ignored recommended actions from in-country staff." (GAO, *Poland and Hungary: Economic Transition and U.S. Assistance*, p. 33–34.)

[31] House of Representatives (Foreign Operation, Export Financing, and Related Programs Appropriations Bill, 1993) report 102–585, June 18, 1992, p. 34–36.

[32] "Final Report: Privatization Phase II Program Evaluation," Submitted to AID, Washington, DC, by Development Economics Group/Louis Berger International, Inc., and Checchi and Company Consulting, Inc., July 30, 1993, p. 11.

[33] However, according to Mark Karns of Washington AID, from time to time Washington AID and the representative offices in the field agree on delegations of authority for certain projects or activities (interview of June 7, 1994).

[34] Interviews in Warsaw with Bernd von Muenchow-Pohl, German Embassy, April 14, 1994; and Dominic Meiklejohn, British Embassy, April 14, 1994.

control and reduced accountability. In any event, it is an inefficient use of human resources to have many representatives in the field acquiring knowledge and experience who are given few decision-making responsibilities.

THE NATURE OF CONTRACTING PROCEDURES

Contracting procedures for hiring consultants greatly affect the delivery of assistance and recipients' responses to it. Reflecting its political and administrative constraints, AID's contracting procedures make it difficult for recipients to select consultants, except to choose from a very limited pool offered by AID. However, the expertise provided by Federal agencies under inter-agency agreements (e.g., the Treasury Department's Financial Sector Technical Assistance Program) provide more flexibility because they are not subject to these contracting constraints. (For a detailed discussion of this, see the section entitled "Technical Assistance: Effective and Ineffective Approaches").

Like AID, the EU's PHARE program has a similar problem because PHARE requires that there be geographical balance among its member states, which may work against hiring the consultants with the most expertise. On the other hand, under PHARE it now is possible to select not only EU consulting firms, but also firms from Eastern Europe. Recipient officials say this is an advantage over U.S. assistance. However, a host of Central and Eastern European officials report that AID is faster than PHARE.[35] Because of this, some recipient officials say they prefer AID when time is an important consideration, but select PHARE when flexibility and input are vital.

By contrast, the British Know How Fund, although small in comparison to these donors, has had a more favorable reputation among many of the region's officials because of its flexibility and relative speed. With few strings attached, recipient officials could choose long-term advisers of their choice to be paid by the Fund. Zdének Drabek, former aid coordinator of the former Czechoslovakia, said that the British Know How Fund had made decisions "very quickly" and "without much bureaucratic procedure."[36]

DEGREE OF RECIPIENT INPUT

There are two issues here. The first is the recipient's ability to influence and guide the development of aid programs. The second is the extent to which the donors exchange information with recipient parties before and during the assistance. U.S. programs that come under AID contracting mechanisms are seen by some officials

[35] These officials include Zdenek Drabek, former aid coordinator of the former Czechoslovakia (interview of July 7, 1994); Agnes Nadhazi of the Hungarian Ministry of International Economic Relations (interview of April 27, 1994); and Pawel Samecki, Director of the Bureau for Foreign Assistance, Polish Council of Ministers (interview of July 26, 1994). In addition, Tomasz Bogutyn, Manager at LOT, the Polish airlines, which used both AID and PHARE in various capacities to help the company privatize, reported that AID, although slow and frustrating at times, in general handled matters more expeditiously than PHARE (interview of April 8, 1994).

GAO confirmed the finding that "AID also has the capability to provide assistance on a more timely basis [than the other donors of private sector assistance] because the IQCs are pre-negotiated." GAO also concluded that the cost of the various programs working in this area is about the same. ("Eastern Europe: AID's Indefinite Contracts Assist Privatization Efforts but Lack Adequate Oversight." General Accounting Office, Jan. 1994.)

[36] Interview of July 7, 1994.

in the region as less effective than European Union programs because the U.S. programs allow recipients less leverage to set terms or to select experts. However, in the case of expertise provided through inter-agency agreements, the predominance of evidence seems to indicate that, in many cases, recipients can have more input. (For a detailed discussion of this, see the section entitled "Technical Assistance: Effective and Ineffective Approaches".)

DONOR RELATIONSHIPS WITH RECIPIENT GOVERNMENTS

Under U.S. aid, publicly financed private groups have an unusual access to Eastern European institutions. The United States in particular has exhibited strong support for "private" solutions; the target of assistance is almost exclusively the private sector, and private firms are also the primary delivery mechanisms. U.S. AID works more with NGOs than do most other donors, and NGOs constitute a large proportion of assistance providers.

The way some programs are structured implies that it is better to bypass government bureaucracies and work directly with the private sector. Although direct aid to the private sector makes sense when the goal is to promote private business, in some program areas (e.g., privatization and environmental improvement), this has led to a situation in which relevant governmental bodies can be virtually ignored. For example, the U.S. preference for bypassing governments almost entirely is counterproductive when the goal is to privatize state-owned enterprises.[37]

The emphasis on the private sector has intentionally created a situation in which government-to-government links are weak. A 1992 letter from the Department of State to the GAO printed in a GAO report reads, "We have also designed our programs to deliver assistance primarily to the private sector rather than to the government. Indeed, we have intentionally avoided government-to-government aid agreements, which contrasts with the EC PHARE program approach."[38] This approach appears to have changed very little and was recently reiterated by the State Department Coordinator of U.S. assistance to the NIS.[39]

However, the fundamental drawback of this approach is, as GAO concluded, that the U.S. assistance program "has lacked coordination in working with the host governments."[40] First, U.S. assistance is not set up for optimal access to recipient governments or to local contacts. Second, the weakness of government-to-government links has resulted in a situation in which mechanisms to establish aid priorities and instruments have sometimes been lacking. This has made it difficult for aid coordinators in the recipient countries to anticipate and coordinate aid projects.[41] (In this re-

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[37] See Janine R. Wedel, Congressional testimony (Hearing before the Subcommittee on Europe and the Middle East of the Committee on Foreign Affairs, House of Representatives), April 7, 1992; and GAO, *Poland and Hungary: Economic Transition and U.S. Assistance*, especially pages 31–36.

[38] GAO, ibid.

[39] See these recent strategy papers for Russia and the former Soviet Union: "United States Assistance and Economic Cooperation Strategy for the Newly Independent States" (Approved January 14, 1994 by the Coordinator of U.S. Assistance to the New Independent States); and "United States Assistance and Economic Cooperation Strategy for Russia" (Approved May 19, 1994 by the Coordinator of U.S. Assistance to the New Independent States).

[40] GAO, *Poland and Hungary: Economic Transition and U.S. Assistance*, p. 34.

[41] Interviews with Kornel Kovats and Agnes Nadhazi of the Assistance Coordination Secretariat of the Hungarian Ministry of International Economic Relations (April 27, 1994); and Pawel

gard the EU's PHARE program is better organized because it is administered through Program Management Units directed by recipients, who naturally have access to local contacts.)

To further complicate aid relations, the United States has had difficulties working out bilateral assistance agreements with many countries in the region. First, many countries, including Poland, Hungary, the Czech Republic, and the Slovak Republic, have refused the U.S. request for diplomatic immunity of its aid workers who do not have diplomatic standing. Officials in these countries indicated that no other donors had made such requests, and that, although such a request might be justified in Third World settings, it is not in Central and Eastern Europe. As one official remarked: "We have flatly refused [the request of diplomatic immunity]. It is the product in our eyes of some bureaucrats who have difficulty distinguishing the Czech Republic from Shangri-La."[42]

The agreements drafted by the U.S. government also included requests for aid workers to be exempt from income taxes and from duties on alcohol and tobacco. These requests also have been poorly received, further frustrating the completion of bilateral negotiations. A cable of August 1992 from the U.S. Department of State addressed to the ambassadors of all Central and Eastern European posts urged them to conclude bilateral agreements as quickly as possible.[43] However, in July 1994 a process of protracted negotiations was still under way in at least the four Visegrad countries.

DEGREE OF DONOR CONCENTRATION ON "INDEPENDENT" AND "PRIVATE" SECTORS

For U.S. assistance, privatization and private-sector development have been stated priorities[44] as well as the largest expenditure areas.[45] By contrast, the EU's PHARE program has included such areas as public administration in which there has been only a very limited amount of U.S. aid.

The U.S. emphasis on private-sector targets and privately developed solutions may have encouraged increased support of the longstanding Fulbright program and of Peace Corps activities in Central and Eastern Europe. Other donors and recipients cite these programs as unique and successful: they offer valuable educational and networking opportunities for individuals on both donor and re-

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Samecki, Director of the Bureau for Foreign Assistance, Polish Council of Ministers (July 26, 1994).

[42] Interviews with and/or documents provided by Zbigniew Lewicki and Zdzislaw Ludwiczak of the Polish Ministry of Foreign Affairs; Jitka Cenkova of the Centre for Foreign Assistance of the Ministry of the Economy of the Czech Republic; Jarmila Hbackova, Andrea Matisova, and Lubo Lubina of the Slovak Ministry of Foreign Affairs; and Kornel Kovats and Agnes Nadhazi of the Assistance Coordination Secretariat of the Hungarian Ministry of International Economic Relations.

[43] The cable stated that "at this time only Albania has signed the draft bilateral transmitted ... and we have no hard information (other than possibly re the CSFR) that we are close to signing anywhere else...The time has come for all posts to make a serious overture to the appropriate host government officials involved at the highest appropriate level and to agree on an imminent timetable for execution of these agreements, so that the program can continue without interruption." (Cable of Aug. 10, 1992 from Acting Secretary of State Lawrence Eagleburger.)

[44] This emphasis has been recently reiterated in AID press releases, as well as in conversations with AID officials, including Mark Karns (June 7, 1994), Donald Pressley (April 12, 1994), and Richard Burns (February 17, 1994).

[45] As of March 31, 1994, more than three-quarters of aid committed to Central and Eastern Europe was in the area of economic restructuring. (U.S. Agency for International Development, "U.S. Assistance for Central and East Europe: FY90–94 Obligation Summary as of 31 March 1994," May 1994.)

cipient sides. However, they have played a marginal role in the overall U.S. assistance effort.

COOPERATION AND COORDINATION WITH OTHER DONORS

It is hard to imagine coordination of specific projects at the highest political levels or at G–24 meetings among officials who are not completely familiar with conditions and projects on the ground.[46] It is generally agreed that the most effective way to achieve coordination at the project level is through donor representatives on the ground. An advantage of having long-term representatives and advisers in the field with similar responsibilities is that they can work with the other donors, not only with the recipients.

However, although discussions of "aid coordination" come up often among the donors of EU and bilateral aid, this is not a realistic goal unless the individual donors see some benefit in coordination. The main problem appears to be that donors tend to operate in isolation from one another. Another problem is that in certain priority areas there is a tendency for donors to compete for projects. Some of those with whom the author talked offered the view that there are relatively few projects worth funding.[47] But once a project gets under way and the structure is settled, there are sometimes opportunities for coordination and division of tasks among donors.

Along with the discussions among the donors about aid coordination have been discussions about "data bases" and "clearinghouses." One clearinghouse that has received donor attention is the OECD Register, an on-line database of technical assistance to Central and Eastern Europe, located at OECD headquarters in Paris. Established for use by donors and recipients in planning and coordinating aid projects, the information contained in the Register ostensibly "provides an overview of assistance being given in relation to needs and priority areas, with a view to identifying duplication, overlap, mismatches and gaps.[48] Although a laudable undertaking, the Register is only as good as the information it gets from donors, and not all donors systematically report.[49] Further, because project descriptions tend to be general and brief, and operational information is often lacking, donors (as well as recipients) are not able to make as effective use of it as they could if it were more detailed.[50] As Polish aid coordinator Pawel Samecki sees it, the Register's usefulness is limited to providing "general slogans" about what is

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[46] Polish aid official Pawel Samecki stated that the G–24 meetings held in Brussels are "too general," that at the working level "they are not working," and that the meetings are "not dealing with issues that are crucial for aid coordination." (Interview of June 7, 1994.)

[47] For example, interview with Witold Radwanski, deputy director of the European Bank for Reconstruction and Development in Warsaw (April 6, 1994).

[48] "CCET Register Statistics," Published by the Centre for Co-operation with Economies in Transition. Paris, OECD, June 1994.

[49] In this regard the United States is not among the best reporters, according to Jean Gomm, OECD official in charge of the Register (interview of May 2, 1994).

[50] The Register has received only limited use by recipients. The Central and Eastern European countries that received aid first are only now getting on-line access in the aid-coordinating bodies, just as aid programs in these countries are being scaled down. The Polish aid coordinating body received on-line access to the Register in July 1994 (interview with Pawel Samecki, July 26, 1994), while the Czech Republic had yet to be connected in July 1994 (interview with Jitka Cenkove, Head of the G–24 Unit, Centre for Foreign Assistance of the Ministry of the Economy, July 7, 1994).

being done in a given area.[51] However, the Register may be a useful tool for some purposes.[52]

The only realistic way to get better aid coordination may be for recipients to take more effective charge of the process. This will be difficult due to the nature of transformations under way (e.g., fragmented and weak leadership and civil service). However, there has been a certain degree of continuity and expertise developed; many officials in Poland's aid coordinating ministry have remained in the agency through the changing governments.

TECHNICAL ASSISTANCE: EFFECTIVE AND INEFFECTIVE APPROACHES

In examining the primary technical assistance priorities and approaches that have been employed under Western assistance, it is clear that some approaches have worked well, while others have not. Although there are many variables that shape the effectiveness of individual projects (e.g., expertise and personalities of personnel and quality of working relationships), this discussion focuses on the possibilities and drawbacks *inherent* in project design and implementation. Of the following two approaches, both under U.S. assistance, one generally has been well received among the recipients, while another has achieved mixed results. Here some conclusions are offered about the factors that might account for the differences.[53]

APPROACH 1: PRIVATIZATION AID THAT HAS ACHIEVED MIXED RESULTS

It is important to examine efforts to assist in the privatization of state-owned companies because this has been the most important priority of the major donors, particularly of the United States. Further, the same priorities and delivery mechanisms in place in Central and Eastern Europe are also being applied further east. Yet privatization aid has not always achieved the desired results, and sometimes may even have resulted in unanticipated consequences. There are several reasons for this:

The Difficulty of Giving Effective and Neutral Aid in a Politicized Arena

The various donors have tended to look to the privatization of large state-owned companies in Central and Eastern Europe as a way to measure progress of the transition from communism to a market economy. Yet other developments, such as the sale or liquidation of smaller state-owned enterprises at the local level and the considerable growth of private sectors, have tended to be the chief engines of restructuring processes. In addition, the privatization of large companies (that has been the focus of some donors) has been much slower and more politically complex than anticipated.

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[51] Interview of July 26, 1994.

[52] Chief German aid coordinator, State Secretary Walter Kittel, reported he has used the Register for planning purposes to learn what other donors are doing in a given area (presentation at The Brookings Institution, May 26, 1994).

[53] In addition to consulting published and unpublished works, as cited, this section is based on interviews with consultants, officials in aid coordinating and auditing agencies, officials in the ministries of privatization, industry, and finance that receive consultants, funds, or both, and representatives of state-owned enterprises. Information and materials also were provided by AID representatives.

Many variables affect privatization, among them the political environment of the country and the political and economic interests of parties to the privatization process, such as ministry officials, factory managers, and employees. Other important players in privatization are the international aid community and consultants. There are few unpoliticized state-owned enterprises or privatization plans. To a greater or lesser degree, politics plays a role at every level and in every plan.

Outside consultants can assist in structuring privatization efforts by helping to develop all-important legal and administrative frameworks for business transactions such as laws that protect private property. Consultants can point out areas of concern involving government regulation and the interface between the government and private enterprise. But in a highly politicized arena with disincentives to quick privatization, the conversion of state-owned enterprises can hardly be accelerated simply by bringing in outside consultants or by hiring public relations firms to promote privatization.[54] Giving aid under these circumstances is politically risky, especially without understanding the relevant political nuances.

One of the dangers of privatization aid is that it can end up in the hands of one group with a specific political agenda. In each country, a small pool of people who are, simultaneously, businessmen, bureaucrats, members of parliament, and representatives of the press are active in policy, government, the economy, and the international arena. When almost all state institutions from education and health care to tax collection and banking are weak and in a state of flux, these powerful groups have every opportunity to pursue their private interests.[55] So while funders may see privatization aid as a way of stimulating the growth of market and democratic institutions, the aid actually may empower already entrenched political and economic "mafias," as they are called in Eastern Europe, and power brokers. This process can also undercut legitimate state institutions and governance, especially where the rule of law is weakly developed.

Further, aid that can be interpreted as political assistance to a particular elite can backfire. Privatization aid is even more risky in many parts of the former Soviet Union.[56]

The ministry level:

At the ministry level, aid-sponsored consultants have recently been sent to "accelerate privatization." Under U.S. assistance, teams of resident consultants, supplemented by short-term experts

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[54] The hiring of Western public relations firms to promote privatization has been tried in at least one country in the region and is under discussion in several others. In Russia aid-funded public relations firms engaged in "public education" to promote the voucher auction, publicized "success story profiles" of privatized state-owned firms, and arranged radio and television spots to promote privatization, including some featuring prominent politicians.

[55] In Poland, for example, these elite cliques exist as a result of friendships, family connections, and political-economic associations that are long-standing. Some are made up of members of the old communist establishment; other cliques are comprised of members of the old anti-communist establishment, such as the Solidarity activists drawn from Poland's intelligentsia-oppositionist establishment. (Janine R. Wedel, *The Unplanned Society: Poland During and After Communism*, Columbia University Press, 1992.)

[56] In Russia, for example, much privatization aid has been put in the hands of the leadership of the Russian privatization committee. But the head of the committee is also a deputy prime minister and also has been a leader of a prominent political party. This situation does little to demonstrate that the aid is being used to establish new democratic structures so that all can benefit.

who come in for specific tasks, have been placed both in Poland's Ministry of Privatization and Hungary's State Property Agency. According to AID official Mark Karns, the teams have been charged with the task of helping certain divisions in the privatization ministries responsible for mass privatization to focus more on transactions and to enable the ministries to move the execution phase.[57] But politics can interfere with this work. After the recent change of governments in Poland, alternative projects had to be sought for the advisers who were just coming on board. No aid agency can reasonably be blamed for not predicting the twists and turns of Eastern European politics. But the politics and changing nature of privatization policies, combined with the time it takes to get contracts signed and consultants into the field, makes providing effective aid difficult.[58]

An exception to this appears to be an advisory team that has been working in the Czech Ministry of Privatization and the National Property Fund since October 1991. After state companies are selected for direct investment from foreign companies by the Ministry of Privatization, the deputy minister then enlists the financial and legal assistance of the team to work on these selected projects, including evaluating offers and bids from prospective foreign investors, and assisting in negotiating fair terms.[59] Several features set this case apart from some others:

First, the team supplies long-term assistance sought by the recipients. Requested by the Minister of Privatization and the administrator of the National Property Fund in 1991, the team has had a long working relationship with the Ministry and is integrated into its work. Work progress is reviewed by the deputy minister on a weekly basis. Although differences in "business and cultural practices" between the American team and its Czech counterparts have been cited and concerns raised regarding the style of at least one of its members, on balance the team is seen as "a highly-skilled" group of financial and legal professionals "representing and negotiating on behalf of the Czech Government." According to the Czech's Republic's chief aid coordinator, on several occasions high-ranking officials have expressed oral and written satisfaction with the team, and have written requests to the U.S. government to extend the teams' stay."[60]

Second, the team is an advocate for the Czech government and an effective interface with foreign investors. The team is set up as a unit within Czech privatization bodies and works on their behalf. As the Czech Republic's chief aid coordinator put it, "The U.S. advisory team's services are directly resulting in financial gains to the Czech Republic on the privatization projects negotiated with the advisory team's assistance. Thus, even among those cynics who

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[57] Conversations of June 7, 1994.

[58] A report commissioned by AID to evaluate AID privatization projects in Central and Eastern Europe independently arrived at the same conclusion. (See "Final Report: Privatization Phase II Program Evaluation," Submitted to AID, Washington, DC, by Development Economics Group/Louis Berger International, Inc., and Checchi and Company Consulting, Inc., July 30, 1993, e.g., pp. 16–17.)

[59] Letter to Janine Wedel from Pavel Rozsypal, director of the Centre for Foreign Assistance of the Ministry of Economy, August 2, 1994; Interview with Michael Gold, Managing Director of Crimson Capital in the Ministry of Privatization, July 8, 1994.

[60] Letter to Janine Wedel from Pavel Rozsypal, director of the Centre for Foreign Assistance of the Ministry of the Economy, August 2, 1994; interview of August 1, 1994.

participate in the foreign assistance process, the U.S. privatization team is often held up as an example of successful foreign technical assistance."[61]

In sum, the team has been helpful because it generally has been seen by the relevant Czech players as impartial, professional, and able to accomplish what local firms could not (at least not early in the privatization process).

The enterprise level:

At the enterprise level, efforts have generally not been effective and/or well received when they have focused on large, politicized enterprises.[62] Of five large firms assisted by AID-paid consultants, only one has been privatized, although not as a result of AID help. A report commissioned by AID to evaluate its Central and Eastern European privatization projects concluded that: "To date, assistance to large individual enterprises has not generally been successful in bringing about privatization promptly and cost-effectively . . . In most cases, privatizations of large enterprises are almost invariably slow in being consummated. Invariably, these enterprise-specific situations and the problems that surround them are new and complex."[63] This is especially bad news for those donors keen to show that socialist models can be replaced quickly with capitalist ones and who are attracted to large enterprises for this reason. Large enterprises tend to be more burdened by national political agendas than medium or small enterprises. Even though donor organizations send aid-supported consultants to offer technical advice on such matters as asset valuation of state-owned factories slated for privatization, the consultants' recommendations often cannot be implemented and "go directly into the trash," as one ministry official put it—rightly or wrongly.

This is more than a case of some Central and Eastern Europeans reacting in a knee-jerk fashion against foreigners' advice. It represents a real fear that the consultants will say something that many of the players in the privatization process may not want to hear; that is, that the consultants might give advice that will result in dramatic changes in the enterprise or community. Traditionally, the socialist enterprise guaranteed not only employment, but also housing, day care, medical, and other services, and in many ways continues to do so. Severe reductions in work forces often have not been tolerated by labor, and the labor lobby has translated this into political influence (Poland is now in its fifth post-communist government; both Poland and Hungary recently elected socialist/leftist governments, as did some nations further east).[64]

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[61] Letter to Janine Wedel from Pavel Rozsypal, August 2, 1994.

[62] A report commissioned by the EU on PHARE consulting in enterprises also came to the same conclusion: that "the impact of the consultants was less satisfactory in highly politicized cases" (Christine A. Bogdanowicz-Bindert, "Interim Report: IDA Assessment," December 1993, p. 1).

[63] See "Final Report: Privatization Phase II Program Evaluation," Submitted to AID, Washington, DC, by Development Economics Group/Louis Berger International, Inc., and Checchi and Company Consulting, Inc., July 30, 1993, pp. 31–33.

[64] A reports commissioned by the EU on PHARE consulting in enterprises independently concluded that the "work of the consultants is often complicated by a management reluctant to introduce changes." (Christine A. Bogdanowicz-Bindert, "Interim Report: IDA Assessment," Dec. 1993, p. 3.)

Confilcts of Interest:

One issue that complicates the aid process in such a politicized arena as privatization is suggestions of conflicts of interest. Westerners have sometimes been suspected of being involved in such conflicts. They have entered into extremely complex settings, both at the ministry and the enterprise levels, in which there are different players with conflicting and sometimes dubious agendas and where some people practice the adage, "the rules are what one can get away with." But many others in the region have expressed outrage against these practices. This outrage is directed not only at foreigners involved in local business, but also at local elites who have profited from this unregulated free-for-all (e.g., consulting firms that do business with privatization ministries set up by high-level government officials or their family members). Central and Eastern European officials, often lacking the requisite resources, are ill-equipped to monitor these activities or have little or no interest in monitoring them.

Conflicts have been alleged by recipients both at the government level (e.g., the privatization ministries) and the enterprise level. Aid-paid consultants have been involved in both cases. Some responsible officials in the relevant ministries point to the situation of Western law firms that are under contract to donor organizations to provide legal assistance to Central and Eastern Europe. Sometimes these firms have clients already doing business in the region or are developing clients. This creates a built-in conflict of interest. Indeed, sometimes these firms appear to be more interested in representing the interests of their clients back home than those of the countries they are there to help. In sum, privatization aid is often not perceived as neutral. As Polish aid official Pawel Samecki put it: "Public opinion thinks that if the British are involved in the privatization of state-owned banks that they must get something out of it, which is not necessarily true."[65]

At the enterprise level, a frequent perception among parties to the privatization process, including managers and workers, is that the relationship between the Western consultants' valuation of properties and their clients' investment interests is suspect. It is believed that Western consultants undervalue the Eastern Europeans' high degree of skill and experience, the importance of trademarks, and the value of land.

These allegations of impropriety are based on the fact that consultants typically have access to industry- or company-specific data. The managers of one enterprise were especially alarmed when, in 1991, representatives of its major competitor were sent to privatize the firm ("It's like General Motors advising Ford"). Also important is the fact that another consulting firm sent to help privatize the enterprise was a Polish firm partially owned by a high-level ministry official. This is an issue to which NIK, the Polish government's chief auditing agency and equivalent of the U.S. General Accounting Office, has devoted some attention. As the deputy director of NIK confirmed, "A few years ago the (consulting) firms had an industrial espionage quality to them. They came and got all valuable information about the enterprises—the state of the firm, the

[65] Interview of July 26, 1994.

amount and cost of production, and so on—and after this they disappeared. This is also the fault of Polish officials. Today there are fewer naive officials who allow this to happen."[66]

One classified report put out by NIK concluded that accepting the recommendations of consulting firms with respect to asset valuations sometimes has resulted in significant losses for Polish enterprises and has harmed the national treasury.[67] It should be emphasized here that asset valuations are extremely difficult even in stable, well-functioning market economies. To further aggravate the situation, Central and Eastern European governments have come up with few standards for conducting valuations, which are taking place amid considerable confusion in policy, public administration, the economy, and the law.

The point is not whether the complaints regarding issues such as asset valuation are valid in a given case, but rather that the involvement of aid-paid consultants may feed the perception among some groups that "foreigners have come to loot." Such involvement may encourage anti-capitalist, anti-Western, and anti-privatization sentiments among those radical populist groups (with elements of radical nationalism) who charge that elites involved in privatization have been corrupted by the West. An example of this extremism are unionists at Ursus, a large tractor factory that was once a hotbed of Solidarity activities. These slogans recently decorated the main entrance to the factory: "A Foreign Elite Steals from Us while the Polish People are at the Bottom" and "Polish Property for all Poles."

On the brighter side, the assistance provided under a U.S. AID contract to Czech privatization bodies (detailed earlier) was helpful in part because it acted impartially and was seen by local officials as an advocate for the Czech Republic in negotiations with potential foreign investors.

Difficulties in Implementing Consultants' Recommendations

Another reason that privatization aid has been difficult to carry out effectively is that the *results of the consultants' work or the recommendations often cannot be implemented.* There is often a disconnection between consultants' activities at the enterprise level and activities that lead to investment. Czech Deputy Minister of Foreign Affairs Pavel Bratinka stated that there is an "over-emphasis on studies and consulting work the result of which is not immediate and in many cases doubtful."[68]

Accounting firms, notably the "Big 6," have been designated by the major donors as prime agents of privatization. The Big 6 have received contracts not only from AID, but also from EU PHARE, the British Know How Fund, the World Bank, and the European Bank for Reconstruction and Development.[69] Although the strength of the Big 6 is often seen in their contacts with potential

[66] Interview with Piotr Kownacki, deputy director of NIK, April 29, 1994.

[67] Janine R. Wedel. "Beware Western Governments Sending Gifts," *Wall Street Journal*, Jan. 14, 1992.

[68] Pavel Bratinka. "Assistance Brings Greater Understanding." In the *G24 Newsletter* published by the Centre for Foreign Assistance of the Ministry of the Economy, Dec. 1993.

[69] Contracts from aid agencies have helped the Big 6 to establish offices in the region and to launch commercial activities. The Big 6 accounting firms are Price Waterhouse, Arthur Andersen, Ernst and Young, Coopers and Lybrand, KPMG Peat Marwick, and Deloitte and Touche.

Western investors (as one enterprise manager put it, "the most important task of the Big 6 is to find investors"), the link between technical assistance and investment too often is missing.

Even well conceived consultants' reports have only the most tenuous links to the realities of implementation. Central and Eastern European officials frequently have reported that there is little concrete activity that follows from consultants' reports. As one privatization official lamented, "No enterprise wants to receive technical assistance without investment. . . . There were many studies without useful results because there were no investments (that resulted from them)."[70] For example, a report funded by U.S. assistance that the recipient Slovak privatization ministry hoped would provide "very concrete and tangible results" and help prepare the Slovak Republic for meeting World Bank requirements instead resulted in a "general description about the current state of privatization and some general targets."[71]

Difficulties with AID's "Indefinite Quantity Contracts"

A third reason why privatization aid is problematic involves *difficulties with AID's "Indefinite Quantity Contracts," or IQCs*. Three consulting consortia led by three of the Big 6 accounting firms (Coopers & Lybrand, KPMG Peat Marwick, and Deloitte & Touche) form the cornerstone of the U.S. privatization and economic restructuring aid package. These firms won IQCs for multiple projects in privatization and related areas over a three-year period (that was extendable) beginning in 1991.

AID's purpose in setting up the IQC structure was to develop a rapid response capability to requests from recipients. Although it took an estimated 8 to 18 months from the time the IQC mechanism was conceived in 1990 to the actual placing of consultants in the field,[72] once the mechanism was in place projects could get under way more quickly than they could under some other AID contracting mechanisms. The idea was that time-consuming "RFP's" (Requests for Proposals) and open competitive bidding would be conducted only once. Once the firms had won IQCs, they did not have to go through the process of open competitive bidding again. A work order could simply be done for individual projects, short-term assignments set up, and personnel dispatched to the field.[73] Indeed, the IQC mechanism enabled consultants to be sent to the field more quickly than under the EU's PHARE program. (See the section entitled "U.S. Assistance Agendas in Perspective," specifically, "The Nature of Contracting Procedures.")

However, a fundamental drawback of the IQCs is that they have generally afforded recipients little flexibility. Ministry and enterprise officials who are recipients of the consultants have essentially no input into the consultants selected; they can choose only among

[70] Interview with Jiri Hodik, coordinator of the PHARE privatization program in the Czech Ministry of the Economy, cited in Janine R. Wedel, "The Unintended Consequences of Western Aid to Post-Communist Europe," *Telos*, no. 92 (summer 1992), p. 136.

[71] Interview with State Secretary Gabriel Palacka of the Slovak Ministry of Administration and Privatization of National Property, July 4, 1994.

[72] One source within AID estimated the period between conceptualization of the program to be 12 to 18 months; another source estimated the same period to be 8 months.

[73] Conversations with Scott Thomas, former AID official, May 2, June 3, and June 6, 1994; and with AID official Mark Karns, June 7, 1994.

three of the accounting firms that received contracts.[74,75] A further drawback is that recipient officials have little ability to monitor or schedule consultants' work. The IQC contracts, as well as work orders, are signed between consultants and Washington AID. Some officials have opted not to use U.S. assistance at all after experiencing a number of frustrations. An official responsible for aid in Poland's Ministry of Industry found that he had no authority to monitor or schedule consultants' work.[76]

There are two ways in which the IQC program has been used in conjunction with privatization and economic restructuring. In the first method, consultants work directly with the enterprise or sector. In the second method, consultants work inside the ministries as advisers. The IQC program has worked especially poorly in the first case because the consultants have worked largely independently of the ministries in charge of privatization. Under the IQCs, for example, freelance consultants can bypass the relevant ministries and go right to the field to find and work on privatization projects. The consultants' reports generally are addressed to U.S. AID in Washington, not to the local officials who supposedly are their beneficiaries. (Copies are sent to the ministries.) Marek Krawczuk has compared the situation to that of "a surgeon who comes, does his work without talking with the patient, and leaves without checking to see whether the operation was successful."[77,78]

Despite these dangers and difficulties, however, in some cases the recipients have learned to use the consultants to their benefit, to help them set up accounting systems or to train employees. There are two major factors, offered both by consultants and recipients, that appear to foster successful working relationships:[79]

- The inclusion and active participation of local professionals in contracting teams. The local professionals speak the native language and can communicate easily in enterprises and government agencies with personnel who often do not speak English.
- The development of clear terms of reference jointly developed by all parties. It is especially helpful if the representatives who

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[74] It is not always the case that recipients can choose among the three IQC companies. In one case brought to my attention the recipient ministry was first told it could choose among the three IQC firms. But when the ministry sent a letter to the local AID office requesting one of the firms, the ministry was told that only another firm could be made available in a timely fashion. A high-level ministry official assessed that "All this selecting [a] company seems to be only a theater."

[75] One way of getting around this was devised in the Czech Republic. A non-IQC firm that wanted to receive funding from AID to advise Czech privatization bodies was hired as a subcontractor to a firm that already had obtained an IQC contract. (Interview with Michael N. Gold, Managing Director of the Crimson Capital project in the Ministry of Privatization, July 8, 1994).

[76] Interview with Marek Krawczuk, April 8, 1994.

[77] Janine R. Wedel, Congressional testimony (Hearing before the House Subcommittee on Europe and the Middle East of the Committee on Foreign Affairs), Apr. 7, 1992).

[78] The setup of some other privatization aid programs, notably EU PHARE, is more effective because it established entities within the relevant ministries to manage funds. This provides recipients leverage to select projects and hire consultants, with oversight by PHARE. If they want to use U.S. aid, Polish officials responsible for handling sectoral or company-by-company privatization must work through totally separate structures than those already established to manage the funds from other donors.

[79] A report commissioned by the EU to evaluate PHARE consulting activities in enterprises also noted these factors as critical determinants in the quality of technical assistance delivered (Christine A. Bogdanowicz-Bindert, "Interim Report: IDA Assessment," Dec. 1993).

helped develop the terms of reference are those that later carry out the work.

APPROACH 2: PROVIDING LONG-TERM INSTITUTIONAL SUPPORT THAT HAS GENERALLY BEEN EFFECTIVE

Short-term "fly-in, fly-out" advisers often have been described in Central and Eastern Europe as redundant, a burden on over-extended Eastern European officials, and sometimes even as engaging in industrial espionage. However well-intentioned the experts, it is not difficult to understand the recipients' point of view: Advisers from international lending institutions and a multitude of donor programs which are, for the most part, working in isolation from one another, tend to descend on the same departments in the same ministries. The staff, political appointees or part of a fledgling civil service that is underpaid and often holding jobs "on the side," is soon overburdened. Only a few staffers have the information sought by the foreigners and the language skills necessary to communicate with them. As a result, the same officials become responsible for meeting the many visiting delegations and consultants.

A representative of the International Relations department of Slovakia's Ministry of Finance lamented that he often is approached by international agencies offering short-term consultants. But he has difficulty placing them and says he is blamed by division heads who complain: "Look, we spent two weeks explaining things [to experts] and then they disappeared forever."[80] A representative of the Slovak Ministry of Foreign Affairs added that people in the same section of a ministry are tired of answering the same questions. The consultants "collect information, get the picture, then they go home. . . . We are solving their [the donors'] own unemployment in this way."[81]

On the other hand, *the policy of dispatching of long-term resident advisers to work in the host country for several years on specific topics requested by the recipients—and mutually agreed upon in advance—has been well received by recipients.* It is important that the prospective advisers are screened by both donors and recipients. It also is critical that the recipient officials requesting and screening the advisers are those with whom the advisers will be working (or at the least are familiar with the specifics of the situation). This helps to avoid the burdens and redundancies described above.

One example of this approach is the long-term expertise provided under the Treasury Department's Financial Sector Technical Assistance Program.[82] The experts, requested by officials in recipient institutions, are hired for specific tasks usually involving taxation, budget, and financial matters. Short-term specialists are brought in to address specific related needs when deemed advisable.[83] The Treasury's Tax Advisory Program, for example, was developed by

[80] Interview with Pawel Fargas, July 1, 1994.

[81] Interview with Jarmila Hrbackova of the Department of Foreign Assistance, July 4, 1994.

[82] This section is based on interviews with consultants, officials in the ministries that receive them, representatives of the U.S. Treasury Department, and materials provided by the Department.

[83] Between FY 1990 and FY 1993, $42.95 million was spent on this program. As of June 1, 1994, the Department had 28 long-term resident advisers in Eastern Europe (interview with Treasury Department official Bob Banque, June 4, 1994).

a program director who traveled to the various countries and, having conducted field work for several weeks at a time, learned what the needs were and who the relevant players were. Prospective advisers were then screened and interviewed by both parties.

Salvatore Pappalardo, an adviser to Poland's Chief Debt Negotiator, received an award from the Polish government for his help in recent successful debt negotiations. As Pappalardo explained, Poles "like to see commitment to understanding the situation and working with them." [84]

Providing strategic support and training to key institutions is a related area where aid can be helpful. Two small programs that appear to have been effective are the Senate-initiated Gift of Democracy program and the Frost Task Force program of assistance to the parliamentary institutions of Eastern Europe, which have received support from the Congressional Research Service. The effort provides information technology and resources to parliaments, as well as training for parliamentary staff, including research and library personnel. For example, the Gift of Democracy program purchased computers for the Polish Parliament and Senate. This enabled them to set up a local area network with local data bases and connections to American and European data bases. The Frost Task Force is providing similar assistance to parliaments throughout Eastern Europe. [85]

Wieslaw Staszkiewicz, director of the Polish Parliament's Bureau of Research, said the program has provided "very significant help" to develop the Bureau of Research, which provides information and training for representatives (like the U.S. Congressional Research Service), expert opinions on prospective legislation, and monitoring as requested by the Parliament (like the U.S. GAO). Especially helpful was the training provided in Washington, where people learned how reference services and libraries can be effectively organized, and where they made valuable contacts that they can continue to call upon. [86]

Helping to build such an independent institution has been especially important in an environment in which information and expertise that is unconnected to a political group or agenda is under constant attack and where it is difficult to remain neutral and professional.

Such long-term programs avoid the lack of continuity and follow-up that often plague programs involving short-term advisers and support. They can be effective because they are integrated into the institutions that they are trying to help and are well received. Not all privatization projects have been ineffective, and not all long-term advisory programs have been ideal. However, the privatization approach as described above is inherently problematic. The other approach—advisory support—is better designed and therefore has a greater chance of being appreciated and effective.

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[84] Interview of April 13, 1994.

[85] Conversations with Wieslaw Staszkiewicz (July 29, 1994 and August 2, 1994), Wlodzimierz Borodziej (July 28, 1994),and Jacek Glowacki (July 29, 1994) of the Parliament's Bureau of Research.

[86] Conversations of July 29, 1994 and August 1, 1994.

Two Models for Aiding the "Private" or "Independent" Sector

As stated earlier, U.S. assistance has considered what lies in the "private" or "independent" sector to be its main aid target. Although this section cannot be comprehensive due to space limitations, a brief discussion of the nature of the debate—and the direction in which it appears to be heading—is warranted.

THE INDEPENDENT SECTOR

Donors have looked to the "independent sector" as a way of replacing the centralized bureaucratic state system of the past, decentralizing services, and building democracy. One way in which they have sought to achieve this is through the funding of nongovernmental organizations (NGOs).[87] In the case of U.S. assistance, this funding is usually provided through organizations based outside Central and Eastern Europe that work with indigenous efforts.

Under communism, the nations of Eastern Europe never had a "civil society." A "civil society" exists when individuals and groups are free to form organizations that function independently of the state and that can mediate between citizens and the state. Because the lack of civil society was part of the very essence of the all-pervasive communist state, creating such a society[88] and supporting organizations independent of the state—or NGOs—have been seen by donors as the connective tissue of democratic political culture—an intrinsically positive objective.

The United States in particular has seen the emerging NGOs of Eastern Europe as important vehicles of technical assistance and training and also as building blocks of civil society. Whether their ostensible purpose is social welfare, election education, or improvement of environmental conditions, NGOs are seen as furthering "transition" or at least as being an important by-product of these other endeavors. This interpretation assumes that the emerging NGOs are similar to their Western counterparts, despite the very different conditions under which they have developed and operate. NGOs can play productive roles, but the reality is that they may not be fully designed to be the "building blocks" of democracy that the donors often envision.

Like privatization efforts, it is difficult, if not impossible, to jump start the creation of genuine NGOs from the outside. Donors need to take a critical look at each NGO before making a funding decision. There are four main factors that donors would be well advised to pay heed.

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[87] This section is based on interviews with representatives of aid programs that fund NGOs, representatives of NGOs, U.S. Environmental Protection Agency officials, parties involved in varying capacities in the Regional Environmental Center, printed sources provided by the Center, and other literature as cited.

[88] The creation of civil society became one of the goals of opposition movements in Eastern Europe in the late 1980s as the communists began to loosen the reins. Hundreds of non-communist elites began to create voluntary associations that were illegal, but sometimes tolerated, for purposes ranging from improved housing and garbage collection to halting the construction of nuclear power plants. Through "social self-organization" and "small circles of freedom," these groups sought to revive long suppressed civic values and grassroots organizations. In Poland, in contrast to other Eastern European countries, church organizations and movements also constituted a kind of civil society. (Janine R. Wedel, *The Unplanned Society: Poland during and After Communism*, Columbia University Press, 1992.)

The Definition of an NGO

Even the vocabulary used to describe the concept of nongovernmental organizations—usually adopted from English—(e.g., "third sector," "independent sector," "private voluntary sector," "nonprofit sector," "charitable organization," and "foundation") is confused in the context of Central and Eastern Europe. According to Jakub Wygnanski, a sociologist and expert on Central and Eastern European NGOs, this has resulted in a "lack of communication" and people describing different things using the same terms, both inside and outside the region.[89]

NGOs in Central and Eastern Europe generally incorporate themselves as either foundations or associations. Registering as a foundation typically provides more favorable legal and tax advantages than registering as an association. Foundations are usually service-providing groups that do not give grants, but raise money in order to carry out activities themselves. Foundations encompass a number of organizational types including larger and more stable NGOs and the region's few grantmaking organizations. On the other hand, most small, grassroots-oriented NGOs organized around common interests are registered as associations.[90] In Poland, for example, there are more than 4,000 organizations registered as "foundations" and more than 4,500 organizations registered as "associations."[91]

Blurred Lines between Profit and Nonprofit Organizations

In Eastern European countries, there are few sharp distinctions between for-profit and nonprofit organizations, as there often are in the West. Foundations can be profitmaking, and some are. As a result, donors sometimes fund NGOs that they mistakenly consider to be nonprofit and operating in the public interest.[92] Under Polish law, for example, foundations can be created to carry out economic activity. In Poland 40 percent of registered foundations have their own economic activity and thus are profit-making.[93]

Support of Explicitly Political Groups

Before and for a period following the revolutions of 1989, Central and Eastern Europeans used NGOs as a political vehicle and as a platform for politics. But after channels of political expression opened up, people politically inclined eventually went to political parties. (In Poland this occurred roughly in 1991.) In the first few years of the aid effort, donors' eagerness to support nonstate organizations led them to fund explicitly political groups. This gave rise to complaints by groups that did not receive funding, some of which were as well-supported and respected in Eastern Europe as those which were funded, that donors were playing favorites. (Some lead-

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[89] Interview of July 15, 1994.

[90] For a more detailed description of the legal and fiscal framework of Central and Eastern European NGOs, see Daniel Siegel and Jenny Yancey, *The Rebirth of Civil society: The Development of the Nonprofit Sector in East Central Europe and the Role of Western Assistance*, The Rockefeller Brothers Fund, Inc., 1992.

[91] Interview of July 15, 1994 with Jakub Wygnanski who created and has maintained a data base on Polish NGOs since 1990.

[92] For more detailed information, see Daniel Siegel and Jenny Yancey, *The Rebirth of Civil society: The Development of the Nonprofit Sector in East Central Europe and the Role of Western Assistance*, The Rockefeller Brothers Fund, Inc., 1992, pp. 29–32.

[93] Interview of July 15, 1994 with Jakub Wygnanski.

ers even protested before U.S. congressional subcommittees.) However, at least in the Visegrad countries, the United States no longer funds explicitly political groups. Currently the risk for donors lies primarily in funding politicized NGOs in aid efforts further east.

Support of Elite Cliques

NGOs developed in an environment in which elite cliques of long-standing acquaintances had their fingers simultaneously in a number of pies—from business to government to the international arena. It was natural, given this political-social environment, that these groups tended to pursue their own private agendas, regardless of their connections to formal institutions. They were "institutional nomads" because circumstances demanded loyalty to the group but not necessarily to the formal institutions with which the members of the group were associated.[94]

One result of this state of affairs is that in Central and Eastern Europe, resources and decision-making tend to be concentrated in just a few hands. With regard to NGOs, the same people tend to sit on the most important boards that make funding decisions. This can have positive and negative aspects: On the one hand, these are sometimes the people best equipped to make decisions. But on the other hand, this has stirred up resentment among those who are outside the networks—especially those who would likely be on the boards if decisions were made purely on the basis of professional qualifications.

This has implications for donors' selection of NGOs for Western funding. A multitude of Western programs tends to offer travel and training opportunities to the same groups and individuals. One Hungarian environmentalist called this the "green jet set."[95] Indeed, the number of people who have gained the trust of Westerners is very limited and these people tend to travel in the same circles. This concentration on a select few contributes to resentment, especially because the few beneficiaries tend to distribute money and favors based on group loyalties and obligations. To overcome this state of affairs requires in-depth knowledge of local groups, their histories and politics. Only a handful of experts on Central and Eastern Europe can provide this expertise.

The Case of the Regional Environmental Center

The history of the Regional Environmental Center in Budapest, created as a result of the SEED legislation, is an example of a project with a troubled beginning—but one that has resulted in learning on the part of both donors and recipients. Although its mandate was to develop institutional capabilities and outreach programs and to promote public awareness and participation, the Regional Environmental Center did much less of this than expected. In its initial years of operation, the Center fulfilled little of its public outreach mission.

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[94] This phenomenon has been described by Polish sociologists Antoni Kaminski and Joanna Kurczewska. (See Antoni Z. Kaminski and Joanna Kurczewska (1994), "Main Actors of Transformation: The Nomadic Elites." In *The General Outlines of Transformation*. Eric Allardt and W. Wesolowski, eds. Warszawa: IFIS PAN Publishing.)

[95] Interview with Judit Vasarhelyi, April 26, 1994.

In 1989–90, Western donors targeted the environment as a top funding priority, not only for the well-being of Eastern Europe but also for the benefit of Western Europe, which is near enough to be damaged by its neighbors' acid rain and polluted waterways. In keeping with their private-sector emphasis, Western donors funded environmental NGOs, directly or indirectly. Austria, Canada, Denmark, the EU, Finland, Hungary, Japan, the Netherlands, Norway, and the United States donated some $20 million to the Regional Environmental Center, housed in a charming old silk mill in Budapest. Under the leadership of Executive Director Peter Hardi, a former communist, the Center had weak links to the Hungarian government as well as to the region's governmental bodies and environmental ministries. "An institution to give out money," the Center's grantmaking resulted in "dividing the NGO community," as Istvan Tokes, an official in the Hungarian Ministry of the Environment, explained.[96] Having virtually no agenda of its own, the Center disbursed money to favored environmental groups throughout the region which were supposed to conduct studies and public outreach activities.

However, in a setting in which there is little tradition of making information available to citizens for free or for "the public's right to know," it should come as no surprise that NGOs often failed to share information and advantages with others and to conduct outreach. Aid-funded environmental NGOs responsible for gathering and disseminating environmental information to the public often guarded the information they acquired and made it available only at a price. And with resources in short supply, organizations tended to use the money and perks they received to feather their own nests and resumes, rather than develop environmental policy or support clean-up activities. Moreover, according to GAO, the Center's "early operations suffered from financial management and programmatic weakness." As a result, AID withheld approximately $1.4 million, about one-third of U.S. funding to the Center, until evidence could be provided that its operations had been improved.[97]

However, following a financial and management audit of the Center in 1992, the Center was radically reorganized. With donors and recipients working together, the management and financial practices, direction of the institution, and its criteria for giving grants to NGOs all have been revamped, a finding that GAO has independently confirmed.[98] Now there is an emphasis on funding long-standing NGOs with indigenous public support and with track records that can be verified.[99]

Donors would be well advised to examine the case of the Regional Environmental Center. It is a case study in how Western funding agencies and Eastern European NGOs can operate on the basis of fundamentally different assumptions and goals, and it

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[96] Interview with Istvan Tokes, head of the Department of International Relations in the Ministry of the Environment, June 7, 1994.

[97] "Environmental Issues in Central and Eastern Europe: U.S. Efforts to Help Resolve Institutional and Financial Problems." General Accounting Office, May 1994, p. 55.

[98] Ibid., pp. 54–57.

[99] Interviews with Judit Vasarhelyi, former board member of the Regional Environmental Center (April 26, 1994), and with Istvan Tokes, Head of the Department of International Relations in the Ministry of the Environment (June 7, 1994).

highlights the importance of understanding the contexts in which East European NGOs are developing. The case of the Regional Environmental Center also shows how learning on both sides can lead to positive outcomes.

THE PRIVATE SECTOR

The creation of new businesses in the former Communist nations has been an important goal for Western donors, particularly the United States. Although there has been an explosion of what the Poles call "*biznes*"—mainly mom and pop enterprises that include traders hawking everything from bananas to computers—a stronger, more highly developed business sector has been seen as a prerequisite to the development of a market economy and democracy. Several aid programs to provide support to small- and medium-sized businesses have been initiated to help develop the private sectors of the region, notably the U.S. Enterprise Funds. The first were the Polish-American and the Hungarian-American Enterprise Funds, designed to promote the development of the private sector, including small business, agriculture, and joint ventures with the United States. How these aid programs are structured and the extent to which they interact with small businessmen to provide assistance otherwise unavailable to them warrants examination.[100]

From the start, the Enterprise Funds were intended to be a different, less-regulated type of foreign aid that would encourage private enterprise mainly through loans and direct investments rather than through more traditional foreign aid grants.[101] Consuming a substantial portion of the overall U.S. aid package, the Enterprise Funds are often cited as an aid "success story" and are notable in that they are one of the only aid programs that puts money into the economy. They also are the envy of other donors that work solely through governments because they are mostly unencumbered by government regulation on either donor or recipient sides.

The author identified four main factors that determine how the Funds will work under the varying financial conditions of the different countries (the Funds will operate in 19 countries and a Fund is getting underway in Russia). The factors are: (1) the mission of the Funds and the degree of risk aversion; (2) the need for loans, equity, or grants to businesses under current financial conditions of the recipient country; (3) the need for loans in the most developed areas—where the Funds have been concentrated—versus underdeveloped areas where there has been much less investment; and (4) the level of adaptation to local conditions and the quality of leadership.

The Mission of the Funds and Degree of Risk Aversion

The major challenge facing the Enterprise Funds is an "identity crisis" that is typical of development banks: Are Funds in the aid

[100] This section is based on interviews with beneficiaries of Fund loans, observers of recipient country financial conditions, Enterprise Fund principals in the United States, Poland, Hungary, the Czech Republic, and the Slovak Republic (and printed materials provided by the Funds), as well as representatives of related programs such as Caresbac and the EU's Struder program.

[101] Each Fund is a private, nonprofit corporation with boards headed by prominent financiers and venture capitalists who donate their time. Among the board members are AFL-CIO President Lane Kirkland and former National Security adviser Zbigniew Brzezinski (Polish-American Fund), and former Congressman Charles Vanik (Czech-Slovak Fund).

business or are they in business, period? Do they support risky business activities that can produce big results, or less risky activities that will demonstrate "success," especially to the U.S. Congress? And is their mission to give aid liberally or to make sound business decisions using stringent Western loan criteria?

The Funds have generally taken a conservative approach to lending money, the idea being to achieve self-sufficiency. Therefore, the Funds have not dispensed money easily or quickly and they have required loan applicants to produce many of the same kinds of financial documentation that are typically required for loans in the United States. This is nearly impossible for most businesspeople in the former communist countries since they lack a paper trail and credit track record (audited financial statements and tax returns are typically unavailable in these countries), and are unaccustomed to Western loan application procedures.

The Funds have generally concentrated on bigger businesses, in some cases joint ventures, which the SEED legislation that authorized the Funds lists as an option.[102] The Funds' partners and staff have an incentive to support joint ventures, which are generally easier to create, more lucrative, yield incentive funds for the partners, and look good to the Congress. Fund managers in Poland have created an Enterprise Fund "clone," the Polish Private Equity Fund, which is funded partly by foreign private investments and partly by the original Enterprise Fund. Unlike the Enterprise Fund, a share of the profits of the private fund go to the managers.[103]

All this has led to criticism that the Funds, being too risk-adverse, fail to fulfill their primary mission of supporting small- and medium-sized indigenous businesses.[104] When the Hungarian Fund invested in companies that had access to other sources of capital (representing 12 percent of its invested capital), GAO questioned "whether such investments were consistent with the Fund's mandate to develop small- and medium-size businesses." Hungarian Fund officials countered that these investments in publicly traded companies "leveraged additional investment capital by (1) encouraging other investors to invest and (2) helping to stabilize the stock market, which was not very efficient in pricing stock offerings." Fund officials added that the investments helped to balance the portfolio and enabled the Fund to invest in other riskier businesses.[105] But Zbigniew Brzezinski, a member of the board of

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[102] Public Law 101–179 (1989), "Support for East European Democracy (SEED) Act of 1989," Nov. 28, 1989; sec 201(a).

[103] Moreover, to bypass the $150,000-a-year salary ceiling for Fund officers set by Congress, some Fund officers have devised enterprising ways to augment their salaries, raising concerns that they may be making too much. The Hungarian-American Enterprise Fund set up and invested $4 million in an independent merchant bank, with some of the partners earning twice the Fund's salary limit. In addition to questions about the salaries of Fund partners and staff, conflicts of interest have been alleged by the U.S. General Accounting Office. In both Hungary and Poland, several Fund board members also received Fund monies for the local projects they set up. (General Accounting Office, "Enterprise Funds: Evolving Models for Private Sector Development in Central and Eastern Europe." Mar. 1994.)

[104] One program that concentrates on small- and medium-sized businesses is Caresbac, an equity program that has been in operation for several years and recently received a small grant from AID. In comparison with the Enterprise Funds, Caresbac appears to operate with much less overhead and make more use of technical assistance resources available from Western voluntary organizations.

[105] General Accounting Office, "Enterprise Funds: Evolving Models for Private Sector Development in Central and Eastern Europe." Mar. 1994, pp. 20–21.

the Polish Fund, seconded the judgment of the General Accounting Office: "These funds should promote native private enterprises. They were not set up to establish foreign private investment."[106]

The Need for Loans to Businesses under Changing Financial Conditions of the Recipient Country

Current needs in the host countries need to be reconsidered periodically due to changing financial conditions. Whereas, for example, there was previously a demand for loans under the Polish Enterprise Fund, this demand has been diminishing due to the fact that its dollar-denominated loans are losing attractiveness to the borrower as the Polish inflation rate is going down and bank interest rates in *zloty* decline accordingly. Businesses generally prefer to take credit in local currency. In addition, the Polish banks are increasingly reluctant to refer the "better" borrowers to the Fund's program since they themselves have become more experienced in credit analysis and risk assessment. Consequently they now are extending loans to those "better" borrowers themselves.

The Need for Loans in Developed versus Underdeveloped Areas

The Funds have tended to focus on the most developed areas of the recipient countries where investment already is concentrated. Yet the greater need for them is often in underdeveloped areas where there has been little investment. For example, in Poland, high unemployment, a virtual stalemate in privatization and the development of business infrastructure, and virtually no foreign investment are concentrated in certain regions, while very low unemployment and a high degree of private sector development, privatization, and investment characterize others.[107,108] A new "micro loans" program under the Enterprise Fund, as well as the EU's "Struder" program, which are now getting under way in Poland, will be important experiments to follow, because their goal is to provide small loans and/or capital/equity grant support in underdeveloped areas.

The Level of Adaptation to Local Conditions and the Quality of Leadership

When asked what factors determine the demand for and effectiveness of the Funds in a given setting, many of those interviewed cited as critical the degree of willingness on the part of Fund principals to adapt to local conditions and the quality of their leadership. For example, the success of the Slovak Fund in a region where doing deals is difficult versus the Czech Fund—where presumably there should be fewer difficulties—has been attributed to leadership and adaptation to local business and cultural practices. Whereas the leadership of the Slovak Fund exhibited much more continuity and interest in local business dynamics, the leadership

[106] Interview of March 10, 1994.

[107] In March 1993, the Warsaw province accounted for about 41 percent of all foreign capital invested in Poland and for about 33 percent of the total number of joint-venture companies. (Szlachta, Jacek, (1993), "Poland's Regional Development under Economic Transformation." Conference on "Regional Development in Poland" sponsored by the Friedrich Ebert Stiftung in Poland, Sept. 30 to Oct. 1, p. 16.)

[108] Interview with Jacek Szlachta, deputy director of Poland's Central Office of Planning, Regional Policy Department, April 22, 1994; Szlachta, Jacek, (1993) "Poland's Regional Development under Economic Transformation."

of the Czech Fund was marked by turnover and exhibited little adaptation to the local business climate.[109]

Many of those the author interviewed emphasized that financial and marketing skills alone are not sufficient to run a successful Enterprise Fund operation. As Paul Gibian, President of the Czech and Slovak Funds expressed: "I don't think that sophisticated deal structures that investment bankers have created almost as an art form is what is ultimately most important . . . the Morgan Stanleys—the numbers people—that may still have a valid role if you talk to airline or utility or energy or [the Czech automobile manufacturer] Skoda because there you have somewhat sophisticated companies that have a market track record. . . . But the sector that we are trying to support . . . has less history, so that's where the operating experience and management evaluation of local companies become much more important. . . . We need to end up not only with Western financial wizards . . . [but also] to develop local operating experience."[110]

A Summing Up

In giving aid to Central and Eastern Europe, the United States sends a clear message that it has a strategic interest in helping the region to become more democratic, stable, and friendly to the United States. To achieve these goals, American policymakers ought to keep the following two things in mind: First, the United States might be well advised to have modest aims and make modest claims. Given the level of donor commitment, donors must recognize what limited aid can and cannot accomplish. Second, given that the donors' approaches to the region include political and social goals, donors should pay particular attention to the political and social implications of aid, as well as to the economic ones. For example, how will aid be received in Ukraine or Tajikistan where the institutional crises and potential for chaos are even greater than in Central and Eastern Europe?

In giving aid, it is important to demonstrate that aid—which entails involvement in a recipient's domestic affairs—is being used to establish new democratic structures so that all can benefit. Aid activities can encourage the development of a more comprehensive market system or inadvertently promote opposition to it. Moreover, recipients' perceptions of assistance and experience with aid-paid consultants may help to form their opinions of donor nations. The following factors are offered by the author to determine whether aid policies are likely to produce the intended outcomes in the recipient countries and further the objective of increased stability and good relations with the United States.

[109] Interviews with Zdenek Drabek, former aid coordinator of the former Czechoslovakia, July 7, 1994; Leighton Klevana of the Slovak Enterprise Fund, July 5, 1994; and Paul Gibian of the Czech and Slovak Enterprise Funds, July 7, 1994. GAO confirmed that many more deals had been finalized in the Slovak Republic, as compared with the Czech Republic. (General Accounting Office, "Enterprise Funds: Evolving Models for Private Sector Development in Central and Eastern Europe." Mar. 1994, pp. 22–33.)

[110] Interview of July 7, 1994.

THE PRESENCE OF AN OVERALL AID STRATEGY

The U.S program has suffered from the lack of a cohesive approach and may have tried to work in too many areas. U.S. assistance would benefit from focusing on the two or three areas of concern where it is best equipped to make a positive contribution. These should be determined in consultation with the recipients of the individual countries.

THE WISDOM OF AID PRIORITIES

Assistance should be more appropriately targeted and structured by concentrating on building institutions in key areas.

Privatization Aid

Aid to privatize state-owned companies has been overemphasized in the aid community and has proven difficult to implement effectively. Privatization aid can be effective, but only if it is regarded in the recipient country as impartial, professional, and if it can accomplish something that firms in the recipient country themselves cannot accomplish. Further, privatization aid must not be seen as serving Western interests; it must be a boon for the recipient nations.

All these conditions are very difficult to achieve on the ground given the dynamics of Central and Eastern European societies and politics. The potential dangers of privatization aid are even greater in Russia and Ukraine, where the rule of law is less established. It is less risky and potentially more helpful to place emphasis on other, less politicized areas.

Private versus Public Sector Aid

Ironically, the strength of the U.S. aid program—its emphasis on the voluntary and private sector—can also be its weakness.

Its strength is in programs that offer educational and networking opportunities for individuals and groups, such as the Fulbright program and the Peace Corps, and in programs that target the private sector directly such as the Enterprise Funds. But the emphasis on the "private" sector can be misplaced. It is unproductive and can be even counterproductive to bypass government institutions as a matter of course. It makes little sense to bypass Central and Eastern European governmental units that manage the critical policies of transition in favor of units whose main merit is that the label "private" can be somewhat accurately applied to them. This is the case in the area of privatization, where U.S. aid sometimes has worked in spite of, rather than with, the government agencies in recipient countries established to manage the processes of privatization. A more sophisticated view of "private" and "public" issues—one that considers when a purely private strategy makes sense and when it does not—is called for.

QUALITY OF INSTITUTIONAL SUPPORT AND THE DESIGN OF TECHNICAL ASSISTANCE

The technical assistance model that has proven most useful involves long-term resident advisers who are integrated into specific institutions in the host country for several years. It is important that prospective advisers be requested by the specific recipient parties who will benefit from their services, that their tasks will be specific and defined in advance, and that they be screened both by the donors and the recipients who will be working with them. One example of this approach is the long-term expertise provided under the U.S. Treasury Department's Financial Sector Technical Assistance Program. In all technical assistance projects, it is critical to have active participation of local professionals in contracting teams and clear terms of reference that have been jointly developed by all parties.

Providing strategic support and training to key institutions is also critical. In this regard, the Senate-initiated Gift of Democracy program and the Frost Task Force program of assistance to the parliamentary institutions of Central and Eastern Europe have been helpful. These modest efforts have supported the development of independent information, expertise, and monitoring services.

Such long-term programs avoid the lack of continuity and follow-up in projects involving only short-term advisers and support, which often do not fit into any overall aid scheme. Long-term programs can be effective because they are integrated into the institutions that they are trying to help.

ADAPTATION TO AND INTEGRATION WITH RECIPIENT INSTITUTIONS

Projects and mechanisms that were designed for use in India are generally less likely to be effective than those that were designed for Central and Eastern Europe and adapted to local cultural, social, and political conditions. Yet the procedures and constraints under which bureaucracies such as AID operate do not lend themselves to adaptation and often offer little flexibility. This has been especially evident in aid delivery in the privatization and economic restructuring area. On the other hand, such projects as the Enterprise Funds have been developed for Central and Eastern Europe and appear to be generally more responsive to local conditions. The Gift of Democracy and the Frost Task Force programs of assistance to parliamentary institutions also have been adapted to the needs of the recipient institutions.

Projects that allow the recipients to be the major designers and controllers of their projects, and that ensure local and long-term support, with targeted oversight by donors, are more likely to be effective.

KNOWLEDGE OF AID REPRESENTATIVES AND CONSULTANTS ABOUT LOCAL CONDITIONS AND PROJECTS

One suggestion the author makes is that the aid effort could take better advantage of field representatives whose main task should be to acquire knowledge and relate it to existing and potential projects. Local knowledge is critical if aid outcomes are to resemble donor intentions. For example, to give effective aid in Russia requires an understanding of the local structures of corruption and of "mafias." The danger is not so much that aid will disappear into a "black hole," but into the pockets of specific groups.

Given that it is difficult to know what will work, new approaches should be tried and more learning built into the system. Ways of monitoring progress should be connected to a mechanism for adjusting the program so as to more effectively achieve the desired targets. This requires leadership and continuing and ongoing dialogue with aid deliverers and recipients.

EFFECTIVENESS OF PROJECT EVALUATION PROCEDURES

The nature of project evaluation needs to be rethought. Much project evaluation is misguided because it is based on narrow accounting and accountability criteria, which are capable of examining only part of the aid story. It is all too possible to imagine a situation in which "We have accounted for every penny and most of it was not well spent." The problem is that the evaluations often fail to take into account local perceptions, realities, and responses. Yet recipients in key positions can frustrate or encourage the implementation of consultants' recommendations. They can direct aid to their friends or encourage aid to be used to benefit a wider public.

If we have learned anything, it is that assistance should be more recipient-driven with informed and significant oversight from donors. The effectiveness of assistance depends on the active engagement of both donor and recipients, and in particular, the *long-term* commitment of those who transmit and receive the aid.

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THE CONGRESSIONAL ROLE IN UNITED STATES ASSISTANCE POLICY IN CENTRAL-EAST EUROPEAN ECONOMIES IN TRANSITION

By William E. Schuerch *

CONTENTS

SUMMARY

This article reviews the unique congressional role in foreign policy and assistance programs to East and Central Europe. It puts forth the thesis that policy leadership in these areas from 1989 to 1991 largely emanated from the Congress, not the executive branch. It further reviews the role of the Foreign Operations, Export Financing and Related Programs Subcommittee of the House Appropriations Committee and the foreign assistance policy of this region and raises questions concerning the assistance programs and their future direction.

INTRODUCTION

This year is the fifth anniversary of both the Polish "Round Table Agreement," signed in the spring of 1989, and of the initial requests for U.S. foreign assistance programs for Eastern and Central European countries. As such, it is an appropriate time to pause and consider what has occurred and is continuing to occur in the region and what part the West and the United States played in developments leading up to and following the extraordinary events in East and Central Europe in 1989.

* William E. Schuerch is Staff Assistant, House Committee on Appropriations, Subcommittee on Foreign Operations, Export Financing and Related Programs, U.S. Congress. The opinions expressed herein are solely the views of the author and are not intended to represent the views of any Members or committees of the U.S. Congress.

This article attempts to accomplish only a portion of that task by focusing on the congressional role in influencing U.S. foreign policy to the region. To a significant degree, that focus will be on the role of the House Appropriations Subcommittee on Foreign Operations, Export Financing and Related Programs in those events. This approach provides one "birds-eye view"—albeit a significant one—of the congressional process during those years. No attempt will be made to present a comprehensive statement of the different roles and impact of all the various congressional committees and subcommittees or of all the individual representatives and senators who influenced United States foreign policy or assistance programs during this period.

The article begins with a historical review. The interests and views of the Subcommittee and the Subcommittee Chairman and their effect on subsequent events are highlighted. General comments about the current status of assistance programs and policies in the region complete the article.

HISTORY

During the 1980s, the United States gave virtually no foreign assistance to the countries of Eastern and Central Europe. The two modest exceptions to that rule were Poland and Yugoslavia.[1]

To the extent it focused on Eastern and Central Europe during the 1980s, Congress primarily was concerned with human rights and emigration issues. One example of congressional interest during this period occurred in 1982. Following the initiation of martial law in Poland, the Reagan Administration imposed a number of tough sanctions on the Polish government. There were, however, Members of Congress and foreign policy experts who wanted the United States to take more punitive actions—including declaring the Polish government in default on its international debt. A bipartisan congressional delegation, led by Congressman David R. Obey (D-WI) with Congressman Mickey Edwards (R-OK) as the senior Republican, went to Poland to judge for themselves the seriousness of the situation. Following meetings in Brussels, Warsaw, Krakow, Vienna, and Rome, the delegation issued a trip report concluding that the Administration's measures were appropriate and that more drastic actions would not be in the interests of the United States.

A strong congressional role in regional foreign policy did not emerge until 1989, despite consistent congressional support of reform elements in Poland during the 1980s and the provision of small amounts of assistance to the Solidarity Trade Union. In 1989 events in Poland and Hungary resulted in strong bipartisan congressional reaction and in the shaping of a substantial assistance package—significantly larger than amounts being proposed by the President.

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[1] Poland received Public Law 480 agricultural assistance of $47.6 million in fiscal 1981 and continued to receive such assistance in declining annual amounts through FY1987. This agricultural assistance was primarily loans. Poland also received small amounts of Economic Support Funds: $5 million in FY1982; $10 million in FY1984; $1 million in FY1987 and FY1988; and $3 million in FY1989. Poland further received $5.8 million in development assistance in FY1988. Yugoslavia received $100,000 or less annually for International Military Education and Training funds throughout the 1980s.

American foreign policy and assistance leadership for a two-year period—from the spring or summer of 1989 to the same period in 1991—was largely dominated by Congress. Congressional actions for the most part overshadowed executive branch proposals. During this period, Congress responded rapidly to the changes in the region while the executive branch, torn by greater internal debate, was incrementally adjusting policies at the prodding of Congress. Bipartisan congressional support permitted a strong response to the political opportunities created by events in Eastern and Central Europe and contributed to the unusual ability of Congress during this period to dominate policy-making in this region.

Despite quick congressional response, Congress also was unable to respond as quickly as might have been desired to rapid political developments in the region.

An examination of political events in the region and executive branch and legislative branch activities underscores these points.

EVENTS IN 1989

On April 17, 1989, President Bush, following the signing of the Polish "Roundtable Accord," proposed an assistance package. It was heavily focused on U.S. support, or consideration of support, for actions within the international financial institutions. It contained few specific bilateral assistance proposals. [2]

On June 6, Congressman Lee Hamilton introduced the "Democracy in Eastern Europe Act of 1989" (H.R. 2550). It contained authorization of assistance programs for Poland and Hungary, including $3.0 million for science and technology exchanges, $2.0 million for medical assistance, and $4.0 million for democratic institution building. It also stated the sense of Congress that the President should work with Western allies on a proposal for comprehensive economic programs for Poland and Hungary. During June, the Subcommittee on Europe and the Middle East of the House Foreign Affairs Committee, which Congressman Hamilton chairs, held hearings on developments in Eastern Europe.

On June 16, Congressman Dante Fascell, Chairman of the House Committee on Foreign Affairs, introduced a major foreign aid reform bill (H.R. 2655), which included $15 million for assistance programs for Poland and Hungary.

In July President Bush traveled to Poland and Hungary. While there, he pledged to seek from Congress the initiation or expansion of a number of assistance programs. The primary ones included $125 million for the initiation of Polish and Hungarian-American Enterprise Funds, $15 million for environmental programs in Krakow, and $5 million for a regional environmental center in Budapest. These pledges totaled $125 million over three years. [3]

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[2] This article depends heavily on two sources: Committee on Foreign Affairs, Committee Prints: *Congress and Foreign Policy 1989*, "Congress and the Transformation of Eastern Europe in 1989," prepared by Francis T. Miko, Congressional Research Service, Specialist in International Relations, Foreign Affairs and National Defense Division; and *Congress and Foreign Policy 1990*, "Congress and the End of the Cold War in Europe," prepared by Steven Woehrel, Congressional Research Service, Analyst in Foreign Affairs.

[3] The White House, Office of the Press Secretary, (Warsaw, Poland) Fact Sheet, "An Action Plan for Poland." The sum of the numbers totals more than $125 million because the Enterprise Fund monies were not estimated to fully spend out in the three-year period.

Also in July Lech Walesa urged President Bush to support a $10 billion Western aid program for Poland.

Political discussions in Congress soon began to include the idea of a "Marshall Plan" for Eastern Europe. Senator Paul Simon introduced S.1582, and Congressman Tom Lantos introduced H.R. 3307 providing authorization of up to $1.2 billion in assistance over three years.

Urged on by speeches from Senators and Representatives and by the contents of proposed assistance bills, President Bush added to his previously proposed assistance package a contribution of $100 million in food aid and a contribution of $200 million to a Polish Currency Stabilization Fund.

Later in July, in response to the developing situation, the House Majority Leader, Congressman Richard A. Gephardt, began organization of an ad hoc group of House leadership and committee representatives to develop a comprehensive three-year assistance package for Poland and Hungary. That group included individuals from the following House committees: Foreign Affairs, Appropriations, Energy and Commerce, Ways and Means, Public Works and Transportation, and Agriculture. Primary authorization responsibility lay with the Foreign Affairs Committee; however, each of the other committees represented on the Majority Leader's working group had jurisdiction over specific matters under consideration for inclusion in a comprehensive package. Appropriations was responsible for finding the resources needed to finance the final package. The group met repeatedly and worked cooperatively to produce an authorization bill that would avoid multiple referrals, jurisdictional or policy disputes, and which, at the same time, would provide substantial political and economic benefit to Poland and Hungary.

On October 4 the product of that effort, the "Support for East European Democracy Act of 1989" (the SEED Act, H.R.3402), was introduced by the Chairman of the House Foreign Affairs Committee, and was endorsed by the bipartisan leadership of the House and Senate. The SEED Act proposals totaled $930 million over three years.

On November 15 Lech Walesa, the Polish Solidarity leader, spoke before an enthusiastic joint session of Congress. Political buttons evident everywhere were declaring "Make the Check to Lech," in reference to the legislative assistance package.

The funding provisions corresponding to SEED Act authorization provisions were incorporated and "front-loaded" into the FY1990 Foreign Operations, Export Financing and Related Programs Appropriations Act (P.L.101–167) in conference. It passed and was signed into law on November 21. The Act provided approximately $659 million in loans, grants, and credit authority and opened the Export-Import Bank and the Overseas Private Investment Corporation for business in Poland and Hungary. Congress adjourned for the year on November 22. The SEED Act (P.L.101–179), which also passed during the last days of the session, was signed into law on November 28.

Eastern and Central European events continued to unfold at remarkable speed. During November and December, as an amazed world watched, the Berlin Wall was opened and ruling govern-

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ments fell in East Germany, Bulgaria, Czechoslovakia, and Romania.

EVENTS IN 1990

No one anticipated the need to authorize additional foreign assistance activities in Eastern and Central European countries within a few short months of passage of the SEED legislation, which had authorized programs for Poland and Hungary only. On February 14, 1990, utilizing the "Urgent Assistance for Democracy in Panama Act" (P.L. 101–243), the Congress amended the SEED Act. The amendment authorized $10 million for election and democracy assistance to provide help and expertise with the spring elections in additional Eastern and Central European countries.

It could be argued that because events were occurring after the spring 1989 submission of the FY1990 budget request, the executive branch was in a difficult position to reconfigure its FY1990 budget request in order to lead the process of responding to events in Eastern Europe. However, that point ignores motivation. President Reagan in his first year in office submitted two large packages of budget amendments adjusting multiple foreign assistance requests as well as many other portions of the budget. Reconfiguration in 1989 of the FY1990 foreign assistance request was certainly a reasonable possibility but was simply not pursued by the executive branch.

The spring 1990 submission of the FY1991 foreign assistance budget proposed only incremental change from previous budgets, further illustrating the weakness of executive branch leadership in responding to events in the region.

FY1991 foreign assistance for Eastern and Central Europe was requested by the Administration at a level of $300 million, including what would later become a $70 million initial request for the European Bank for Reconstruction and Development (EBRD). This proposed amount was actually less than what the Appropriations Act had contained in the previous year.

Surprisingly, the new FY1991 foreign assistance requests from the Administration were for an increase of $317 million in military grants to third world countries and for the shift of $410 million in military loans into grants. No proposals were made to transfer funds from defense or international military programs to international economic programs in order to provide more resources with which to respond, within budgetary constraints, to the strategic opportunities created by a rapidly changing world.

This "status quo" (also referred to as "sleepwalker's budget") request for FY1991 was brought to the attention of senior Bush Administration officials in repeated congressional hearings. Secretary of State Baker pointed out that the FY1991 budget had been developed during fall 1989, before the political changes in Eastern Europe. Other senior officials responded that changes in the world were not so significant and that regional threats had not disappeared despite remarkable changes in the Soviet Union. No FY1991 budget amendments were proposed by the Bush Administration during the remainder of 1990 to respond more adequately to events in Eastern and Central Europe.[4]

When the House Appropriations Subcommittee on Foreign Operations, Export Financing and Related Programs, chaired by Congressman David R. Obey, "marked up" the FY1991 Foreign Operations, Export Financing and Related Programs bill, it rejected the Bush Administration's proposed international military spending increases; it proposed instead for Eastern and Central European program funding a total of $489 million, including $70 million for the initial funding for the EBRD. The Senate proposed $390 million, including EBRD. Conference settled on a level of $440 million, 147 percent above the Bush Administration request.

The FY1991 Appropriations Act also prohibited the obligation of the funds made available for the initial U.S. contribution to EBRD until the international community recognized the real value of Polish external debt. There was concern that EBRD funds, provided to support new democratic governments in Eastern Europe, not be siphoned off to repay commercial bankers or governments that had chosen to provide financing to the previous communist government of Poland.

Another illustration of the unusual congressional interest and initiative in the region was the creation in April 1990 of the Special Task Force on the Development of Parliamentary Institutions in Eastern Europe by the Speaker of the House, Thomas S. Foley (D-WA). This bipartisan group, headed by Martin Frost (D-TX) and often referred to as the Frost Task Force, provided assistance to parliaments in Eastern Europe and the Baltics, utilizing resources from the House Information System, Congressional Research Service, Office of the Parliamentarian, and committee staffs. These activities included providing books, library research materials, computers, and seminars on parliamentary procedure and the role and function of members, committees, and legislative staffs.

In spring 1991 the Administration proposed an FY1992 budget for the region totaling $470 million, including EBRD funding. The House agreed with that level, but, because of the presidential veto threat over Israeli Loan Guarantees, foreign assistance funding was provided through a Continuing Resolution. That Resolution included $440 million for Eastern and Central Europe, including EBRD funding. Consequently, it is fair to say that in terms of assistance levels and policy, the major differences between the Administration and the Congress by summer 1991 had disappeared. From FY1992 through FY1995, funds provided by the Congress have been approximately what was requested, and differences on policy and assistance have been comparatively minor.

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[4] The term "status quo" is found in U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Hearings for 1991, Part 3, "Promoting Political Stability, Democracy and Economic Opportunity, March 15, 1990, p.381. The term "sleepwalkers' budget" is found in U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Bill, 1991, House Report 101-533, p.6. Secretary Baker's explanation is found in U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Hearings for 1991, Part 3, March 1, 1990, p.189. Other senior officials comments can be found in U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Hearings for 1991, Part 3, March 15, 1990, p.383.

AREAS OF FOCUS

The Foreign Operations, Export Financing and Related Programs Subcommittee of the House Appropriations Committee and Subcommittee Chairman, Congressman David R. Obey, were particularly interested and active in a number of specific areas related to Eastern and Central European foreign policy and assistance programs. The areas, which received particular attention during the past five years, include programatic flexibility; the Polish debt; the duration of the assistance programs; the size and function of field staff; public sector programming; EBRD management and lending practices; and Enterprise Fund accountability.

PROGRAMMATIC FLEXIBILITY

The Subcommittee and the Chairman have been strong believers in assuring the executive branch that the program has the necessary flexibility to respond to country-reform initiatives and to other rapidly developing political, economic, or humanitarian circumstances. Assistance programs to Eastern and Central Europe and to the newly independent states of the former Soviet Union (NIS) have benefited enormously from this approach.

Assistance to these regions has been provided with unusual flexibility. For the most part, the funds have been available until expended and without earmarks. These funds have been granted notwithstanding any other provision of law, without detailed budget justification at the time of request, and with liberal transfer authority among assistance subcategories.

This flexibility has meant that funds have no fiscal year limitation, no legal requirement that specific amounts be spent on particular projects or countries, no application of other laws that might otherwise prohibit the availability or the speed with which assistance might be provided and no detailed country and project justification material normally required prior to appropriation. Program administrators have been given authority to shift unlimited funds between the assistance subcategories set up in the legislation.

Congress limited this unusual flexibility only by the requirement that the committees of jurisdiction be notified concerning the planned use of funds prior to their obligation. This notification process was used to reach agreement on specific project levels. It also permitted many of the projects to be implemented on a region-wide rather than country-specific basis.

The flexibility of the program was further enhanced by consolidation of the Eastern and Central European funding into a single account in FY1991. Executive branch officials, responsible for managing programs in Eastern and Central Europe, criticized Congress about the fact that FY1990 funding for the region specified amounts for individual programs through many different accounts—with the argument that "earmarking" and "micromanaging" the program made management difficult. However, these complaints were mostly disingenuous. Inasmuch as the Administration never requested much of this money in the first place, had the FY1990 funds not been specifically "earmarked" by account, these same officials would not have had most of these resources to manage. These official comments often also implied that these executive branch officials believed that, in providing a significantly higher level of resources to the region than what was requested by the Bush Administration, Congress should not have specified what the money was for—a rather dubious proposition. Nevertheless, in FY1991, at the request of the Administration, the Subcommittee consolidated all the FY1990 programs into a single appropriations account that has been operational since that time.

POLISH DEBT

The Subcommittee and the Chairman played a strong leadership role in this region's foreign policy by persuading the Bush Administration, other creditor governments, and commercial banks, to recognize the basic uncollectability of much of Poland's external debt, then totaling approximately $40 billion. The Congress, following the leadership of the Chairman and the Subcommittee, linked U.S. membership and funding for the European Bank for Reconstruction and Development (EBRD) to an international resolution of Poland's extreme external debt overhang. The idea was to prevent the use of scarce foreign assistance funds to repay both official and commercial debts of the prior communist government when those funds were needed to assist the efforts of the new Polish government to transform that country into a stable democracy and a market economy. The proposal was in direct conflict with the position of the Department of Treasury and the Administration which, along with other Western creditor governments, had been rolling over Polish official debt through Paris Club agreements.

A full review of the actions leading to both the Polish official and commercial debt deals is well beyond the scope of this article. However, it is important to understand that the Chairman and the Subcommittee strongly felt that Poland was a strategic key to the stabilization and transformation of Eastern Europe, and that Poland could be an example to pro-reform elements in Russia of the possibility of successful transformation. They believed that Poland, a strong Western ally during World War II, deserved treatment of its debt in terms at least as generous as were provided to the German people after World War II in the London Agreement of 1952. That policy position was strongly influenced by Harvard University economist Jeffery Sachs and by Leszek Balcerowicz, the Polish Deputy Prime Minister and Minister of Finance. Dr. Balcerowicz had told the Chairman that resolving the debt overhang would be the single most helpful action that the West could take in assisting Poland's transformation.

It is important to recognize that while the political initiative for action on the Polish debt was provided by the Congress on a bipartisan basis, the legislation was not mandatory. The Bush Administration was required to reverse its policy position on Polish debt and to work through Western governments a politically, economically controversial, and technically difficult international agreement. The fact that the greatest impact of the proposed policy fell on governments other than the United States (which held approximately only ten percent of the official debt) made reaching agreement harder. David Mulford, Under Secretary for International Affairs of the Department of Treasury, convinced officials of other governments of the wisdom and necessity of resolving the Polish debt. He was responsible for crafting the phased approach to official debt reduction, which helped ensure that Poland would stay on the politically difficult economic reform path. The efforts of first Polish, and then U.S. officials, aimed at achieving a comparable reduction of Polish commercial debt were regularly prodded by hearing questions from the Chairman and by occasional letters. However, these efforts did not finally result in a London Club agreement on commercial debt reduction until the Clinton Administration, under the leadership of Lawrence H. Summers, the new Treasury Under Secretary for International Affairs. Full implementation of that recent agreement remains to be accomplished.

DURATION OF ASSISTANCE PROGRAMS

As previously discussed, in FY1990 and FY1991 the Administration and the Congress disagreed on how quickly and how extensively to respond to the changes in Eastern and Central Europe. Additionally, the Subcommittee from the beginning disagreed with the Administration concerning the likely duration of the assistance program. Administration officials, as early as late 1990, were describing the assistance program in Eastern and Central Europe as "transitional." They meant not only "transitional" in terms of a program aimed at helping the political and economic transitions in the region but also in the sense of being implemented over a short period of time.

Agency for International Development (AID) budget documents for FY1992, which were available in early 1991, stated: "The U.S. Government sees the provision of this assistance as a top foreign policy priority during a three- to four-year transition period."[5] A February, 1991 report of the Government Accounting Office states: "State officials say that assistance to Eastern Europe is being managed with the view that it will terminate in three to five years, it is not a long-term development assistance program."[6]

In April 1991, during the FY1992 appropriations hearings, Chairman Obey pursued this issue. The assistance coordinator predicted that the FY1993 request would be between $250 million and $300 million and that the FY1994 request would be between $200 million and $250 million. The Chairman noted that no other organizations believed that the transition period in Eastern and Central Europe was going to take only three to five years and expressed the opinion that the Administration was seriously underestimating the difficulties involved in completing the transformation process.[7]

There was no direct confrontation over this issue because appropriations decisions are annual by their nature. Decisions about future funding needs could be decided in future years. In looking at Eastern Europe today, it is clear that the Chairman, although he

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[5] U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Hearings for 1992, Part 2, Justification of Budget Estimates, Agency for International Development, p. 547.

[6] U.S. General Accounting Office, Report to the Chairmen, Committee on Foreign Relations, U.S. Senate and Committee on Foreign Affairs, House of Representatives, *Eastern Europe, Status of U.S. Assistance Efforts*, p. 6.

[7] U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Hearings for 1992, Part 4, April 24, 1991, p. 548.

would have preferred otherwise, was correct in his judgment concerning the likely need for, and duration of, assistance programs to the region. The executive branch budget request for FY1995 for Eastern and Central Europe is $380 million. Only now, after five years, is there discussion of graduating the first countries from the program over the next few years. The Czech Republic and Estonia are being mentioned as candidates.

The "slow-in, fast-out" attitude concerning the assistance program was most strongly held by senior State Department officials and by senior appointed officials at AID. This attitude in part manifests itself in a desire to run the program from Washington D.C., without assistance staff in the field, and it further affected the assistance program content because activities to develop government institutional capacity building were avoided.

SIZE AND FUNCTION OF FIELD STAFF

The Subcommittee and the Chairman were highly skeptical of the Bush Administration's idea that the Eastern and Central European programs could be run responsibly entirely from Washington D.C., without AID staff in the field. While the Subcommittee was not impressed with the Washington management concept, it was the planned total lack of field staff to oversee program performance and provide feedback that brought the issue to the forefront. Disagreement over the lack of AID field staff evolved into a confrontation when the Subcommittee, on December 3, 1990, placed Congressional Notification No. 20 on "hold." This proposal requested $2 million for administrative expenses for the AID and stated the intention of the Bush Administration to place no permanent AID personnel in the field to manage or oversee the assistance programs.

The disagreement was discussed repeatedly and two months later resulted in a proposed compromise from the Administration. On February 12, 1991, a letter from AID Administrator, Ronald W. Roskens and Deputy Secretary of State, Lawrence S. Eagleberger stated plans to place eight "direct hire" AID employees in the region—four in Poland, and one each in Hungary, Czechoslovakia, Bulgaria, and Romania along with sixteen "foreign service national" employees. The letter also promised to continue to use temporary duty, "TDY", staff as necessary and to reassess the situation every six months.

Chairman Obey responded in a February 25 letter to the AID Administrator that released the "hold" on the requested administrative expenses, but which also said the Committee would review the matter further. The letter in part stated:

> ". . . Over the years, the efficient and effective use of scarce foreign assistance resources has been a top priority of this Subcommittee. In that regard, I have grave concerns about the current and future management of these programs. The fiscal year 1990 bill passed Congress in late November, 1989. Yet, today, fifteen months later, only one American employee of AID is stationed in Eastern Europe. . . . I do not believe that starving this new program for staff is either a responsible management approach or consistent with showing how good a job can be done in

running this high profile program. . . . The Committee has received no adequate explanation as to why an experimental policy of centralized Washington management is appropriate for Eastern Europe when it is not being followed elsewhere in AID or by other US agencies present in the region. . . ."

The letter also noted that in contrast to the proposed AID staffing of 8 Americans and 16 foreign nationals, the State Department staffing in the region included 178 Americans and 305 foreign nationals, the U.S. Information Agency regional staff included 27 Americans and 56 foreign nationals, and that the Department of Defense regional staff had 81 Americans and 8 foreign nationals. The letter further pointed out that the Administration was proposing that AID have fewer staff in the East and Central Europe region than AID had in any one of the following African countries: Cameroon, Kenya, Mali, Niger, Senegal, Sudan, Tanzania, or Zaire.

A responding letter was received on April 3 from the AID Acting Administrator providing a further defense of the AID staffing plans.

The issue finally came to a head at a Subcommittee hearing on April 24. After a considerable period of discussion back and forth with Mrs. Carol C. Adelman, Assistant Administrator AID, who strongly defended the Administration position, the Chairman, realizing that he was not successfully convincing the witness of his seriousness stated, in part:

"All I'm telling you is if we don't have a plan from you with specific targets about expansion of AID people in the field; and if we don't, we're going to write it ourselves in the bill. I would think that you would not want us to do that. I would think that you would prefer to keep flexibility. I'll be happy to give you that flexibility within reasonable limits, but I want to see some movement. . . . All I can tell you is when I talk to people in the field whether they are Eastern Europeans or whether they are Americans they are . . . telling me they are sitting in a room arguing with each other, because of gaps, I think they need more on-hand presence there, and they are going to get it. The question is are they going to get it cooperatively between the branches, or is it going to be mandated. So I think we ought to get with it, and your people ought to sit down with my people and work something out before we mark up on the 11th . . ."

Following the hearing, as soon as he was out of the hospital, Secretary Eagleberger visited the Chairman and reached agreement on a new Administration proposal to place approximately 30 permanent AID personnel in the region. Since that time, permanent staffing in the region has increased at the initiative of the executive branch. Further, when the NIS assistance program was initiated there was no attempt to eliminate field staff.[8]

[8] U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Hearings for 1992, Part 4, April 24, 1991, pp. 577–581.

Nevertheless, despite this resolution of the matter, disagreements concerning field staff continued. Actually identifying and relocating personnel took AID over a year. Then senior officials in Washington D.C. attempted to essentially run the program around the field staff by minimizing their role. This situation eventually led the Congress in the FY1993 Appropriations Act to take the highly unusual step of legislating a management issue—requiring that AID delegate certain authorities to the field staff.[9]

PUBLIC SECTOR PROGRAMMING

In terms of private- and public-sector activities, the Subcommittee generally has supported the private-sector thrust of the assistance program. However, the Chairman in several annual hearings and in Subcommittee reports stated that the overwhelming support for private-sector related activities in the assistance program should be tempered with a recognition that public-sector institution building was necessary in order to achieve and maintain the market economies and stable governments that were our goal. Congressman Hamilton also encouraged a public-sector focus, including governmental decentralization and local government programs. Unfortunately, the Administration, while funding a few small programs, largely ignored these views in their virtually exclusive enthusiasm for private-sector programs.

The Bush Administration asserted the position that the United States was uniquely qualified among other assistance donors to carry out private-sector programs. The Administration never entertained the idea that the United States is probably more unique in its governmental sector than in its private sector. Consequently, the assistance program, particularly in the first three years, virtually ignored the need to educate and train individuals below the level of reform ministers and deputy ministers to run governmental institutions. The need to explain merit-based personnel systems, competitive procurement, functioning budgetary systems, and varying types of federalism was largely neglected even when a country asked for such assistance. In fact, the initial response of the Administration to the idea that the public sector ought to receive some attention was to stall and then to recategorize a range of private-sector related activities into a public sector program category i.e., privatization advisors. Eventually, small amounts were allocated for local government and later for public administration activities; these are now being implemented.

EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

After using the initial FY1991 U.S. contribution to EBRD to encourage the international recognition of the uncollectability of Polish debt, the Subcommittee was supportive of funding for the Bank. However, in FY1993 the Senate proposed to eliminate funding for EBRD in frustration over many complaints concerning its administration and slow program initiation. The House prevailed in conference and EBRD was given a one-year reprieve—receiving only a $10 million cut in funding for FY1993.

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[9] U.S. Congress, House, Committee on Appropriations, Foreign Operations, Export Financing and Related Programs Bill, 1993, Conference Report 102–1011, Amendment No. 66, pp. 7–8.

The Bank, however, took no apparent notice of this close call or of growing criticisms. In FY1994 there was great publicity concerning a wide variety of executive abuses and the overly grand headquarters building it was completing. Those problems, added to the fact the Bank seemed incapable of making loans and taking risks, led the Chairman, with strong bipartisan support, to recommend elimination of all funds for EBRD for FY1994. The full House and Senate enthusiastically agreed. Other Western governments also found the situation unacceptable. The Bank president was forced to resign with a number of other senior officials. Now the new EBRD president is pursuing the multiple goals of cleaning up the management problems, ending the abuse of executive perks, decentralizing staff, and moving lending more rapidly to assist economic transformation.

ENTERPRISE FUND ACCOUNTABILITY

Perhaps no program initiated by the Administration was backed with more political enthusiasm in the executive branch than the new Enterprise Funds. The initial two funds, the Polish-American and Hungarian-American Enterprise Funds, were chaired by close colleagues and personal friends of senior Bush Administration officials. This high political profile and the consequent attitude of senior appointed officials made oversight of the funds by executive branch professionals impossible. Consequently, the Subcommittee was forced to play a strong oversight role.

The initial notification requesting money for the Funds arrived in Congress before these supposedly nongovernmental private-sector creations even existed. The request for money preceded the selection of a Board of Directors, the incorporation of the organizations, the hiring of any staff, or the creation of a financial or business plan. Much to the concern of the Board Chairmen and senior Administration officials, the Subcommittee placed a "hold" on the initial request for several months, until the above basic necessities were in place.

The Subcommittee became involved again when the Funds insisted on receiving large amounts of cash "up front," without prospective investments. An arrangement was worked out whereby the Funds would receive an initial letter of credit but no cash. They would then draw funds from AID based on projected needs; receive advances; and report on disbursements and balances.

The Subcommittee also forced the Administration and the Funds to change initial agreements which gave complete authority to each fund concerning decisions about when to declare their missions accomplished, when to begin liquidating investments, and how to distribute the assets. The resolution of these matters took some time because after these issues were raised by the Subcommittee, the Administration, without consultation, reached an agreement with the Funds that these decisions would be mutually agreed with the President. The Chairman, however, felt strongly that the President should not be put in the position of negotiating these decisions with private citizens, particularly when the assets would result entirely from the investment of taxpayer dollars. He also felt that Congress should have a stronger role than the Fund Boards. The resolution of this matter now leaves these decisions entirely up to the President, subject to the advice from the Fund Boards and consultation with the Congress.

Problems also arose when the Administration attempted to avoid congressional oversight of the Funds by seeking to "end run" the Congress by refusing to submit notifications concerning the Funds when the Funds desired to restructure themselves, make highly unusual investments, or make compensation agreements far in excess of those previously agreed to by the Congress. These matters were eventually resolved, but not before they led to the resignation of one of the Fund presidents.

These Subcommittee actions may seem to indicate some lack of support of the Funds by the Subcommittee. In fact, the opposite is true. The Subcommittee has supported these Funds throughout their existence and has provided every dollar that has been requested. Nevertheless, the Subcommittee and the Chairman have found it necessary to play a strong role in oversight of the Funds. In general, the Subcommittee position has been that AID should not second-guess individual investment decisions of the Enterprise Funds, but that, in all other ways, the Funds should be treated like other AID grant recipients. However, only with the Clinton Administration has AID begun to play its appropriate role.

GENERAL COMMENTS

Five years have passed since the start of assistance programs for Poland and Hungary. Many similar assistance programs have been initiated in Russia and in the new independent states of the Soviet Union (NIS). Yet, it is remarkable to observe how little evaluation and analysis of the Eastern and Central European programs has occurred. Few experts are prepared to testify on which of the myriad of Western assistance programs being delivered in Eastern and Central Europe have had real impact, or might in the longer term. Few experts can be found to suggest that specific programs are more appropriate to obtaining specific short-, medium- or long-term results. There has been little expert suggestion concerning an optimal sequence for democratic and market transition assistance programs.

Seemingly, there has been little coordination among Western assistance donors in the Eastern and Central Europe assistance programs and that pattern seems to be repeating itself to some degree in the NIS programs. However, due to little evaluation, it is unclear how this lack of coordination has lessened the accomplishments or the efficiencies of assistance programs in the region. Regardless of programmatic coordination among donors, it is remarkable how little informational coordination has occurred. Limited information about the assistance programs of other donor countries is available in the United States or in Europe.

Clearly, the executive branch asserted duration of three- to five-years for successful transition and ending of assistance programs has proven to be at best wildly optimistic. But, initial decisions about ending programs in the Czech Republic and in Estonia over the next three years have been made public.

The Eastern and Central European region is changing. Accomplishments are evident. But clearly much remains to be done.

Consideration needs to be given to what strategic and programmatic changes need to be made in the assistance program to reflect the progress that has occurred on a country-by-country basis. More reflection needs to be aimed at specifically what the United States hoped to accomplish when government officials said they wanted to assist the creation of stable democracies and market economies in the region. When and how will it be known that these goals have been achieved, or at least sufficiently achieved, such that the assistance programs can be reduced or shifted to a long-term strategy?

Difficult trade- and market-access issues, regional membership issues, including NATO and the European Union, and the effect of the return of communists to the governments of three countries all raise new questions concerning the sustainability of transformational success. How is the judgment made that politically and economically sustainable results have been achieved?

The predominant assertion of the American assistance programs should also be reflected upon—that the United States is uniquely qualified to provide private-sector assistance. Private-sector programs aimed at creating a market transition are clearly important. But, it is at least an equally accurate assertion that the United States is uniquely qualified to provide public-sector assistance.

The United States has a unique balance of government regulation and private-sector freedom. Americans also have a unique belief that government gains its legitimacy from them and that it ought to work for them. American tradition includes public choice, openness of information, fairness, decentralization of authority and, perhaps, most of all, the institutionalization of accountability. These values are critical to the sustainability of the democratic and market revolutions in Eastern and Central Europe. How successful are our assistance programs in communicating and transferring these values to Eastern and Central European cultures?

The early stages of the transition in Eastern and Central Europe are over. Western values are in the lead; however, the tide of the game is changing and the final outcome is not assured. Premature declarations of victory should be avoided. Transforming economies and political systems have a long way to go before they are stable and fully functioning. Premature elimination of assistance in the medium- and long-term could be far more expensive than staying engaged over the longer-term and slowly tapering off an assistance program only as the results become clearer.

III. REGIONAL RELATIONS

OVERVIEW

By William H. Cooper*

The revolutions of 1989 and 1990 in East and Central Europe overthrew the Communist regimes and spawned embryonic movements to democracy and market economies, at least in most of the countries. They also have radically changed the geopolitical and geoeconomic framework within which the countries of Eastern Europe have operated. Along with the breakup of the Soviet Union, the political and economic changes in Eastern Europe have fundamentally altered the relationships and concerns these countries have with their onetime ally—the (former) Soviet Union, with their previous enemies—the United States and Western Europe, and with one another. They are also forcing the United States and its allies to redefine the structure and mission of NATO; they are compelling the European Union to rethink its evolution as an economic and political entity; and they are driving the former Soviet Union, especially Russia, to redefine its national interests in Europe.

After five years, those relationships and concerns are still evolving and raise important issues of economic and national security for the region: What interests does Russia see for itself in post-cold war East-Central Europe, and what implications does this vision have for the region, the rest of Europe, and the United States? How have the relationships among the countries of East-Central Europe evolved? What role do the countries of the region see for themselves in their relationships with the West, particularly the European Union and NATO, and is this vision shared by their prospective partners in the West? Five contributions to this section address these questions from different perspectives.

EAST-CENTRAL EUROPE AND RUSSIA

The Soviet Union's political, military, and economic domination of East-Central Europe left legacies that will burden the countries of the region for the foreseeable future. Each country, for example, continues the task of dismantling the Soviet-imposed political structure dominated by communist parties and building a democracy in its place. This task has proved formidable, with some of the countries being more successful than others.

Soviet military domination was manifested in control over the East European military establishments through the Warsaw Trea-

*William H. Cooper is a Specialist in International Trade and Finance in the Economics Division, Congressional Research Service, Library of Congress.

ty Organization (WTO). Under the WTO, the military interests of the respective states were subordinated to those of the Soviet Union. But as the paper by Paul Gallis, Julie Kim, and Francis Miko points out, the breakup of the Soviet Union and the dissolution of the WTO has left a security framework vacuum in the region. That vacuum has bred instability within the region in the form of ethnic and nationalistic tensions that have resurfaced after almost a century in the former Yugoslavia, in other regional states, and in areas of the former Soviet Union itself.

The Soviet Union dominated East and Central Europe through its foreign trade and control within the Council for Mutual Economic Assistance and was the primary market for East European exports and their chief source of imports—primarily energy—much of it at heavily subsidized prices. But trade collapsed with a significant impact on the East European economies. In their paper, András Köves and Gábor Obláth cite one study indicating that the collapse of trade with the Soviet Union was responsible for between one-third and one-half of the decline in GDP that occurred throughout the region by 1991.

Russia's relationship with East-Central Europe continues to evolve in the post-cold war era. In some respects, Russia remains a negative influence. As the paper by Sarah Terry points out, fears caused by the political uncertainty that arose in the Soviet Union during the August 1991 coup against Gorbachev were a major factor in the East and Central European states, especially the so-called Visegrad states (the former Czechoslovakia, Hungary, and Poland), which are seeking closer ties with the West in the form of membership in NATO and the European Union. Those fears have resurfaced as Russia reasserts its security interests in the region.

But others attribute a more benign, if not positive, role to Russia in the region. Angela Stent concludes in her paper that Russia will be preoccupied for at least the next decade in getting its own house in order. This period will provide the East-Central European states with a unique, historical window of opportunity to develop and pursue their own interests and build a political and economic order uninhibited by Russia or other outside forces. Köves and Oblath assert that East and Central Europe can and should rebuild economic ties with Russia, albeit on a limited basis, to stem the decline that has affected many of their industries.

Intraregional Relations

In her paper, Terry summarizes the plight of relations among the states of East-Central Europe during the post-cold war period:

> It is important to remember that [East-Central Europe] has been defined far less by ties binding these countries together than by the comings and goings of the larger powers that flanked them.

Terry analyzes the various efforts the states of the region have made to form regional bodies that coordinate political, foreign policy, and economic relations. The most evident of these efforts was the so-called Visegrad Triangle or group that was formed through an agreement signed in Visegrad, Hungary to collaborate on the various aspects of transition from communist dictatorships and centrally planned economies to democracies and free-market economies. It was also designed to coordinate efforts in obtaining membership in the European Community (now the European Union).

The Visegrad group members appeared on the surface to have shared much in common that would make cooperation successful. They were among the most economically advanced (besides East Germany) of the former communist East European states and had made the greatest strides toward political and economic reform. All three (later four when Czechoslovakia split into two separate states) were among the most westward oriented of the former communist states. Poland and Hungary, in particular, had extensive foreign policy and economic ties with the West during the communist period. According to Terry, even Western countries looked on the Visegrad group as a model for post-communist cooperation in Eastern Europe.

The author points out that the initiative did not meet the expectations of its members or interested states outside the region. The Visegrad members succeeded in establishing unified positions regarding their accession to the European Community and NATO and managed to reach agreements on liberalizing trade among them. But, differences within the group that are rooted in such issues as ethnic autonomy (Hungary's concerns over the treatment of the Hungarian minority in Slovakia), the uneven pace of economic and political reforms of the member states, and divergent foreign policy interests, reduced the effectiveness of Visegrad. The author considers Visegrad a tenuous grouping without much potential.

Terry concludes that the states of East and Central Europe cooperate most when faced with a common objective (such as accession to the European Union) or threat (the reemergence of Russian assertiveness in Eastern Europe). Efforts also improve when cooperation is broadened to include countries outside the region, such as the Central European Initiative that includes Italy and Turkey, and other countries. Terry's conclusion strongly implies that East-Central Europe should not be viewed as an entity. The states of the region will in time go their own ways, with some being drawn to the West into the European Union, as in the case of Hungary, Poland, the Czech Republic, and Slovakia, and perhaps into NATO, while others will be drawn to the East.

East-Central Europe and the West

If the countries of East-Central Europe do not see their future focused within the region, many are looking outward and primarily to the West. This implies association if not membership in Western-based institutions—the European Union and NATO.

The paper by Angela Stent as well as the one by Heinrich Machowski and Wolfram Schrettl underscore the importance of a unified Germany in the efforts of the East-Central European states, especially Poland, Hungary, the Czech Republic, and Slovakia, to become part of the West. Both papers attribute positive roles to Germany in the affairs of the region. Stent indicates that the historical ghost of German domination of the region is no longer valid. Germany is preoccupied with its development as a unified state. It is well anchored in the European Union and

NATO, Stent writes, and will not revert to its expansionistic past. Furthermore, she asserts, Germany has played a leading role in promoting East-Central European interests in NATO and the European Union and will continue to do so.

Germany has been and will continue to be important to the region from an economic perspective, according to Machowski and Schrettl. Although unification resulted in a significant decline in trade between Eastern Germany and the East-Central European countries, the loss was more than made up by a surge in trade with Western Germany. Consequently, Germany has become the leading trading partner of most of the East-Central European states. Germany's economic role will probably increase as it recovers from a recession and imports more from the region, helping to boost economic growth there. Germany is likely to become an important source of foreign investment.

The East-Central European states look upon the West and its institutions as the anchor for their security. In their paper, Gallis, Kim, and Miko write

> The primary foreign and security policy objectives of all the countries of East-Central Europe have been association with and integration in the major European multilateral institutions, especially the European Community (now the European Union) and NATO. . . . Alternative foreign policy endeavors such as regional cooperative groupings, various "special relationships," and other pan-European approaches are regularly pursued as parallel objectives, but not substitutes for integration in the West.

Members of NATO and the European Union have had to grapple with responding to these objectives. NATO has had to address East-Central European fears of a reassertive Russia and Russia's concerns of an expanded security alliance directed against it. It responded with the "Partnership for Peace" program.

The European Union has had to deal with its own efforts at becoming a political as well as economic entity while addressing the desires of the East-Central European states to become members. The response has been association agreements with some of the states. These agreements provide for closer economic ties and the possibility of membership down the road, but the European Union still maintains an "arms-length" relationship with the East-Central European states. Neither the Partnership for Peace nor the European Union association agreements has completely satisfied the states in the region who want assurances of becoming full members of NATO and the European Union. The United States and the West will continue to face this issue for the foreseeable future.

THE REGIONAL ROLE OF THE FORMER SOVIET UNION AND THE CMEA: A NET ASSESSMENT

By András Köves and Gábor Oblath *

CONTENTS

SUMMARY

Focusing on relations between the former Soviet Union and the small East European member countries of the Council for Mutual Economic Assistance (CMEA), the article discusses some antecedents, reasons, and consequences of, as well as perspectives after, the dissolution of the organization. First, the short-term (price-related) and the longer term (dynamic) effects of CMEA economic cooperation are analyzed and explanation is offered why the Soviet Union did not realize sizable benefits from the switch to dollar payments and world market prices in 1991. In discussing different interpretations of the relationship between the collapse of trade and decline in output in Eastern Europe, the authors emphasize the negative effect of the export decline on output levels, but reject the proposition that this was the major factor in inducing the recession. Finally, expectations of different participants regarding prospective economic relations between Eastern Europe and the former Soviet Union are addressed. While the authors stress the constraints to the growth of this trade and warn against illusions regarding its future importance, they do see some scope for an increase from its present depressed level.

INTRODUCTION

This article reviews some aspects of the break-up of the CMEA and its aftermath. It focuses on relations between the small Central and East European (or briefly, East European) countries on the one hand, and their dominating partner in the organization, the Soviet Union (and its successor states), on the other. This choice is explained by the well-known fact that the CMEA was a "radial" integration: the important economic relations among mem-

* András Köves and Gábor Oblath are with the KOPINT-DATORG Institute for Economic, Market Research and Informatics, Budapest.

ber countries were chiefly those that linked individual economies to the Soviet Union. Discussion of the relations among the smaller former member countries of the CMEA, and their recent endeavors to establish a regional free trade arrangement, is beyond the scope of this study.

Our review assumes that the reader is familiar with the main characteristics of the CMEA; no attempt is made to describe the institutions and the workings of the system. The first section offers an introduction to some of the major post-CMEA issues and addresses the expectations on the Soviet side. Next, expectations on the East European side are reviewed and the effects of the demise of the CMEA are treated. The last section discusses questions pertaining to the future of the relations between Eastern Europe and the former Soviet Union.

SOVIET-EAST EUROPEAN TRADE: THE END OF THE CMEA

The political confusion and economic collapse in what used to be the Soviet Union, as well as the uncertainty in the future of the former superpower, indicate that detachment from the Soviet Union and discontinuation of CMEA-type relations has been crucial for the political and economic transformation in Central and Eastern Europe. There is a necessary process of revising former development strategies and reorienting foreign economic relations from the Soviet Union toward the global international economy, more specifically toward Western Europe (the European Union). The process appears to be a necessary, though insufficient, precondition for the longer-term economic and social development, independent statehood, political democratization, successful modernization and "catching up" of Eastern Europe with the developed part of the world.

While Eastern Europe's movement away from the former Soviet Union may be reassuring for the future of the region, the short- and medium-term implications of the disintegration are far from unequivocal. As will be shown below, quantitative assessments and rational arguments vary, and the macroeconomic significance of the collapse of trade across countries is different. Yet there is broad consensus among analysts that part of the economic shock, industrial and agricultural decline, unemployment and the macroeconomic disequilibria in Eastern Europe, is due—directly or indirectly—to the Soviet collapse that resulted in the end of CMEA-type relations, and to the strains of compensating for the loss by expanding sales to alternative (Western) markets.

The losses to Eastern Europe arising from the disengagement from CMEA-type trade with the Soviet Union brought a retrospective relevance to the decades-old debate concerning the merits and drawbacks of intra-CMEA economic relations from the point of view of different participants in this trade. After the early post-war years, when intra-CMEA trade had been viewed in the West basically as a tool of Soviet exploitation of Eastern Europe, more economic analysis was devoted to clarifying the actual advantages and disadvantages in CMEA trade. In the late 1970s, a school of thought had gained strong influence which stressed that East Europe had important terms-of-trade advantages from trading with the Soviets under the CMEA rules. According to this view, presented by Michael Marrese and Jan Vanous,[1] the overpricing (as compared to international prices) of low-quality manufactures predominant in East European exports and underpricing of energy and raw materials (overwhelming in Soviet exports) amounted to a significant and lasting "implicit" subsidization of East European countries by the Soviet Union. Supporters of this view insisted that the distribution of advantages and disadvantages made the Soviet Union the loser and the East European countries the winners in Soviet-East European trade. To their credit, Marrese and Vanous avoided judgments on the long-term implications of their analysis. They emphasized that their results did not imply any judgment on "whether East European countries are better or worse off as a result of their close association with the Soviet Union than they would be if they were closely associated with Western Europe."[2]

Other scholars discussing the Marrese-Vanous theory have emphasized that—in contrast with the static approach implicit in their analysis focusing on relative prices—dynamic considerations were more important: judgments on static gains and losses in Soviet-East European trade may be extremely misleading if issues related to dynamic advantages and disadvantages are ignored. The point is that there was a close interdependence between Eastern Europe's trade position vis-á-vis the Soviets on the one hand, and the West on the other. The same inward- (i.e., CMEA-) oriented economic policy that was the basis for advantages in trade with the Soviet Union was also responsible for the weak export potential of East European countries in international markets.[3] Therefore, the price of those static advantages proved to be very high. For instance, although the long-term stability of large-scale transactions had been regarded as an important microeconomic advantage arising from intra-CMEA relations, in the course of the 1980s, when both the stability and the certainty were lost, it become clear that this was mostly a politically motivated illusion and had even been responsible for mistaken strategic decisions on the macroeconomic, industry, and firm levels. The assumed advantages and stability of intra-CMEA trade for the East European countries became a source of considerable uncertainty and weakness on the international markets and one of the main reasons for the external disequilibrium that has haunted them for more than a decade. In a word, the traditional CMEA trade system was a tool for an inward-looking, autarkic, and Soviet-dominated development strategy for the member countries.

At first glance, what happened in the early 1990s in post-CMEA trade seems to support two distinct lines of thinking. East European countries suffered very serious terms-of-trade losses as a consequence of the discontinuation of the CMEA-type trade with the Soviet Union. However, against expectations and Soviet policy intentions of the time, the Soviet Union was as much a loser from

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[1] M. Marrese and J. Vanous, *Soviet Subsidization of Trade with Eastern Europe. A Soviet Perspective* (Berkeley: University of California, Institute of International Studies), 1983.

[2] Op. cit., p. 4.

[3] A. Köves, "Implicit Subsidies and Some Issues of Economic Relations within the CMEA," *Acta Oeconomica* (Budapest) vol. 31, nos. 1–2 (1983), pp. 128–129. The Marrese-Vanous hypothesis was criticized on other grounds as well, namely that deviations of CMEA prices from world market prices reflected a "customs union effect." See e.g., J. Brada, "Soviet Subsidization of Eastern Europe: The Primacy of Economics over Politics?" *Journal of Comparative Economics* (March 1985).

the end of CMEA as East Europeans were. Soviet officials expected that the transition from CMEA to hard currency trade would substantially improve their terms of trade and balance of payments both with respect to Eastern Europe and—more important—in their overall foreign trade. As far as the first part of those expectations is concerned, it turned out to be correct. However, the implications for the country's overall trade were influenced by the special circumstances of the Soviet economy at that time. The effects of the improvement proved to be almost negligible as compared to the other consequences of the rupture. By design or by default, the Soviet authorities did not adjust their internal institutions and regulations to the new external framework of economic relations with their former CMEA partners.

On the one hand, Soviet behavior may have been influenced by the intention of "punishing" former allies for their "ingratitude": the Soviet Union was no longer willing to do a favor for Eastern Europe by taking specific steps to cushion the transition from ruble to dollar trade.

On the other hand, several other factors hindered the adjustment of the domestic institutions and regulations on the Soviet side. First, Soviet authorities believed that they need not do anything, because the end of CMEA-type trade would automatically improve their position. Second, the political and administrative incapacity of the authorities may also have hampered the eventual steps for managing the transition. Third, the increasing foreign exchange shortage was also a constraint to implementing the appropriate changes in the regulations. Therefore, the most significant effect of the switch to dollar trade for the Soviet Union was the virtual halt in the exports of the former CMEA. According to expectations, the Soviets cut their imports from Eastern Europe, but not because they had found imports on more favorable terms. [4]

Yet the collapse of trade with the Soviet Union made the dynamic negative effects of Eastern Europe's long-term involuntary association with the Soviet Union absolutely clear. The end of the CMEA was the final point of a whole development impasse. For the sake of simple survival, strategic reorientation became inevitable; what was involved was not *trade* reorientation only. The change had to encompass development strategies that had been shaped by the existence of the CMEA as well as Soviet political priorities and the nature of Soviet demand and supply. As has become quite clear in the past three or four years in Eastern Europe, many of the difficulties of what is called systemic transformation are related to the former strategic disorientation.

Given the tremendous problems in the overall restructuring of the East European economies, it was inevitable that reorientation would be a most painful process necessitating hard decisions, wide vision, and scrupulous day-to-day cost and benefit analysis. But, to be sure, the end of the CMEA was not the only blow for the small economies of Eastern Europe. The depression of the early 1990s has largely been due to a combination of the effects of the Soviet collapse, the onerous legacy inherited from the past, and "objective

[4] For more on this, see A. Köves, *Central and Eastern European Economies in Transition: the International Dimension* (Boulder, Colorado: Westview Press), 1992.

and subjective" difficulties in the formulation and realization of feasible policies of economic transformation.

THE SWITCH TO DOLLAR PAYMENTS, TRADE COLLAPSE, AND OUTPUT DECLINE

Two sharply contrasting views prevail on the relationship among the dissolution of the CMEA (involving the switch-over in 1991 to hard currency—i.e., dollar—payments and the application of world market prices in mutual trade), the collapse of intraregional trade, and the sharp fall of output in the former member countries of the CMEA in the early 1990s. According to one view, it was the demise of the CMEA that led to the collapse of trade among former member-countries, which, in turn, was the major cause of the deep recession in the countries of the region.

According to the other view, the line of causation is different, if not exactly the opposite. In the latter interpretation the fall in output was not the result, but the cause (or, more mildly, the reflection) of the trade decline within the region. Proponents of this view hold that the trade collapse was an endogenous component of the "transformational recession" that cannot account for the fall of output. However, before reviewing these interpretations, it should be useful to compare the ideas and proposals concerning the possible changes in economic relations between Eastern Europe and the USSR, as well as their expected effects, with the actual outcomes. As endeavors and expectations on the Soviet side have already been addressed, an overview of those in Eastern Europe is in order.

In 1988–1989 the early ideas for reforming the framework of economic relations between Eastern Europe and the Soviet Union came from Eastern European countries, most notably Hungary, and not from the Soviet side. Moreover, these proposals did not consider the possibility of eliminating the CMEA system; rather, the major goal was to change the workings of the existing institutions. From a Hungarian perspective, where the decentralization of decision making and market-oriented reforms were already under way, there appeared a basic inconsistency between the prospective domestic economic system and that of the CMEA.

The CMEA implied a totally different relationship between government agencies on the one hand, and economic agents on the other, than what domestic economic reforms in Hungary strived to achieve. In fact, the CMEA system required that companies simply execute international agreements reached among government agencies (ministries, planning offices etc.) involving detailed lists of products to be exported and imported. Thus the system embodied not just a lack of autonomy, but the complete subordination of companies to the central authorities—exactly the opposite of what the Hungarian reforms wished to accomplish. Since, at that time, reforming the CMEA did not appear to be feasible, a committee of Hungarian economists proposed to change some of the substantive elements of economic relations, without altering the formal aspects, i.e., the institutional and payments system, of the CMEA.[5]

[5] L. Szamuely (ed.), *A világgazdasági nyitás: gazdaságpolitikai fordulat és intézményi reform* (Opening up to the world economy—a turn in economic policy and institutional reform—in Hun-

Continued

Still, it is likely that this proposition was one of the impulses that finally led the Soviet authorities to enforce the switch to actual dollar payments among countries of the region in 1991.[6]

In 1990, before the switch-over, several surveys and studies were completed to assess the potential impact of implementing hard currency payments and applying world market prices in trade among countries that used to form the CMEA.[7] These surveys focused on the impact on the terms of trade and the balance of payments of the switch-over.

The results, quite correctly, predicted that Eastern Europe would suffer a terms-of-trade and income loss, as well as a deterioration in balance of payments, while the Soviet Union would experience a substantial gain in its terms of trade with respect to the East European countries. Indeed, the Soviet terms of trade are likely to have improved in the order of 40–45 percent with respect to the smaller CMEA partners.[8] The preliminary studies did not consider the effect of the switch-over on the volume of trade. However, it was the impact on trade volumes that turned out to be the most significant and lasting effect of the switch to dollar trading.

Because of the simultaneous change in trade prices and the currency of trade, it is not easy to measure the change in trade volumes; in fact, no such estimates are readily available. According to the Hungarian Statistical Office, the volume of both Hungary's exports to, and imports from, nonmarket (i.e., former socialist) countries fell by roughly 45 percent in 1991. Since the fall in trade with the Soviet Union was greater in exports, and smaller in imports than the average, and since, in this respect, Hungary can be considered a "representative country" of Eastern Europe in 1991, according to our estimate the volume of East European exports to the Soviet Union declined by about 50–55 percent, and imports from the Soviet Union declined 35–40 percent.[9]

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garian), Közgazdasági és Jogi Könyvkiadó, Budapest, 1989. The main proposal was to adopt a system based on ruble clearing, similar to that of Fino-Soviet economic relations, where annual protocols for exports and imports and medium- and long-term agreements were in force, just as in the CMEA, but their actual contents were significantly different. These agreements were not obligatory and, more important, on the Finnish side they simply reflected the intentions of companies to buy or to sell on the Soviet market. (For more on this see G. Oblath, "Internal Regulation of Foreign Trade with Respect to Socialist Trading Partners: A Comparison of the Finnish and the Hungarian Systems," in M. Marrese, and S. Richter (eds.), *The Challenge of Simultaneous Economic Relations with East and West* (London: Macmillan, 1990, pp. 109–125.) However, other, more far-reaching solutions were suggested as well. One was the switch to a clearing dollar system; the other involved the introduction of settlements in hard currency.

[6] Of course, this is not to say that without the Hungarian proposals, the Soviets would not have thought of enforcing the switch to hard (i.e., convertible) currency trade. Neither does it imply that in Eastern Europe there would have been a total opposition to the idea of introducing a payments system based on hard currency and world market prices. In particular, in Hungary several academicians believed that the switch to dollar trading among CMEA countries would be beneficial, as it would automatically result in the transformation of CMEA economic relations into relations characterizing those of market economies. Although it may seem surprising, there were several managers who also had great expectations regarding the switch-over: they hoped that the change in the payments system would remove the constraints imposed on their exports by the Hungarian authorities, due to the large Hungarian trade surplus at that time.

[7] See, e.g., *The Demise of the CMEA: Implications for Hungary*, The World Bank, Report No. 9074-Hu, Washington D.C., 1990, and G. Oblath, and D. Tarr, "The Terms of Trade Effects from the Elimination of State Trading in Soviet-Hungarian Trade," *Journal of Comparative Economics*, no. 1 (March 1992).

[8] This corresponds to roughly a 30 percent deterioration in the terms of trade of the East European countries with the Soviet Union. On the terms-of-trade estimate see B. V. Christensen, *The Russian Federation in transition. External Developments*, International Monetary Fund, Occasional Papers, Washington D.C., February 1994. p.32.

[9] For the Hungarian trade volumes see *Foreign Trade Statistical Yearbook, 1992*, Budapest, 1993. The UN Economic Commission for Europe (ECE) made an attempt to measure the change in U.S. dollar terms. For 1991, these estimates indicate a fall by 25 percent in East European

Although the exact magnitude of the trade decline is still unresolved, there can be no question that it was extremely steep. The sharp drop resulted in the controversy, referred to at the start of this section, over the causes and the effects of the trade collapse. According to one school of thought, represented by scholars like János Kornai and Josef Brada, the collapse of trade was simply a reflection of the general decline of economic activity in the region.[10] This interpretation may be supported by the observation that trade between the USSR and Eastern Europe started to shrink before the dissolution of the CMEA and the introduction of hard currency payments in mutual trade. Moreover, these developments coincided with the recession related to the transformation of the East European countries and the disintegration of the Soviet Union. All these changes are likely to have resulted in a decline in the demand for goods and services from other countries in the region. Therefore, a part of the fall in the eastern trade of these countries was endogenous and inevitable.

However, the *extent* of the trade decline cannot be explained by these factors alone, and, more important, it would be a grave mistake to disregard the effects of the trade collapse on economic activity in the individual countries concerned. It is certainly true for the region as a whole that the level of economic activity and that of mutual trade fell simultaneously, but from the point of view of the Eastern European countries, the trade (in particular, the export) decline to the Soviet Union has certainly had a strong negative impact on production and the overall level of economic activity.

This observation has led some analysts to conclude that the major part of the decline in economic activity in Eastern Europe since 1991 is the result of the collapse of trade with the former USSR.[11] The implications of this finding are straightforward: it is not domestic policies and economic developments related to the transformation that have resulted in the sharp contraction of output in the East European region, but "exogenous forces", i.e., the fall of trade volumes, mainly deriving from the dissolution of the CMEA and the switch to hard currency payments and world market prices.

Nonetheless, to objective observers it has always been clear that neither of the two opposing interpretations are appropriate; the question cannot be formulated in terms of "either-or." While there could be no question that a part of the trade decline within the region was due to the domestic recession in the countries, it was also quite evident that the fall in output was the consequence of the

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exports to the USSR, but a 52 percent decline in Soviet imports from this region. Similarly, there is a large difference in the estimate for the change in imports: a 9.5 percent fall in East European imports from the Soviet Union, but 40 percent decrease in Soviet exports to these countries. *Economic Survey of Europe in 1992–1993*, UN ECE, New York, 1993, p. 112.

[10] See J. Kornai, "Transformational Recession. A General Phenomenon Examined through the Example of Hungary's Development", Collegium Budapest, Institute for Advanced Studies, Discussion Papers, no. 1, June 1993; and J. Brada, "Regional Integration in Eastern Europe: Prospects for Integration within the Region and with the European Community", in J. De Melo and A. Panagariya (eds.), *New Dimensions in Regional Integration*, (Cambridge University Press), 1993.

[11] See, in particular, D. Rodrik, "Making Sense of the Soviet Trade Shock in Eastern Europe: A Framework and some Estimates," in M. Blejer, G.A. Calvo, F. Coricelli and A.H. Gelb, *Eastern Europe in Transition: From Recession to Growth?* World Bank Discussion Papers, no. 196, The World Bank, Washington D.C., 1992. For a critical evaluation of Rodrik's framework and results see G. Oblath, "Comment," in the same volume and D. Rosati, "The Impact of the Soviet Trade Shock on Central and East European Economies," *Empirica*, no. 1, 1994.

sharp drop in the demand for their exports in other East European countries—of course most notably, in the Soviet Union.

An unbiased approach to the relationship between the trade and output decline in Eastern Europe is represented by the related studies of János Gács and Dariusz Rosati.[12] A detailed review of their findings is not feasible here, but some of their main conclusions are worth noting. Gács found that in Hungary the contribution of the contraction of (former) CMEA exports to total output decline was roughly 40 percent in the period 1988–1992, and in this respect the strongest negative impact was experienced in 1991 (the year of the switch-over and dissolution of the CMEA). Rosati concluded that in 1991 the negative impact of the CMEA trade collapse on the East European economies varied from country to country, but for most, this factor could explain one-third to one-half of the GDP decline. These results more or less correspond to what one intuitively expects: a significant, though certainly not the major, part of the collapse of output in Eastern Europe was due to the fall in trade with the USSR.

THE FUTURE OF POST-CMEA TRADE PROSPECTS AND POLICY OPTIONS

The foregoing explains why restoring economic and trade relations with the former Soviet Union became an issue throughout Eastern Europe from the day after the break. Indeed, the need to reconquer the lost big market has become a popular slogan of political parties of different persuasions, and of business and labor organizations. Various schemes for new trading and payments systems among the former CMEA countries have been put forward. Plans for the renewal of regional trade integration with the former Soviet Union have made an impression in the West as well. An explanation for this may be the belief that the reconstruction of trade among the former socialist countries could balance somewhat the Eastern drive for easier access to Western markets. Yet, while various schemes for financial cooperation and for creating a multilateral accounting system within the former CMEA region were suggested, no effective Western contribution to the reconstruction of trade between Eastern Europe and Russia was ever offered.

As far as the East European countries are concerned, disillusionment with the West has certainly played a role in the new emphasis on eastern trade. Progress toward joining the European Union (an act that would amount to an acceptance by the West of the East European countries' endeavors to become an integrated part of the international economy) is much slower than hoped; external financial constraints on their economic development have also remained problematic; and Western direct investment is clearly insufficient in most of the countries. In addition, some early successes in the regional restructuring of exports of the region have been reversed. This indicates that the former role of the Soviet Union as a large market that absorbs a significant part of output in Eastern Europe is yet to be filled. Understandably enough, this situation increases the respect for eastern trade, even if the prior-

[12] See Rosati, op. cit. and J. Gács, "Output Decline and the Demise of the CMEA and the USSR: the Case of Hungary," *Empirica*, No. 1, 1994.

ity of developing trade with the West is maintained in all countries of the region.

Regarding the regional orientation of trade policies in the East European countries, and given the difficulties in trade with the West, some balancing act appears to be necessary: trade with Russia (and some other post-Soviet states) seems to offer the only—though very limited—possibility for the shift. Trade with developing countries, as well as trade *within* Eastern Europe, is relatively insignificant and constitutes only a small share of the total trade of the countries of the region.

Besides these strategic or trade policy concerns, there are considerable vested interests in Eastern Europe behind the efforts to reconstruct trade with the former Soviet Union. Although the motives for intra-CMEA trade were mainly political, the decades-long priority for trading with the Soviet Union created a large and influential group of economic agents with a vital interest in this trade. For this group, the Soviet market was the *only* market they could cope with. They possessed the technology, the know-how, the personal ties and the language that enabled them to trade with the Soviets. For several representatives of this group survival in the former Soviet market after 1990 meant the survival of their company and/or the source of rapid moneymaking. In contrast, a large number of the firms that were unable to survive the post-CMEA conditions, became bankrupt or were liquidated. The foregoing factors explain why efforts aimed at restoring trade with the former Soviet Union receive significant support in Eastern Europe.

These endeavors were reciprocated from the very beginning by several trading partners in Russia—and for very similar reasons. Given the chaotic economic situation, the general shortage of imported goods and foreign exchange, and the sharp depreciation of the ruble, foreign trade has become one of the most lucrative economic activities in Russia and other post-Soviet republics. Traditions from the CMEA times, the need for continuity in trading relations, as well as geographical proximity and mutual interests were factors behind the attempt of many old firms and new businessmen to maintain trade with Eastern Europe.

As for Russian policy makers, they were strongly influenced by the Marrese-Vanous type of view of economic relations with the former CMEA, and nourished illusions regarding trade with, or aid from, the West. As a result, they underestimated the significance of the eastern trade for their own economy. Somewhat later, however, the mainstream of the Russian perception of trade with Eastern Europe changed. Subsequent Russian estimates indicated that a large part of the economic decline in the country was due to the collapse of intra-CMEA trade.[13] Among others, the collapse of urban transport in many Russian cities, as well as the decline in some of the most important manufacturing activities was due to the halt of deliveries from the former CMEA countries. Con-

[13] Some authors estimate that the collapse in intra-CMEA trade was responsible for about 30 percent of the decline in Russia's output in 1991–1992, and 70 percent in the fall of manufactured goods exports from the country was also related to the disruption of trade with former CMEA countries. See I. Faminski and V. Vinogradov, "Vneshneekonomitsheskie sviazi Rossii so stranami Vostotshnoi Evropi" (Foreign trade relations of Russia with the countries of Eastern Europe), *Vneshnaija Torgoulia* (Foreign Trade), no.2–3 (1994), p.41.

sequently, Eastern Europe regained some of its earlier appeal in Russian (post-Soviet) foreign economic relations.

The East European countries, just as in their overall economic policy, need a realistic and pragmatic approach to trading with Russia and other post-Soviet republics. This approach has to be based on a view of Russia as an important trading partner, especially as far as its longer-term potential is concerned, but actual difficulties in developing trade cannot be neglected. The point is that the factors behind the collapse of the CMEA—i.e., the Soviet political disintegration and economic collapse—are still present and are not likely to disappear in the near future. More specifically, the lack of foreign exchange for imports will remain a significant barrier to trade in the former Soviet Union. Therefore, no major changes in trade relations can be foreseen in the short- or medium-term.

In this situation, a realistic and pragmatic policy in Eastern Europe would emphasize a preference for trade relations based on the risks and costs of the participating firms. This implies that no specific country-related government support (i.e., beyond that offered to exporters to any other country) be offered on a regular basis: East European governments would do well if they tried to limit their involvement in supporting participants in this trade. Furthermore, in view of the present economic situation in Russia, and especially due to the problems in Russian oil production, the dependence of East European countries on imports (mainly those of oil) from Russia appears to be excessive. It would be in the interests of these countries to reduce this dependence (by way of import reorientation, or at least by making the reorientation technically feasible by establishing pipelines that would connect East European countries, especially the land-locked ones, with the West European oil transport system).

From a more "strategic" aspect, there are at least two important questions that should be answered concerning the policies of the East European countries toward Russia. The first is whether developing trade relations with Russia involves political risks for them. Five years after the political changes in Eastern Europe, three years after the end of the CMEA and the Warsaw Pact, and, of course, after the breaking up of the Soviet Union itself, the answer seems to be a definite "no." Even if one concludes from recent Eastern European history that no situation, however stable it may seem to be, is unchangeable, and if one expects that the present Russian policies may eventually change, and, therefore, a Russian comeback in Eastern Europe (or in some parts of the region) should not be totally excluded—even then, such a turn in events would certainly not result from an increase in trade relations. Trade in itself would not result in political reunion. In contrast, political rapprochement could indeed result in a renewal of the pro-Soviet trade orientation in the former CMEA countries or lead to their renewed economic integration.

Thus, no risks in developing economic relations with Russia should be foreseen—provided Eastern Europe's global integration continues, and recovery and progress can be foreseen in the economies of the region. Under this likely scenario, the increase of the region's trade with Russia would be welcome. Should, however, the region's integration with the West "get stuck" and if economic depression in Eastern Europe persists, the revival of trade with Russia may have a quite different meaning—with negative political connotations. Since political and economic development of the different countries of the region may diverge, this statement may have different implications for individual countries.

The other question concerns the future division of labor between Eastern Europe and Russia (and possibly other former Soviet republics). The traditional pattern of intra-CMEA trade was based on the exchange of East European manufactures, principally machinery (and agricultural products) for Soviet energy and raw materials. Considering this division of labor, the year of the breakdown of the CMEA was not 1991; it collapsed much earlier. The fall started in the mid-1980s, when the Soviets became unable to pay for the required amount of East European commodities by delivering the required quantities of oil, gas, and other raw materials. Obviously, even provided the present chaotic situation in Russia (and in the other former Soviet republics) comes to an end in the foreseeable future, trade will continue to be limited by the Russian capacity to export to Eastern Europe. Certainly, for at least two decades starting in the early 1970s, the Soviet Union had claimed that its CMEA partners should focus on purchasing Soviet manufactures instead of raw materials, the exportable amounts of the latter being limited. This claim was never really serious: the Soviet Union lacked the competitive manufactures (even in CMEA markets) that could be exported. Little, if any, change has taken place since. The development of Russian manufactures exports is still only an expectation.

This being the case, Russia will remain a market for East European manufactures to a limited extent. The country will be an even narrower market for food and other agricultural products from the small former CMEA countries. This is so because the mass food products (grain, meat) dominating in East European exports are much more expensive than the highly subsidized and/or low-cost food products of Western Europe or North America, whereas, for various reasons, the traditional pattern of East European exports of manufactures is in high demand in Russia and other post-Soviet states. It is up to East European countries to decide to what degree they will be ready to restore and develop capacities for exporting manufactures to those markets. Given the depressed state of their economies, and especially the critical situation of the machinery industry that used to be oriented toward the Soviet market, there is significant pressure for those industries to turn once again to Russian markets. Exports to Russia may be a question of survival for many firms in many sectors and regions in countries of Eastern Europe. However, whether or not these exports can be expanded ultimately depends on the existence of an effective demand—i.e., the ability to pay—for the required East European products in Russia (and other former Soviet republics).

In the final analysis, the future of economic relations between Eastern Europe and the former Soviet Union is essentially a function of developments in and the prospective economic potential of, the latter region—very much as in the final years of the CMEA or in the period of depression in the first half of the 1990s. There are, however, significant differences. In the late 1980s, due to the economic deterioration and dissolution of the Soviet Union, the overwhelming Soviet orientation of the East European countries was simply unsustainable; they had to reassess their development strategies and their foreign economic relations. At this time, it is highly improbable that Russia would, once again, become their major partner. Most probably, their strategic orientation toward the West is here to stay. However, depending on developments in Russia, it may, or may not, become an important trading partner for the East European economies.

INTRAREGIONAL POLITICAL AND ECONOMIC RELATIONS

By Sarah M. Terry*

CONTENTS

SUMMARY

How one assesses the status of intraregional cooperation in East-Central Europe depends on whether such cooperation is seen as an end in itself, or only as one means toward the larger goal in integration into European political, economic, and security structures. Viewed from the former perspective, the record of the four years since the collapse of the Warsaw Pact is rather meager and, with the fading of Visegrad's luster, the outlook is not promising. Viewed from the latter perspective, however, the central weakness in intraregional relations is that the primary goal of most of these countries has not been integration or cooperation within the region, but escape from a narrow regional identity with a lot of negative historical baggage.

After examining the various obstacles to cooperation in East-Central Europe, including the divisive legacies of both the pre-communist and communist periods, this paper looks at several intra- and inter-regional initiatives (most important, the Visegrad group and the Central European Initiative), as well as the implications of shifts in Russian policy toward the republics of the former Soviet Union and its former Warsaw Pact allies. It concludes that interregional initiatives are more likely to be successful because they bring the East-Central European states into cooperation with states outside the region (in particular states belonging to the European Union and NATO), and because the latter are more likely to have the resources necessary to carry out proposed projects. It also concludes that Russia's recent attempts to reassert its domi-

*Sarah M. Terry is Associate Professor of Political Science, Tufts University. This chapter draws on two earlier and longer articles that appear in Richard F. Staar (ed.), *Transition to Democracy in Poland* (New York: St. Martin's Press), 1993; and S. Lieberman, D. Powell, C. Saivetz and S. Terry, (eds.), *The Soviet Empire Reconsidered* (Boulder: Westview Press), forthcoming 1994.

nance in the former Soviet space, and especially in Ukraine, leaves the countries of East-Central Europe little choice but to press their case for full membership in West European/North Atlantic structures.

INTRODUCTION

Cooperation in East-Central Europe since 1989 has been shaped by the two foreign policy goals that all countries in the region share: (1) the need to dismantle the structures of the old Soviet bloc and to ensure that they do not again fall under Russia's heel; and (2) their hope of becoming full-fledged members of Western political, economic, and security organizations. Toward those ends, a number of regionally focused initiatives emerged—most important, the Visegrad Triangle (embracing Poland, Hungary, and Czechoslovakia, and later "squared" with the breakup of the last) and the Central European Initiative (successor to the original "Adria-Alpine" group). Yet, only four years after the collapse of communism in the region, "Visegrad" has virtually disappeared from diplomatic vocabulary, the Central European Initiative's more pragmatic agenda is at risk of being overshadowed by contentious political issues, while some other initiatives never made it off the drawing boards.

In attempting to comprehend the dispeptic state of relations among the post-communist states of East-Central Europe, it is important to remember that this region has been defined far less by ties binding these countries together than by the comings and goings of the larger powers that flanked them. Already twice in this century—in the wake of World Wars I and II—democracy, national sovereignty, and regional cooperation in East-Central Europe fell victim to some combination of four mutually reinforcing factors: (1) political instability and economic weakness; (2) regional tensions based on territorial or ethnic disputes, as well as diverging perceptions of national interest; (3) long-standing expansionist ambitions of Russia and/or Germany; and (4) the benign—or should one say malign?—neglect on the part of the Western powers to which the new and fragile states in the region looked for support.

The primary objective of this paper is to focus on the second or intraregional dimension, although (as will soon be apparent) it cannot easily be isolated from the other three. Nor is it possible to separate political and economic relations entirely from security issues. Within the region, the focus will be on the core Visegrad states, reflecting the less visible roles Romania and Bulgaria have played in regional politics. Yugoslavia is the subject of a separate chapter and will be considered here only as events there affect the region as a whole. The second section of the paper offers an overview of the impediments to cooperation, while the third section looks at the several regional cooperation initiatives that have emerged since 1989. The concluding section attempts to draw up a balance sheet not only of the status of relations within the region but also of the roles, both positive and negative, that West and East have played in the transition process—especially the emergence of a reassertive Russia.

WHY EAST-CENTRAL EUROPE?

What may seem a facetious question in the West is, in fact, one of the most important and contentious issues in the minds of people in this part of Europe. What makes it an identifiable region, and should it continue to be treated as such? The answer to the first question is that East-Central Europe is the product less of a community of economic and political linkages than of twentieth century history—most of it turbulent and unhappy for the countries in question—from their emergence out of the wreckage of the empires that dominated them before the First World War to their incorporation into the Soviet orbit at the end of the second. Thus, the East-Central European identity is one that many inhabitants of the region associate with the political instability, economic backwardness, and ethnic conflict of the interwar period, and with subjugation to Moscow during the cold war—in brief, an identity they wish to shed for an unhyphenated European one. Viewed in this light, the answer to the second question is that, while in the near term "East-Central Europe" is a handy label for lumping the non-Soviet post-communist states together, it is an elastic concept and one that will likely lose its relevance as their transitions proceed, and as other supra- and sub-regional orientations emerge (or reemerge).

Not only do all these countries aspire to be integrated into West European and North Atlantic communities as soon as possible, but their reluctance to forge closer links among themselves has deeper structural roots—in particular, the multiple legacies of four decades of forced cohabitation in the Soviet bloc that only compounded a long history of mutual grievances and distrust. Cultural and ethnic tensions were allowed to fester under a blanket of ritualized protestations of fraternal friendship, exacerbated by policies of covert or overt assimilation. Leaving aside the fratricidal conflicts in Yugoslavia, the most serious problems concerned the large Hungarian minorities in Romania and Slovakia, as well as Slovakia's increasingly vocal demands for more autonomy in a still united Czechoslovakia. Moreover, the shared pathology of Marxist-Leninist rule, misdirected development, and "integration" within the confines of CMEA meant that all these states suffered from similar structural distortions. It should have been no surprise, then, that they saw each other as inappropriate and undesirable partners, or that trade among them plummeted after 1989. As one journalist noted: "When a blind man takes the hand of a lame man, they create a pair which together can move forward more easily. Those afflicted with the same handicap do not have that chance."[1]

Other divisive factors included geopolitical, demographic, and economic asymmetries—especially between the Central European countries in the north and the Balkan states in the south, and within Central Europe between Poland, on the one hand, and Hungary and Czechoslovakia, on the other. As a Polish analyst put it in 1990, the geopolitical concept of Central Europe "embraces the countries between Russia and Germany . . . [But] the only country truly in that unenviable position is Poland. And that is precisely one of the main reasons why other Central Europeans do not nec-

[1] Joanna Solska, "Grupa Wyszehradzka," *Polityka*, no. 1 (January 1, 1993), p. 3.

essarily wish to associate them themselves with Warsaw."[2] Indeed, through much of that year, the Poles were perceived by themselves and others as uncomfortably exposed on both flanks.

To the west, uncertainty over a reunited Germany's continued recognition of the Oder-Neisse boundary caused Poland, reluctantly and temporarily, to view the presence of Soviet troops as a guarantee of its territorial integrity at a time when Budapest and Prague were negotiating stepped-up withdrawals of Soviet troops and pushing for an early end to all Warsaw Pact (officially Warsaw Treaty Organization, WTO) activities. To the east, Moscow's acquiescence in the demise of allied communist regimes in East-Central Europe did not mean that it had accepted a total loss of influence in the region. Evidence was Russia's concerted efforts well into 1991 to negotiate new bilateral treaties with all the countries in question, including special security clauses prohibiting them from joining alternative alliance systems that the Soviet side deemed hostile. By virtue of size and strategic location, Poland once again became the target of unwanted attention. According to the same source cited above, "the Soviets [were] resigned to allow two separate regional confederations, one in the north, with the Baltics and Scandinavia, and one in the south over former Hapsburg lands, but neither embracing Poland."[3] Under the circumstances, it was understandable that Prague and Budapest sought to insulate themselves from Warsaw's problems.

From a demographic perspective, Poland, with a population approaching 40 million (or nearly 50 percent more than Czechoslovakia and Hungary combined), was seen by some as a heavyweight in the region, "too large and too risky a partner" for the others. In addition, smaller neighbors were wary of a political style that was sometimes overbearing. "Poles are generally disliked in other Central European countries for their cockiness . . . [and] pretentious sense of self-importance."[4] Likewise, from an economic perspective, Poland was out of step with the others, not only due to its crushing external debt and decade-long history of political and economic instability, but also because the Poles were the first to bite the bullet of free-market austerity, throwing the country into deep recession ahead of its neighbors. By contrast, Czechs and Hungarians were still in the grip of excessive optimism over the ease and speed of their expected "return to Europe"; the latter in particular were convinced that their long history of reform efforts and the fact that they were well ahead of the others in attracting foreign investment gave them preferential status. Indeed, despite official denials, there was a palpable sense of competition among the three—a race to join Europe that was perceived as a kind of zero-sum game in which, if one wins, the others must lose.

A final asymmetry—this one political—stemmed ironically from the 1989 "Roundtable Agreement" that led to the installation of the first non-communist government in East-Central Europe in more

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[2] Grzegorz Gornicki, "Is Poland Really in Central Europe?" *East European Reporter* 4, no. 2 (spring-summer 1990), p. 57.

[3] Ibid., p. 58. Gornicki cited an unnamed Pentagon source; but it is a position reminiscent of the Soviet attitude toward regional organizations during World War II, also reflected in a resolution adopted by the Central Committee of the Communist Party of the Soviet Union in January 1991 (see note 7 below).

[4] Gornicki, "Is Poland Really in Central Europe?" pp. 57–58.

than 40 years. Having been the front-runner in 1989, Poland soon found itself in an anachronistic compromise struck at a time when both the communists and the Solidarity opposition assumed that Moscow would maintain hegemony over the region. In the spring of 1990—as Czechs, Slovaks, and Hungarians were voting their former communist rulers out of office in fully free elections—the Poles were stuck with an unfinished housecleaning: the "contractual" Sejm in which 65 percent of the seats in the more powerful house of parliament were reserved for parties in the old communist-led coalition; a newly established executive presidency expressly designed for General Wojciech Jaruzelski, the man who had imposed martial law in 1981; and communists in four key cabinet posts, including the defense and interior ministries.

If the asymmetries dividing the Central European states were substantial, those separating these three from their Balkan neighbors to the south were more like a chasm. By mid-1990 the former (despite the Polish anomaly) all had democratic governments committed to market reforms, while elections in Romania and Bulgaria had returned their communists-turned-socialists to power, putting serious economic reform in question. And while civil war had not yet broken out in Yugoslavia, already evidence could be seen that Belgrade was intent on carving out a "Greater Serbia."

REGIONAL COOPERATION INITIATIVES

In light of the obstacles outlined above, it was almost a foregone conclusion—despite verbal commitments to the principle—that regional cooperation in East-Central Europe would get off to a slow start, that the incentives would come largely from outside the region, and that Romania and Bulgaria would be left on the sidelines. Over the past four and a half years several regional or subregional initiatives have been proposed. The primary focus of this section will be on the two organizations that have had the greatest impact on intra- and inter-regional relations—the Visegrad group, confined to the three, now four, northern tier states, and the Central European Initiative (CEI), which crosses regional boundaries—with less detailed attention to the other groupings. The successes and failures of these initiatives demonstrate both the benefits and limits of regional cooperation in this troubled part of Europe.

THE VISEGRAD GROUP

Established in February 1991 in the provincial Hungarian town of the same name, the Visegrad Triangle (as it was initially known) was hailed as a major breakthrough in intraregional relations. The first Triangle summit ended with the adoption of an ambitious agenda focused around four goals:

- Restoration in full of each state's independence, democracy and freedom
- Dismantling of the economic and spiritual structures of the totalitarian system
- Building of parliamentary democracy and a modern constitutional state, and respect for human rights and fundamental freedoms

- Total integration into the European political, economic, security and legislative order.

These goals were to be achieved through multilayered collaboration at the European, regional, and subregional levels in eight priority areas. In addition to the "harmonization" of relations with European institutions, they included initiatives to foster intraregional understanding at the social, cultural, and local government levels; free movement of capital and labor; interenterprise cooperation and development of strategies for attracting foreign investment; improvements in transportation infrastructure, telecommunications, and energy networks; environmental cooperation; and the creation of "optimum conditions" for ensuring minority rights. [5]

The reality proved quite different. Instead of becoming an organization promoting *intra*regional cooperation, as well as integration at the European level, the Visegrad process became focused almost exclusively on the latter—in effect, a vehicle for coordinating Central Europe's "road to Europe," while development of closer ties within the region, to the extent they were pursued at all, languished on the back burner, with little in the way of an institutional infrastructure for regional cooperation.

The reasons for the partial rapprochement in Central Europe were related to changes in the domestic and external environments that both pushed and pulled the three states together. On the "pull" side, the political and economic asymmetries that weighed so heavily on relations in 1990 were reduced as Hungary and Czechoslovakia began to experience the trauma of economic transition (especially the impact of slumping trade with the Soviet Union), and as Poland took the steps necessary to complete its democratic transition. In addition, the signing in November 1990 of a treaty in which a united Germany formally recognized its postwar boundaries with Poland finally allowed Warsaw to open negotiations with Moscow over the withdrawal of Soviet troops and to take a stance parallel to that of Prague and Budapest on dissolution of the WTO. On the "push" side, by early 1991 all three had a more realistic appreciation of the long time frame as well as stringent conditions that the EC was determined to impose for admission—also that none stood to be admitted on a preferential basis and that further pursuit of competitive tactics would only be counterproductive. [6]

But the most important "push" toward closer regional cooperation came from a renewed sense of threat from the East, fueled by the conservative backlash in the Soviet Union that first appeared in the waning months of 1990 and culminated in the abortive coup against Gorbachev in August 1991, and that shattered the perception of a relatively benign international climate that had prevailed a year earlier. In particular, the Soviet military and communist hard-liners began showing their frustration over loss of empire and privilege by bringing mounting pressure on Gorbachev's reform leadership to reverse course. Most alarming for the Central Europeans was the resignation of Foreign Minister Shevardnadze, the

[5] See Jan B. de Weydenthal, "The Visegrad Summit," *Report on Eastern Europe* 2, no. 9 (March 1, 1991), p. 29; and *East European Reporter* 4, no. 4 (spring-summer 1991), pp. 68–70.

[6] On this more realistic approach to EC integration, see, e.g., Grzegorz Gornicki, "Visegrad: The Three-cornered Umbrella," *East European Reporter* 4, no. 4 (spring-summer 1991), pp. 68–69.

man probably most responsible for the peaceful implosion of Moscow's external empire, as well as the blatant attempt to evade CFE (Conventional Forces in Europe) arms limits and the military crackdown against breakaway Lithuania.

By this time also, all three countries were finding Soviet negotiators increasingly truculent over a range of issues related to troop withdrawals, the termination of WTO activities, and the new bilateral treaties under preparation. Warsaw, which had opened withdrawal talks only at the end of 1990, was told that a large contingent of Soviet troops had to remain in Poland until the completion of the larger-scale withdrawals from the former German Democratic Republic sometime in the mid-1990s. Even Budapest and Prague, both of which had reached withdrawal agreements in 1990, now found themselves in testy arguments over reparations for alleged "improvements" on former Soviet bases and counterclaims for environmental damages. In addition, all three had become alarmed over repeated postponements of a promised meeting to discuss a timeframe for dissolution of the alliance, and even more so over Moscow's repeated insistence on inclusion of the special security clause noted earlier in new bilateral treaties. Indeed, this last point was adopted as a core tenet of Soviet policy in a January 1991 Central Committee resolution that restated Moscow's opposition to the inclusion of any East-Central European state in West European security structures and advocated the use of economic leverage to maintain a Soviet sphere of influence in the region. [7]

It was this heightened threat perception, as much as the shared aspiration for EC membership, that provided the driving force behind the limited degree of cohesion that the Triangle countries developed in 1991. The new, more sober attitude was reflected in their response to the Lithuanian crisis in January. Within days of the outbreak of violence, the three foreign ministers issued a joint appeal for the immediate dismantling of the WTO's military structures, as well as a stepped-up timetable for ending its political activities and disbanding the Council for Mutual Economic Assistance (CMEA). [8] The signing during the next two months of bilateral military cooperation agreements among the Triangle states marked the beginning of intensified coordination on defense and security issues. The agreements provided for consultations on a wide range of issues from the development of new military doctrines to practical problems such as training, maintaining aging Soviet equipment, and coping with the threat of mass migrations from an increasingly unstable Soviet Union. At a followup meeting on August 2, the three defense ministers agreeed to a "system of regular consultations at all levels of their military establishments." [9]

In all these contacts, Triangle officials were scrupulous in maintaining that they had no intention of creating a new military alliance and that their cooperation was "not aimed at any other coun-

[7] See Rudolf L. Tokes, "From Visegrad to Krakow: Cooperation, Competition, and Coexistence in Central Europe," *Problems of Communism* (November-December 1991), pp. 104–107. The resolution of the Central Committee of the Communist Party of the Soviet Union, "On the Development of Conditions in Eastern Europe and Our Policy in This Region," dated January 22, 1991, was published in *Izvestiya TsK KPSS*, no. 3, 1991, pp. 12–17.

[8] de Weydenthal, "The Visegrad Summit," p. 29.

[9] See Douglas L. Clarke, "Central Europe: Military Cooperation in the Triangle," *RFE/RL Research Report* 1, no. 2 (January 10, 1992), pp. 42–45.

try." But, as one analyst noted, the reaction of the three to the attempted coup in Moscow just two weeks later "indicated . . . a greater depth to their military cooperation than they were willing to make public." At a hastily called meeting on August 20, a day after the coup began, they agreed on "concrete measures regarding cooperation in the areas of immigration, border protection, and exchange of political information." It was later disclosed that at least Warsaw had issued standby mobilization orders, and that "constant liaison" had been maintained among the three capitals throughout the crisis. Another round of post-coup consultations led to a joint appeal in early October for their "direct inclusion . . . in the activities of the [NATO] alliance"—a status short of full membership but one that presumably would have implied the extension of a security umbrella over the Triangle.[10]

Cooperation on political and economic issues in 1991 yielded more mixed results than in the security area. At the European level, trilateral efforts were rewarded in December with the signing of association agreements with the EC, but only after very difficult negotiations (and an initial veto by France). Moreover, although they offered the prospect of full membership within ten years, with a gradual lowering of trade barriers, the agreements were seen by the Triangle as something of a consolation prize. Particularly distressing was the EC's refusal to open its markets wider to Central European exports in the "sensitive" areas of steel, textiles, and agricultural products. The only other regional achievement in 1991 (apart from security cooperation), was the agreement in November to begin talks on establishing their own free trade zone; but this, too, appears to have been motivated more by the loss of markets in the East and constraints on access in the West than by a genuine commitment to regional integration.[11]

The reasons for the lack of progress within the Triangle were several. Most important at this point was the shared fear that successful collaboration at the regional level would be used as an excuse to derail integration into the EC, and that the Central European states would be left in a second-class status. French President Mitterrand's suggestion that the Triangle should form its own regional association rather than seek early EC membership did nothing to calm such fears. A second set of issues concerned the reemergence of ethnic and interstate conflicts: between Czechs and Slovaks over the latters' demands for autonomy and a slowdown in the pace of economic reforms in their still common state; between Hungarians and Slovaks over both the status of Magyar minority in Slovakia and the controversial Gabcikova-Nagymoros dam on the Danube; and, at a lower level of contention, between Poles and Czechs over cross-border trade and the status of the Czech and Slovak Federal Republic's small Polish minority. Other issues included divergent approaches to economic reform which complicated the

[10] Ibid.; concerning the October summit, see Jan B. de Weydenthal, "The Cracow Summit," *Report on Eastern Europe* 2, no. 33 (October 25, 1991), pp. 27–29; also "The Triangle," *East European Reporter* 5, no. 1 (January-February 1992), p.

[11] Karoly Okolicsanyi, "The Visegrad Triangle's Free-Trade Zone," *RFE/RL Research Report* 2, no. 3 (January 15, 1993), pp. 19–22.

free-trade talks, and the perpetuation of mutually negative social stereotypes of one another.[12]

At the official level, the response to these concerns was a joint effort to deny any intention of "institutionalizing" the Triangle; instead, it was repeatedly described as "a political club." In reality, there were serious discrepancies on this point. The Poles, in particular, were eager for closer economic cooperation. As Walesa told an interviewer shortly after the French veto in September:

> Each of us very much desires to link up with Western Europe. A really serious question arises here: Should we strive to make the most rational use possible of the . . . potential of comparable economies for better cooperation among the CSFR, Poland, and Hungary, and then . . . attempt a more effective approach toward an integrated Western Europe? On more than one occasion experience has taught us the extent to which we are mutually dependent on each other. I think we can simultaneously continue . . . transformations oriented toward where the West is now and at the same time utilize our existing possibilities . . . This would be perhaps perceived in the way you mentioned in your question: training hard in the second league and then breaking through to meet the best competition.[13]

As sensible as this point of view might have seemed, it was not one shared in Prague or Budapest where insistence on maintaining the "informal" nature of trilateral cooperation remained firm. As 1991 came to a close, it was among some Polish commentators that one could detect the greatest sense of disappointment over continuing disparities among the three and their inability to overcome the element of competitiveness in their common "road to Europe."[14]

It soon became clear that 1992 would be a year in which the few hard-won gains of 1991 were threatened by events both within and beyond the Triangle. First, domestic preoccupations again became a major stumbling block as all three countries found themselves in the throes of domestic crises of quite different sorts: In Poland, where the first fully free elections in late 1991 had yielded a badly fragmented Parliament, the resulting political gridlock came close to derailing economic reforms and undermining the international confidence won over the previous two years. In Czechoslovakia the issue of greater autonomy versus independence for Slovakia was effectively decided by the June 1992 elections, which saw the victory in each republic of the party most determined to split the federation. Indeed, while the issue was initially forced by the Slovaks, it was now the Czechs who seized the opportunity to cut the weaker

[12] Concerning the various structural, economic, and psychological obstacles to closer cooperation among the Triangle countries, see, e.g., Rafal Wisniewski, "Po Wyszehradze—Srodkowoeuropejskie perspectywy," *Polska w Europie*, no. 5 (June 1991), pp. 66–78; and Stanislaw Puzyna, "Trojkat srodkowoeuropejski—wyzwanie i szansa," *Polska w Europie*, no. 6 (September 1991), pp. 82–88.

[13] Quoted in Tokes, "From Visegrad to Krakow," pp. 110–11.

[14] See the summary report of a conference at the Center for International Studies of the Polish Senate in October 1991, *Polska w Europie*, no. 7 (January 1992), pp. 53–58. For an overview of the first year of Triangle cooperation from the perspectives of all three countries, see the special section on "The Central European Triangle" in *RFE/RL Research Report* 1, no. 23 (June 5, 1992), pp. 15–32.

Slovak economy loose and to distance themselves from rising tensions between Slovakia and Hungary. In Hungary, amid deepening economic recession and plummeting popularity ratings for the government, political debate became focused increasingly on the status of Magyar minorities in Romania and Slovakia and the dispute with the latter over the Gabcikova-Nagymaros dam on the Danube.

In addition, the breakup of the USSR following the failed August coup had a differential impact on the Visegrad states. Poland now found itself bordering on four post-Soviet states: Russia (in the form of the highly militarized Kaliningrad Oblast), plus Lithuania, Belarus, and Ukraine. By contrast, Hungary and Slovakia bordered only on one, Ukraine, and the Czech Republic on none. This discrepancy not only left the Poles more exposed in the event of disorder in the East, but also gave Warsaw a greater incentive to build a network of political, economic, and security ties with its new neighbors to the east as one means of fostering stability. In both official and unofficial commentaries, there was a growing awareness based on historical precedent that Poland had a choice between providing a bridge between East and West, with strong links in both directions, or risk seeing that bridge built over them and, again, at their expense.[15]

A final external factor affecting trilateral relations was the unexpected disarray in the European Community. The December 1991 Maastricht Treaty, which was supposed to inaugurate the final stage in the creation of a single market by the end of 1992, instead ushered in a year of wrangling over everything from monetary policy and interest rates to agricultural policy and larger subsidies for the EC's poorer southern tier. In brief, the much anticipated "Europe 1992" was not going to happen on schedule and, as defined by Maastricht, might not happen at all. In the interim, complications in the process of "deepening" EC integration could only postpone a "widening" of the Community. Under the circumstances, prospects that Brussels would step up the pace of trade liberalization with Central Europe (especially in the "sensitive" areas) were slim.

The combined effect of these developments on the Triangle was to sharpen the differences among members on questions of deepening their own cooperation even as they continued to coordinate relations with the EC and NATO—the main fault-line being the question of whether or how far to institutionalize the Visegrad process. Again, Warsaw was the lone proponent of some measure of institutionalization, proposing both a deepening and widening of cooperation as the best way of promoting regional stability and economic recovery until full integration at the European level could be achieved. At the other extreme, especially as leadership passed from Havel to Klaus after the June elections, Prague remained firmly opposed; indeed, as the year closed, Klaus seemed increasingly intent on weakening what minimal substance the Visegrad framework had acquired.

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[15] See, e.g., excerpts from former Prime Minister Jan Krzysztof Bielecki's talk delivered at the Institute of Economic Affairs in Brussels (March 9, 1992), and Jerzy Marek Nowakowski, "Polska i Europa Srodkowa wobec nowych wyzwan na wschodzie," both in *Polska w Europie*, no. 8 (April 1992), pp. 5–8 and 20–26 respectively; also Foreign Minister Skubiszewski's June 1992 report to the Sejm, and Edward Wende, "W europejskiej tradycji," both in *Polska w Europie*, no. 9 (July-September 1992), pp. 5–12 and 13–15, respectively.

Thus 1992 was a year of decidedly mixed results in trilateral relations. Most progress was made in cooperation on security matters, where the pattern of regular consultations established in 1991 continued. Even the implications of the pending breakup of Czechoslovakia and the creation of an independent Slovak army were handled smoothly. In addition, new areas for consultations were agreed on—in particular, joint air defense planning and confidence-building measures in the framework of the CFE treaty and "Open Skies" agreement.[16] However, a serious discrepancy in approaches to regional security arose shortly before the September defense ministers' meeting when Warsaw floated the concept of a "NATO–2," comprising not only the Visegrad states but also several post-Soviet states (the Baltics, Belarus, and Ukraine), as well as Romania and Bulgaria. The concept reflected both Poland's greater exposure to potential instability in the East and a conviction that the CSCE and North Atlantic Cooperation Council were too "passive" and "symbolic" to be of practical significance. As presented by a top security aide to Walesa, the rationale was not to create a new alliance system as an alternative to NATO; indeed, he specifically stated that a guarantee of eventual NATO membership would be a precondition of any new regional grouping. Rather, the aide saw NATO–2 as a transitional organization to defuse conflicts in the region and prepare the way for more rapid entry into NATO–1. On the latter point, he noted that:

> we will be welcome in NATO to the extent that NATO reaps an advantage from our membership, and . . . we show that our relations with the East are good . . . [O]ur trump card will be well-established cooperation with the countries of our region, as is the case within the "Visegrad Triangle." . . . What we want is the formation of active mechanisms genuinely capable of . . . dispelling tension.

Toward that end, members of this transitional security system would be required to renounce all territorial claims and contribute to the formation of a joint peacekeeping force. Prague and Budapest rejected the idea of a military pact either within the Triangle or on a broader regional basis.[17]

On the economic front, trilateral cooperation remained focused on the joint effort to speed up access to Western markets and set a timetable for full integration into the EC. That effort yielded limited success with the March 1992 decision to put the gradual trade liberalization features of the association agreements into effect in advance of the required ratification by all twelve EC members. Beyond that, repeated appeals by the Triangle countries for a clear commitment to early entry into the Community met with repeated rebuffs.[18]

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[16] See FBIS-EEU-92-188 (September 28, 1992), pp. 6–8; Alfred A. Reisch, "No Plans for a Military Pact by the Visegrad Three," *RFE/RL Research Report* 1, no. 40 (October 9, 1992), p. 55; *Rzeczpospolita*, November 21–22, 1992, p. 7; and FBIS-EEU-92-237 (December 9, 1992), p. 1.

[17] *Rzeczpospolita*, September 8, 1992, in FBIS-EEU-92-177 (September 11, 1992), pp. 14–16; and *RFE/RL Research Report* 1, no. 44 (November 6, 1992), p. 61.

[18] The most important initiative was the submission of a joint memorandum to the EC, in anticipation of the October meeting of EC and Visegrad leaders in London and the EC's December summit in Edinburgh, in which the Visegrad countries appealed for further trade concessions,

Continued

The one promising new dimension of EC-Triangle relations—especially in light of the West's inaction in the face of the Bosnian tragedy—was the newfound willingness of European institutions to play a mediating role in regional affairs. In the first instance, this involved an attempt to defuse the Danube dam dispute.[19] In the second instance, the West was successful in bringing pressure to bear on the Czechs not to pull out of negotiations on the trilateral (now quadrilateral) "free-trade" zone, already almost a year behind schedule. The agreement, finally signed in late December, was hailed at the official level as a major breakthrough that would promote intraregional trade and attract more foreign investment. Unofficially, however, it was widely recognized that the phased reduction of tariffs (mostly on industrial goods) would have little impact in the presence of non-tariff barriers left untouched by the agreement and provisions for the continued protection of agricultural markets.[20]

Frustration over the slow pace of trade liberalization, both with the EC and within the Triangle, led the Poles to float a second trial balloon in the form of a "Central European Trade Initiative"—in effect, a kind of "EC–2" as the economic counterpart of "NATO–2." Like the latter, EC–2 (which would also embrace countries beyond the Triangle) was not intended as an alternative to full EC membership but as a transitional arrangement "to fill the vacuum left by the collapse of CMEA . . . that will exist until Poland (and similar countries) are integrated with the [EC]."[21] The potential benefits of such an arrangement for Poland were obvious; not only were Polish exports the most adversely affected by remaining non-tariff barriers within the Triangle, but a restoration of trade ties with neighboring post-Soviet states was seen as vital to the country's economic recovery. However, the idea fell on deaf ears, especially in Prague where, with the approaching breakup of the CSFR, Klaus was making it increasingly clear that cooperation within the Visegrad group would henceforth be "no more important" to the Czechs than bilateral relations with other states. By this time, he had also rejected the decision taken at the Triangle's Prague summit in May 1992 to coordinate their applications to the EC; the offi-

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an agreed timetable for beginning negotiations on full EC membership, expanded political dialogue at all levels, and more financial aid especially for small and medium-size enterprises; *Rzecz-pospolita*, September 12–13, 1992; and FBIS-EEU–92–183 (September 21, 1992), pp. 23–24. See also the follow-up report in FBIS-EEU–92–206 (October 23, 1992), p. 3; and Marek Ostrowski, "Po szczycie w Edynburgu: na slabych nogach," *Polityka*, no. 51 (December 19, 1992), p. 2.

[19] See, e.g., Nicholas Denton and Anthony Robinson, "Danube dam threatens to open floodgates of hostility," *Financial Times*, October 29, 1992; and Karoly Okolicsanyi, "Slovak-Hungarian Tension: Bratislava Diverts the Danube," *RFE/RL Research Report* 1, no. 49 (December 11, 1992), pp. 49–54. A ruling is due to be handed down by the International Court at the Hague sometime in 1994.

[20] For details of the agreement, see *Gazeta Wyborcza* (December 23, 1992), in FBIS-EEU–92–250 (December 29, 1992), p. 32; also Okolicsanyi, "The Visegrad Triangle's Free-Trade Zone." Neither source mentions the issue of remaining non-tariff barriers, although Okolicsanyi does note Western pressure on Klaus not to bolt the Visegrad group; on this point see also Klaus's final remark at a press conference, on his return from the October 28 EC-Visegrad meeting in London, to the effect that "we do not see any major reason why the EC should force us to create a free-trade zone . . ." in FBIS-EEU–92–211 (October 30, 1992), p. 5. For press commentaries that took a less favorable view of the agreement than official statements, see Solska, "Grupa Wyszehradzka"; Leszek Mazan, "Trojkat biedy," *Polityka*, no. 47 (November 21, 1992), p. 19; and Zsuzsa Regos, "Forced Integration," *Nepszabadsag*, December 9, 1992, in FBIS-EEU–92–240 (December 14, 1992), pp. 27–28.

[21] Arkadiusz Milewski, "Nostalgia na CEMA?" *Nowy Swiat* (Warsaw), September 15, 1992; in FBIS-EEU–92–183 (September 21, 1992), pp. 24–25.

cial Czech position now was that each country should enter when it was "ready."[22]

Thus, it was hardly a surprise when Klaus seized the moment of the formal separation of the Czech and Slovak republics to distance himself even further from Visegrad in two high-profile interviews. At the beginning of January 1993, he told *Le Figaro* that the Triangle had been an artificial construct from the start, imposed on the Central European states by the West. Later that month, at the World Economic Forum in Davos, he argued that to focus on cooperation with non-EC members (i.e. Visegrad) would distract Prague from its primary goal of joining the EC—in effect, transforming the relationship between membership in Visegrad and the EC into a zero-sum game, a position vehemently rejected by the Poles.[23]

Clearly there were other question marks hanging over the group in 1993 and early 1994: the ambiguities in the foreign policy of a newly independent Slovak state, where then Prime Minister Vladimir Meciar, a populist opponent of market reforms, was initially at odds with his westward looking foreign minister; the exacerbation of Slovak-Hungarian tensions over fears that the breakup of the federation would expose the Magyar minority to even greater discrimination; and, as the year ended, the potential impact on intraregional relations of the return to power of post-communist parties first in Poland, and later in Hungary as well. But it was almost certainly the vocal disinterest of the Czechs that was most responsible for the diminished vitality of the Visegrad process. To be sure, Prague did join the other three in yet another appeal to the EC, on the eve of its Copenhagen summit in June, to "set the date and define conditions" for membership; the Czechs also continued to cooperate to some degree on defense matters at least through early September.[24]

Otherwise, however, it was a year of declining activity: the first year since the group's founding that no summit meeting was held;

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[22] See Klaus's December 15 statement in Vienna, in FBIS-EEU-92-244 (December 18, 1992), p. 9. This was the first time he had stated this position so bluntly, but hardly the first time he had presented the Czech Republic as more qualified for rapid integration into the EC than the other Visegrad countries; see also FBIS-EEU-92-215 (November 5, 1992), pp. 10-11; and Milada Anna Vachudova, "The Visegrad Four: No Alternative to Cooperation?" *RFE/RL Research Report* 2, no. 34 (August 27, 1993), pp. 41-42 and 45-46. On the issue of non-tariff barriers, the most serious tensions were between Poland and the CSFR over the latter's tight border controls to prevent Poles from buying up subsidized Czech goods following the adoption of free-market reforms by Warsaw. As former Czechoslovak Foreign Minister Dienstbier later commented, he went along with this policy against his will: "It was terrible. . . . The borders went down with the West and up in the East"; quoted in William Echikson, "Falling from grace in Eastern Europe," *The Boston Sunday Globe*, January 31, 1993, p. 66.

[23] For reports of Klaus's statements, see *RFE/RL News Briefs* 2, no. 4 (January 11-15, 1993), p. 12, and no. 7 (February 1-5, 1993), p. 10. Polish Foreign Minister Skubeszewski was quick to contradict Klaus on the origins of Visegrad, restating that it remained for Warsaw "a valuable tool" for improving Central Europe's leverage with Western institutions; Vachudova, "The Visegrad Four," p. 42. See also Jozef Wiejacz, "Ugrupowania regionalne w nowej Europie," *Polska w Europie*, no. 11 (April 1993), p. 110; Ambasador Wiejacz, an advisor to the Polish Foreign Ministry on regional relations, emphasized the compatibility of regional and sub-regional cooperation with pan-European integration: "The rise of a new united Europe and a new security system . . . will be a long and difficult process, constructed like a mosaic. A new and important phenomenon in this process . . . is the formation or activation of various groups and associations, more or less formal, bringing together different states on the basis of regional interests and recognition of shared fundamental values. . . . There is no contradiction [between the "new regionalism" and] the tendency toward integration and unification of the continent."

[24] For the appeal to the EC, see *RFE/RL News Briefs* 2, no. 25 (June 7-11, 1993), p. 13. For reports of a two-day working meeting in Krakow on September 6-7, attended by deputy defense ministers, chiefs of staff, and other military experts, see *RFE/RL News Briefs* 2, no. 37 (September 6-10, 1993), pp. 10-11 and 13-14; also FBIS-EEU-93-171 (September 7, 1993), p. 2.

a year in which what little high-level activity there was took place in other forums—such as the March foreign ministers' meeting with EC and NATO officials in Brussels and the May defense ministers' meeting in Rome (not attended by the Czech minister) during a session of the Western European Union. It was also a year in which the Czechs not only restated their preference for bilateral relations both in intraregional relations and in contacts with Western organizations, but gratuitously misinterpreted the others' support for a coordinated approach to integration with the West as a desire to set up alternative structures.[25]

The acid test of Visegrad cohesion came in the closing months of 1993 and early 1994, with Moscow's challenge to the group's aspirations for NATO membership and NATO's compromise "Partnership for Peace" proposal. Ironically, while fears of a resurgent Soviet Union had been one of the main catalysts for the formation of the Triangle in 1991, the reemergence on the European stage of an assertive Russia three years later contributed to the group's demise, prompting the less exposed Czechs to abandon even the pretense of a coordinated strategy. Moreover, the structure of the Partnership proposal, to be based on a bilateral agreement between NATO and each non-member "partner," played neatly into Klaus's game plan. Thus, when Warsaw, Budapest, and Bratislava called for a meeting of defense ministers to coordinate their stance in advance of NATO's January summit, the Czechs sent only a deputy minister. A follow-up summit in Prague on January 11–12, at which the four heads of state met with U.S. President Bill Clinton, was also arranged (much to the displeasure of the others) to underscore the bilateral as distinct from the regional dimension.[26] Within a week, Czech Defense Minister Baudys pronounced the Visegrad grouping "obsolete," adding that "associating entry into NATO with military cooperation among the Visegrad countries is nonsense."[27]

Thus three years after its founding, Visegrad, initially seen both in the West and within the region as the centerpiece of cooperation in East-Central Europe, appears to have reached a dead end. After the defection of the Czechs, the remaining three states have continued to affirm their commitment to policy coordination, but the process is unlikely to regain the momentum of its first two years.

[25] Concerning the Brussels and Rome meetings, see *RFE/RL News Briefs* 2, no. 12 (March 8–12, 1993), p. 12, and no. 23 (May 24–28, 1993), p. 11. Concerning the Czech attitude, see the statements by President Havel and Foreign Minister Baudys in September and November respectively, in ibid., vol. 2, no. 37 (September 6–10, 1993), p. 19, and no. 48 (November 22–26, 1993), p. 10.

[26] Concerning the defense ministers' meeting on January 7, see *RFE/RL News Briefs* 2, no. 49 (November 29-December 3, 1993), p. 12, and ibid., vol. 3, no. 3 (December 27, 1993-January 7, 1994), pp. 22–23. For different perspectives on the summit, see the interviews with Czech Foreign Minister Josef Zieleniec from *Hospodarske Noviny* (January 20, 1994), in FBIS-EEU–94–015 (January 24, 1994), pp. 10–12; and Hungarian Foreign Minister Geza Jeszenszky, "Nastroje w poczekalni," in *Polityka*, no. 3 (January 15, 1994), p. 16. The last notes that, at the closing dinner (after the departure of the Americans) the Czech hosts sat each of the four Visegrad delegations at its own table.

[27] From *Lidove Noviny* (January 14, 1994), in FBIS-EEU-94–012 (January 19, 1994), p. 14. Views in Prague were not unanimous on this point. In an interview with Prague Radiozurnal, Jiri Dienstbier, former foreign minister and now chairman of the Free Democrats, said: "Of course . . . each of these countries has to create its own internal conditions for joining [Western] structures . . ., including NATO. However, I also strongly believe that, if these four countries take a joint course of action, they will, either jointly or individually, achieve this much sooner. If the four countries keep quarreling and outdoing each other . . ., there is no guarantee of a desired [outcome]; in FBIS-EEU–94–007 (January 11, 1994), p. 8.

Meanwhile one achievement seems destined to outlive the group itself—namely, the Central European Free Trade Agreement (CEFTA). In another ironic twist, the most reluctant party to the original CEFTA talks, the Czech Republic, found itself by early 1994 with a deteriorating trade balance caused not only by the sharp decline in trade with Slovakia, but also by decreasing exports to (and rising imports from) other regions of the world, leaving it little choice but to seek accelerated trade liberalization within Central Europe.[28]

In retrospect, Visegrad was probably destined to be a transitional phase. One never knew whether to call it a group, a process, or an informal political club; certainly it never evolved into a coherent organization, much less the alternative "institution" of which Prague claimed to be so fearful and which none of the others really wanted either. Central Europe alone (not to mention in combination with the Balkan states to the south) was too lacking in resources, too burdened by the multiple legacies of the past, to shape itself into a viable regional entity without the political mediation and financial assistance of the West. Had these countries, especially the Czechs, not been so opposed to a deepening of cooperation within the region, much more might have been achieved by way of removing cultural barriers and building a network of political, economic, and social linkages supported by the central governments. On balance, however, the glass should be seen as half full rather than half empty.

THE CENTRAL EUROPEAN INITIATIVE

By contrast with Visegrad, the CEI was from the start an *inter*regional grouping unafraid of "institutionalization"; indeed, its primary mandate was to develop a network of cooperative links among members, with preparation for integration of non-EC states into that organization only a secondary goal. In its original "Adria-Alpine" form, the group was a unique organization in cold-war Europe. Set up in the late 1970s, it provided a limited forum for cooperation on largely apolitical issues among neighboring provinces of four countries in the Adriatic-Alpine region: neutral Austria, communist but nonaligned Yugoslavia, NATO/EC member Italy and, by the mid-1980s, Warsaw Pact member Hungary. From the beginning its agenda was a practical one, including regional planning, environmental and health issues, economic and agricultural problems, and cultural cooperation. Despite its ostensibly apolitical character, and especially as the cold war waned, membership in the group became a vehicle for Hungary's policy of "stealth neutrality." Thus, it was no accident that it was at a meeting in Budapest in early November 1989, as the region's communist regimes were unravelling—a meeting attended for the first time by the foreign ministers of the four member countries—that the group was reconstituted from a subnational organization to one operating at the state level. Hungary alone lacked the clout to effect such a transformation; the critical hand behind the scenes was apparently that

[28] Concerning the agreement to accelerate implementation of CEFTA, see FBIS-EEU-94-065 (April 5, 1994), pp. 8–10; on Prague's mounting trade problems, see "Czech Economic Monitor: Economic Growth Resumes, but Early Signs Emerge of Potential Difficulties in Foreign Trade Sector," *PlanEcon Report* 10, nos. 14–15 (June 10, 1994), pp. 7–11 and 36–39.

of Italy's foreign minister, Gianni de Michelis, who was eager to counterbalance Germany's growing influence in Central Europe.[29]

Adria-Alpine's appeal to other states in the region was obvious. As a group spanning the two alliance systems as well as the nonaligned world, membership would not imply an explicit break with Moscow (still a politically impossible, if not unthinkable, move); but it would mean formal affiliation with states outside the WTO and a tentative first step toward the shared goal of full EC membership. For Poland, in particular, it would also have meant the first step toward realization of a long-nurtured dream of building a network of cooperative linkages along a north-south axis to offset the pressures from east and west. In early 1990 both Prague and Warsaw applied, but only the Czechoslovak application was accepted. The likely reasons for Poland's exclusion at this point were, first, that other members were wary of being drawn into the uncertainties over the Polish-German border and the still unresolved status of Soviet troops in the country and, second, that they were sensitive to Moscow's objections to Poland's participation in any independent regional grouping.

At its Venice summit held July 31-August 1, the group, now officially re-named the "Pentagonale," set for itself an ambitious agenda. Five working groups were confirmed or newly established (road transport, environment, telecommunications, small business development, and culture and tourism), and plans for two more (energy and migrations) were announced. On a more political level, the declaration adopted at the summit described the Pentagonale as a "geographically circumscribed" initiative within the broader spectrum of European organizations, representing "a level of cooperation which will be helpful in bringing those member countries not yet participating in—or candidates to—the EC closer to the European Community." It also foresaw "a regular exchange of views . . . on matters of a political nature," inter-parliamentary cooperation, and support for contacts among nongovernmental organizations of member countries. While not excluding involvement of nonmember states in specific Pentagonale projects, the statement appeared to preclude further expansion. Small wonder that many Poles felt frustrated by their exclusion.[30]

As with Visegrad, it was the conservative backlash in Moscow that led to Poland's admission. Already in late 1990, Warsaw had been invited to establish closer relations with the Pentagonale. In January 1991—again only days after the violence in Vilnius—it was the Italians who again took the initiative, with de Michelis telling a meeting of parliamentarians from member countries that, in "the present international situation, . . . it is impossible for us to leave Poland between two great powers when the formation of a new pan-European security system is still quite a long way off." Poland's membership became offical with the next—now "Hexagonale"—summit in August, by which time the number of

[29] Johnathan Sunley, "Alpe-Adria: A Community that Works," *East European Reporter* 4, no. 2 (spring-summer 1990), pp. 65–66; and Alfred A. Reisch, "The Central European Initiative: To Be or Not to Be?" *RFE/RL Research Report* 2, no. 34 (August 27, 1993), p. 31.

[30] "Realizing Central Europe: the Pentagonale," *East European Reporter* 4, no. 3 (autumn-winter 1990), pp. 54–56. Concerning Poland's exclusion, see Grzegorz Musial, "An End to Solidarity?" in ibid., pp. 59–60; and Robert Soltyk, "Penta, hexa czy wcale?" *Gazeta Wyborcza*, July 11, 1991.

working groups had nearly doubled and others had had their mandates expanded.[31]

Following the summit, the Hexagonale disappeared from view for almost a year, effectively paralyzed by the outbreak of civil war in Yugoslavia, the designated chair for 1991. In 1992, when the rotating chairmanship passed to Austria, a low-profile summit in July renamed the organization the Central European Initiative and admitted three former Yugoslav Republics (Slovenia, Croatia, and Bosnia-Herzogovina) as members in their own right. However, the CEI really emerged from dormancy only with the November foreign ministers' meeting in Graz. The working groups had continued to function during the year-long hiatus in high-level contacts and had elaborated more than 100 projects; in addition, a major constraint on CEI activities, a severe shortage of financial resources, had by this time been partially resolved with the promise of funding from the European Bank for Reconstruction and Development (EBRD) for seven infrastructure projects—mostly for modernization of rail and road networks.[32]

Why member countries chose this point to call attention to the CEI is not entirely clear. Apart from badly needed EBRD funding, however, there appear to have been at least three agendas at work—one overt and two less obvious. One purpose shared by all was to coordinate their responses to the Bosnian crisis and the danger of a spillover of "ethnic cleansing" into Hungarian enclaves in the Voivodina region of Serbia; in fact, a month after the Graz meeting, four of the foreign ministers travelled to New York to appeal directly for United Nations intervention. Another less explicit Polish agenda may have been to try to gain acceptance in a forum other than Visegrad for their vision of broader and more institutionalized cooperation embodied in the earlier EC–2/NATO–2 proposals. Hence, Skubiszewski's appeal that the CEI be "open for cooperation with all interested states"; hence also the significance of the presence for the first time of observers from Ukraine and Belarus, as well as Romania and Bulgaria. Still a third, specifically Hungarian, agenda appears to have been Budapest's intention to use a reenergized CEI, of which it would be the chair in 1993, as a forum for bringing pressure to bear on Slovakia over both the Danube dam and minority issues. Thus, even as the CEI resumed regular meetings, these volatile issues threatened to politicize the organization and overwhelm progress on more mundane but, in the long term, vital goals.[33]

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[31] See, e.g., Jozef Wiejacz, "Grupa Pentagonale i miejsce Polski," *Polska w Europie*, no. 5 (June 1991), pp. 79–88. Soltyk ("Penta, hexa, czy wcale?") lists twelve working groups—the new ones being statistics, tourism (now apparently separated from culture), and cooperation in disaster assistance; he also notes Poland's proposal for a thirteenth, for agriculture and food processing.

[32] Reisch, "The Central European Initiative," pp. 30–32; see also Katarzyna Kolodziejczyk, "Inicjatywa Srodkowoeuropejska: Nikt nie chce byc sam," *Rzeczpos-polita*, November 21–22, 1992, p. 7. It is worth noting that, in his wide-ranging review of Poland's foreign policy to the Sejm, June 1992, Foreign Minister Skubeszewski made no mention of the Central European Initiative; see the text of his speech in *Polska w Europie*, no. 9 (July-September 1992), pp. 5–12.

[33] For general coverage of the Graz meeting and Skubiszewski's remarks, see Kolodziejczyk, "Inicjatywa srodkowoeuropejska." The subsequent appeal to the United Nations is reported in FBIS-EEU-92-246 (December 22, 1992), p. 1. In an interview shortly after the Graz meeting, a Hungarian Foreign Ministry official singled out "cooperation along the Danube" as Budapest's priority; other points in the interview were his hint that Hungary might try to use the breakup of Czechoslovakia as leverage by forcing the successor states to apply for readmission, his emphasis on the increasing salience of political issues, and his reference to the "special problem"

Continued

The new year began auspiciously with the establishment of a Secretariat, sponsored jointly by Italy and the EBRD, to provide technical assistance and funding for some projects. By this time also, a Committee of Country Coordinators had been added to the CEI's organizational structure. But it did not take long for the divisive minority rights issue to surface. At their March meeting (the same meeting at which the Czech and Slovak Republics were readmitted as separate members), the foreign ministers accepted Hungary's proposal to organize a conference on the issue by the end of the year. It was not the first time that the group had taken up nationality questions; in 1990 and 1991, still as the Pentagonale, it submitted two proposals on protection of minority rights to the Conference on Security and Cooperation in Europe. This time, however, the Hungarian initiative set the stage for a prolonged stalemate at top levels of the CEI, distracting attention from its practical agenda and causing dissension at the parliamentary and working group levels. [34]

The Budapest summit in mid-July dealt with several issues—some more contentious than others. On a noncontroversial note, the CEI again expressed its alarm over the Yugoslav situation and endorsed Bosnia's territorial integrity, admitted Macedonia as its tenth member, and agreed to cooperate with the four aspirants for membership (the observer states at Graz which were in attendance for the second time). In a more dispeptic vein, Czech Prime Minister Klaus, true to his form in denigrating the utility of Visegrad, dismissed the core rationale of the CEI, stating that the group would be of "little use" if it did nothing but "build highways and railroads through neighboring states"—a posture firmly rejected by the others.

But by far the most contentious question facing the summit was whether the CEI should adopt legally binding norms for the treatment of minorities within the region. In particular, an Italian draft, strongly supported by Hungary, endorsed the right of minorities to set up autonomous territorial units and would have prohibited any redrawing of administrative boundaries to the detriment of minorities—positions that were clearly unacceptable to the Slovaks. The issue was made even more acrimonious by an ill-fated attempt on Budapest's part to enlist Prague's support against Bratislava on this issue. Already miffed by Hungary's attempt to delay Slovakia's admission to the Council of Europe, Klaus demonstrably sided with Meciar, arguing that minority issues were not in the purview of the CEI but should be decided by all-European organizations such as the Council of Europe or the CSCE. [35]

In the end, no document was adopted; nor was the proposed conference on minority rights held. If there was any positive outcome of this situation, it was to engage the Council of Europe in monitoring the status of minorities in both Slovakia and Romania as a con-

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of national minorities. See FBIS-EEU-92-239 (December 11, 1992), pp. 16–17. The official's approach to broadening CEI cooperation was also more cautious than Skubiszewski's; referring specifically to the four observer states, he noted, "this does not mean the expansion" of the CEI, only that they could participate in some working groups.

[34] For an overview of developments in the CEI through summer 1993, see Reisch, "The Central European Initiative," pp. 30–37; also Wiejacz, "Ugrupowania regionalne," pp. 111–12.

[35] For coverage of the CEI's 1993 summit, see Reisch, "The Central European Initiative," pp. 30–37; also *RFE/RL News Briefs* 2, no. 30 (July 12–16, 1993), pp. 17 and 19, and no. 31 (July 19–23, 1993), pp. 9–10 and 17.

dition of their membership[36]—although this has not prevented the issue from continuing to dominate CEI meetings. Meanwhile, a statement issued by the Parliamentary Committee following its November session suggests a serious lack of internal coordination. Expressing "profound dismay that communication problems between the [governmental and parliamentary] forums have not been resolved," the statement called for "meaningful joint working sessions between CEI ministers and parliamentarians" as a "fundamental element" of the CEI framework. It also noted the need for "greater awareness" of EBRD priorities "so that projects suitable for EBRD support [could be] elaborated," called on the working groups "to define projects more clearly," reiterated its suggestion that "committees of national parliaments should be included in the activities of working groups," and expressed regret that no agreement on the permanent financing of the working groups had yet been reached.[37]

On balance, the CEI's record so far is more positive than negative in that it has brought together ten countries, most newly independent and some just new, in finding mutually beneficial solutions to shared concrete, practical problems. It has, in contrast to Visegrad, established institutional structures that at least in principle give representation to different interests in member states. At the same time, there appear to be serious internal communication gaps; half of the CEI's members are either directly involved in, or potentially threatened by, the Yugoslav imbroglio; major political and ethnic tensions within the region threaten to politicize the agenda and deflect energies from its original pragmatic goals; finally, the two most prosperous members, Italy and Austria, are by themselves incapable of meeting the organization's needs.

OTHER INITIATIVES

Although more peripheral to East-Central Europe (or too new to assess their potential), three other organizations merit at least brief mention here: the Council of Baltic Sea States, the Black Sea Economic Cooperation Council, and the Carpathian Euroregion. The first two in particular bear somewhat greater resemblance to the CEI than to Visegrad in that they bring one or more East-Central European states together with neighboring states outside the region and, second, that they have not resisted some degree of institutionalization. In addition, the growing phenomenon of less formalized cross-border cooperation in the region deserves a few words.

The Council of Baltic Sea States (CBSS), the most promising of the three, evolved out of a 1990 Polish-Swedish initiative to convene a meeting of prime ministers of all Baltic Sea states. The following year, on the initiative of the Polish city of Gdansk, an Association of Baltic Cities was founded, and in March 1992, at a for-

[36] See, e.g., *RFE/RL News Briefs* 3, nos. 4 (January 10–21, 1994), p.21, and 14 (March 28–31, 1994), p. 19.

[37] For reports of the November 1993 and March 1994 foreign ministers' meetings, see *RFE/RL News Briefs* 2, no.48 (November 22–26, 1993), pp.10–11, and vol. 3, no.11 (March 7–11, 1994) pp.9–10; also FBIS-EEU-94-045 (March 8, 1994), p. 1. At the former, it was announced that Ukraine and Moldova had applied for membership, and that Belarus, Bulgaria, and Romania wanted to participate in some working groups. The Parliamentary Commitee's statement appears in FBIS-EEU-93-225 (November 24, 1993), p. 1.

eign ministers' conference in Copenhagen, the CBSS was created. Of the ten members, five belong to some combination of NATO, the EC and the European Free Trade Association (Denmark, Germany, Norway, Sweden and Finland)—a fact that should prove of considerable benefit to the organization's effectiveness not only because of their access to the financial and technological resources necessary for implementing joint projects, but also because their political clout should afford them some leverage in mediating conflicts among members. Of the other five, Central Europe is represented only by Poland, the remaining four being the former Soviet republics of Estonia, Latvia, Lithuania and Russia. In addition to an annual meeting at the foreign minister level, the Council's institutional structure includes an executive body (the Committee of Permanent Representatives), which is charged with implementing the goals agreed to in the Copenhagen Declaration, and a forum for parliamentary delegations, which also appears to meet on an annual basis.

The agenda adopted in Copenhagen is similar in many respects to that adopted by the CEI because it emphasizes such practical tasks as the modernization of transportation and communications networks (most immediately, construction or reconstruction of highways linking Finland and the Baltic states to Western Europe through Poland), environmental protection and energy policy, economic and technological cooperation, health and humanitarian issues, as well as culture, education, and tourism. Like the CEI, the CBSS's declaration also stressed the synergistic nature of regional cooperation ("the creation of a Baltic identity") and the building of an overall "European architecture," rather than an alternative to it. The Council specifically excluded "problems of military security" from its formal agenda, but did not exclude an indirect security role in such matters as confidence-building measures and environmental remediation (of, for example, extensive radiological and chemical contamination of the Baltic Sea).

Another important aspect of the CBSS's declared agenda was the salience given to "support for [the development of] new democratic institutions. (It is worth noting here that, as the lone Central European member, Poland has not only been a recipient of such support but has also provided advice to Russia and the Baltic states on functioning of an ombudsman's office.) Along these lines, the Council has also begun playing an active role in easing tensions between Russia and the Baltic states over questions of troop withdrawals and minority rights. Overall, of the several regional organizations involved in Central and Eastern Europe, the CBSS appears to have the best prospects for achieving its goals. By contrast with the CEI, half of its members are already well integrated into Western institutions, leaving little possibility that conflicts among any of the post-communist members could deflect the Council's activities; the ability of the more developed members to assist in the political and economic transitions in the others also provides leverage in mediating potential conflicts; in addition, members share a vital interest in restoring the health of an international body of water on which they all depend.[38]

The Black Sea Economic Cooperation Council (BSECC) presents a very different picture. Established in 1990 on the initiative of late Turkish President Turgut Ozal, the intention was to create a new barrier-free economic grouping similar to the EC. In addition to Turkey, it has ten other members—Albania, Bulgaria, Romania and Greece, plus six former Soviet republics (Russia, Ukraine, Moldova, Georgia, Armenia, and Azerbaijan). Formal structures include a chair that rotates every six months, a parliamentary assembly, and a Committee for Economic Trade, Technology, and Environmental Cooperation. In June 1993 members also agreed to set up a secretariat and a regional bank. While the group may have some potential in the long term, progress has been stalled by several factors: serious economic problems in all member states, including EC and/or NATO members Greece and Turkey; political instability and/or armed insurrections in all of the post-Soviet states; and the lack of any compelling common purpose. Indeed, the main impetus here appears to have been Turkey's ambition to become a major regional player in neighboring parts of the post-communist space.[39]

Most recent and more amorphous is the so-called Carpathian Euroregion (also referred to as the Carpathian-Tisza Region). Established in February 1993, this new subregional group presently embraces adjoining provinces of Hungary, Poland, Slovakia, and Ukraine—with the hope that Romania will eventually join. The stated purpose is to facilitate cross-border cooperation among local communities in contiguous border areas. But, in contrast to other cross-border activities, the Carpathian Euroregion has begun to establish its own institutional framework: a twelve-member council (three from each country), a rotating general secretary, and a small permanent staff. Nonetheless, the group has yet to prove that it can contribute to intraregional cooperation and integration. The primary initiators, Poland and Hungary, appear to have somewhat different agendas: the Poles are seeking primarily to reinvigorate economic relations with Ukraine; the Hungarians in part want to do the same, but also to highlight Ukraine's minority policy as a model for fair treatment of Magyar minorities elsewhere. Under the circumstances, Bucharest is likely to remain aloof.[40]

Less formal forms of cross-border cooperation have sprung up across the region, usually as a result of local initiatives, and sometimes in disregard of official government policy. Most such activities involve the local economy and trade, but may also expand to ecological issues, cultural exchanges, tourism, and even joint investments. Some of the earliest and most successful examples of cross-border cooperation can be found all along the Polish-German

[38] Concerning the founding and activities of the CBSS, see Wiejacz, "Ugrupowania regionalne," pp. 112–118; and *RFE/RL News Briefs* 3, no. 22 (May 24–27, 1994), p. 17.

[39] See, e.g., *RFE/RL News Briefs* 2, nos. 26 (June 14–18, 1993), p. 20, and 41 (October 4–8, 1993), p. 14. For a comprehensive overview published after this chapter was completed, see Daniel A. Connelly, "Black Sea Economic Cooperation," *RFE/RL Research Report 3*, no. 26 (July 1, 1994), pp. 31–38.

[40] Reisch, "The Central European Initiative," p. 31; Jan B. de Weydenthal, "Cross-Border Cooperation in East Central Europe," *RFE/RL Research Report* 3, no. 2 (January 14, 1994), p. 33. Concerning Romania's antipathy, see *RFE/RL News Briefs* 2, no. 10 (February 22–26, 1993), p. 14.

border. The phenomenon is not without potential problems, as a result of unregulated trade for instance, or because of conflicts between local and central authorities. In general, local cross-border contacts work best where they take place with the support of the central governments; but local initiatives can also begin the process of breaching cultural barriers—as has been the case along the Polish-Czech border—even where one of the governments seems disinterested.[41]

URSUS REDUX?

One final factor needs to be thrown into the mix of complex forces shaping regional dynamics in East-Central Europe—namely, the reemergence in 1993 of an assertive, some would say a neo-imperialist, Russia—especially in the wake of the strong showing of ultra-nationalists and hard-line communists in the December 1993 parliamentary elections. Two aspects of Russian policy are particularly relevant here. The first has been Moscow's creeping redefinition of the "Near Abroad" to include not only the former Soviet republics but by inference its old Warsaw Pact allies as well. The second is the central place of Ukraine in the fine-tuning of Russia's policy toward East-Central Europe. Indeed, Russian President Yeltsin's August 1993 "flip-flop" on NATO membership for the latter cannot be understood without reference to Moscow's resolute determination to head off any efforts by the former to reorient itself westward as a counterweight to pressures for closer integration within the Commonwealth of Independent States (CIS).

The first point was most clearly articulated by Russian Foreign Minister Andrei Kozyrev in an interview with the Warsaw weekly *Polityka*. Reminding Kozyrev of his own conceptualization of Russia's most vital foreign policy orientations as consisting of "three circles of good neighborliness"—the former Soviet republics (or "Near Abroad"), the developed countries of the northern hemisphere, and the southern arc from the Near East to China—the interviewer asked where Central and Eastern Europe fit into this picture, whether this region "which played a critical role in the foreign policy of the USSR" was being pushed into the background. Kozyrev's answer was as revealing as it was blunt:

> Eastern Europe has not been pushed to the background by us. The countries of this region have never fallen out of Russia's field of interest. Considering their geographical proximity and traditional centuries-long ties, *we include them rather in the first circle*. The goal of our policy toward Poland, the Czech Republic and Slovakia has been to *maintain the existing infrastructure of mutual relations* while simultaneously changing the basis on which these relations operated. [emphasis added]

Kozyrev went on to warn the three countries that joining NATO would strengthen reactionary forces in Russia and would transform the region into a "buffer zone that could be crushed in any situa-

[41] See de Weydenthan, "Cross-Border Cooperation," pp. 32–35; also the special report "Po obu stronach Odry," in *Zycie Gospodarcze*, no. 11 (March 13, 1944), pp. 22–33.

tion"; instead, Poland and its neighbors should form a neutral "bridge" linking Russia with Western Europe.[42]

Another key reference point is the "Foreign Policy Concept of the Russian Federation," adopted by the Foreign Ministry and Supreme Soviet in January 1993, which foreshadowed some of Kozyrev's themes but also directly linked the issue of relations with the "Near Abroad" to policy toward Eastern Europe:

> East Europe does not just retain its significance for Russia as an historically formulated sphere of interest. The importance of maintaining good relations with the countries of this region has become immeasurably greater with the formation of the belt of sovereign states—Ukraine, Belarus, Moldova, Lithuania, Latvia and Estonia—the climate of interrelation with which cannot help but be influenced by the effect of the nature of our ties with East Europe. . . .
>
> The strategic task at the current stage is to prevent East Europe from turning into a sort of buffer zone, isolating us from the West. On the other hand, we cannot allow the Western powers to force Russia out of the East European regions, which is already becoming a reality. This is a task which is well within our powers considering the fact that the states of East Europe, despite their noticeable and somewhat artificially emphasized recent political distancing from Russia, are economically, and to a significant degree also in a cultural-humanitarian respect, still oriented as before toward Russia and the other CIS countries. . . . Energetic measures in restoring economic ties are especially important.

A later section dealing with general European security and the role of the CSCE spelled out Moscow's opposition to "subregional organizations," especially those that might include other CIS states without Russia's participation, adding that: "We must work toward Russia's direct inclusion in subregional cooperation when conditions permit and our interests demand."[43]

That Ukraine and Poland, as the relative heavyweights on each side of the CIS/Central European divide, were the prime targets of this new assertiveness should come as no surprise. Although Warsaw's September 1992 proposal for extended security cooperation in Central and Eastern Europe had fallen on deaf ears among its Visegrad partners, Kiev was definitely interested. Not only did Ukraine express interest in closer cooperation with Visegrad and

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[42] The interview was given on the eve of Yeltsin's visit and reported briefly by the Polish Press Agency PAP; extensive excerpts were published only after Yeltsin's apparent concession. See *RFE/RL News Briefs* 2, no. 35 (August 23–27, 1993), p. 12; and "Nie chcemy poprawiac geografii," *Polityka*, no. 36 (September 9, 1993). For additional details, see Sarah M. Terry, "Beyond the Cold War: Prospects for Central European Security and Cooperation in a Post-Communist World," in *The Soviet Empire Reconsidered*, Sanford R. Lieberman, et al., eds. (Boulder: Westview Press, forthcoming 1994), especially notes 41 and 42.

[43] "Foreign Policy Concept of the Russian Federation," dated January 25, 1993, in *FBIS Report: Central Eurasia* [FBIS-USR-93-037], pp. 10–12. Note the similarity in the formulation of Moscow's sphere of interest in this concept paper and the CPSU Central Committee resolution adopted almost exactly two years earlier, prior to the breakup of the USSR (see note 7 above). Concerning the Soviet military's distrust even of the Visegrad group, see Alfred A. Reisch, "Central Europe's Disappointments and Hopes," *RFE/RL Research Report* 3, no. 12 (March 25, 1994), p. 20.

the CEI, President Kravchuk launched his own plan for a Baltic-to-Black Sea security zone. First broached on a state visit to Hungary at the end of February 1993, Kravchuk's initiative was presented to all four Visegrad states and the CSCE over the next four months, and was based on concerns very similar to those that had motivated Walesa: that the security vacuum left by the dissolution of the Warsaw Pact and the collapse of the USSR had created a situation of "latent military and political instability" in Central and Eastern Europe; that Western security structures were "not yet ready to enlarge their 'zone of responsibility'"; and that an "all-European security space" could only be created when regional stability had been reestablished. While Kravchuk's proposal did not preclude Russian participation, several of the conditions Kravchuk wanted participants to accept were clearly at odds with Moscow's goal of reasserting its dominant position in the former Soviet republics and gaining international recognition of its right to carry out unilateral "peacekeeping" operations. These included the "inadmissibility of strengthening one's own security at the expense of the others' security"; "strict respect for political sovereignty and territorial integrity . . . in Central and Eastern Europe"; and the "inadmissibility of deploying foreign troops in territories of other states without their clearly expressed consent."[44]

Moscow did not wait for Kravchuk's diplomatic offensive before moving to preempt Ukraine's westward reorientation. On a visit to Warsaw in January (as the Foreign Ministry was finalizing its concept paper), Yeltsin adviser Sergei Stankevich is reported to have warned his hosts that Moscow was opposed to close military ties between Warsaw and Kiev. In addition, in a meeting at the Polish Senate, a question concerning Ukraine's possible membership in the Visegrad group elicited an elliptical response: "In no case would we wish that post-communist Europe create any structures aimed . . . at constraining Russia [or] her alleged aggressive designs. We have no aggressive intentions and operate on the principle that Russia has never had any such intentions."

Stankevich then warned against the formation of any groups for which "Russia might be the object of joint actions" and advised that, in their search for a "place in the system of international relations," the post-communist states must consider Russia's "legitimate interests and her legitimate concerns." He also put Warsaw on notice (more than six months in advance of Kozyrev's *Polityka* interview) that Moscow would not look favorably on Poland's quest for membership in NATO, at least in its present form. In yet another evasive response that could be construed as a veiled threat, Stankevich stated that, should NATO seek to "expand its sphere of responsibility" before making unspecified changes in the character

[44] Ukraine never issued an official document outlining Kravchuk's proposal; however, the Ukrainian embassy in Warsaw did issue a press release (apparently without authorization) on April 22, 1993, entitled "To strengthen regional security in Central and Eastern Europe: Initiative of Ukraine." The author is endebted to Dr. Paul Goble of the Carnegie Endowment for International Peace for sending a copy. For other accounts of Kravchuk's initiative, see Roman Solchanyk, "Ukraine's Search for Security," *RFE/RE Research Report* 2, no. 21 (May 21, 1993), pp. 1–6.

of the alliance, "doubts will arise and consultations will be necessary" (presumably between Moscow and Warsaw?).[45]

The consistency of Russia's policy not only in opposition to NATO's eastward expansion but also on recouping its dominant position in the "Near Abroad" would appear to shed new light on Yeltsin's motives in signing the August declaration in which, in addition to dropping Russia's objections to Poland's membership in NATO, he also gave his blessing to the "development of subregional cooperation" within the framework of Visegrad and the CEI—again contradicting his foreign minister.[46] Clearly, Yeltsin must have wanted something very badly—a *quid pro quo* that could justify a high-visibility reversal (albeit temporary) of well-established policies. What that something was must remain a matter for speculation, but in this observer's opinion Moscow's first priority had to be to derail the Kravchuk initiative—to drive a wedge between Ukraine on the one hand, and the Visegrad states (especially Poland) on the other.

For the Poles and the other Central Europeans, Russia's new assertiveness has dramatically narrowed their options and raised the stakes in their race to join the West. Not only is the notion of an expanded Central and East European zone of cooperation—embracing also Ukraine, Belarus, and even the Baltic States—no longer viable; but they now face the possibility that at least some of these post-Soviet states may effectively lose their independence, leaving the Central Europeans in all too familiar and uncomfortable proximity to Russia. This would not only pose a security threat but, should CIS reintegration include a monetary and customs union (as proposed in the case of Belarus), could expose them to economic blackmail as well. Clearly, this would not be a situation that these countries are capable of dealing with on a strictly intraregional basis; indeed, it might not be too much to say that the shift in Russian policy at the beginning of 1993 was the final stake in the heart of the Visegrad process.

Thus, in assessing the record of intraregional relations in East-Central Europe in the first four and a half years of post-communist transition, it is essential to keep in mind the totality of the context in which these countries have had to undertake that difficult process—not only their limited resources but also the ongoing external uncertainties. If viewed as an end in itself, intraregional cooperation has so far yielded rather meager results, and future prospects are not promising. If viewed as only one element of a larger process of European integration, however, both the record and the outlook are considerably brighter. True, Visegrad could have achieved much more if all partners had been willing to deepen their cooperation within the region. But the more telling lesson of the past four years—as the experiences of the Central European Initiative and the Baltic Sea Council amply demonstrate—is that cooperation is

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[45] Solchanyk, "Ukraine's Search for Security," p. 3; and "Stosunki polsko-rosyjskie—wyjscie z cienia katynia (Stenograficzny zapis dyskusji ze spotkania z Siergiejem Stankiewiczem w Senacie RP, 20 stycznia 1993 roku)," in *Polska w Europie*, no. 11 (April 1993), pp. 71–92.

[46] By some accounts, these concessions were extracted only after hard bargaining at the last minute and over the strenuous objections of his entourage, including Kozyrev. Concerning the latter's somewhat embarrassed retraction of positions taken in his interview less than a week earlier, see Ryszard Malik, "Czas rozpoczac odliczanie na nowo," *Rzeczpospolita*, August 26, 1993.

more effective when it is *inter-* rather than intraregional. In light of recent developments in Russia, a second lesson might be that the real danger for the East-Central European countries today would be not in integrating them too soon, but in leaving them too long in the anterooms of Europe.

REGIONAL SECURITY RELATIONS AND NATO

By Paul Gallis, Julie Kim, and Francis Miko*

CONTENTS

SUMMARY

The end of the cold war in Europe has fundamentally altered European and trans-Atlantic security relations. While the division of the continent into two mutually threatening military blocs has disappeared, unity has not yet emerged. Nations to the west and east of the former cold war divide are currently deliberating the shape of the post-cold war security framework, and how to progress toward the goal of common security.

As the very definition of security continues to evolve in the post-cold war era, existing norms and institutions are being challenged. Some argue that new approaches, methods, and institutions are required to address new threats to security. A sense of urgency to respond to these challenges is felt more strongly in the eastern part of the continent, where the end of the cold war has left countries without firm security ties. Without adequate solutions to the secu-

*Paul Gallis is a Specialist in European Affairs; Julie Kim, an Analyst in European Affairs; and Francis Miko, a Specialist in International Relations. All three authors are with the Foreign Affairs and National Defense Division, Congressional Research Service, Library of Congress.

rity problems of the region, some feel that the prospects for regional stability and successful democratic and market transformation could be placed in jeopardy. Among Western states, however, consensus is still lacking as to how countries can continue to foster their own security and promote national interests, while addressing the new challenges to the East.

This paper discusses regional security issues in East-Central Europe, with a focus on relations with NATO. The evolving concept of security in the post-cold war era and aspects of the new security environment are the subject of the first section. The quest for security by former communist countries, such as Poland, Hungary, the Czech Republic, Slovakia, Romania, Bulgaria, and Albania, has given rise to a sharp policy debate in the West, reviewed in the next section, over appropriate responses. The outcome of that debate will be determined not only by Western views, but also by policies and perspectives of the East-Central European states, which are outlined in the final section.

THE POST-COLD WAR SECURITY ENVIRONMENT IN EUROPE

For over forty years, the cold war imposed a certain stability in Europe through a balance of terror between two clearly distinguishable enemy camps. The end of the cold war was both a defeat from below of the Eastern communist order and a victory for the steadfastness of the Western alliance, NATO, and the political/economic model provided by the European Community (EC). Unlike the end of other wars, the end of the cold war did not leave a new post-war order in the European continent. The division of the continent—manifest in mutually threatening military build-ups—has disappeared, but pan-European unity has not emerged. The opportunity for peace in the whole of Europe appears unprecedented, but the cold war division has not been completely overcome. Peaceful unity may be the long-term goal for all states, but the path toward this goal has proven uncertain and difficult to implement. The uncertainty of this process of integration has become a point of concern especially for the former communist countries in Eastern Europe.

The full effects of the global change resulting from the end of the cold war have yet to be realized. Most fundamentally, the nature of threats to security has been transformed. Instead of a single massive military threat, which unquestionably affected the security of all Western countries, the outbreak of more localized conflicts has challenged existing international means of response. Often these conflicts reflect far more complex ethnic, social, and historic factors than purely military objectives. Paradoxically, from the Western vantage point, the world appears simultaneously less dangerous with the elimination of the Soviet nuclear threat, and more dangerous with the proliferation of local conflicts and lesser threats. The former danger was more threatening but less imminent, while the latter kind of threat is now less than a vital interest to other states but far more likely.

For the West, the changed security environment has brought about some unexpected consequences. At first, some observers predicted that the end of the Warsaw Pact threat would signal the demise of the successful Western alliance, since the absence of the threat would nullify the alliance's very purpose of being. Instead, NATO has proven (to some) a surprisingly durable institution. NATO's role has transformed from serving as a bulwark against the East to embodying successful Western cooperation and integration in security. NATO has maintained its core collective defense function while it has cautiously explored new roles and missions. The alliance has been a magnet for others, as former enemy states have turned to NATO for security and membership in increasing numbers. Nevertheless, NATO will continue to be challenged to adapt to the new security environment, and to strive toward the vastly different objective of collective security rather than just collective defense. The absence of a common threat to all alliance members opens the door to divergent interests, perspectives, and priorities among member states. It also renders consensus in the alliance difficult on even the most basic security issues, such as threat assessment.

For the states in the Eastern part of the post-cold war divide, the issue is more basic and pressing: how best to provide for one's security, where no security currently exists.

SECURITY CONCERNS IN EAST-CENTRAL EUROPE

The former communist countries of East-Central Europe, which includes Poland, Hungary, the Czech Republic, Slovakia, Romania, Bulgaria, and Albania, is currently in a state of flux. The cold war had the greatest impact on the post-World War II development of these states, and the end of communism after 1989 was felt most dramatically in East-Central Europe. But East-Central Europe is also where the absence of a security framework is perceived as the most threatening. The post-cold war future for East-Central Europe is free, but not necessarily more secure.

The disintegration of the communist empire unleashed a natural resurgence of long suppressed feelings of national identity among the former Soviet satellite states. In varying degrees, this process has been accompanied by, or manipulated to foster, a growth of nationalism, which can feed latent suspicions of other nations. The consequences of this phenomenon have been most tragically played out in the case of the former Yugoslavia. There, mutual suspicions primarily between Serbs and Croats managed to create an unfortunate axiom, now widely accepted, that "ethnically pure" states are inherently more stable because they reduce the "risk" of ethnic unrest. Other states have been more careful to discount military means to address cross-border ethnic issues, but latent threats stemming from ethnic nationalism exist throughout East-Central Europe, the Balkans, and the former Soviet Union, areas all undergoing profound internal upheavals. These regions' uncertain futures could make their populations receptive to the appeal of historical revisionism or scapegoating for painful transitions.

Similarly, internal instability can present threats to regional security. The precise military balance between countries now appears far less important than the internal political stability of a potentially threatening country, such as Russia. A failure of its political and economic transformation might lead to a breakdown of internal security and foster civil war. Domestic turmoil in East-Central Europe might also have external consequences, since violence might not easily be contained where interests cross borders. The relationship between internal and external stability is thus far more pronounced than before.

A less tangible danger to the security of East-Central Europe is the very absence of a security framework in the region. The Warsaw Treaty Organization, never a voluntary organization, was dissolved in 1991. Most Soviet troops left East-Central Europe that same year, and all by the end of August 1994. Membership in Western institutions appears either remote (in the case of NATO) or inadequate (in the case of the CSCE). While few East-Central European states would claim that they face an imminent threat of aggression, the lack of a security anchor appears itself to present an ominous situation that the "insecure" states cannot address individually. The national military structures of the East-Central European countries are facing huge restructuring tasks that must take into consideration new defense doctrines, new command and control structures, re-deployment, and extremely scarce resources. National defenses are unlikely to provide adequate security against sudden crises, cross-border conflict spillover, or other security threats. Officials from many countries contend that the region's security vacuum is inherently unstable and destabilizing. It signifies a "no man's land," or buffer zone, to the more secure West European countries. It could encourage regional rivalries and foster various ad hoc rather than pan-European allegiances.

REGIONAL SECURITY GOALS

Emerging from the disintegration of the Soviet empire as fully sovereign and independent states, East-Central European states have sought to adjust to new geostrategic considerations and enhance their security through a variety of means. Each country no longer was a militarily indistinguishable part of the communist bloc, but rather was surrounded by neighboring states with sovereign interests, forming new issues in bilateral relations. Many East-Central European countries have sought formally to reestablish relations with neighboring states through extensive bilateral agreements, regular contacts, and programs of cooperation. Others have yet to overcome newly emerging difficulties as well as age-old suspicions of each other, but most have sought at least to stabilize relations with countries at their borders. Most former Eastern bloc states have also sought to start on a new footing with Russia, the main successor state to the Soviet Union. While highly suspicious of Russian great power aspirations in foreign policy, officials from East-Central European states emphasize that stability to their East enhances their own security. All former satellite states expressed strong support for Russian reformers when directly challenged by hardline communist forces, as well as alarm when the hardliners and nationalists fared well in the 1993 Russian national elections.

Above all, however, the primary foreign and security policy objective of all the countries of East-Central Europe has been association with and integration in the major European multilateral institutions, especially the European Union (EU) (formerly the European Community), and NATO. This has been the overriding goal of most of the East-Central European countries since shortly after the democratic revolutions, and has remained so over four years and many changes in governments later. This steadfastness in foreign and security policy priorities has withstood repeated rebuffs from the institutions themselves, as well as radical upheavals in the domestic political scenes of the East-Central European countries.

This objective reflects the attractiveness of the Western institutions which have proven themselves as successful, mutually beneficial initiatives. West European economic and political integration is on track toward European union. Security is provided for by NATO in a more meaningful way than it is by other European security institutions such as the Western European Union (the eventual defense arm of the EU), or the CSCE, although both of the latter institutions remain important to the East-Central European countries. NATO's mutual defense guarantee is regarded as the most effective security enhancer vis-à-vis a potentially hostile Russia. Inclusion in NATO would provide for the stability necessary to attract foreign investment, promote economic growth, and build democratic structures. NATO membership would also bring with it the integral involvement and engagement of the United States, which is also sought by all the East-Central European countries.

The goal of inclusion in NATO and the EU also signifies to the East-Central European countries the clearest path toward their "return to Europe." Possibly even more meaningful than the tangible benefits of membership such as trading preferences or security guarantees, the political significance of inclusion in the European order (as it exists for the West) and equal partnership would symbolize the most durable security. Consensus on this goal is therefore not hard to come by in East Europe. Alternative foreign policy endeavors such as regional cooperative groupings, various "special" relationships, and other pan-European approaches are regularly pursued as parallel objectives, but not substitutes for integration in the West.

The strength and clarity of the goal of the East-Central European states to join the process of Western integration and security was perhaps underestimated in the West. Institutional access, such as was provided to NATO through the North Atlantic Cooperation Council (NACC), proved insufficient to fill the gap between shared future goals of a united, secure Europe, and current realities of a secure West and insecure East. NATO and the EU have been pushed both to consider and to begin to prepare for institutional enlargement, even as they struggle to adapt themselves to other, equally pressing challenges.

Over four years since the democratic revolutions in Central and Eastern Europe, the security goals of these countries appear only slightly closer to being fulfilled. Some observers have begun to consider the broader impact the ongoing security void might be having on the process of political, economic, and social transformation from communism in Eastern Europe. The return of post-communist parties to power in some countries has been cited as one consequence. Some fear that the communist successor parties might be less committed to the transition and Western integration, and might seek to pursue less predictable routes to security (although little if any evidence of this is yet apparent). Without firm anchorage in the West, some observers fear that other, more destabilizing consequences in East-Central Europe could follow, such as enhanced cross-border suspicions and/or regional rivalries.

WESTERN RESPONSES

The cold war's end has provoked changing perceptions of security in the West. While some U.S. and West European officials share the East-Central European tendency to continue to define security in terms of military readiness and political solidarity against a Russian threat, Russia's economic decline and political instability have diminished such concerns for others. Increasingly, European Union officials view security as political and economic stability, which can be nurtured only if democracy and improving economic conditions in East-Central Europe take root. They believe that different methods, and perhaps different institutions, are necessary to pursue these evolving definitions of security.

NATO'S EVOLUTION

At the NATO summit in Brussels on January 10–11, 1994, member states sought to bring into greater focus the Alliance's mission in the wake of the changes brought by the end of the cold war. They created the Partnership for Peace program, meant primarily to move former Warsaw Pact states toward democracy and greater civilian control of their militaries as steps toward possible NATO membership. They also took steps to create "Combined Joint Task Forces," intended to provide flexibly configured NATO forces for a range of out-of-area contingencies.

The summit left important issues unresolved. Russia's relationship to the Alliance remains uncertain. Is NATO's purpose primarily to provide a mutual security guarantee against a Russian military threat? If so, can that purpose co-exist comfortably with the objective of providing financial aid to Russia in the effort to push Russia toward democracy and a market economy, and Russia's possible entry one day into the Alliance? NATO's invitation to Moscow to join the Partnership for Peace is opposed by the former Warsaw Pact states in East-Central Europe because they believe that it reflects a dilution of the Alliance's will to curb an "imperialist" Russia, against which European countries must stand firm.

NATO's political relationship to these former Warsaw Pact states, and to the Baltic states and Ukraine, also remains uncertain. A principal gain from the end of the cold war was the independence of these states. NATO members do not wish to see that gain slip away through possible Russian efforts once again to exert influence over these states, but there is no consensus to guarantee the security of these countries by admitting them to the Alliance.

Behind these unresolved issues lies the question of the United States' future intentions in Europe. Some allies wonder whether the United States will maintain the currently deployed 100,000 troops on European soil. Some believe that U.S. unwillingness to send its ground forces to Bosnia signals an intention in Washington to disentangle the United States from the continent. Some Clinton Administration officials caution that clear-cut decisions on NATO's shape and purpose cannot be made while Russia, other states of the former Soviet Union, and Eastern Europe remain in rapid evolution.

There is a consensus in NATO that the Alliance's mission must move beyond mutual security and toward more political objectives. Among proposed missions are peacekeeping and peace-enforcing; humanitarian assistance; and aiding states in the development of democratic institutions. But there is no consensus over how to secure these proposed objectives. Some NATO members, for example, are reluctant to send forces to assure implementation of a peace agreement in Bosnia, should such an agreement be achieved. Some NATO members may not wish to enter peacekeeping operations out of concern that peacekeeping may become peace-enforcing. Some states are reluctant to contribute resources to humanitarian assistance, especially if, as in Somalia, such operations may ultimately involve combat operations or expand into "nation-building." And, while all NATO states support the development of democratic institutions to the East, some European officials believe that this is more the province of the European Union or CSCE than of NATO. Behind such a preference lies a sentiment in some European quarters that other institutions having a nonmilitary focus are more well-suited than NATO to build security by encouraging economic growth and democracy. Usually unspoken in such a sentiment is a belief that NATO may be searching for a *raison d'être*, now that some European and U.S. officials no longer view a Russian threat as credible.

PARTNERSHIP FOR PEACE AND THE COMBINED JOINT TASK FORCES

The United States and its European allies are taking steps through NATO intended both to encourage democracy to the east and to make more flexible the Alliance's capacity to respond with military force to a range of contingencies. Partnership for Peace, a U.S. proposal endorsed at the NATO summit in January 1994, emerged as the Clinton Administration's effort to develop closer relations in security affairs with former adversaries. At the same time, the Administration wished to "draw no new lines" in Europe; it sought to include, rather than exclude, Russia in new arrangements to build stability.

Partnership for Peace does not extend Article V protection (the NATO Treaty's mutual defense commitment in case of attack) to members, but NATO does describe it as a path to possible Alliance membership. The Partnership commits a member state to develop "transparency" in its defense budget and military planning in order for its public and other states to understand its military capabilities, and to establish civilian control of its armed forces. In addition, each member is encouraged to develop military forces able to work under UN or CSCE auspices, and to undertake joint missions with NATO for peacekeeping, search and rescue, and humanitarian operations. These measures are meant to encourage democratic norms and to integrate the former Warsaw Pact countries, including Russia, Ukraine, and the Baltic states, into Western security structures.

Russia is the pivot around which the debate over the effectiveness of Partnership for Peace revolves. The Administration believes that Russia can be persuaded to play a constructive role in Europe;

U.S. officials cite the peace brokered in Sarajevo between Serbs and Bosnians in February 1994 as evidence of such a role. However, the Administration has altered its position toward Russia as the government of Boris Yeltsin has voiced a right to influence the policies of states in the former Soviet republics outside Russia. In February 1994 Secretary of Defense William Perry said that Partnership for Peace could be used to form "a protective grouping against Russia if things go wrong in Moscow." Russia should pursue legitimate concerns on its borders, but not "by relying on the old Soviet practices of intimidation and domination. . . ." [1]

Russia joined the Partnership for Peace program in June 1994 and sought a special status as co-equal with NATO in deciding courses of action in major European security issues. NATO has rejected any such formal elevation of Russia within NATO councils, but NATO officials have acknowledged that Russia's size and strength mean that Moscow will likely be consulted on many important issues. Some officials of East-Central European governments contend that giving Russia any special status amounts to a "soft Yalta," a reference to the allied powers' meeting near the end of the Second World War where, in the absence of East-Central European representatives, decisions were made contributing to the post-war division of Europe. In this view, NATO is allowing Moscow to drive Western policy toward expansion of the Alliance, and signalling Russia that it may pursue a policy of intimidation toward its former Warsaw Pact allies if it so desires.

At the summit, NATO members also created the "Combined Joint Task Forces" (CJTF), by which NATO commands may designate forces for contingencies outside the NATO Treaty area. Forces from non-NATO states might join with NATO in peacekeeping operations, crisis-management efforts, and humanitarian missions. Creation of CJTF signals recognition by NATO that some member states may wish to participate in operations that could require combat forces, while others might not. In this view, "a willing coalition" could use NATO resources to deflect or contain a threat that some member states believe prejudicial to their interests.

The concept of Combined Joint Task Forces could be put to difficult political tests. In theory, CJTF provides flexibility: those allies wishing to use NATO resources might do so to act in situations in which NATO members lack unanimous commitment to deploy forces. [2] Translating theory into practice could prove difficult. If, for example, several European NATO states wished to send combat forces for peace-enforcement, and not peacekeeping, to Bosnia, would the United States permit use of its lift capacity, intelligence resources, and the NATO communications structure? An operation in Bosnia would face great obstacles without such resources. Some observers believe that the CJTF, without U.S. participation, would be a hollow force. In the absence of a clear political consensus in the United States to assist such an undertaking, utilization of the

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[1] Cited in "NATO Peace Partnership's New Look: A Protective Shield against Moscow," *Washington Post*, February 8, 1994.

[2] For a discussion of this point, see the testimony of Undersecretary of Defense for Policy Walter B. Slocombe, in NATO Summit and the Future of European Security, Hearing before the Subcommittee on Europe and the Middle East of the House Foreign Affairs Committee. 103rd Congress, 2nd sess. February 2, 1994. pp. 7, 19–20.

CJTF for possible combat operations in Bosnia or elsewhere could prove difficult to implement.

THE EUROPEAN UNION

The European Union is exploring means to build security on the continent both through development of a more flexible military capacity, and through greater stability in political and economic affairs. The Western European Union (WEU), the European Union's designated defense arm, is still developing a capacity for undertaking combat operations. The Clinton Administration has endorsed the effort to develop a European security and defense identity through the WEU. France and Germany have proposed that their "Eurocorps" become the nascent WEU European army. NATO's CJTF could also supply necessary resources—"separable but not separate" from NATO—to WEU operations.

Political difficulties abound in efforts to make the WEU effective. These difficulties have important implications for U.S. interests in Europe. Defense budgets in Europe are declining, not increasing; more resources are likely necessary if the WEU is to develop an effective combat capacity. In addition, the European Union is set to expand in January 1995 to include, among other states, Finland. For the first time, the European Union will have a member, formerly neutral, with a border abutting Russia. The Finnish government has stated its intention to subscribe to the EU's common foreign and security policy, which ultimately implies signing the Brussels Treaty (containing a mutual security commitment) and thereby joining the WEU.

In the view of some U.S. and European officials, the addition of Finland and other non-NATO members to the European Union is a move through the back door to a U.S. security guarantee. Because the WEU's military capacity is embryonic, and because any threat to one EU member's stability threatens the well-being of the entire European Union, these officials believe that the United States, in the event of a crisis, could be drawn into defense of its NATO allies as a result. The problem could become more apparent by the year 2000, when Poland, Hungary, and the Czech Republic will likely wish to attain EU membership.[3]

The European Security Conference in May 1994 illustrated one EU approach to enhancing security by building economic and political stability. Designed by France, the Conference reviewed means to resolve issues in Eastern Europe involving borders and minorities. Those countries, in the EU view, that successfully resolve such issues will enjoy a greater chance of attaining EU membership one day.

U.S. CONGRESS AND PUBLIC OPINION

There is no firm consensus in Congress to extend a security guarantee through NATO membership to East European states, the Baltic states, Ukraine, or Russia. Some in Congress express concern that NATO membership for these states might embroil the

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[3] For a discussion of these points, see Claire Tréan, L'Europe associe neuf pays de l'Est à ses réflexions sur la défense du continent, *Le Monde* (LM). May 10, 1994. p. 4; Daniel Vernet, La Russie aux frontières de l'Union européenne, *LM*. May 12, 1994. p. 1.

United States and its allies in potential ethnic and border conflicts in the region. There remains a sentiment that NATO is a prudent hedge against an unstable Russia, but questions over the effectiveness of Partnership for Peace and the CJTF are evident. Some Members of Congress have noted that the American people understand and have been comfortable with the security guarantee to existing NATO members, long-time combatants in the cold war against the Soviet Union, and that significant changes to these arrangements may not correspond with similar levels of public support.

Some Members of Congress are questioning the value of NATO's continued existence, and believe that there is little justification for the Alliance now that the Russian threat has diminished. However, much more common is the view that prosperous European allies allow the United States to bear the central burden for defense, while they use their financial resources to build economies more competitive with the United States. This view prompted many Members to support an amendment to the 1995 Defense Authorization bill to reduce U.S. troops in Europe unless the allies agree to assume 75 percent of stationing costs of U.S. forces.

Public opinion in the United States toward NATO and toward Europe is also in evolution. Europe remains the principal U.S. trading partner, but other traditional bonds to the continent may be diminishing. Significant if not equally vital interests of the United States elsewhere in the world have gained in prominence. American public sentiment has registered an interest in reducing U.S. obligations and commitments abroad, and focusing on pressing domestic concerns, leaving the debate on the future U.S. role in Europe, let alone considerations of broader military commitments, quite uncertain. Non-European minorities since the late 1970s have grown steadily as a percentage of the U.S. population. It is not clear that minorities will call upon their government to turn its attention more to their regions of origin and less towards Europe. At the same time, it is not surprising that their interest in Europe is less pronounced than that of immigrants from Europe, and their children, who came to the United States in such great numbers between 1880 and 1920. In addition, the generation that fought in or lived through the Second World War, a time when strong emotional bonds were formed with Europe, is diminishing; approximately 75 percent of all U.S. citizens today were born after the war. With the passage of time, many Americans of European heritage may feel a weakened link to the continent as sustaining the culture, language, and religion of their ancestors becomes less important to them.

East European Policies and Perspectives

Given their strong interest in gaining membership in NATO, East-Central European countries have given little attention to other security alternatives, at least publicly. This is true not only for the "Visegrad" countries of Poland, Hungary, the Czech Republic and Slovakia,[4] whose candidacy for membership has been in the

[4] Leaders from Poland, Czechoslovakia, and Hungary held a summit meeting in the Hungarian town of Visegrad in February 1991, launching an ongoing process of consultation on joint political, economic, and security issues.

forefront, but also Romania, Bulgaria, Albania, as well as the Baltic states. Yet rapid accession by some or all of the countries is not certain by any means. Even under the most optimistic projections, integration into NATO will take time and is not likely to proceed at the same pace for all of the countries. Even if integration were to take place more quickly than expected, NATO could be transformed to such an extent that it no longer offers the level of defense guarantees that these countries are hoping for. No East-Central European country is comfortable with the security vacuum currently felt in the region, so measures to redress it are considered urgent. Without adequate solutions to the security problems of the region, the prospects for regional stability, successful democratic and market transformation could be placed in jeopardy. This section looks at East European possibilities within the NATO context, as well as other realistic security options for the region.

EAST-CENTRAL EUROPEAN VIEWS ON NATO

As discussed earlier, membership in NATO is viewed as the best means to address their security concerns in the broadest sense and, together with eventual membership in the EU, ensure their integration into Europe. They believe that any efforts to create alternative structures would divert attention from their principal aim and take pressure off the West to make the difficult commitment to rapid integration.

So far, even the socialist (post-communist) parties that have been voted back into power in a growing number of countries seem as committed to the NATO path as their predecessors. Throughout East-Central Europe and the Baltics there exists a remarkable consensus on foreign and security policy, especially with regard to the two pillars of seeking integration into NATO and the EU. In none of the recent elections have these policies been challenged. By contrast, such a security consensus is far less evident in the former Soviet Republics, even Ukraine, where a reorientation toward Russia is considered a serious option by some factions.

Overcoming Barriers to Expansion

Since East-Central European confidence concerning eventual NATO acceptance is not yet matched by any NATO consensus on expansion, a considerable sales job and concrete actions by East-Central European governments may be needed to persuade Western skeptics that expansion is in their own interest. Presumably East-Central European countries can continue to count on support from Germany, which has been the most active promoter of bringing East European countries into NATO. Central and East Europeans can also count on some supporters within the U.S. Administration and Congress, despite continuing divisions on the issue. President Clinton has stated that NATO expansion is "no longer a question of if but when." However, the issue of NATO expansion beyond the current Partnership for Peace structure has yet to be seriously debated in the United States. In many other countries NATO expansion faces stronger resistance.

It is likely to take performance as well as words to convince the Western skeptics. They have doubts on several scores. First, they question whether the West has interests in the region sufficient to expand the alliance and offer security guarantees, with all of the possible costs and risks. Some still see most of the region as remaining essentially in the Russian sphere of interest and see expansion to the East as an act that could reignite a cold war with Russia. Second, they question whether new East European states would add to or subtract from NATO's military strength. Some doubt that NATO can cope with expansion at a time of declining public commitment to the organization in the West. Third, some consider the region a bad risk, inherently unstable and problematic. They view democracy in the region as extremely fragile and uncertain of success, especially in light of the lack of historical precedent in most countries. They still doubt the success of the region's economic transition. They also doubt whether the region can overcome historical tensions between countries and ethnic groups, fearing that countries would bring conflicts with them into the alliance.

To show that East-Central European membership is a net asset to the Western alliance will require many steps. First, these countries will have to be willing to invest in modernizing and upgrading their defense capabilities so as to be able to contribute to the common defense. They haven't yet developed strategies and plans for doing this, given the mixed signals by NATO. The investment, moreover, will not be easy given the strong competing demands on very scarce resources. More important, East-Central European governments will need to show in their domestic and foreign policies that they are a force for stability in the region. This requires continuing demonstration of a firm commitment to democracy and market reform. They must convince skeptics that expansion will not bring new tensions and conflicts inside the NATO organization. This means taking serious steps to overcome conflicts with neighboring states, as well as ethnic frictions at home. Western skeptics will also have to be convinced that NATO expansion will not have a negative impact on the desired evolution of Russia and the former Soviet Union.

Yet the East-Central Europeans make a strong case for their integration and believe that it will be persuasive in the end. With regard to all of the legitimate Western anxieties, they see membership in Western institutions as the best guarantee against negative trends. With regard to Western interests in East-Central Europe, they argue that European stability and prosperity is indivisible. No longer can the West insulate itself from trouble and turmoil in the East. In so far as NATO membership would help to stabilize the East, it would be the most effective investment in the West's own security. They believe that this is also true of the United States, which has historically been drawn into European conflicts and has invested heavily in stabilizing the continent over the past fifty years. Furthermore, many East-Central Europeans argue that their countries offer the best long-term opportunities for West European economic expansion and growth. American economic stakes in the region are strong and growing, with the U.S. now the leading investor in several countries. They argue that even without East-Central European membership in Western institutions, the German presence in the region will be significant, but to anchor that presence and influence in a Europe-wide structure would be more desirable for all. East-Central Europeans are most baffled by the tendency in some circles to relegate the region again into the Russian sphere of influence and to expect Russia to take care of security problems there. They see it as a total misreading of the history of the cold war and the historic changes that occurred in 1989. Countries of the region will not accept incorporation into that sphere and any European "stability" built on Russian domination of the region will again carry the seeds of its own destruction.

East-Central Europeans believe that they can add to NATO's strength over time. In terms of charges of being a poor risk they feel that NATO membership could improve the odds a great deal. While readily conceding the fragility of their democracy and economic transformation, the troubled relations between nations and ethnic groups, they stress that, with the exception of former Yugoslavia (which is a distinct case), they have maintained a remarkable stability and commitment to reform under very difficult circumstances.

The East-Central Europeans also see how membership in Western institutions has solidified democracy and economic prosperity in other countries coming out of non-democratic traditions, most recently Spain and Portugal. As it becomes increasingly clear that the full transformation of East-Central European societies will take time, incentives and outside reinforcement become even more important.

Integration with the West is seen in the region as the best hedge against a flare-up of tensions between East-Central European countries, or between ethnic groups within countries carrying the danger of spillover. The disintegration of Yugoslavia and the Soviet Union has led to conflict, accompanied by casualties and horrors not witnessed in Europe since World War II. The policies of "ethnic cleansing" have presented a particular challenge to the international community. These conflicts seem to have had a sobering effect on the passions of other countries. Although NATO has not been able to end the fighting in Yugoslavia, East-Central Europeans generally attribute this to a lack of political will rather than lack of capacity. In any case, they believe that the "prize" of full membership in the Western community will be one for which most East European countries will accept stringent conditions in terms of overcoming disputes with their neighbors. As part of the process of integration Western powers could be very helpful interlocutors in achieving reconciliation. In any case, regional tensions are fueled largely by intense feelings of insecurity and distrust on all sides rather than expansionist ambitions. This psychology could be changed by NATO membership, East-Central Europeans believe.

Issues of NATO's Membership and Purpose

Once the terms of NATO expansion become clear and are embraced by the Western partners, there are several paths that integration might follow, affecting the security requirements and planning of the East-Central European countries. In theory, under the Partnership for Peace, all of the East-Central European and former Soviet countries are eligible for eventual NATO membership. In practice, membership for all in the foreseeable future is very unlikely and would probably drastically dilute NATO's credibility as a military alliance. Short of an all-encompassing expansion, various alternatives have been suggested. According to one variant, membership would be limited in the short-run to the four "Visegrad" countries on the grounds that they are most ready in their political and economic transformation and links with NATO. A second variant would bring in all the East-Central European countries at more or less one time and defer admission to countries of the former Soviet Union. A third variant is to seek simultaneously to bring in all of the East-Central European countries, the Baltic States, Ukraine, and Russia.

With the first two versions, there is concern over how the widened alliance will affect relations with those who are left out. The Baltic states present a particular problem. In many ways they are as ready and eager for NATO membership as other East-Central European countries. However, the issue of their participation is a very sensitive issue in NATO relations with Russia.

Any of the countries which would be left out of a NATO expansion might feel their own insecurity heightened and therefore strongly oppose it. Ukrainian officials across the political spectrum have expressed concern that NATO membership for their Western neighbors would isolate Ukraine. Yet NATO membership for Ukraine would face very serious obstacles, and it is not even clear that the current government would view it as desirable. Russian leaders, after earlier signs that they would not oppose NATO enlargement, have recently expressed strong opposition to NATO expansion to the East, perhaps as a reaction to the rising political influence of extreme Russian nationalists. The third version would be likely to place NATO expansion far down the road and significantly alter the organization and its role, once expansion occurs.

East-Central European and Baltic states, while not opposing each others' membership bids to NATO, have sought to highlight their particular readiness to join. None would want to slow their own accession as a result of having to wait for anyone else. East-Central European governments have fluctuated between cooperating and competing with one another to woo NATO. As countries have seen themselves in an advantageous position for early membership, they have been more inclined to go ahead unilaterally. NATO and Western governments have sent mixed signals to the East-Central Europeans on this score. The formation of the Visegrad group was to some extent encouraged by earlier Western signals that a joint approach to gaining admittance to Western institutions would be more effective, at least among those countries. More recently, the four countries have shown a tendency toward unilateralism again. Partnership for Peace would seem to encourage more individualistic approaches.

Most East-Central Europeans are wary about expanding the organization to include Russia because they want NATO to remain a mutual defense organization, principally as a hedge against a resurgent Russia. Also, in a NATO that includes Russia, East-Central Europeans fear that Russian interests would prevail over their own.

Should NATO pursue any of the variants for expansion, the question of how to reassure and not destabilize countries left out is critical. The goal is clearly not to create a new dividing line in

Europe to replace the old one. Such a division might force those on the other side of the line to seek other accommodations, potentially harmful to NATO interests and European stability. While differentiation may still be prudent and justified on the basis of the existing state of readiness in each Central and East European country, the effect should be to encourage positive trends in nonmember countries, as well as in the new member states. There is particular concern in some quarters that the addition of some countries could cause instability in Russia, as a result of a strong negative reaction from nationalists. The extent to which those countries not included are shown a real prospect and a clear path to eventual membership may be critical. The challenge for any policy will be to avoid these new divisions.

Debates about radical changes to NATO's mission are not welcomed by most Central and East European governments. They generally want NATO to remain as close as possible to the defensive military alliance built on the strong U.S. military presence in Europe that existed throughout the cold war period, albeit in an enlarged area. They perceive NATO membership as coming with security guarantees. However, NATO is changing, and its ultimate shape is not yet clear. Many experts already see NATO as moving from mutual defense to a more political role. If NATO's mission shifts from mutual defense to essentially political confidence-building, will membership still have the same significance to East-Central Europe? As long as the United States maintains a strong presence and commitment to the organization, NATO is likely to continue to have a unique attraction to East-Central Europeans, even if its role has changed.

REGIONAL PERSPECTIVES ON RUSSIA AND UKRAINE

Russia

Russia remains a crucial factor in the East-Central European security equation. The two biggest potential threats to the region would come from a resurgent Russia with imperial ambitions or alternately from a former Soviet Union in turmoil and conflict. The first of these threats is believed to be growing, as East Europeans perceive renewed Russian efforts to dominate their neighbors, especially the former Soviet republics but even some of the former satellites. East-Central Europeans are particularly troubled by Russian efforts to obtain veto power over their accession to Western institutions. They believe that, while Russia has significantly diminished as a potential threat to the United States and its Western allies, even a much weakened Russia could pose a profound military threat to its immediate neighbors. East-Central Europeans do not believe that they can deter Russian military power, individually or collectively, without Western support.

The former Soviet Union is still seen as an area that could be engulfed in turmoil with a very real danger of spillover into East-Central Europe. Conflict or chaos in the former Soviet Union could embroil neighboring countries in conflict. At the least, it could create massive refugee problems.

The best guarantee to East-Central Europe against renewed threats from the former Soviet Union would be provided by a democratic and prosperous Russia, constructively engaged in the international community. Therefore, while deterrence is important, East-Central Europe shares with the West an interest in promoting a successful Russian transformation and not isolating Moscow. Over the longer term, there will be a great power in Eurasia, whether this proves to be Russia or a new federation of some reconstituted parts of the former Soviet Union. By itself, Russia occupies an area twice the size of the United States and has a wealth of natural resources; it has rich human capital, with a highly educated population of 150 million, and the predominant military power in the region.

Might any of the East-Central European countries be tempted to seek a new security alliance with Russia? Some experts have suggested that a move by NATO to include Visegrad countries but not others could force those outside the alliance to turn to Russia. At present, this seems a very remote possibility unless a country's very survival is threatened.

Ukraine

Ukraine holds a major key to the security and stability of the Central and East European region. It is also one of the least predictable variables. Situated between Russia and East-Central Europe, Ukraine borders Poland, Slovakia, Hungary, and Romania, in addition to the former Soviet republics of Moldova and Belarus. With a population of 50 million and a land area comparable to France, Ukraine could become a major European power in its own right. Ukraine has an advanced industrial base, as well as mineral, agricultural, and, most critically, human resources to become a leading economic power of the former Soviet Union. A stable, prosperous Ukraine, at peace with Russia and its neighbors to the West, could contribute significantly to European security.

However, Ukraine remains a very unsettled country with sharp divisions between the more nationalistic and Western-oriented West of the country, and the more Russian-oriented Eastern part, with a sizeable Russian population. In the South, Crimea with a Russian majority has elected a president who advocates Crimean independence from Ukraine and reincorporation into Russia. The country's economy is stagnating and the government has introduced only very limited economic reforms to date. The potential for unrest and even civil war cannot be dismissed. A conflict in Ukraine or between Ukraine and Russia would be an unimaginable security nightmare for East-Central Europe. The United States and Western Europe have concluded that Ukraine must be helped, encouraged, and engaged. This corresponds with East-Central European interests as well. They have generally sought to cooperate with Ukraine without tying themselves too closely to the country and its problems, despite Ukrainian initiatives to form a new regional security organization between East and West.

ALTERNATIVES TO NATO?

Some observers believe that the East-Central European countries should be looking beyond NATO to ensure their own security, especially given Western ambivalence about expansion and uncertainties about NATO's future. But are there realistic security alternatives?

Role of the European Union and West European Union

Over the longer term, the EU is likely to become their most important association. Even more than NATO, the EU is viewed as the structure that can permanently anchor them in the West and ensure their long-term stability and prosperity. However, they do not see the EU and the WEU as alternatives to NATO. Like many of their Western counterparts, they view them as a package, with NATO providing the essential transatlantic link to the United States. If greater attention is presently being paid to NATO it is because, rightly or wrongly, NATO membership is viewed as a more realistic short term prospect than EU membership and a more viable security option. Some EU countries consider the year 2000 as a good time frame for some East-Central European states' entry into the EU. If NATO closes its door to East-Central Europe or weakens as an organization, then East-Central Europeans are likely to look more to the EU and WEU as their primary security link.

CSCE

At one time, the Conference on Security and Cooperation in Europe was held out as the logical all-European security structure for the post-cold war era. However, the attractiveness of CSCE and any other "architectural" alternatives to NATO was tarnished by the experience of the last few years, in face of crises in the former Yugoslavia and the former Soviet Union. Nevertheless, CSCE has been active in Europe, focusing on conflict prevention, crisis management, and early warning of potential conflicts. To perform these tasks, CSCE has created new institutions, such as that of the High Commissioner on National Minorities. While CSCE has performed a useful role, its wide membership and mode of operation have proven too unwieldy for any country to want to bank on for its security. At the same time, East-Central European countries continue to value the role CSCE plays, and are very active participants. However, they believe that CSCE cannot and should not strive to become a military security alternative to NATO.

Sub-Regional Arrangements

Among the most positive developments in post–1989 East-Central Europe have been the efforts to promote regional cooperation among groups of countries, including some whose relations have not been good historically. The Visegrad group has provided a very useful consultative mechanism and has probably been successful in promoting the interests of its four members with the West. The Central European Initiative, expanding on what began as the "Pentagonale" group has had an additional appeal in that it includes West European as well as former communist countries. The Black Sea Cooperation Council has also promoted cooperation across former ideological lines. However, all these arrangements have explicitly stopped short of significant military cooperation (though Visegrad defense ministers meet regularly). Most participants have seen that task as too heavy a load to impose on these new forums. Any efforts to use these nascent groups as a framework for security cooperation, it is believed, would complicate and delay membership in Western institutions. Also, East-Central Europeans believe that these groupings would be inadequate to meeting any of the likely security threats to these countries. These groups suffer from the wavering commitment of members. For example, the Czechs have sought to downplay Visegrad in favor of the Central European Initiative, in part because of concern about Polish domination of the group and because it is made up entirely of East-Central European members.

Ukrainian officials have promoted the idea of a new security grouping of countries between NATO and Russia (a Baltic to Black Sea security group) but this initiative has not been embraced by others. Such a group would be likely to provoke Russia and turn away the West, in the view of many East-Central Europeans, and further relegate the region to a "grey zone" between East and West. It is not even clear that the new Ukrainian government supports the idea.

Bilateral Efforts

All of the East-Central European countries have sought to enhance their security through bilateral initiatives with neighbors, major European powers and the United States. U.S. bilateral military cooperation with all the countries of the region has expanded considerably in recent years. German and Franco-German military relations, especially with Poland and the Czech Republic, have grown significantly. Constructive military consultations and cooperation within East-Central Europe, for instance between Hungary and Slovakia, as well as Hungary and Romania, have provided a counterweight to tense political relations. However, all these efforts are generally seen as components of and stepping stones to wider security cooperation in the framework of NATO. If NATO membership were foreclosed, these arrangements might gain enhanced importance as a necessary substitute.

Unilateral Measures

With the break-up of the Warsaw Pact, the initial trend in East-Central Europe was to institute drastic cuts in military spending and a build-down of forces. That downward cycle seems to have run its course in most countries, which are now feeling militarily weak and vulnerable. Most have begun a modest modernization program and tried to address some of their most serious deficiencies such as air defenses. They have also begun to adapt their military doctrine and force structure to the post-cold war environment, introducing concepts of territorial defense and redeploying forces to meet a range of potential threats. These efforts are hampered by a severe shortage of resources and continuing priorities in other areas. Should East-Central European countries be permanently frustrated in their effort to gain membership in NATO, one possible consequence could be to encourage very destructive local defense build-ups and arms races, diverting resources from other high priority areas and increasing regional tensions. So far there is no evidence of such trends.

In addition to defense decisions, the most significant domestic policies affecting security are those concerning political and economic conditions within each country. Countries that have best stayed the course toward democracy and market reform have also been the most stable. Prospects of NATO and European integration provide strong outside incentives to stay the course. However, the decisive factor remains the commitment of the people and political elites. Thus far, frustration and disillusionment with political leaders as a result of the hardships of transformation have not translated into weakened support for the democratic system in most of East-Central Europe.

PROSPECTS

NATO membership in the not too distant future for at least some East-Central European countries is a real possibility, though not assured. Their persistence and NATO's search to recreate itself could combine to effect such an outcome. They are making the most of Partnership for Peace to draw closer to NATO. NATO association at whatever level and speed seems better than any other security instrument that might be available in the view of most East-Central European governments. However, even full NATO membership might not provide the security panacea that the East-Central Europeans had hoped for, if NATO is changing as much as many experts believe. NATO may no longer offer iron-clad security guarantees.

In the end, the East-Central Europeans may not have available the single comprehensive security arrangement they desire. Perhaps the security options outlined above should not be seen as alternatives but rather a package of imperfect measures which, taken together, nevertheless would provide significant enhancements to East-Central European security.

THE ECONOMIC IMPACT OF UNIFIED GERMANY ON CENTRAL AND EASTERN EUROPE

By Heinrich Machowski and Wolfram Schrettl *

CONTENTS

SUMMARY

For Eastern Germany, unification with Western Germany resulted in quantum (upward) jumps of both the exchange rate and real wages. As a result, Eastern German producers were priced out

* Heinrich Machowski is a Research Analyst and Wolfram Schrettl is Head, Central & East European & NIS Dept. with the German Institute for Economic Research (DIW), Berlin. The authors are indebted to Axel Schumacher for valuable help in compiling the statistical data.

of their markets, including those in Central and Eastern Europe (CEE). By 1993, Eastern German exports to CEE had collapsed to around or below 20 percent of their 1990 levels. The collapse of imports was in the same order of magnitude as Eastern German demand turned away from products of local (Eastern German) and CEE origin. Thus, German unification almost wiped out the CEE region's trade with Eastern Germany. It was hoped that increased CEE trade with Western Germany would, in the long run, make up for the lost trade with Eastern Germany.

To the surprise of many observers, that expectation has materialized already over a very short period. The increase of CEE trade with Western Germany was spectacular enough to exceed the losses to the CEE region from reduced trade with Eastern Germany. As a result, Germany now ranks first among the trading partners of Central and Eastern Europe, both with regard to exports and with regard to imports, and unregistered exports of CEE countries to Germany appear to have grown vigorously. In the case of Poland, they are estimated to have reached $2.3 billion in 1993, almost exactly the size of the country's official current account deficit.

These developments are all the more remarkable as they have occurred at a time of recession in Germany, i.e. total German trade declined, while trade with the CEE region increased dramatically. The cyclical recovery currently under way in Germany may trigger an even more dramatic expansion of CEE-German trade, provided the region is capable of meeting demand and the European Union (EU) does not restrict market access.

As German unification was largely financed through capital markets, it did have a significant impact on interest rates, thus raising concern that the CEE region's cost of capital would be driven up, in this way delaying transformation of its economies. The concern proved to be short-lived. After a brief increase, long-term interest rates fell back, in the wake of the global recession, to near their all-time lows. Although short-term rates remained indeed high for quite a while, this did not affect the CEE region in the same way as Western Europe. There, the combination of German fiscal boost and monetary restraint mattered, whereas in the CEE region it was only the former that made itself felt.

At present exchange rates, wage costs in the CEE region average only one-tenth or less of Western German levels. Even on very optimistic assumptions about growth of labor productivity in the CEE region, a huge wage differential is bound to persist for the foreseeable future. It opens opportunities not only for trade but also for direct investment. German direct investment in the CEE region increased considerably, especially into Hungary and the Czech Republic, where the respective cumulative totals reached DM2.3 billion and DM1.9 billion in 1993, from virtually nil in 1989. Hungary had a head start of about one year, with the Czech Republic catching up rapidly. Poland is trailing behind with relatively meager DM0.5 billion. Although concentration of Germany's foreign direct investment on the CEE region is now twice as strong as that of its exports, the United States is ranking ahead of Germany as the most important foreign investor in the region. Once Germany has come to grips with the problems posed by unification and once the cyclical upturn gains strength, German direct investments in the CEE region are very likely to receive an additional boost.

Unified Germany, while supportive of Central and East European efforts to move closer to the EU, is embedding its policy firmly into an EU context. The ambitions of the Visegrad countries (CEFTA) are clearly directed at early EU membership, on a firm time schedule for entry. However, a number of obstacles stand in the way. Most important, the EU policy has been thrown into turmoil by the partial failure of overambitious Maastricht plans. The present redesign-stage is far from over. Conflicting interests, both within and among EU member states, are likely to delay the CEE countries' integration into the EU. Prospects for an early commitment, on the part of the EU, regarding the time schedule of CEFTA countries' access to the EU look slim. Eventual membership, however, looks certain.

INTRODUCTION

Before German unification, West Germany was Eastern Europe's leading Western trade partner. At the same time, East Germany ranked second, after the Soviet Union, among Eastern Europe's trade partners within the now-defunct Council of Mutual Economic Assistance (CMEA).[1] For those two reasons alone, it should not come as much of a surprise that unified Germany was early on expected, by the majority of observers, to play a substantial role in the emerging trade pattern of, and possibly other matters of importance for, Eastern Europe. Such expectations may be further substantiated by looking back a bit farther into history: The expansion of the Soviet empire after World War II entailed an enormous amount of trade diversion for the East European economies, i.e., away from the traditional trading partners in Western Europe. That process, as well as that of trade creation, to the extent that it occurred within the CMEA, was dominated by political rather than economic considerations. Hence, with the disappearance of the underlying political distortions, memories of losses from suppressed trade should translate into efforts to reap gains from renewed trade, i.e., "natural" factors, such as comparative advantage and geographic proximity, should be expected to resurface as major determinants of Central and Eastern Europe's trade patterns.

At the same time, there is no denying that memories extend beyond the losses from suppressed trade. They also include concerns, indeed *angst*, that German economic dominance may (re-)create a pattern of dependence.[2] For Eastern Europe, which is still struggling to escape from the gravitational pull of the Russian geopolitical mass, the prospect of being exposed to the unchallenged force of unified Germany does not appear to be overly attractive. Thus, for Eastern Europe, the expansion of economic ties with unified Germany inevitably entails quite a mixed bundle of pros and cons—as it does for Germany. Yet, the bottom line signals such irresistible advantages for all the countries involved that, in the four years that have passed since German unification, the expansion of

[1] See, for example, Inotai (1992) and Woods (1989).
[2] Cf., for example, Inotai (1992), p. 294.

economic ties has clearly ceased to be put in question. The only remaining issue is "how" best to expand those ties.

In this paper we first look at the developments in the area of foreign trade between Eastern Europe and Germany that have occurred since unification. Next, we briefly touch upon the situation in the respective labor markets that are underlying the evolving trade. In the subsequent section, we look at the German record of foreign direct investment (FDI) in Eastern Europe. This is followed by a discussion of the German role in shaping the EU's policy *vis-à-vis* Eastern Europe. Finally, we try to evaluate the impact of unified Germany on Eastern Europe from a number of more general perspectives.

For the purpose of the present paper, the notion of Eastern Europe, or Central and Eastern Europe (CEE), is understood to comprise Poland, the Czech Republic, the Slovak Republic, and Hungary, i.e., the Visegrad countries or, as the become increasingly called, the Central European Free Trade Agreement (CEFTA) countries.[3] While the major reason for confining our attention to those countries is data availability,[4] it is also true that, by a wide margin, the most important developments in the region did, and will continue to, happen in the Visegrad countries' relationship with unified Germany.

FOREIGN TRADE

For Eastern Germany, unification with Western Germany implied quantum (upward) jumps both of the level of exchange rate and of the real wages.[5] As a result, Eastern German producers were priced (or priced themselves) out of their domestic as well as foreign markets, especially CEE markets. Beginning in 1991, Eastern German exports to the CEE region experienced an outright collapse. According to the latest available figures, for 1992 and 1993, respectively, Eastern German exports to CEE have fallen to around 20 percent of their 1990 levels (see Table 1A).

At the same time, Eastern German demand turned away from products of local (Eastern German) and CEE origin toward products of Western (German or European) provenance. This reorientation of demand resulted in a dramatic decline of Eastern German imports from the CEE region which, of course, is tantamount the loss of an important export market for those countries. The extent of the decline (see Table 1B) does not appear to be quite as dramatic as the decline of Eastern German exports. However, the collapse of Eastern German imports, unlike that of exports, began already in mid-1990. Therefore, the use of 1990 as a year of reference understates the true extent of the collapse. A rough attempt to cor-

[3] On 21 December 1992 the economic ministers of Poland, the Czech Republic, Slovakia, and Hungary signed an agreement in Cracow, Poland, providing for the establishment of a free-trade zone between the four—formerly three—members of the so-called Visegrad Triangle. The agreement, which took effect on 1 March 1993, is to reduce customs duties over a three-stage, eight-year period. See Okolicsanyi (1993)

[4] For completeness, it should be mentioned that data problems have emerged both in CEE and within the EU. In the former, it is simply because transition happens to affect statistical methodologies and the collection of data as well. In the latter, with the beginning of the EU single market, foreign trade statistics have been thrown into turmoil. Finally, the adaptation of statistical reporting in the previous German Democratic Republic (GDR) to a different set of standards did not happen instantaneously.

[5] An economic rationale for these policies is given in Schrettl (1992).

rect for that bias (by assuming that the level of Eastern German imports during the first half of 1990 was maintained during the second half-year, i.e., by doubling the former import figure) indicates that the subsequent collapse of imports was in the same order of magnitude as the collapse of exports.

In sum, German unification almost wiped out Eastern German trade with the CEE region. For the latter, this meant that an important source of export revenues was drastically reduced. This in turn was taken as the basis for vigorous demands raised in some CEE countries that the new unified Germany should compensate them for the losses.[6]

However, these claims need to be put in perspective in an number of ways.[7] As a minor point, it should be noted that the collapse of CEE trade with Eastern Germany also meant the disappearance of a trade deficit that the region had been running with Eastern Germany. Moreover, the exchange rate and wage policies pursued in Eastern Germany, while resulting in the collapse of trade with the CEE region, also helped that region to get rid of yet another low-wage competitor country.

Most important, however, the decline of the CEE region's trade with Eastern Germany needs to be juxtaposed to the increase of trade with Western Germany in order to allow for a proper assessment of the net impact. It became clear soon after unification that CEE trade with Western Germany would follow a significant upward trend.[8] What appears to have taken observers by surprise is that the increase was spectacular enough to fully make up for, and exceed, the lost CEE trade with Eastern Germany (see Tables 2A, 2B, 3A, 3B). Thus, the hope that, in the long run, the short-term losses to the CEE region from reduced trade with Eastern Germany could be recouped has materialized already. This is all the more remarkable as it occurred at a time of recession in (Western) Germany. Both Western German imports from and exports to the CEE region increased dramatically while total Western German imports and exports stagnated or even slightly declined.

It is tempting to expect an even more dramatic expansion of CEE-German trade once the cyclical recovery that seems presently to be under way in Germany gains strength. However, a word of a warning is in order: The most recent trade figures appear to indicate that some stagnation may have set in. To the extent that this is more due to the exhaustion of quotas for critical EU imports (steel, textile, and agricultural products),[9] rather than to the exhaustion of the regions' export potential, hopes for a further expansion of CEE exports may be better justified. However, at present this is an open issue.

A further remark concerns the trade balance of the CEE region with unified Germany. Western German imports from as well as exports to the region increased dramatically. At the same time, the increase of Western German exports exceeded that of imports. As a result, a Western German trade surplus with the CEE region developed (see Table 2C). When combined with the disappearance of

[6] See, for example, the discussion in Inotai (1992), pp. 284–85.
[7] We do not go into the legal aspects of the discussion. See again Inotai (1992), pp. 284–85.
[8] See Möbius (1992).
[9] In addition, there are tariff quotas, for example, for cement.

the Eastern German trade surplus with the CEE region (see Table 1C), the overall result is still a trade surplus of unified Germany with the region (see Table 3C). In particular, German exports to the region continued to grow strongly in 1993 while German imports from the region stagnated, resulting in a tripling of the CEE trade deficit with Germany as compared to the previous year. Should this pattern persist, it cannot fail to have further repercussions, as ways will have to be sought to finance the trade deficit, for example by an adequate policy for attracting more substantial amounts of foreign direct investment. A strong mitigating factor may be seen in the apparently very large amounts of unregistered exports of CEE countries to Germany.[10] For example, a Polish estimate puts the country's unregistered net exports to Germany in 1993 at $2.3 billion, practically equivalent to the current account deficit Poland incurred in the same year.[11]

The impact of unified Germany on the CEE region's trade pattern can be put in perspective by looking at the individual CEE countries' statistics of foreign trade. Trade developments in the Czech and Slovak Republics (see Tables 5A, 5B, 6A, 6B) continued a trend that had begun in the previous Czechoslovakia (see Tables 4A and 4B): Within a very short period, basically in the years from 1990 to 1992, the share of Czech and Slovak exports going to Germany virtually doubled, i.e. from about 15 percent of total exports to about 30 percent. Over the same period, the share of Czech and Slovak exports going to the region of the former Soviet Union that had previously accounted for more than 30 percent collapsed to about 10 percent. In the case of the Czech Republic, the decline was much more pronounced (share of former Soviet Union in 1993: 6 percent) than in the Slovak Republic.[12] As a result, from 1991 Germany swapped ranks with the former Soviet Union and became the number one buyer of Czechoslovak exports. This is also true for the Czech Republic. In the Slovak Republic, the ranking changed one year later, i.e., in 1992.[13]

On the side of Czech and Slovak imports, the same trends prevail, although not quite as pronounced (see Tables 5A, 5B, 6A, 6B). Germany's share in total imports rose from about 17 percent to about 25 percent. Again, the increase proved stronger in the Czech than in the Slovak Republic. Furthermore, as was the case on the export side, the share of the former Soviet Union in Czech and Slovak imports declined. Mainly due to continued energy deliveries from the Russian Federation, the decline remained comparatively modest, i.e., from about 30 percent to 25 percent. For the Slovak Republic alone, the respective share remains significantly higher, i.e., at about 50 percent. As to the ranking of trade partners, Germany again assumed the role of the former Soviet Union as the, quantitatively at least, most important source of imports for the Czech Republic. For the Slovak Republic, however, the former Soviet Union managed to retain its position as the foremost supplier of imports.

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[10] Mainly purchases of German visitors in the border area.

[11] Estimate of the Polish Central Planning Agency; see *Frankfurter Allgemeine Zeitung*, March 14, 1994, p. 16.

[12] This applies to the decline up to 1992. Slovak figures for 1993 are not directly comparable because trade with the Czech Republic is defined as foreign trade for the first time.

[13] From 1993, the Czech Republic is Slovakia's largest trade partner.

Taking the export and import sides of Czech and Slovak foreign trade together, the most important change in the regional composition of trade is the quite dramatic reorientation from the former Soviet Union to Germany as the primary trade partner.

In the case of Poland, the picture appears to be almost identical. The share of Germany in total Polish exports increased from below 20 percent in 1988 to over 35 percent in 1993 (see Table 7B), with the majority of the increase taking place in 1990 and 1991.

The share of the former Soviet Union in Polish exports declined from almost 25 percent in 1988 to below 15 percent in 1993. As a result, in 1990 Germany took over from the former Soviet Union as the most important buyer of Polish exports. As to Polish imports, the share taken by Germany increased from below 18 percent in 1988 to 28 percent in 1993, while the share of the former Soviet Union decreased over the same period by about 15 percentage points, i.e., from about 22 to about 7 percent (see Table 7A). Already in 1989, Germany replaced the former Soviet Union as the leading source of Polish imports.

Overall, taking together the export and the import sides, the regional composition of Polish foreign trade experienced a radical reorientation away from the former Soviet Union, with Germany taking its place instead.

The changes in the regional orientation of Hungary's foreign trade display a general pattern that is similar to that of Poland and the Czech and Slovak Republics. The share of Hungarian exports going to Germany rose from about 16 percent in 1988, by a full 10 percentage points, to about 26 percent in 1993 (see Table 8B). Most of the increase occurred in 1990 and 1991. The share of the former Soviet Union in Hungary's total exports declined from 28 percent in 1988 to about 15 percent in 1993. Again, most of the decline happened within only two years, 1990 and 1991. Consequently, from 1991 Germany became the primary buyer of Hungarian exports, a position previously held by the former Soviet Union.

Hungarian imports seem to represent an exception to the general pattern that has so far emerged. The share of imports coming from Germany does not display a clearly discernible upward or downward trend. Instead, it hovered, from 1988 through 1993, around a level slightly above 20 percent (see Table 8A). Although the share of Hungarian imports originating from the former Soviet Union declined from over 25 percent in 1988 almost down to 15 percent in 1991, it bounced back strongly in 1993 to over 22 percent. This may be due to a singular event, namely the settling of old (Soviet era) debts on the part of Russia by way of providing military equipment. Nevertheless, Hungarian exports to Germany did not expand dramatically, as was the case of the other CEFTA countries. This seems to indicate that the expansion, which had occurred earlier and over a longer period, has begun to encounter ever more formidable obstacles.

The overall picture that emerges from the foreign trade statistics of the CEE region supports the proposition that the expansion of Western German trade with the region not only made up for the decline of the region's trade with Eastern Germany but was vigorous enough to catapult Germany to the number one rank among the trade partners of Central and Eastern Europe, both with regard to exports and imports.

FACTORS OF PRODUCTION

While developments in the field of foreign trade are clearly the main channel for unified Germany's impact on the CEE region, it is worthwhile to take a look at other areas of importance as they, to a considerable extent, represent the basis for the observed trade pattern. As to labor markets, the "giant sucking sound of jobs" so vividly discussed, but not heard, in the context of NAFTA, resounded all the more deafening throughout Eastern Germany. The jobs lost there were spread mainly over Western Germany and Western Europe but, indirectly at least, went also to the CEE region as evidenced by the dramatic expansion of German imports from there. While the jobs that have already been lost were almost exclusively located in Eastern Germany, concerns about further job losses in all of Germany play a significant role in the current public debate of the country.

The basis for such concerns is the huge wage differential between Germany and its neighbors to the East.[14] At present exchange rates, hourly wage costs in the CEE region average only one-tenth, or less, of Western German wage costs which currently stand at around DM45. It is true that wage costs in Eastern Germany have not yet fully reached Western German levels. However, they have been catching up rapidly, and continue to do so, although not quite as rapidly as some had hoped or feared, respectively. In any case, Eastern German wages are clearly in the ballpark of Western German wages, not CEE wages. The crucial point, however, is that the wage-differential between Germany and the CEE region is an important, if not the most important, factor underlying the continued expansion of mutual trade. Even on extremely optimistic assumptions about the growth of (economy-wide) labor productivity in the CEE region, a very substantial gap of the average wage differential relative to Germany is bound to persist over the foreseeable future, lest the CEE region were intent on pricing itself out of the market—as Eastern Germany did, though the latter could do so only with the help of huge financial transfer payments from Western Germany.

As German unification was largely financed via the capital markets, it did have a significant impact on interest rates. This effect initially raised some concerns that CEE countries' costs of capital would be driven up, in this way delaying the transformation of the region's economies. The concerns proved to be short-lived. Increased German needs for long-term financing were indeed accompanied by an increase of long-term interest rates of about 2 percentage points. However, in the wake of the recession that had already started in the Western industrialized economies, long-term interest rates quickly fell back, in some countries to near their all-time lows. Not surprisingly, complaints about the impact of German unification on long-term interest rates on world capital mar-

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[14] However, the discussion in Germany is not formulated in terms of the proverbial "giant sucking sound of jobs," as in the United States, but, less graphically (or, rather, less acoustically), in terms of *Billiglohnländer vor der Haustür* (cheap-labor countries at the front door).

kets soon subsided. Of course, short-term (money market) interest rates shot up steeply in the wake of unification and, until recently, remained very high in Germany and Western Europe.

Yet, the inverted term structure of interest rates ("yield curve") did not have a discernible direct impact on the CEE region. Accordingly, complaints were raised mostly in Western Europe. In the United States, short-term rates have been extremely low throughout and, actually, began only recently to nudge up. In Western Europe, short-term rates are still on their way down, with the inverted yield structure having ended some time ago. It may be argued that high short-term rates nevertheless had a detrimental influence on the CEE region simply by contributing to the recession in Western Europe.

However, already in the Western European cases, the complaints about restrictive German monetary policies mostly fail to look at the other side of the coin—the expansive German fiscal policy. After all, the latter caused a significant boom in exports from Western European countries to Germany. While the net effect of German monetary restraint and fiscal boost on Western Europe continues to be subject to debate, for the CEE region it was overwhelmingly the fiscal boost that mattered. To the extent that short-term interest rates in the region were and continue to be high, the underlying reason is to be found in the monetary authorities' desire to combat domestic inflation rather than the need, as in Western Europe, to follow Bundesbank policy.

The concerns raised in Germany about job opportunities leaking to the CEE region mostly come in tandem with concerns about investment leaking to that low-wage region as well. The criticism these "twin leaks" meet in Germany does not necessarily imply that they are welcome in the CEE region. The aforementioned fear that German dominance may create a pattern of dependence is palpable even to the casual observer. At the same time fears are expressed in the CEE countries that the disappearance, in the wake of unification, of the German current account surplus has weakened the country's foreign investment capacity to such an extent that little will be left for the region's economies. Furthermore, German companies are feared to have adopted a wait-and-see attitude, considering investment in Eastern Germany, regardless of the high wage costs, rather than in the CEE region, because of the former's prospects for a rapidly improving infrastructure. [15] In short, "twin fears" coexist: the fear that German investors will come and the fear that they will not come.

It is worthwhile to take a look at actual developments in the area of German direct investment in the CEE countries. However, a word of warning is due with respect to the data. Various sources differ by significant orders of magnitude. Satisfactory explanations are missing. Therefore, the data should be taken with more than a grain of salt. In particular, it could be strongly misleading to make comparisons based on data originating from different sources. With these reservations in mind, Table 9 indicates that, up to the end of 1993, Hungary has managed to attract larger amounts of German direct investment than any other economy in the region,

[15] For both concerns, see Inotai (1992), p. 288.

with the cumulative total reaching DM2.26 billion at the end of 1993. The Czech Republic is following closely, with DM1.91 billion, whereas Poland is trailing behind, having accumulated only a modest amount (relative to the country's size) of DM0.55 billion. The Hungarian lead has to be put in perspective, however, as the country benefitted from a clear head start of at least one year. The Czech Republic is catching up vigorously, and it may become ever harder for Hungary to maintain its lead. It should be noted that, in both countries, individual projects have a strong impact on aggregate figures. Thus, in the Czech Republic, for example, the stake taken by Volkswagen in Skoda is a case in point. The same applies to the stake taken recently by Deutsche Telekom in Matav, the Hungarian telephone company.[16] Not surprisingly, the Slovak Republic, due both to its late start and its size, has attracted only insignificant amounts of German direct investment. This is even more true for those CEE countries that are not mentioned in the table, as the CEFTA-four taken together capture as much as 92 percent (1993) of total German direct investment in CEE countries (the Baltic states and the Commonwealth of Independent States included).

A comparison of German foreign direct investment and German exports reveals a strong discrepancy in the extent of reorientation toward the CEE region (Table 10). While the share of the CEE region in German exports increased from 3 percent in 1990 to 4 percent in 1993, the region's share in German foreign direct investment jumped over the same period from a mere 0.7 percent in 1990 (and practically nil before) to as much as 8.5 percent in 1993. Thus, the concentration of German foreign direct investment on the CEE region is now more than twice as strong as that of exports.

It is tempting to combine this result with our previous finding that Germany has become the leading trade partner of the CEE region and to conclude that Germany has also developed the strongest foreign direct investment presence in the region. However, this is not so. As can be seen from Table 11, the leading country of origin as far as foreign direct investment in the CEE region is concerned, is the United States; Germany ranks second. Thus, for the United States we see a considerably stronger presence in the area of foreign direct investment than in the area of trade whereas for Germany the opposite is true. Of course, this observation is to some extent merely a reflection of the different overall share of both countries in world trade and foreign direct investment, respectively, and in particular of the different shares of both countries in OECD trade with the CEE region.[17]

In sum, the information available to date about German direct investment in the CEE region justifies neither of the "twin fears." It would certainly be wrong to say that German investors are absent. But it would be equally wrong to speak of an overwhelming presence. Of course, the picture as it has evolved in the years since unification may be an ill-suited guide to future developments.

[16] At the end of 1993 Telekom, the telecommunications arm of Deutsche Bundespost, together with American International, acquired a 30.3 percent stake in Matav for $875 million. See, for example, *Neue Zürcher Zeitung*, May 25, 1994.

[17] For example, in 1992 Germany's share in OECD exports to the CEE region was 37.5 percent, whereas the share of the United States was only 8.5 percent.

Thus, it may be argued that once Germany has come to grips with the problems posed by unification, German foreign direct investment in the CEE region will start in earnest.[18]

On the assumption that this window-of-opportunity theory correctly portrays the situation and is indeed believed and acted upon by non-German investors, it must be concluded that the mere presence of potential future German investment should be regarded as extremely helpful for the CEE countries because it coaxes competing investors into action, with German investors coming on top. Of course, the theory may turn out to be little more but an unsuccessful sales pitch.

A dramatic increase of the role of German banks in hard currency debt of CEFTA countries can be observed in 1991. The share of gross bank debts of the Czech and Slovak Republics owed to German banks jumped from 23.4 percent in 1990 to 41.0 percent in 1991 (see Table 12). Over the same period, the respective share for Poland increased from 31.9 percent to 41.1 percent, and in the case of Hungary from 30.9 percent to 37.1 percent. These increases are due to German government policy during and in the immediate aftermath of unification. The German government had decided to continue the CMEA's regime of trade settlement in transferable rubles through the end of 1990, i.e., beyond the currency union (July 1, 1990).

In so doing, the German government applied the general rate of converting Marks (GDR) in DM, i.e., 2:1, thus setting the new exchange rate of the transferable ruble at DM2.34 (instead of the previous 4.67 Marks).[19] Only at first glance does this look like a devaluation of the transferable ruble. In reality, the new rate amounted to a revaluation of the transferable ruble, in the same way as the intra-German rate of currency conversion, was "much too favorable" for the Mark (GDR). Not surprisingly, imports of the CMEA region from Eastern Germany continued more or less unchanged whereas the region's exports to Eastern Germany collapsed. As a result, as long as the trade regime in transferable rubles lasted, i.e. throughout 1990, Eastern Germany ran a huge current account surplus with the CMEA.[20]

In February 1991 the short-run debt incurred by the CMEA-Bank in Moscow was transformed into long-term debt of the individual countries' foreign trade banks. In sum, the significant increase of the CEFTA countries' hard currency debt *vis-à-vis* German banks that can be observed in 1991 was not due to the banks decision to lend "fresh money." Instead, it can be traced back to a German government decision to introduce and guarantee an exchange rate of the transferable ruble that was highly favorable especially for Eastern German companies exporting to the CMEA.

[18] It is worth quoting Inotai (1992), p. 296: "The best chances for non-German investors to establish firm positions in Central and Eastern Europe are probably limited to the period in which Germany is still fundamentally absorbed in intra-German issues. Once these problems have been settled . . . a new, dynamic Germany emerges in Europe, German influence in Central and Eastern Europe will increase rapidly if other interested countries do not establish themselves in the region beforehand."

[19] For some background, see Machowski (1991).

[20] According to the International Bank for Economic Cooperation, Moscow, the current account surplus amounted to 10.5 billion transferable rubles, roughly DM24 billion at the (arbitrarily fixed) exchange rate. More than 60 percent of that surplus originated from trade with the (former) Soviet Union (DM 15 billion).

Settlement of the debt, incurred in this way by the CEFTA region, is still an open issue.

EUROPEAN UNION

The states of Eastern Europe, in particular the CEFTA countries, are making considerable efforts to escape from the gravitational pull of the Russian geopolitical mass, both for economic and for security reasons. And they expect Western assistance in their efforts to become the east of the west rather than the west of the east. For geographic reasons as well as for reasons of weight within the EU, most East Europeans and many West Europeans expect Germany to play a crucial role in facilitating that process. At the same time, various concerns have been raised. One old fear raised in the West was that Germany might turn eastward alone. Another danger, seen in Eastern Europe, is that Germany might just replace Russia as the dominant partner. In response to both concerns, Germany is making every effort to fulfill its task *vis-à-vis* Eastern Europe while remaining firmly embedded in the West, especially in the EU.[21] However, this strategy again raises concern that Germany may be tempted to throw around its weight within the EU, i.e. may unduly influence EU policy. Others in turn fear that Germany may be too weakened by the burden of unification to be particularly effective at all.

The German tactics that have evolved since 1989 aim at bringing Eastern Europe closer to the EU and, in particular, facilitating eventual EU-membership of the CEFTA countries. It appears that Germany is now intending to show more resolve in implementing its tactics than in the past. While the association agreements with Poland and Hungary were signed in December 1991, it took the German Parliament more than two years to ratify them; they became effective only in February 1994.[22] The agreement with the Czech and Slovak Republics, which needed to be renegotiated as a result of the breakup of Czechoslovakia, and with Bulgaria and Romania still await ratification.

However, a partial change of speed may be in the offing. Germany has announced that during its six-month presidency of the EU (from July 1, 1994), it will seek to accelerate market-opening measures and push for EU restraint in instituting anti-dumping and other protectionist measures against CEE countries. Most important, the German minister of foreign affairs, Klaus Kinkel, has given priority to the task of bringing CEE countries closer to the EU over the task of improving ties between Russia and the EU.[23]

For the CEE countries, it is of particular importance to see whether the EU is prepared to go beyond the resolutions of the Copenhagen Summit (June 1993) of the EU, where it had been decided that, in principle, associate states can become EU members.[24] At the same time, however, conditions for membership had been defined in such a way as to allow for the de facto exclusion , if nec-

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[21] For a discussion of related issues, see Franzmeyer (1993).

[22] In all fairness, it should be added that the trade parts of the association agreements had been effective, in the form of "interim agreements," from March 1992.

[23] At the same time, Kinkel argued, the emergence of new rifts with Russia need to be avoided. See *Süddeutsche Zeitung*, May 19, 1994.

[24] For a discussion, see Machoswki (1993).

essary perpetually, of CEFTA countries. These conditions are: (1) the capacity of the country concerned to assume the obligations of membership (the acquis communautaire); (2) the stability of institutions in the candidate country guaranteeing democracy, the rule of law, human rights and respect for minorities; (3) the existence of a functioning market economy; the candidate's endorsement of the objectives of political, economic and monetary union; (4) its capacity to cope with competitive pressure and market forces within the Union; and (5) the EU's capacity to absorb new members while maintaining the momentum of European Integration.

Demands, such as that by the Polish minister of foreign affairs, Andrzej Olechowski, for a "more committed statement" are a clear reference to the limitations of Copenhagen. The type of commitment which CEE countries would need more than anything else is a firm date for membership.[25] A firm date would provide a secure base for potential investors to plan activities in the region. At present, prospects for an early commitment on the part of the EU look slim. Günter Rexrodt, the German economics minister, in outlining his government's strategy for the forthcoming German EU presidency, stated that formal EU membership negotiations with Poland and Hungary could only begin once the EU had agreed on the next round of institutional reforms scheduled for 1996, i.e., the follow-up conference to Maastricht.[26] This appears to indicate that a firm commitment of the EU on an entry date for the CEFTA countries will not materialize during the six-month German presidency. However, as France and then Spain will follow Germany in the presidency, the considerable degree of coordination among the three that has apparently emerged[27] leaves some chance that the period of equivocating on the issue of an entry date may come to an end before 1996.

Realistically, this would require the removal of a number of obstacles along the way. Thus the Czech Republic, which makes every effort to distance itself from Poland and Hungary, much to the dismay especially of Poland, has not even bothered to submit a formal application for membership. A probably more formidable obstacle is to be found in the as yet unresolved conflicts of interest both within Germany and within the EU. For example, the extent of "deepening" envisaged in the Maastricht treaty had been quite ambitious already at the design stage. It entailed sacrifices that went to the limit of what appeared acceptable to the participating states. However, as Maastricht had been conceived before the collapse of the CMEA and before German unification, some of the underlying assumptions have changed in the meantime. As a result, what had, at the outset, appeared merely ambitious, may now have become outright unrealistic. Thus, the usual conflict between widening and deepening of European integration has sharpened. The resolution of this conflict is far from clear. Various models are being dis-

[25] The Czech Prime Minister Václav Klaus (1993, p. 11) puts it less directly: "... we ask for a realistic timetable for the major moves towards integration." The winner of Hungary's election, Gyula Horn, directed an "urgent request" to the EU members and the EU commission to come up with a timetable for the CEE countries' EU membership. (See *Süddeutsche Zeitung*, June 13, 1994.)

[26] See *Financial Times*, May 27, 1994.

[27] For example, see the report on the meeting of the Spanish Prime Minister, Felipe Gonzalez, and Chancellor Helmut Kohl in *Financial Times*, June 8, 1994.

cussed. Recently the German Bundesbank has thrown its weight in favor of the model of "concentric circles" as a way of reconciling deepening with widening, at the same time de-emphasizing the role of commitments to time schedules.[28] Should this or any other method of reconciliation turn out to be infeasible, then the conflict will have to be resolved by at least partially sacrificing one of the two alternatives. It appears that the number and weight of those favoring a faster integration of CEFTA countries, i.e., a faster widening of the EU at the expense of deepening, are increasing. This includes various business groups, with the exception, of course, of those who would be negatively affected, particularly steel and agriculture. At the other end of the spectrum, the strategic interest of the West both in the success of the economic reforms in the CEE countries and, as an argument of last resort, in their military security continues to build. The important point, however, is the lack of a consensus on these issues. Thus, the time to reach such a consensus will most likely translate into a considerable loss of time.

Concluding Remarks

This paper has described the developments in the area of foreign trade between the CEE countries and Germany as they have evolved over the period 1990 through 1993. We have taken a look at the pertinent developments in the labor and capital markets as well as in the area of foreign direct investment. Finally, we have discussed the role of Germany in the EU's policy *vis-à-vis* CEE countries.

The impact of a unified Germany on the CEE region appears to have been almost uniformly positive, insofar as Germany provided an outlet for CEE exports and a source of foreign direct investment. In this sense, unified Germany has very significantly contributed to the stabilization and transformation efforts of the region. Nevertheless, a number of critical remarks are in order. First, the CEE countries clearly would have appreciated an even stronger expansion of their exports to Germany. This criticism targets EU restrictions concerning market access. A fully satisfactory solution to this complex set of issues is closely intertwined with progress in the current redesign phase of European integration. Second, although German foreign direct investment in the CEE region could easily have been much stronger, this has not met much criticism for the obvious reason that CEE countries aim at maintaining a prudent balance among investment's countries of origin. Thus, non-German investors are called upon to come forward. Third, although Germany did indeed considerably strengthen its economic ties with the CEE region, this turns out to have been an almost exclusively Western German affair. Eastern German economic ties with the region experienced an outright collapse, which even now shows little signs of reversal. In this sense, then, it can be concluded that the economic impact of *unified* Germany is yet to come. Much will depend on the economic recovery of Eastern Germany which, fortunately, has begun to proceed with undeniable momentum.

[28] See the interview with Hans Tietmeyer, President of the Bundesbank, in *Handelsblatt*, June 6, 1994.

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TABLE 1A. Trade of Eastern Germany with CEFTA: Exports, 1990–1993

Export Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Exports	38.1	17.4	13.3	11.9	7.3	5.6
CEFTA	9.0	2.0	1.5	NA	0.7	0.6
Czech and Slovak Republics	3.4	0.6	0.8	NA	0.4	0.3
Poland	2.9	1.0	0.5	NA	0.2	0.2
Hungary	2.7	0.4	0.2	NA	0.1	0.1
Ex-CMEA[b]	29.8	11.4	7.2	6.3	4.0	3.1
	Annual Rate of Change, Percent					
Total Exports	[c]	–54.2	–23.6	–10.8	–16.6	–23.4
CEFTA	[c]	–77.7	–26.0	NA	–43.7	–15.8
Czech and Slovak Republics	[c]	–81.0	22.1	NA	4.5	–24.8
Poland	[c]	–66.2	–47.2	NA	–67.0	–2.3
Hungary	[c]	–86.0	–52.4	NA	–53.9	–11.5
Ex-CMEA[b]	[c]	–61.7	–37.1	–12.9	–49.4	–22.0
	Index 1990 = 100					
Total Exports	100.0	45.8	35.0	31.2	NA	NA
CEFTA	100.0	22.3	16.5	NA	NA	NA
Czech and Slovak Republics	100.0	19.0	23.2	NA	NA	NA
Poland	100.0	33.8	17.9	NA	NA	NA
Hungary	100.0	13.9	6.6	NA	NA	NA
Ex-CMEA[b]	100.0	38.3	24.1	21.0	NA	NA
	Share of Total Exports, Percent					
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0
CEFTA	23.8	11.6	11.2	NA	9.5	10.5
Czech and Slovak Republics	8.9	3.7	5.9	NA	5.2	5.1
Poland	7.7	5.7	3.9	NA	3.0	3.9
Hungary	7.1	2.2	1.3	NA	1.3	1.5
Ex-CMEA[b]	78.3	65.4	53.9	52.6	54.4	55.4

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.

[a] January–June.

[b] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.

[c] This table shows annual rate of change beginning with the change from 1990–1991.

Note: NA = not available.

TABLE 1B. Trade of Eastern Germany with CEFTA: Imports, 1990–1993

Import Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Imports	22.9	10.9	9.6	8.5	4.1	4.0
CEFTA	4.8	1.7	1.7	NA	0.8	0.7
Czech and Slovak Republics	1.7	0.7	0.7	NA	0.3	0.3
Poland	1.8	0.8	0.8	NA	0.4	0.3
Hungary	1.2	0.3	0.2	NA	0.1	0.1
Ex-CMEA[b]	14.9	6.1	4.6	3.9	2.1	1.9
	Annual Rate of Change, Percent					
Total Imports	[c]	–52.5	–11.5	–11.4	–33.6	–3.4
CEFTA	[c]	–63.2	–4.7	NA	–12.2	–10.4
Czech and Slovak Republics	[c]	–58.4	–8.5	NA	–11.7	–6.5
Poland	[c]	–56.8	8.5	NA	–5.5	–7.4
Hungary	[c]	–79.2	–34.2	NA	–32.8	–35.6
Ex-CMEA[b]	[c]	–58.8	–24.2	–15.0	–15.3	–7.8
	Index 1990 = 100					
Total Imports	100.0	47.5	42.0	37.3	NA	NA
CEFTA	100.0	36.8	35.1	NA	NA	NA
Czech and Slovak Republics	100.0	41.6	38.0	NA	NA	NA
Poland	100.0	43.2	46.8	NA	NA	NA
Hungary	100.0	20.8	13.7	NA	NA	NA
Ex-CMEA[b]	100.0	41.2	31.2	26.6	NA	NA
	Share of Total Imports, Percent					
Total Imports	100.0	100.0	100.0	100.0	100.0	100.0
CEFTA	20.8	16.1	17.3	NA	18.4	17.1
Czech and Slovak Republics	7.5	6.6	6.8	NA	7.4	7.1
Poland	7.9	7.2	8.8	NA	8.9	8.5
Hungary	5.4	2.4	1.8	NA	2.2	1.4
Ex-CMEA[b]	65.0	56.4	48.3	46.3	50.6	48.3

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.
[a] January–June.
[b] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.
[c] This table shows annual rate of change beginning with the change from 1990–1991.
Note: NA = not available.

TABLE 1C. Trade of Eastern Germany with CEFTA: Balance, 1990–1993

Balance Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Balance	15.2	6.6	3.7	3.4	3.2	1.6
CEFTA	4.3	0.3	–0.2	NA	–0.1	–0.1
Czech and Slovak Republics	1.7	–0.1	0.1	NA	0.1	0.0
Poland	1.1	0.2	–0.3	NA	–0.1	–0.1
Hungary	1.5	0.1	0.0	NA	0.0	0.0
Ex-CMEA[b]	15.0	5.3	2.5	2.3	1.9	1.2

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.
[a] January–June.
[b] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.
Note: NA = not available.

TABLE 2A. Trade of Western Germany with CEFTA: Exports, 1990–1993

Export Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Exports	642.8	648.4	657.3	592.1	329.5	290.7
CEFTA	11.1	15.6	19.7	NA	8.5	11.0
Czech and Slovak Republics	3.1	4.3	7.5	NA	3.0	3.9
Poland	4.7	7.5	7.7	NA	3.4	4.8
Hungary	3.4	3.8	4.5	NA	2.1	2.3
Ex-CMEA[b]	23.5	26.0	30.1	36.4	13.5	16.7
	Annual Rate of Change, Percent					
Total Exports	0.3	0.9	1.4	–9.9	3.0	–11.8
CEFTA	2.6	40.5	25.7	NA	18.2	29.2
Czech and Slovak Republics	12.6	40.2	72.5	NA	66.9	28.8
Poland	4.9	59.4	3.0	NA	–3.7	40.8
Hungary	–7.8	14.2	17.3	NA	12.1	11.2
Ex-CMEA[b]	1.0	10.9	15.8	20.9	17.9	24.4
	Index 1990 = 100					
Total Exports	100.0	100.9	102.3	92.1	NA	NA
CEFTA	100.0	140.5	176.6	NA	NA	NA
Czech and Slovak Republics	100.0	140.2	241.9	NA	NA	NA
Poland	100.0	159.4	164.3	NA	NA	NA
Hungary	100.0	114.2	134.0	NA	NA	NA
Ex-CMEA[b]	100.0	110.9	128.4	155.2	NA	NA
	Share of Total Exports, Percent					
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0
CEFTA	1.7	2.4	3.0	NA	2.6	3.8
Czech and Slovak Republics	0.5	0.7	1.1	NA	0.9	1.3
Poland	0.7	1.2	1.2	NA	1.0	1.6
Hungary	0.5	0.6	0.7	NA	0.6	0.8
Ex-CMEA[b]	3.6	4.0	4.6	6.2	4.1	5.8

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.

[a] January–June.

[b] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.

Note: NA = not available.

TABLE 2B. Trade of Western Germany with CEFTA: Imports, 1990–1993

Import Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Imports	550.6	633.1	628.2	536.3	319.4	269.8
CEFTA	11.1	14.9	18.5	NA	8.7	9.0
Czech and Slovak Republics	2.7	4.4	6.6	NA	3.1	3.3
Poland	5.2	6.5	7.4	NA	3.4	3.6
Hungary	3.3	4.0	4.5	NA	2.1	2.0
Ex-CMEA[b]	21.8	26.4	30.4	32.0	14.5	15.0
	Annual Rate of Change, Percent					
Total Imports	8.7	15.0	–0.8	–14.6	0.9	–15.5
CEFTA	27.0	33.8	24.5	NA	31.2	3.5
Czech and Slovak Republics	8.4	62.1	51.2	NA	74.5	6.6
Poland	44.2	25.3	15.0	NA	16.5	4.7
Hungary	21.1	23.5	10.8	NA	13.0	–3.2
Ex-CMEA[b]	18.9	21.4	14.9	5.4	29.0	2.9
	Index 1990 = 100					
Total Imports	100.0	115.0	114.1	97.4	NA	NA
CEFTA	100.0	133.8	166.6	NA	NA	NA
Czech and Slovak Republics	100.0	162.1	245.1	NA	NA	NA
Poland	100.0	125.3	144.2	NA	NA	NA
Hungary	100.0	123.5	136.9	NA	NA	NA
Ex-CMEA[b]	100.0	121.4	139.5	147.0	NA	NA
	Share of Total Imports, Percent					
Total Imports	100.0	100.0	100.0	100.0	100.0	100.0
CEFTA	2.0	2.4	2.9	NA	2.7	3.3
Czech and Slovak Republics	0.5	0.7	1.1	NA	1.0	1.2
Poland	0.9	1.0	1.2	NA	1.1	1.3
Hungary	0.6	0.6	0.7	NA	0.7	0.8
Ex-CMEA[b]	4.0	4.2	4.8	6.0	4.6	5.5

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.
[a] January–June.
[b] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.
Note: NA = not available.

TABLE 2C. Trade of Western Germany with CEFTA: Balance, 1990–1993

Balance Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Balance	92.2	15.3	29.1	55.8	10.1	20.9
CEFTA	0.0	0.8	1.1	NA	–0.1	2.1
Czech and Slovak Republics	0.4	–0.1	0.8	NA	–0.1	0.6
Poland	–0.5	1.0	0.3	NA	0.0	1.2
Hungary	0.1	–0.2	0.1	NA	0.0	0.3
Ex-CMEA[b]	1.7	–0.4	–0.3	4.4	–1.1	1.8

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.
[a] January–June.
[b] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.
Note: NA = not available.

TABLE 3A. German Foreign Trade with CEFTA: Exports, 1990–1993

Export Measure	1990	1991	1992	1993[a]	1992[b]	1993[b]
	Billions of DM					
Total Exports	680.9	665.8	670.6	604.0	336.8	296.3
CEFTA	20.2	17.7	21.2	24.2	9.2	11.6
Czech and Slovak Republics	6.5	5.0	8.2	9.1	3.4	4.2
Poland	7.6	8.5	8.2	9.9	3.6	5.0
Hungary	6.1	4.2	4.7	5.2	2.2	2.4
Ex-CMEA[c]	53.3	37.4	37.3	42.7	17.5	19.9
	Annual Rate of Change, Percent					
Total Exports	d	−2.2	0.7	−9.9	2.6	−12.0
CEFTA	d	−12.5	19.8	14.4	9.1	25.8
Czech and Slovak Republics	d	−23.4	65.9	10.4	56.5	22.8
Poland	d	11.0	−2.9	20.2	−13.8	38.2
Hungary	d	−30.4	11.1	10.9	5.5	10.2
Ex-CMEA[c]	d	−29.7	−0.3	14.4	7.3	13.8
	Index 1990 = 100					
Total Exports	100.0	97.8	98.5	88.7	NA	NA
CEFTA	100.0	87.5	104.9	119.9	NA	NA
Czech and Slovak Republics	100.0	76.6	127.1	140.3	NA	NA
Poland	100.0	111.0	107.8	129.7	NA	NA
Hungary	100.0	69.6	77.3	85.8	NA	NA
Ex-CMEA[c]	100.0	70.3	70.0	80.1	NA	NA
	Share of Total Exports, Percent					
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0
CEFTA	3.0	2.7	3.2	4.0	2.7	3.9
Czech and Slovak Republics	1.0	0.7	1.2	1.5	1.0	1.4
Poland	1.1	1.3	1.2	1.6	1.1	1.7
Hungary	0.9	0.6	0.7	0.9	0.7	0.8
Ex-CMEA[c]	7.8	5.6	5.6	7.1	5.2	6.7

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.

[a] Country figures for 1993 are estimated using data for January to November.

[b] January–June.

[c] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.

[d] This table shows annual rate of change beginning with the change from 1990–1991.

Note: NA = not available.

TABLE 3B. German Foreign Trade with CEFTA: Imports, 1990–1993

Import Measure	1990	1991	1992	1993[a]	1992[b]	1993[b]
	Billions of DM					
Total Imports	573.5	643.9	637.8	544.8	323.5	273.8
CEFTA	15.9	16.6	20.2	20.9	9.4	9.6
Czech and Slovak Republics	4.4	5.1	7.3	7.9	3.4	3.6
Poland	7.0	7.3	8.3	8.5	3.8	3.9
Hungary	4.5	4.3	4.6	4.5	2.2	2.1
Ex-CMEA[c]	36.6	32.6	35.0	36.0	16.6	16.9
	Annual Rate of Change, Percent					
Total Imports	[d]	12.3	–0.9	–14.6	0.5	–15.4
CEFTA	[d]	4.7	21.4	3.5	26.1	2.4
Czech and Slovak Republics	[d]	15.3	42.8	8.5	60.5	5.5
Poland	[d]	4.1	14.3	2.6	13.9	3.5
Hungary	[d]	–4.7	8.1	–2.7	9.8	–4.5
Ex-CMEA[c]	[d]	–11.1	7.6	2.7	23.9	1.5
	Index 1990 = 100					
Total Imports	100.0	112.3	111.2	95.0	NA	NA
CEFTA	100.0	104.7	127.2	131.7	NA	NA
Czech and Slovak Republics	100.0	115.3	164.6	178.6	NA	NA
Poland	100.0	104.1	119.0	122.1	NA	NA
Hungary	100.0	95.3	103.0	100.3	NA	NA
Ex-CMEA[c]	100.0	88.9	95.6	98.2	NA	NA
	Share of Total Imports, Percent					
Total Imports	100.0	100.0	100.0	100.0	100.0	100.0
CEFTA	2.8	2.6	3.2	3.8	2.9	3.5
Czech and Slovak Republics	0.8	0.8	1.1	1.4	1.1	1.3
Poland	1.2	1.1	1.3	1.6	1.2	1.4
Hungary	0.8	0.7	0.7	0.8	0.7	0.8
Ex-CMEA[c]	6.4	5.1	5.5	6.6	5.1	6.2

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.

[a] Country figures for 1993 are estimated using data for January to November.

[b] January–June.

[c] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.

[d] This table shows annual rate of change beginning with the change from 1990–1991.

Note: NA = not available.

TABLE 3C. German Foreign Trade with CEFTA: Balance, 1990–1993

Balance Measure	1990	1991	1992	1993	1992[a]	1993[a]
	Billions of DM					
Total Balance	107.4	21.9	32.8	59.1	13.3	22.5
CEFTA	4.3	1.0	1.0	3.3	–0.2	2.0
Czech and Slovak Republics	2.1	–0.1	1.0	1.2	0.0	0.6
Poland	0.7	1.2	–0.1	1.4	–0.2	1.0
Hungary	1.6	–0.1	0.1	0.7	0.0	0.3
Ex-CMEA[c]	16.6	4.9	2.3	6.7	0.8	3.0

Sources: Statistisches Bundesamt, Aussenhandel, Fachserie 7, Reihe 1, Zusammenfassende Übersichten für den Aussenhandel, Monatshefte; Statistischer Wochendienst.

[a] Country figures for 1993 are estimated using data for January to November.

[b] January–June.

[c] Albania, Bulgaria, Czech and Slovak Republics, Poland, Romania, Hungary, former Soviet Union.

Note: NA = not available.

TABLE 4A. Czechoslovak Foreign Trade with Germany: Imports, 1988–1992

Import Measure	1988	1989	1990	1991	1992
			Billions of Korunas		
Total Imports	210	215	238	323	354
Germany[b]	37	37	52	69	89
Former Soviet Union	65	64	51	97	87
Austria	11	12	23	27	33
			Share of Total Imports, Percent		
Total Imports	100.0	100.0	100.0	100.0	100.0
Germany[b]	17.6	17.2	21.8	21.4	25.1
Former Soviet Union	31.0	29.8	21.4	30.0	24.6
Austria	5.2	5.6	9.7	8.4	9.3
			Ranking		
Germany	2	2	1	2	1
Former Soviet Union	1	1	2	1	2

Sources: Federálni Statisticky Urad, Statistická rocenka Ceské a Slovenské Federativni Republiky '92; Statistické Prehledy (Monthly Statistics of the Czech Republic), August 1993.

[a] The figures for Germany 1988 through 1990 include the former GDR.

TABLE 4B. Czechoslovak Foreign Trade with Germany: Exports, 1988–1992

Export Measure	1988	1989	1990	1991	1992
			Billions of Korunas		
Total Exports	214	218	215	334	329
Germany[b]	32	33	38	84	100
Former Soviet Union	72	66	54	65	36
Austria	9	10	13	19	25
			Share of Total Exports, Percent		
Total Exports	100.0	100.0	100.0	100.0	100.0
Germany[b]	15.0	15.1	17.7	25.1	30.4
Former Soviet Union	33.6	30.3	25.1	19.5	10.9
Austria	4.2	4.6	6.0	5.7	7.6
			Ranking		
Germany	2	2	2	1	1
Former Soviet Union	1	1	1	2	2

Sources: Federálni Statisticky Urad, Statistická rocenka Ceské a Slovenské Federativni Republiky '92; Statistické Prehledy (Monthly Statistics of the Czech Republic), August 1993.

[a] The figures for Germany 1988 through 1990 include the former GDR.

TABLE 5A. Czech Foreign Trade with Germany: Imports, 1988–1993

Import Measure	1988	1989	1990	1991	1992	1993
			Billions of Korunas			
Total Imports	....	....	....	209	290	366
Germany	....	....	....	52	79	92
Former Soviet Union	....	....	....	49	53	42
Slovak Republic	....	....	....	a	a	65
Austria	....	....	....	17	27	28
			Share of Total Imports, Percent			
Total Imports	....	....	....	100.0	100.0	100.0
Germany	....	....	....	24.9	27.1	25.1
Former Soviet Union	....	....	....	23.4	18.2	11.5
Slovak Republic	....	....	....	a	a	17.7
Austria	....	....	....	8.2	9.2	7.7
			Ranking			
Germany	....	....	....	1	1	1
Former Soviet Union	....	....	....	2	2	3

Sources: Federálni Statisticky Urad, Statistická rocenka Ceské a Slovenské Federativni Republiky '92; Statistické Prehledy (Monthly Statistics of the Czech Republic), August 1993, March 1994, and April 1994.
[a] Separate statistics for the Czech and Slovak Republics not available.
Note: The Czech Republic and the Slovak Republic became independent states Jan. 1, 1993.

TABLE 5B. Czech Foreign Trade with Germany: Exports, 1988–1993

Export Measure	1988	1989	1990	1991	1992	1993
			Billions of Korunas			
Total Exports	....	....	....	234	248	372
Germany	....	....	....	64	82	100
Former Soviet Union	....	....	....	41	22	22
Slovak Republic	....	....	....	a	a	75
Austria	....	....	....	14	18	23
			Share of Total Exports, Percent			
Total Exports	....	....	....	100.0	100.0	100.0
Germany	....	....	....	27.3	32.9	26.9
Former Soviet Union	....	....	....	17.5	8.9	6.0
Slovak Republic	....	....	....	a	a	20.0
Austria	....	....	....	5.8	7.2	6.2
			Ranking			
Germany	....	....	....	1	1	1
Former Soviet Union	....	....	....	2	2	4

Sources: Federálni Statisticky Urad, Statistická rocenka Ceské a Slovenské Federativni Republiky '92; Statistické Prehledy (Monthly Statistics of the Czech Republic), August 1993, March 1994, and April 1994.
[a] Separate statistics for the Czech and Slovak Republics not available.
Note: The Czech Republic and the Slovak Republic became independent states Jan. 1, 1993.

TABLE 6A. Slovak Foreign Trade with Germany: Imports, 1988–1993

Import Measure	1988	1989	1990	1991	1992	1993
			Billions of Korunas			
Total Imports	....	....	....	114	64	194
Germany	....	....	....	17	11	23
Former Soviet Union	....	....	....	48	35	38 [a]
Czech Republic	....	....	....	[b]	[b]	69
Austria	....	....	....	10	7	12
			Share of Total Imports, Percent			
Total Imports	....	....	....	100.0	100.0	100.0
Germany	....	....	....	14.9	17.2	11.7
Former Soviet Union	....	....	....	42.1	54.7	19.6 [a]
Czech Republic	....	....	....	[b]	[b]	35.4
Austria	....	....	....	8.8	10.9	6.4
			Ranking			
Germany	....	....	....	2	2	3
Former Soviet Union	....	....	....	1	1	2 [a]

Sources: Federálni Statisticky Urad, Statistická rocenka Ceské a Slovenské Federativni Republiky '92; Statistické Prehledy (Monthly Statistics of the Czech Republic), August 1993; Monitor of the economy of the Slovak Republic, January 1994; Trend, November 3, 1993; Slovenského Statisticky Urad Bulletin, January 1994.

[a] Russian Federation.

[b] Separate statistics for the Czech and Slovak Republics not available.

TABLE 6B. Slovak Foreign Trade with Germany: Exports, 1988–1993

Export Measure	1988	1989	1990	1991	1992	1993
			Billions of Korunas			
Total Exports	....	....	....	100	82	167
Germany	....	....	....	20	19	26
Former Soviet Union	....	....	....	24	14	8 [a]
Czech Republic	....	....	....	[b]	[b]	70
Austria	....	....	....	6	7	8
			Share of Total Exports, Percent			
Total Exports	....	....	....	100.0	100.0	100.0
Germany	....	....	....	20.0	23.2	15.3
Former Soviet Union	....	....	....	24.0	17.1	4.7 [a]
Czech Republic	....	....	....	[b]	[b]	41.9
Austria	....	....	....	6.0	8.5	5.0
			Ranking			
Germany	....	....	....	2	1	2
Former Soviet Union	....	....	....	1	2	3 [a]

Sources: Federálni Statisticky Urad, Statistická rocenka Ceské a Slovenské Federativni Republiky '92; Statistické Prehledy (Monthly Statistics of the Czech Republic), August 1993; Monitor of the economy of the Slovak Republic, January 1994; Trend, November 3, 1993; Slovenského Statisticky Urad Bulletin, January 1994.

[a] Russian Federation.

[b] Separate statistics for the Czech and Slovak Republics not available.

TABLE 7A. Polish Foreign Trade with Germany: Imports, 1988–1993

Import Measure	1988	1989	1990	1991	1992	1993
			Billions of Zlotys			
Total Imports	5,474	15,416	92,918	166,744	219,950	340,183
Germany[a]	966	3,054	15,587	43,597	52,582	95,251
Former Soviet Union	1,228	2,689	15,370	23,193	26,129	23,132
Italy	175	616	5,796	7,323	15,235	26,534
U.K.	222	664	4,382	6,531	14,732	19,731
			Share of Total Imports, Percent			
Total Imports	100.0	100.0	100.0	100.0	100.0	100.0
Germany[b]	17.6	19.8	16.8	26.1	23.9	28.0
Former Soviet Union	22.4	17.4	16.5	13.9	11.9	6.8
Italy	3.2	4.0	6.2	4.4	6.9	7.8
U.K.	4.1	4.3	4.7	3.9	6.7	5.8
			Ranking			
Germany	2	1	1	1	1	1
Former Soviet Union	1	2	2	2	2	3

Sources: Glowny Urzad Statystyczny, Warszawa, Rocznik Statystyczny Handlu Zagranicznego 1993; Biuletyn Statystyczny March 1994. *Polityka*, May 21, 1994.
[a]The figures for Germany 1988 through 1990 include the former GDR.

TABLE 7B. Polish Foreign Trade with Germany: Exports, 1988–1993

Export Measure	1988	1989	1990	1991	1992	1993
			Billions of Zlotys			
Total Exports	6,012	19,476	136,055	157,716	179,687	257,568
Germany[a]	1,050	3,703	32,503	46,428	56,488	92,724
Former Soviet Union	1,475	4,048	19,768	17,312	17,030	11,848
Italy	139	449	3,811	6,466	9,980	13,394
U.K.	132	506	4,057	8,172	10,752	15,197
			Share of Total Exports, Percent			
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0
Germany[b]	17.5	19.0	23.9	29.4	31.4	36.0
Former Soviet Union	24.5	20.8	14.5	11.0	9.5	4.6
Italy	2.3	2.3	2.8	4.1	5.6	5.2
U.K.	2.2	2.6	3.0	5.2	6.0	5.9
			Ranking			
Germany	2	2	1	1	1	1
Former Soviet Union	1	1	2	2	2	4

Sources: Glowny Urzad Statystyczny, Warszawa, Rocznik Statystyczny Handlu Zagranicznego 1993; Biuletyn Statystyczny March 1994. *Polityka*, May 21, 1994.
[a]The figures for Germany 1988 through 1990 include the former GDR.

TABLE 8A. Hungarian Foreign Trade with Germany: Imports, 1988–1993

Import Measure	1988	1989	1990	1991	1992	1993
			Billions of Forint			
Total Imports	461	524	545	856	879	1,162
Germany[a]	95	117	127	183	207	251
Former Soviet Union	116	116	104	131	148	258
Italy	15	18	22	62	55	70
Austria	34	45	54	114	126	135
			Share of Total Imports, Percent			
Total Imports	100.0	100.0	100.0	100.0	100.0	100.0
Germany[b]	20.6	22.3	23.4	21.4	23.5	21.6
Former Soviet Union	25.2	22.1	19.1	15.3	16.9	22.2
Italy	3.1	3.4	4.1	7.2	6.3	6.0
Austria	7.3	8.6	10.0	13.3	14.4	11.6
			Ranking			
Germany	2	1	1	1	1	2
Former Soviet Union	1	2	2	2	2	1

Sources: Központi Statistikai Hivatal, Magyar statisztikai évkönyv 1992 (1993); Statisztikai Havi Közlemények, January 1994.
[a] The figures for Germany 1988 through 1990 include the former GDR.

TABLE 8B. Hungarian Foreign Trade with Germany: Exports, 1988–1993

Export Measure	1988	1989	1990	1991	1992	1993
			Billions of Forint			
Total Exports	492	571	604	764	844	820
Germany[a]	81	100	122	205	234	218
Former Soviet Union	138	144	122	102	111	125
Italy	21	27	35	58	80	66
Austria	28	37	45	83	90	83
			Share of Total Exports, Percent			
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0
Germany[b]	16.5	17.4	20.2	26.9	27.7	26.6
Former Soviet Union	28.0	25.1	20.2	13.4	13.1	15.3
Italy	4.3	4.7	5.9	7.6	9.5	8.0
Austria	5.7	6.5	7.5	10.8	10.7	10.1
			Ranking			
Germany	2	2	2	1	1	1
Former Soviet Union	1	1	1	2	2	2

Sources: Központi Statistikai Hivatal, Magyar statisztikai évkönyv 1992 (1993); Statisztikai Havi Közlemények, January 1994.
[a] The figures for Germany 1988 through 1990 include the former GDR.

TABLE 9. German Direct Investment in the CEFTA Countries, 1989–1993

(DM Millions)

Measure	1989	1990	1991	1992	1993
Total	69	210	1,323	1,510	1,634
Cumulative Total	69	279	1,602	3,112	4,746
Czech Republic[a]	[b]	2	799	536	573
Cumulative	[b]	2	801	1,357	1,910
Slovak Republic	[b]	[b]	[b]	[b]	21
Cumulative	[b]	[b]	[b]	[b]	21
Poland	[b]	7	62	148	336
Cumulative	[b]	7	69	217	553
Hungary	69	201	462	826	704
Cumulative	69	270	732	1,558	2,262

Sources: *VWD-Osteurope*, August 23, 1993; *Frankfurter Allgemeine Zeitung*, May 7, 1994.
[a] Figures for 1989 through 1992 cover all of the former Czechoslovakia.
[b] Zero or negligible.

TABLE 10. Share of CEFTA Countries in German Foreign Direct Investment and Exports, 1990–1993

(Percent)

Share of CEFTA in total German	1990	1991	1992	1993
FDI	0.7	4.3	6.3	8.5
Exports	3.0	2.7	3.2	4.0

Source: Deutsche Bundesbank, *Zahlungsbilanzstatistik*, April 1994, Table 3A.

TABLE 11. Ranking of Foreign Direct Investment in the CEFTA Countries, by Origin, Cumulative at End of 1993

Target Area	Cumulative FDI at End of 1993 ($Billions)	First Rank		Second Rank		Third Rank	
		Source	Share in Percent	Source	Share in Percent	Source	Share in Percent
Czech Republic	2.1	Germany	31	United States	28	France	13
Slovak Republic	0.37	Austria	24.5	Germany	21	United States	13
Poland	3.0	United States	37	Multinationals	12	Italy	12
Hungary	7.0	United States	29	Germany	25	Austria	12

Sources: Czech Republic: Československa Obchodni Banka, A.S., April 1994; Slovak Republic: *Bulletin Slovenského Štatistického Uradu,* no. 12/1993; Poland: *Rynki zagraniczne,* no. 49, April 23, 1994; Hungary: *Népszabadság,* December 31, 1993.

TABLE 12. Gross Hard Currency Debts of CEFTA Countries with German Banks, 1990–1993[a]

Country and Measure	1990	1991	1992	1993
Czech and Slovak Republics/CSFR[b]				
DM Billions	2.2	3.4	3.4	3.6
Share in Total Bank Debts,[c] Percent	23.4	41.0	43.0	47.0
Poland				
DM Billions	6.1	8.5	9.0	8.7
Share in Total Bank Debts,[c] Percent	31.9	41.1	42.7	43.5
Hungary				
DM Billions	5.5	5.9	6.4	5.5
Share in Total Bank Debts,[c] Percent	30.9	37.1	45.7	43.0

Sources: Deutsche Bundesbank, *Zahlungsbilanzstatistik*, April 1994; Bank for International Settlements, *Entwicklung des Internationalen Bankgeschäfts und der Internationalen Finanzmärkte*, February 1994.

[a] Inclusive of their subsidiaries and offices abroad.

[b] The Czech Republic and the Slovak Republic became separate states Jan. 1, 1993.

[c] Gross debt with Western banks reporting to the Bank for International Settlements (BIS).

BETWEEN MOSCOW AND BONN: EAST-CENTRAL EUROPE IN TRANSITION

By Angela Stent*

CONTENTS

SUMMARY

As East-Central Europe negotiates its transition, it is keenly aware of its difficult historical legacy. Sandwiched between Russia and Germany, which have in the past both sought to dominate the area, East-Central Europe is concerned about what role these two countries will play in its future. Will they assist or hinder the construction of viable, post-communist societies?

Germany is preoccupied with the domestic challenges of unification. Firmly embedded in the European Union, it has no hegemonical designs on the area. It is, however, closely involved economically and politically with East-Central Europe, seeking to integrate it into Western institutions. The German government and the private sector also remain committed to stabilizing Russia's political and economic system.

Russia, too, is preoccupied with its domestic problems and with redefining its international role. It does not seek to recreate the Soviet empire in Eastern Europe, but recently Russia and East-Central Europe have begun to establish closer ties after three years of mutual neglect. The uncertainties about the outcome of Russia's transition, do, however, leave questions about Russia's future policy toward East-Central Europe. This reinforces the necessity for transatlantic partnership in assisting both East-Central Europe and Russia in the difficult transition process, to ensure that the ghosts of the past do not reappear.

* Angela Stent is professor in the Department of Government at Georgetown University.

INTRODUCTION

Since the collapse of communism, the specter of history has begun to haunt East-Central Europe. As the countries in the region struggle to become market-oriented, democratic societies, they must also make the transition from dependent semi-colonial countries to viable, sovereign nation-states, capable of defining and protecting their national security. Yet they are keenly aware that history does not augur well for this third transition. Sandwiched between Russia and Germany, the nations of East-Central Europe have been carved up and ruled by Russia and Germany (and Austria) for centuries, be it the eighteenth-century partitions of Poland, the Holy Alliance of 1815, the Molotov-Ribbentrop Pact of 1939, Nazi occupation, or the establishment of the postwar Soviet empire in Eastern Europe. No wonder there are serious doubts among the leaders and populace in the emerging new European democracies about whether they will be able to achieve true sovereignty and avoid either Russian or German domination in the twenty-first century.

What role are Germany and Russia playing in post-communist Europe? Do their foreign policies and their bilateral relations support or hinder the transitions that are taking place? This paper lays out a framework for understanding these issues by addressing both internal and external influences on the development of German and Russian policies.

The dilemma of the East-Central European countries preoccupied nineteenth-century political analysts. East-Central Europe is a great territory of unanswered questions and unresolved contradictions; a region of half demands that, until now, have enjoyed as little realization as proposals counter to them and which seemed products of visionary caprice because they aim at something whole, something new and enormous.[1]

Certainly the historical evidence of Russian and German policies in East-Central Europe is not comforting. At its height, the Russian empire in the eighteenth and nineteenth centuries was a major player in all European questions. The Tsars sought to annex or dominate the lands to Russia's West, helping to crush nineteenth-century revolts in East-Central Europe. Before the Russian revolution the drive for empire and attempt to Russify all subject populations was an extension of domestic autocracy. After the Second World War, Stalin's drive to control the countries that lay between the Soviet Union and Germany was a product of pre-revolutionary imperial impulses, reinforced by the devastating experience of the war and fear of future German designs on the USSR. The official ideology might have changed, but Central and East Europe experienced Soviet occupation and control and the imposition of Soviet-type systems as a repetition of the past two centuries, this time in communist disguise, backed by the full apparatus of the modern technology of repression.

Germany's drive for hegemony over Central Europe has been less consistent than that of Russia in the past three centuries, although before that it was more concerted, but the legacy of German—espe-

[1] Bruno Bauer, 1854, cited in Timothy Garton Ash, "Mitteleuropa?" *Daedalus* (winter 1990), vol. 119, no. 1, p. 1.

cially Nazi—occupation is powerful. Moreover, Germany has long enjoyed a close economic relationship with East-Central Europe, one of unequal dependency. Nevertheless, weakness has been more characteristic of Germany's role in East-Central Europe than has strength and domination. Every time Germany began to expand and annex territories, it was checked and defeated by its neighbors, be it in the eighteenth century or twice in the twentieth century.[2]

The continuous experience of Russian domination—with the exception of the inter-war period—influenced the East-Central European states to look more favorably on West Germany during the 1970s and 1980s, as they sought to find alternatives to Soviet-type communism. The idea of Central Europe, or *Mitteleuropa*, as a unique geographical-cultural construct gained favor among intellectuals. In their attempt to differentiate themselves from the Soviet Union, people in Poland, Hungary, Czechoslovakia, and East Germany stressed that they were part of European civilization, in which freedom, the Enlightenment and the rule of law had created societies different from that in the Soviet Union. They also stressed their common links with German civilization, with the positive aspects of German liberal traditions.[3] When communism collapsed, therefore, the major preoccupation was to throw off Russian domination and return to European civilization. The concern about Germany was secondary, but has grown as the political and economic landscape of Europe has redesigned itself.

Powerful as historical ghosts are, however, the countries of East-Central Europe should not be overly preoccupied with them. They remain locked in between Germany and Russia in the post-communist era. But Russia and Germany are new states, both preoccupied with their own domestic problems and both seeking to redefine their national and international identities.

THE GERMAN AGENDA

DOMESTIC PRESSURES ON THE NEW STATE

When Germany was unified in October 1990, it became a new state, with new borders, facing the challenge of integrating sixteen million Germans in the new Laender. Even though East Germany was unified with West Germany by accepting the West German constitution, German unification has not been a simple question of *Anschluss*, or annexation. The addition of East Germany has changed both Germany's perception of itself and the outside world's perception of what its place in Europe is and should be. Germany is thus facing a redefinition of its own national interests and identity as it seeks to integrate Eastern Germany, which is currently costing DM100 billion per year. The self-image that West Germans had of themselves—as prosperous members of a generous democratic welfare state and of the European Community, with a limited foreign policy role and generous attitude toward non-Germans seeking to live in Germany—has been severely challenged. A united Germany has suffered economically from unification and a Euro-

[2] See Josef Joffe, "After Bipolarity: Germany and European Security," in *European Security After the Cold War*, Adelphi Paper no. 285 (London: International Institute for Strategic Studies, 1994) pp. 34–35.

[3] Tony Judt, "The Rediscovery of Central Europe," *Daedalus*, (winter 1990), pp. 23–54.

pean-wide recession; it also has more fundamental structural economic problems—its welfare state and health care system have come under serious strain, its allies are pressuring it to play a more active foreign policy role, and resentment against foreigners and asylum-seekers has manifested itself in both parts of Germany in violent and disturbing ways.

Germans complain of *Politikverdrossenheit*, or disenchantment with politics, a general skepticism about their leaders and the ability of their politicians to deliver on their promises. Their expectations from unification were too high and thus their disenchantment has grown regarding how long East Germany's economic recovery is taking and how much it is costing them. In the face of economic and social dislocation, it is particularly important to achieve consensus on a new national identity but that, too, is problematic, given Germany's past.[4]

One issue that continues to preoccupy Germans and has a significant impact on Germany's *Ostpolitik*—its policy toward East-Central Europe and the new independent states (NIS)—is the problem of immigrants and asylum-seekers. Germany is the magnet for refugees from the former communist countries and other areas, who are fleeing from political persecution or seeking a better life. It is the front-line state because of its prosperity and its liberal asylum laws. West Germans used to welcome or at least accept foreign workers because they performed important tasks in the economy. But the situation has changed dramatically since unification. Unemployment in the East is high, up to 40 percent in some areas, and people are venting their feelings against foreigners, regardless of their origins. Resentments against migrants from East-Central Europe and Russia, who are involved in a semi-underground economy, and are perceived to have brought organized crime to Germany, is also high. Although the majority of Germans are tolerant and accept foreigners in their midst, foreigners have become scapegoats for the extreme right in both parts of Germany.

The new German asylum law of July 1993 has had a direct effect on East-Central Europe. Germany will no longer accept asylum-seekers who have entered Germany through neighboring countries that have been declared secure countries—such as Poland or the Czech Republic—or whose countries of origin have been declared safe by Germany, such as Hungary, Bulgaria, Rumania, and the Slovak Republic. Asylum-seekers will be returned to their neighboring safe country, a situation that has caused consternation in East-Central Europe. Germany's eastern neighbors have complained that their difficult transition processes are being complicated by an influx of refugees who are denied entrance to Germany.

FOREIGN POLICY OPPORTUNITIES AND CONSTRAINTS

German unification has thrust onto Germany international responsibilities for which it was unprepared and which it has been reluctant to accept. From 1949 to 1989, West Germany had limited sovereignty, was closely integrated into the NATO alliance, and never systematically developed an autonomous concept of national

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[4] See Angela Stent, "The One Germany," *Foreign Policy*, no. 81 (winter 1990–91), pp. 67–70.

interest or national security. The combination of Marshall Aid and the NATO alliance succeeded in rebuilding Germany into a prosperous democracy, one of the pillars of the European Community, whose Constitution states that Bundeswehr forces can only be used for defense within a "system of collective security."[5] The Bundeswehr has not fought a war during its entire forty-year history and one might question under what future circumstances it could conceivably conduct such a war. The fierce public debate within Germany about whether the Constitution permits the use of Bundeswehr troops for peacekeeping operations outside of Europe indicates how reluctant many Germans are to contemplate the use of German troops in anything but strictly defensive circumstances. During the cold war, West Germany became comfortable with the notion of being a "civilian power" (or *Zivilmacht*), a country for whom the use of military force except for defense purposes is not acceptable.[6] Unification has reinforced these tendencies. Most East Germans, in response to forty years of Soviet occupation and military education in school, are anti-militarist, remain suspicious of NATO, and tend to favor a minimal national military force and no military alliances. Polling data indicate that a majority of Germans would prefer to be like the Swiss—prosperous and neutral—and would reject the role of a major power.

Despite this reluctance to take on a greater international role, the collapse of communism and the end of postwar bipolar stability have forced upon Germany responsibilities that it has been unwilling to accept, but it has also given Germany opportunities for greater international assertiveness that have caused concern among its allies. It has gone from a refusal to send troops to fight in the Persian Gulf War (although it contributed $11.4 billion to the war effort) to pressuring its reluctant European Community partners to recognize Slovenia and Croatia in December 1991, an act that some believe precipitated the further breakup of Yugoslavia and the spread of hostilities to Bosnia and potentially to other parts of the former Yugoslavia. However, Germany itself has said that its soldiers cannot take part in peacekeeping operations there because, as the former head of the Free Democratic Party, Otto Lambsdorff put it, " We were there fifty years ago, and that's enough." Since unification, German officials have cited the economic, political, and psychological difficulties of integrating Eastern into Western Germany as the main reason for their ambivalence about assuming a more active international role, especially a military one.

GERMANY AND EAST-CENTRAL EUROPE

Germany has, however, been an active proponent of closer integration of East-Central Europe with Western Europe. It has been a leading supporter of NATO's Partnership for Peace program, whereby the former Warsaw Pact nations can develop close ties with NATO, including joint military exercises, consultations in times of crisis, and participation in a broad political-military dialogue. Some German officials have called for NATO membership for

[5] Joffe, "After Bipolarity."
[6] See Hanns Maull, "Zivilmacht Bundesrepublik Deutschland: Vierzehn Thesen fuer eine Neue Deutsche Aussenpolitik," *Europa Archiv*, vol. 47 (1992).

the Visegrad four—and possibly other countries—in the foreseeable future; others are concerned that such a step would provoke a Russian counterreaction. Moreover, Germany is the chief advocate of membership in the European Union for the Visegrad four by the end of the century and has pledged to use its Presidency of the EU during the second half of 1994 to advance the candidacy of these countries. Germany has played an active and positive role in promoting the economic and security interests of East-Central Europe and the closer integration of these countries into Western institutions because it is very concerned about buttressing their stability and assisting with their transitions.

Germany also has become the major economic partner of these countries and its growing economic influence is undeniable. East-Central Europe has always been a natural market for German exports. Today, it is a source of cheap, educated, productive labor and as such has added attraction for German investors and entrepreneurs. Clearly, this German role is a source both of support and concern to East-Central Europe. As one Czech politician put it, "The only thing we fear more than German economic domination is the absence of German economic domination." So far, most countries in this area agree that the positive effects of German economic involvement outweigh its negative aspects.

Germany is the largest aid donor to the former communist countries. From 1989 to 1993, Germany spent a total of DM 41.1 billion ($24.2 billion) in grants, credits, export guarantees and transfer ruble credits (sums owed by the former German Democratic Republic) and commitments to the European Bank for Reconstruction and Development (EBRD) and the International Monetary Fund, for Central and Eastern Europe. Germany is also the region's leading trade partner. As Chancellor Kohl has said, opening up Western markets to goods from these countries is of "strategic importance." "In the final analysis," he remarked, "opening our markets contributes more to the success of economic reforms and consequently to stabilization than economic aid, know-how and loans."[7] Germany imported DM 22 billion ($13 billion) from Central and Eastern Europe in 1992, and exported DM 23 billion ($13.7 billion) to the area in 1992. This was almost double the level of 1990 trade.[8] German companies are the largest investors in most of these countries, and there is no sign that their interest will diminish.

In the interwar period, as in other periods of German history, the German government used its close economic ties with Central and Eastern Europe as a form of political influence and leverage. The question that some in East-Central Europe are asking is how and whether economic influence translates into political influence. Clearly, there is a correlation; but it must be remembered that Germany is a member of the EU, is committed to its further growth and integration, and sees its role in Central and Eastern Europe not in a strictly bilateral sense, but as part of a multilateral EU policy of stabilizing East-Central Europe and contributing to its economic growth. While these countries tend to view German policies as those of a national state, the Germans themselves do

[7] *The Stabilization of Central and Eastern Europe* (New York: German Information Center), April 1994, p.2.
[8] Ibid.

not see it that way. Thus, concerns about the political implications of German economic activities in East-Central Europe should be tempered by the realization that, as long as the EU survives and grows, Germany's ability to dominate will be strictly limited. Moreover, if these countries are able to become successful market economies and institutionalize democratic forms of government and the rule of law, then their vulnerability to outside influences will be considerably lessened.

GERMANY AND RUSSIA

Since the unification of Germany, the relationship between Bonn and Moscow has changed significantly. After all, until 1990, West Germany was heavily exposed to Soviet military power. There were Soviet troops on West Germany's borders that could have been used in a major East-West German conflict. Today, Soviet troops have gone home, Russia and Germany are separated by the new independent countries, and Bonn no longer depends on Moscow for good relations with East Berlin. Russia has, therefore, very little with which to blackmail or bribe Germany, and the "Moscow connection" is a latent, as opposed to a live, option, compared to the immediate tasks of stabilizing East-Central Europe.[9] Indeed, there is a debate in Germany about how important Russia remains as a priority for German foreign policy, given the challenge of the East-Central European transitions.

When German unification was negotiated, an implicit German-Soviet bargain was struck: in return for the Soviets renouncing their control over East Germany and agreeing to the incorporation of a united Germany in NATO, Germany would compensate the USSR economically and politically. The economic compensation included credits, the assumption of all of the GDR's economic obligations to the USSR, the construction of housing and retraining centers for returning Soviet soldiers and their families, and a variety of other incentives. Politically, it was understood that Germany would encourage its allies to become more committed to assisting the USSR's transition and that it would take the lead in the creation of a new security system in Europe to replace the Warsaw Pact, one that would give the USSR an important role to play in future European affairs. Much of this was enshrined in the twenty-year Treaty on Good Neighborliness, Partnership and Cooperation, and the Treaty on Developing Comprehensive Cooperation on the Economy, Industry, Science and Technology signed by President Gorbachev and Chancellor Kohl in Bonn on November 9, 1990.[10]

Germany remains committed to doing as much as it can to assist Russia's difficult transition. It is the largest aid donor to the states of the former Soviet Union, with the lion's share going to Russia itself. It has provided DM87.55 billion ($51.5 billion) to the new independent states (NIS), half of which is credits and export guarantees. About one-fifth has been provided in the form of grants and free shipment of goods. Another fifth is being spent on the economic and social reintegration of Soviet troops, including $5.6 bil-

[9] Joffe, "After Bipolarity," p. 39.

[10] For the text of these treaties, see Karl Kaiser, *Deutschlands Vereinigung* (Bergisch Gladbach: Gustav Lubbe Verlag, 1991), pp. 334–357. After the dissolution of the Soviet Union, Russia inherited these treaties.

lion for housing construction in Russia, Ukraine, and other NIS states. Trade between Germany and Russia has, however, not been as dynamic as both sides initially hoped. In the first ten months of 1993, trade between Germany and the NIS states reached DM 18.277 billion ($10.751 billion), with a German trade surplus of $2.379 billion. Russia's share in total NIS trade with Germany was 79.77 percent, followed by Ukraine (7.88 percent) and Belarus (4.37 percent). Private German investment in the NIS has been very low, about $200 million altogether.[11] Otto Wolff von Amerongen, chairman of the German East-West Trade committee (*Ostausschuss der deutschen Wirtschaft*), advises caution, because of the uncertainties of the Russian market and because of the debt problem: half of the former Soviet Union's debt is tied up in Germany in the form of state guarantees for unpaid bills.[12] Hermes credit guarantees have not been continuously available because of the problems of Russian repayments.

Despite these economic difficulties, the German business community continues to believe that, in the longer run, there is a natural coincidence of economic interests between Germany and Russia, which were traditionally close trading partners, particularly before the 1917 revolution, when 47 percent of Russian imports came from Germany. Germany remains interested in the Russian market, especially the energy sector, but also realizes that Europe will have to open its markets more to Russian goods if trade between Germany and Russia is to grow. Germany is also involved with Russia in many other ways, both on the federal and state level, with individual Laender playing an important role. The *Ostausschuss* encourages the opening of local chambers of commerce all around the Russian federation and is actively involved in creating business associations there.[13] Sister City projects have sprung up all over Germany and Russia, and Germany is training future Russian business managers. The Central Institute for Retraining Military Personnel in Moscow is a German-funded center that teaches returning officers commercial and computer skills, and there are nine of these centers in Russia. German-Russian cooperation will, therefore, continue on a variety of levels for some time to come.

Germany's major concern about Russia involves fears about the impact of instability in Russia on East-Central Europe and on Germany itself. Germany has the largest stake in the outcome of the transition process there because it is more directly affected by the consequences of instability there than are its European Community partners. Instability in Russia and other NIS states means migrants, refugees, and the potential for violence both within the NIS and in East-Central Europe. For these reasons, Germany has supported President Yeltsin's reform efforts, backed him in his struggle with the Parliament in October 1993, and continues to encourage its partners to be more generous in their assistance. As Foreign Minister Kinkel put it, "Russia is of central importance for Europe. Therefore, there is no alternative at all to future support for President Yeltsin. If stability and economic progress is achieved there,

[11] German Information Center. *The Stabilization of Central and Eastern Europe*, pp. 2–3.
[12] Interview with Otto Wolff von Amerongen on the Deutschlandfunk network, October 5, 1993, in Foreign Broadcast Information Service, FBIS–WEU–93–192, October 6, 1993, p. 12.
[13] Interview with Karl-Hermann Fink, *Handelsblatt*, October 13, 1994.

the whole of Europe will benefit from it. Russia must be fully integrated within the world economy—."[14]

Two major issues dominated Germany's agenda prior to August 1994. The first was the withdrawal of Soviet troops from East German soil. Given the difficulties of negotiating the withdrawal agreements and the high political symbolism of the Soviet retreat, the whole process has gone remarkably smoothly. There were, after all, 380,000 troops plus their dependents in 1990. After the collapse of the Soviet Union at the end of 1991, there was German concern that the withdrawals might encounter major problems, since not all the soldiers were Russian and they had to decide to which country they were to return. In addition, the Germans had initially envisaged building the housing for the soldiers in Ukraine. After the end of the USSR, they had to revise their plans. Despite all these problems, and the periods of high tension during the August 1991 putsch and the October 1993 assault on the Parliament, the troop withdrawals proceeded uneventfully. Occasionally Soviet officials would bargain (usually successfully) for extra financial assistance and there were some incidents of desertion and clashes between East Germans and Russians; but, given all that could have gone wrong, the process was highly successful.

The second, and enduring issue, has been the situation of the two million ethnic Germans in Russia and Kazakhstan. These descendants of eighteenth-century settlers, who were deported from their homes in the Volga ASSR to Siberia and Central Asia after the Nazi attack on the USSR in 1941, have a constitutional right to German citizenship. In the 1970s and 1980s, Bonn offered the Soviet Union economic incentives to permit these people to emigrate to West Germany. After unification, however, the German government can no longer absorb these immigrants, and it has, since 1991, offered the Russian government financial incentives to keep the ethnic Germans in Russia and to encourage those in Kazakhstan (about one million) to emigrate to Russia, not Germany. The ethnic Germans are divided among themselves about whether they should emigrate. Meanwhile, after much German prodding, President Yeltsin has agreed to restore partially the Volga republic around the areas of Saratov and Volgograd, although he has run into opposition from local Russian groups. At the March 1994 meeting between Sergei Shakhrai, Russia's Minister for Nationalities and Regional Policy, and Horst Waffenschmidt, parliamentary State Secretary in the German Interior Ministry, it was agreed that Russia was "interested in keeping all Russian Germans in Russia," and that both the German and Russian governments would assist ethnic Germans residing in Russia.[15]

The German government has announced that it will not accept more than 225,000 ethnic German immigrants from the former Soviet republics per year. Twice as many have recently applied to emigrate. In response, German public and private organizations are involved in improving living conditions for ethnic Germans. They are promoting German cultural, language and Lutheran reli-

[14] Kinkel speech to the Bundestag, quoted in *Das Parlament*, March 25–April 1, 1994.
[15] Moscow Interfax in English, March 15, 1994, in Foreign Broadcast Information Service, FBIS-SOV-94-051, March 16, 1994, p. 11.

gious training in magnet areas such as Saratov, Volgograd, Omsk, Altai, and Odessa. The Interior Ministry has earmarked more than DM 300 million for housing construction, small and medium-sized enterprises, agricultural and medical facilities in which both ethnic Germans, Russians and other groups will work. German firms are building modern infrastructure in these regions, hoping to persuade ethnic Germans to remain in these magnet regions and to convince the local Russian population that they, too, will benefit from these services. It remains to be seen whether the German government will be able to dissuade these people from emigrating. Much will clearly depend on the evolution both of the Russian economy and of regional and local government structures within the Russian Federation.

A related issue is the future of Kaliningrad, the former Koenigsberg, which the USSR took from Germany after the Second World War. Since the fall of the Soviet Union, the Kaliningrad oblast' is physically separated from Russia by Lithuania and Poland, although it remains juridically part of the Russian Federation. A highly militarized area, it has attracted a considerable amount of German investment, which the Russian government has encouraged, claiming that Kaliningrad should become a prosperous free trade zone, "*Yantar*" (amber), in which foreign firms will invest. But the Russian government has resisted any plans that would give the appearance of "Germanizing" the Kaliningrad area. It has discouraged ethnic Germans from migrating there, and has rejected German requests to open a consulate there. That, according to Foreign Minister Kozyrev, would portend a relapse "into the German urge to the East." [16] Germany has stated unequivocally that it is not interested in revising borders or reconstructing East Prussia, but the region's anomalous situation will continue to present the potential for conflict between Russia, Germany, Poland and Lithuania.

Despite these areas of tension, the German-Russian relationship has evolved positively in the past three years, according to German government officials and politicians. The visit by Yeltsin to Bonn in May 1994 had all the attributes of a normal summit; that is, despite areas of disagreement, there was an expectation of continued partnership and a basic consensus on most issues. The German government remains committed to institutionalizing President Yeltsin's reforms. It favors a close partnership with Russia in NATO, although does not envision full Russian membership for the foreseeable future. It will continue to push for Russia's integration into the G–7 group of countries, to create a G–8. But it remains concerned about Russia's future course. As one commentator put it, "For Bonn, Moscow is a Janus-faced partner. Should it look to the future? Or should it look back in anger? It is going in both directions at the same time." [17]

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[16] Andrei Kozyrev, quoted in *Der Spiegel* (21 March 1994), p. 145.
[17] *Sueddeutsche Zeitung*, March 22, 1994.

THE RUSSIAN AGENDA

RUSSIA IN SEARCH OF AN IDENTITY

Russia, like Germany, is a new state, but the domestic upheavals it is experiencing are far greater than those in Germany. In many ways, Russia is like a defeated country, except that there was no war. Not only did the seventy-four-year-old communist system collapse; Russia also lost its internal and external empire. When Presidents Yeltsin, Kravchuk and Shushkevich signed the agreement on December 8, 1991, that led to the dissolution of the USSR and the creation of the Commonwealth of Independent States (CIS), they had no clear idea of what the relations between the new post-Soviet states would be. Since 1991, it has become clear that many Russians, even if they have rejected communism, find it difficult to reconcile themselves to the breakup of the Soviet Union. Difficult as the domestic transitions are—from a centrally planned to a market economy, and from totalitarianism to democracy—the third transition—from an imperial to a post-imperial, national state—is perhaps the most daunting, because it is the dimension in which perception lags furthest behind reality. After all, Russia dominated its neighbors for four centuries; its sense of national identity and national interests arose in conjunction with its imperial destiny, and was inseparable from it. Although Russia's military prowess and ability to project power abroad have diminished, its self-perception as a major European power with legitimate interests both in the countries of the former Soviet Union and Eastern Europe is still very much alive.[18]

Russia's major preoccupation is with its domestic economic and political problems, as it struggles to implement market reforms and develop an effective pluralistic political system. Its foreign policy is thus largely dependent on its domestic situation. The magnitude of trying to construct a viable democracy and market economy on the ruins of communism absorbs much of its leaders' energy. Inasmuch as foreign policy plays a role, the principal focus is with the new independent states. A major difficulty is dealing on an equal footing with former subject states whose own history of independence and statehood is somewhat ambiguous. It has been a major readjustment for Russia to view its dealings with Ukraine as a foreign country, as opposed to part of its own jurisdiction. The overriding issues between Russia and the successor states concern legitimacy and sovereignty, questions made all the more complicated by the countries' continuing close economic integration.

Moreover, the presence of 25 million Russians in the successor states has created a diaspora that can easily fuel ethnic tensions outside Russia. The Russians' tendencies to define nationality in an extraterritorial way, implying that a Russian living in Ukraine owes their first loyalty to Moscow, not Kiev, has exacerbated tensions. Russia claims that it has the right to defend all ethnic Russians living outside of the Russian Federation. Conversely, some of the new states have passed legislation that discriminates against the Russian population. The potentially explosive combination of

[18] See Angela Stent, Thane Gustafson, and Daniel Yergin, "The Return of a Great Power," in *Russia 2010*, chap. 15 (London: Nicholas Brearly), 1994.

economic, ethnic, and security tensions could cause serious conflicts between Russia and its neighbors, particularly Ukraine. Russia has clearly stated that it has a special sphere of influence in the successor states (The Russian Monroe Doctrine) and has the right to act as an intermediary in conflicts between them.

In terms of relations with countries beyond the borders of the former Soviet Union, Russia is again engaged in a debate that is centuries old—whether Russia should be part of Europe, or whether it is a Eurasian power, with its own unique interests and destiny that is distinct from that of Europe. After a brief period of almost unquestioning cooperation with the West and neglect of East-Central Europe, Russian officials and politicians began to revise their views in 1993, and by 1994, even Foreign Minister Kozyrev, known as a firm supporter of a pro-Western policy, began to distance himself from automatic support of the United States and Western Europe. Russia has begun to play an active role in the conflict in the former Yugoslavia, pursuing policies that do not always coincide with those of NATO and it has criticized American policies in other areas of the world, especially since the December 1993 State Duma elections, which brought communists and nationalists, as well as reformers, to power. After a brief period of relative inactivity, therefore, Russia has begun to pursue a more assertive foreign policy.

RUSSIA AND EAST-CENTRAL EUROPE

Russia's attitude toward East-Central Europe has also undergone changes since the fall of the USSR. After the unification of Germany, and the collapse of the Warsaw Pact and the Council for Mutual Economic Assistance, Soviet relations with East-Central Europe atrophied, largely because the countries of East-Central Europe, having just liberated themselves from communism, precipitously severed many of their links with Moscow. For their part, the Soviet officials and then the Russians focused on building up a new relationship with the West and on developing ties with the successor states, largely neglecting East-Central Europe. The seeming disinterest in East-Central Europe coincided with the brief honeymoon period with the West, in 1991 and 1992. But that has now changed.

Although no responsible politicians or foreign policy commentators are calling for the restoration of the Soviet empire in East-Central Europe, Russia has increasingly stressed that it does have legitimate security interests in that region. Its major concern is to ensure that East-Central Europe does not threaten Russian territorial and economic security, by joining an alliance that could be directed against Moscow.[19] It seeks to minimize East-Central Europe's ties to West European or transatlantic structures that exclude Russia, although it is well aware that these countries will do all they can to join the EU and NATO. As President Yeltsin's press spokesman, Vyacheslav Kostikov, put it: "Russia considers itself to be a great power and the successor to the Soviet Union and all its might. Everybody clearly understands that Russia cannot and does

[19] See Allen Lynch, "After Empire: Russia and Its Western Neighbors," *RFE/RL Research Report*, vol. 3, no. 12, (25 March 1994).

not want to wait in the entrance hall of the "European house" and to ask permission to enter."[20] One commentator has even suggested that Russia can protect East-Central Europe from growing German ambitions in this area.[21]

Russia's more assertive stance in East-Central Europe was clearly evident in its policy toward NATO's eastward expansion. Although in August 1993 it appeared that President Yeltsin had endorsed Poland's desire to join NATO, a month later he clarified his position, stating that Russia opposed NATO expansion if it were to threaten Russian security, and that, unless Russia itself were admitted to NATO, no East-Central European state should be. Russia fears that NATO expansion would redraw the boundaries of Europe at the Polish-Ukrainian border and would leave Russia exposed to possible dangers from the East and West. As Kozyrev said, "The future of Eastern Europe lies in its transformation—not into some kind of buffer zone but into a bridge connecting the east and the west of the continent."[22] Other commentators have alluded to the psychological shock that NATO membership for East-Central Europe would cause, particularly among the Russian military and the more rabid nationalists. Partly in response to this Russian argument, the NATO alliance formulated the Partnership for Peace concept, which offers a framework for enhanced cooperation between NATO and all of the former Warsaw Pact states, including Russia, but falls short of full membership. It should also be remembered that this compromise is to NATO's liking, because there is as yet no consensus within the West about whether NATO's vital interests are sufficiently involved in East-Central Europe to warrant membership for these states.

The revival of Russia's relations with East-Central Europe does not presage a concerted effort to reestablish Soviet-type hegemony. But it does mean that Russian will continue to assert its interests in the region and to block the area's incorporation into economic or political structures from which Russia is excluded. It also indicates that Russia and East-Central Europe have realized that the precipitous rupture of their economic and political relations after 1989 was counterproductive for both sides, and that it is in their interest to rebuild their relations, albeit on a more equal footing than previously. Recently, East-Central European states themselves have indicated their interest in improving ties with Russia. "Poland cannot turn its back on the East," said Polish Foreign Minister Andrej Olechowski, urging closer economic and political links with Moscow.[23] As more left-wing governments have come to power in the area, they have realized that Russia remains a promising market for their goods, especially given the restrictions on exports to the EU. This revival of Russian-East-Central European ties is inevitable and may have positive economic results; but the uncertainty about Russia's future direction and ambitions has also reinforced the conviction in East-Central Europe that it must keep its West-

[20] Cited in Suzanne Crow, "Russia Asserts its Strategic Agenda," *RFE/RL Research Report*, vol. 2, no. 50 (17 December 1993), p. 2.
[21] Aleksei Zubov, "Vostochnaia Evropa Mezhdu Rossiei i Germaniei" (Eastern Europe Between Russia and Germany), *Izvestiia*, December 22, 1994, p. 9.
[22] Kozyrev, quoted in Crow, "Russia Asserts," p. 5.
[23] *New York Times*, June 9, 1994.

ern options alive and press for closer integration with the West at the same time as it pursues ties with Russia.

RUSSIA AND GERMANY

Prior to unification, the Soviet Union's major source of leverage over Germany was the inter-German relationship, over which Moscow had considerable control. After unification and the withdrawal of the last Soviet forces from East Germany, Russia's sources of leverage have greatly diminished. The major source of leverage will be negative—Russia's ability to disrupt European security because of its own instability and to threaten Germany's stability through a major influx of refugees. The Russians are conscious that the German fear of Russian weakness is probably as great as the German fear of Russian strength, yet they remain uncertain about Germany's future commitment. Around the time of President Yeltsin's May 1994 visit to Bonn, there were major discussions in the Russian press about whether Germany would lose interest in Russia after the final troops were withdrawn, focusing rather on East-Central Europe, whose economic and political prospects seem more secure. Russia has also become more aware that it must compete with East-Central Europe for Germany's limited financial resources.

The major Russian interest in Germany is economic. Russians have long admired German technological and economic prowess, particularly since the eighteenth century, when Catherine the Great brought Germans to settle in Russia and build its cities and farms. Russians have also recently been studying West Germany's experience after 1945, when it constructed a viable, democratic market society and experienced an economic miracle on the ashes of the destruction of World War II (and with the assistance of Marshall funds). They hope that they can somehow apply the lessons from German experiences to their own challenges. Gorbachev hoped that the price for German unification would be a massive German commitment to rebuilding the Russian economy, and Yeltsin has inherited this view.

Although Germany has given more assistance to Russia than to any other country, its economic involvement in Russia has not lived up to Moscow's expectation (which were unrealistic initially). No outside country can rebuild the Russian economy; the Russians must accomplish this themselves. But the low level of German private investment has been troubling to the Russian government. Yeltsin's visit to Bonn yielded little movement in this area; but Germany remains committed to encouraging its businesses to invest in Russia. Moreover, whereas Germany is committed to seeking EU membership for the Visegrad countries, it has excluded the possibility of Russian membership, although it is supporting an Association agreement with Russia. Thus, Russians have had to come to terms with the limits of German economic involvement.

As far as Russia's hopes for Germany reconstructing a European security system that would grant Russia a special role, these have also fallen short of Moscow's initial expectations. Germany has been a vocal supporter of NATO's Partnership for Peace Program, but it has also been in the forefront of advocating full membership for the Visegrad countries, to Russia's annoyance. Moreover, German politicians have also said that it is highly unlikely that Russia or any other NIS state will ever join NATO. Whereas Germany is willing to take into consideration Russia's security interests and to include Russia in a number of European institutions, it has not supported the creation of a new European security system that would grant Russia a privileged role, a *droit de regard* over East-Central Europe or veto power over its future orientation. However, Russians also recognize that Russia itself has so far been unable to achieve a consensus on what its security interests in Europe are, and that these positions are still evolving. In other words, while Moscow might wish that its relations with Bonn were more productive, it also realizes that it must put its own house in order before reaping major new rewards from this relationship.

IS THE PAST PRELUDE TO THE FUTURE?

Although much uncertainty surrounds the evolution of post-communist Europe, there are powerful forces mitigating against a resurrection of German or Russian domination of East-Central Europe. Germany remains firmly anchored in the EU and harbors no expansionist goals east of the Oder-Neisse. It is preoccupied with the reconstruction of unified Germany and will remain so for the forseeable future. It has learned important lessons from its history, namely that military domination of East-Central Europe has twice led to its defeat. There is no significant domestic constituency in Germany that argues for retaking the lands that Germany lost after 1945. Germany has been actively involved in promoting the transitions in East-Central Europe and will remain a major influence there, but its agenda does not threaten the interests of the states in that region.

Russia, too, remains preoccupied with its domestic problems and with its relations with former Soviet republics. Its post-communist transitions will be long and difficult and will absorb its energies for decades to come. There is a fundamental lack of will to reconquer the Soviet empire, particularly since most Russians believe that they were economically exploited by East-Central Europe and that while they bore the burden of occupying these countries, their subject populations lived better than those in the USSR. Nevertheless, Russia and East-Central Europe have begun to revive their contacts and will continue to do so, for economic as well as political reasons. And there are some politicans in Russia who believe that Russia should reassert a sphere of influence, as opposed to a sphere of control, in East-Central Europe.

Thus, if Europe continues on its current path, East-Central Europe will enjoy greater independence than it has for a long time. But, given the unpredictability of the transition processes, there could be unanticipated and unwelcome surprises down the road. If Germany's economic problems were to increase rapidly and if unemployment grew at a much faster rate, then the disenchantment with establishment politics could grow. It is conceivable that a right-wing government could come to power, and that this government might reassess Germany's postwar commitment to European unity and to eschewing great power politics. However, it must be stressed that this scenario is extremely unlikely.

Russia might well provide more surprises, given the potential for instability there. It is conceivable that a more nationalist, anti-reform, neo-communist or right-wing government could come to power and that this government would seek to restore the Soviet Union and possibly Russian hegemony in East-Central Europe.[24]

Short of a serious deterioration in Russia and the coming to power of an aggressive government, however, East-Central Europe should, for the next decade, enjoy a unique window of opportunity to construct a viable post-communist order while Germany and Russia are engaged in similar endeavors. To maximize the region's chances for continued independence, it will be vital to maintain American engagement in East-Central Europe and U.S.-European cooperation on all levels. United States support for the emerging democracies east of the Oder-Neisse will act as a stabilizing force, ensuring that Germany and America continue their work together to assist East-Central Europe and Russia in the enormous challenges that they face.

[24] For a fuller discussions of possible future scenarios, see Stent, Gustafson and Yergin, "The Return of a Great Power," Part IV.

IV. COUNTRY STUDIES

OVERVIEW

By John P. Hardt and Phillip J. Kaiser*

The Central-East European region has emerged from the shadow of the Soviet Union. The individual states of the region—each with its own different historical, cultural, political and economic characteristics—are now visible in a new light. Each country is pursuing its own course of reform and each is appropriately assessed separately in the section below. However, there are some similar, overarching characteristics. Historically, stronger neighbors to the east and west have vied for influence and control over the area of the current states. Four great empires, Austro-Hungarian, Prussian, Russian, and Ottoman have influenced or controlled major parts of the region. From 1945 to 1991 some or all of the countries, including the former East Germany, were under direct military and/or strong political and economic influence from the Soviet Union through the Warsaw Pact and Council for Mutual Economic Assistance (CMEA). Relations among the states of the region were controlled by the USSR, and integration was primarily with the Soviet Union. Regional dependence and isolation from the West was reinforced by both sides during the height of the cold war by Soviet control and Western embargoes such as through the Coordinating Committee for Multilateral Export Control (CoCom).

Each state has welcomed the end of the Soviet empire and the system of communist party control. The transformation from a command economy with legality determined by party leaders, toward a democratic and market system under a rule of law, is generally under way, although each state has pursued a somewhat different path of change and has seen different performance in the period marking the end of Soviet dominance in the region from the fall of 1989 to 1994. With the possible exception of Poland and Romania, each has the constraint of having a relatively small domestic economy, and they all start from a position of substantial dependence on external economic relations. Some are more independent due to resource endowment, size, geographic location or other factors.

Political, economic, and security problems due to either ethnic or political differences are common and influence their economic performance; some have more domestic consensus and stability than others. All the states now look more to the West for assistance, in-

*John P. Hardt is Senior Specialist in Post-Soviet Economics, and Phillip J. Kaiser is a Consultant; both are with the Congressional Research Service, Library of Congress.

vestment and security, than to each other and still less to their eastern neighbors.

Many in the region feel that the area suffers because they drew attention when they were under the imposed control of Great Power neighbors, but with independence they are forgotten by the very countries that could provide critical assistance and open markets. Part of the reason they aspire for membership in the European Union and NATO may be so they will not be forgotten.

Within the regional assessment of similarities and differences described above, economic performance has varied significantly. How their performance differs and why is the subject of the country studies that follow. The country studies deal with three major topics that differ for each country: the heritage of the communist period since World War II; transformation and performance in the post-revolutionary period 1989–1994; and future prospects for the individual countries. There are both strong common factors as well as substantial differences among the nations of Central-Eastern Europe in these three areas.

HERITAGE

All countries in the region were strongly influenced from 1945–1989 by Soviet policy. Initially the Soviet leaders were especially concerned with making the region secure from future threats such as those posed by Nazi Germany; as a consequence they extended Soviet influence beyond divided Germany and channelled resources from the region to facilitate recovery of the war-devastated Soviet Union. The tight Soviet political-military control and transfer of resources varied from the occupation and heavy reparation burden on the Soviet zone of Germany to the initially less intrusive policy toward Czechoslovakia after 1948 when they came into the Soviet orbit of power. The transfer of resources from Eastern Europe to the Soviet Union may have rivalled the Marshall Plan in value, but from 1949–1955 resources were flowing out rather than into the region.

This initial period of more direct occupation was eased after the Hungarian uprising in 1956, but the "misdevelopment" continued by compelling planned development of the region's economies to give priority to meeting Soviet needs and to emulate the Stalinist model. From 1960–1989 the dependency of the region increased for cheap Soviet oil and gas; this energy dependency was financed in large part by export of relatively noncompetitive machinery production. As this exchange was valued at Western market prices it could be said to favor the region and was referred to by some as an "implicit subsidy" by the Soviet Union.

Caught in the cold war conflict, the region was denied access to markets and technology of the West through CoCom, and their own closed economies effectively cut them off from their major pre-communist and natural trading partners. An exception to this policy of mutual isolation was the special inter-German relationship that made the Soviet sector of Germany, later the German Democratic Republic, a special de facto member of the Common Market.

The misdevelopment resulting from the imposition of Soviet priorities not only forced the countries from their natural economic development path based on comparative advantage of small, foreign dependent countries, but led to the destruction of the professional classes currently needed for staffing the market transition; instead of economists, bankers, and entrepreneurs, the economies were guided and managed during the communist period by the party-oriented apparat. With few natural resources, the need to rely on professional expertise and skilled labor forces for comparative advantage was compromised in most countries.

The burden of regulated trade conforming to Soviet plans and misdevelopment imposed by conformity to the Soviet model was particularly heavy on the more economically advanced countries in the northern part of the region: the eastern sections of Germany, Poland, Czechoslovakia, and Hungary suffered the greatest distortion in value of output. While Bulgaria was often given a preferential position in trade with the Soviet Union, and Romania and Albania were largely left to their own devices, little assistance was provided for the Balkan countries' economic development. Indeed, Soviet influence in the post-Stalin period might have helped Romania avoid its belated Stalinism in industrial and agricultural development and encouraged more openness and consumer-oriented development in Albania.

Symbolic of the heritage carried over from the communist period were the massive metal working, machinery plants such as Nowa Huta in Poland that were dependent on a captive Soviet market for survival—the modern version of the windmills of the middle ages that survived the industrial revolution in the West. Managers of these plants were economic bureaucrats that were assured that their production would be absorbed by uncritical Soviet demand—a modern version of Say's law so strongly criticized earlier in the West by J. M. Keynes as a factor in encouraging the Great Depression.

TRANSFORMATION AND PERFORMANCE, 1989–1994: THE GREAT DEPRESSION IN THE EAST

All countries committed to a transition to a market system were faced with an inevitable period of recession, inflation, and unemployment. The reduction in Soviet demand for heavy industrial, military-related products was accompanied by a general collapse in trade with the East and a loss of the German market. Liberalization of prices, the Soviet oil price shock, deficit spending, and the exposure of hidden inflation contributed to increased inflation in all countries. The fall of output, closing of unprofitable enterprises, and recognition of concealed unemployment led to higher rates of reported unemployment. Foreign debt burdens further exacerbated the negative performance measures in Poland, Hungary, and Bulgaria. Interenterprise debts and related subsidies increased these adverse trends and resulted in a fall in real wages. A greater disparity in income distribution began to appear. The rise in real interest rates and very short duration of loans discouraged domestic investment. Political and economic uncertainty encouraged capital flight and discouraged direct foreign investment, which fell short of the needs of funding restructuring and recovery. The expectations for prosperity to come with freedom in this revolutionary period were disappointed in most countries in the region.

Poland, the first in revolutionary change, recovered first from the transformation recession, experiencing accelerating GDP growth since 1992. As Ben Slay points out, Poland has been one of the fastest growing economies in Europe, East or West, in the past several years. Growth in light industry, services, and some export sectors has been brisk. Privatization of small and medium enterprises helped the recovery. However, as with other countries in the region, privatization has been slow in the large, heavy industrial, defense-related enterprises. Poland's explicit and relatively firm austerity program largely stabilized the economy and laid the groundwork for economic expansion, however inflation and unemployment remain too high and the debt burden is still a cloud on the horizon. Political instability has characterized the transition, but the strict economic policies have remained largely intact.

Hungary has attracted the largest amount of foreign investment, most likely due to its decades-long heritage of reforms that provided at least a margin of advantage in market skills. Political upheaval, including the return of former communists to the government, and a heavy debt burden have dampened performance thus far, but reforms appear to be generally on track, and according to Paul Marer, a period of sustained economic growth may be in the offing.

Perhaps most successful in dealing with the economic downturn was Czechoslovakia and later the Czech Republic. The government has done well in articulating a strategy defining where and why it is changing the economy. The country also benefitted from a reasonably stable government, popular support for change, and low foreign debt. Government intervention in the economy has maintained low inflation and unemployment, while keeping wages low. The split with Slovakia in January 1993 caused more disruption than anticipated, but the Czech Republic seems to be headed for an economic upturn this year.

Slovakia, as part of the Czech and Slovak Federal Republic, followed policies that began the stabilization of the economy, but the results had a heavier economic cost than in the Czech lands. Higher unemployment and national self-determination motivated political leaders to push for sovereignty. Policies since the split were more ambiguous; privatization was delayed, for example, but as Josef Brada points out, "compared to other Central European countries such as Poland and Hungary, the Slovak Republic fares surprisingly well."

Bulgaria, like Poland and Hungary, has a heavy foreign debt burden that limits the options of government policy. Economic stabilization has been largely successful, but is fragile as unemployment and inflation remain high. Large-scale privatization has been very slow and foreign investment is low. Michael Wyzan states that "the biggest Bulgarian economic problem is undoubtedly the politicization of all major policy decisions."

Romania's reform policies have been stop-and-go during the transition, according to Marvin Jackson. The government's lack of political credibility has hindered implementation of reform measures, as few economic actors believe that reform measures will be properly administered and enforced. Labor unrest has been volatile. The political opposition also appears to lack economic expertise, strong leadership, and credible alternatives.

Remarkable post-revolutionary growth has occurred in the most ideological country of the recent past, Albania. Isolated by communist orthodoxy (first Stalinist then Maoist), and the strict control of the leader Enver Hoxha, it is an extremely poor and undeveloped country. However, admitting that it is moving up from a very low base, Albania has achieved a measure of stabilization, and the prospects for economic growth are favorable. Robert Cohen credits the government's consistent reform policy, which has laid the foundation for economic development.

The former Yugoslavia was beyond the direct influence of Soviet power with economic ties to the East and West, and seemed poised to move early toward transformation to the market. Unfortunately, most of the successor states of Yugoslavia have become either a war zone too politically unstable to foster economic reform or are subject to embargoes related to the war or historical disagreements. Only Slovenia has made good progress in establishing macroeconomic stabilization and improved economic performance, and projects what Franjo Stiblar describes as an optimistic view of the future. Croatia has made progress on reforms despite the war, although the war has significantly increased the costs of transition as production has fallen steeply, according to Ivo Bicanic. Milica Bookman describes the difficulties of both implementing reforms during the chaos of war, and assessing the economies. The economies of Serbia, Montenegro, Bosnia-Herzegovina, and Macedonia are characterized by "economic decline and chaos . . . [including] a growing underground economy."

The eastern states of unified Germany have an expanding economy, although they are plagued by large macroeconomic imbalances and structural distortions, according to Lutz Hoffman. Economic growth is largely due to a financial transfer from Western Germany, which generally became the conservator of the bankrupt states of the former German Democratic Republic. Still, the Germans were not spared the burden of unemployment and fall in incomes.

For the region as a whole, the quality-of-life measures that deteriorated during the communist period have been slow to improve and in many cases have deteriorated further, including the environment, health, and housing. Moreover, as the ranks of unemployed increased the problem of social security—the social safety net provided by the enterprises—became more important and a cause for further distress.

Future Prospects

An overarching problem for the future transformation in most countries in the region is a lack of a clear strategy and a political consensus supporting transformation. Determining where they are going with a credible expectation that living standards and employment opportunities will improve may be a necessary basis for a consensus on change. Without a clear vision and strategy it is also difficult for foreign assistance and international organizations to pattern their support for consistent programs of transformation to the market.

Joining Western institutions, particularly the European Union, seems to be the common aim of all countries now looking intently to the West for policy direction and markets to improve trade and performance, much as they once looked to the East in earlier times. EU association agreements have been established, but the timing of full membership is yet to be decided. The need to revive natural trading relations with their former CMEA trading partners seems to receive less attention than merited. It is an area where they may find expanding markets for steel, textiles and agricultural goods. Without expanding trade and commerce how can they afford to pay for oil and gas from Russia and elsewhere in the new independent states?

Privatization needs to go beyond a change of ownership from the state to private hands, and the large enterprises need to be restructured and broken up. Substantial increases in beneficial direct foreign investment requires not only a clearer strategy and consensus but institutional steps toward becoming competitive enterprises. That is, privatization must include a hard budget constraint—an end to large state subsidies and an end to government bail-outs of firms with heavy inter-enterprise debts.

Likewise, market-friendly institution building is critical to assure stable domestic economic growth and expanded trade and investment. Included in these institutional requirements are: (1) an independent central bank and efficient commercial banking system; (2) market-related revenue and budgetary systems; (3) an institutional framework for a social safety net and; (4) a legal and regulatory framework for foreign commerce and investment. There have been promising developments in these institutional changes in the Czech Republic, Poland, and Hungary, but further institutional developments are essential even in these countries.

Finally, the small economies of the region depend heavily on their external environment, especially for energy resources and markets for their products. An ideal scenario would have successful reform with positive economic performance in Russia and other major states of the former Soviet Union, robust growth in the Western industrial economies, avoidance of the instability of the former Yugoslavia, and attainment of domestic political and economic stability and consensus in each country. Paul Marer suggests that in a favorable environment "Hungary could be poised to enter a period of rapid and sustained economic growth by the year 2000." This could be said of many of the countries of the region. If the electorate, the leadership in the region, and Western supporters of reform could be assured of a strong takeoff in the countries of Central-East Europe, the strategy for change could attain an early consensus.

THE POLISH ECONOMIC TRANSITION

By Ben Slay *

CONTENTS

SUMMARY

The significance of the Polish economic transition extends well beyond Poland. Poland is the largest, in terms of area and population, of the post-communist Eastern European countries that are not former republics of the Soviet Union. Poland's location between Germany on the one hand and Ukraine, Belarus, Lithuania, and Russia's Kaliningradskaya oblast' on the other means that Poland serves as a gateway to Europe for much of the former USSR. Poland was the first former Warsaw Pact country in which the communist party (in Poland, the PZPR) was voted out of office (in 1989) and replaced by a coalition led by the opposition Solidarity movement. Poland's "big bang" program for the transition from socialism to capitalism that is frequently dated to January 1990 was also the first of its kind, and as such had an important influence on the transition programs adopted in the former Soviet Union, as well as in other Eastern European countries.

While the Polish transition has been full of surprises and can hardly be viewed as an unqualified success, it is this observer's opinion that the transition has on the whole been successful, especially when compared with Poland's neighbors to the East and South. While important mistakes were committed during the transition, many of Poland's economic problems have resulted either from developments beyond policy makers' control or from the nature of the post-communist transition, much of which, for Poland, was unprecedented.

In terms of successes, Poland was the first country in the region to break the recessionary forces accompanying the Eastern European transition. Since March 1992, in fact, Poland has been one of

* Ben Slay is Assistant Professor of Economics at Middlebury College, Middlebury, Vermont.

Europe's fastest growing economies. The restoration of growth occurred simultaneously with sustained declines in inflation rates, which were bordering on hyperinflationary levels at the start of the transition in late 1989 and early 1990. Poland since 1990 has made major progress in attaining external balance and increasing external creditworthiness; agreements were concluded forgiving significant shares of Poland's external indebtedness vis-à-vis the Paris Club of creditor governments (in 1991) and the London Club of creditor banks (in 1994). Poland's foreign trade has been definitively reoriented away from the former members of the Council for Mutual Economic Assistance (CMEA) toward the developed capitalist countries of the Organization for Economic Cooperation and Development (OECD). Poland has been a leader in establishing new forms of intra- and extra-regional integration. Finally, Poland has established the region's largest private sector, and the Warsaw stock market enjoyed an impressive boom in 1993.

On the other hand, Poland's economic successes have been neither complete nor widely generalizable to other countries. Large, inefficient state-owned enterprises (SOEs) have resisted programs for privatization, restructuring, and bankruptcy, and the banking system's serious problems have eluded resolution. State budget deficits on the order of 3–5 percent of gross domestic product (GDP) have persisted since 1991, and foreign investment has been less than anticipated (or needed). Moreover, a largely apathetic Polish electorate, when given a chance to register its (dis)approval of the course of the economic transition, has on two occasions failed to deliver votes of confidence. The second and most definitive vote occurred in the parliamentary elections of September 1993, which led to a government formed by the PZPR's successor, the Democratic Left Alliance (SLD), in coalition with the Polish Peasant Party (PSL), a former PZPR ally. Finally, however the pluses and minuses of the Polish transition are assessed, the Polish-style "big bang" attempted in Russia during 1992–93 can only be characterized as a failure, the consequences of which have not yet been fully understood.

MACROECONOMIC DEVELOPMENTS

When the Solidarity-led government of Prime Minister Tadeusz Mazowiecki assumed power in September 1989, it acquired an inheritance fraught with political and especially economic obstacles. Due to Solidarity's wage demands and the PZPR's attempts at improving its electoral prospects through easy money policies, the previous reform communist government of Prime Minister Mieczyslaw Rakowski lost control of the state budget and the money supply in 1989. The central government budget deficit stood at 10 percent of GDP in September 1989;[1] the population's money incomes nearly quadrupled over the course of the year;[2] and retail price inflation (as measured by the official statistics) for 1989 was 243.8 percent.[3] Meanwhile, Poland's more fundamental economic problems continued unabated. The inefficient, highly monopolized

[1] Branko Milanovic, "Poland's Quest for Economic Stabilisation, 1988–91: Interaction of Political Economy and Economics," *Soviet Studies*, vol. 3 (1992), p. 522.
[2] *Rocznik Statystyczny 1990*, (Warsaw: Glówny Urząd Statystyczny), 1991, p. 186.
[3] Ibid., p. 163.

socialized sector accounted for some 80 percent of Polish national income, while prices and incomes for the most sensitive products (and the political lobbies standing behind them) were still determined by the central authorities. Pervasive shortage pressures continued, and servicing (incompletely) Poland's $40 billion foreign debt was becoming increasingly burdensome.

The "big bang" transition program introduced in January 1990 by Deputy Prime Minister and Finance Minister Leszek Balcerowicz was based on the premise that harsh measures were required to forestall hyperinflation while simultaneously setting Poland on course toward a well-functioning market economy. "Third roads" between socialism and capitalism were dismissed as "experiments": the destination was Western-style capitalism, and it was to be reached as quickly as possible. The design and implementation of the "Balcerowicz Plan" benefitted from financial and technical assistance offered by the International Monetary Fund (IMF). Additional assistance was subsequently provided by the World Bank, Western governments, and other international financial organizations.

The near-hyperinflationary conditions in which the Polish transition began were highly unfavorable, and resulted in an understandable emphasis on macroeconomic stabilization. The consolidated government budget was brought into surplus by mid-1990;monetary growth slowed and interest rates increased in real terms; the share of subsidies in GDP fell from 15 percent in 1989 to six percent in 1990.[4] In addition to the anti-inflationary anchors of interest and exchange rate policies, stabilization efforts relied heavily on tax-based incomes policies based on prohibitive taxation of "excessive" SOE wage growth. Not surprisingly, austerity policies were accompanied by rapid increases in unemployment (see Table 1), by large initial declines in real output and wages, and by increases in poverty rates.[5] However, following an initial spurt of corrective inflation in early 1990 (retail prices increased by 132 percent during the first quarter), inflation rates subsequently trended strongly downward.

Emphasis was also placed on price and enterprise liberalization, and on increased currency convertibility. Some 90 percent of prices were completely liberalized in early 1990, and the endless lines that had been an endemic feature of Polish socialism mostly disappeared within a matter of weeks. The major devaluation in January 1990[6] furthered the expansion of zloty convertibility begun by the Rakowski government's legalization of black-market currency trading in early 1989. The liberalization of foreign trade,[7] the deregulation of private and state enterprise activities, and the privat-

[4] Stanislaw Gomulka, "Polish Economic Reform, 1990–91: Principles, Policies and Outcomes," *Cambridge Journal of Economics*, vol. 16 (1992), p. 366.

[5] The official poverty rate doubled during 1989–91, from 17.3 percent to 34.4 percent of Polish households (Branko Milanovic, *Social Costs of the Transition to Capitalism*, working paper, World Bank Policy Research Department, Washington D.C., August 1993).

[6] The official exchange rate was set at 9,500 zloty per dollar on January 1, 1990, following a series of devaluations from 1,775 zloty per dollar in October to 5,200 zloty per dollar in December 1989 (Milanovic, "Poland's Quest for Economic Stabilisation, 1988–91: Interaction of Political Economy and Economics," p. 521).

[7] Kazimierz Dziewulski, "Kogo protegować?" *Zycie Gospodarcze*, February 2, 1992.

TABLE 1. Macroeconomic and External Trends, 1990–93

Category	1990	1991	1992	1993
Gross Domestic Product (Change)	−11.6%	−7.8%	1.5%	4.0% [a]
Industrial Production (Change)	−22.0%	−17.1%	2.6%	6.2%
Consumer Price Inflation	352.2%	70.3%	43.0%	35.3%
Unemployment	6.1%	11.8%	13.6%	15.7%
Consumption (Change)	−11.7%	3.3%	5.0%	6.4%
Merchandise Trade Balance (Convertible Currencies)	$2.2 billion	$51 million	$734 million [b]	−$2.04 billion [b]
Current Account Balance (Convertible Currencies)	$716 million	−$1.36 billion	−$36 million [b]	−$2.27 billion [b]

Sources: *Rocznik Statystyczny 1991*, Warsaw, 1992, Główny Urzad Statystyczny; *Maly Rocznik Statystyczny 1992*, Warsaw, 1993, Główny Urzad Statystyczny; *Rocznik Statystyczny: Handel Zagraniczny 1992*, Warsaw, 1993, Główny Urzad Statystyczny; "Uwiad sektora państwowego, rozwój—prywatnego," *Polska Agencja Prasowa*, January 31, 1992; *Statystyka Polski* supplement to *Rzeczpospolita*, February 6, 1993, pp. I, III, IV, VI; and "Polish Economic Monitor," *PlanEcon Report*, February 14, 1994.

[a] Preliminary official data.

[b] NBP financial data for eleven months. Not consistent with customs data.

ization efforts begun by the Rakowski government were also expanded.

The Balcerowicz Plan was a source of intense controversy, especially during 1990–91. The recession of 1990–91 which, according to official statistics, saw Polish GDP decline by some 20 percent (Table 1), was frequently blamed on Balcerowicz's "shock therapy"; and its author did not politically survive Poland's fully free parliamentary elections in October 1991. However, neither the right-wing populist government of Prime Minister Jan Olszewski that held power from December 1991 to June 1992, nor the "post-communist" SLD-PSL coalition government of Prime Minister Waldemar Pawlak that followed the September 1993 parliamentary elections, were able to definitively break with the logic of the transition program begun by Balcerowicz. This resulted from a number of factors, including the constraints on economic policy imposed by IMF conditionality,[8] Poland's inability to fund grandiose industrial policy schemes, and the positive economic trends that began to take root in 1992.

In any case, Poland's "transitional recession" of 1990–91 has affected the economies of the former Soviet bloc, and can be traced to two other causes besides stabilization efforts. The liberalization of prices and enterprise activity leads to the "creative destruction" of productive capacity that had previously been employed in value-subtracting activities. Also, Poland (and the rest of the region) during 1990–91 was hit by external shocks in the form of reductions in intra-CMEA trade, higher oil import prices, and the loss of Middle Eastern export markets.

The combination of Polish stabilization and liberalization efforts meant the introduction of market competition, less central paternalism, and new pressures on SOEs to become more efficient. On the one hand, restructuring initiatives often fell victim to "wait and see" postures that many SOEs (especially larger ones) adopted when faced with these tighter budget constraints, and to unclear

[8] Wojciech Bieńkowski, "Can Poland Deviate from IMF Requirements?" *Radio Free Europe/Radio Liberty Research Report*, vol. 1, no. 31 (July 31, 1992).

intra-SOE governance, since property rights were often contested by enterprise managers, workers' councils, and trade union officials.[9] On the other hand, the number of SOEs responding to market pressures by restructuring production lines and seeking new markets did increase with time.[10] Combined with the rapid expansion of the private sector (discussed below), this helped Poland to break out of the transitional recession in 1992. In 1993, in fact, Poland recorded the second highest rate of GDP growth in Europe (after Albania). As a result, even according to the official statistics, consumption by the end of 1993 had essentially returned to its pre–1990 level.

Polish macroeconomic performance during 1990–93 was less favorable in a number of respects. Inflation rates were consistently higher than predicted, especially during 1990–91. While the importance of Poland's escape from hyperinflation can scarcely be exaggerated, Polish inflation rates in 1993 were still the highest in Central Europe.[11] Polish unemployment rates, while difficult to interpret unambiguously (see below), were at the end of 1993 the second highest in Eastern Europe (after Bulgaria). And after maintaining a fiscal surplus for most of 1990, the central government budget lurched violently into the red in 1991, necessitating a series of tax increases and spending cuts to keep the deficit from ballooning beyond the 5 percent share of GDP sanctioned by the IMF. Because serious reforms of the social safety net were not attempted, Poland's post–1990 budget deficits have had a strong structural (as opposed to discretionary, policy-based) element, and are therefore not easily amenable to cyclical correction. Consequently, Poland's public debt dramatically expanded after 1990, while the partial monetization of the fiscal deficits injected additional inflationary stimuli into the economy. (This contributed to the higher-than-forecast inflation rates during 1991–93). These problems can only be addressed by tackling the structural causes of the deficit. While the introduction of the personal income tax in 1992 (payable in 1993) and value-added tax (VAT) in July 1993 (intended to reduce the scale of tax evasion in the enterprise sector) represented the beginnings of a solution on the revenue side, the rationalization of government programs via means testing was too politically controversial to be generally introduced.

EXTERNAL PERFORMANCE

Increased external creditworthiness and restored external balance, goals that had eluded Poland's communist governments throughout the 1980s,[12] were two of the stabilization program's most impressive accomplishments, especially in 1990. This was particularly important in that, at the end of 1989, Poland's foreign exchange reserves were at critically low levels, while the increasing use of hard currency to finance domestic transactions was restrain-

[9] Wojciech Bieńkowski, "Poland's Bermuda Triangle," *Radio Free Europe/Radio Liberty Research Report*, vol. 1, no. 17 (April 24, 1992).

[10] See, for example, Ian M. Hume and Brian Pinto, "Prejudice and Fact in Poland's Industrial Transformation," *Finance and Development*, vol. 2 (1993), pp. 18–20.

[11] In 1993 the Czech Republic, Hungary, Slovakia, Slovenia, Latvia, and Estonia registered lower inflation rates than Poland.

[12] See Paul Marer and Włodzimierz Siwiński (eds.), *Creditworthiness and Reform in Poland: Western and Polish Perspectives* (Bloomington: Indiana University Press), 1988.

ing the government's ability to conduct macroeconomic policy.[13] Both the $2.2 billion trade surplus and the $716 million current account surplus recorded in 1990 (see Table 1) were well in excess of official projections and most expectations for that year.[14] While deficits were subsequently recorded in the current account (during 1991–93) and the trade balance (in 1993), Poland's foreign exchange reserves have generally remained at healthy levels, so that the gains of 1990 have not been put at risk.[15] This external turnaround occurred despite a dramatic real effective appreciation of the zloty.[16] So while Polish exporters were becoming more internationally competitive during 1990–93, the zloty's real appreciation was simultaneously helping to reduce inflation.

A major geographic reorientation in Polish trade also occurred after 1989, away from the former CMEA countries and toward the developed OECD economies, especially the European Union (EU), as well as developing countries (see Table 2). While the decline in intraregional trade associated with the CMEA's dissolution in 1991 contributed to this shift, Poland's associate membership agreement with the EU (the trade provisions of which went into effect in early 1992) also played an important role.[17]

These improvements in Poland's external creditworthiness were not lost on the international community. Poland in April 1991 signed a major debt reduction accord with the Paris Club of creditor governments, according to which the governments holding the lion's share of Poland's foreign debt would forgive half of this debt (some $15 billion), provided Poland continued the economic program begun in 1990. A similar agreement with the London Club of Poland's commercial bank creditors was concluded in March 1994, according to which 45 percent of their debt (some $13 billion) would be forgiven. In return, Poland agreed to fully service the country's remaining debt obligation (which it had not done since 1981). The debt reduction agreements, accompanied by the support of the IMF and World Bank during 1990–93, connoted the international financial community's explicit approval for Poland's economic program. The capital inflows that financed the country's current account deficits during 1991–93 (and which kept Poland's foreign exchange reserves at safe levels) can be seen as additional

[13] The share of zloty-denominated money in the total Polish money supply in December 1989 was only 41 percent at prevailing exchange rates. As a result of the stabilization program, this share had risen to 75 percent by the end of 1991. See Stanislaw Gomulka, "Polish Economic Reform, 1990–91: Principles, Policies, and Outcomes," p. 363.

[14] A $3.8 billion hard-currency merchandise trade surplus was recorded in 1990, and Polish exports to the European Union (then the European Community) increased by 52 percent in that year. Poland also registered a 2.5 billion ruble trade surplus with the Soviet Union, and a 1.4 billion trade surplus with the other "socialist" countries in 1990. See Keith Crane, "Polish Foreign Trade in 1990 and the First Half of 1991," *PlanEcon Report*, August 30, 1991.

[15] Throughout 1993, for example, reserves were sufficient to cover about three months worth of imports ("Polish Economic Monitor", *PlanEcon Report*, February 14, 1994, pp. 30, 32).

[16] The zloty's real effective appreciation between January 1990 and April 1992 was estimated at 128 percent ("East European Currency Exchange Rates: Recent Developments and Near Term Outlook," *PlanEcon Report*, April 28, 1992, p. 1–2), despite devaluations of 16 percent in May 1991, 11 percent in February 1992, and 8 per cent in August 1993.

[17] Poland also concluded a free trade agreement with the European Free Trade Area in 1992, and played a leading role in the creation of the Central European Free Trade Area (which went into effect March 1993). See *Russian and East European Finance and Trade*, vol. 30 (1994), no. 1.

TABLE 2. East-West Trade Reorientation, 1989–92

(Percentage, in current prices)

Trading Partner	Share of Polish Imports		Share of Polish Exports	
	1989	1992	1989	1992
Former USSR	18.1	11.9	20.8	9.5
Germany[a]	15.7	23.9	14.2	31.3
(Former) CMEA[b]	32.2	16.3	34.8	15.4
European Union	33.8	53.1	32.1	57.9
(Former) Socialist Countries[c]	31.5	18.2	33.9	16.9
Non-Socialist Countries[d]	68.5	81.8	66.1	87.1

Sources: *Rocznik Statystyczny: Handel Zagraniczny 1991*, Warsaw, 1993, Glówny Urzad Statystyczny; Tomasz Telma, "Polish Foreign Trade in 1991 and Early 1992." *PlanEcon Report* (June 19, 1992); and "Review of East European Foreign Trade Developments in 1992," *PlanEcon Report* (June 29, 1993), pp. 62–63.

[a] The 1989 share is for West Germany only.

[b] Includes European members only.

[c] The 1989 shares are based on data for transactions conducted in the second currency area. The 1992 shares are based on data for former European CMEA countries, plus former Yugoslavia, China, Vietnam, North Korea, Cuba, and Mongolia.

[d] The 1989 shares are based on data for transactions conducted in the second currency area. The 1992 shares are for all countries not included in note c.

international confirmation of Poland's improved external creditworthiness.[18]

On the other hand, Poland's inability to sustain the current account surplus recorded in 1990 raises questions about the durability of these improvements. Worries came to a head in 1993: according to preliminary national bank data, the value of Polish exports during the first eleven months of 1993 declined by some 4 percent, while imports grew by some 19 percent.[19] While recessionary and protectionist trends in the EU (Poland's largest export market) obviously contributed to this result,[20] it did not bode well for Poland's ability to meet the debt-servicing obligations contained in the Paris Club and London Club agreements. Moreover, growing imports have since 1990 eroded the liberal trade regime introduced during 1989–90, although the agreements with the EU, the European Free Trade Association (EFTA), and the General Agreement on Tariffs and Trade (GATT) have constrained Polish protectionism.

To be sure, Poland was in dire need of the growing capital inflows recorded since 1991, and movements on the capital account may have increasingly determined Poland's current account position. However, Poland's difficulties in attracting direct foreign investment (on a per-capita basis, Polish direct-foreign investment, DFI, lagged well behind DFI in Hungary and the Czech Republic) and the 1993 boom on the Warsaw Stock Market implies that much of the capital inflow took the form of portfolio investment. While

[18] These capital inflows also raise the possibility that capital account developments may have increasingly determined Poland's current-account position, rather than the other way around.

[19] "Polish Economic Monitor," *PlanEcon Report* (February 14, 1993), p. 5.

[20] See Bartlomiej Kaminski, "Central European Access to EC Markets: Hard or Easy?" *Transition: The Newsletter About Reforming Economies*, vol. 4, no. 7, September 1993, pp. 6–8; Alan Winters, "Should Eastern Europe Feel Privileged with Its Limited Market Access to the European Community," *Transition: The Newsletter About Reforming Economies*, vol. 4, no. 8, October–November 1993, pp. 11–12; and "Review of East European Trade Developments in 1992," *PlanEcon Report* (June 29, 1993).

these inflows were hardly undesirable, they did imply that Poland's external financing was increasingly dependent on capital of a relatively short-term, speculative nature.

Statistical problems associated with the atomization of Polish foreign trade, the introduction of a new data collection (SAD) system in 1992, and the primitive state of Polish banking produced major discrepancies in Polish trade data, especially during 1992–93. According to data released by the Central Statistical Office (based on customs declarations), Poland ran a $2.7 billion merchandise trade deficit in 1992; while National Bank of Poland (NBP) data (based on payment flows) registered a $400 million merchandise trade surplus.[21] The confusion produced by the SAD system, as well as the relative stability of Poland's foreign exchange reserves, convinced most observers that the NBP data were the more plausible. Still, the presence of such "anomalies" did little to instill confidence in Polish foreign trade accounting.

PRIVATIZATION[22]

The Polish privatization experience is full of paradoxes. On the one hand, Poland has the largest private sector in the region, officially producing 45 percent of Poland's GDP by the end of 1992, and employing 59 percent of the labor force by April 1993.[23] (Unofficially, both shares were much higher, due to shadow-economy activities thought to range as high as 40 percent of GDP.) Private enterprise was particularly well developed in trade and construction activities (Table 3), as well as in agriculture (which was not recollectivized following Poland's 1956 anti-Soviet uprising). Poland's 1993 stock market boom, which was described as "leaving the rest of the world in the dust,"[24] was another indicator of the private sector's dynamism. However, the program for privatizing 400–600 of Poland's largest enterprises was only beginning to take hold in mid-1994, and direct foreign investment (generally estimated in the $4–5 billion range during 1993)[25] lagged well behind DFI in Hungary and the Czech Republic in per-capita terms. The issue of physical restitution of, or compensation for, property confiscated during the communist period remained unresolved. Perhaps most important, privatization was a lightning rod for political opposition to the transition, and has been a source of much political grief for all of Poland's post–1989 governments.

The rapid growth of the indigenous private sector,[26] as well as successes of the small and "liquidation" privatization programs, are

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[21] "Review of Eastern European Trade Developments in 1992," pp. 57–58.

[22] Much of this section is drawn from Ben Slay, "The Indigenous Private Sector in Poland," and "The Perils of Privatizing State Property: The Polish Case," in P.L. Patterson (ed.), *Capitalist Goals, Socialist Past: The Rise of the Private Sector in Command Economies* (Boulder: Westview Press, 1993), See also Louisa Vinton, "Privatization in Poland: A Statistical Picture," *Radio Free Europe/Radio Liberty Research Report*, vol. 2, no. 32 (August 13, 1994), pp. 58–62.

[23] See Ben Slay, "Roundtable: Privatization in Eastern Europe," *Radio Free Europe/Radio Liberty Research Report*, vol. 2, no. 32 (August 13, 1993), pp. 47–57.

[24] According to one source, "Polish stocks offered an average return of 513% in dollar terms" between December 31, 1992 and November 5, 1993. See "East European Stock Market Report," *PlanEcon Report* (November 19, 1993), p. 2.

[25] Louisa Vinton, "Privatization in Poland: A Statistical Picture," *op. cit.*

[26] This term refers to the expansion of private firms that were never owned by the government, i.e., non-privatized private firms.

TABLE 3. Shares of Private Activity in Selected Sectors, 1991–92

(Percentage, share of total employment in a sector, end of year data)

Sector	1991	1992	1993
Industry	35.8	40.5	46.9
Construction	59.5	71.9	80.9
Transport	26.0	25.4	28.5
Trade	88.3	90.7	92.5

Source: *Statystyka Polski* supplements to *Rzeczpospolita*, February 6, 1993, p.I; and February 7, 1994, p.I.

explanation for these apparent paradoxes. The transfer of shops, stores, and small firms to the private sector occurred fairly smoothly in the two years following the passage of Poland's landmark privatization legislation in July 1990. Under the liquidation privatization program, SOE physical assets are transferred (usually via leasing, often with an option to buy) to private corporations in which SOE managers and workers often hold large interests. While this form of privatization can result in the physical and legal liquidation of the SOE, this need not occur in every case. The scale of liquidation privatization was most evident in the fact that, as of March 31, 1994, almost 75 percent of the 2,765 SOEs slated for privatization had been (or were to be) privatized via liquidation.[27]

This grass-roots expansion of the private sector was partly overshadowed during 1991–94 by the controversy surrounding the mass privatization program. Originally announced in June 1991, this program calls for the transformation of 400–600 of Poland's largest industrial SOEs into state-owned corporations, to be owned, managed, and restructured by five to twenty investment funds that would initially also be state-owned corporations. According to the version of the program approved by the Parliament in April 1993, non-transferable certificates (exchangeable for stock in the investment funds) are to be sold at nominal prices to Polish citizens, and SOE managers can decide whether their firms will participate in the program. The funds, which are to receive 60 percent of the stock in the 600 firms, are to be the firms' owners; the funds themselves are to be owned by Polish citizens. Directors of the funds are to appointed by a selection committee, whose members are in turn chosen by the president, government, and the Parliament. Western and Polish consulting firms are to assist the funds in managing and restructuring the 600 "privatized" SOEs. Of the remaining 40 percent of the firms' stock, 10 percent is to be given gratis to the firms' workers, while 30 percent is to remain state property.

Although mass privatization was a cornerstone in the privatization programs pursued by the governments of Prime Ministers Jan Krzysztof Bielecki (January-December 1991), Jan Olszewski (December 1991-May 1992), and Hanna Suchocka (July 1992-October 1993), it did not receive parliamentary approval until April 1993. Opposition to the program was based on numerous economic and political arguments, including: 1) budgetary pressures, which militated against "giving away" 400 of Poland's largest firms; 2) fears

[27] *Statystyka Polski* supplement to *Rzeczpospolita*, May 11, 1994, p. III.

that the investment funds would become neo-socialist ministries unaccountable to their millions of owners; 3) charges that Western consultants would somehow manipulate the program to skim off the cream of Polish industry; and 4) fears of the possible inflationary consequences of creating trillions of zloty worth of new assets that could be exchanged for cash, which would then increase consumption. In any case, by June 1994, neither the exact number of national investment funds, nor their managerial/ownership structures, had been determined; and the sale of certificates to be exchanged for stock in the investment funds had not commenced.

Reprivatization generated almost as much controversy as the mass privatization program.[28] All five of Poland's post–1989 governments resisted well-organized calls for the general restitution of confiscated property to former owners. Fiscal motives played a large role in this position, since restitution of properties that could otherwise be sold would reduce the budgetary revenues privatization is expected to produce, while financial compensation for former owners would be a further budgetary strain. The fear that reprivatization would produce a bureaucratic morass that would forestall other forms of privatization also played a role. Thus, the policies pursued during 1990–93 only sanctioned the return of those properties whose expropriation was clearly illegal at the time of seizure, and whose restitution was not clouded by issues of alteration or modernization. As of mid-1994, no reprivatization program succeeded in gaining parliamentary approval.

The privatization of Poland's 1,494 state farms has also proceeded fitfully. The Agricultural Property Agency, charged with overseeing state farm privatization, was only created in October 1991, more than two years after the collapse of communism. The agency was charged with the hopelessly ambitious mission of restructuring and privatizing all farms by the end of 1993. The farms' privatization has faced numerous obstacles, the most important of which has probably been the deterioration in farm finances that began with the withdrawal of subsidies in 1990. By mid-1992, some 400 farms had become virtual bankruptcies, and another 800 were teetering on the edge of insolvency.[29] Since state farms are often the sole employers in the towns where they are located, their difficulties have had dramatic socioeconomic implications. The lack of rural capital has been another obstacle, as was the need to use privatization proceeds to subsidize unprofitable farms, or to provide new employment (or job retraining) for state farm employees,[30] instead of financing pre-privatization farm restructuring. Thus, only 1.8 percent of the acreage at the agency's disposal had been sold by the end of 1993; another 27.2 percent had been leased.[31]

The failure to develop effective programs for many farms, and their generally poor fiscal condition, imply that some sort of mass distribution of state farm land and assets may ultimately be the only viable agricultural privatization option. However, all five of Poland's post–1989 governments have resisted popular demands for

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[28] Christopher Wellisz, "The Perils of Restitution," *Radio Free Europe Report on Eastern Europe*, vol. 2, no. 22 (1991).

[29] Andrzej Mozolski, "Upadek Kolosa," *Polityka* (June 27, 1992).

[30] State farm employment declined by some 38 percent during 1991–1993 (*Statystyka Polski* supplement to *Rzeczpospolita*, February 7, 1994, p. V).

[31] *Statystyka Polski* supplement to *Rzeczpospolita*, February 7, 1994, p. V.

parcelization since, in contrast to other Eastern European economies, land ownership in Poland prior to the start of the transition was already highly atomized. Promoting the "rational concentration" of land ownership and production has thus been a central goal of the post-communist agricultural reform process; the haphazard dissolution of the state farms would, it is believed, prevent attainment of this goal.

Corruption is perhaps the most serious general problem facing Poland's privatization efforts. While the roots of corruption certainly precede the post-communist era, the problem was exacerbated by the fact that the deregulation of the private sector (which began under the Rakowski government) was not accompanied by the creation of regulatory, fiscal, and legal mechanisms appropriate to the new setting. Although these mechanisms are being constructed, the general weakening of state authority accompanying the transition has prevented them from adequately dealing with corruption. This has damaged prospects for establishing the rule of law, and has furthered the popular impression that Poland is drowning in a sea of corruption and criminality.

The shadow economy, which comprises a large share of economic activity that is beyond the reach of the fiscal authorities, may be the most important economic aspect of corruption. In addition to routinely underreporting sales and turnover figures in order to reduce tax liabilities, Polish entrepreneurs are known to create dummy enterprises for the purpose of conducting a single transaction. Once the transaction is completed, the firms vanish without a trace, and taxes and customs duties are not paid. Losses to the state treasury in 1992 resulting from tax evasion and underground economic activity were estimated at 40–60 trillion zloty (approximately $3.0–4.5 billion)—a sum of greater magnitude than the 1991 budget deficit.[32] While the introduction of the personal income tax in 1992 (payable in 1993) and the value added tax in July 1993 were intended to reduce the scale of tax evasion, the impact of these new fiscal instruments is unclear.

Statistical problems add to the uncertainty concerning the size of Poland's private sector. On the one hand, the exclusion of data on underground economic activities from official GDP calculations underestimates the size of the private sector.[33] On the other hand, even in Poland's relatively successful small and liquidation privatization programs, transfers of state property to private actors have often occurred via leasing, rather than outright sale. In addition to being a less permanent form of privatization, the terms of leasing arrangements are more likely (than outright sales) to contain conditions that limit the reallocation of state properties to their most highly valued uses. Moreover, the Polish statistical authorities in 1990 reclassified the private sector in a very broad manner, so that activities associated with cooperatives, political organizations, foundations, labor unions, and other nonprofit groups have since been classified as belonging to the "new private sector." This definition is considerably broader than those used in neighboring countries,

[32] Krystyna Doliniak, "Strefa cienia", *Kurier Polski*, March 26, 1992.

[33] Also, the problem of cross ownership, where stock in SOEs is held by a variety of other state-owned (as well as private) entities, has been relatively unimportant in Poland, in contrast with other post-communist economies (such as Hungary).

and has the effect of inflating the size of private enterprise in Poland.

THE BANKING AND FINANCIAL SYSTEMS[34]

Of the institutional obstacles facing Poland's economic transition, problems in the banking system have perhaps been the most serious. Polish banks began the transition burdened with a stock of bad loans inherited from the pre–1990 system, and the absence of effective bankruptcy procedures have created moral hazard problems distorting the flow of new bank credits to borrowers. Scourges of bad debts, crises of enterprise arrears, and credit allocation via negative selection have resulted.

The problems in a sense began with the 1989 divestiture of the NBP's commercial banking function, when nine state-owned "commercial" banks were spun off from the NBP and made into legally independent banking entities. The "big nine" commercial banks, who were supposed to base their lending decisions on their assessments of enterprise creditworthiness and risk, thus began to function as commercial entities with administratively determined asset portfolios of unknown value. The 1990 stabilization program increased the banking system's importance, since banks were supposed to impose hard budget constraints on SOEs, while liberalization measures produced significant increases in interest rates and (after mid-1990) created a clearer picture of the true financial positions of enterprises (and banks).

It was not a pretty sight, since SOEs that the transition showed to be uncreditworthy were increasingly unable to service their bank debts. The absence of effective bankruptcy procedures allowed these firms to refuse payment to suppliers, thus shifting the burden of their inefficiency to otherwise healthier firms, and creating chains of inter-enterprise debts that obscured all firms' financial prospects. Enterprise inability (or unwillingness) to meet their fiscal obligations in a timely manner also exacerbated the budget deficit.

Commercial banks in this situation often found it easier to continue lending to traditional (and frequently insolvent) SOE clients, for a number of reasons. First, the absence of effective bankruptcy procedures endowed debtors with a form of reverse-leverage over banks (and other creditors). Second, getting tough with recalcitrant debtors would have meant that banks would have to mark down the quality of their loan portfolios, with all the attendant unfavorable implications for the banks' financial position. Third, the uncertainties introduced into enterprise finance by the inter-enterprise debt problem complicated assessments of enterprise creditworthiness. By contrast, commercial banks were much less willing to extend credits to small private firms, who were something of an unknown quantity.

Not surprisingly, "bad debts" of enterprises rose from 8.3 percent of the banking system's total credits in June 1991 to 36.1 percent in September 1993, while the total value of bad loans rose from 1.5

[34] This section draws heavily upon Louisa Vinton and Ben Slay, "Bad Debts and the Polish Restructuring Program," *Most*, vol. 3 (1994).

percent of GDP in 1991 to 6.1 percent of GDP in 1992.[35] The bad debts in the big nine's portfolios had risen to an estimated 20 trillion zloty (roughly $1 billion) in February 1992, when the banks were instructed to establish nonperforming loan departments, to which 1,888 firms were consigned.[36] Enterprise arrears (from both SOEs and private firms) to the fiscal authorities and to other firms also grew rapidly. In August 1993, enterprise nonbank debt (owed to other firms and the fiscal authorities) amounted to almost 250 trillion zloty ($11.4 billion).[37] By the end of 1993, enterprise arrears to the fiscal authorities (including the Social Insurance Office) exceeded 50 trillion zloty (about $2.5 billion).[38]

Thus, while unprofitable SOEs were able to extract credits from banks, suppliers, and the fiscal authorities, private entrepreneurs frequently had to rely on internal financing. The effects of the stabilization program were also weakened, since the inter-enterprise debt mechanism gave firms access to credits outside of the banking system. By obscuring many firms' true financial position, the "bad debt" problem made the banks' task of determining enterprise creditworthiness even more difficult. Finally, the commercial banks' bad loans prevented their privatization, which is viewed as a necessary pre-condition for improving the quality of lending decisions.

A program for loan consolidation and bank recapitalization was introduced in March 1993 in response to these difficulties. According to this program, seven of the big nine state-owned commercial banks are to restructure and liquidate chronically unprofitable firms via bank-led restructuring programs. In exchange, the banks are to be recapitalized through the exchange of bad debts for 15-year restructuring bonds, financed in part by some $650 million in new external borrowing. The principles for recapitalization were set to give banks an incentive to take a hard line with relatively creditworthy firms, while loans to truly hopeless firms or projects were recapitalized almost in full.[39] This would relieve banks of the burden of their worst loans, while simultaneously depriving the least creditworthy SOEs of reverse leverage over the banks. Banks (and other creditors) were authorized to sell debt on secondary markets, thus paving the way for privatization via debt-for-equity swaps. This new secondary debt market was also meant to provide a market-friendly solution to the inter-enterprise debt problem. Once their balance sheets had been restructured, the commercial banks were expected to become more attractive candidates for privatiza-

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[35] *Gazeta Bankowa*, January 8, 1994.

[36] Slawomir Lipiński, "Oddlu enie tak, ale nie dla kaz dego," *Gazeta Bankowa* (February 19, 1993).

[37] *Gazeta Bankowa*, December 3, 1993.

[38] Other significant problems for Polish banks, besides bad debts, include: (1) falling bank profitability (especially during 1991–93); (2) scandals that have buffeted a number of very important financial institutions, including the NBP (whose President, Grzegorz Wójtowicz, was arrested in September 1991); and (3) an excessively rapid structural deconcentration of the banking sector. Combined with relatively lax regulation during 1990–91 and the concentration of commercial lending in the big nine, the profusion of private and semi-private banks meant that many were undercapitalized, frequently corrupt, and too small to effectively pool risk. A start was made in dealing with these problems in 1992, when the new NBP president, Hanna Gronkiewicz-Waltz, moved to crack down on some of the more egregious examples of corrupt, under-capitalized banks.

[39] Loans whose performance was judged to be "substandard" were to be recapitalized at 20 percent of their nominal value; loans classified as "doubtful" were to be recapitalized at 50 percent of their nominal value; and loans classified as "lost" were to be recapitalized at 90 percent of their nominal value.

tion, preferably through sales of controlling packets of stock to Western financial institutions.

Initial reports on the success of the debt restructuring program have been mixed. On the one hand, at least 160 firms originally classified as bad debtors (up to half of the total, for some banks) began servicing their debts in 1993. This improved their creditworthiness with the banks, allowing the firms to avoid being classified as "bad debtors" and being included in bank restructuring programs. This reflected a general trend: the proportion of firms paid up at the banks and not requesting new credits rose from 49.7 percent in January 1993 to 66.3 percent in November 1993.[40] Some SOEs, such as the Szczecin Shipyard (which served as a proving ground for the new program) were able to significantly reduce their debt burden and go on to capture millions of dollars worth of new business.

On the other hand, the secondary debt market had not really gotten off the ground by mid-1994, as most banks were able to sell off only a fraction of their bad loans. While some 300 debts (representing 2 trillion zloty in failed loans) were put up for public sale between March 1993 and April 1994, only 140 debts (worth 28 billion zloty) were sold overall, a figure comprising less than 0.2 percent of the nominal value of the loans offered for sale. And some large, insolvent SOEs (such as the Ursus tractor manufacturer in Warsaw, and the Star truck firm in Starachowice) were able not only to avoid liquidation—they also squeezed exceptionally favorable restructuring agreements out of their creditors. So while the debt restructuring program seemed to make progress in resolving some of the Polish financial system's problems, much still remained to be tackled.

AN ASSESSMENT OF THE POLISH TRANSITION

Assessments of the Polish transition often make extensive use of official data. This is problematic, however, since standard macroeconomic statistics leave much to be desired as measures of changes in social welfare associated with the post-communist economic transition.[41] The 20 percent decline in Polish GDP during 1990–91, for example, should not be equated with wholesale economic devastation; rather, it reflected in large measure the cessation of activities that could not survive the introduction of market forces. While the immediate damage caused to enterprises, workers, and communities closely tied to these activities should neither be denied or minimized, this damage generally speaking was an unavoidable cost of the restructuring needed to create economic institutions capable of surviving and competing in the global economy. Poland as a whole should ultimately benefit from this restructuring. Moreover, the inclusion of underground economic activities in the official statistics would produce a more accurate picture of changes in aggregate economic activity, one which certainly would have shown a smaller decline in GDP during 1990–91, and larger increase after 1991. Improvements in product quality that

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[40] Slawomir Lipiński, "Marchew bez kija?" *Gazeta Bankowa* (April 2, 1994).

[41] Jan Winiecki, "The Inevitability of a Fall in Output in the Early Stages of Transition to the Market: Theoretical Underpinnings," *Soviet Studies*, vol. 4 (1991), pp. 669–676.

followed the creation of the buyer's market in 1990 have also increased consumer welfare in a manner not captured by the official statistics.

Likewise, the rapid increase in official unemployment rates (from 0.0 percent at the start of 1990 to 16.0 percent at the end of March, 1994)[42] is also misleading in three respects. First, some of those now classified as unemployed were not, prior to 1990, really gainfully employed, since the full-employment, soft-budget constraint policies of Soviet-type socialism meant that all workers, no matter how (un)productive they might have been, had to be (nominally) employed. Thus, for a share of Poland's unemployed, the post-communist transition has meant exchanging hidden unemployment compensation—a paycheck for a make-work job in a value-subtracting SOE—for explicit unemployment compensation in a labor office. Second, many workers officially classified as unemployed also work in the second economy. The Central Statistical Office's spring 1992 survey of 2,500 employment offices found that, according to the officials involved in monitoring individual unemployment cases and distributing benefits, only about one case of unemployment in six was genuine.[43] Finally, the structural disproportions inherited from the communist period imply that some amount of structural unemployment in Poland is the inevitable byproduct of industrial (and labor-market) restructuring. So while the rapid rise in unemployment rates since 1990 should not be seen as a blessing, the opposing extreme—that unemployment in Poland is both an unmitigated disaster and an avoidable calamity brought on by policy mistakes—is equally difficult to accept.

Thus, a more balanced interpretation of the changes in production and employment since 1989 seem to support the conclusion that declines in social welfare have been more mild than the official data would suggest. Also, as the data in Table 1 show, consumption by 1994 had essentially returned to pre–1990 levels—with better product quality and more variety than before. Finally, it is worth mentioning that the 17 percent decline in Polish GDP during 1989–92 was lowest in the Eastern European economies.[44] Nonetheless, the economic transition is generally viewed as anything but a success within Poland, and Polish voters have in two national parliamentary elections failed to deliver electoral votes of confidence for the parties and politicians most closely associated with the transition. Most recently the September 1993 elections led to the formation of Prime Minister Waldemar Pawlak's "post-communist" government, based on parties descended from the (formerly despised) communist regime.

This apparent discrepancy between the economics and politics of the Polish transition can be explained in various ways. Some groups and regions in Poland have clearly been put at risk by the economic transition. These include first and foremost women, who

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[42] *Statystyka Polski* supplement to *Rzeczpospolita*, May 11, 1994, p. I.

[43] Rafal Walicki and Leszek Adamczuk, "Bezrobocie: prawda i urz dowa fikcja," *Zycie Warszawy* (July 9, 1992). To the extent that this argument is correct, it also implies that post–1989 poverty rates are overstated.

[44] According to PlanEcon data, the declines for the other Eastern European economies were Hungary—17 percent; Slovenia—20 percent; Slovakia—23 percent; the Czech Republic—24 percent; Bulgaria—28 percent; Romania—32 percent; and the other (former) Yugoslav Republics—40–70 percent. Source: "Slovenian Economic Monitor," *PlanEcon Report*, vol. 18 (May 1993), p. 1.

face higher unemployment rates than men, and for whom the weakening of Poland's social safety net poses a relatively greater burden.[45] Other groups at risk include young people, who comprise a disproportionately large share of the unemployed and face the burden of rising costs and declining quality in public education; unskilled laborers in general (and on state farms in particular); the long-term unemployed, many of whom have lost their eligibility for unemployment compensation; and residents of rural areas and smaller communities whose economies are dominated by a single, large, insolvent employer. Regions most threatened by high unemployment rates were located either in the Northwest (unemployment rates at the end of March 1994 in the Koszalin and Slupsk voivodships (provinces of Poland) were 28.9 and 28.4 percent, respectively), or in the Northeast (unemployment rates at the end of March 1994 in the Suwalskie, Olsztyn, and Elbląg voivodships were 28.6, 28.2 and 27.4 percent, respectively). These areas had not (in recent history) belonged to Poland prior to 1945, and the somewhat artificial nature of their post-war development (state farms tended to play agreater role in these regions than elsewhere, for example) has apparently played a large role in their economic problems.

The legitimate grievances of these groups and regions have created a strong socio-political base for parties and lobbies opposed to the transition (or to the course it has taken since 1990). Their grievances have to some extent been internalized by other elements of Polish society, such as workers who are currently employed, but fear they may be the next victim of the "scourge of unemployment." More generally, the heightened risk and uncertainty posed by the transition (in contrast with the stagnant stability of socialism) in itself tends to reduce the welfare of risk-averse individuals. Also, the distribution of income and wealth in Poland is widely perceived as having become less equal since 1989.[46] This perceived trend toward inequality may have signified declines in welfare for the "have-nots," of course. But it may also have aggrieved those Poles who, regardless of increases in their own incomes and consumption, see their own welfare as a partial function of the material situation of others (e.g. Western consumers, or the Polish *nouveaux riches*), whose consumption since 1989 has risen faster than theirs. Finally, the fact that Poland was the first to begin the transition in Eastern Europe meant that many Poles (both in and out of government) initially had naive and excessively optimistic expectations about the magnitudes of the social costs of the transition. The disabusal of these expectations was bound to be unpleasant.

Political developments have simultaneously been a major obstacle to the economic transition and an important source of popular discontent with the course of events since 1989. Instability and infighting have been constant features of Polish political life: between January 1990 and June 1994, Poland has had five governments, six Prime Ministers, and six Ministers of Finance. The frequency with

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[45] Bozena Leven, "Unemployment Among Polish Women," *Comparative Economic Studies* (winter 1993), pp. 135–146.

[46] While this supposition is not necessarily borne out by the data (according to one study, income distribution by household actually became more equal between 1989–91—Milanovic, *Social Costs of the Transition to Capitalism*, pp. 14–16), the perception of growing inequality was certainly present, and was politically charged.

which governments fell and elections occurred kept parties and politicians in semi-continuous campaign mode, and those excluded from ministerial portfolios frequently attempted to improve their fortunes by appealing to the electorate's populist instincts. Once in power, though, they tended to find little room for deviating from the stabilization, liberalization, and privatization policies of their predecessors. While this consistency may have been beneficial for the economic transition, it tended to alienate those voters who thought they had cast a ballot for a change in economic course.

The rapid decomposition of the Solidarity movement during 1990–1991 into dozens of squabbling parties, many of which were differentiated more by personalities than by ideology or policy, contributed to the failure to create lasting political structures to promote the economic transition and strengthen the Polish state. Indeed, the victory of the SLD and PSL in the September 1993 parliamentary elections probably had more to do with public disaffection because of the squabbling, arrogant anti-communist parties who descended from the Solidarity movement than with any nostalgia for much-maligned People's Poland. Thus political instability and infighting not only disrupted the continuity of economic policy; they deepened public cynicism about government (which had been quite strong in the communist period), and strengthened the well-entrenched view that affairs of state were neither honorable nor important. While Polish society's political disaffection during 1990–93 manifested itself more in voter apathy[47] than in extremism, it nonetheless did not bode well for Poland's future.

The results of all three of Poland's post–1989 national elections—the presidential election of November-December 1990, and the parliamentary elections of October 1991 and September 1993—were widely described (both within Poland and the West) as dangerous, if not catastrophic, for the economic transition. In fact, however, while deviations from the policies begun in 1990 have occurred, they have on the whole been fairly insignificant. Indeed, by 1992, the Polish economy was increasingly insulated from instability emanating from the political sphere, and beginning to function according to its own logic. While there is much with the economic transition that could still go wrong, especially with inflation and the public debt, the Polish economy's increasing insulation from the politics of the transition was perhaps the greatest cause for optimism.

[47] Only 52 percent of the eligible voters participated in the September 1993 parliamentary elections; while only 40 percent of the eligible voters took part in the October 1991 parliamentary elections, which were the first democratic elections to the Sejm since the 1920s.

HUNGARY DURING 1988–1994: A POLITICAL ECONOMY ASSESSMENT

By Paul Marer *

CONTENTS

SUMMARY

When the first post-communist Hungarian government assumed power in the summer of 1990, that nation had faced inherited economic problems as well as unfavorable external economic conditions that were quite similar to those of other transforming economies in the region. Yet in certain respects Hungary's problems were less severe than those of, for example, Czechoslovakia and Poland. Hungary's relatively favorable position was the result of the cumulative effects of 25 years of reforms, although some of the impacts of those reforms could be considered drawbacks.

Hungary's first post-communist government did not have a clear economic strategy, did not give the highest priority to economic is-

* Paul Marer is Professor of International Business at Indiana University. The comments, suggestions, and insights obtained by the author from several economists and policymakers in Hungary are very much appreciated. The statements herein are the author's interpretation of those conversations, and thus the author bears sole responsiblity for the contents.

sues, and could not skillfully handle the extremely difficult economic policy problems and choices. As a consequence, Hungary's transformation depression was deeper and lasted longer, and the foundations for sustained economic recovery and growth were established less securely than if other—theoretically feasible but politically difficult—economic policies had been followed. Consequently, while Hungary's medium-term growth prospects are good, they are not robust.

INTRODUCTION

This chapter presents an interpretation of what happened in Hungary during the past six years: the last two years of the communist regime (1988–1989), which handed a set of legacies to its successor, and the first four years of transformation under the government that was in power during 1990–1994, after Hungary's first post-communist democratic elections.

Any assessment and interpretation, especially one made so soon after these historic events, is subjective. So is the criterion selected as the basis for the assessment. The author asks: in an ideal but not utopian scenario—one in which the government of Hungary would have done "all the right things" (in the opinion of the author)—what could have been achieved in 1990–1994, i.e., where would Hungary be in the fall of 1994 as the new government takes over, following the second post-communist national elections? How much of the country's presumed potential in 1990 was realized in four years, and where and why has the country fallen short of what it could have achieved? What are the main legacies that the first post-communist government passes on to the new government? What are the economic policy lessons? And what are Hungary's medium-term economic prospects?

Even if experts could agree on what would have been all the right things to do in 1990–1994, that is a very tough standard against which to assess the government of any country. Nevertheless, such an approach can be useful, not only for the historians of this era but also for policymakers in transition economies, since all of the problems discussed are still present in some way in all of the transition economies.

The many contributions in this volume present a great deal of country-specific economic data. To avoid repetition, to keep the chapter's length manageable, and to focus on ideas and cause and effect relationships, this chapter purposefully makes sparse use of economic statistics.

REFORMS UNDER COMMUNISM: LEGACY AND SIGNIFICANCE

Between the mid-1960s and late 1980s the communist party of Hungary had moved to exercise its absolute political power in a more enlightened way than in the preceding 15 years and also introduced significant economic reforms. To be sure, the party's political and economic reform course had many zig-zags. This section briefly reviews these reforms to identify the initial conditions under which political and economic transformation in Hungary began.

A GRADUAL LOOSENING OF THE REINS

The communist party, led by Janos Kadar, decided in the mid-1960s to exercise its absolute political power in a gradually more benevolent way. This meant that fewer people became incarcerated for political "crimes," that the arts and the media were granted increased latitude of discourse, and that travel to the West became possible not just for the elite but for most ordinary citizens also.

During the second half of the 1980s two events helped the reform wing to take control of the communist party and thus also the government, which gave a new impetus to changes in the system. One was the retirement and later the death of Kadar. His departure had thus removed a "brake" in the reform movement. The other was Gorbachev's decision that the Soviet Union would no longer use, or threaten to use, intervention by the Red Army in order to keep in power the communist parties in Central and Eastern Europe. Gorbachev gave up the Brezhnev doctrine in order to improve relations with the West, which was a precondition for moving resources from the Soviet military to the civilian sector. Discarding the Brezhnev doctrine had released hitherto suppressed anti-communist forces in Central and Eastern Europe.

In Hungary, "reform circles"—alternative cells within the party structure—were formed in 1988 and grew rapidly, so that at the extraordinary party congress in 1989, the reformers succeeded in having the old communist party vote itself out of existence and reorganize as a Western-style democratic socialist party. [1] This development made it possible for other political parties legally to organize also. Eventually a multiparty agreement was reached to hold democratic elections—elections that the ruling party knew it was going to lose. In 1989, despite strong protest by East Germany's leaders, Hungary's communist government allowed East German citizens to emigrate to the West through Hungary, a decision that rendered the Berlin Wall meaningless and thus was a key factor in its collapse.

The significance of this political legacy for transformation was threefold. First, Hungary's transition to democracy was peaceful. Second, the domestic political situation in 1989–1990 was not so bitter as to preclude the possibility of putting together a broad political consensus to support a comprehensive economic transformation and recovery program. And third, the actions of the last communist government reinforced the reservoir of Western goodwill toward Hungary. Hungary's image was that of a country that had pushed political and economic reforms as far as they could be pushed while the country was forced to remain under the Soviet umbrella. Western goodwill toward Hungary, in turn, was one of the factors that accounts for the country's jump-start during 1989–1992 over the other countries in the region in obtaining a substantial inflow of foreign investment. Western goodwill also contributed to Hungary becoming a leading contender among the transition economies for affiliation with, and possible eventual membership in, the European Union. A further benefit was Hungary's front-row position as claimant on Western economic assistance, although eco-

[1] Patrick O'Neil, "Political Transformation in Hungary: Role of the Socialist Workers' Party," Ph. D. dissertation (Bloomington: Indiana University), 1994.

nomic aid has turned out to be modest in size and quite limited in impact.

ECONOMIC REFORMS

Three kinds of reforms were implemented between the mid-1960s and the late 1980s: allowing greater scope for the private sector, giving increased autonomy to the managers of state enterprises, and liberalizing certain economic policies.

By far the most important—not in terms of the reform concept but in terms of improving the performance of the economy and creating a positive legacy—was allowing greater scope for private initiatives, first in agriculture and then in the other sectors. In agriculture the collectives, established earlier by force, were gradually transformed into real collectives, accommodating private initiatives. This was a major factor in the rapid development of agriculture, which made possible an abundant food supply for the population and sizable exports. The private sector also began to grow in the early 1980s, and its development accelerated during the second half of the decade. To be sure, the authorities always had a "schizophrenic" attitude toward the private sector—periodically easing controls for economic reasons and then stalling or partly reversing the course for political reasons. Nevertheless, the Hungarian people ingeniously took advantage of the opportunities they had been given. Consequently, by the late 1980s, more than 20 percent of the GDP originated in the private sector.[2]

Second, the "New Economic Mechanism," introduced in 1968 and modified several times thereafter, intended mainly to improve the efficiency of state-owned enterprises by giving them somewhat greater autonomy. Artificial rules of enterprise operations were established that tried to simulate how firms in a market economy would function if a real market economy existed. But, despite the sophisticated intellectual edifice that a large army of economic reformers had constructed, under politically established constraints the efficiency of state-owned enterprises could not be fundamentally improved. In the absence of real owners and a real capital market, and in the face of the many remaining regulations that tied their hands, enterprise managers could not adapt to the new rules without making fundamental changes.[3] Still, the New Economic Mechanism, especially the reforms introduced during 1988–1989, left positive legacies:

- The reforms established certain institutions and instruments that a real market economy would later require. For example, exchange rates and interest rates were given a more meaningful economic role. In 1987 a semi-independent set of commercial banks were established, replacing the previous

[2] J. Arvay and A.Vertes, *The Share of the Private Sector and Hidden Economy in Hungary, 1980–1992* (Budapest: Economic Research Co.), 1994.

[3] Janos Kornai, "The Hungarian Reform Process: Visions, Hopes, Reality," *Journal of Economic Literature* (December 1986), presents a comprehensive analysis of reform ideas, policies and their impact on economic performance. Gabor Revesz, *Perestroika in Eastern Europe: Hungary's Economic Transformation, 1945–1988* (Boulder, CO: Westview Press), 1989, offers a broader and less technical account. Paul Marer, "Economic Reform in Hungary: From Central Planning to Regulated Market," in *East European Economies: Slow Growth in the 1980's*, vol. 3, Country Studies in Eastern Europe and Yugoslavia (Washington D.C.: U.S. Government Printing Office), 1986, gives still another perspective on the reform process.

"monobank" system typical under central planning. And a personal and corporate income tax system was introduced that by and large conformed to the tax systems of Western countries.

- The reforms reduced some of the most egregious distortions typical of a traditional centrally planned economy, such as the pervasive shortages of goods and services, and made cost computations and price determination generally more realistic, allowing many consumer prices to be market determined.
- The reforms encouraged enterprise managers to familiarize themselves with market economy concepts and operations. For example, managers were given increased autonomy to trade and to enter into joint ventures with Western partners.
- The reforms prepared society to better understand and to accept a market-driven economic system. (That, of course, is not the same as accepting large declines in the standard of living or increases in unemployment and income inequality.) To be sure, it also got people accustomed to semi-legal activities and pervasive corruption. Stealing state property and evading personal taxes became morally acceptable, a hindrance in establishing a normal market economy.

Third, during 1988–1989, Hungary's reform communist government introduced economic policies that set the country on a course of transformation to a market economy, thus beginning the process sooner than its neighbors. Most important were a three-year program of import liberalization, the introduction of a modern tax system, the transformation of a certain number of state-owned enterprises into companies, and the beginning of their privatization. To be sure, the government during 1988–1989 was thinking in terms of reforming and not transforming the economic system. One important difference is that while the reformers admitted that the private sector should have an important economic role, the dominance of the state and collective sectors was not questioned; another was that while price and some degree of foreign trade liberalization were to be pursued, a substantial degree of protection of domestic producers was to be retained.

URGENT ECONOMIC TASKS OF THE GOVERNMENT IN 1990

Hungary's new government, formed in the summer of 1990, faced a number of difficult and interdependent economic problems, similar in nature but different in scope from those that the governments of Czechoslovakia, Poland, and the region's other transforming economies had to address. The collapse of the communist political and economic systems had revealed, with a sudden force and impact, the misdeveloped nature of the economy

The economies inherited by the new governments were misdeveloped in terms of economic structure, ownership structure, size structure, product composition and quality, the structure of relative prices, and the skill composition of the labor force. Of course, all these structures conformed to the logic of the old system. But the inherited structures were quite different from those required to make these countries competitive in the global economy while also maintaining or improving the standard of living. The macroeconomic structure of the economy was inappropriate because energy- and raw-material-intensive heavy industry was much too large as compared with high-value-added industrial branches, services, and infrastructure.

A disproportionately large part of output and an even larger share of productive assets were accounted for by state-owned enterprises, which tended to be large, not like Western multinationals, but with poor internal structures, often comprised of small, inefficient plants. Excessive vertical integration within each large enterprise tried to substitute for the absent horizontal links that market-driven economies routinely create. At the same time, private businesses were forced to remain small and thus could not be efficient.

Relative prices—especially those of the factors of production (labor compensation as well as the charges for capital, for the services of infrastructure, and for real estate) were not appropriate, given relative scarcities. The labor force was skilled in the technical domains but lacked training and experience in modern finance, marketing, management, and other services.

All these distortions, combined with specialization for the autarkic CMEA "market," caused serious shortfalls in the structure, assortment, and quality of the goods and services produced. Communist economies could become and remain misdeveloped because producers faced no competition in their home markets. The system protected the more and the less efficient alike, keeping enterprise budgets "soft" through grants, soft loans, negotiated taxes, and administrative price increases if costs could not otherwise be covered. At the same time, much of profits and depreciation was taxed.

When the communist system collapsed, the relatively small and thus trade-dependent Central and East European countries had no choice but to try to become predominantly market driven and to integrate into the world economy. This meant that their producers suddenly faced strong international competition, both because imports were liberalized and because with the collapse of CMEA and domestic and Third World demand, exports to the world market became the main survival option for many firms. Imports had to be liberalized and currencies had to be made convertible to support export expansion, among other reasons. The collapse of the CMEA's trading arrangements caused Hungary's terms of trade to deteriorate, resulting in a loss of several percentage points in the gross domestic product (GDP) (not revealed by constant-price GDP volume indexes). Sustained foreign trade reorientation was made all the more difficult by the recession and protectionism in the West.

When this highly protected but strongly trade-dependent economy was opened up to international competition, its misdeveloped structures were revealed. Many state-owned enterprises found themselves in severe economic difficulties, as revenues from CMEA exports were lost and direct subsidies cut. Initially a portion of the revenue losses were compensated for by bank loans, which soon became nonperforming. In combination, these developments had a devastating impact on production, employment, and the state budget. And since it takes time for the small private sector to become large enough and strong enough to pull the economy out of its difficulties, a "transformation depression" is inevitable. And because the private sector initially faces an adverse economic environment and weak institutional support structures, special help from the state is temporarily needed.

The critical questions were: how long and deep will be the transformation depression, and what economic strategy should be pursued to control the inevitable hardships and to lay the foundations of a healthy recovery and growth?

A substantial economic decline was inevitable. Many investment projects—undertaken earlier, in an economic system and external environment that were fundamentally different—were revealed to be mistakes. As domestic, CMEA, and Third World demand for many products plummeted, subsidies were cut, and relative costs and prices altered, a large number of enterprises became loss-makers. Sooner or later, large layoffs could not be avoided. Growing unemployment and the inflation tax on pensions meant that many people would become poorer.

As more and more state enterprises and many new private businesses became loss makers, they could no longer service their debts to commercial banks. Because under the old system, enterprises did not as a rule go bankrupt, banks were not required to maintain large reserves. This made the inherited financial system weak and vulnerable. It was clear that financial intermediation—so crucial for a well-functioning economy—would be severely impaired unless the state helped. But the state budget came under severe pressure as a significant number of enterprises became loss makers and did not pay taxes; as the emerging private sector did what it could to avoid taxes; as the budget burden of the old, cradle-to-grave welfare system and rising unemployment compensation (introduced in 1989) increased rapidly; and as the new government decided to service Hungary's large foreign debts. The state budget redistributed approximately 60 percent of Hungary's GDP; the consolidated general budget (which includes the various extra-budgetary funds), 63 percent to 64 percent. Few countries, including the region's other transforming economies, channeled through the government such a large share of its output.[4] Relief was urgently needed. At the same time, a more sustainable balance between production, consumption, and investment was to be established.

Another urgent task was to restructure state enterprises, which required two fundamental political decisions: how to privatize and how to manage the assets that would remain, temporarily or permanently, under state control. Controlling inflation and the balance of payments were also priority tasks. Not mentioned here, owing to space limitations, are the myriad other governmental tasks to create or strengthen a market economy's institutional foundations.[5]

Substantial open and repressed inflation (in the case of Hungary, mostly the former) had to be brought under control. During the initial stages of economic transformation, new inflationary pressures were generated by price and exchange rate liberalization and the

[4] Richard Judy, "Hungary," Occasional Paper, Hudson Institute, Indianapolis, June 1993.

[5] A very large and rapidly growing number of works deal with the tasks and strategies of transformation. See, for example, Paul Marer and Salvatore Zecchini (eds), *Transition to a Market Economy*, vols. 1 and 2 (Paris: OECD), 1992.

reduction of subsidies—essential steps to move toward a market economy.

Another serious problem was that the countries inherited a large foreign debt, Hungary's being the highest on a per capita basis. This presented the dilemma: default, seek to reschedule it, or continue to service it fully?

When and how these tasks would be performed would largely determine the depth and length of the transformation depression and the future course of economic recovery.

Initial Conditions Compared with Czechoslovakia and Poland

The three sets of economic reforms Hungary had introduced between the mid-1960s and the late 1980s had moved the country, by 1990, approximately one-third of the way on the road leading to a market economy. This had placed the new government of Hungary in a relatively advantageous position to implement a program of economic transformation and recovery, although vis-à-vis the Czech Republic and Poland, Hungary had certain disadvantages also.

In the economic realm, Hungary's economic structure was less distorted in 1990 than those of Czechoslovakia and Poland because the structure of its heavy industry was not quite as energy- and raw-material-intensive as in the other two countries. Hungary's private sector, although perhaps not as large as Poland's, was much larger than Czechoslovakia's.[6] Price distortions were much smaller than in Czechoslovakia and inflationary pressures much less severe than in Poland. Shortages were less pervasive and confidence in its currency considerably greater than in the other countries.

Hungary's disadvantage vis-à-vis Czechoslovakia was its large foreign indebtedness: Hungary had a gross foreign debt of $20 billion versus around $7 billion for Czechoslovakia's larger economy. Poland, which also had a burdensome foreign debt, had not been servicing it for years. That was an advantage over Hungary in that smaller resource outflows were required. But that advantage was offset by the consequent discrimination against Poland by foreign creditors and investors, at least until the completion in 1994 of partial debt forgiveness and rescheduling negotiations.

If shock therapy is defined as price liberalization and the bringing of inflationary pressures under control relatively quickly, then in 1990–1991 Czechoslovakia needed shock therapy to quickly remove large distortions in relative prices and to make sure that the resulting price increases would be once-and-for-all and not continue to spiral upward. Poland required shock therapy to bring its galloping inflation under control, while removing the remaining controls on (mostly energy) prices. In Hungary, there was no need for shock therapy. To be sure, Hungary, too, needed to adjust to large external shocks (collapse of the CMEA and of the Middle Eastern markets in the wake of war with Iraq). Moreover, given Hungary's large debt-service obligations and the very low share of investment in GDP, the level of consumption had to be kept tightly in check,

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[6] Exact comparisons are difficult, owing to problems of definition and the availability and accuracy of data. Moreover, the *conditions* under which a country's private sector was permitted to operate have to be considered also.

which required tight monetary and fiscal policies, not unlike under shock therapy in Czechoslovakia and Poland.

In the political realm, Czechoslovakia had a deeply-rooted political tradition that was discredited completely, whereas in Hungary the communist economic system was quasi-legitimate on account of the reforms and policies that kept consumption levels higher than was justified by productivity levels, by foreign borrowing, and by skimping on investment. The new Polish government had the political advantage that the economy was in a crisis and partly collapsed before the transformation, whereas in Hungary, many of the old problems surfaced under the new government, which the population would blame.

Hungary had an advantage over Czechoslovakia and Poland in its newly established democratic governance structures. In May 1990, before the second round of Hungary's first post-communist elections, an agreement was reached among the main political parties to amend the constitution to make it exceedingly difficult to bring down the government between national elections. The constitutional amendment specified that not only would a Parliamentary majority be required for a vote of no confidence in the government, but that the same vote would also have to designate the new prime minister. Called the "constructive motion of no confidence," the provision is advantageous for the party or coalition in power.

In Hungary, elections were to be held every four years, versus every two years in Czechoslovakia. And whereas Hungary's constitution practically eliminated the possibility that the government would be forced to step down before the next election, the system in Poland made the government vulnerable to a no-confidence vote by the legislators, as is demonstrated by the frequent government changes during 1990–1994. Furthermore, the amendment in Hungary specified that Parliament would not be able to remove an individual cabinet member as long as he or she enjoyed the confidence of the prime minister. Hungary's governance system thus promoted political stability and gave the government substantial Parliamentary protection to implement its programs. The system also gave the prime minister a potentially more powerful role than heads of government typically enjoy.

MISSING: ECONOMIC STRATEGY AND POLITICAL CONSENSUS

The tasks of economic transformation and recovery for Hungary's new government were immense. They were daunting not only in and of themselves, but were made even more difficult because they had to be handled by a hastily assembled and inexperienced new political elite, in the midst of an unavoidable depression for which the new elite would quickly be blamed.

What Hungary needed in this crisis situation was a well-designed and clearly articulated economic strategy, political leadership that could mobilize broad support for it, and bold implementation. In reality, none of these materialized. In Czechoslovakia these tasks were largely performed by Vaclav Klaus, as Minister of Finance and then as Prime Minister; in Poland during the especially difficult initial period it was Deputy Prime Minister Leszek Balcerovicz. Both men are economists by training.

The point of mentioning these two countries and leaders is not to say or imply that their economic strategies were flawless or that either country should be considered a model. But in both countries there was an economic strategy, as well as leadership that gave priority to its implementation. To be sure, political consensus behind the program has been difficult to maintain, especially in Poland.

It seems paradoxical that—as a major economic crisis loomed, and in a country that had a surfeit of sophisticated economists—economic strategy should be given low political priority and insufficient professional care. It was not that professional advice was lacking. Already during 1989–1990—before the International Monetary Fund, The World Bank, the OECD, and other organizations became deeply engaged in advising the governments of the transition economies—two multi-party committees were formed to address the strategic issues of economic transformation. One was the Joint Hungarian-International Blue Ribbon Commission, made up of leading Hungarian economists and politicians (assembled in part with a view toward political balance), who worked with experienced policymakers from ten market-economy countries.[7] The other group was the Bridge Commission comprised of leading Hungarian economists. In both commissions the "bridge" logo symbolized attempts to forge a consensus among the political parties on the most critical economic policy issues. Although both commissions admitted there were large uncertainties about policies, both had strong internal disagreements on certain issues, and both gave advice that, by hindsight, was far from perfect. In spring 1990 each commission did come up, independently, with a comprehensive and not too dissimilar economic transformation and the recovery program for the then unknown future democratic government of Hungary.[8] But neither the new government nor Parliament had paid much attention to their reasoning and recommendations.

Hungary's first post-communist government did not have a clearly articulated economic strategy, nor did the government attempt to build a broad political consensus to help it design and implement an economic transformation and recovery program, even though such an act of statesmenship might have been desirable and politically feasible.

There is usually no single or simple explanation of why something happens or does not happen at crucial junctures in a nation's history. But if pressed to identify the key reasons why what could have and should have been done did not take place, one may point to political developments during 1989–1990 and to the background and personality of the Prime Minister, Jozsef Antall.

As background for assessing political developments during 1990–1994, certain features of Hungary's political culture may be noted.

[7]The author was a founding member of the Blue Ribbon Commission and served as its co-managing director.

[8]"Hungary: Transformation to Freedom and Prosperity," Analysis and Recommendations of the Joint Hungarian-International Blue Ribbon Commission (Indianapolis: Hudson Institute), 1990. For summaries of the Commission's recommendations, see *Wall Street Journal*, April 6, 1990, and *New York Times*, April 6, 1990. The Commission's analysis and recommendations were also published as a book in Hungarian and distributed widely in the country. The full report was also published in Hungary's leading economic weekly, *Figyelo*, April 10, 1990.

The inherited political culture—from the prewar era as well as from the period of communism—is authoritarian in structure, alternating between a more malevolent and a more benevolent kind. Consequently, a civil society in which democracy is nurtured by leaders who emerge from, and are supported by the interest groups they represent, did not take hold immediately. Most of the new political parties were elitist, dominated by white-collar professionals with little social backing by organized interest groups. Most of the newly formed political parties were "catch-all" parties, trying to appeal to everybody, while claiming exclusivity and showing a lack of tolerance toward others. Parties defined themselves more through criticism of their opponents than in terms of their own programs. None of these features, of course, is alien even in advanced democracies, including that of the United States.

One of the socio-political divisions in Hungary is between territorial-ethnic nationalists versus those who believe that Hungary's best course is to link up with a modernizing Europe. The nationalists yearn to bring back Hungary's pre-Trianon borders and many of its pre-World War I and inter-war social arrangements, including the close connection between the Christian church and the state. They believe that a Hungarian "third way" can be found, one that resembles neither competitive capitalism nor imposed communism. The best guess is that such a vision is shared by no more than 20 percent of the population. The majority of Hungarians are pragmatic and accept the world "as it is," including the borders, believe in the separation of church and state, and support those who seek workable solutions to the bread-and-butter problems that concern the ordinary citizen.

In 1989–1990, as the newly formed political parties began the campaign, there was a great deal of uncertainty about the country's economic future. The belief was widespread among ordinary citizens—shared by many Western politicians and even some economic advisors—that all economic problems could be attributed to the communist system and Soviet domination. Therefore, as those constraints are removed, the belief was that economic growth and improved living standards would follow, painlessly and relatively quickly.

Many Hungarian economists knew better and were able to convince several of the parties that their platforms should mention the problems of transformation and the sacrifices that will be called for. Thus, while slogans and images had dominated the campaigns of all parties, some had campaign statements that alluded to the coming difficulties, while others campaigned by invoking a supposedly glorious past, linking it to the promise of a prosperous future.

The Democratic Forum promised the electorate painless transition. That was certainly one of the reasons it received sufficient votes to form a coalition government, allied with the agrarian Smallholders' party and the Christian Democratic party. Only later was it revealed that the Democratic Forum and the coalition government communicated with, catered to, and was supported mainly by the historical-ethnic-nationalists minority. A number of government programs, such as those in agriculture (discussed below), were manifestations of looking backward, to history, for economic solutions to today's problems, searching for a (probably nonexisting) "third way." In the process, the government had alienated most other political and social groups. For example, it dismissed all developments under communism, and the people who cooperated with the authorities, as having nothing worthwhile to contribute. The new ruling elite made no distinction between communism in the Stalin-Rakosi era in the 1950s and reform communism of the late 1980s. The government refused to cooperate with those who were the country's elite in the 1980s (except those who became early ardent supporters of one of the coalition parties). Among those dismissed were many economists and other professionals who had played active roles in dismantling central planning and who were unquestioned supporters of a democratic, market-oriented, and Europe-linked Hungary. Consequently, while in the Czech Republic and Poland, the post-communist governments were able to work with a broad coalition of anti-communist forces, Hungary during the first four years was governed by one particular, and rather narrowly based, anti-communist political movement.

It is in this context that Jozsef Antall—a historian and the son of a prewar politician, who was steeped for professional as well as for family reasons in the politics of the past—became prime minister and served in that capacity for 3½ years (1990–1993) until his death. Because he came into office at a crucial time in the nation's history, it is worth noting the special circumstances that surrounded his years as prime minister.

Prime Minister Antall was a decent and well-meaning person. At the same time, he had several traits—none of them unusual for leading politicians in any country—that were not helpful for formulating and implementing a consistent economic strategy or for building a broad political coalition to tackle the difficult economic issues. Mr. Antall had no understanding and little interest in economics. He placed his trust largely in his relatives and long-time friends, even though they were not the best qualified in every instance to advise him on economic issues. He had a tendency to allow irreconcilable differences of views to persist—in his party's leadership, in the governing coalition that his party, the Democratic Forum, had dominated, as well as in his government. No "economic czar" was allowed to emerge, although creating such a position would have been advisable under the circumstances. Mr. Antall preferred to "remain above the fray," presumably because he thought that thereby he would be less likely to be challenged, that his leadership position would remain more secure. Consequently, economic transformation and the government's role in promoting economic recovery were not given the highest priority. Nor was there much official concern about inconsistencies in economic policies, as will be illustrated.

These critical remarks about the first post-war government are not meant to suggest that Hungary made no significant progress in four years in further transforming its economy, and generally in the right direction. Many of the required laws were passed and a large number of essential institutional changes and economic policy decisions were made. Foreign investors exhibited confidence in Hungary by investing several billion dollars during 1990–1993, more than in any other European transforming economy. But progress on transforming the economy was slower, the transformation depression was deeper and lasted longer, and the foundations of sustained economic growth were less firmly established than they could have been and should have been, given the economic and political circumstances.

That a comprehensive and well-articulated economic blueprint was never presented by the government, that there was no attempt to build a broad political consensus in Hungary's economic crisis situation, and that the economic decline was steeper and lasted longer than perhaps was necessary may help explain why the party of the former reform communists—today's socialists, whose platform is social democratic—was able to obtain a clear majority of the vote in the June 1994 national elections, whereas the lead party of the government coalition, the Democratic Forum, could garner only 11.8 percent of the vote. Numerous other factors of course were also at work. For example, the Socialists worked hard to build a broad base of support among distinct social and economic groups. They refused to engage in mud slinging, focusing on their own program. And they reminded the electorate of what they had done in 1988–1989.

ECONOMIC POLICIES: THE "BEST OPTIONS" VERSUS ACTUALITY

What economic strategy should have been pursued during 1990–1994 to simultaneously address the most urgent economic problems, speed transformation to a market economy, and set the foundations for sustained economic growth? And what was, in fact, done?

The tasks faced by the government were exceedingly complex, and there was no single correct way to handle them. What are called below the "preferred policy options" represent the author's views. Some of the preferred options were perhaps clear in 1990 already and were among the recommendations of the Blue Ribbon Commission, the Bridge Committee, or both; others are formulated differently today with the benefit of hindsight.

In every society, social concerns and other political considerations modify what economists consider the best course of action (assuming that economists can agree on it). Nevertheless, suggesting one set of preferred options that could have, and perhaps should have, guided the actions of policymakers during 1990–1994 may be useful for economic historians as well as for policymakers in transition economies today who continue to face many of these problems and policy dilemmas. A brief accounting of the policy issues follows. Each topic is introduced with an explanation of the preferred policy, followed by a statement and interpretation of actual policies.

TAXES, SOCIAL EXPENDITURES, BUDGET REFORM

Preferred Option. One of the most urgent tasks was a fundamental reform of social programs whose cost was rising rapidly in absolute as well as in relative terms (as a percent of the budget and of GDP), as the proportion of retired persons rose, as unemployment compensation increased, as budget revenues declined, and as the cost efficiency of the social programs—poor to begin with—continued to deteriorate. Specifically:

The retirement age was 55 for women and 60 for men, younger than in the much richer OECD countries, so it clearly should have been raised.

Pensions were established at the generous level of 65 percent of the average income of the retired person during his or her last three earning years (which were often bloated through the tacit cooperation of employers and employees). This should have been changed, for example, by switching to life-time earnings or reducing the ratio of pension to earnings.

The social insurance fund pays sick benefits from day one of an illness—one reason for the widespread and costly abuse of the system. One essential reform should have been to put the burden of financing sick benefits during the first 30 days onto the shoulders of the employees and employers, so as to burden society only with the cost of catastrophic illness.

Not only elementary and secondary but higher education was also free to everyone, irrespective of need. Tuition should have been introduced to those who could afford it.

The rates and structures of the various taxes should have been altered in order to reduce the large burden of social insurance taxes on employers (53 percent of direct compensation in 1994) and to reduce widespread tax evasion. Personal income taxes are zero up to an annual income of about $1,200 (120,000 Hungarian Forints), thereafter becoming steeply progressive. This encourages cash payments under the table and tax evasion. Having a much lower flat rate on all income up to some middle- or upper-middle income category would reduce tax evasion and substantially increase tax revenues.

Fact. None of these steps was taken during the four years. While it must be recognized that legal and social obligations incurred earlier cannot be changed overnight, a strong start should have been made. Although a law was passed early on to begin to increase the retirement age as of January 1994, in December 1993 it was rescinded to improve the governing parties' 1994 election prospects. Tuition was to be introduced in higher education, but Parliament postponed it.[9]

The substantial costs of neglecting to reform the expenditure side of the budget, except for reducing direct subsidies to enterprises, include a significantly larger-than-desirable budget deficit, an exceedingly high level of total taxation, and a large increase, in real terms, of the national debt, which is a burden on future generations.[10] To be sure, the major source of the revenue loss was the transformation depression that caused large segments of the economy to become loss-makers, on a net basis. The sudden appearance

[9] For details see "Hungary's Welfare State in Transition: Structure, Initial Reforms and Recommendations," Policy Study no. 3 of the Joint Hungarian-International Blue Ribbon Commission (Hudson Institute, Indianapolis), 1994.

[10] During the government's first three years, the national debt almost doubled. One-third of the increase was due to the regular budget deficit, two-thirds to the large deficits incurred in the government's extra-budgetary accounts. These include the state assuming the debt obligations of a significant number of state enterprises as well as a large portion of the mortgage-debt obligations of households, and compensating the National Bank of Hungary for domestic currency losses arising from devaluations of the forint. Istvan Hetenyi, "Allamhaztartasi folyamatok a kilencvenes evek elejen" (State Budget Processes at the Beginning of the Nineties), *Kozgazdasagi Szemle*, Vol. XLI, No. 5 (May 1994).

of 600,000 unemployed, for whom unemployment compensation was paid, was another large burden for the budget.

That the needed budget reform measures were not taken and tax rates therefore were high generated costs that have hurt the private sector, directly and indirectly. Large budget deficits have preempted a substantial share of the economy's savings to help finance the deficit—and thus consumption—rather than productive investments. The exceedingly high level of taxation and charges have choked business expansion, promoted tax evasion, and contributed to the short horizons for business planning. High deficits during 1992–1993 were a factor in keeping real interest rates too high for business credits to be affordable by domestic investors. [11] And with high budget deficits, some of the burden to fight inflation had to be placed on a substantial real appreciation of the currency during 1992–1993, which, on balance, hurt exports and the balance of payments.

FINANCIAL SECTOR REFORM

Fundamental reform was urgently needed to strengthen the financial sector for the real economy (and vice versa) and to eliminate a serious moral hazard problem, namely, that government ownership and control of the banks, especially during a period when they were becoming insolvent, would conflict with the government's other responsibilities (namely, collection of taxes, spending decisions, prudential supervision of financial institutions, and implementation of economic policy). The temptation is much too great to use its control over the banks to achieve the government's economic or political objectives, preventing the emergence of a professionally managed banking system. Yet financial sector reform required (1) the prudent handling of the bad debts of the banking system, (2) the professionalization of bank management, including the modernization of banking operations and the establishment of new types of financial intermediaries; (3) putting in place sound and independent prudential bank regulation; and (4) the privatization of at least some of the large banks.

Bad Debts

Preferred Option. At some point, a once-and-for-all cleaning up of the financial sector's bad debts—whose costs must be financed by the public purse in some form—is essential. If only a portion of the financial sector's bad debts is paid, if no line is drawn between old bad debts and new bad debts created by imprudent new lending, then bank managers will know that the state will have no choice but to bail out the banks again and again. This gives rise to a "moral hazard" problem for bank managers: the safest course of action will be to continue to finance loss-making enterprises.

A key question is, at what point is it possible "to draw the line"? It probably cannot be done at a very early stage, while the transformation depression is running its course, because it is difficult to

[11] According to a survey by The World Bank, small businesses in Hungary were much less likely to obtain bank financing at every stage of business development than their counterparts in the Czech Republic, Slovakia, or Poland. Leila Webster, "Private Sector Manufacturing in Hungary: A Survey of Firms" Working Paper No. 67, Industry and Energy Department of the World Bank, Washington, D.C., December 1992.

establish immediately which enterprises have survival potential. The true financial condition of debtors is also clouded by an accounting and financial reporting system that is not yet in conformity with the requirements of a market economy.

Everything considered, it would seem that four years should have been sufficient to clean up all bad debts in some way, and thereby to draw a firm line. State enterprises must be restructured more or less at the same time as their bad debts are removed, to make sure that they would not create a huge volume of new bad debts for the banking sector. What this second step entails is discussed in the next section.

Fact. In 1992 the government undertook a partial "loan consolidation" program, which could no longer be postponed because the banking sector was becoming insolvent. At the end of 1993 and in May 1994, the commercial banking system was "recapitalized," but the line was still not drawn fully. Because only a portion of the bad debts was addressed, the mentioned moral hazard problem for the banks' managements continued. Ultimately, the total real cost to the public treasury will certainly be greater than if the actions would have been taken sooner, or at least with greater finality. The large indirect costs of what was done, and how it was done, were again borne largely by the economy's more productive—mostly private—sectors. Continued financing of loss-making enterprises preempted funds that would otherwise have been available for potentially more profitable ventures. And the methods chosen to finance some of the cost of the cleanup had a similar effect. Large direct and indirect taxes were levied on the banks, forcing them to have unusually large spreads between the interest rate paid to savers and the interest rate charged to borrowers. This squeezed out many businesses that would have borrowed if the spreads would have been smaller. And as payment to the banks for taking over a portion of the bad debts, the government created large new debts (which is aceptable), but without providing for a revenue stream to cover the cost of servicing them (which is a problem). It means that future taxes, budget deficits, or both will have to be larger to cover the obligations. [12]

Professionalizing Bank Operations

Space limitations make possible only a partial listing of the shortcomings that in 1993 were still found in Hungary's major state-owned commercial banks; progress on solving them was rather slow: no credit policy or procedures manual; no business or marketing plan; no in-house credit training program; no settlements or clearing system; and no commercial credit risk rating system. Recommendations made by management, especially over refinancing state enterprises, were often rejected for political reasons by boards of directors whose members typically represented the State Property Agency, key government ministries, and state-owned enterprises. Essential elements of a modern financial system, such as investment banks, venture capital firms, and private pension funds,

[12] "Financial Sector Reform in Hungary," Policy Study no. 4 of the Joint Hungarian-International Blue Ribbon Commission, (Hudson Institute, Indianapolis), 1994.

are still missing, forcing commercial banks to take on tasks that should be performed by specialized financial institutions.

Prudential Regulation

The need for strong and well-enforced prudential oversight of financial institutions by an independent government agency is self-evident.

Fact. The Law on Banking was passed at the end of 1991, specifying that bank regulation in Hungary should gradually reach West European standards. The office of State Banking Supervision was established and given the responsibility to oversee the banks' operations. However, the quality of the agency's work is constrained by shortcomings in the enabling legislation, by its limited access to information from the banks it supervises, by overlapping responsibility with the country's central bank, and by staff shortages and inadequate training. [13]

Bank Privatization

Preferred Option. The privatization of at least some large banks is essential to avoid the moral hazard problem; to take away or to reduce the temptation for the government to continue to finance the losses of state enterprises in a nontransparent way through the banking system; and to provide competition among financial intermediaries. And because it is quite likely that the privatization of large banks would bring into the country a substantial foreign banking presence, with it would also come foreign capital and badly needed improvements in banking services. To be sure, it is debatable whether banks saddled with lots of nonperforming assets could find reputable foreign investors.

Fact. The government did not support the rapid privatization of the large banks, though in 1994 the Foreign Trade Bank (the country's fifth or sixth largest) was privatized. There was a debate on what should come first: the clean-up of the bad debts or privatization. Either solution would have had certain advantages, but no decisive step was taken in either direction.

Although it is useful to allow new banks to be foreign owned, as the government did allow, that is not sufficient. New banks understandably select the best business opportunities, leaving the state-owned banks (and thus the public purse) to handle the more risky loans, mostly automatic refinancings.

RESTRUCTURING THE ENTERPRISE SECTOR

Restructuring the enterprise sector involves coordinated actions in four main areas: removing the unserviceable debts of state enterprises (discussed above); privatizing the economy, a key component of which is the privatization of state-owned enterprises; improving the management of enterprises that will remain temporarily or permanently controlled by the state; and putting in place effective bankruptcy procedures.

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[13] "Financial Sector Reform in Hungary."

Privatization

Privatization may be defined narrowly or broadly. A narrow definition is the sale or transfer of assets from state to private ownership; a broad definition is the growth of the share of the private economy in total economic activity, whether as a result of privatization or independently.

In the narrow definition the supply of firms to be privatized during the initial transformation years was not hugely attractive, given the inherited problems of a misdeveloped economy, the inevitability of a transformation depression, fundamental weaknesses in the legal, financial and physical infrastructures, and the high level of business taxation and charges. The rapid opening up of the economy to import competition also reduced, initially, the profit prospects of many domestic firms. To be sure, there are important exceptions to this generalization.

The demand to acquire state-owned firms was also limited. Domestic purchasing power in private hands—and the portion of it that households were willing to risk by investing in equity—was quite small. The situation was made more difficult by the absence or undeveloped status of such institutions as the stock market, mutual funds, pension funds, and venture capital firms.

Although the fundamental purpose of privatization is to reduce the role of the state in the economy—essential for political as well as for economic reasons—the choice of the basic strategy of privatization—sale to outsiders, sale to insiders (to managers and workers), or giving the property away (voucher privatization)—is essentially a political choice. Whatever method is chosen, criticism is inevitable, since any approach or combination of approaches also has shortcomings. Many citizens, living on small incomes and facing deteriorating economic conditions, look at privatization as someone stealing public property rather than as an instrument of market development and modernization.

Preferred Option. Because each method of privatization has its pluses and minuses, there can be only two general recommendations: that privatization should be quick and its "quality" high. Speed is important to improve efficiency (in which the quality of privatization is also a factor); to privatize before the values of nonprivatized assets erode, which happens quickly; and to make the learning period about privatization as brief as possible. "Quality" focuses on whether those who become new owners are in a good position to exercise the essential ownership functions, namely, to hire and fire managers, to insist that managers act primarily in the interest of the owners (rather than in their own interest or that of the immediate interest of the work force), and to provide or secure the investment needed.

Facts. Privatization had a head start in Hungary because it got under way a year or two before the new government took power. After the rapid and generally successful privatization of small (mostly retail service) establishments, privatization was unnecessarily slowed by frequent changes in the government's strategies and policies on privatizing large and medium-sized enterprises, which created uncertainty, although it may have mobilized new participants. First, there was a government-orchestrated campaign against "spontaneous" privatization by the politically disfavored "old guard" managers, even though they were often in the best position to come up with a feasible plan and buyers. The preferred alternative became large, centralized, single-package privatization programs, which were generally unsuccessful. Next came a rather bureaucratic "controlled self-privatization," applicable only to firms of modest size, which was largely successful.

Until 1993 the quality of privatization was quite high because assets were mainly sold, not given away. Hungary was the only country in the region that had privatized largely through sale to outsiders, although preferred distribution to such domestic groups as managers, workers, holders of compensation vouchers, and those purchasing with some type of government subsidy, was also a feature. In principle, the sale did not go automatically to the highest bidder; the prospective buyer's plans for the business, including his commitment to making restructuring investments, were also taken into account. In practice, the decisive factor was the price, to gain revenue for the budget.

In 1991–1992, nearly two-thirds of the sales were to foreign investors. This led to a backlash against foreign investors. In response, the government distributed assets free of charge to holders of compensation coupons and instituted a program to sell assets to domestic buyers who had little money but were willing to take out government-guaranteed loans with which to make the purchase, in many cases with scant prospects of repayment. Charges of corruption increased greatly, but were not all politically motivated. After the elections in mid-1994, this special program was discontinued.

Managing State Enterprises

Because the valuation of enterprises that have remained under the effective control of the state is so uncertain, no precise figures can be given on the proportions of privatized versus non-privatized state assets. At the end of four years, significantly more than half of the original (and no longer very meaningful) total book value of assets that were in state hands in the late 1980s were still controlled by the state. Some of those assets were under state control because the property could not be privatized as yet; other assets were controlled because the authorities had decided to keep their control more or less permanently in state hands. Responsibility for managerial oversight over these enterprises has been given to a variety of public bodies, including large commercials banks that are also controlled by the state.

Preferred Option. Because public bodies are notoriously ineffective in soundly exercising the key ownership functions, it is essential that their management be placed in private hands, through holding companies or by contracting out enterprise management directly. In those cases when privatization is one of the objectives, the contracts should include incentives for rapid privatization.[14]

Facts. One of the economically most damaging omissions of the government was its failure to improve the management of enterprises still controlled by the state. At best, the public overseers did nothing or did very little. At worst, they interfered with manage-

[14] "Privatizing the Management of Temporary State Property," Policy Study No. 2 of the Joint Hungarian-International Blue Ribbon Commission, (Hudson Institute, Indianapolis), 1993.

ment continuously. Because the government had no clear strategy of what to do with the enterprises it controlled, the public bodies responsible for them acted in a typically bureaucratic fashion. It was safer to veto the occasionally decisive action a manager would propose than to have to answer to the politicians on why a certain course of action was followed. Enterprise managers, judged by their peers to be competent, were on several occasions replaced with people considered to be politically more trustworthy. Appointments to the newly formed board of directors of such enterprises were made as much to reward political loyalists as to find people with strategic competence in their fields. The result was generally poor management of a significant bundle of public resources, adding to the problems of the state budget, contributing to the depth and length of the transformation depression, and hurting the private sector, directly as well as indirectly.

Bankruptcy

Bankruptcy laws serve several related functions in a market economy.[15] First, they provide a mechanism to liquidate inviable enterprises and repay creditors' claims according to agreed priority rules. Second, if the debtor's operations are potentially viable, bankruptcy procedures provide a framework for negotiating binding agreements to revalue assets and liabilities and to reorganize operations. Third, the threat of bankruptcy imposes a degree of financial discipline on enterprise managers. In sum, bankruptcy laws are important promoters of restructuring.

A transition economy has two groups of potential "users" of bankruptcy procedures. One group is state enterprises that need restructuring or liquidation. For them, the threat of liquidation provides motivation to restructure that otherwise might be absent. The other group is the newly emerging private sector. For the latter, bankruptcy laws provide debt-collection procedures, such as foreclosure, which facilitates the essential flow of private credit to investors. It is difficult enough to establish bankruptcy procedures that serve well even one of these users, much less both of the groups.

Preferred Option. For legal and other reasons, there can be only one basic kind of bankruptcy procedure, and it should be designed to serve both sets of its "users." But other than bankruptcy procedures should be employed to take care of the inherited bad debt problems of the banks and to restructure state-controlled firms of special national importance.

Facts. The key provisions of the initial bankruptcy code that became law in September 1991 were designed to be more strict, more punitive toward all debtors (private or state) than the laws of almost any market economy, not to mention the "softer" economies of Poland or Czechoslovakia. Hungary's law provided that any enterprise that owed as little as one forint and was in arrears for a minimum of three months, to any creditor, that debtor had to place itself under bankruptcy proceedings, regardless of whether its creditors wished to push it into a bankruptcy procedure. The man-

[15] Cheryl W. Gray, et. al., *Legal Reform for Hungary's Private Sector* (Working Paper No 983, Country Economics Department, The World Bank, 1992).

agement of the debtor firm then had 90 days to submit a restructuring and refinancing plan. Only if 100 percent of the creditors accepted it could liquidation be avoided. Bankruptcy was thus to be the main device to stop the growth of inter-enterprise debt (called "queuing" in Hungarian terminology), to help eliminate the nonperforming loans of banks (but only a few were converted into equity), to provide for debt-collection in the private sector, and to impel managers of state enterprises to improve operations.

When the bankruptcy law became operational in 1992, along with the Banking Law and the Law on Accounting, the number of bankruptcy filings jumped to well over 10,000 for the year, as compared to 528 in all of 1991. This had two negative impacts. First, the tough laws forced some solvent but illiquid enterprises into bankruptcy. At the same time, the few bankruptcy courts and judges in the country were overwhelmed with cases, causing procedural delays of a year or longer, which often made it impossible for the creditors to collect any revenue before the remaining assets were used up or squandered. The benefits were that the queue of mutual indebtedness was stopped, losses were made transparent, and a good number of inviable enterprises were liquidated. A portion of the 1992–1993 decline in GDP has been attributed to the bankruptcy law's impact. In 1993 several provisions of the law and procedures were amended, bringing them in line with those in market economies.

Mention might be made that there are still no strong laws against white-collar crime, which is one reason that lenders insist on large interest rate spreads.

AGRICULTURE

In 1990–1994 agriculture, which once was one of Hungary's relatively well-performing sectors, was hit by severe drought, the loss of export markets in the CMEA, reciprocal liberalization with the European Community that has made it possible for European Union (EU) exports to increase faster than EU imports from Hungary, and the government's own policies. The basic policy dilemmas were, what should be done with the agricultural cooperatives (collective farms) and whether, to what extent, and how to subsidize agriculture.

Preferred Options. The initial collectivization drive in the early 1950s and the recollectivization drive ten years later forcibly created socialist ownership forms. During the next generation, a reasonably well-functioning symbiotic relationship was allowed to develop between the collective farm and its members, making it possible to combine the advantages of modern, mechanized, large-scale farming and to harness the private interests and initiatives of the members. Whether to continue or to disband any collective farm should have been left to the discretion of the majority of each collective's members because in a large number of cases existing arrangements were workable and satisfactory to those most directly affected. During the 1980s agriculture was subsidized modestly, on a net basis, mainly through income supports, although beef and veal production received large price subsidies also. The pressure to increase subsidies to West European levels should be resisted. Government support should take mainly the form of collateral subsidy (meaning that a government guarantee partially substitutes for the borrower's collateral) and, if necessary, income subsidy, not price support, as in the EU.

Facts. For ideological and political reasons, the government decided to forcibly break up the collective farm system and to replace it with small and miniature "family" farms, of the kind that today are no longer economically viable. The main instrument of this policy was the Law on Restitution, which (in agriculture only) provided for the return of the *specific* property (that 30 or 40 years ago was collectivized) to the original owner or to the descendants. This policy has badly hurt production because it prompted mass litigation of conflicting ownership claims and because it stopped the flow of commercial credits to collective farms, since lenders did not know which ones would survive. Second, since most of the original owners were too old or dead, and their descendants were engaged in other occupations, restitution caused a widespread separation of land ownership from land cultivation. Third, neither the owners nor the cultivators have the means to enlarge and modernize the farms and thus make them economically viable. And, at the same time that agriculture was hit by these policy shocks, by external shocks, and by recurring drought, subsidies were drastically cut. For a combination of these reasons, agricultural production declined by about a third during 1990–1993 and exports plummeted also.

MONETARY AND FISCAL POLICIES

The Antall government inherited a relatively modest level of combined open and repressed inflation. During 1988–1990, as the prices that were still controlled were freed, and as consumer and certain other types of subsidies were reduced, inflationary pressures remained considerable. Inflation was in the 20 to 35 percent annual range, which is not unusually high for a transition economy. Nevertheless, it was especially important for Hungary to follow prudent monetary and fiscal policies because it had large foreign debt-service obligations, which required holding domestic "absorption," especially consumption, in check. In 1989 the government introduced a three-year program of economic stabilization, whose key elements were tight (but not excessively tight) monetary policy (including a positive real rate of interest); prudent fiscal policy, which meant a government budget close to balance; controls on wage increases in the state sector (imposing steeply progressive wage taxes on compensation increases that exceeded inflation); and a modestly appreciating real exchange rate.

Preferred Options. Some combination of the above policies should have been continued, in a steady fashion, for several years. Other economic policies—namely, rapid and high-quality privatization, other types of restructuring of state enterprises, substantial revamping of the expenditure side of the budget, the encouragement of foreign investment to strengthen financial intermediation and to improve infrastructure, special support for the emerging private sector, and an export-promoting industrial policy—should have been relied on to promote economic recovery and to lay the foundations for sustained economic growth.

Facts. Between 1989 and mid-1992, prudent monetary and fiscal policies were followed and a number of key macroeconomic indicators—inflation, exports, the balance of payments, net foreign debt, and central bank reserves—showed impressive improvements. Additional factors behind these outcomes were the steep fall in production, which cut imports and promoted exports, especially since many firms faced an export or die situation; and the booming German market, Hungary's main export market.

Between mid-1992 and mid-1994, after the presidency of the central bank changed hands, monetary and fiscal policies became erratic. For example, at one point central bank and Ministry of Finance policies pushed the real rate of interest to strongly negative levels to make it cheaper to finance government borrowing. When, predictably, this quickly reduced Hungary's impressively high rate of personal savings, policies were reversed, pushing the real rate of interest too high to be affordable by business borrowers. Such policy swings hurt the business sector. And a coordinated policy to promote economic recovery and sustained growth was not undertaken.

From late 1993 on, as the elections approached, the government began to prime the pump, increasing budget expenditures, running unsustainably large deficits, and making large future budget commitments. As a consequence, while (official) GDP produced declined by 2 percent, domestic absorption increased by 7 percent, a difference that is too great to be accounted for by production in the hidden economy. As domestic absorption increased, import demand rose substantially, while exports fell. Although in 1993 Hungary was still in a recession, the balance of payments worsened dramatically. This suggests that the structure of the economy is much too weak still.

One aspect of fiscal policy is taxation. The total tax burden on businesses and individuals is so high that the incentives to work and, especially, to pay the taxes, has been lowered. Although the levels of the profit tax on business and of the income tax on individuals are comparable to those in Western Europe (which means that they are high), especially onerous are the value-added tax (VAT) rates that everyone pays and the social insurance contributions levied on business. The steep early progressivity of the profit and income tax rates is also a problem.

INTEGRATING INTO THE WORLD ECONOMY

Preferred Options. A small, heavily trade-dependent country like Hungary has no option other than to integrate itself into the world economy. That means the more or less simultaneous introduction of the convertibility of its currency for current-account transactions; substantial import liberalization; strong export promotion; moving toward affiliation with the EU; and granting national treatment to foreign investors (that is, business conditions for them should be approximately the same as for domestic investors). On the very difficult question of whether in 1990 Hungary should have continued to service its large foreign debt fully, the recommended option is "yes," on the grounds that the direct and indirect costs of rescheduling would have been at least as large as the considerable burden of servicing the debt fully.

Facts. Hungary's first post-communist government generally receives good marks on its foreign economic strategy. Most of the remaining restrictions on convertibility were removed so that the forint has become a convertible currency, for all practical purposes.[16] The program of import liberalization, introduced by the previous government in 1989, was implemented. An association treaty was signed with the European Community in 1991 and Hungary became the first transition economy to apply, in 1994, for full membership in the European Union, even though it will be years before its application (and those of its neighbors) will be seriously considered. Openness toward foreign investment increased; in fact, large foreign investors received preferential treatment, regrettably, however, often through private bargaining, so that the concessions granted were not transparent, and more standard and open procedures were not perceived as the norm. While one may argue that granting preferences is not equitable toward the domestic business sector, it must be recognized that Hungary competes for foreign investment with neighboring countries whose conditions it must approximately match. The large inflow of foreign investment during 1989–93—when Hungary had obtained approximately half of the total foreign capital inflow into the countries of Central and Eastern Europe—is one of the country's notable economic successes. A further plus is that the country obtained foreign capital through acquisitions, joint ventures, and greenfield investments (greenfield investments are new, from the ground up, as compared to investments in existing enterprises). From the point of view of the host country, a negative phenomenon was that a considerable share of foreign investment purchased market share (for example, by acquiring oligopolistic channels of distribution), in some cases displacing with imports apparently competitive domestic products. Whether the government should have tried to make such investments more difficult is a debatable issue.

Perhaps the main policy shortcoming was the absence of a sustained export-promotion strategy, which should have been the focus of a (generally absent) industrial policy. Elements of such a policy should have included favoring investment over consumption, a more active policy of restructuring state enterprises, promoting domestic and foreign investment in infrastructure (including banking), and better coordination between monetary, fiscal, exchange rate, and industrial policies. Foreign debt continued to be serviced fully.

TIMING THE POLICY INITIATIVES

Preferred Option. With an assured four-year political mandate, the government should have wasted no time in carrying out the politically most difficult but essential economic policy steps during the first few "honeymoon" months or during the first year. (This was one of the key recommendations of the Blue Ribbon Commission as well as the Bridge Committee.) Long delays would have economic as well as political costs. The sooner certain steps are taken,

[16] *Forint Convertibility: When and How to Introduce It?* (Policy Study No. 1 of the Joint Hungarian-International Blue Ribbon Commission) (Indianapolis: Hudson Institute, 1992).

the more likely that the economic and thus political payoffs would come before the next election.

Fact. Only a fraction of the economic measures that should have been taken were taken quickly. The following, not all mutually consistent, explanations have been advanced as the likely reasons. The Democratic Forum had promised a painless transition. Political priorities lay elsewhere. In the fall 1990 local elections, the coalition parties lost substantial ground, prompting the government to seek more popularity. With no need to face the electorate for four years in national elections, there was insufficient pressure to take the difficult steps. Maybe the economy will rebound on its own by the time of the next election. And once the continuation of the 1988–1989 reform program was discarded, for ideological-political reasons, there was no clear alternative to put in its place, with the new privatization programs being the notable exceptions.

CONCLUSIONS

Hungary's first post-communist government did not have a clear economic strategy, did not give priority to economic issues, and made a series of economic policy mistakes of omission as well as commission, which had adverse impacts on the business sector. At the same time, significant progress was made in transforming Hungary into a market economy, in terms of strengthening its institutions, domestic business start-ups, and a significant inflow of foreign investment. A large number of Hungarians have opened up businesses, a reflection of the entrepreneurial spirit of the people as well as the unusually difficult employment situation that many had suddenly faced. However, government policies did not adequately support the growth of the private sector. That a large number of private businesses have gone bankrupt, while many others have survived only barely, is partly explained by the unavoidable economic difficulties during a "transformation depression," which was deeper and lasted longer than was perhaps necessary.

Hungary's first post-communist government is considered "right of center," a label that probably depicts accurately its domestic political and foreign policy orientation. But its economic policy was clearly "left of center." In many areas it unnecessarily preserved and even enlarged the role of the state (for example, in the management of state enterprises and banks). It also took a series of populist economic policy steps.

PROSPECTS

In May 1994 the Socialist Party won an absolute majority in the second round of national elections and joined with the Free Democrats to form a government, which controls 72 percent of the votes in Parliament. Once again, economic stabilization has to become a high priority in the short- and medium-term because of the specter of large twin deficits: in the balance of payments and in the government budget. For the longer-term, some additional foundation bricks for sustained growth and modernization also will have to be put in place. In brief, the country still requires both an austerity program and a strategy that will promote sustained economic growth, as it did in 1990. In the meantime, the room to maneuver is small. Although the dominant faction of the Socialist Party is realistic, has run a responsible campaign, and has been making prudent statements about the economy since the election, the politics of implementing sound economic policies is going to be difficult. There is disagreement within the Socialist Party about economic policy (there is a faction that supports populist measures), and the alliance with the Free Democrats is more an uneasy marriage of convenience than anything else. One of the key political problems is that it is difficult for the people to understand, much less to accept, why the economic situation has remained precarious for such a long time, and why further sacrifices are needed.

Looking at the fundamentals, one can be optimistic about the economic future of Hungary. The country has a strong human capital base—its strongest asset—to do well economically, to become a country like a Denmark or a Sweden. All that is necessary is to remove some of the constraint, to provide the people a bit of encouragement, straight talk, and intelligent government support. The governing coalition has the intellectual capital, the political power, and the time it needs to set Hungary on the right economic course during the next four years. For these reasons, the chances are good that the country will enter a period of sustained economic growth within a few years.

THE CZECH REPUBLIC: AN ASSESSMENT OF THE TRANSITION

By Phillip J. Kaiser* .

CONTENTS

SUMMARY

The Czech Republic, which, together with the Slovak Republic, has been independent of the Soviet Bloc since late 1989 and has been separate from Slovakia since January 1993, has achieved a measure of success in terms of positive economic indicators. It inherited a number of favorable factors and has implemented policies that have built on them. For example, it inherited a low foreign debt burden, low budget deficit, and low inflation; it has followed policies that have kept foreign debt and budgetary deficits low, maintained low unemployment and reasonably low inflation, promoted a rapidly growing private sector, growth in gross domestic product (GDP), and a relatively stable political environment.

Comparatively low wage levels and highly skilled workers have attracted foreign investment, although not on the levels in either Hungary or Poland. Enterprises have been successfully reorienting trade from Eastern Europe and the former Soviet Union to Western Europe and the Third World. If Western Europe pulls out of its economic slump and further opens its markets, and if the former Soviet Union—especially Russia, Ukraine, and Belarus—be-

*Phillip J. Kaiser is a consultant with the Congressional Research Service. The author would like to thank John Hardt and Julie Kim for comments on an early draft, and Keith Crane and Robert Cohen of PlanEcon for providing much useful information.

gins to stabilize and show the fruits of reform, the prospects for foreign investment and trade with the Czech Republic would look promising.

On the other hand, political solidarity may break down if unemployment and inflation rise significantly, and if government policy on wages continues to hold down the wages of even the more productive workers. The Czech Republic has a relatively small domestic market and is not well endowed with natural resources. Production, while increasing, is still below its 1989 level. Quality-of-life factors, such as the environment, health care, education, and housing are negative and continue to deteriorate for many people, and may be difficult to improve due to budget constraints. These issues will create additional pressure on the government and may weaken the consensus for reform.

THE HERITAGE OF CZECHOSLOVAKIA IN THE FALL OF 1989

At the time of the peaceful "velvet revolution" of 1989, the economy of Czechoslovakia was what many observers picture as typical of the Soviet Bloc—perhaps the most centrally planned and controlled state in the region, industrialized with an emphasis on military and heavy industry, and collectivized in agriculture. The private sector owned only 2 percent of assets and provided just 1.2 percent of total employment.[1] With a per capita GDP of about $8,580, it ranked at about the level of Spain or Ireland.[2] While certainly not a developing country along the lines of those in Latin America or Africa, when measured in GDP, it was developed to fit in with the Soviet Bloc's production and trade requirements.

Similar to some developing countries, however, Czechoslovakia had a very small service sector, and production of consumer goods was relatively small. Likewise, the quality of goods and services, produced by enterprises isolated and protected from competition, was not up to the standards of Western Europe or the United States. Much of the capital stock and infrastructure was old and uncompetitive by Western standards.

Trade was primarily oriented to the Soviet Union and Eastern Europe, and a smaller amount with the Third World, especially arms trade with clients of the Soviet Union such as Iran, Iraq, Syria, etc. Agriculture employed over 12 percent of the work force in 1989.[3] Productive capacity was located and developed not according to the economic rationale of Czechoslovakia's domestic needs or comparative advantage in the regional market, but rather geared to the Soviet Union's policies and the Council for Mutual Economic Assistance (CMEA). The result was overemphasis on heavy industry and military industry (especially in Slovakia), subsidized energy inputs resulting in inefficient energy use, and a lack of concern for environmental pollution.

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[1] *OECD Economic Surveys: the Czech and Slovak Republics* (hereinafter *OECD*), 1994, Organization for Economic Cooperation and Development, Paris, p. 82.

[2] The level of productivity depends on the methodology used, and there is a wide variation regarding former centrally planned economies. In the case of Czechoslovakia, the CIA *World Factbook 1989* lists a per capita GNP (for 1988) of $10,130, while the World Bank estimated 1990 per capita GNP to be $3,300. The $8,580 figure is a purchasing power parity rate calculated by PlanEcon.

[3] *PlanEcon Review and Outlook for Eastern Europe* (hereinafter *PlanEcon*), June 1994, p. 77.

A measure of the weight given to heavy industry is that it accounted for 17.5 percent of total employment in Czechoslovakia, compared to about 3 percent in developed West European states.[4] Along the same vein, consumption of energy and raw materials for a given amount of production was about 50 percent higher in Czechoslovakia compared to an average of comparable developed countries.[5] Thus an industrialized but inefficient and misdirected productive base, by market standards, is the legacy of the communist era. In addition, skills such as marketing and management, and staffing of market-friendly institutions both public and private were moribund.

The legacy of the past is not all negative, however. The post-communist Czech government entered the transition to a market economy with many favorable economic indicators. It inherited a very low gross hard-currency foreign debt of about $6 billion and a slight budget deficit. This has provided the government with greater freedom regarding reform policy, because large debt payments were not due as is the case in Poland, Hungary, and Bulgaria. After an initial burst of inflation due to price liberalization, and an additional jump after introduction of a value-added tax (VAT) in 1993, price increases have been low. In addition, the work force is technically skilled and well educated. Following a tradition of conservatism, tight fiscal and monetary policies have kept the budget and inflation controlled. In addition to the legacy of the communist era, the Czech Republic has the heritage of democracy and an industrialized market economy from 1919 to 1948 (as well as a brief period of reform in the mid-1960s just previous to the 1968 crackdown). This tradition, though not quantifiable, should be considered a positive, if marginal, influence.

THE EFFECT OF CZECH-SLOVAK FRICTION AND THE SPLIT[6]

Differences between Czech and Slovak officials became evident almost immediately after independence from the Soviet Bloc was achieved. These differences were exacerbated by the economic and social turmoil of the early post-communist years, 1990–1992. While there was broad support for economic reform and integration with the West, many Slovaks felt their problems were being neglected. Unemployment was significantly greater, for example, in Slovakia, where by the end of 1991 unemployment was 11.8 percent compared to 4.1 percent in the Czech lands.[7] Some of this difference has been attributed to more generous unemployment benefits in Slovakia, which discouraged swift re-employment.[8] Nevertheless, the disparity of unemployment fueled political tensions between the two republics. Slovak activists pushed hard for greater recogni-

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[4] Valtr Komarek, "CSFR: A New Approach," in *Economic Transformation in Central Europe: A Progress Report,* edited by Richard Portes, 1993, Centre for Economic Policy Research, London, p. 68.

[5] Ibid. p. 68.

[6] For additional discussion on Czech-Slovak relations see "The Slovak Economy After One Year of Independence," by Josef Brada, in this volume.

[7] Jan Svejnar, "Czech and Slovak Federal Republic: A Solid Foundation in Economic Transformation in Central Europe," a progress report, edited by Richard Portes, Centre for Economic Policy Research (1993), p. 36

[8] *OECD*, p. 13.

tion, and the state was renamed the Czech and Slovak Federal Republic in 1990.

Virtual deadlock in the federal assembly over the pace and direction of economic policy stalled many reforms. After the June 1992 elections the Slovak leaders pressured for greater devolution of power to the republic level. Czech and Slovak leaders agreed to a split of the federation as of January 1, 1993, becoming the Czech Republic and Slovakia.

Despite agreements signed in late 1992 designed to ease the transition, including establishment of a temporary common currency and a customs union, the ramifications of the split were generally more severe than anticipated. Trade between the two republics fell 40 percent from January to August 1993.[9] The two states intended to maintain a single currency temporarily, but speculation driven movement of money from Slovakia to the Czech Republic caused the 1:1 connection between the currencies to be severed in February 1993. The Slovak currency was devalued in March, July, and December of 1993 to alleviate trade imbalances with the Czech Republic.[10]

The customs union, which was to provide for duty-free trade between the two states is still in effect, despite policies of the Slovak government that, while intended to address the trade imbalance, have violated at least the spirit of the agreement. For example, in May 1993 Slovakia began requiring quality certificates for food imported from the Czech Republic and enforced by inspections at the border, and a separate 10 percent surcharge on consumer goods was introduced.[11]

Czech banks have been reluctant to maintain reserves in Slovak currency, out of concern that another devaluation would leave the bank with losses, and this has resulted in greater difficulty of obtaining Slovak koruny in the Czech lands. In addition, the devaluation of the Slovak currency has made travel to the Czech Republic more expensive for Slovaks.[12] Also, the split delayed voucher privatization for several months, as the Czech government halted share distribution to Slovaks, in an effort to pressure the Slovak government to agree to pay debts incurred before the split. While the voucher program proceeded, the debt issue remains. The division of debts and assets of Czechoslovakia was made at a ratio of 2:1, because the Czechs have approximately twice the population of Slovakia.

Views differ regarding the ultimate beneficiary of the split. The Czech Republic, with about two-thirds of the population (about 10.5 million), is now more homogeneous, and does not have as many of the extremely large and arms-producing industrial enterprises, nor as many one-company towns as does Slovakia. In addition, there is no longer a budget transfer from the Czech lands to Slovakia as had been common throughout the post-war years.[13]

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[9] "Czech-Slovak Relations Two Years after the Elections," *RFE/RL Research Report* (hereinafter *RFE/RL*), July 8, 1994, p. 11.
[10] *RFE/RL*, p. 14–15.
[11] *RFE/RL*, p. 15.
[12] Ibid.
[13] *OECD*, p.64.

RECENT ECONOMIC POLICY AND PERFORMANCE

DOMESTIC POLICY AND PERFORMANCE

Domestic economic performance in the Czech Republic, as measured by indicators such as GDP growth, unemployment, and inflation, is positive in most respects. As noted below in more detail, unemployment and inflation have been low relative to other states in the region, and GDP growth is rebounding. However, these measures do not completely capture what may be called the quality of life. On the one hand, even some of the less quantifiable measures of living standards are undoubtedly positive, such as the variety and quality of goods and services available. On the other hand, income disparities are widening, and people on fixed incomes may be at risk if the social safety net is not secured. And while privatization is likely to increase efficiency, some critics believe that it has been a boon to the nomenklatura and foreigners more than to anyone else, and that it will add to the unemployment rolls. This has sometimes been described as the conflict between efficiency and equity.

Production

Production fell steeply in the Czech Republic in 1991 and 1992, as the Soviet Union required hard currency for its natural resources, and orders for military and other goods from the USSR and Eastern Europe stopped (see Table 1). GDP fell 14.2 percent in 1991 and an additional 6.6 percent in 1992, before stabilizing in 1993 with a drop of only 0.3 percent.[14] Production in the military industrial sector was especially hard hit. Czechoslovakia was the largest arms producer of the Warsaw Pact nations, with the exception of the USSR, and more than 75 percent of what it produced was exported.[15] The traditional market for Czech arms, the Soviet Union, disintegrated and other former buyers—such as Libya, Iraq and Iran—were dropped by the new Czech leaders who wanted to improve relations with the West.

TABLE 1. Selected Czech Economic Indicators, 1989–1994

(Percentage)

Measure	1989	1990	1991	1992	1993	1994[a]
GDP growth	4.5	−1.2	−14.2	−6.6	−0.3	4.8
Inflation	1.4	9.7	56.7	11.1	20.8	9.0
Unemployment	N/A	0.8	4.1	2.6	3.5	4.2

Source: *PlanEcon Review and Outlook* (June 1994).
[a] Projected.

[14] *PlanEcon*, p. 73. It is likely that production data understate the productivity of the economy, because they fail to capture the full extent of the private sector. This is, in part, due to private economic activity that goes unreported or under-reported in order to evade taxation, as well as a lack of experience and institutions for gathering such data.

[15] See Thomas S. Szayna, "Defense Conversion in Eastern Europe," in this volume.

The domestic market also shrank as the budget was under extreme pressure and a reorientation to a market economy and consumer goods took precedence. GDP is forecast to grow an impressive 4.8 percent in 1994 and over 6 percent in 1995.[16] The service sector has grown explosively; retail sales have been strong; and exports are growing. Tourism from the West has increased greatly, especially in Prague. Yet, in spite of this dynamic growth rate, the level of total GDP may not reach the 1989 level until 1997 or 1998. In addition, while production is increasing, productivity may not be rising proportionally, because workers are not being shed despite the vast drop in production.

The decline in production is not entirely a negative outcome. To the extent that production was inefficient, wasteful of energy, and excessively polluting the environment, the decline is a positive outcome. Falling output, in the brown coal producing region, for example, has alleviated somewhat the environmental pollution, resulting in both economic and noneconomic benefits.[17] The concept of "negative value added," in which the output has less value than the sum of the inputs, applies to some of the production in the Czech Republic, and the release of these resources for more productive uses is a plus. From a western strategic perspective, to the extent that production was not directed to domestic consumption or export, but rather to the defense industry and the Soviet Bloc, the decline is a positive outcome.

Unemployment

Registered unemployment has remained very low, only 3.5 percent in 1993, much lower than in the United States or Western Europe, largely through government action that kept wages low—eliminating the need for massive layoffs—and the lack of an effective bankruptcy law, among other factors. These policies enabled enterprises to maintain "over-employment." In 1992 an estimated 350,000 excess workers were on the payrolls of enterprises. This number would have increased the unemployment rate by 4 percent if they had all been let go.[18] Some of the workers who might have joined the unemployment rolls have found work in Austria and Germany. This is a "safety valve" of sorts; the Czechs are fortunate to be geographically close to those countries.[19]

Early retirement programs were also instituted to relieve the pressure for layoffs, and some 70,000 workers took advantage of them through 1992.[20] This may reduce some pressure for layoffs temporarily, but if pensions are too low or do not keep pace with inflation these early retirees are likely to be back in the job market.

While the Czech government has predicted unemployment of around 8 percent for 1994 and 1995, other analysts believe that the rate will be closer to 4–5 percent.[21] Some observers speculate that while many workers have been absorbed by the private sector, which has kept the unemployment rate low, these workers rep-

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[16] *PlanEcon*, p. 98.
[17] *OECD*, p. 10.
[18] *OECD*, p. 15.
[19] *OECD*, p. 67.
[20] *OECD*, p. 153.
[21] *OECD*, p. 94; *PlanEcon*, p. 99.

resent the more motivated and desired workers, while those remaining at state enterprises may find it more difficult to find work in the private economy.

Unemployment is likely to increase when the government implements bankruptcy proceedings, which have been largely postponed. Between November 1992 and September 1993 only some 30 enterprises declared bankruptcy, while 592 cases were pending.[22] Obviously the government is unable or unwilling to expedite these cases. Of course, such actions would not be cost-free to the government, economically or politically. Economic costs include increases in unemployment compensation, job training, and pensions, and perhaps a drop in tax revenues as unemployed people tend to buy less (resulting in reduced sales taxes) and earn less (resulting in reduced income taxes). Some of the economic costs would be offset by a reduction of government subsidies to enterprises.

Major banks also have been unwilling to press bankruptcy of their big clients. Some bankers may fear that if they do classify many of their loans as nonperforming, it could make the bank's overall creditworthiness decline, which would make them appear less attractive for investment and possibly a candidate for bankruptcy themselves. One estimate is that 55 percent of loans were nonperforming at the end of 1991. According to one authority, it is likely that the government will have to accept the burden of cleaning up the banks' balance sheets, because of the importance of banks for overall economic restructuring.[23]

There also has been a change in the structure of employment. Immigrant labor has tended to be laid off before native labor, and unemployment is higher among gypsies than it is on average for Czech citizens.[24] Unemployment is higher among women than men.[25] There has also been a shift in employment from agriculture (including forestry) and industry to services. During the past several years employment in agriculture has declined 30 percent and in industry by 12 percent.[26] Many workers have been absorbed by retail trade, financial services, and the tourist industry, as well as by work in the gray economy of which there is no accurate measure.[27] An estimate by the Czech Ministry of Labor and Social Affairs in 1992 was that there were some 250,000 workers in the "gray" or "second" economy.[28]

Inflation

Inflation in the Czech Republic has been quite low by regional standards, largely as a result of tight fiscal policies, including a relatively balanced budget, tight monetary policy, and wage controls. For 1994 the increase in consumer prices is forecast to be under 10 percent. The wage controls have been implemented by taxing, at progressively higher rates, any wage increases above a set

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[22] *OECD*, p. 91.
[23] See "Banking Sector Reform in Central and Eastern Europe," by Michael Marrese in this volume.
[24] Svejnar, p. 36. The higher rate among gypsies may be due to discrimination, or to the fact that education levels among gypsies tend to be lower than average.
[25] Svejnar, p. 51.
[26] *OECD*, p. 68
[27] "Czech Economic Recovery: Why the Official Statistics Understate It," *PlanEcon Report*, June 20, 1994, p. 2.
[28] *OECD*, p. 16.

norm.[29] The controls affected large state-owned or state-controlled enterprises only, due to the government's view that the private sector has no incentive for excessive wage increases.[30] The controls were relaxed in early 1993, but were reimposed by summer of that year on enterprises with 25 or more employees due to the rapid increase in wages during that time.

Inflation is likely to increase when the controls are lifted, and for several reasons in addition to wages. The wage pressure is present because the unit costs of labor are lower in the Czech Republic than in Poland or Hungary, held down by government policy on wages. In addition, the demand for goods is likely to be increasing, and since Czech production is unlikely to be able to meet that demand, there will be upward pressure on prices. While some argue that there is a reserve of unused or underused industrial capacity in the Czech Republic, much of that productive capacity is not suited for the market economy. The capacity is not energy-efficient and it is not consumer-oriented, for example. Thus much of the decline in production is a long term, not cyclical, drop.[31]

Privatization

Privatization in the Czech Republic has proceeded apace, and the private sector now accounts for over 50 percent of GDP. Small enterprises, typically in the retail and service sectors, were almost entirely in private hands by the summer of 1993. Medium and large enterprise privatization has progressed through the establishment of joint-stock companies, of which 62 percent of their shares were offered for voucher privatization and the remaining 38 percent of shares were either sold to foreign or domestic buyers or kept by the National Property Fund.[32] In the first stage of voucher privatization some 985 Czech enterprises were privatized and the National Property Fund ended up with 10–30 percent of the stock in 395 companies, 30–50 percent in 180 companies, and more than 50 percent in 114 companies.[33] Thus the state continues to be a strong, if not the predominant, force in most of these firms. The Fund has used revenues from sales of shares to clear debts of firms preparing for privatization, inter-enterprise debt clean-up, and recapitalization of commercial banks.[34] The majority of the vouchers were invested in privatization investment funds (These are virtually unregulated, and some are likely to be unable to deliver on their promises of high returns.).

If it stays on track, by 1995 the privatization program will have transferred four-fifths of the property owned by the state in 1989. The Czech voucher privatization program has already resulted in a large transfer of wealth from the state sector to the private sector, on the order of $5 billion. Broad participation in the privatization program is likely to result in political support for reform generally. In addition, the privatization process has resulted in reve-

[29] Companies are taxed on a sliding scale, up to 300 percent, for wage rises of more than 5 percent above the ratio of the wage bill to revenues plus 15 percent. "This mechanism . . . allow[s] companies to increase the real wage bill by up to 15 percent, providing that their sales revenue per employee increases at least in line with the general level of prices." *OECD*, p. 79.

[30] *OECD*, p. 153, note 79.

[31] *OECD*, p. 74.

[32] *OECD*, p. 82.

[33] *Hospodarske noviny*, August 12, 1993, p. 1; cited in *OECD*, p. 155.

[34] *OECD*, p. 87.

nues to the government. These revenues have been used, in part, for job creation efforts.[35]

Privatization of land and housing has been approached differently from privatization of the industry and service sectors.[36] A primary difference was the issue of restitution for property expropriated by the government. At the beginning of the transition about half the housing stock was owned by the state and the other half was owner-occupied. In 1991 the responsibility for state-owned housing was transferred to previous owners or to local governments to decide whether to privatize units or to continue renting them. The process has been slow, and some rent controls are still in effect.

Private farm land used by cooperatives was never nationalized during the collectivization of agriculture in the 1950s, although many private farmers were forced to join these cooperatives. Their property title never expired, so the issue became how to divide the cooperatives' assets. At the end of 1991, the federal parliament approved a law on the transformation of agricultural cooperatives that tried to reconcile the interests of people who worked on the farm but owned no land (about half the active members) and people who owned land but did not work. Current farm workers could purchase one-quarter of the net assets of the farm. Owners would receive one-half of the remaining assets and those who contributed capital or labor would receive the other half. Most of the cooperative farms decided to become cooperatives of owners rather than becoming corporations or splitting into many small private farms. State farms bogged down on the issue of restitution claims. Expropriated landowners could file claims until the end of 1992 if they were citizens and permanent residents. More than 300,000 claims regarding agricultural land were filed, and this onslaught overwhelmed the government's ability to process them.

An additional issue regarding property rights and privatization has been whether and how to provide restitution or compensation to Jews whose property was nationalized by the Nazis, which later became state property, and also the property of Sudeten Germans who were forced to leave the Czech lands after World War II.

EXTERNAL ECONOMIC RELATIONS

The Czech economy, like most in the region, is highly dependent on external factors. These include trade issues such as market access, foreign investment, the price of energy, the growth of the West European economy, and the stabilization and growth of markets to the east. If external factors are positive, that is, neighboring economies grow, markets open more fully, investment flows increase, the Czech economy will grow rapidly; if external factors are negative, however, the Czech economy will find growth more difficult.

Trade

External factors have had a major effect on Czech trade. The 1990 unification of Germany was a major shock, as the German

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[35] *PlanEcon*, p. 80.

[36] This section draws heavily on *OECD*, pp. 38–39.

Democratic Republic had accounted for 10 percent of Czechoslovak trade.[37] The disintegration of CMEA, the move to world prices in trade with the Soviet Union in January 1991, and the depression of the economies of the former Soviet Union and Eastern Europe left the Czechs with no alternative but to reorient trade elsewhere, and in this shift they have been quite successful. Germany has replaced the USSR as the main Czech trade partner; it received 26.9 percent of Czech exports and provided 25.1 percent of Czech imports in 1993.[38] Slovakia remains the second largest trade partner, but the trend continues to be downward. Austria was the third largest recipient of Czech exports with 9.8 percent, followed by the United Kingdom and Russia with 3.2 percent each (data from the first quarter of 1994). Russia was the third largest supplier of Czech imports with a 13.8 percent share. Trade with Poland and Hungary is quite low: Poland accounted for 2.7 percent of total trade, Hungary, 1.7 percent.[39]

Overall U.S. trade with the Czech Republic in 1993 was slightly less than Poland's trade with the Czech Republic. U.S. imports were valued at $275 million; and U.S. exports, $266 million.[40] The United States restored most-favored-nation trade status to the Czech Republic; a trade agreement came into effect in November 1992, and a double taxation prevention agreement was implemented in December 1993.

Investment

Foreign direct investment in the Czech Republic from 1990 through 1993 was over $3 billion (the Czech lands were the recipient of 88 percent of foreign capital at the end of 1992, with the remaining 22 percent to Slovakia[41]). The largest source of foreign direct investment has been Germany, with a total of $641 million between 1990 and 1993 (31.2 percent of total foreign investment). The United States is the second largest source of investment, with $572 million (27.9 percent), followed by France (12.6 percent), Belgium (7.1 percent), and Austria (6.1 percent).[42] While the Czech Republic has attracted less investment than Hungary, and somewhat less than Poland (on a per capita basis, however, it leads Poland), its political stability and progress on privatization may improve its position.

The sectors that have attracted the most investment are consumer goods and tobacco (23 percent of the total; Philip Morris' investment in the Czech firm Tabak was the largest single investment of 1993), the automotive industry (20.3 percent), construction (12.8 percent), banks and insurance (10.1 percent), and the food industry (9.8 percent).[43] Another important source of foreign capital has been portfolio investment. Capital inflows from purchases of shares and bonds increased to $350 million in 1993, up from just $15 million in 1992. In addition, Czech enterprises were successful

[37] Svejnar, p. 34.
[38] *PlanEcon*, p. 83.
[39] *PlanEcon*, p. 84.
[40] *The Czech Republic in the International Economy, Quarterly*, Centre for Foreign Economic Relations, Prague, June 1994, p. 85; and U.S. Chamber of Commerce.
[41] *OECD*, p. 35.
[42] *PlanEcon*, p. 92.
[43] Ibid., p. 92.

in drawing financing directly from abroad. This amounted to $800 million in 1993, compared to $300 million in 1992.[44]

Integration

Official affiliations of the Czech Republic are likely to promote further trade and integration, and perhaps the most important is that with the European Union. The association agreements with the EU, signed in December 1991, have improved market access by reducing tariff and nontariff barriers to trade over a period of years, and are an early step toward full membership, although the schedule is uncertain. Nevertheless, restrictions still apply, including anti-dumping actions, voluntary export restraints, and quotas on imports of steel, textiles, coal and agricultural products.[45]

Czechoslovakia was a founding member of the General Agreement on Tariffs and Trade (GATT) in 1947, although its participation was dormant after the communists took power in 1948. Active membership to the GATT should improve market access, as well as reduce nontariff barriers and provide rules and a forum for trade disputes. Responsibilities of states under the GATT may institutionalize market-based reforms.[46]

The seven countries of the European Free Trade Area (EFTA: Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland) have also negotiated a trade agreement with the Czech Republic to phase in the elimination of tariffs, but this is likely to be less important as the major EFTA members are seeking to become EU members.[47]

The Visegrad group (Slovakia, Hungary, Poland, and the Czech Republic) has agreed upon a Central European Free Trade Agreement (CEFTA) in which all trade barriers will be dropped by January 1, 1998. Many tariffs have already been reduced or dropped, although duties on steel, textiles, and some other products remain.[48] The economic utility of this group has been questioned by some, because the markets are relatively small and labor costs similar, providing little in the way of comparative advantage in trade. This is contrasted with the relatively high labor costs in the EU.

Prospects for Economic Growth and Integration

The Czech Republic entered the transition in perhaps the best position of any state in the region. Economic policies of the previous regime had resulted in low foreign debt and inflation. Proximity to Germany and Austria provided readily accessible trade and employment opportunities. The new government, bolstered by strong public support for reform, continued tight fiscal policies, including slow growth of the money supply, a balanced budget target, and wage controls that kept inflation under control despite price liberalization. The split with Slovakia was disruptive, but any additional long-term effects are likely to be marginal.

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[44] Czech Centre for Foreign Economic Relations, p. 86.
[45] George Holliday, "Russian and East European Exports to the West: The Problem of Market Access," *CRS Report*, February 15, 1994, p. 6.
[46] *Transition, the Newsletter About Reforming Economies*, The World Bank, vol. 5, no. 2–3, (February–March 1994), pp. 10–12.
[47] Holliday, p. 14.
[48] Ibid. p. 84

Most observers agree that the Czech Republic has established a stable foundation for economic growth, but "macroeconomic stabilization can unravel if microeconomic transformations are inadequate."[49] Expectations are high for rising living standards and an improved quality of life. The leadership of the Czech Republic must take full advantage of its situation to move ahead with privatization and restructuring of industry, privatization of housing and farm land, anti-monopoly and pro-competition policies, and legal and regulatory development. At the same time, the government has emphasized that the social safety net must be provided for the most vulnerable.

On the negative side of the balance sheet, income differentials are increasing and inequality is a potential political tinderbox. The Czech Republic is vulnerable to external factors—it has little in the way of natural resources, including energy, and its domestic economy is relatively small. While foreign debt is low, inter-enterprise debt may be a significant problem, although the size is difficult to gauge. This may present a problem in determining the viability of enterprises to be privatized, and may also burden the banking sector, due to the "intertwined insolvency of banks and enterprises."[50] Inflation is likely to increase when wage controls are lifted, and unemployment will undoubtedly rise when privatization, restructuring, and bankruptcy processes are implemented. Quality-of-life issues such as health care, education, the social safety net, and environmental issues must be addressed.

Nevertheless, the Czech economy is well positioned to secure a successful transition, geographically as well as politically and economically through its policies and performance. A best-case scenario would include economically dynamic and open neighbors to the east, especially Russia, Ukraine, and Belarus; improved openness and growth of the Visegrad group; an end to the recession in Western Europe and increased growth and openness of the EU; restructuring and privatization of large state-owned or state-dominated enterprises; and continued political consensus.

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[49] Svejnar, p. 21.

[50] See Michael Marrese, "Banking Sector Reform," in this volume.

THE SLOVAK ECONOMY AFTER ONE YEAR OF INDEPENDENCE

By Josef C. Brada *

CONTENTS

SUMMARY

The Slovak Republic began its existence as an independent state in 1993. Before that time, it had participated in developments that characterized the Czech and Slovak Federated Republic (CSFR). These included the liberalization of prices in January 1991; the devaluation of the koruna and the introduction of partial convertibility, and the liberalization of foreign trade; and extensive privatization of both small establishments as well as of large state-owned firms, the latter largely by means of voucher privatization. Macroeconomic policies adopted by the Federation called for restrictive monetary policy and an almost-balanced government budget.

The effect and reception of these policies differed between the two republics. Unemployment in Slovakia was greater than in the Czech Republic, as was the output decline, and the Slovak government was unable to balance its budget.

The separation of the two republics was based on a series of treaties and agreements, including the creation of a customs and currency union, the latter not lasting more than two months. The separation had a negative effect on the Slovak economy, both due to a loss of trade and to the need of the Slovak government to finance the government deficit. The level of unemployment did not fall

* Josef C. Brada is a professor with the Department of Economics, Arizona State University.

after independence, and output has continued to decline gradually. Although the new government had campaigned on a policy of stimulating economic activity by means of expansionary monetary and fiscal policies, the need for support from the International Monetary Fund (IMF) forced the government to try to reduce its budget deficit and to devalue the Slovak koruna.

Although the government was constrained in its macroeconomic policy, it was able to adopt a more interventionist policy toward enterprises than had been possible under the Federation. However, a lack of ministerial direction has hampered these efforts.

HISTORICAL BACKGROUND

On January 1, 1993 the Slovak Republic emerged as an independent state, a status that, with the partial exception of the German-sponsored Slovak state of World War II, Slovakia had not experienced for nearly 1,000 years. The short-term economic challenges facing the new state were daunting. Not only did the process of the political and economic separation of Czechoslovakia require considerable government attention, but the government also had to deal with issues such as macroeconomic stabilization, the reorientation of trade, the restoration of economic growth or at least the arresting of the output decline, and continuing the transition from a socialist to a capitalist market economy that had to be faced by all governments in Central and Eastern Europe. At the same time, the Slovak economy had some important advantages, including, by regional standards, a good measure of internal and external equilibrium and relatively rapid progress in the process of transformation in terms of privatization and the creation of market-oriented institutions before the separation.

The Slovak Republic's economic structure and the challenges faced by the newly independent state are largely the result of its post-World War II history. A key element of the regional policy of the communist regime that controlled Czechoslovakia was the rapid industrialization of Slovakia. After World War II, relative to the Czech lands, Slovakia was more dependent on agriculture and had lower levels of per capita output. After 1949 higher levels and faster growth of investment, much of it channeled into industry and infrastructure, altered the composition of output and the pattern of employment in Slovakia and also raised per capita wages and output closer to the levels that existed in the Czech Republic (see Table 1). [1]

This spurt of industrialization, of course, reflected the priorities and development strategies of the communist regime. Thus the growth of Slovak industry was pursued by means of the construction of large new enterprises, which often came to dominate the economic life of individual cities or even regions. The sectoral emphasis reflected the regime's obsession with heavy industry, exemplified by the increase in the index of output of ferrous metallurgy from a base of 100 in 1948 to 4,144 in 1989, and of machine building and metal working to 10,218 from the same base over the same

[1] Care should be taken in making intertemporal and interregional comparisons due to the likely distortions caused by the system of prices that existed in a centrally planned economy.

TABLE 1. Patterns of Development in the Czech Lands and Slovakia, 1948–83

(1,000 Kčs Comparable Prices)

Country	National Income Produced (NIP)	NIP per Economically Active Person	Share of NIP from		Investment per Economically Active Person	Average Monthly Wage*
			Agriculture %	Industry %		
1948 Czech Lands	57,097	14.34	14.8	70.2	2.09	834
1948 Slovakia	12,728	8.41	30.1	48.6	2.39	764
1983 Czech Republic	294,933	57.26	6.9	64.9	18.20	2,808
1983 Slovak Republic	124,280	53.07	9.6	61.2	20.09	2,745

Source: Federal Statistical Office of the Czechoslovak Republic, *Historical Statistical Yearbook*, 1990.
*Current Kčs, excluding collective farms.

period. The extreme dependence of Czechoslovakia on Soviet trade and Slovakia's easy access to the Soviet Union via broad-gauge rail lines, the Danube river, and oil pipelines also played an important role in shaping industrial development. Between 1948 and 1989 the output of the chemical sector increased from a base index of 100 to 9,035, largely on the basis of imports of oil from the USSR, and many large factories for the production of consumer goods destined for the Soviet market were also built. A final factor influencing the structure of the Slovak economy was its integration into the Soviet defense sector. Numerous large factories, mainly for the manufacture of heavy armaments, were built in Slovakia. By the late 1980s the output of Slovak defense-sector plants accounted for 6 percent of Slovak industrial output, and over 80 percent of the output of this sector was destined for export, mainly to Warsaw Pact countries and to client states of the USSR.

This era of "socialist development" gave many Slovaks a rather more favorable attitude toward state intervention in the economy than was held by residents of the Czech Republic.[2] At the same time, it raised among many Czechs the perception that the Slovak development had been subsidized by them. Given the lack of transparency caused by socialist-era pricing and budgetary machinations, putting such suspicions to rest was impossible, and the same could be said for Slovak beliefs that they were being exploited by Prague.

The Slovak Republic in the Transition Process of the ČSFR (1989–1992)

The collapse of the communist regime in 1989 led to sweeping political and economic changes in the CSFR, and while these represented important progress toward the establishment of multiparty democracy and the creation of a market economy, they also created strains that eventually led to the breakup of the CSFR. The passage of the Compence Act of 1990, which arrogated all government power except that over defense, foreign affairs, transportation and communications, and monetary and fiscal policy

[2] See, for example, Table I. 2 in OECD, *Economic Review of the Czech and Slovak Republics* (Paris: OECD, 1994), which describes public opinion in the two republics on a number of economic issues.

to the two republic governments, granted greater autonomy to the two republics but at the same time imposed on them greater economic responsibilities that had to be fulfilled within the constraints established by federally set fiscal and monetary policies and reform measures. This tension between federally mandated constraints and the republics' responsibilities was exacerbated by the fact that the effects of the transition from planning to market and of the collapse of the CMEA and the Soviet market were much more severe in the Slovak Republic, most visibly in the case of unemployment.

KEY TRANSFORMATION MEASURES IN 1990–1992

The economic reform implemented in the ČSFR was developed in 1990, although most of it was not implemented until 1991.[3] Prices, which had been partially liberalized in 1990 as part of the elimination of many subsidies, were liberalized in January 1991 and in several subsequent steps, so that, by June 1991, about 90 percent of GDP consisted of goods whose prices had been liberalized, although a nation-wide system of wage tariffs was maintained, at first through a tripartite agreement between the government, labor unions and employers, and later through wage controls that remained in force in the Slovak Republic until late 1992.

At the same time that prices were being liberalized, the foreign trade system was also undergoing major change. The Czechoslovak koruna (Kč) was made convertible for current account purposes following the unification of the so-called commercial and non-commercial exchange rates at 16.5 Kčs per dollar and subsequent devaluations to 24 and 28 Kčs in 1990. The exchange rate was set relative to a basket of foreign currencies, and the nominal rate was easily maintained through 1992, despite some real revaluation.

With the convertibility of the koruna came trade liberalization. The predominant role of the old foreign trade corporations was broken by giving all firms the right to engage in foreign trade, and the system of foreign trade subsidies was dismantled. A new system of tariffs, averaging about 5 percent ad valorem, was introduced, supplemented at first by a temporary surcharge on imports. The regime for foreign investment was also liberalized in 1990, allowing for 100 percent foreign-owned firms to be established in the CSFR. National treatment for foreign investors was guaranteed in 1992.

The privatization of small-scale commercial establishments began in January 1991. Auctions, by means of which individuals could acquire either outright ownership or ownership of inventories and a five-year lease on the premises, were the primary instrument of the so-called "small privatization," augmented by restitution. By early 1993, more than 8,500 such auctions of small-scale retail and service establishments in the Slovak Republic had been carried out, raising some 11.6 billion Kčs.

Large-scale privatization was carried out principally by means of the well-known voucher method, by direct sales to a new owner, auction, or invitation to tender, and with restitution playing a supplementary role. In the first wave of voucher privatization, which

[3] Surveys of this period include Karel Dyba and Jan Švejnar, "Czechoslovakia: Recent Economic Developments and Prospects," *American Economic Review* (May 1991), vol. 81, pp. 185–190, and Josef C. Brada, "The Economic Transition of Czechoslovakia from Plan to Market," *Journal of Economic Perspectives* (Fall 1991), vol. 5, pp. 171–177.

began in 1991 and ended in 1992, 1,491 firms, of which 487 were located in Slovakia, were privatized. The book value of the Slovak firms was 133.6 billion Kčs. Shares of firms thus privatized were distributed in 1993 to the individuals and investment funds making winning bids. The distribution of shares was delayed by maneuvers between the Czech and Slovak governments over the settlement of property disputes involved with the separation of the federal state. Interestingly, while residents of the Slovak Republic were active in bidding for shares of Czech firms, Czech investors tended to show little interest in the shares of firms located in Slovakia.

The former State Bank was stripped of its monopoly over credit operations in 1990 and converted into a Western-style central bank. Its credit operations devolved to two newly established commercial banks, one of which, the Všeobencná úverová banka, was located in Bratislava. Additional commercial banks were created out of specialized communist-era banks, and, as part of the privatization program, these banks were privatized in 1991–1992.

ECONOMIC PERFORMANCE IN 1990–1992

The economic performance of the Slovak Republic in many ways mirrored that of the Czech Republic, Poland; and Hungary in 1990–1992. As Table 2 shows, the modest output decline of 1990 turned into a major collapse in 1991, with industry bearing the brunt of the output decline. The demise of the CMEA and the collapse of exports to the USSR in 1991 had a particularly harsh effect on Slovak industry due to its structural dependence on Soviet markets. The conversion of formerly intra-CMEA trade to dollar clearing at world market prices also forced the Slovak Republic to pay higher prices for imports of Soviet oil and natural gas, important inputs for its chemical sector. Armaments exports to ex-Warsaw Pact countries also decreased, as did domestic sales, and the Federal government was hostile toward the pursuit of markets for such weapons in third world markets. [4]

The external demand shock was reinforced by one of domestic origin. The price liberalization of January 1991 led to a rapid increase in prices, which quickly subsided to a core level of inflation of 10–12 percent per year. However, wages did not keep pace with price increases, thus leading to a decline in both real wages and real wealth. This, coupled with a natural decline in consumer demand due to preemptive buying at the end of 1990 in advance of price liberalization, reduced retail sales. [5] Changes in relative prices also adversely affected a number of key sectors of industry. The increase in food prices, in part due to the elimination of subsidies, led to a decline in demand for agricultural products, and the

[4] For the relative importance of these factors in the output decline, see Dani Rodrik, "Making Sense of the Soviet Trade Shock in Eastern Europe: A Framework and Some Estimates," in Mario I. Blejer et al. (eds.), *Eastern Europe in Transition: From Recession to Growth?* (Washington: The World Bank), 1993.

[5] Josef C. Brada and Arthur E. King, "Is there a J-Curve for the Economic Transition from Socialism to Capitalism?" *Economics of Planning*, vol. 25, (1992), pp. 37–53, provides some estimates of these effects.

TABLE 2. Main Macroeconomic Indicators for the Slovak Republic, 1990–1992

(Percentage Change from Previous Year)

Indicator	1990	1991	1992
Real gross domestic product	–2.5	–11.2	–7.0
Real industrial output	–4.0[a]	–25.4[a]	–13.7
Real gross agricultural output	–7.2	–7.4	–13.9
Retail sales in constant prices	0.6	–39.2	15.5
Gross investment in constant prices	5.3	4.5	–24.3
Monthly real wages	–5.9	–25.6	8.9
Unemployment at year end (%)	1.5	11.8	10.4
Consumer prices	10.4	61.2	10.0
Government deficit as % of GDP	0.2	3.8	3.4

Sources: FSU, *Statistická Ročenka České a Slovenské Federativní Republiky* (Praha: SEVT), 1992; and Statistický Úrad Slovenskej Republiky, *Ekonomický Monitor* and *Bulletin* (various issues).

[a] Covers only firms with 100 or more employees.

price of agricultural inputs, especially energy and mineral fertilizers, increased much more rapidly than did agricultural output. As a result, investment in new capital declined in both industry and agriculture. Only the accumulation of unsalable stocks kept total investment up.

Finally, federal fiscal and monetary policy was restrictive during 1991. The government sought, with considerable success, to maintain a balanced budget and a tight rein on the money supply. As a result, there was no budgetary stimulus to the economy, and firms faced a credit crunch that many were able to weather only on the basis of increased enterprise debt.[6] The sharp fall in output and increase in unemployment in the Slovak Republic strained the Slovak budget.

A fundamental difference between the Czech and Slovak Republics, but not between the Slovak Republic and other East European states, was the level of unemployment. In the Czech Republic, due to the rapid growth of tourism, services, and private entrepreneurship, smaller layoffs by state-owned firms, and an aggressive effort to find jobs for displaced workers, the level of unemployment never exceeded 4.5 percent. In the Slovak Republic, on the other hand, industrial structure, the dominance of large firms over towns and regions, and a slower evolution of tourism led to much higher rates of unemployment. The large defense sector contributed disproportionately to this problem.[7] As a result, the Slovak Republic, with

[6] This is not to suggest that expansionary policies or easier credit could have avoided much of the output decline in either the short or long term. Indeed, special funds intended to help the conversion of defense plants were used almost exclusively to build up inventories of precisely the weapons that these plants had produced in the past. Thus "demand stimulating" exercises for other sectors would likely have had similar consequences. As it was investment was buoyed up by inventory accumulation in 1991.

[7] OECD, *Review of Industry and Industrial Policy in the Czech and Slovak Republics* (Paris: OECD, 1994). Total unemployment at end–1992 in the Slovak Republic stood at 260,000, so those unemployed in the defense sector accounted for about 15 percent of the total.

about one-third of the federation's labor, accounted for more than one-half of the number unemployed.[8]

There was some improvement in the economic situation in 1992, but despite growth in real wages and more buoyant aggregate demand, industrial output continued to decline, in large part due to de-stocking. Consequently, the unemployment gap between the Czech and Slovak Republics did not narrow, which further eroded support for federal macroeconomic and monetary policies among Slovak voters, and other troublesome economic "gaps" also began to appear.

One of these was the gap in foreign investment between the two republics. Foreign investors largely focused on the Czech Republic, bypassing opportunities in the Slovak Republic. Since foreign investment was seen as critical to the restructuring of firms and their reorientation toward Western markets, this became a cause for concern. The magnitude of the problem is illustrated by the fact that, by the end of 1991, there had been over 6,000 foreign direct investments in the ČSFR; of these, only a little more than 1,000 were located in the Slovak Republic. Investment inflows into the ČSFR were $180 million in 1990, $600 million in 1991 and over $1 billion in 1992, but direct foreign investment into Slovakia was only $17.9 million in 1990, $81.6 million in 1991, and $100 million in 1992. This economic marginalization of the Slovak Republic was also probably true for receipts from tourism, although data are not available.

A second gap that began to appear between the two republics was a budgetary one. In 1992 the consolidated government budget slipped from a slight surplus in 1991 to a deficit of 7 billion Kčs. The Slovak Republic's budget showed a deficit of 7.9 billion Kčs, in part because of the lower profitability of Slovak firms, 1 billion Kčs, relative to Czech firms, whose profits were 48 billion Kčs. The Czech Republic had a small surplus of 1.7 billion Kčs. Since the profit and turnover taxes were apportioned between the federal and republic budgets, this implied a fiscal transfer from the Czech to the Slovak Republic. The magnitude of the fiscal transfer may be inferred from the fact that, in 1992, 28.5 percent of all government revenues was raised in Slovakia, but 33.8 percent of all government expenditures was spent in the Slovak Republic. The difficulty in financing the deficit of the Slovak government, as reflected in the reluctance of commercial banks to hold Slovak government bonds, also meant that the Slovak Republic's deficit had implications not only for federal fiscal policy but for monetary policy as well.

These gaps, along with differences in attitudes toward the economic reforms, combined with political and other differences to make the possibility of separation of the ČSFR into two independent states sufficiently real that planning for the eventuality began before the 1992 elections.

[8] Particularly hard hit were gypsies. There were also regions, especially in eastern Slovakia, where unemployment was in the neighborhood of 20 percent.

PLANNING FOR THE SEPARATION

Planning for the separation of the ČSFR into two independent republics was driven by two, partly inconsistent, considerations. One was to minimize the costs, social and economic, of the breakup. While the Yugoslav experience was unlikely to be repeated, there was considerable concern that a decline in trade between the two republics would represent a second "CMEA shock" that would both reduce output in each republic and delay the onset of economic restructuring and recovery.

Each republic's government-produced estimates of the effects of separation on trade and output, and individual economists, added their own prognostications.[9] These suggested that the effects of separation on trade would "cost" each republic at least 1.0–1.5 percent of GDP and conceivably even more if trade relations deteriorated. Because about one-third of Slovak output was exported to the Czech Republic while only 10–15 percent of Czech output was exported to Slovakia, it was believed that the costs of a trade shock would be much greater for the former.

Consequently, both sides sought to arrange for an amicable separation, drafting over 30 treaties that, among other things, divided national assets and liabilities, mainly proportionally on the basis of population. To maintain as much trade as possible, the two republics envisaged a transitional monetary union and a customs union. The monetary union was based on the assumption that each republic would eventually have its own currency, but that retaining a common currency for a transitional period of six months or so, moving to fixed 1:1 exchange rate, and then only gradually moving to a more flexible exchange rate between the two national currencies would help preserve the volume of trade in the early stages. The customs union called for the absence of tariff and nontariff barriers between the two states and for a common external tariff.

It was understood that a monetary union could only succeed if economic trends such as inflation and monetary and fiscal policies in the two countries were similar. Indeed, the monetary union treaty explicitly envisioned the end of the union under circumstances such as large government deficits or loss of foreign exchange reserves by one partner or large speculative currency movements from one member to the other. Since a fundamental cause of the breakup of the ČSFR was to give the Slovak Republic the freedom to follow monetary and fiscal policies that differed from those of the former federation, either the monetary union or the Slovak Republic's greater policy flexibility would have to be sacrificed. Indeed, it was widely expected that the Slovak government would devalue the new Slovak currency because the country would run a current account deficit that could not be offset by capital inflows and because Slovak firms were less competitive than their Czech counterparts, a belief based on lower ratio of output per worker to nominal wages in the Slovak Republic. It was also widely anticipated that the Slovak government would either follow up its campaign promises of

[9] See Peter Martin, "Slovakia: Calçulating the Cost of Independence", *RFE/RL Research Report*, vol. 1, (1992), pp. 33–38; Ivan Sujan, "Economic Outlook of the CSFR: Estimation of the Consequences of the Czecho-Slovak Divorce," *Hospodařské Noviny* August 13, 1992; Stanislava Janáčková and Kamil Janáček, "Après la partition de la Tschécoslovaquie: les perspectives des nouveaux Etates," *Revue du Marché commun et de l'Union europenne* (June, 1993), pp. 537–540.

more expansionary fiscal and monetary policies or, in fact, be forced to do so by the loss of fiscal transfers from the Czech Republic.

As a result, in the second half of 1992, there were large outflows of money from the Slovak to the Czech Republic, and Slovak foreign exchange reserves reached dangerously low levels. Moreover, the volume of trade between the two republics began to decline already in 1992.

Economic Performance of the Slovak Republic, 1993–1994

The Slovak Republic became an independent state on January 1, 1993. As one of the successors of the CSFR, it quickly assumed membership in international organizations such as the United Nations and took over the CSFR Association Agreement with the EU and its membership in the Central European Free Trade Area.

Prime Minister Vladimír Mečiar's party, the Movement for a Democratic Slovakia (HZDS), at first ruled through an informal coalition with the Slovak National Party, whose leader Ludovit Cernák served as Economics Minister until his resignation in March 1993. Subsequently, HZDS ruled by means of informal coalitions and as a minority party, in part because other parties were not anxious to take up the reins of power during the Slovak Republic's turbulent first year.

Consequently, it was not until March of 1994 that the Mečiar government was turned out and replaced by a caretaker coalition. The coalition has acted with surprising vigor to introduce more orthodox economic policies and to accelerate privatization, while simultaneously freezing some of the more questionable privatization deals engineered during the last weeks of the Mečiar regime. The intention is to carry the transition measures far enough forward so that, even should the HZDS prevail in elections slated for fall, 1994, they will remain irreversible.

THE EARLY CRISIS

The HZDS economic platform had been one of greater government involvement in the economy, more gradual, privatization and an end to the monetary and fiscal orthodoxy that had characterized the economic policy of the CSFR. For many Slovaks, this meant not only an end to rapid privatization and greater government assistance to industry, but also more expansionary monetary and fiscal policies. The outcome of such expectations was that the Slovak balance of trade would quickly slip into deficit and that devaluation rapidly would follow.

As a result, even before separation, Slovaks began to make more deposits to the Czech Republic, a trend that continued into the beginning of 1993. The drain on the foreign exchange reserves of the Slovak National Bank (SNB) caused them to fall to about $200 million in January 1993. Capital flight was exacerbated by the emergence of a trade deficit at the start of the year, which further reenforced expectations of devaluation.

Since convertibility of the Slovak koruna (sk) was required by the country's desire to maintain its Association Agreement with the EU, room for maneuver was limited. Exchange controls were imposed for certain import transactions, and the access of Slovak commercial banks to the SNB's foreign exchange assets was constrained. The result was a decline in the total volume of trade, but also eventually an improvement in the trade balance and a gradual growth of foreign exchange reserves.

However, it was clear for this reason, as well as because of the Slovak Republic's budget crisis, described below, that the monetary union was infeasible. The two republics passed laws on the division of the common currency on February 2, 1993, and old banknotes stamped with the signs of the new republics began to circulate in each country by February 8.

The breakup of the monetary union left payments between the two countries cleared by two means. Obligations incurred before the end of the monetary union continue to be cleared under the so-called old bloc at a 1:1 exchange rate so as to protect transactors from the effects of devaluation. Subsequent transactions were cleared through the so-called new bloc, which allows payment in the payer's national currency. Conversion into the recipient's currency was at first at a rate of 1:1, but each party to the arrangement could unilaterally alter the rate by 5 percent. Thus, in March, 1993, the Czech koruna was appreciated by 5 percent and the Slovak koruna was depreciated by 2 percent. The new bloc-clearing arrangement provided for 130 million ECU swing credits, with hard currency clearing every three months.

Although the end of the monetary union ended capital flight and foreign exchange reserves had stabilized, in the course of negotiations with the IMF for an $89 million Systemic Transformation Facility loan, the Slovak government, albeit reluctantly, agreed to devalue the koruna by 10 percent on July 12, 1994.

The second crisis that quickly faced the new government was the budget deficit. The Slovak budget had been in deficit in 1992, and the separation involved a loss of transfers from the Czech Republic estimated to be in excess of 7 percent of Slovakia's GDP.[10] In addition, significant new expenditures would be required to build up the state administration. This implied that either the Slovak Republic would have a massive government deficit or that vigorous efforts to raise taxes and lower expenditures would be required.

Compounding the difficulty was the government's decision to go ahead with a major reform of the tax system. The old system, which depended heavily on communist-era taxes, was replaced by a modern system consisting of a value added tax (VAT) with 5 percent and 23 percent rates for necessities and other goods, an income tax with brackets ranging from 15 to 47 percent, a 14 percent social security contribution by employees and 36 percent by employers and a 45 percent tax on profits.

The Slovak government formulated a balanced budget, but from the very outset, tax revenues lagged far behind projections. In part this may have been due to inexperience; Slovak authorities also pointed to fraud and noncompliance. Also at fault, however, were excessively optimistic economic assumptions built into the revenue

[10] Many Slovak politicians claimed that such transfers had not existed. This clearly exacerbated the problem of trying to deal with the fiscal shock of separation.

forecasts. The result was that the first quarter's deficit was equivalent to 12.2 percent of GDP.

The government covered the deficit by issuing Treasury bills, but commercial banks were too illiquid, and the interest rates on the bills too low, to allow appreciable sales to these institutions. The Slovak National Bank thus bought up the bills, at first avoiding monetization of the debt by using up its assets, thus exacerbating problems being caused by capital flight and at the same time contributing to the demise of the monetary union.

Although the government's economic team was to some extent nonexistent—the Economics Minister resigned, the Governor of the SNB had not yet been appointed—the government was able to act effectively and decisively. The VAT rates were increased to 6 percent and 25 percent, respectively, and all government departments, except for the social security system, were required to curtail expenditures. The objective was to reduce the deficit to 5 percent of GDP, a target that was set in consultation with the IMF.

The financing of even this sharply-reduced deficit placed considerable strain on Slovakia's banking system. The supply of credit in real terms to enterprises and households declined during 1993, in part crowded out by government borrowing. State-owned enterprises were probably least injured by this because they could, and did, resort to inter-enterprise debt, and many failed to pay taxes.

INDUSTRIAL POLICY

The government's policies toward the enterprise sector also achieved a mixed record at best. Further voucher privatization was abandoned in favor of so-called standard methods, meaning various forms of sale to new owners. To attract foreign investors, the government exempted firms with more than 30 percent foreign ownership from profits taxes in their first year of operation and allowed lower taxes for the subsequent two years. Foreign direct investment increased to $135 million in 1993, but a better image and greater coherency of economic policy could have enabled Slovakia to parlay its location, infrastructure, low wages and skilled labor force into even greater flows.

Despite, or because of, the dismissal of the Privatization Minister in June 1993, little progress was made in privatizing Slovak industry. Private firms accounted for about 20 percent of industrial output, 45.5 percent of transportation, 47.7 percent of construction, and 83.9 percent of services. Under the new regime, the share of the private sector in industrial output has increased, but in this regard, the Slovak economy remains largely partitioned into state-owned industry and a private sector that predominates elsewhere.

Efforts to formulate an industrial policy have also been fruitless. On the one hand, much of the money that the goverenment has spent on firms has gone to cover losses and to maintain unprofitable operations rather than to restructure operations. Policies for supporting investments by future "winners" have been framed in suspiciously specific ways, often specifying the firms to receive investment support as well as the technologies and products that are to benefit from government subsidies. It is quite likely that such specific policies are formulated on the basis of the type of "bottom up" aggregaton of enterprise investment plans that gave the Slovak economy its present industrial structure rather than on the basis of a dispassionate analysis of the likely export competitiveness of Slovak industry.

MACROECONOMIC OUTCOMES

Given the chaotic beginnings of the new state, the simple populist economics of its leading political party and the inability to fill many important economic policy posts within the government, the performance of the Slovak Republic in 1993 was better than expected. GDP declined by only 4.1 percent (Table 3).

TABLE 3. Main Macroeconomic Indicators for the Slovak Republic, 1993–1994

(Percentage Change from Previous Year)

	1993	1994
Gross domestic product (billions of Slovak korunas, current prices)	336.7	—
Real gross domestic product	–4.1	—
Real industrial output	–13.5	6.7[a]
Real construction output	–23.8	–11.3[a]
Real gross agricultural output	–15.9	—
Retail sales in constant prices	10.0	4.8[a]
Gross investment in constant prices	–8.9	–5.7[b]
Monthly real wages	–3.8	—
Unemployment (%) at year end	14.4	14.5[c]
Consumer prices	25.1	2.0[d]
Government deficit as % of GDP	6.8	—
Government deficit (billions of Slovak korunas, current prices)	23.0	6.0[c]

Sources: FSU, *Statisticá Ročenka Ceské a Slovenské Federativní Republiky* (Praha: SEVT), 1992; Statistický Úrad Slovenskej Republiky, *Ekonomický Monitor* and *Bulletin* (various issues); National Bank of Slovakia, *Monetary Survey*, various issues; and Ceská Národni Banka, *Indikátory Menového a Hospodářského Vývoje Ceske Republiký, no. 5, 1994.*

[a] Annualized average, first quarter.

[b] Annualized average, first two months.

[c] End of first quarter.

[d] Monthly average, first quarter.

The decline in industrial production continued in 1993, but industrial output stabilized toward the end of the year and increased in the first quarter of 1994. Construction activity had been hard hit, both by inadequate credit and the decline in fixed capital formation. During 1993 unemployment flirted with the 15 percent level and real wages declined. Nevertheless, retail sales increased in 1993 and continued their growth in 1994.

While inflation increased from 10 percent in 1992 to 25.1 percent in 1993, a good part of the increase is attributable to the introduction of the VAT. Nevertheless, the results for 1994 suggest that core inflation in the Slovak Republic may be accelerating.

ASSESSMENT

The Slovak economy weathered a difficult start surprisingly well when measured in macroeconomic terms. Budgetary and foreign exhange crises were avoided despite the government's lack of experience and preocccupation with noneconomic issues. At the same time, a number of problems await resolution. A key one is the further privatization of state-owned industry, which continues to be a drag on the budget and to undermine the soundness of the state's finances and of the banking system. The state's finances also need to be revamped, particularly because social expenditures are large but do not target the truly needy. The banking sector may need recapitalization, and the deposit base of commercial banks needs to be strengthened.

Greater cohence in economic policy making is also required. While the populist rhetoric of many Slovak parties has been more extreme than the policies that they have been willing to implement, such rhetoric has an undesirable effect on the electorate, on firms, and on foreign investors.

Perhaps the greatest disadvantage that the Slovak Republic bears in the assessment of its economic policies is the inevitable comparison with the economic performance of the Czech Republic, whose inflation rate and unemployment are, by regional standards, outstanding. Nevertheless, it should be borne in mind that the Slovak Republic was unable to achieve similar unemployment figures when it was part of the federation, so it cannot be criticized for not achieving them outside the federation. More important, when compared to other Central European countries such as Poland and Hungary, the Slovak Republic fares surprisingly well.

BULGARIA: A COUNTRY STUDY

By Michael L. Wyzan *

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TABLES

SUMMARY

The economic legacy of communism in Bulgaria was an economy that saw rapid growth in the early years, but experienced monotonically declining performance after the mid-1960s and numerous unsuccessful attempts at economic reform. It also includes a high degree of dependence on Council for Mutual Economic Assistance (CMEA) trade and a crushing foreign debt burden.

On the heels of very poor economic performance in 1990, an ambitious macroeconomic stabilization program was launched in early 1991, which included price liberalization, establishing a market-determined and unified exchange rate, checking wage growth, reducing the budget deficit, and a tight monetary policy. The program was quite successful in many respects and established the basis for a functioning market economy. Nonetheless, subsequent years have seen a steep decline in production, high unemployment, continuing relatively rapid inflation, worrisome budget deficits, and exchange

* Michael L. Wyzan is Associate Professor, Stockholm School of Economics, Sweden, and Macroeconomic Policy Advisor, Bulgarian Ministry of Finance. The views expressed here are the author's own and do not represent those of the Bulgarian or U.S. governments.

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rate volatility. The last named factor was especially evident in late 1993 and early 1994.

The International Monetary Fund (IMF) has played a major role in financing and evaluating Bulgaria's economic reforms. The IMF provided about $700 million in two standby facilities in 1991 and 1992 and agreed in April 1994 to provide a third worth over $300 million. The most important foreign economic agreement, however, is the Brady-type deal signed with the London Club (to which Bulgaria owes $8.1 billion) in June 1994. The deal, while a large burden to the economy, and opposed by many in the country, promises to restore access to private foreign finance. Bulgaria has received relatively little foreign investment.

Large-scale privatization, until recently based on a 1992 law allowing only the market method, has made very little headway. However, in June 1994 amendments to the law allowing a controversial form of mass privatization were made. At the end of 1993 a law was passed converting some of the bad debt of state enterprises to state commercial banks into state obligations; yet the law seems unlikely to solve this serious financial problem.

THE LEGACY OF THE PAST

During the 1980s there was a marked deterioration in economic performance, including a neglect of investment and a buildup of monetary overhang and foreign debt. The evidence of economic decay is clearer in Western than in official data. Table 1 provides various statistical indicators of Bulgarian economic performance during the postwar period. In many ways that performance was impressive, especially during the early decades, as official growth rates of net material product (NMP), industrial production, and consumption were quite high by international standards. Nonetheless, the downward trend in these indicators is obvious, and recalculations performed by Western scholars paint a less rosy picture. Especially striking are the monotonic decline in industrial production and the miserable performance of agriculture that set in during the mid-1970s.

In the early years after the communist takeover (1944), Bulgaria followed an extensive growth strategy modelled more closely on the Soviet experience than those of other East European lands.[1] The early five-year plans emphasized the growth of heavy industry based on raw materials imported from the USSR; by 1960 industry accounted for 48 percent of net material product (NMP), versus 23 percent in 1948. During these plans the economy was able to generate rapid industrial and agricultural growth and structural transformation in favor of the former, as well as substantial rural-urban migration. However, economic performance declined monotonically after the mid-1960s (see Table 1), and the need for reform became increasingly clear to the country's leadership.

The approach to economic reform of the Bulgarian communists was characterized by ceaseless experimentation with new mechanisms. These reforms, while ill-thought out and unsuccessful, were based on what sounded at the time like sensible economic analysis

[1] John R. Lampe, *The Bulgarian Economy in the Twentieth Century* (New York: St. Martin's, 1986), pp. 139–55.

TABLE 1. Bulgarian Statistical Indicators under Communism, Selected Periods, 1953–1989

(Annual Average Percentage Growth)

Indicator	1953-60	1961-65	1966-70	1971-75	1976-80	1981-85	1986-89
Official Bulgarian data							
Net Material Product	9.4	6.7	8.75	7.8	6.1	3.7	3.1
Industry	16.2	NA	12.5	6.7	6.1	4.3	2.1
Agriculture	4.8	NA	−0.7	9.9	−6.8	−0.3	0.2
Forestry	NA	NA	NA	NA	0.5	1.9	−2.5
Construction	NA	NA	NA	NA	3.8	5.4	2.0
Transport	NA	NA	NA	NA	5.4	3.6	6.6
Communications	NA	NA	NA	NA	5.9	7.6	7.2
Trade [a]	NA	NA	NA	NA	25.9	−0.06	14.0
Other material branches	NA	NA	NA	NA	12.9	−0.8	2.4
Gross fixed capital formation [b]	NA	7.8	12.6	8.7	6.4	4.7	4.7
Net investment [c]	NA	NA	11.6	13.7	2.5	2.7	4.2
Material consumption [d]	NA	NA	7.3	7.0	4.0	4.0	3.3
Western calculations							
Gross national product	NA	6.6	4.7	4.5	1.2	0.9	−1.8
Industry	NA	NA	8.7	5.5	3.4	1.9	−3.2
Agriculture and forestry	NA	NA	−0.8	1.6	−2.5	−1.8	−2.2
Construction	NA	NA	6.6	3.0	1.9	0.3	−3.6
Transport and communications	NA	NA	11.9	7.8	3.0	1.2	0.4
Trade	NA	NA	8.7	7.9	1.1	2.1	−0.6
Housing	NA	NA	2.1	3.4	2.5	2.3	1.6
Government and other services	NA	NA	4.0	4.6	−0.1	1.2	0.4

Sources: Bulgarian data are from Rositsa Rangelova, "National Accounts for Eastern European Countries: A Case Study for Bulgaria in an International Comparative Perspective," paper for seminar on Comparative Historical Accounts for Europe in the 19th and 20th Centuries, Groningen, Netherlands, June 1994, pp. 20, 21, 36, and Natsionalen statisticheski institut (NSI), *Statisticheski godishnik na Narodna Republika Bŭlgariya 1971* (Sofia: Tsentralno statistichesko upravlenie, 1971), p. 94 (hereafter referred to as SGNRB); SGNRB, 1976, p. 126; SGNRB, 1981, pp. 141-42; SGNRB, 1986, p. 137, SGNRB 1988, p. 146; SGNRB, 1990, pp. 36, 122, 140, 152; SGRB 1991, p. 114 (the word "Narodna" was dropped from the title of the publication in 1991). Western data are from Rangelova, "National Accounts for Eastern European Countries," p. 27, and are based on the work of Thad Alton's Research Project on National Income in East Central Europe.

[a] Trade, Material-technical supply, and procurement.
[b] Kapitalni vlozheniya.
[c] Fond natrupvane.
[d] Fond potreblenie.
NA Not Available.

on the part of long-standing party and state leader Todor Zhivkov and his economic advisors. None of these reforms had a discernible (positive) effect on economic performance.[2]

Two important and particularly painful aspects of the communist legacy relate to foreign economic relations: the greatest degree of dependence upon CMEA trade among the European member-states

[2] The last piece of significant economic legislation of the communist era was Decree No. 56 of January 1989; although much of its content was superseded by the commercial code of May 1991, some of its provisions, such as those on the liquidation of enterprises, remain in force as of this writing. The decree was intended as an attempt to create a modern business law governing the operations of firms of various types. See Michael L. Wyzan, "The Bulgarian Economy in the Immediate Post-Zhivkov Era," in Örjan Sjöberg and Michael L. Wyzan (eds.), *Economic Change in the Balkan States: Albania, Bulgaria, Romania and Yugoslavia* (London: Pinter, 1991), pp. 85–89.

of that organization and the most crushing foreign debt burden among such states. With respect to the former, in 1990 the CMEA purchased 80.4 percent of Bulgarian exports (the USSR alone accounting for 64 percent), while providing 76.4 percent of the country's imports (of which 56.5 percent came from the USSR).[3] Bulgaria was highly dependent on petroleum, iron ore, and timber from the USSR priced at below world market prices, and equally reliant on undiscerning markets there for its low-quality industrial exports. Moreover, this high degree of trade dependence, along with a high oil-intensity of production, and a pattern of specialization highly at variance with the country's seeming comparative advantage, set Bulgaria up for the biggest foreign trade shock in the CMEA when that grouping switched to trade in world market prices at the start of 1991.[4]

A particularly important legacy of the communist era in Bulgaria is the foreign debt accumulated during the final years of that era. As shown in Table 2, beginning in the mid-1980s a disastrous external debt situation arose, with most borrowing coming from commercial creditors. The crisis was so severe that the first post-Zhivkov government (the long-time leader fell on November 10, 1989) declared a unilateral moratorium on principal and interest repayment in the spring of 1990. Much of the increase in the gross debt was the result of running current account deficits. The borrowing was oriented more toward the import of consumer goods and raw materials from OECD countries than capital and intermediate goods: consumption was maintained while production stagnated and net investment fell. Another factor behind the increase in foreign debt was the conclusion of trade protocols with such OPEC member states as Iraq and Libya, which often failed to pay for their imports of Bulgarian goods and services. Meanwhile, Bulgaria racked up corresponding obligations to banks and governments in the West.[5]

MACROECONOMIC POLICY AND PERFORMANCE

FEBRUARY 1991 STABILIZATION PROGRAM

The IMF-approved macroeconomic stabilization program of February 1991 was launched amid the extraordinarily severe downturn that had resulted from the collapse of CMEA trade and the inaction on economic reform of the first post-Zhivkov government.[6]

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[3] Organisation for Economic Co-operation and Development, Bulgaria: An Economic Assessment (Paris: OECD, 1992), p. 44.

[4] The OECD has estimated that the shift to international prices caused a terms-of-trade loss of 27 percent and a decline in exports to the former Soviet Union of two-thirds in volume terms. Together, these two effects are said to have generated a decline in import volumes on the order of 60 percent and a fall in GDP of about a third between 1989 and 1991. See OECD, *Bulgaria: An Economic Assessment*, pp. 99–101.

[5] OECD, *Bulgaria: An Economic Assessment*, pp. 95–97.

[6] See Wyzan, "The Bulgarian Economy in the Immediate Post-Zhivkov Era," pp. 89–97, for a discussion of economic policy under the government of Andrew Lukanov, the last communist party prime minister, who presided from February 3, 1990, through elections in June 1990 until his resignation under fire on November 29 of that year. His successor was Dimitŭr Popov, an independent judge, who headed a coalition government with ministers from the Bulgarian Socialist Party (BSP; the former communist party, having renamed itself in March 1990) and the anti-communist coalition known as the Union of Democratic Forces (UDF), in office from December 7, 1990, until November 1991. On November 8, 1991, lawyer Filip Dimitrov formed an all-UDF government on the heels of the UDF's strong showing in the October 1991 general elec-

TABLE 2. The Buildup of Bulgarian Foreign Debt, 1985–1989
(Millions of Dollars)

Measure	1985	1986	1987	1988	1989
Gross foreign debt	3,240	4,671	6,139	8,186	9,201
Official foreign reserves	2,081	1,451	1,128	1,747	1,306
Net foreign debt	1,159	3,220	5,011	6,439	7,895
Increase in net foreign debt	NA	2,061	1,791	1,428	1,456
Current account deficit	NA	715	773	840	1,306
New loans to Third World	NA	462	450	409	145
Residual	NA	884	568	179	5

Source: OECD, *Bulgaria: An Economic Assessment*, p. 96.
NA Not Available.

Table 3 reveals the extent to which the economy deteriorated during 1990; especially alarming were the large declines in production and investment, the beginnings of serious inflation (even before price liberalization), and the growing real wage. Table 4 describes the worrisome fiscal situation in recent years. Table 5 illustrates the foreign dimensions of the crisis, reflected in worsening trade imbalances, current account imbalances, and rising foreign debt.

Upon admission to membership in the IMF and the World Bank in September 1990, Bulgaria started Article IV consultations with the IMF, which resulted in the filing of a Letter of Intent in February 1991. The objectives of the stabilization program for 1991 were as follows: to halt the fall in output, so that an upturn could be observed in the second half of the year; to lower inflation to 1–2 percent per month by the second half of the year; and to keep the current account deficit at no more than $2 billion. The program's nominal anchors included domestic credit and incomes policy, but not the exchange rate, which could hardly be supported without foreign exchange reserves or access to international capital markets (after the unilateral debt repayment moratorium).[7]

More concretely, the original stabilization program contained the following elements:

- Price liberalization;
- Establishment of a market-determined, floating, and unified exchange rate, and deregulating most current account transactions;

tions, which enabled it to rule in informal coalition with the ethnic Turkish Movement for Rights and Freedoms (MRF). The Dimitrov regime eventually lost the support of the MRF and of President Zhelyu Zhelev, himself a founding member of the UDF, and ultimately fell victim to a parliamentary no-confidence vote on October 28, 1992. Dimitrov's replacement, Lyuben Berov, a politically unaffiliated economic historian, has been in office under a MRF mandate since December 30, 1992, surviving myriad no-confidence votes and quadruple-bypass surgery.

[7] The material in the next several paragraphs draws heavily upon Michael L. Wyzan, "Stabilization Policy in Post-Communist Bulgaria," in Laszlo Somogyi (ed.), *The Political Economy of the Transition Process in Eastern Europe* (Aldershot, England: Edward Elgar), 1993, pp. 124–45, and Michael L. Wyzan, "Bulgaria: Shock Therapy Followed by a Steep Recession," RFE/RL Research Report, vol. 1, no. 45, November 13, 1992, pp. 46–53. See also OECD, *Bulgaria: An Economic Assessment*, pp. 34–45. The Letter of Intent described here may be found in "Letter of Intent of the Bulgarian Government to the IMF," *News Bulletin*, Bulgarian National Bank, February 29, 1991, pp. 2–34.

TABLE 3. Recent Bulgarian Domestic Macroeconomic Indicators, 1989–1994

Indicator	1989	1990	1991	1992	1993	1994
GDP (billion leva)	35.6	45.4	131	195	286	460[a]
GDP (billion dollars)[b]	17.6	6.9	7.5	8.4	10.4	8.6[a]
GDP per capita (dollars)	1,957	769	836	990	1,226	1,019[a]
Share of private sector in GDP (percent)	NA	NA	9.1	11.8	15.3	19.4
Unemployment (thousands, end-period)	0	65	419	577	626	556[c]
Unemployment rate (percent)	0	1.6	10.8	15.5	16.0	NA
Average monthly wage[d].						
Leva	274	378	1,012	2,047	3,145	4,211[e]
Dollars	136	58	58	88	114	89[e]
	(Percent Change)					
Real GDP	−1.9	−9.1	−11.7	−5.7	−4.2	−2.0[a]
Gross industrial production	−2.6	−12.5	−18.6	−11.2	−3.9	−4.0
Gross agricultural production	−4.8	−3.7	7.7	−13.8	−16.3	NA
Gross fixed investment[f]	−0.5	−25.1	−15.6	−26.3	−21.6	NA
Consumer price inflation[g]	10.0	72.5	338.9	79.6	64.0	53.5[h]
Producer price inflation[g]	NA	NA	284.0	24.9	15.3	24.7[i]
Growth of nominal average wage[d,g]	NA	8.7	38.0	167.7	102.3	53.6
Broad money[g]	NA	NA	124.8	41.1	52.6	32.2[i]
Net domestic assets[g]	NA	NA	318.6	21.9	47.3	51.7[i]
Domestic credit[g]	NA	NA	148.2	51.0	65.0	34.8[i]
Credit Granted to government sector[g]	NA	NA	286.9	91.3	79.5	47.9[i]
Credit Granted to nongovernment sector[g]	NA	NA	112.5	32.3	55.4	46.2[i]

Sources: Ivan Angelov, "Makroikonomicheski izmereniya na sdelkite po dŭlga," *Pari* (June 28, 1994), pp. 4–5; OECD, *Bulgaria: An Economic Assessment*, p. 52; NSI, *Naselenie*, 1993, p. 16; Michael L. Wyzan, "Stabilisation Policy in Post-Communist Bulgaria," in Laszlo Somogyi (ed.), *The Political Economy of the Transition Process in Eastern Europe* (Aldershot, England: Edward Elgar), 1993, p. 127; SGRB 1990, p. 80; Bŭlgarska narodna banka (BNB), Informatsionen byuletin, no. 2 (1994), p. 26; NSI, *Statisticheski spravochnik*, 1994, pp. 89, 114, 115, 117.

[a] Prognosis.
[b] Converted at average annual official exchange rate; for 1994 the rate for June 30 is used.
[c] As of end of May 1994.
[d] State sector only, not including women on maternity leave.
[e] For March 1994; dollar wage calculated at average daily exchange rate for March.
[f] Bruto natrupvane na dŭlgotrayni aktivi i fizichesko izmenenie na zapasite.
[g] On end-of-period basis.
[h] Through June 1994.
[i] Growth between December 1993 and May 1994.

- Checking the growth of nominal labor remuneration in the state sector;
- Setting stringent nominal targets for the budget deficit, while initiating a restructuring of both the revenue and expenditure sides of the budget;
- Establishment of a policy of tight credit through both significant increases in nominal interest rates and bank-specific ceilings on the extension of credit.

TABLE 4. Bulgarian Consolidated State Budget, 1989–1994
(Percent of GDP)

Budget Component	1989	1990	1991	1992	1993	1994[a]
Revenue	57.9	52.8	41.0	42.1	36.7	34.0
Customs duties	0.8	1.0	0.9	2.0	3.2	2.6
Income tax	4.1	4.2	2.9	5.6	5.3	5.2
Profit tax	23.2	17.9	13.1	7.0	5.7	4.6
Social security contributions	9.6	9.6	6.0	11.7	10.5	10.0
VAT/turnover tax and excises	11.2	9.0	5.7	6.3	7.6	7.8
Nontax revenue	7.8	9.9	5.1	5.4	3.2	2.7
Expenditure	58.5	57.7	44.8	47.4	48.1	40.1
Defense and security	4.9	4.8	3.1	4.3	4.2	3.8
Interest payments	3.1	9.5	14.2	6.7	9.8	8.5
Maintenance and operations	14.5	12.2	7.2	8.3	7.4	6.0
Social security benefits	10.4	12.0	13.5	13.9	15.8	13.7
Subsidies	15.5	14.9	4.0	1.9	2.3	1.3
Wages and salaries	4.7	5.5	5.0	5.9	6.7	5.4
Cash balance[b]	–0.6	–4.9	–3.8	–5.3	–11.4	–6.1
Overall balance[c]	–0.6	–9.2	–15.7	–13.6	–15.0	NA

Source: Bulgarian Ministry of Finance.
[a] According to the budget program for the year, which assumes a GDP of 501 billion leva.
[b] Excludes unpaid interest on foreign debt.
[c] Includes unpaid interest on foreign debt.
NA Not available.

The quantitative assumptions found in this first Bulgarian Letter of Intent were the following: a decline in real GDP of eleven percent; retail price inflation on the order of 200 percent; a fall in real wages of 35 percent; an average annual unemployment rate of five percent; M2 growth of 25.5 percent; an income velocity of money of 2.3; a cash budget deficit (i.e., not including unpaid but due interest on foreign debt) of 3.5 percent of GDP; an exchange rate of 7–10 leva to the dollar; a 28 percent decline in convertible currency exports, coupled with a 25 percent fall in convertible currency imports; an addition to the foreign exchange reserves of $500 million; a current account deficit of $2 billion; and the receipt of $1.6 billion in external finance.

The extent of price liberalization was at its inception and remains impressive: only the prices of goods reflecting about 10 percent of the 1989 retail and wholesale retail trade turnover were subject to some form of state intervention. State involvement in price-setting via margin controls continued for flour, bread, meat and meat products, cooking oil, sugar, pharmaceuticals, and petroleum products. The prices of electricity, heating, butane and propane gas, and coal remained under state control, but were subject to gigantic one-time price increases so as to bring them closer to world levels. In general, the intention was to reduce such state involvement to a very small number of products, to intervene only by market means, and to pay particular attention to sectors where monopoly power was present.

The Letter of Intent was pessimistic with respect to developments in the external sector, as a deterioration of $3.5 billion in

TABLE 5. Bulgarian Balance of Payments, 1989–1993

Millions of Dollars

Measure	1989	1990	1991	1992	1993
Current Account	–1,306.0	–860.0	–77.0	451.6	–900.4
Trade balance	–1,199.0	–757.0	–32.0	484.5	–695.1
Exports	3,138.0	2,615.0	3,737.0	5,093.0[a]	3,635.3[b]
Imports	4,337.0	3,372.0	3,769.0	4,608.5[a]	4,330.4[b]
Services, net	–179.0	–211.0	–114.0	–75.8	–242.2
Shipments, net	108.0	51.0	–13.8	–31.7	–83.9
Travel, net	169.0	78.0	–84.2	26.1	69.3
Interest, net[c]	–555.0	–396.0	–28.1	–76.0	–192.3
Other, net	108.0	56.0	12.1	–5.8	–35.5
Transfers, net (private)	63.0	108.0	50.0	39.8	36.9
Interofficial unrequited transfers	0.0	0.0	19.0	3.1	0.0
Capital Account	596.0	–135.0	115.0	–31.5	148.4
Direct foreign investment	0.0	0.0	55.9	41.5	55.4
Medium- and long-term loans, net	712.0	–414.0	–48.1	42.1	–46.3
Drawings	3,042.0	NA	108.0	232.4	97.2
Repayments	2,330.0	NA	156.1	190.3	143.5
Loans extended, net	–167.0	299.0	294.9	32.5	207.3
Developing countries	NA	NA	92.4	23.4	46.1
Drawings	NA	NA	12.1	3.7	–9.5
Repayments	NA	NA	104.5	27.1	36.6
Yamburg pipeline[d]	NA	NA	202.5	9.1	161.2
Short-term debt	51.0	–20.0	–187.7	–147.6	–68.0
Deposits and loans	NA	NA	–85.2	53.0	–68.1
Clearing account with former USSR	NA	NA	–102.5	–197.5	–3.8
Clearing account with Russia	NA	NA	NA	–3.1	3.9
Errors and omissions	276.0	127.0	26.2	–94.0	263.2
Overall Balance	–434.0	–868.0	64.2	326.1	–488.8
Addenda:					
Change in reserves	NA	NA	–64.2	–326.1	488.8
Gross reserves, BNB	NA	NA	–358.0	–575.1	232.2
Gold, BNB	NA	NA	0.0	0.0	0.0
Reserves, BFTB[e]	NA	NA	–70.9	–55.0	20.4
Reserves, commercial banks	NA	NA	–213.4	–85.4	160.1
Credit from IMF	NA	NA	385.6	217.2	44.1
Loan from Switzerland	NA	NA	NA	NA	32.0
Loan from EC	NA	NA	192.5	172.2	0.0

Sources: Bulgarian National Bank (BNB), *Godishen otchet*, 1993, p. 151, and *Annual Report*, 1991, p. 100.
Note: For 1989–91, data refer to foreign economic activity in convertible currency only; for 1992–93, they refer to all such activity.

[a] Based on foreign trade activity reflected in payments operations of commercial banks.

[b] Based on foreign trade activity reflected in customs statistics; data gathered from commercial banks show $4,700.6 million in exports and $4,567.1 million in imports in 1993.

[c] Includes only interest actually paid, not that falling due.

[d] Includes repayments by former USSR in form of natural gas.

[e] Bulgarian Foreign Trade Bank.

NA Not Available.

the country's current account was expected. This would result from the worsening of the terms of trade with the CMEA after its switch to trade at world market prices, the demand shock of largely losing the Soviet market, and the shocks associated with the break in economic relations with Iraq in the wake of the latter's invasion of Kuwait. The overall effect, as mentioned above, was anticipated to be a $2 billion current account deficit. To finance this deficit, as well as to allow for an increase in foreign exchange reserves of $500 million—even assuming a successful outcome to negotiations with the Paris Club and no debt or debt service payments to the London Club—$1.6 billion in fresh foreign credit would be required.

The foreign exchange regime introduced on February 1, 1991, is one of the most liberal in Eastern Europe. As of that date, Bulgaria has a unified exchange rate and a decentralized system of foreign exchange allocation based on an interbank market. The Bulgarian National Bank (Bulgarska narodna banka, BNB) sets a central exchange rate against the dollar for each weekday based on developments on that market during the previous weekday.

With respect to trade policy, February 1991 saw the elimination of all quantitative import restrictions; a reduction in the application of import-licensing requirements to a very small number of, largely military-related, goods; and a cutback in the use of export bans and licensing requirements, so that they applied to only 21 products, and of export ceilings, so that they affected just 9 product categories. Enterprises may participate freely in foreign trade without the intercession of foreign trade organizations. However, two restrictive temporary measures were undertaken as "safeguards": a temporary export tax of 20–30 percent was placed on 26 goods and a 15 percent surcharge was set on most imports.

The chief instrument of incomes policy would be ceilings on total wage bills at state enterprises, in line with the aforementioned goal of a fall in the average real wage of 35 percent. Tight controls on such wage bills, enforced through a special tax on wage hikes above the ceiling, were aimed at discouraging overmanning and allowing labor-shedding enterprises to raise real wages. During the first half of 1991, such controls, combined with an effort to protect low wage earners, resulted in major reductions in both the average real wage and wage differentials. Other significant labor market milestones early in the reform process were amendments to labor law to allow enterprises to lay off workers (1990); the Tripartite Agreement on labor relations and social policy between the government, management, and the two chief trade union confederations (January 1991); and the beginning of enterprise-level collective bargaining (November 1991).

In the fiscal sphere, in addition to the goal of reducing the cash budget deficit to 3.5 percent of GDP, reductions in the government debt to the banking system and in the shares of GDP of both expenditures and revenue were targeted. Due to price liberalization, it would be possible to reduce price subsidies from 16 to 3 percent of GDP (retail price subsidies were eliminated for all goods and services but heating). Subsidization of enterprise losses would be reduced from 7.7 to 2 percent of GDP, while subsidies for exporters to former CMEA lands would be limited to those under a recent agreement with the USSR. Other economies on the expenditure side would be effected by cutting staff, limiting the wage bill, and reducing real defense outlays. On the revenue side, the profit tax rate was cut to 40 (from 50) percent; the turnover tax was streamlined in a revenue-enhancing manner; changes in the individual income tax were proposed that would harmonize rates across income sources and lessen progressivity and discrimination against nonlabor income; and a number of temporary revenue-increasing measures were enacted.

As mentioned above, monetary/credit policy was based on steep increases in nominal interest rates—the BNB's refinance rate going from 4.5 percent in late 1990 to 45 percent in early February 1991, 52 percent in June, and 63 percent at the start of 1992—and extraordinarily restrictive bank-specific credit ceilings. These latter targets were set on the basis of the share of a given bank in total credit at the end of the previous year.

A final matter of concern touched upon by the Letter of Intent was the social safety net, to which a number of changes would be made: increasing the funds allocated for unemployment compensation from 22 million to 768 million leva (consistent with a level of unemployment of 260,000), financed by increases in enterprises' contributions; strengthening job training and job search services; trebling child allowances; doubling the minimum pension and indexing it to inflation; and increasing other types of assistance (e.g., to the disabled).

INITIAL RESULTS OF STABILIZATION PROGRAM

The stabilization program was in many respects a success. The OECD, for example, observed in 1992 that "the monetary overhang was eliminated; prices and trade were liberalized; hyperinflation was avoided; budgetary adjustment was undertaken; wages were kept under control; and external balance was obtained."[8]

Nonetheless, the economy performed worse than expected in 1991, as can be seen by comparing the results for 1991 contained in Tables 3–5 with the targets discussed above. Accurate projections were made for the fall in GDP (11.7 percent versus the anticipated 11 percent), and for the cash budget deficit (3.8 percent versus the expected 3.5 percent).

On the other hand, retail price inflation was much higher than expected (333.5 percent on annual average basis versus the projected 200 percent); the fall in real wages was larger than anticipated, as was (somewhat paradoxically) the rise in unemployment, which reached 280,075 by July and 419,123 by the end of the year; the average lev/dollar exchange rate for 1991 was 17.373 (21.718 for December), versus the expected 7–10; and the level of external finance that was received came to only $600 million, against the hoped-for $1.6 billion. There were positive surprises as well: an addition to the BNB's and to the Bulgarian Foreign Trade Bank's foreign exchange reserves of $624 million (versus a projected $500 million), and a current account deficit of a mere $77 million (against an expected $2 billion).[9]

MACROECONOMIC POLICY AND PERFORMANCE SINCE FIRST STANDBY

Table 3 reveals that the years since the signing of the original standby agreement with the IMF have proven to be quite difficult

[8] OECD, *Bulgaria: An Economic Assessment*, p. 74.

[9] The shift to trade in convertible currency within the CMEA at the beginning of 1991 meant that all CMEA trade was included for the first time within the convertible currency category, creating an artificial surge in exports and imports against such currency. PlanEcon has estimated that on a customs basis exports actually fell by 60 percent, and that imports fell by 74 percent, while on payments basis the declines were 48 percent and 62 percent, respectively. See "Bulgarian Foreign Trade Performance in 1991: Trade Collapses to Less than One-Half the 1990 Level," *PlanEcon Report*, vol. 8, no. 32 (August 14, 1992), p. 5. These figures may be compared with the anticipated 28 percent decline in exports and 25 percent decline in imports.

for the Bulgarian economy. Although the declines in real GDP have fallen from their 1991 peak, they remained substantial in 1992 and 1993; if the projected 2 percent decline for 1994 holds, GDP will have fallen by a cumulative 30.3 percent over 1989–94. Making a similar assumption about 1994 for industrial production, the fall in that indicator during 1989–94 will be an even more striking 43.2 percent; gross fixed investment declined by an astonishing 63.6 percent over 1989–93.

It should be pointed out, however, that official Bulgarian output statistics tend to underestimate the size of the economy, and under conditions of a growing private sector, to provide overly pessimistic growth rates. Calculations of GDP from the income side—as opposed to the production side, as are the statistics presented in Table 3—produce a GDP 20 or 30 billion *leva* higher than the official one, as do various financial computations.

Consumer Price Index (CPI) inflation has averaged a disconcertingly high but far below hyperinflationary 5 percent per month since the inception of the stabilization program. Even so, monetary policy has been relatively tight all along. At the very beginning, credit controls proved extraordinarily effective, as real credit fell to a fifth of its previous level during the first quarter of 1991, while over the entire year real domestic credit fell by 78 percent, M2 declined in real terms by 66 percent, and the income velocity of M2 rose from unity to 1.8. Even the nominal value of domestic credit did not reach its December 1990 level until June 1991.[10]

As far as interest rate policy is concerned, the BNB has consistently maintained high nominal rates, certainly positive in real terms for producers whose prices are rising at the rate of producer price index (PPI) inflation, if not for depositors watching the CPI. At times when inflation seemed to be subsiding, the lev seemed stable, and its own foreign exchange reserves were increasing, the BNB lowered its refinance rate, as it did in the summer of 1992 and spring of 1993. Margins between borrowing and lending rates at commercial banks remain extremely high—around 20 points—mostly due to the preponderance of bad state-enterprise debt in commercial bank loan portfolios (see below).

The growth of the *lev* money supply accelerated in the summer of 1991 (in the aftermath of the tight conditions at the start of the program) and, more disturbingly, toward the end of 1992 to finance an increasing budget deficit. Moreover, while monetary financing of the government sector accounted for only 6 percent of lev money growth in 1991, this figure rose to 26 percent in 1992. Of the credit made available to nongovernment in 1992, 88 percent went to state enterprises, leaving little for the small but growing private sector.

Turning to the fiscal situation, Bulgaria has managed to reduce the size of its government sector relative to GDP to a greater extent than any other European former CMEA member state. Although this has to some degree been the result of conscious policy, the expenditure cutbacks have for the most part been forced by an extraordinarily steep decline in revenue, which has fallen from 57.9 percent of GDP at the start of the reform to a projected 34.0 per-

[10] See Lyubomir Hristov, "Bulgarian Stabilization Program and Performance in 1991," paper presented at the Conference on the Future of Democracy in Bulgaria and the Transition to Market Economy, sponsored by the U.S. Chamber of Commerce, Washington, D.C., March 1992, p. 4.

cent in 1994 (see Table 4). The poor state of the state enterprise sector is reflected in the collapse of revenue from the profit tax from 23.2 percent of GDP to an estimated 4.6 percent this year. The individual income tax and the value added tax (VAT)—the latter having replaced the turnover tax on April 1, 1994—still account for small shares of total revenue.

In 1991 and 1992, the cash budget deficit was kept within acceptable limits, but the fiscal situation deteriorated markedly in 1993, as that deficit grew from 5.3 to 11.4 percent of GDP. In 1993 it proved impossible to make sufficient real cutbacks on the expenditure side to keep up with the continued deterioration of revenues; problems emerged with regard to changes in the method of wage indexation (see below), growing social security expenditures, and mounting domestic debt service. [11]

Looking at trends in the structure of expenditures, subsidies fell from 15.5 percent of GDP in 1990 to a mere 1.2 percent in 1992, and have remained at about this level, by far the lowest in Eastern Europe; the only sectors receiving subsidies today are energy and public transportation. On the other hand, interest payments have become a substantial burden for the economy, even with little or no interest on foreign debt being paid since 1990, the result of cumulative government borrowing and the prevailing high interest rates.

Social security benefits are becoming a cause of serious concern: although their share of total expenditure is not particularly high by international standards, it is rising. The ongoing trends in spending on pensions, which account for about 70 percent of total social spending, are especially worrisome. Bulgaria has one of the world's oldest populations, as well as one of its youngest retirement ages (60 for men and 55 for women): in 1991 the ratio of pensioners to economically active population was 0.63, a figure that is projected to rise toward 0.8 over the next few years, especially in the absence of pension reform. [12]

A substantial proportion (about 30 percent in 1993) of the funds used to finance government deficits now comes from the sale of securities, rather than from direct BNB financing. However, in the absence of a secondary market for such securities, they are sold largely to commercial banks, who use them as collateral when receiving Lombard loans from the BNB; they may borrow up to 60 percent of their government security holdings. Such refinancing of commercial banks on the basis of their holdings of government securities increases the monetary base and hence stimulates inflation, although perhaps to a lesser extent than does direct BNB financing of the deficit. [13]

Exchange rate policy has been a bone of contention over the last several years. Bulgaria is generally described as having a floating exchange rate, although the BNB has intervened to purchase for-

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[11] Agency for Economic Coordination and Development (AECD), *The Bulgarian Economy in 1993: Annual Report* (Sofia: December 1993), pp. 7–20.

[12] OECD, *Bulgaria: An Economic Assessment*, pp. 19–20. A "White Paper" containing proposals for reform of the social welfare system was recently approved by the government.

[13] See Jeffrey B. Miller, "The Bulgarian Banking System," University of Delaware, Department of Economics, Working Paper 93–12, October 1993, pp. 53–55. Lombard and discount refinancing of commercial banks have as of March 1993 completely replaced the use of direct uncollateralized lending to such banks.

eign currency for its reserves and in an attempt to stabilize the foreign exchange market. The failure to create a stabilization fund for the lev was a striking feature of the initial stabilization effort; although the BNB's scant $125 million reserves (see Table 6) would hardly have supported the creation of such a fund, it is less clear why no support from the international community was available for this purpose. In any case, the official reserves grew impressively in absolute terms—if not relative to imports—during 1991 and 1992, reaching over $900 million by the end of 1992.

TABLE 6. Bulgarian Foreign Debt, Reserves, and Import-Export Trade, 1990–1994

Measure	1990	1991	1992	1993	1994
Foreign Debt and Reserves					
Gross foreign debt [a] (billions of dollars)	10.007	11.375	12.951	11.5–12.0 [b]	NA
Debt as percentage of exported goods for convertible currency	383	304	254	316–330	NA
Official reserves of BNB [c]	125.0	310.6	902.0	663.7	1,160 [d]
Reserves in months of imported goods for convertible currency	0.4	1.0	2.4	1.8	4.6 [e]
Direction of Trade [f]					
Exports (percent)					
OECD	9.0	26.3	42.2	43.1	43.3
EC/EU	5.0	15.7	29.4	28.1	31.5
EFTA	1.5	3.4	3.7	3.0	2.0
Eastern Europe [g]	80.2	57.7	39.2	35.4	34.5
Arab countries [h]	6.1	8.3	8.6	7.0	7.6
Imports (percent)					
OECD	15.0	32.8	43.8	42.6	52.8
EC/EU	9.6	20.7	31.1	30.2	40.3
EFTA	3.2	7.8	6.0	5.7	5.9
Eastern Europe [g]	75.9	48.5	36.3	42.9	28.2
Arab countries [h]	4.3	4.5	8.6	4.9	3.0
Exchange rate (leva:dollar) [i]	6.580	17.373	23.348	27.587	53.658

Sources: BNB; OECD, *Bulgaria: An Economic Assessment*, p. 58; NSI, *Statisticheski spravochnik*, 1994, p. 185; NSI, *Iznos i vnos*, no. 1, 1994, pp. 5–7; "IMF Reviews Third Standby Agreement," *168 Hours BBN* vol. 4, no. 28 (June 11–17, 1994), p. 3; "Dŭlgŭt ni kŭm kreditorite e 12 mlrd. dolara," *Standart* (June 24, 1994), p. 10.

[a] In convertible currencies only. Data reflect debt as measured by Bulgaria; creditor data are somewhat different.

[b] Figure provided on June 23, 1994, by First Deputy Finance Minister Dimitŭr Kostov.

[c] Including SDR and foreign exchange holdings of the BNB but not monetary gold. End of year unless otherwise noted.

[d] At the end of June 1994.

[e] Based on average monthly imports from January to March 1994.

[f] As calculated by National Statistical Institute on the basis of trade denominated in leva.

[g] Includes European former CMEA member states, former Yugoslavia, Albania, and in 1990 the former East Germany.

[h] Includes Algeria, Egypt, Iraq, Jordan, Kuwait, Libya, Lebanon, Morocco, Saudi Arabia, Syria, Sudan, Tunisia, and Yemen.

[i] Annual average except for 1994, which is for June 30.

The biggest problem with respect to exchange rate policy, at least until the late autumn of 1993, was the nominal stability of the lev, which under the prevailing high inflation meant a substantial real appreciation. The effects of such appreciation are visible in Table 5—in 1993, after the lev weakened against the dollar by only 15.4 percent in 1992, in the face of almost 80 percent CPI inflation, the trade and current account balances turned sharply negative, after very good performance on this front in 1992.

External sector performance was impressive in 1992 not only with respect to the overall balance of payments (Table 5), but also with regard to the direction of trade (Table 6). In that year, 42.2 percent of exports went to the OECD area, versus only 26.3 percent the year before; the comparable figures for imports are 32.8 and 43.8 percent, respectively. Even the poor overall foreign trade performance in 1993 did not reverse these trends to any meaningful degree. Corresponding declines in the weights of trade with Eastern Europe can also be seen in Table 6. The deterioration during 1993 was the result of a number of factors, including the real appreciation of the lev, the UN sanctions against Yugoslavia, and delays by the European Community in ratifying its association agreement with Bulgaria.[14]

As for labor market developments, the initial year of the stabilization program saw real wages decline by 39 percent if one uses the CPI as the deflator (see Table 3); the decline during the first half of the year was actually much larger but wages made up some ground in the second half. This recovery was due, in addition to seasonal factors, to the breakdown of the tripartite negotiation process in favor of enterprise-level negotiations.

In 1992 the government took the view that the decline in the real wage had been sufficient, so that the goal for the year was to maintain the current size of the wage bill at enterprises, allowing an increase in the average real wage for enterprises that had reduced their work forces. Quarterly adjustments to wages were to be tied to projected inflation, so that if the latter were more than 10 percent above its projected level, an adjustment to wages would be made. In 1992 the real average monthly wage rose by almost 13 percent; in dollar terms that wage rose by nearly 52 percent from its admittedly very low 1991 level. The year 1993 saw a small decline in the real average monthly wage (just over six percent), but the real appreciation of the *lev* again caused a sharp rise in its dollar equivalent (by almost 30 percent, to $114), this time with undoubted consequences for the country's international competitiveness.[15]

In 1993 and 1994, incomes policy has been subject to considerable controversy and policy reversal. The Berov government was at the outset more favorably disposed to the consultation mechanism between government, management, and labor than its predecessor (which had discontinued meetings of the Tripartite Commission in February 1992). The result was an agreement in early 1993 on a cost-of-living-adjustment mechanism allowing wages in state enterprises to be adjusted quarterly by up to 90 percent of inflation dur-

[14] The agreement was initialed on December 22, 1992, and signed on March 8, 1993, but only went into effect on January 1, 1994, instead of the expected July 1, 1993.

[15] For a generally favorable evaluation of Bulgarian incomes policy during 1991 and 1992, see Željko Bogetić and Louise Fox, "Incomes Policy During Stabilization: A Review and Lessons from Bulgaria and Romania," *Comparative Economic Studies*, vol. 35, no. 1 (Spring 1993), pp. 39–57.

ing the previous quarter. This mechanism was criticized by representatives of international financial institutions for being pro-inflationary, and for 1994 a new mechanism was developed that once again tied wage indexation to projected inflation.[16]

RECENT MACROECONOMIC DEVELOPMENTS

After going without a standby agreement with the IMF in 1993, in December of that year the authorities submitted another Letter of Intent, on the basis of which the IMF agreed in April 1994 to provide another (the third) standby facility. The parameters of the agreed-upon macroeconomic framework for 1994 included a cash budget deficit of 6.2 percent of GDP, zero growth of GDP, CPI inflation of 30 percent, an end-of-year exchange rate of 35–40 *leva* to the dollar, and a BNB base interest rate of 35 percent.[17]

As it turns out, most of these projections have proved to be wildly inaccurate in the face of the three severe episodes of exchange rate depreciation that began in autumn of 1993. One of the factors behind the initial such event (November 1993) was the knowledge of traders that the budget deficit was growing alarmingly and the view of the BNB's governor—backed up by declines in the base interest rate in August—that the lev needed to fall to make up for its previous real appreciation. Critics, led by the quasi-governmental AECD (Agency for Economic Coordination and Development), charged the BNB with responding too slowly to speculative pressure against the lev when the bank decided to raise its interest rate again late in the autumn.[18]

In January and March 1994, two further rounds of precipitous decline in the value of the lev against the dollar took place; on March 31, there were 64.9 leva to the dollar, versus 32.7 at the end of 1993, a depreciation of nearly 50 percent. Once again, different observers viewed these developments through different lenses. Some noted that the real exchange rate had finally returned to approximately the level of 1992, while others, including the AECD, saw no need for this depreciation and once again blamed speculators and the BNB for the dramatic turn of events. One factor was uneasiness about the need to buy U.S. government securities under the pending agreement with the London Club; at the time foreign finance for the agreement was uncertain and the BNB's foreign reserves were at a very low level, bottoming out at $593.2 million in February 1993 after peaking at $1.095 billion in October 1992.

Whatever the causes of the rapid decline in the lev's value, many of its consequences are worrisome. Fanned not only by the fall in the lev, but also by the introduction of the VAT and increases in the price of electricity on April 1,[19] inflation took off to levels unseen since the start of the stabilization effort; the CPI registered increases of 7.5 percent in March, 21.7 percent in April, and 7.9

[16] "Incomes Policy for 1994 Endorsed," *168 Hours BBN*, vol. 4, no. 7, February 14–20, 1994, p. 11. Under the new system, if actual inflation during the previous quarter exceeds that projected by more than 6.2 percent, the difference between these two indexes is multiplied by 0.7 and the average wage is increased to this degree during the succeeding quarter.

[17] "IMF Reviews Third Standby Agreement," *168 Hours BBN*; and BNB, "Vrŭzki s mezhdunarodni finansovi institutsii," *Pari* (July 12, 1994), p. 8.

[18] See AECD, *The Bulgarian Economy in 1993*, pp. 20–22.

[19] "April Inflation Runs at 20 Per Cent," *168 Hours BBN*, vol. 4, no. 19 (May 9–15, 1994), pp. 1, 15.

percent in May. There will inevitably be a large increase in the average wage under the indexation mechanism to make up for the fall in the monthly dollar wage to below $80 from its post-communist peak of almost $130 in September 1993. Since wages in the budgetary sphere and pensions are tied to the average wage, a large increase in the latter will worsen the fiscal balance, as will the higher expenditures on servicing the domestic debt due to the rise in interest rates.

As a result of the economic instability in early 1994, by mid-year several parameters in the Letter of Intent were far from reality: CPI inflation was 59.5 percent for the first half of the year (versus a projected 30 percent for the year), the base interest rate was 62 percent (versus 35 percent), and the lev had settled down at around 53.8 to the dollar (versus 35–40).[20] An IMF mission in July was alarmed by the high inflation, shaky confidence in the lev, and rapidly growing monetary/credit indicators (especially net domestic assets), which resulted partly from the BNB's refinancing of one or two shaky commercial banks. Nonetheless, while recommending a tighter monetary policy and measures to rehabilitate the banking system, the IMF apparently agreed to provide special financing for the London Club deal.[21]

RELATIONS WITH INTERNATIONAL ORGANIZATIONS, FOREIGN DEBT, AND FOREIGN INVESTMENT

The IMF has figured prominently in the story so far in its role as arbiter of the country's ongoing stabilization efforts and provider of support for the balance of payments and for the deal with the London Club. Bulgaria received $394 million from the IMF under the March 1991 standby agreement and another $131 million under the IMF's Compensatory and Contingency Financing Facility.[22] A second standby agreement in April 1992 was to provide Bulgaria with $212 million in four tranches, although the fifth tranche was never received due to Bulgaria's noncompliance with some of the agreement's conditions; this agreement expired in April 1993. The most recent standby accord, approved by the IMF in April 1994, promised $328 million, and was conditional on the passage of the law on bankruptcy and of changes to the law on privatization allowing mass (voucher) privatization, as well as on general progress on structural reform.

The World Bank granted a SAL (structural adjustment loan) in August 1991 of $250 million; however, the second $100 million tranche of that loan was not received until April 1994, due to dissatisfaction on the Bank's part with the slow pace of structural reform. An agreement was signed with the Bank on September 30, 1993, on a PIEF (Private Investment and Export Finance) loan for the provision of investment finance and export credit, with the first

[20] There were positive signs as well. As of June 30 the feared budgetary difficulties had yet to show up, as the cash deficit amounted to only 37.2 percent of the anticipated annual figure. CPI inflation ran at 4.1 percent in June. The foreign reserves have more recently been increasing rapidly, reaching $1.16 billion at the end of June. There was also an encouraging fall in the numbers of unemployed between January and May, even though the decline in production seemed to be continuing.

[21] "MVF shte dade 100 i obeshta oshte 200 mln. dolara," *Pari* (July 18, 1994), p. 1.

[22] Much of the material on relations with the international financial community is derived from BNB, "Vrŭzki s mezhdunarodni finansovi institutsii."

concrete agreement within the framework of this loan made in January 1994 through a Bulgarian private bank. Bulgaria expects to receive an additional $50 million from the Bank in 1994 to support agricultural development. Negotiations with the Bank over a $150 million FESAL (Financial and Economic Structural Adjustment Loan) will take place in autumn 1994.

Bulgaria was the last European former CMEA member state to sign an association agreement with the EU. The agreement, which went into effect on January 1, 1994, instead of the expected July 1, 1993, grants 70 percent of Bulgarian industrial goods tariff-free entry into the EU, but provides less favorable conditions for many important Bulgarian export goods (including textiles, metals, coals, and agricultural products). With respect to G–24 support, the non-EU members of the group failed to come up with the $400 million agreed upon in early 1991 to match $400 million pledged by the EU members. However, the EU provided $100 million in balance-of-payments support after the signing of the third standby with the IMF, and the G–24 has promised $330 million as part of a joint effort with the IMF and World Bank to help finance the London Club deal.[23]

Three foreign debt rescheduling agreements have been signed with the Paris Club of official creditors (which holds about 15 percent of the country's $12 billion debt)—in April 1991, December 1992, and April 1994. Each agreement covers payments due during the succeeding twelve months; the first two provided for repayment over ten years, with a six-year grace period, while the most recent one calls for repayment over eleven years, with a seven-year grace period.[24]

Far more important was the Brady-type deal with the London Club, finally signed on June 29, 1994, after years of negotiations. The agreement is a particularly favorable one in certain respects, providing a reduction of 47 percent in the principal (of $8.16 billion), versus 42 percent in the case of the Polish deal with the London Club earlier in the year. Yet the deal will represent a heavy burden for the small—and still declining, according to official statistics—Bulgarian economy.

From 1994 through 2000, annual sums on the order of from $250 million to $350 million will be needed for servicing the London Club debt; total annual debt service obligations, including those to the Paris Club, IMF, and World Bank, over this period will range from $500 million to $1.3 billion (see Table 7). The most difficult year will be 1997, when debt service will peak at 28.4 percent of exports and 17.3 percent of GDP. About $500 million in support from the international community is expected in 1994.[25]

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[23] "EU Allocates ECU 100 M to Bulgaria," *168 Hours BBN*, vol. 4, no. 21 (May 23–29, 1994), pp. 1, 3. Bulgaria has also agreed with the European Bank for Reconstruction and Development (EBRD) on the funding of about $150 million in infrastructural projects.

[24] "Agreement with Paris Club Negotiated," *168 Hours BBN*, vol. 4, no. 16 (April 18–24, 1994), pp. 1, 3.

[25] Angelov, "Makroikonomicheski izmereniya na sdelkite po dŭlga"; "Prognoza za obsluzhvane na vŭnshnite dŭlgove do 2000 godina, v mln. USD," *Demokratsiya* (June 30, 1994), p. 4; "Blizo 6,5 miliarda dolara tryabva da platim do 2000," (*Demokratsiya*), June 30, 1994, p. 4. The figures cited in the text are from the Angelov article and differ somewhat from those appearing in *Demokratsiya*.

TABLE 7. Bulgarian Debt Service Obligations, 1994–2000

Obligations	1994	1995	1996	1997	1998	1999	2000
Payments to London Club[a]	249	278	299	309	318	327	335
Payments to Paris Club[a]	36	36	36	36	92	165	181
Payments to IMF, World Bank, and G-24[a]	156	339	336	522	168	195	225
Other debt service[a]	57	88	239	446	84	87	121
Total debt service[a]	498	741	910	1,313	662	774	862
As share of exports (percent)	13.1	18.3	20.9	28.4	13.8	15.5	16.6
As share of GDP (percent)	7.6	10.7	12.9	17.3	8.6	9.8	10.5
As share of budget expenditure (percent)	23.3	17.7	14.1	11.2	10.0	10.0	10.0

Source: Angelov, "Makroikonomicheski izmereniya na sdelkite po dŭlga."
[a]Millions of dollars.

Some 13 percent of the debt ($954 million) is subject to buy-back, the most desirable option from the Bulgarian point of view, at an agreed upon price of 25.19 cents on the dollar. This is a source of some disappointment, since it had been hoped that about 19 percent of the debt ($1.5 billion) would be eligible for such treatment. The up-front payment on the deal to be made in 1994 is on the order of $775 million.[26] Various forms of foreign finance notwithstanding, the BNB's reserves will fall by $350 million–$400 million as result of the deal.[27]

This agreement, which must be approved by Parliament, is controversial: the Union of Democratic Forces (UDF) has vowed to oppose it on the grounds that it is too large a burden for the economy, that there is insufficient recourse to the buy-back option, and that a better deal could have been reached when it was in power. Others argue that there is no alternative to the deal, which, while indeed burdensome, will finally give Bulgaria renewed access to international capital markets. They also point out that much of the burden is debt to the IMF/World Bank, which will be willing to reschedule if failure to do so would cause the breakdown of an agreement that they themselves are helping to finance.[28]

Bulgaria has received less foreign direct investment (FDI) than any other East European land (including Albania). As of late April 1994, according to the Commission for Foreign Investment at the Council of Ministers, some $230 million had been received in FDI.[29] The true figure is surely somewhat higher, taking into ac-

[26]This sum includes the funds for the buy-back; $240 million for the purchase of U.S. Treasury zero-coupon bonds to guarantee the various types of obligations (FLIRBs, i.e., front-loaded interest-reduction bonds, and Brady obligations with 50 percent principle reduction); $150 million–$200 million for interest payments on those obligations, and another $80 million in payment of past-due interest.

[27]"Sdelkata po dŭlga e veche garantirana," *Pari*, (July 11, 1994), p. 4; "Po 909 dolara shte plati vseki ot nas," *Demokratsiya*, (June 29, 1994), pp. 1–2.

[28]The UDF position is expressed in an interview with former Finance Minister Ivan Kostov; see Polina Mihaylova, "Sdelkata po dŭlga s Londonskiya klub e neponosima za Bŭlgariya," *Demokratsiya* (June 20, 1994), pp. 1, 4. The deal is defended by current First Deputy Finance Minister Dimitŭr Kostov in Iva Varsanova, "Dimitŭr Kostov: Sdelkata po dŭlga gŭrmi, ako parlamentŭt ne ya ratifitsira do 28 yuli," 24 *chasa* (July 19, 1994), p. 10.

[29]See the interview with Commission member Daniela Bobeva in Aneliya Bŭklova, "Za privlichaneto na kapitali e nuzhna politicheska volya," *Pari* (April 26, 1994), p. 5. Looking at the balance of payments (Table 5) reveals an even smaller figure for 1991–93: $153 million.

count the many small unregistered Greek and Turkish ventures and the fact that the value of such in-kind contributions as licenses and know-how is almost impossible to estimate.[30] The relatively low interest of foreigners in investing in Bulgaria may be ascribed to problems in dealing with the bureaucracy, the instability of the lev, the slow pace of large-scale privatization (and the primacy of restitution over other forms of privatization), and weaknesses in the banking system. These problems have arisen despite a very liberal law on foreign investment, passed in January 1992, that grants foreigners virtually equal rights with Bulgarians and requires permission for only a small number of activities.[31]

PRIVATIZATION AND FINANCIAL SECTOR ISSUES

Large-scale privatization in Bulgaria is governed by a law passed in April 1992 that provides for market, as opposed to mass, privatization. The UDF government at the time was against mass privatization, partly due to a general preference for market-based methods and partly because of the need to have valuable properties available for debt-equity swaps under an eventual deal with the London Club. The privatization process under the law is based on the promulgation of an annual program by the Privatization Agency (PA) containing a list of enterprises to be privatized; decisions on the privatization of an enterprise are made either by the PA or the Council of Ministers, depending on the size of the enterprise (or by the municipality in the case of its own property). The law allows a variety of market methods, including offering of stocks to the public, public auctioning of blocks of stock, publicly invited tenders, and negotiations with potential investors. Preferential terms are available on a one-time basis to employers, former employees, and pensioners, who may purchase at a discount of 50 percent up to 20 percent (in total) of the stock.[32]

The annual lists of enterprises destined for market privatization under this program have never been operational documents. By the end of 1993, 115 smaller objects had been privatized, only 17 of which were entire enterprises, the rest being shops, service stations, and so on, forming parts of larger entities.[33] Attempts to privatize large enterprises, such as the trucking firm SO MAT[34] or major hotels in Sofia,[35] have been controversial, frequently generating charges of corruption and favoritism and resistance by management and labor.

The Berov government has now drawn up a mass privatization program; amendments to the privatization law in this direction

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[30] "Bulgarian Economic Monitor: The Economy Reaches the Bottom of the Downturn Cycle," *PlanEcon Report*, vol. 9, nos. 34–36 (October 12, 1993), p. 7.

[31] See Michael L. Wyzan, "Bulgarian Law Lowers Foreign Investment Barriers," *RFE/RL Research Report*, vol. 1, no. 13 (March 27, 1992), pp. 41–43. Bureaucratic obstacles include inconsistent behavior over time and between agencies in approving ventures and charging customs duties on goods that should be exempt. See Bŭklova, "Za privlichaneto na kapitali e nuzhna politicheska volya."

[32] The most complete discussion of privatization in Bulgaria may be found in Roman Frydman, Andrzej Rapaczynski, and John S. Earle, et al., *The Privatization Process in Eastern Europe* (London: Central European University Press), 1993, pp. 3–37.

[33] NSI, *Statisticheski spravochnik 1994* (Sofia, 1994), p. 211.

[34] "Rows Continue over SO MAT Sale," *168 Hours BBN*, vol. 4, no. 27 (July 4–10, 1994), pp. 1, 10.

[35] "Argument Over Privatisation of Luxury Hotels Turns into War," *168 Hours BBN*, vol. 4, no. 6 (February 7–13, 1994), p. 11.

were passed by the Parliament in June 1994. Every adult Bulgarian citizen will receive against a fee investment vouchers worth 25,000 leva, which may be used to buy shares in 500 enterprises—whose net worth is 36 percent of that of all state enterprises—or shares in investment funds. Estimates of how many people will participate range from 2.5 million to 4 million (from a population of 8.5 million).[36]

The program has proved quite controversial, with opponents observing that the enterprises included on the list are mostly unprofitable, that the vouchers are nonnegotiable and cannot be used for collateral when taking out loans, and that the relationship between mass and market privatization has not been elaborated.[37] Despite these objections, the program apparently has the support of the World Bank.

In late 1993, a law was passed under which debt to state commercial banks contracted before 1991 that had not been serviced for 180 days would be converted to long-term government bonds. Two types of bonds are involved, covering 32 billion leva worth of lev debt and $1.808 billion worth of hard-currency debt.[38] The program is vulnerable to criticism because it does not cover enough debt to clean up the bank's balance sheets, because the interest rates paid to the banks are below market levels in the early years, and because there is no guarantee that the operation will not have to be repeated annually in the future.

Conclusions

The Bulgarian approach to postcommunist economic reform has seen its share of successes and failures. On the positive side, the macroeconomic stabilization program launched in February 1991 has in many respects fulfilled its expectations in liberalizing prices and foreign trade, eliminating the monetary overhang, reducing the weight of the government in the economy, and keeping current account imbalances under control. Certain aspects of structural change have also been proceeding rapidly, including the creation of a sector consisting of new private firms and banks and the consolidation of the existing network of state commercial banks. Recently the country has finally come to an agreement with the London Club, the absence of which has made it eligible only for credits from the international financial community.

On the other hand, many aspects of the economic policy and performance have been less satisfactory. Less progress has been made on the privatization of large-scale industrial enterprises than any-

[36] "500 State Enterprises Listed for Mass Privatization," *168 Hours BBN*, vol. 4, no. 24, June 13–19, 1994, pp. 1, 8.

[37] If large-scale privatization has made little progress thus far, the same cannot be said for restitution of small-scale urban property, under which 56.5 percent of all eligible objects (including 83 percent of stores and restaurants) had been returned to their former owners by June 30, 1993; see NSI, *Statisticheski spravochnik*, 1994, p. 206. Mention should also be made of return of agricultural land to its former owners; by January 25, 1994, 40.5 percent of the eligible land had been restituted, mostly based upon land distribution plans rather than within original boundaries; see "91% of Private Farmers Will Own Under 10 Dca," *168 Hours BBN*, vol. 4, no. 10 (March 7–13, 1994), p. 7. Finally,the growth of the sector consisting of new private firms, especially in trade and services, has been impressive; that sector now accounts for 18.5 percent of GDP and employs about 900,000 people; see AECD, *The Bulgarian Economy in 1993*, pp. 38–39.

[38] "Parliament Approves Bad Debts Act," 168 Hours BBN, vol. 4, no. 1 (January 3–9, 1994), pp. 1, 15.

where else in the European former CMEA. The banking system is still dominated by state commercial banks with portfolios of uncollectible debt from struggling state enterprises, and the recent bad-debt deal will not solve this problem. Even the achievements in economic stabilization are fragile. In the medium term the need to service the obligations under the London Club agreement will represent a heavy burden for the economy. Growing interest payments on domestic debt make the fiscal situation worrisome, and exchange rate crises like those of late 1993 and early 1994 are far from impossible.

In the end, the biggest Bulgarian economic problem is undoubtedly the politicization of all major policy decisions. One hopes that as communism's harsh legacy recedes into the past, the prospects for achieving an economic policy consensus will improve substantially.

POLITICAL INCREDIBILITY AND BUREAUCRATIC TRANSITION IN ROMANIA

By Marvin Jackson *

CONTENTS

TABLES

* Professor Marvin Jackson is Director of the Leuven Institute for Central and East European Studies, Faculty of Economics, Catholic University of Leuven, Belgium.

SUMMARY

Romania continues to be a land of contradictions. Last year, 1993, saw a number of successes. According to official statistics, GDP grew 1.4 percent during the year after it had fallen to only 71 percent of the reported 1989 level in 1992. Nevertheless, unemployment grew to over 10 percent by year-end and consumer prices rose 3.6 times over 1992 levels.

A recent World Bank report characterized Romania as an "outlier" (in contrast to Poland, Hungary, the former Czechoslovakia, and Bulgaria) with "stop and go" macroeconomic policies resembling Russia's in many ways. Budget deficits driven by enterprise subsidies, lack of control over inter-enterprise credits, and negative interest rates for borrowers fueled inflation. Negative deposit rates and the failures of the National Bank to allow a clean float of the Romanian *leu* currency were causing a move into foreign currency accounts.[1] Privatization floundered and enterprise restructuring was only a topic being discussed at that point.[2]

"Transition" in Romania amounts to an impressive list of legal measures with less evident substance in either domestic market development or private enterprise. Nevertheless, numerous new bureaucracies have been set up, most of which provide their bureaucrats with both opportunities to influence new wealth creation and international connections. At the same time, this may be serving the interests of a corp of Western consultants, who are supported by international agencies and who seem to have become the new friends of Romania. The Romanian people and Western supporters have so far paid little attention and received few results.

The third transition government headed by former planning official Nicolae Vacaroiu started in Nov 1992 and continues despite scandals and problems between the ruling party and its nationalist-communist partners. His government managed, if for no other reason than being in power at the right time, some impressive international achievements: signing of a European Association Agreement in February 1993, joining the Council of Europe and then receiving MFN treatment by the U.S. Congress in October 1993, and then first to sign a Partnership for Peace agreement with NATO in January 1994.

The latest achievement, an International Monetary Fund standby Agreement, negotiated in December 1993 and finally approved by the IMF on 11 May 1994, required at the insistence of the IMF a debate and approval of the Romanian Parliament. The austerity budget for 1994 required by the IMF received Parliament's approval on 31 May.

To the credit of the government and especially the National Bank, inflation rates have fallen below the double-digit monthly rates of 1992 and 1993. Nevertheless, the annual inflation this year

[1] Leszek Balcerowicz and Alan Gelb, *Macropolicies in Transition to a Market Economy: A Three-Year Perspective*, Annual Bank Conference on Development Economics, The World Bank, Washington D.C., 28–29 April 1994.

[2] Marvin Jackson, "The Economic Penetration between the EC and Eastern Europe: The Romanian Case" *European Economies*, Brussels 1994, forthcoming.

will push over 100 percent. Yet as the rate of inflation has declined so has industrial output in the first quarter (a 1.4 percent decline compared to the same period in 1993) and unemployment has nudged up. Now, as the evident pressures rise to make good on privatization and restructuring, there are signs of labor unrest.

This labor unrest occurs at a time when the ruling Party of Social Democracy of Romania (PSDR) has just gone through difficult negeotiations with its ultra-nationalistic-communistic allies that are necessary for its parliamentary majority; and the PSDR has probably been discouraged by President Iliescu from courting new partners in the opposition. Labor unrest has been manipulated by those around the President to harness previous governments that seemed poised to risk their continued political control through more radical and rapid reform. The government and the President also have been criticized by a recent Council of Europe report for slow reforms and failures on the treatment of ethnic, religious, and other minorities.

We believe that Romania's problems arise because of a lack of political credibility for real marketization and property rights reforms.[3] Because no economic agent believes reform measures will be properly administered and enforced, no economic agent will risk the changed behaviors that are necessary to launch the reforms on paper. Lack of political credibility arises from the behavior of Iliescu (and his shadow supporters). That the President is no friend of markets and private enterprise is no surprise, given his background. But the more important question for him and his shadow supporters is that power does not slip from their fingers until they have been assured of a place in the new system and control of wealth. This is surely more important to them than is ideology.

Perhaps this time the government cannot avoid reforms without losing international support. Without equivocating reforms it also may lose the domestic political support of the trade unions and the nationalist-communists. In the past, President Iliescu has manipulated this balance to avoid both radical reforms and the emergence of a political alternative to him as he sought a gradual shift of economic power and wealth to the former nomenklatura who form his real constituency. This time his choices seem much more limited.

Romania faces a great dilemma because many of the capable cadres are pulled into the forces of Iliescu. At the same time, the opposition in Romania still flounders without clear alternatives and strong leadership.

INTRODUCTION

ROMANIAN DEVELOPMENT UNDER COMMUNIST RULE THROUGH 1989

Like other countries undertaking transition, Romania inherited fundamental technological, institutional, and behavioral distortions which have not been easily corrected by political and economic liberalization. In addition, its transition politics have been marked by attempts to avoid a disruption by uncounted former nomenklatura who seek to control politics and the economy.

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[3] Concerning the importance of political credibility for economic reform, see Aymo Brunetti and Beatrice Weder, "Political Credibility and Economic Growth in Less Developed Countries," *Constitutional Political Economy*, 5:1 (winter 1994), 23–44.

By either official or Western recalculations, Romania shared with Bulgaria a particularly rapid increase of national product, especially growth of industrial output. Although its structural change was not as rapid as that of Bulgaria, both countries shared the problems of having forced industrialization beyond the capacities of their administrative-engineers, which has left their new generations of industrial working classes stripped of services and urban infrastructure.[4] Not surprisingly, and despite following different lines of transition, both countries experienced the same high losses of industrial output since 1989.

Romania's unique distortions arose after Ceausescu first turned away from integration with other communist countries, particularly the Soviet Union. In turning West it gained both means (technology and funds) and markets and in turning South, both raw materials and other markets for producer goods. This strategy already failed in the 1970s when it became necessary to reschedule the country's foreign debts in 1981 and the country's political image worsened. The Ceausescu government imposed on the country a severe regime of import substitution for investment goods and consumer goods. In 1988 and 1989 domestic sources supplied virtually all standard investment goods. Of course, many investment goods were produced in tiny quantities with consequent high real costs and low quality.

In the 1980s Romanian industry was becoming increasingly self-equipped, with the consequence that production was held up by the failure to start up new capacities on time. Often, key equipment simply quit working soon after it was commissioned. Repairs were frequent and brought poor results. Thus, the Romanian economy in 1990 and since has been faced with one of the most severe restructuring challenges in the region, especially in heavy industry.

POLITICAL DISTORTIONS BEFORE AND AFTER 1989

A second marked feature of Ceausescu's rule from the mid-1970s on was the increasing exclusion of other communists, except his wife, from public power roles and the effort to identify Romanian accomplishments with him. Increasing pressure on Romanian means to pay in the 1980s pushed the level of deprivation ever deeper and wider, even threatening the material means to compensate the often politically abused Romanian nomenklatura.[5]

Once the assurance of Soviet support was withdrawn from Ceausescu (although not necessarily from continued communist rule) it made sense that any "revolution" against Ceausescu should have been provoked or accompanied by a coup of high-level communists. After all, why should they and the nomenklatura have to go down with Ceausescu?

Since the December 1989 overthrow and execution of Ceausescu and his wife, Romanian politics seemingly have been orchestrated

[4] See Marvin Jackson, "The Rise and Decay of the Socialist Economy in Bulgaria," *Journal of Economic Perspectives*, (fall 1991); and also Marvin Jackson, "The Politics and Economics of Post-Communist Bulgaria and Romania," *Nato's Sixteen Nations*, September 1991.

[5] See Marvin Jackson, "Restructuring the Romanian Economy," *Berichte des Bundesinstituts für ostwissenschaftliche und internationale Studien*, 1990, 53 pp; and also "Statistics and Political Economy in Romania: What Comes Next—Relief or More Exploitation," in *Pressures for Reform in The East European Economies*, papers submitted to The Joint Economic Committee, Congress of the United States (Washington, D.C.: U.S. Government Printing Office), 1989.

by Ion Iliescu, a former member of Romania's communist elite who seemed to have disappeared from the front lines of power for well over a decade. Iliescu at first shared power with Petre Roman in the ruling National Salvation Front, which won elections in May 1990 and designed a new constitution that was approved by referendum in December 1991. Iliescu was reelected president in October 1992. Roman served as the first prime minister until he broke from Iliescu. In September 1991 he was replaced by Theodor Stolojan (now with an international agency). After the elections in November 1992, Stolojan was replaced by the present Prime Minister, Nicolae Vaçaroiu, a former official in the central planning office.

Although Vacaroiu was identified as an "independent," he is associated with the left conservative ruling Party of Social Democracy of Romania (which proposes slow and limited reform). The PSDR, said to be the party of Iliescu, controls the Parliament with the help of four nationalist-communist radical parties. The next elections are scheduled for 1996.

ECONOMIC PERFORMANCE SINCE 1989[6]

OVERALL ECONOMIC PERFORMANCE

According to official statistics, total GDP fell 29 percent from 1989 to 1992, while 1993 recorded a slight growth of 1 percent. Declines are concentrated in industry, construction, and transport-communications. As in other transition countries, there is reason to believe that the official estimates overstate the amount of decline in aggregate output. Other economic indicators are shown in table 1.

At first, large rises in the unemployment rate were avoided by increased subsidies and reduced working time. In general, the unemployment rate reported in Romania has lagged behind other transition countries. Finally, in 1992, the unemployment rate rose to 8.2 percent, then to 10.2 percent in 1993 and now is over 11 percent. The number of registered unemployed exceeds the decline in employment by more than a half million people. Employment in agriculture, trade, and services has increased significantly.

Romania's large decline in official measured GDP and real income is matched by equally pronounced increases in prices. Failure to stabilize prices is a marked feature of the country's reform policies. The cost of living has risen dramatically, faster than implicit prices in GDP. The latter, in turn, has moved ahead of increases in the money supply, suggesting cost and structural forces at work in the inflation process.

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[6] A note on Romanian statistics: The execution of study of Romania that is comparable with the other country studies has been hindered by (1) the slow publication of some statistics, like the input-output tables for 1991 and 1992, (2) the lack of publication of details of output, employment, and foreign trade for example, in sufficient detail to permit conversions to approximate NACE categories (NACE is the standard statistical nomenclature of the EU), (3) the numerous changes in statistical definitions and the lack of longer series, and (4) the lack of cooperation of Romanian offices in possession of unpublished statistics.

TABLE 1. Main Economic Indicators of Romania, 1990–1993

(annual change in percent)

Measure	1990	1991	1992	1993
GDP	–5.6	–12.9	–13.6	1.0
Industry	–13.5	–14.7	–16.0	1.0
Construction	1.0	–21.7	–8.8	NA
Agriculture	15.3	–8.6	–12.1	NA
Transport/communications	–23.6	–14.7	–17.2	NA
Trade	6.1	–21.7	–17.4	NA
Services	6.3	–0.3	–1.1	NA
GDP per capita	–5.8	–12.8	–10.9	1.0
Implicit price in GDP	13.5	194.3	214.9	211.7
Broad money supply (yearend)	22.0	101.2	79.6	143.2
Exchange rate (yearend) (1989 = 100)	140.5	444.6	143.4	177.4
Lei/US Dollar	34.7	189.0	460.0	1,276.0
Total foreign trade [a]				
Exports	–41.7	–46.0	–25.6	NA
Imports	–2.9	–66.8	–20.0	NA
Total foreign trade [b]				
Exports	–41.5	0.5	14.2	4.0
Imports	50.5	–6.9	1.9	–5.5

Sources: Government of Romania, *The Governing Programme: Strategy for Economic and Social Reform*, Bucharest, March 1993; National Commission for Statistics, *Social Situation and Economy of Romania in 1992*, Bucharest, September 1993; *Anuarul statistic 1993*; and *Romania Economic Newsletter*, 4:1, (April-June 1994).

[a] Ruble trade converted at 2.62 rubles per dollar.

[b] Official data.

NA = Not Available.

ECONOMIC PERFORMANCE IN 1994 [7]

Although improved production became evident in the first quarter of 1993, it was not followed in the first quarter of 1994. Industrial output fell 1.4 percent compared to the first quarter in 1993 and 2.7 percent when compensation is made in hours worked. A good sign is that labor productivity rose 4.4 percent. The dollar volume of exports also rose 28 percent.

Unemployment rose to 1.2 million persons, while the unemployment rate rose to 11.2 percent at the end of the quarter. Real wages fell 6.7 percent. Employment and income indicators for several years preceding 1994 are shown in table 2 for comparison.

The monthly inflation rate in the first quarter of 1994, 6.4 percent, declined compared to the 9.6 percent registered in the first quarter of 1993 and the 12.6 percent registered in the last quarter of 1993. Measures taken to free current account convertibility seem to have stopped depreciation of the *leu*. Both good signs probably reflect efforts of the National Bank to enforce the IMF conditions for the new standby agreement.

[7] *Tribuna economica*, 19 May 1994.

TABLE 2. Key Indicators of Employment and Income, 1990–1993

Measure	1990	1991	1992	1993
	(beginning of year, 1000s of persons)			
Total employment	10,946	10,839	10,786	10,458
Industry	4,169	4,015	3,817	3,301
Agriculture and forestry	3,056	3,097	3,095	3,449
Trade	648	678	872	929
Share of manufacturing in employment (percent)	34.3	31.3	27.4	under 25
Unemployment (year-end)	NA	266	929	1,165
Unemployment rate (percentage)	NA	3.0	8.4	10.2
Average working time/week [a]	NA	–15.4	–4.0	NA
Consumer price index [a]	5.1	174.5	210.9	365.1
Real salaries [a]	5.6	–17.2	–13.0	NA
Real peasant incomes [a]	NA	–8.0	–22.0	NA
Real pensions [a]	8.0	–21.0	–14.0	NA

Sources: National Commission for Statistics, *Social Situation and Economy of Romania in 1992*, Bucharest, September 1993; *Anuarul statistic 1993*; and *Romania Economic Newsletter*, 4:1 (April-June 1994).
[a] Percent change.
NA = Not Available.

CHANGES IN THE INDUSTRIAL SECTOR

According to one official Romanian source, only 70 percent of the country's industrial capacity was used in 1989.[8] By 1992 and 1993, use rates fell well below 50 percent, although it remains to be seen how much of the unused capacity can ever be regained. Surely some will be scrapped while other parts will require severe rehabilitation.

Employment in industry appears to have fallen by one million or more persons. Some have surely found their way into new occupations, including a number who are not registered as employed. In any case, official estimates show that the share of employment in manufacturing falling from over 35 percent of total employment in 1989 to about 25 percent in 1993. Much of this fall is a desirable correction of previous "over-industrialization."

The official index of industrial output has fallen even more dramatically than GDP produced in industry (from 1989 to 1993 a decline of 54 percent compared to a decline of 38 percent). Growth of total industrial output of 1.3 percent in 1993 has not been followed by continued growth in the first quarter of 1994 (as noted above). See table 3 for output by specific industry.

Through 1993 "high technology" branches were especially hard hit, although paper and metallurgy also have done poorly. On the other hand, automobiles and household electrical appliances did relatively well in 1993. Energy industries have done better than average. Tobacco and especially the furniture industry have done well. Both furniture and automobiles owe success to export markets.

[8] Government of Romania, *The Governing Programme: Strategy for Economic and Social Reform*, Bucharest, March 1993.

TABLE 3. Industrial Output Compared to 1989, 1990–1993

(1989 = 100)

Measure	1990	1991	1992	1993
Industry output total	76	59	46	47
Electric and thermal energy	76	63	58	60
Coal mining and preparation	60	50	57	58
Petroleum and gas extraction	88	75	72	73
Metallic ores mining and preparation	67	51	48	48
Other extraction activities	92	69	NA	NA
Oil, coke, nuclear fuel processing	77	49	44	44
Chemicals and chemical fibers	78	57	50	52
Rubber and plastics processing	72	52	37	39
Other non-metallic minerals	62	48	NA	NA
Metallurgy	72	52	36	38
Metal structures and products	62	52	36	33
Machines and equipment	89	58	43	37
Means of road transport	75	56	40	50
Other transport means	70	53	42	47
Computers and office machines	73	45	33	24
Electric machines and appliances	100	71	47	50
Radios, TV, communication equipment	66	59	36	40
Optical, watches, instruments	66	53	38	38
Furniture and other	87	82	68	87
Wood industry (excluding furniture)	74	56	46	41
Pulp, paper and cardboard	70	48	36	33
Food and beverages	81	65	54	47
Tobacco products	78	75	75	65
Textiles and textile products	77	65	45	44
Clothing of textiles, fur and leather	74	65	47	44
Leather goods and footwear	80	67	48	47

Sources: *Anuarul statistic 1992*; *Informatii statistice operative: Industrial in anul 1992*; *Monthly statistical bulletin* 12/1993; and *Revista Romane de Statistica*, 2:1994. Data are not adjusted for changes in working days.

NA = Not available.

AGRICULTURAL PERFORMANCE

Because of the more decentralized nature of the production process, more privatization has taken place in agriculture than in industry. Nevertheless, incomplete and confusing institutional change has seriously constrained a much more positive response of Romania's peasants to market opportunities.[9] Despite a significant disruption of farm supplies and technical services, mostly due to the unconstrained monopolies of the regional-rural nomenklatura, gross output in 1993 was about 96 percent of that in 1989 (see table 4). Probably serious amounts of output, especially consumption by farmers, has escaped the official statistics.

[9] David C. Henry, "Reviving Romania's Rural Economy," *RFE/RL Research Report* (18 February 1994).

Both the declines of output in 1992 and the rise in 1993 reflect continued sensitivity of agricultural output to unstable regional climate. There is a need to increase the effectiveness of irrigation and to provide more drought-resistant crops. It is unfortunate that severe drought has again been reported in the first months of 1994.

TABLE 4. Agricultural Performance Compared to 1989, 1990–1993

(1989=100)

Measure	1990	1991	1992	1993
Gross agricultural output	97	98	85	96
Crop output	93	97	83	NA
Animal products	102	98	88	NA
Grain output	93	105	67	84

Sources: National Commission for Statistics, *Social Situation and Economy of Romania in 1992*, Bucharest, September 1993; *Anuarul statistic 1993*; *Romania Economic Newsletter*, 4:1 (April-June 1994); and *Revista Romana de statistica*, 2:1994.

FOREIGN TRADE PERFORMANCE

Overall Trade Performance

As shown in Tables 1 and 5, the extent of decline in foreign trade depends on what exchange rate one should use to convert rubles into dollars. At a rate of 2.62 rubles per dollar, total imports in 1992 would equal total imports in 1989, while total exports in 1992 would be 56 percent of total exports in 1989. By 1993 virtually all foreign trade is denominated in convertible currencies. By then total dollar exports dropped to 75 percent of 1989 rates, and total dollar imports jumped 50 percent.

The first year of transition saw a massive turnaround in Romania's dollar trade balances of over $4 billion as forced exports were stopped and large imports of energy and food were undertaken in order to correct the distortions of Ceausescu's policies and to seek political favor of the people. Because initially there were no foreign debts, the country could afford the negative current and foreign trade balances. By 1993 the deficits are at a level that could be financed with foreign assistance and investment flows if the government can manage stability and push reforms at the same time.

The Commodity Composition of Trade

In terms of the overall composition of exports (table 6), Romania has been a heavy importer of petroleum (as attested by "mineral products") for both energy and petrochemicals and has exported both. Recently the heavy concentration of imports has been reduced and, although absolute exports have also fallen, export shares combining both mineral and chemical products have remained constant.

Relatively high shares of trade are also found in machinery, electrical, and transportation equipment, although a decline of Council for Mutual Economic Assistance (CMEA) markets probably has accounted for the reduced export shares. Export shares in textiles

TABLE 5. Changes in Ruble and Dollar Foreign Trade and Balances, 1989–1992

(Million Currency Units)

Year	Exports		Imports		Balances			
					Trade		Payments (dollars)	Debt[a] (dollars)
	Ruble	Dollar	Ruble	Dollar	Ruble	Dollar		
1989	4,641	5,990	5,126	3,471	–485	2,519	1,324	174
1990	2,699	3,502	4,437	5,223	–1,738	–1,721	–1,646	230
1991	830	3,537	574	5,298	256	–1,761	108	1,143
1992	89	4,286	143	5,433	–54	–1,147	138	2,354
1993	[b]	4,527	[b]	5,239	[b]	–712	168	3,334

Sources: Comisia nationala pentru statistica, *Informatii statistice operative, Seria C: Comert*, various issues; *Romania Economic Newsletter* (April-June 1994).

[a] FOB/FOB basis.

[b] Trade in rubles negligible.

and clothing have been maintained, but with an increasing import dependence.

Export shares in agricultural, food, and tobacco products are unusually low, reflecting the country's difficulties inherited from the Ceausescu years. Finding supplies that could not be produced in transition agriculture has also accounted for higher import shares in this area.

The Geographical Distribution of Trade ,

Statistics on the geographical distribution of trade are highly sensitive to the assumed exchange rates between the ruble and the dollar. Official Romanian data, which overvalue the ruble, show that shares of Romanian exports going to both the EU and the former Soviet Union increased slightly from 1988 to 1991. These reflected reduced shares to other CMEA countries and the rest of the world. In 1992 export shares of both the EU and the former Soviet Union fell. The EU share in the first nine months of 1993 was 36 percent. Export shares to developing countries rose, suggesting that Romania might yet win back some former markets on the basis of price discounting. In fact, in the first nine months of 1993 China replaced Germany as Romania's most important export market.

Romania has been exporting smaller shares to the United States possibly reflecting the loss of most-favored-nation (MFN) status plus greater market opportunities with the EU. These shares should rise as a consequence of the recent restitution of MFN. Romania import shares from the United States have been rising.

In 1993 Romania's three most important trading partners were, in exports, Germany (13.9 percent), China (9.1 percent), and Italy (8.0 percent). In terms of imports most important were Germany (15.9 percent), Russia (12.7 percent), and Italy (9.5 percent). See table 7 for Romania's import and exports by geographical area.

TABLE 6. The Commodity Structure of Romanian Exports and Imports in Terms of Two-Digit Harmonized System Classification, 1990–1992

(annual share, in percent)

	Classification	1990	1991	1992
Exports				
I.	Live and animal products	0.4	3.7	4.3
II.	Vegetable products	0.7	1.6	1.2
III.	Animal and vegetable fats, oils	0.0	0.1	0.2
IV.	Food products, beverages, tobacco	0.4	0.9	1.1
V.	Mineral products	19.4	14.3	13.3
VI.	Chemical products	5.1	6.9	9.7
VII.	Plastic and rubber materials	1.8	1.3	2.0
VIII.	Hides, furs, etc	0.6	0.5	0.6
IX.	Wood, charcoal, fibre products	3.1	2.8	3.6
X.	Pulp, wood fibres, paper wastes	0.6	0.5	0.4
XI.	Textiles and products	9.8	9.0	10.6
XII.	Footwear, umbrellas, ties, etc	2.2	1.9	1.7
XIII.	Items of stone, cement, plaster	1.3	1.8	2.0
XV.	Metals and metal products	16.2	15.4	17.1
XVI.	Machinery, electrical, electronics	16.1	13.3	10.8
XVII.	Transportation equipment	13.1	9.8	10.4
XX.	Miscellaneous goods and materials	7.0	9.5	8.5
Imports				
I.	Live and animal products	3.5	0.8	1.5
II.	Vegetable products	4.0	6.8	7.3
III.	Animal and vegetable fats, oils	0.5	0.3	0.7
IV.	Food products, beverages, tobacco	4.3	6.6	7.4
V.	Mineral products	42.4	48.2	32.0
VI.	Chemical products	7.2	7.5	7.0
VII.	Plastic and rubber materials	1.0	1.4	3.0
VIII.	Hides, furs, etc.	1.0	0.3	1.3
IX.	Wood, charcoal, fibre products	0.8	0.6	0.6
X.	Pulp, wood fibres, paper wastes	0.5	0.7	1.5
XI.	Textiles and products	2.9	4.5	9.5
XII.	Footwear, umbrellas, ties, etc.	0.2	0.8	0.7
XIII.	Items of stone, cement, plaster	1.2	1.3	0.9
XV.	Metals and metal products	5.7	4.3	4.6
XVI.	Machinery, electrical, electronics	14.5	10.0	15.3
XVII.	Transportation equipment	7.0	2.3	2.9
XX.	Miscellaneous goods and materials	0.8	0.5	0.9

Sources: Comisia nationala pentru statistica, *Anuarul statistic al Romaniei, 1991, 1992*; *Romanian Economic Newsletter*, April-June 1993; Comisia nationala pentru statistica, *Romania in cifre*, 1993.

Trade with the European Union

Romanian import shares from the EU increased significantly from about 14 percent in 1988 to 43 percent in 1993. This appears to have come from significant declines in the import shares of the former Soviet Union and other CMEA countries.

Thus far there has been little tendency for Romania to shift exports from the former CMEA countries to the EU. In 1992 the shift

TABLE 7. Geographical Distribution of Romanian Exports and Imports, 1988 to 1993

(Percentage)*

Classification	1988	1990	1991	1992	1993
Exports					
EU	28.5	31.4	34.5	32.5	38.7
EFTA	3.2	3.6	5.0	5.6	4.7
Japan	1.3	1.6	2.1	1.3	1.1
USA	NA	5.8	3.0	2.0	1.9
Total OECD	41.4	45.8	44.1	44.2	48.2
Total Transition countries	NA	NA	28.7	24.0	NA
Total Central and Eastern Europe	NA	32.6	23.9	14.9	NA
Former USSR countries	21.7	25.2	27.0	NA	NA
Former CMEA countries	11.4	9.1	8.6	NA	NA
Developing countries	NA	NA	17.7	27.1	27.8
Other Countries	25.5	19.9	20.3	NA	NA
Imports					
EU	13.8	19.7	27.5	37.5	42.5
EFTA	1.3	3.9	6.0	6.5	5.7
Japan	0.7	0.8	1.2	1.2	0.7
USA	NA	2.8	3.2	3.8	4.9
Total OECD	20.8	31.3	38.2	51.1	57.3
Total Transition countries	NA	NA	25.4	24.9	NA
Total Central and Eastern Europe	NA	28.3	24.3	23.1	NA
Former USSR countries	31.6	23.6	19.3	NA	NA
Former CMEA countries	15.7	12.1	8.8	NA	NA
Developing countries	NA	NA	30.3	22.8	17.8
Other countries	31.8	33.0	33.7	NA	NA

Sources: Comisia nationala pentru statistica, *Informatii statistice operative, Seria C: Comert*, various issues; *Monthly Statistical Bulletin* (December 1993).

*The dollar and ruble trade have been converted to a common base using official exchange rates.

was more from the former CMEA to developing countries. Yet Romania has shifted sources of imports from the former CMEA countries to the EU.

In terms of EU data, Romania's significant export surplus with the EU in 1988 and 1989 shrunk dramatically in 1990 and 1991; then it turned into a deficit in 1992. Exports fell in 1990 while imports rose. In 1991 both exports and imports rose slightly (although the opposite shift shows up in Romanian data). In 1992 exports rose slightly and imports rose quite a lot.

In 1991 Romania's trade statistics shifted to the Harmonized System so that Romania is in accordance with the shares of its exports and imports with the EU in the system's broad categories. The EU has taken roughly 30–33 percent of total Romanian exports since 1989, with shares of 50–60 percent for footwear, cement, textiles and clothing, hides and furs, and food products. While the share of total Romanian exports going to the EU has not risen, the share of total imports from the EU has jumped from 13 percent in 1989 to 38 percent in 1992. The EU's share is 60 percent or more for transportation equipment, footwear, textiles and clothing; and over 50 percent in food products.

In terms of commodity structure, more than 40 percent of Romania's exports to the EU in 1992 were in textiles, footwear, and clothing (NACE 43, 45). Another 20 percent of exports were wood products (furniture). On the import side, large shares of chemicals are being replaced by large shares in mechanical engineering, as the country attempts to redress distortions of the former regime. Food imports have been important for the same reason, especially in 1990. In 1991 textile import and export shares were almost the same (6 percent and 8 percent, respectively), but now the share of textile imports from the EU is higher than the share of textile exports to the EU.

In 1991 Romania had the largest share of its exports to the EU subject to quota restrictions and the highest average MFN duty rate. In both cases, average EU protection was up from 1990 and earlier years.

The trade barriers of the EU have been changed by the European Agreements; Romania's was initialled 17 November 1992 and put in force from 1 May 1993. Romania has the dubious distinction among the countries with such agreements of having the largest share of its 1992 exports to the EU fall into categories of industrial commodities for which market access will continue to be restricted after the agreement comes into force (May 1993). In addition, Romania has the largest share of exports in textiles, which will continue to face both duties and quotas.

In both 1991 and 1992 Romania's exports that perform well often fall into medium and highly protected groups in the EU. There was a shift, however, from low protection to high protection, partly because wooden furniture (low protection) lost some of its export shares and clothing (high protection) gained export shares.

More than 60 percent of Romania's exports in 1991 were in commodity areas that are labor-intensive in the EU. In 1992 the labor-intensive share rose to 65 percent. Romania's exports "perform better" in terms of coverage ratios when those commodities in the EU are labor-intensive. Also, coverage ratios are negatively correlated with commodities that in the EU are skilled labor-intensive (strongly), R&D content-intensive, and capital-intensive. Romania appears to overcome EU trade barriers with commodities that are labor-intensive and to a lesser extent, energy-intensive.

TRANSITION REFORMS AND POLICIES

Tight central controls over Romanian industry were weakening in 1989 and were abandoned in 1990. Successive governments, nevertheless, have continued to try to direct the economy with both formal and informal measures. At the same time, the increasingly autonomous forces in the economy are far from the competitive market forces in both product and factor markets. The economy is surely highly distorted. The greatest sources of price distortions are the lack of competition in domestic markets and continuing extensive control of prices at the producer and wholesale levels by the government. This is both a structural problem and a behavioral problem. Also, the uses of informal means to shift capital funds among units in the sector of state-owned enterprises obliterates the effects of market transactions on the financial accounts of enterprises.

PRICE POLICY

According to a recent World Bank report, "Continued high rates of inflation combined with ad hoc government price intervention, distort relative prices, so that they no longer reflect domestic scarcity costs or relative prices in the international market."[10] One could add that prices are further distorted by the lack of financial control and domestic competition.

Decontrol of wholesale and retail prices began in November 1990 and has been modified several times since, as shown in table 8.

TABLE 8. Price Liberalization Measures: Percentage of All Goods Transactions in Each Category, Selected Dates, November 1990–November 1991

Measure	November 1990	April 1991	July 1991	November 1991
Wholesale prices				
Control of the Ministry	47.7	0.0	30.8	29.2
"Free" prices	52.3	30.0	69.2	70.8
Retail prices				
Fixed prices	12.6	12.8	13.1	12.4
Controlled seller's margin	25.0	25.0	50.0	30.0

Source: Information of the Ministry of Economy and Finance in GATT, *Romania Trade Policy Review*, vol. 2.

The measure of November 1991, Decision 776, was issued at the same time that exchange rates were devalued and unified (see below). The action provided considerable government influence in price setting. The major provisions are as follows:

- Price maximums are set for 24 industrial goods according to the relevant international price at the exchange rate prevailing at the time. No provision is made for adjustment in case of changes in the exchange rate.
- The Ministry of Agriculture is given authority to establish state procurement prices for cereals and livestock.
- Price changes for more than 100 goods produced by fewer than three producers are subject to approval by the Ministry of Economy and Finance or by another designated authority.
- Prices of all goods must be registered with the Ministry and a 90-day notification of price changes is required (subsequently reduced to 30 days).
- A 30 percent limit is placed on margins above wholesale costs.

The effects of price controls must be seen in combination with other market distorting measures, especially import restrictions and tariff measures.

Available information on relative wholesale prices in industry is presented in table 9. It shows some large relative price changes. Such relative shifts at lower levels of disaggregation would be even greater. *A major issue is the extent to which relative price shifts*

[10] World Bank, *Romania Economic Report*, March 29, 1993.

have reduced or increased price distortion in the Romanian economy.

TABLE 9. Wholesale Price Indexes in Industry Compared to 1989, 1990–September 1992

(1989=100)

Industry	1990	1991	September 1992
Total industry	128.8	431.6	1,251.3
Food and beverages	115.2	343.0	1,234.3
Textiles	124.5	355.9	936.9
Clothing	115.3	272.8	742.2
Leather and footwear	145.1	415.9	1,276.9
Wood products	137.9	523.5	1,469.6
Pulp and paper	143.5	670.3	1,813.2
Crude oil processing	143.6	592.6	2,254.4
Chemical industry	128.8	471.3	1,277.7
Metallurgy	125.7	490.0	1,642.7
Machinery and equipment	120.7	372.0	1,290.4
Power and heat	130.1	599.2	1,701.8

Source: *Buletin Statistic Trimestrial*, 1992:3.

There has been an important correction of the underpricing of energy and industrial raw materials, which was characteristic of the former regime. Energy prices have risen about 3 times more than prices of foods and consumer goods. Also, the prices of most other industrial goods have risen faster than those for machinery. Thus, while machinery, foods, and consumer goods have faced more cost pressure, they would also be more attracted to export markets. The large devaluation of the *leu* also stimulated exports of these goods.

WAGE CONTROLS AND INCOME POLICY

The old system of detailed wage fixing was in effect until February 1991. At that time, Law 14/1991 introduced annual contract bargaining between workers and management. Free negotiations applied only to privately owned (majority) companies. State-owned companies, i.e., most of those in industry, were still subjected to a complicated constraint of income policy. Allowable wage increases were referenced to base occupational groups, and any wage increases greater than those brenchmarks were heavily taxed.

Since January 1992 the system was simplified to encourage elimination of excess labor (at that time the unemployment rate rose rapidly). Overall wage bills of enterprises in excess of stated limits are taxed between 20 percent and 500 percent. The allowable increases are linked to changes in the prices of subsidized goods, plus a formula linked to the consumer price index. Indexation was 50 percent from November 1991 to November 1992 and 65.5 percent thereafter.

TAXES AND SUBSIDIES

In July 1990 the former system of mandatory profit remittances to the budget and highly variable turnover taxes was changed to more market-oriented systems. The main direct taxes are a variable profits tax (rates of 30 percent and 45.5 percent) and income tax. Profit tax reductions are granted for new companies, reinvested income, and foreign investments. The direct tax system does not appear to distort markets in any unusual way.

The main indirect taxes are a turnover tax of up to 30 percent and a wholesale-level excise tax of up to 70 percent. The 1992 rates of the excise tax varied from 25 percent to 60 percent. A value-added tax was introduced in the summer of 1993.

The excise tax is paid on both domestic and imported goods, the latter on the basis of import value plus duties. It is market distorting in a few cases where items are not provided domestically, such as automobiles having an engine over 1500cc or color TV sets with wireless remote controls.

Three categories of commodity subsidies are applied to extractive industries for strategic purposes, consumer goods for social purposes, and other products as a consequence of price regulation.

Most subsidies on consumer goods have been phased out. They were reduced by 25 percent in May 1992; differentiated reductions were made in September 1992. Remaining cuts were made in May 1993.

Subsidies in the extractive industries are not scheduled for reductions. According to principles announced by the government, such subsidies were to be applied strictly according to product.

The budgeted sums available to industry were only 3.7 percent of the reported value of industrial output in 1991. Nevertheless, larger off-budget subsidies have also been available through the foreign exchange system and the system of finance.

FOREIGN TRADING AND EXCHANGE SYSTEM [11]

In February 1990 the former foreign trade monopoly was abolished and the dual exchange rate both unified and devalued (from 16 to 21 *lei* to the dollar). Trade licenses were issued automatically; most quantitative controls were removed; and for imports controls were replaced with a low tariff (see below). By the end of 1992 the number of licensed traders increased to about 30,000, including many large companies that trade on their own account. Still, most trade in machinery and industrial materials remained in the hands of state-owned companies.

Since then the main impediment to reducing market distortions through the foreign trading system has been the shortage of foreign exchange brought on by an awkward, often changed foreign exchange regime. This became evident under the new system when the combination of fixed rates and domestic price controls led to excess demand and a rapid depletion of foreign exchange reserves.

In November 1990 a dual exchange rate was introduced in which an official rate of 35 *lei* to the dollar was applied along side a commercial interbank rate that was supposed to float. Exporters were

[11] The custom tariff and quota system is described below.

required to surrender 50 percent of their proceeds at the official rate to the State Currency Fund which financed imports of basic food and energy at that rate. The official rate fell to 60 *lei* to the dollar in April 1991, while the commercial rate fluctuated from 180 to 225 *lei* to the dollar. The desired stimulus to exports is said to have been diminished by the expectation that all foreign exchange receipts would have to be surrendered before the end of the year. Exporters were encouraged to understate export receipts in order to hold unrecorded foreign currency accounts.

A year later in November 1991 the dual rate system was dropped. In January the unified exchange rate was devalued to 180 *lei* to the dollar and all foreign exchange accounts and receipts were required to be surrendered. A new rate would be set by daily interbank auctions managed by the National Bank. An effort to divert more foreign exchange by exporters is suggested by the 66 percent increase in exports in December 1991.

In 1992 the unified exchange rate should have eliminated the off-budget subsidies to food and other raw material imports since the exchange rate would henceforth be passed on into import prices. In practice, however, price adjustments were delayed by Decision 776 (see above) while liquidity pressures increased on many enterprises. In any case more quantity rationing of foreign exchange was reported, while exporters increased efforts to divert proceeds abroad.

In May 1992 exporters were once again allowed to retain 100 percent of their foreign exchange earnings in the banks. Daily auction and exchange institution rates were restricted to adjustments of 5 percent and 2 percent, respectively. Even then, however, rates were sometimes kept unchanged in the face of excess demand. Later in the autumn, the minimum required to enter the auction market was lowered and the 5 percent adjustment restriction lifted.

Despite some immediately favorable effects on reserves, later in 1992 reserves again fell. Large spreads also developed between the auction rate and the open rate, reaching 30 percent, even though the rate fell to about 450 *lei* to the dollar. By October 1993 official rates fell to more than 1000 *lei* to the dollar, while street rates went over 1,800 *lei*. Since April 8, 1994, under pressure from the IMF, restrictions on convertibility for current account purposes were lifted to allow banks and companies to freely buy and sell foreign exchange. Combined with the National Bank's effort to tighten monetary policy, this appears to have brought about unification of the official and black-market rates and stopped the fall in the *leu* at about 1,650 per dollar.

ROMANIAN IMPORT BARRIERS

With the transition from the former system of state trading monopolies and centrally determined import-export quotas, a relatively liberal import customs tariff, based on the CCCN (Customs Co-Operation Council Nomenclature), came into effect in early 1990. Because of the combined effects of the many other distortions in the Romanian economy it is doubtful if the duty rates were ever a factor in determining whether goods were imported.

A new and current tariff was introduced on January 1, 1992. It is based on the Harmonized Commodity Description (HS) and comprises 5,018 positions at the six-digit level. Duties, which are ad valorem, are provided in one column that are applicable on an MFN basic country, with columns for the EU, European Free Trade Association (EFTA), and GPS Generalized Preference Scheme (tariffs) situations. When weighted according to 1991 imports, the average duties in former schedules were about 7 percent compared with a higher 11.7 percent under the new schedules. As would be expected, the duty levels are also escalated according to degree of processing. The highest duty rates are for tobacco, textiles, clothing, musical instruments, photographic supplies, and footwear.

Notable exemptions are provided in the case of foreign capital contributions in kind, as well as raw materials and subassemblies necessary for commercial companies with foreign investment. Also, in 1992 temporary duty reductions were introduced on an MFN basis for 2,271 commodities (at the six-digit level). According to the General Agreement on Tariffs and Trade (GATT), about 45 percent of imports in value terms benefited from these reductions in 1992. In addition, some 45 commodities received duty exemptions on the basis of a tariff quota. Differences between statutory rates and average applied rates are usually small for finished products and increase for raw materials. They are also large for machinery items, suggesting the patterns of exemptions favoring investors.

There were no other import quotas and no application of minimum import prices. There were two cases of surcharges to the normal rates. Beginning August 1992 a fee of 0.5 percent of both exports and imports was levied in order to provide funds to modernize the customs system. A temporary safeguard surcharge was applied on 23 items, which was to be discontinued at the end of 1992.

Romania carries on some trade with the former Soviet Union on the basis of bilateral (barter) trade. In 1991 this amounted to just over $147 million. Some trade on this basis was also conducted with the former Yugoslavia, but has been embargoed.

In the case of government procurement, the only official preference granted to domestic suppliers is in the case of tenders based on World Bank credits, for which a 10 percent preference is allowed.

Quotas, antidumping, countervailing duties, and restrictions for balance-of-payments reasons were permitted, but not practiced by Romania at the time of the GATT report.

THE FINANCIAL SYSTEM

The former National Bank was broken into central bank and commercial bank components in December 1990. Among the commercial banks are new private banks, of which two were organized in 1991. Also, banks outside Romania have been allowed to engage in domestic currency transactions since early in 1991.

Financial transfers are probably the source of the greatest distortions in the Romanian economy. Although interest rates were liberalized in April 1991 there was little response, partly because commercial banks had access to cheap money from the State Savings Bank. They practiced selective credit rationing to favored clients. According to a report by the consultants, McKinsey & Co., the economy suffers from "massive cross-subsidization between different companies and sectors, a lack of financial discipline, and an inadequate circulation of foreign exchange."[12]

Early in 1992 deposit rates started to rise, reaching 70 percent, but the State Savings Bank continued to provide funds at 50 percent. Still, most enterprises have been hard pressed and many have simply stopped paying suppliers and the banks. At the same time, neither suppliers nor the banks have found it in their interest to use the credit laws to foreclose on assets, because to do so would mean collecting mostly worthless debt. By the end of 1991, gross credit arrears reached 40 percent of enterprise turnover (and enterprises listed credit and financing as their major problem).[13]

At the end of 1991 the government and the National Bank arranged what was supposed to be a one time "global compensation," which allowed commercial banks to extend credit in order to liquidate company arrears, with such credits secured by the state or by the assets of the debtors. The immediate effect of the compensation program was to reduce arrears to 25 percent of their former level. Also, there was an attempt to increase credit discipline. Nonetheless, the basic problems of falling production and unrestructured companies remained, so arrears rose by mid-1992 to 25 percent of turnover. By September, however, inflation appeared to have reduced debt-stock values relative to turnover so that the ratio fell to about 15 percent.[14]

THE CAPITAL FUNDS

As part of its privatization program, the Romanian government established a State Ownership Fund (SOF) that will hold 70 percent of the shares of former state-owned companies. Its task is to privatize most of them over the coming years. The SOF will be autonomous from the government in the same way as the National Bank and largely self-financing. This means that it will be able to use funds from the sale of companies and from profits paid to undertake restructuring and subsidization of existing companies.

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[12] As reported in *Finance East Europe* (August 5, 1993).

[13] According to a Romanian survey of enterprises in 1991, the chief reasons for the decline in output, according to enterprises themselves, were as follows:

Financial difficulties	40%
Raw materials shortages.	
Domestic stocks	15%
Imports	16%
Energy shortage	10%
Shortage of demand	7%
Shortage of production capacity	1%
Other reasons	11%

At the end of 1991 stocks of industrial products rose to 227.4 billion *lei*, 107.9 percent of 1990 levels. This compared to a GDP in industry of 973.1 billion *lei*, or 23 percent. That is a large "product overhang" that could be dumped on foreign markets. Also, there was 162.5 billion *lei* in unhonored contracts, including 36.3 billion *lei* for exports by foreign customers, probably mostly in the former Soviet Union. We assume that the major reason for financial difficulties, given that "shortage of demand" is less of a problem, is that Romanian companies are not being paid for goods delivered or orders supplied. This suggests that customers either have no cash funds or cannot obtain credits. Also, the inability to find sound buyers may indicate that Romanian companies have customers only because they do not ask for payment. Shortages of raw materials and energy may also indicate that companies simply do not have the means of payment necessary.

[14] Tom Hoopengardner, "Enterprise Arrears in Romania: How to Cope with Unpaid Debts?" *Transitions*, 3:10 (November 1992).

What standards the SOF will use in this regard is still unclear, but it would appear to have substantial powers to distort markets (as well as play favorites in the way companies are being set up for privatization).

There have been unconfirmed reports of "nonprofit foundations" having been set up in order to permit financial transfers among enterprises at a local level. It is believed that these could be used to enable forms of "nomenklatura privatization." The potential for market distortion resulting from this activity is unknown.

INDUSTRIAL CONCENTRATION AND POTENTIAL MARKET COMPETITION

The Transformation Law of 1990 expressed goals of breaking up existing monopolies and of creating competing companies within existing branches of industry. However, there has not been any body set up to enforce competition or oversee mergers, etc. A law of January 1991 (Law 11/1991) does define a series of unfair practices, but a proper competition law is still lacking.

Romanian employment concentration by branches of industry is shown in Table 10. More ample opportunities for emerging competition lie in food processing, textiles, and leather goods.

TABLE 10. Size Distribution of Romanian Companies, by Industrial Categories, May 1992

Industrial Category	Companies, by Number of Employees									
	Fewer than 500 Employees		500–1000 Employees		1001–2500 Employees		2501–5000 Employees		More than 5000 Employees	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Manufacturing	229	2.8	271	8.9	436	31.3	166	25.2	69	31.9
Textiles	35	3.9	67	16.6	87	44.2	25	27.1	4	8.1
Leather/Footwear	13	2.0	22	9.6	49	45.8	20	37.4	1	5.2
Wood processing	7	1.4	2	0.8	12	13.1	8	16.5	3	68.1
Pulp-paper	NA	NA	5	11.7	10	44.9	4	43.4	NA	NA
Crude oil	3	2.9	1	2.1	3	13.4	2	23.4	3	58.3
Chemicals	15	2.8	11	5.3	35	37.0	7	14.0	10	40.9
Plastics-rubber	12	6.9	10	13.7	14	38.9	6	40.6	NA	NA
Metallurgy	7	1.0	7	3.0	24	20.8	11	19.5	9	55.7
Machinery	20	1.9	38	8.7	55	26.6	23	24.9	14	37.8
Metal products	9	2.3	19	14.2	24	43.7	10	32.2	1	7.7
Electronics-optics	10	1.0	7	2.3	31	21.1	16	23.9	9	51.7
Transport equipment	14	2.1	10	3.2	20	15.3	18	27.2	13	52.1
Glass-construction materials	12	2.5	32	16.1	43	49.5	8	21.5	2	10.5
Other	72	11.7	40	23.4	29	41.0	8	23.9	NA	NA

Source: *Romanian Economic Newletter* (July–September 1992).

As Table 11 shows, since 1989 significant deconcentration in the three Central European countries has taken place. A general comparison of the size structure of Romanian SOEs with those of Czechoslovakia, Poland, and Hungary shows that the Romanian government has done less to deconcentrate (which is probably seen as undesirable neoliberal policy by the Romanian president). Concentration measured by employment in May 1992 resembled that of Czechoslovakia in 1989.

TABLE 11. Comparison of Employment Concentration between Romania and Central Europe, Selected Dates, 1989–1992

(Percentage Share of Total Employment)

Country and Date	Employment Size (Number of People)				
	Fewer than 500	500–1,000	1,001–2,500	2,500–5,000	More than 5,000
Romania—Manufacturing Industry SOEs[a]					
May 1992	19.6	23.1	37.2	14.2	5.9
Czechoslovakia—Total Industry SOEs[a]					
1989	9.2	19.4	41.3	18.5	11.6
1990	43.4	21.1	24.5	8.2	2.9
1991	49.1	19.7	20.3	7.5	3.4
Czech Republic—Total Industry SOEs					
1991	45.4	21.3	22.3	7.6	3.4
Slovakia—Total Industry SOEs					
1991	56.9	16.4	16.1	7.1	3.4
Poland—Total Industry					
1990, All Companies	72.4	13.4	8.2	4.5	1.5
1990, SOEs	53.6	21.2	14.4	8.1	2.7
Hungary—Total Industry, All Companies					
December 1990	90.6	9.4	NA	NA	NA
December 1991	95.3	4.7	NA	NA	NA
October 1992	97.0	3.0	NA	NA	NA

Source: Calculated from country statistical reports and Table 10.
[a] State-owned enterprises.

Very large firms with more than 5,000 employees have more than 50 percent of total branch employment in wood processing (three firms with 68 percent), metallurgy (nine firms with 56 percent), and transport equipment (thirteen firms with 52 percent). Also, there is a high concentration of large companies in the oil refining, chemicals, and plastic-rubber sectors of the economy. These sectors have low potential for domestic market competition.

Little is known about informal coordinating structures within sectors or sub-sectors of the economy and the development of competitive management. One can assume, judging from Romania's past, that the potential for informal coordination is high, while the chances of immediately having competitive behavior on the part of the former nomenklatura, who dominate present management, is low. When competition comes, it is likely to be a process, depending on privatization and the role of foreign investors.

The legal framework for privatization in Romania has included the following:[15]

- General enabling of private enterprise in 1990.
- Law 15/1990, which required the conversion of former SOEs into over 6,300 "commercial companies," most of which are joint stock companies with 100 percent state-share ownership and about 800 "regies autonomes" in defense, energy, mining, railways, etc.
- The Privatization Law (Law 58/1991).
- The Foreign Investment Law (Law 35/1991).

The organizational framework for privatization includes the National Agency for Privatization (NAP), the State Ownership Fund (SOF), and five Private Ownership Funds (POFs). The NAP is the main organizational force for privatization, including organizing the sale of "assets" and whole companies and originally having some oversight functions with respect to the SOF and POFs. As the organization of privatization has developed, the NAP appears to have lost power, and the SOF has become the dominant agency.[16]

The rapid increase in small private companies, typical of other transition countries, is seen in table 12. Of the 362,000 reported in October 1992, 188,000 were proprietorships and 174,000 were registered private companies (so-called "commercial companies"). Fewer than than 25 percent had more than 20 employees. Some 70 percent were concentrated in trade and services and only 18 percent were in manufacturing.

According to the latest statistics, on 25 March 1994 the number of proprietorships increased to 217,287, of which 74,037 were family associations and 143,250 were single-person operations. Private "commercial companies" increased to 334,777. At the same time, there were 8,496 "commercial companies" with state capital and 494 "regii autonome" (true government independent companies).[17]

The Privatization Law provides an important adjunct to the formation of new private companies through the provision to sell off "individual assets" of state properties normally at auction by the National Agency for Privatization . Such assets are defined as excess parts of a commercial company that can be separated without affecting the company's main activity. As of January 1994 some 7,841 "assets" had been identified for sale; only 2,921 of these had been sold. They involved 13,353 employees.

The Privatization program focuses on the former SOEs. The SOF has become the ownership agent for 70 percent of the shares of state-owned commercial companies, concentrating on very large companies. Under the law, it is required to liquidate its holdings in seven years.

The POFs manage, as "mutual funds," the remaining 30 percent that has been distributed to citizens under a mass privatization

[15] National Agency for Privatisation, *Privatisation in the Sequence of the Romanian Reform*, Bucharest, April 1993.

[16] The president of the NAP, Aurelian Dochia, resigned in September 1993 protesting about the weakness of his agency and was not replaced until early in 1994.

[17] *Revista Romana de statistica*, 4–5:1994.

TABLE 12. Economic Indicators of the Private Sector in Romania, 1989–1993

Measure	1989	1990	1991	1992	1993
Share of GNP (percent)	12.0	15.5	21.5	28.0	30.0
Active population (percent)	26.7	27.1	34.1	36.6	NA
Share of investment (percent)	1.9	4.3	8.4	10.5	NA
Share of sales (percent)	NA	0.8	21.9	44.9	56.0
Share of retail services (percent)	NA	2.6	6.8	26.0	NA
Share of exports (percent)	NA	0.3	18.5	26.1	29.0
Share of imports (percent)	NA	0.7	14.7	32.3	24.0
Number of enterprises	8,252	109,887	240,716	406,386	NA
Private	NA	99,460	227,455	396,208	NA
State	3,960	4,560	6,105	6,560	NA
Cooperative	4,292	5,867	7,156	3,618	NA
Average rate of profit (percent)	NA	NA	5.0	4.9	NA
State (percent)	NA	NA	4.1	3.3	NA
Private (percent)	NA	NA	16.0	11.5	NA
Joint (percent)	NA	NA	8.7	12.2	NA
Number of joint ventures	NA	1,551	8,095	12,156	NA
With over $1 million capital	14	34	61	NA	NA

Source: Government of Romania, *The Governing Programme: Strategy for Economic and Social Reform*, Bucharest, March 1993.
NA = Not Available.

program. The POFs are located in five different cities in Romania and are semi-specialized by branch of industry (some branch holdings are assigned to all five). Also, their focus is more on medium-sized companies.

Under the "mass privatization" program "certificates of ownership" have been distributed to more than 15 million Romanians. Each certificate has five coupons or claims on each of the five POFs. The coupons can be sold for cash or invested in a POF or one of its constituent companies. The certificates can be offered, for example, for up to 30 percent of a company in a management-employee buyout (MEBO), which has been the most common form of privatization so far.

As might be expected, the privatization program has not been easy because of problems both in the lack of Romanian expertise for such activity and in the combination of difficult economic conditions and company structures. Beginning in the summer of 1992 a PHARE-assisted program (Poland-Hungary Aid for Reconstructing the Economy) supported the effort by Western consultants to evaluate the first companies. The operation of the five POFs is now assisted on a bilateral basis by five different Western countries (Germany, Holland, the United States, the United Kingdom, and France).

By the end of January 1993 only sixteen companies had been privatized from a list of thirty candidates. Of these, eleven were MEBOs and five were outside investors, including at least three foreign companies.[18] By April 1993 a total of nineteen companies

[18] *Romania Economic Newsletter* (January–March 1993), and *Privatisation in the Sequence of the Romanian Reform* provide lists of the companies.

were privatized. By August only three more had been sold, including one more foreign investor.[19] By branch, they included: seven in construction; one in design-construction; four in agricultural, meat, or vegetable processing; one, brewery; one, printing; two, furniture; three, clothing; one, ceramics; and one, foreign trade. They employed some 19,000 persons.[20] Recently the SOF claimed that 292 companies with 80,575 employees had been privatized from December 1992 to January 1994.[21]

Privatizing existing state assets is clearly going very slowly. Also, the participation of foreign investors in privatization is rather limited (only three companies up to the summer of 1993). By contrast, the number of joint ventures set up in Romania is very high. By April 1994 there were reported 31,816 companies (compared to 23,706 a year earlier), with social capital of $820.9 million ($642 million the previous year) (not actual foreign asset contributions). The investors expending the most funds were the Italians, and the Germans had participated in privatizing the largest number of companies.

It is still too early to identify the foreign role in the country. In the case of the low interest in privatizing existing assets, *one must ask whether foreign capital is not attracted or is it being pushed away by the Romanian government as part of a policy of reserving some companies for domestic control?*[22] Probably the best arrangement for the Romanian managers is to be able to acquire shares and jobs in companies that initially will receive large doses of foreign capital and management.

INDUSTRIAL RESTRUCTURING

The decline in capacity utilization rates means all sectors of the Romanian economy have some facilities that are virtually unused and some have large shares so idled. Nevertheless, in many cases employment subsidies are still paid, sometimes through the credit system, including interenterprise credits.

In July 1993 the government set up a Restructuring Committee, which then selected 30 large SOEs to study for restructuring with international assistance. A restructuring agency was decreed on January 24, 1994; it has expanded the list by more than 200 other enterprises. The restructuring effort, which is included in the IMF conditions, will have international financial and technical assistance.

CONCLUSIONS

Romania inherited especially difficult structural distortions from the Ceausescu years. The other special condition of Romania arises from the widely perceived view that successive governments have

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[19] *Finance Eastern Europe* (19 August 1993).

[20] The numbers reported by the Western business publications are always confusing, perhaps because confusing information is given to them. *PlanEcon Business Report* reported 1 September 1993 that the SOF had sold its first company and then on 29 September reported that it had sold 97 companies so far in 1993.

[21] *Romanian Economic Newsletter* (January–March 1994).

[22] It should be remembered that in the 1920s Romania was the originator, even before Mexico, of "nationalization" policies requiring minimum participation norms for Romanian capital, management, and technical manpower under the former National Liberal Party, a party more nationalist than liberal. The middle- and upper-level cadres of the former communist regime, who are now in power, might push to become the new capitalists.

not made a clear political break from the communist past. No authentic opposition party has come to power, which could thoroughly vet the past of political officials and challenge the managerial and bureaucratic nomenklatura, as has been the case in other transition countries. The tone of Romanian policy is usually set by the President, who, in a case that typifies his attitudes, at a recent gathering in Bucharest of an association for private enterprise, stressed the dangers of speculation and the need of the state to guide the transformation. In this atmosphere and in the face of continuing economic decline, the supporters of real transition among Romania's economists and administrators face great problems. Romania suffers from a lack of political credibility at the highest levels.

On the surface, many laws have been passed and programs put forward to launch a rapid economic transformation program. At the informal level, there is much behind-the-scenes manipulation. Behavior in enterprises changes little. Markets have emerged only at the retail level, where privatization has also been significant. Otherwise, one cannot really speak of markets. Old networks still hold the structures of command and interference in place, and large-scale privatization has barely started.

Comparing Romania's progress in transition reveals that the attempt to have a gradual transition has resulted in large decreases in output and high inflation, even higher than in neighboring Bulgaria. Real private companies of any significance in manufacturing are limited to a few foreign investments. The country still depends on some old foreign partners to a surprising extent, Russia for imports and China for exports. Yet there is little reason for optimism in Romania's chances in 1994. There is a large bill still to pay in the unrestructured and unprivatized state sector.

It remains to be seen if and how restructuring can work. As with other aspects of transition in Romania, the approach is bureaucratic rather than market-oriented. Even though more high paying jobs have been set up in Bucharest and more reasons for getting international assistance created, opposing forces have already appeared. Existing bureaucratic agencies such as the Development Agency and the State Ownership Fund also see restructuring as their territority, that is, access to international assistance and opportunity for eventual wealth acquisition. And some elements of the trade unions and workers are mobilizing publicly against restructuring and privatization. The forces around Iliescu are surely moving to continue to harness any government official who might risk their position with radical reform moves. Romania's economic future is as confused as its political present.

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ECONOMIC TRANSFORMATION IN ALBANIA

By Robert Cohen *

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SUMMARY

Albania had the fastest-growing economy in Europe in 1993. The Albanian economy was the most backward and isolated in Europe until just over three years ago, but the ruling Democratic Party has instituted an ambitious shock therapy economic reform program that has garnered both praise and financial support from the international community. Although it is still an extremely poor country, Albania has made considerable progress on stabilizing its economy and beginning the process of transformation to a market economy. The country still suffers from massive unemployment, but inflation has fallen to one of the lowest levels in Eastern Europe and progress on economic reform has surpassed other Balkan countries. With the government maintaining a consistent reform program, the prospects for continued economic growth are favorable, especially if significant foreign investment flows into the country.

* Robert Cohen is an economist at PlanEcon, Inc.

INTRODUCTION

Before its transition to a market economy, Albania went through almost five decades of self-imposed isolation and economic backwardness. For many years the inefficiencies of the socialist economic system were offset somewhat by considerable economic assistance from the Soviet Union in the 1950s, and in the 1960s and 1970s from China, with whom the government in the capital city, Tirana, sided in the aftermath of the Sino-Soviet split. This patronage provided Albania with substantial external resources, fueling steady periods of growth and permitting significant accumulation of foreign exchange reserves.

Albania went its own distinctive way in the mid-1970s when its authoritarian leadership institutionalized national self-reliance as a guiding tenet of economic policy. In 1976 the government enacted a constitutional ban on external credit, aid, and investment. In 1978 it severed economic and financial relations with China. Albania entered a period of self-imposed isolation and economic autarky. Economic growth decelerated considerably, from nearly 5 percent in the 1970s to an annual average of about 1 percent in the 1980s.[1]

Albania was the last country to succumb to the political and economic transformation sweeping the rest of Eastern Europe. By the time a multiparty coalition government comprised of both communists and reformers was formed in June 1991, the economy was collapsing. Albania's economy, already the smallest in Europe in both absolute and per capita terms, shrank by more than half in 1991. Output of agriculture (the country's largest economic sector) fell 60–80 percent. Inflation in 1991 totalled 104 percent and was around 600 percent in 1992, adding to the chaos and instability in the economy. Albania entered the post-communist world as the poorest and least developed nation in Europe, with a standard of living resembling a Third World country.

Despite the country's mountainous terrain, agriculture remains the most important sector in the Albanian economy. Industry, while built up in certain areas, remains largely undeveloped. Other sectors that might hold promise for the future, such as tourism, were neglected under communist rule.

Albanian economic statistics are now published on a regular basis in the media. The methods of data collection are not clear, so it is hard to ascertain the exact reliability of the figures. There are still a number of areas where little or no information is available, and other published numbers—such as unemployment—that may be questionable. Nonetheless, the increased public access to economic figures, spurred by an independent press, provides a much clearer picture of the Albanian economy.[2]

ECONOMIC REFORM

When the current government, led by President Sali Berisha of the Democratic Party, came to power after winning a landslide vic-

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[1] Mario I. Blejer, et. al., "Albania: From Isolation toward Reform," IMF, Occasional Paper no. 98, Washington, D.C, p. 3.

[2] Table 1, at the end of this paper, lists the main indicators for the Albanian economy from 1985 to 1993.

tory in elections of March 1992, it embarked on a "shock therapy" economic reform program designed to create a market economy. President Berisha, capitalizing on his high level of popularity and backed by a team of young administrators, promulgated an economic reform program that called for tight monetary and fiscal policies; privatization of agricultural land, large industrial enterprises, and small businesses as well as the sale of housing units to citizens; encouragement of the private sector through the elimination of the state's monopoly on foreign trade, and stimulation of foreign investment; price and trade liberalization; and reform of the country's banking and finance sector.

MACROECONOMIC STABILIZATION

One of the major successes of the stabilization policies adopted in mid-1992 has been reining in inflation. Price liberalization began in earnest in July 1992 at a relatively rapid pace, and most prices were freed in the ensuing months. Tighter monetary and fiscal policies, as well as limits on wage increases, reduced the monthly inflation rate, which had reached a high of 45 percent in August 1992, to close to zero during April-June of 1993. Although the monthly rate temporarily increased to 7.8 percent in July, when further liberalization of wheat prices took place, the inflation rate averaged 1 percent monthly for the rest of the year. This impressive record on inflation has been achieved during a period in which further price liberalization has taken place. Annual indicators also reflect the progress made on controlling inflation in Albania. The inflation rate in 1992 was 225.9 percent (calculated by taking the average of the change in retail prices in each month of 1992 relative to the corresponding month of 1991), which gave Albania one of the highest inflation rates in Eastern Europe in 1992. In 1993 the average annual inflation rate was reduced to 85.2 percent, and in 1994 the inflation rate has fallen to 21.6 percent. The final stage of price liberalization took place on April 1, 1994, when the government freed prices of fuels, electricity, drinking water, and telephone services. The population has been fairly accepting of the overall price liberalization policy, with little opposition to the price increases on a national scale.

After inflation, perhaps the greatest achievement of Albania's macroeconomic stabilization policies has been reducing the budget deficits. During 1991 and early 1992, the Albanian government lost control over the country's finances as collapsing revenues failed to keep up with rising expenditures. The size of the country's budget deficit relative to gross domestic product (GDP) skyrocketed from less than 5 percent in 1990 to a staggering 43.7 percent of GDP in 1991. Consumer confidence in the lek currency evaporated in light of the high inflation rates, and Albanians sought to immediately convert any leks they held into dollars or tangible assets such as consumer durables or cars so as to hedge against future drops in the lek's value.

The Albanian government moved in mid-1992 to regain control over the country's internal finances. Subsidies to industry were slashed, payments to idled workers were reduced or phased out, the corporate profit tax was increased from 10 percent to 30 percent, and new excise taxes were introduced. These and other austerity measures were implemented to curtail a budget deficit that already amounted to 20 percent of GDP after the first 4 months of the year and threatened to climb to around 60 percent of GDP for all of 1992. Instead, tough adherence to the austerity measures brought the full-year 1992 budget deficit down to the equivalent of 17.4 percent of GDP.

Albania successfully further restricted further limits on the budget deficit in 1993, cutting it to 11.3 percent of GDP. The government introduced more taxes (including land taxes, new excise taxes, road taxes, and higher customs duties and social security contributions), cut jobs in the national government, further trimmed price subsidies, and tightened eligibility requirements for retirees to receive pensions.

PRIVATIZATION

Albania has made significant strides in small-scale and agricultural privatization, while large-scale privatization has made minimal progress to date. Privatization of agricultural land was carried out in a spontaneous and sometimes violent fashion over the past 2 years. In many cases, peasants simply seized land (sometimes along with the livestock on the land). The resulting disorder adversely affected Albanian agricultural output in 1991 and 1992. Nonetheless, the results of agricultural privatization are impressive. By the end of 1993, 505,000 hectares—94 percent—of the country's total farmland had been privatized. About 425,000 hectares of land that once belonged to agricultural cooperatives were distributed, resulting in the creation of more than 315,000 private farms. Approximately 80 percent of the land of former state farms has also been privatized. The privatization of farmland in Albania is expected to be completed in 1994.

Trade activities, both domestic and foreign, were also liberalized very rapidly. Most wholesale and retail trade is now carried out by private entities; the importance of private foreign trade activity has been rapidly increasing. In the case of wholesale and retail trade, small-scale privatization of shops and stores have not only contributed to an explosion in private sector activity, but have also transformed the appearance of Tirana and other major cities, seemingly overnight. Whereas in early 1992 a visitor to Tirana still found uninviting, dingy state-owned stores with little available for sale, by early 1993 there was a proliferation of private shops that were extremely well-stocked by Albanian standards. Some estimates claim that 30,000 private businesses are operating in Tirana. Most are small individual businesses, but a growing number are joint ventures and foreign private companies. The private sector services industry is also taking off in the country, with more than 500 restaurants and small pubs operating in the capital city.

In retail trade and various services, privatization has also been fairly rapid. By May 1993, 100 percent of retail trade establishments had reportedly been privatized. Wholesale trading enterprises are also being privatized, but this is taking longer than for retail establishments. Privatization of some 500 other small and medium-sized enterprises is expected to be carried out by the Albanian government in 1994.

Large-scale privatization of Albania's factories and other large enterprises has made minimal progress to date. The government's approach to medium- and large-scale privatization has been tempered by a desire to prevent social unrest. Albania has not yet implemented a far-reaching, large-scale privatization program similar to that of the Czech Republic or Slovakia. Nor is one likely, since a good portion of existing industrial capacity seems destined for closure, not for sale to investors—either domestic or foreign. In certain key industrial branches, such as mining, energy, and perhaps chemicals or metals processing, sales to foreign investors are likely. This process, however, will probably take several years and will be closely tied to the process of enterprise restructuring.

ECONOMIC PERFORMANCE

Albania underwent a spectacular economic turnaround in 1993, posting a GDP growth rate of 11 percent. By the end of 1993, the newly privatized agriculture sector was the principal engine of growth for an economy buoyed by coherent economic reform polices. Radical economic reform has paid dividends, as the Albanian recovery has been driven by increased private sector activity in agriculture, retail trade, construction, and transportation, more than offsetting the moribund, state-dominated industrial sector. Strong growth in personal consumption and net investment, aided by large remittances from Albanians working abroad, has spurred the nascent private sector.

In assessing the turnaround in Albania, it must be remembered that, since the fall of the communist regime, the economy suffered a massive economic contraction, far worse than in any other country in Eastern Europe. During 1990–92, Albania's aggregate economic output, already among the smallest in Europe in both absolute and per capita terms, shrank by nearly one-half; industrial output dropped by 75 percent. Total GDP fell 9.7 percent in 1992, coming on top of declines of 10 percent in 1990 and 27.7 percent in 1991, the year of deepest economic crisis. Thus, between 1989 and 1992 Albanian GDP shrank by 42 percent, far greater than the declines witnessed in other East European countries during that period. GDP in 1993 is still one quarter below the 1990 level. Albanian gross national product (GNP, calculated at purchasing power parity exchange rates) totaled just $3.12 billion in 1993, down from a peak of $4.78 billion in 1989. From a level of around $1,500 in 1989, per capita Albanian GNP has plummeted to just over $950 in 1993.

AGRICULTURE

Rapid privatization has made agriculture the dominant sector in the Albanian economy, accounting for 55.8 percent of net material product (NMP) in 1993. Although gross agricultural production fell by 20.9 percent in 1991, agriculture has since become the driving force behind Albania's economic revival. Production increased by 14.4 percent in 1993 compared to 1992; output increased in 1992 by 18 percent. The agricultural sector achieved this impressive growth despite a lack of chemical fertilizers and pesticides, a low level of mechanization and irrigation facilities. The agriculture sector, which accounted for only 35.9 percent of total NMP in 1990, has now almost regained its output level of 1989.

After the centralized administration of agriculture was abolished, Albanian food production changed significantly. Farmers are free to respond to market signals to raise whatever crops that are deemed more profitable. The result has been an increase in the production of crops for consumer markets and a large reduction in the output of industrial crops as a result of the poor state of the textile industry, which once was a large consumer of agricultural raw materials. Food markets throughout Albania are now brimming with vegetables, fruit, meat, and dairy products. Albania should become a net exporter of food products in the near future.

One of the primary reasons for the improved performance by agriculture is the crop sector, whose output increased 20 percent in 1993. Wheat is by far the most important type of grain harvested in Albania, accounting for about 80 percent of total grain production. In 1993, the production of wheat increased 84 percent compared to 1992. Other crops that fared well in 1993 included vegetables, beans, and potatoes. Fruit production also increased significantly, particularly grapes and olives.

INDUSTRIAL SECTOR

Since 1990 the industrial sector in Albania has almost collapsed, declining not only in aggregate terms but also as an overall share of the Albanian economy. In 1993 industrial output fell 10 percent relative to 1992. However, this represented a relatively small decline compared to the staggering 60 percent decline in 1992 and the 36.9 percent decline in 1991.

During 1991 and 1992 the majority of factories in Albania either shut down altogether or operated at a mere fraction of capacity owing to shortages of inputs and loss of traditional markets at home and abroad. Industrial output in 1993 amounted to a mere 22.7 percent of production in 1990. Many of the industrial enterprises in the country have been destroyed or closed down. This extraordinary fall in output has relegated industry to a relatively minor role within the Albanian economy. In 1993 the share of industry in total NMP totalled just 13.8 percent, compared to 41.8 percent in 1990.

The Albania industrial sector is one of the least sophisticated in Eastern Europe, with a heavy bias toward raw materials or manufacturing. Albania is the third largest producer of chrome in the world. Copper is another a major product as well as a leading hard-currency earner from exports. Machine-building accounts for a smaller share of total industrial output (about 15 percent) than in most East European countries. The high share of food processing (over 25 percent) in total industrial output reflects the importance of agriculture in Albania.

Industry is still dominated by state enterprises. Many of them are either closed or are operating at well below full capacity. Restructuring these enterprises should be a fairly high priority, but there has been little to no progress to date because emphasis has been placed on restarting production after the collapse in industrial output in 1991 and early 1992.

ENERGY

Although basically rich in energy resources (especially oil and coal), Albania has been unable to develop its energy potential fully with domestic technology. The country was a net exporter of energy during much of the late 1980s, though net exports typically accounted for less than 10 percent of total consumption during this period.

Oil producers are currently operating at about half capacity. Of all industrial sectors, the oil sector has had by far the best economic performance over the past two years. Albania produced an estimated 550,000 tons of oil in 1993, 5.9 percent more than in 1992. This is substantially less than the 1.067 million tons produced in 1990. The country reached its peak level of production in 1970 at 1.5 million tons. Activity by foreign firms has gained momentum, as many are engaged in prospecting and providing financing and technical expertise to the sector.

Total primary energy production peaked in Albania at 54.8 tbdoe (thousand barrels per day oil equivalent) in 1986 and since then has slid about 40 percent to only 33.4 tbdoe in 1992. After declining by 28.5 percent in 1992, aggregate primary energy production increased 1.5 percent in 1993. Because of lack of restructuring in industry and continuation of old energy consumption habits, energy consumption in Albania has not fallen as sharply as output in recent years. Between 1986 and 1993, total primary energy consumption in Albania declined 30 percent (from 49.0 to 34.3 tbdoe). The much sharper decline in energy output than consumption has resulted in Albania becoming a net importer of energy. In the past, Albania was not only self-sufficient in the production of petroleum products but was also a net energy exporter.

TRANSPORTATION AND COMMUNICATIONS

Reported value-added in the transportation sector increased 13 percent in 1993. This impressive increase comes after three consecutive years of enormous declines in transport activity. Transport was one of the first sectors of Albania's economy to enter recession, declining 20 percent in 1992 and 29.9 percent in 1991. Transport of freight (measured in ton-kilometers) fell about 8 percent in 1989 and then 14.5 percent in 1990, far steeper than the declines registered for other major sectors of the economy that year. In contrast, gross industrial output fell only 7.5 percent in 1990, or at about one-half the rate of decline of freight transport.

Private sector transport activity is growing extremely rapidly in Albania. At the end of 1993 there were 146,876 transport vehicles (trucks and cars) operating in Albania, almost double the total in 1992 and 400 percent more than in 1991. There is now one vehicle per twenty Albanians. Nearly 80 percent of the total vehicles were imported in 1992 and 1993. Most of the increase is accounted for by private vehicles. The number of private cars has risen from virtually nil in the late 1980s to more than 61,000 in 1993. More than 8,000 private buses operated in Albania by the end of 1993. The rapidly increasing private car fleet, in particular, is encountering problems due to the small number of gas stations, the lack of development of an adequate road system, and increased traffic accidents (many of the cars are secondhand and do not meet current Western safety standards). Further indications of the growth of private transport in Albania is its rising share of foreign trade activity as a growing number of Albanians are engaged in transporting goods and passengers by vehicles (trucks, buses, cars, etc.) around the country as well as abroad. Such private activity tends to be organized on a small-scale basis and as such is not fully captured by national statistics. The private sector now dominates intercity and international passenger and goods traffic.

The government has accepted that the transport system is of low-quality and its poor condition is hampering economic development. One of its priorities is to repair the main roads and to build links to the mountainous areas. It is also developing programs to upgrade the rail network, modernize the country's main international airport at Tirana, and expand and improve existing port facilities. Western assistance is being sought for many projects. The European Union and the Italian government have both provided aid for the development of Albania's railways; the World Bank has provided assistance in upgrading the country's road system; and in June 1993 Kuwait announced a $9 million credit to modernize the port of Durres.

CONSTRUCTION AND INVESTMENT

The sector with the single largest growth rate in 1993 was construction; increasing output by 31.5 percent relative to 1992. Construction activity rose by 5 percent in 1992, after suffering a huge 30.4 percent decline in output in 1991. This sector accounted for 9 percent of total NMP in 1993, up from 6.2 percent in 1991.

As with other sectors in Albania, the private sector has driven the recovery in construction, although private firms still account for a small share of total activity. However, in order to alleviate the housing shortage and improve the current housing stock, the government has made plans to enhance the role of the private sector. Legislation has been approved that will rapidly privatize the housing stock. Rents of recently built homes have been deregulated in order to encourage private construction.

Exact figures for investment in Albania are difficult to obtain. Investment was severely affected by the declines in GDP during 1990–92, but it seems to have turned around. Gross investment in fixed capital was slashed by 40 percent in 1991; it is estimated to have dropped a further 20–25 percent in 1992. In 1993 investment increased an estimated 20 percent. Gross investment is still down more than 50 percent from the pre-crisis peak of 1989. During a period in which output of industry and other branches of the economy was collapsing, Albania could not afford to make the investments needed to improve economic performance and rebuild the country's infrastructure. In 1993 most foreign aid flows to Albania were used for investment rather than for food assistance.

CONSUMER WELFARE

While official statistics suggest a decline in Albanian living standards since 1990, the declines have not been as sharp as witnessed in many other East European countries. Real wages (i.e., adjusted for inflation) declined 23 percent between 1989 and 1992, compared with a 25 percent decline in Poland and a 35 percent drop in Slovenia over the same period. In 1993 real wages are estimated to have increased by more than 10 percent. Wages in the state sector still remained quite low in 1993, but the thriving agricultural sector accounted for most of the increase. Similarly, retail trade turnover declined 22 percent in real terms in Albania between 1989 and 1992, but rebounded in 1993 with an estimated rise of 10.3 percent.

Albanian official statistics report that domestic absorption actually declined by 0.2 percent in real terms in 1993. This figure is misleading, however, because it is based on the current account excluding official transfers; therefore it does not account for the relatively large amounts of foreign aid and remittances that have poured into the country. Foreign aid totalled over $800 million in 1993, one of the largest inflows in Eastern Europe, and remittances from the estimated 300,000 Albanians working abroad brought an estimated additional $800 million into the country. These flows are partly responsible for the explosion in private sector retail trade activity. There has been an extremely rapid rise in purchases of imported Western consumer goods (including home electronics, appliances, and cars) far in excess of what the average salary, equivalent to about $30 per month, would suggest. Foreign assistance plus remittances from abroad contributed over $1 billion to Albanian disposable income last year. This is equivalent to almost one-half of total GNP and helped to soften the blow to living standards implied by official statistics. Clearly, Albanians are living well beyond their means. Domestic absorption was 139 percent of GDP in 1993 and 172 percent of GDP in 1992.

Albania has benefited from a steady flow of foreign financing for its fledgling market economy. The IMF approved a $28 million standby arrangement for Albania in August 1992, which was followed up by a second standby agreement worth $59 million in July 1993. The World Bank provided credits to Albania worth $40 million right after the second IMF standby was signed; these credits are designated for technical assistance to Albania's transport and agriculture sectors. The World Bank is currently helping to finance projects worth a total of $100 million in Albania. In mid-April, the IMF provided Albania with another $12 million in structural reform funds, after qualifying the reform program as "courageous and radical."

UNEMPLOYMENT

According to official data, the number of unemployed Albanians fell from a peak level of 394,000 in 1992 to 301,289 in 1993. With a work force of some 1.54 million, this represents a fall in the unemployment rate from 25.5 percent to 19.6 percent. According to these statistics, a little more than 100,000 people are living off government assistance, while the remainder are searching for employment. The actual employment rate is probably higher, because factories have kept idled workers on the payroll in recent years, paying them at least a portion of their wages. Although the government sought to eliminate this practice last year, some factories have continued to pay idled workers. Such aid is reportedly being extended to about 300,000 workers (which, along with the officially unemployed cited above, would imply an overall unemployment rate of almost 40 percent). Official data show that unemployment has more than doubled since 1990, when the number of unemployed totalled 1,433,000.

As privatization of the Albanian economy continues, the number of people working in the private sector has grown substantially. Over the past three years, the total number of workers in the nonstate sector has grown to 601,000 (almost 40 percent of the labor force). This number includes half a million people working in the nonstate agricultural sector and 100,000 people in the nonagricultural private sector (6.5 percent). Between 1991 and 1993 state sector employment has fallen from 850,000 to just over 400,000 (26 percent). The majority of those unemployed have been laid off from state industrial enterprises that have ceased operations. Their chance for future employment lies with enterprises that reopen or smaller private firms that start up.

FOREIGN TRADE AND DEBT

Albanian foreign trade in recent years has been characterized by relatively small levels of exports, burgeoning imports, and record trade deficits. In 1993 Albanian exports totalled $97 million, a 27.5 percent increase over the 1992 export figure of $76 million. Last year marks the first year exports have increased since 1987–1989, when exports rose by about one-third from $100 million in 1987 to $133 million in 1989. In 1990, exports began to fall, and there was a sharp contraction in 1991 due to the intensification of industrial decline. During this 2-year period, Albanian convertible-currency exports fell by nearly one-half, from $133 million in 1989 to just $72 million in 1991. The 1993 export level is still 27 percent less than the 1989 level.

Albania's most important exports are chrome and chrome products (accounting for 18 percent of total exports), bitumen (10.7 percent), tobacco (6.5 percent) and electricity (4.9 percent). Other exports include copper, petroleum, and food products such as canned fish, fresh melons, and beans.

In contrast to exports, imports have risen since the late 1980s without suffering a subsequent sharp fall. In 1993 imports totalled a record $589 million, a 14 percent rise from $516 million in 1992. From a level of around $100 million in 1987, convertible-currency imports nearly tripled to $281 million in 1991. The unprecedented rise in imports was made possible by sizeable amounts of foreign assistance as well as convertible-currency remittances flowing into Albania.

Industrial goods made up most of Albania's imports in 1993. Used cars were the single biggest item (over 20,000 total) and vehicles of any type (cars, tractors, buses) accounted for more than 16 percent of total imports.

Most trade is conducted with neighboring countries, with Italy by far Albania's largest trading partner, accounting for 34 percent of total Albanian foreign trade turnover. Albania's largest markets are Italy (41 percent), Greece (17.9 percent), Macedonia (11.8 percent), Belgium (6.1 percent), Germany (4.3 percent) and the United States (3.7 percent). Imports to Albania come from Italy (31.2 percent), Greece (17.9 percent), Germany (11.9 percent), France (11.5

percent), Bulgaria (5.3 percent), Macedonia (3.2 percent) and Turkey (2.9 percent).

The much faster growth in imports than in exports in Albania in recent years has resulted in large convertible-currency trade deficits. Although the increase in exports was two times the increase in imports, the convertible-currency trade deficit increased from $440 million in 1992 to $492 million in 1993. In both years, the trade deficit was considerably larger than total exports and was also much higher than the relatively modest deficits of previous years. The current account deficit was not as large as the trade deficit in 1992 and 1993 thanks in large part to huge inflow of remittances from Albanians working abroad. As a result, the convertible-currency current account deficit was $139 million in 1993, slightly up from the $113 million deficit of 1992. In 1993 the current account deficit was $353 million less than the trade deficit the same year.

According to Albanian National Bank Governor Dybler Vrioni, Albania's debt as of February 1994 was $480.3 million. However, an IMF report and other Albanian sources indicate that this figure only includes the debt inherited from the previous government (before April 1992).[3] The debt should also include $638 million borrowed in the past two years, bringing the total to $1.118 billion. Albania's debt is thus approximately equal to its overall GDP (at market exchange rates).

Albania's increased borrowing has increased net debt substantially. During the communist era, Albania's foreign borrowing was extremely limited; in 1988 the country's gross convertible-currency debt was only $65.6 million. When Albania began borrowing large sums after 1990, it drew down its convertible-currency reserves to dangerously low levels during 1991 and 1992. Net convertible-currency debt totalled an estimated $920 million at the end of 1993, while just four years previously the country had been a net convertible-currency creditor to the tune of $355 million.

A deterioration in net debt of almost $1.3 billion dollars over a four-year period is of concern, as the current low level of exports does not assure Albania's ability to service this debt. Albania has been able to service its debt with the help of substantial foreign aid, including $265.5 million in balance-of-payments support between 1991 and 1993. This convertible-currency inflow has permitted Albania to run very large foreign trade and current account deficits in recent years. Nevertheless, as the amount of aid falls in future years, the sharp increase in foreign debt will have to be brought under control if Albania hopes to avoid serious balance-of-payments problems.

FOREIGN INVESTMENT

One of the most important factors affecting Albania's economic future will be the amount of foreign investment flowing into the country. Albania went a long way toward improving the foreign investment climate when Parliament passed a new law on foreign investment that is much more liberal than its predecessor (which was in effect for a little more than a year). By scrapping the old

[3] "Focusing Reform," *Albanian Economic Tribune*, March, 1994, p. 12.

law so quickly, the government demonstrated considerable flexibility in responding to investors' concerns about the previous foreign investment regime. Foreign firms can now invest anywhere in Albania without restriction. Final authorization for a given investment project is no longer required. Under the previous law, authorization from the Ministry of Foreign Economic Relations was required, and other agencies of the Albanian government, including the Ministry of the Economy and local organizations, were to provide their opinion on certain deals. This generated bureaucratic haggling, which hindered investment. Some investors began to pay bribes to secure licenses. The new law provides "national treatment," that is foreign investors are treated the same way as local ones.

The government has also introduced certain incentives for foreign investors. All investors in the production sector will be provided tax-free status for four years, with extensions for those firms that reinvest and for those that invest in tourism. When profits are reinvested in Albania, the authorities will reimburse part of any taxes paid. Liberal customs concessions for capital goods in productive investments have been enacted, and all taxes on incomes transferred out of the country have been abolished. Foreigners may now lease land for 99 years at a favorable rate and may also buy it for certain activities. It is expected that private ownership of land and the rights arising from such ownership will be legalized in the coming months as well.

To date, foreign investment has been minimal. Measured in either absolute or per capita terms, Albania trails most other countries of Eastern Europe in terms of foreign investment. At the end of 1993, foreigners had invested $291 million in the Albanian economy. In per capita terms, the volume of foreign investment in Albania is about $90. Joint ventures with state-owned enterprises accounted for 70 percent ($205.3 million) of total investments. The remaining investments ($85.7 million) were either 100 percent owned by private foreign companies or in venture collaboration with private Albanian companies or persons.

Of the 204 authorized investment projects, 112 (55 percent) were granted in 1993 alone, as the pace of Western investment in Albania has clearly picked up steadily over the past year. A new liberal foreign investment law, combined with a low-wage, relatively well-educated work force, abundant natural resources, liberal economic policies, and generous Western support, should all serve to foster much needed investment in Albania.

OUTLOOK

CONTINUED REFORMS

In 1994 the government plans to attend to microeconomic features of the economic reform, including further privatization of the economy, promotion of foreign investment, improvements in infrastructure, and expanded investment in the economy. According to reported details of the government's mid-term economic program, 72 billion leks (over $700 million at current exchange rates) will be invested in the economy over the next three years. This money will come from three sources: the domestic budget; credits and aid from the World Bank, the European Bank for Reconstruction and Development, the EU and other international organizations; and private investment. The government will devote 37 percent of this investment to the country's infrastructure (mainly transportation and communications), 30 percent to national resources (agriculture, mining, and energy), and the remainder to social assistance, the development of industry and financial institutions and credits. According to the government's economic goals, state investments will amount to 24 percent of GDP in 1994–1996, and private investments will account for another 10 percent.[4]

In what is perhaps a response to socialist criticism of high unemployment rates, the Democratic Party proposed a budget for 1994 that increased government "social" support. Albania is constrained by strict guidelines from the IMF, but expenditures on social services are high in the planned budget due to the costs of restructuring. Despite the increase in social spending, the budget projects a continued slowdown in the rate of growth of the budget deficit, to 8 percent of GDP. State revenues are expected to rise to 46.2 billion leks ($426 million), from 32.2 billion leks in 1993 ($315 million). Spending on social welfare is slated to increase by 44 percent (11 billion leks, or about $100 million).[5] According to Berisha, 38 percent of the 1994 state budget has been earmarked for social compensation.

PROSPECTS

Albania's economy is one of the first East European economies to have entered recovery following recession. The recovery is certainly in its most fragile stage, and the economy remains extraordinarily dependent on the agricultural sector. Nevertheless, Albania has the capability to sustain last year's growth and rebuild its shattered economy. It possesses an abundance of natural resources, a beautiful coastline and low labor costs. These three potential benefits to the economy did not play a large role in the economic turnaround begun in 1993. The once-powerful mining industry continued to struggle; the oil sector has not yet reached its potential; tourism remained underdeveloped due to inadequate infrastructure; and a large percentage of the labor force was still unemployed due to the decline in industrial production. If these factors begin to improve within the economy, Albania should be able to sustain its recovery for a number of years.

Although Albania is still a very poor country, and unemployment remains extremely high, the progress of the "shock therapy" program has left most Albanians optimistic about the future. The current government, especially President Berisha, enjoys widespread popular support. A recent poll for the EU indicated that almost 60 percent of Albanians expect their standard of living to increase in the next year—the highest rate in all of Eastern Europe. In the poll, only 10 percent were pessimistic about their economic fortunes in the next year, and 21 percent said nothing would change. The same poll indicated that 77 percent believe the country is heading

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[4] Louis Zanga, "Albanian Parliament Passes Budget and Economic Program," RFE/RL Research Report, May 13, 1994, p.36.

[5] Ibid., p.35.

in the right direction, and 84 percent believe the current political system is better than the previous one.[6]

[6] Reported in *Albanian Economic Tribune*, February 1994, p. 8.

TABLE 1. Economic Data, 1985–1991

		1985	1986	1987	1988	1989	1990	1991
NATIONAL INCOME								
GNP, Total								
At Purchasing Power Parity Rate (PPP)	Millions of 1990 Dollars	4,210	4,448	4,413	4,350	4,778	4,300	3,109
Per capita GDP (PPP)	1990 Dollars	1,424	1,475	1,435	1,386	1,493	1,321	942
At Market Exchange Rate	Current Mil. Dollars	1,874	2,174	2,157	2,126	2,335	2,102	824
GDP, Total	Bil. Current Leks	16.9	17.4	17.3	17.0	18.7	16.8	16.5
GDP, Total	Mil. 1990 Leks	16,462	17,390	17,254	17,008	18,681	16,813	12,156
Real Growth in Percent	Percent	4.9	5.6	–0.8	–1.4	9.8	–10.0	–27.7
Non-material Services & Depreciation	Mil. 1990 Leks	2,860	3,377	3,554	3,377	3,458	3,691	2,659
NMP Produced	Mil. 1990 Leks	13,602	14,013	13,700	13,631	15,223	13,122	9,497
Industry	Mil. 1990 Leks	5,886	6,196	6,276	6,310	6,822	5,486	3,465
Agriculture & Forestry	Mil. 1990 Leks	4,703	4,768	4,550	4,296	4,919	4,705	3,730
Construction	Mil. 1990 Leks	979	936	879	891	989	845	585
Transport, Trade and Other	Mil. 1990 Leks	2,034	2,113	1,995	2,134	2,493	2,087	1,717
Percent Growth In:								
NMP Produced	Percent	4.9	3.0	–2.2	–0.5	11.7	–13.8	–27.6
Industry	Percent	NA	5.3	1.3	0.5	8.1	–19.6	–36.9
Agriculture & Forestry	Percent	NA	1.4	–4.6	–5.6	14.5	–4.4	–20.9
Construction	Percent	NA	–4.4	–6.1	1.4	11.0	–14.6	–30.4
Transport, Trade and Other	Percent	NA	3.9	–5.6	7.0	16.8	–16.3	–17.7
Net Exports and Losses	Mil. 1990 Leks	150	462	315	–164	–152	–1,207	–368
Utilized National Income	Mil. 1990 Leks	13,452	13,551	13,385	13,795	15,375	14,329	9,865
Social Consumption	Mil. 1990 Leks	1,510	1,471	1,521	1,486	1,522	1,522	1,162
Personal Consumption	Mil. 1990 Leks	8,896	9,024	9,330	9,433	10,093	10,209	7,144
Net Investment	Mil. 1990 Leks	3,047	3,055	2,535	2,876	3,760	2,598	1,559
Percent Growth In:								
Utilized National Income	Percent	NA	0.7	–1.2	3.1	11.5	–6.8	–31.2
Social Consumption	Percent	NA	–2.5	3.4	–2.3	2.5	0.0	–23.7
Personal Consumption	Percent	NA	1.4	3.4	1.1	7.0	1.2	–30.0
Net Investment	Percent	NA	0.3	–17.0	13.5	30.7	–30.9	–40.0

TABLE 1. Economic Data, 1985–1991—Continued

		1985	1986	1987	1988	1989	1990	1991
KEY PRODUCTION MEASURES								
Gross Industrial Output	Index; 1990=100	94.6	99.4	100.9	102.9	108.1	100.0	63.1
	Percent Change	–1.1	5.0	1.5	2.1	5.0	–7.5	–36.9
Gross Agricultural Output	Index; 1990=100	99.5	103.5	104.0	97.5	108.0	100.0	79.1
	Percent Change	3.8	4.0	0.5	–6.2	10.7	–7.4	–20.9
Crops	Index; 1990=100	118.8	124.8	122.7	108.6	117.8	100.0	78.0
	Percent Change	5.2	5.0	–1.7	–11.5	8.4	–15.1	–22.0
Animal Products	Index; 1990=100	80.1	82.0	85.1	86.4	98.2	100.0	74.0
	Percent Change	1.8	2.4	3.7	1.5	13.7	1.8	–26.0
Construction Sector Output	Index; 1990=100	101.2	101.1	99.5	100.7	108.1	100.0	69.6
	Percent Change	–7.4	–0.1	–1.5	1.2	7.3	–7.5	–30.4
Gross Investment in Fixed Capital	Index; 1990=100	97.4	100.8	103.2	105.1	116.6	100.0	60.0
	Percent Change	–8.8	3.5	2.3	1.9	10.9	–14.2	–40.0
ENERGY SECTOR								
Total Primary Energy Production	tbdoe [a]	49.6	54.8	52.9	51.0	51.0	48.4	46.0
	Percent Change	NA	10.4	–3.5	–3.5	0.1	–5.2	–5.0
Total Primary Energy Consumption	tbdoe	47.8	49.0	49.7	51.5	53.4	51.9	48.3
	Percent Change	NA	2.5	1.5	3.6	3.5	–2.7	–6.9
Net Energy Exports	tbdoe	1.8	5.8	3.1	–0.5	–2.3	–3.5	–2.3
	Percent Change	NA	221.1	NA	NA	NA	NA	NA
PRICES, CONSUMER WELFARE								
GDP Deflator		NA	–2.4	0.0	0.0	0.0	0.0	95
Avg. Change in Consumer Prices	Percent	0.0	0.0	0.0	0.0	0.0	0.0	100
Nominal Net Monthly Wages	Leks	446	451	443	445	466	459	780
Nominal Net Monthly Wages	Dollars	50	56	55	56	58	57	39
Real Wages	Percent Change	0.9	1.1	–1.8	0.5	4.7	–1.5	–15.0
Retail Trade Turnover	Mil. Leks	7,679	8,097	8,315	8,373	8,768	8,694	13,232
Retail Trade Turnover	Mil. Dollars	853	1,012	1,039	1,047	1,096	1,087	662
Real Growth in Ret. Trade Turnover	Percent Change	1.5	5.4	2.7	0.7	4.7	–0.8	–23.9
POPULATION AND UNEMPLOYMENT								
Population (annual average)	Thous. People	2,957	3,016	3,076	3,138	3,199	3,256	3,300

Labor Force	Thous. People	1,378	1,419	1,457	1,495	1,535	1,558	1,586
Unemployed Workers (end-year)	Thous. People	80	78	75	90	104	136	143
Unemployment Rate (end-year)	Percent	5.8	5.5	5.2	6.0	6.8	8.7	9.0
MONETARY & FISCAL POLICY MEASURES								
Govt. Budget Deficit/Surplus	Mil. Leks	−721	−9	−288	−28	−1,029	−773	−7,199
Percent of GDP	Percent	−4.3	−0.1	−1.7	−0.2	−5.5	−4.6	−43.7
Percent of Gov't Expenditures	Percent	−8.1	−0.1	−3.3	−0.3	−9.7	−7.5	NA
Interest Rate	Percent	2	2	2	2	2	2	NA
Exchange Rate	Lek/Dollar	9	8	8	8	8	8	20
Real Effective Exchange Rate	Index; 1990=100	105	115	112	109	104	100	77
BALANCE OF PAYMENTS AND DEBT								
Convertible-currency Exports	Mil. Dollars	91.2	95.5	100.3	106.6	132.7	123.0	72.0
Convertible-currency Imports	Mil. Dollars	119.9	96.1	99.3	141.4	223.6	232.6	281.0
Conv.-currency Trade Balance	Mil. Dollars	−28.7	−0.6	1.0	−34.8	−90.9	−109.6	−209.0
Hard-curr. Current Account Balance	Mil. Dollars	−27.8	0.5	7.8	−23.5	−70.4	−96.4	−170.3
Gross Convertible-currency Debt	Mil. Dollars	NA	NA	NA	65.6	74.4	342.0	406.7
Convertible-currency Assets	Mil. Dollars	24.4	23.0	34.7	165.3	429.5	223.2	28.0
Net Conv.-currency Debt	Mil. Dollars	NA	NA	NA	−99.7	−355.1	118.8	378.7

Source: PlanEcon. During 1985–91, figures include PlanEcon estimates of ruble trade calculated at world market prices in dollars.
ª tbdoe is thousands of barrels per day of oil equivalent.
NA = Not Available.

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TABLE 2. Economic Data and Projections, 1992–2000

		1992	1993	1994	1995	1996	1997	1998	1999	2000
NATIONAL INCOME										
GNP, Total										
At Purchasing Power Parity Rate	Millions of 1990 Dollars	2,807	3,116	3,414	3,689	3,947	4,156	4,340	4,492	4,635
Per capita GDP (PPP)	1990 Dollars	864	954	1,035	1,107	1,173	1,223	1,264	1,295	1,324
At Market Exchange Rate	Current Mil. Dollars	645	969	1,262	1,553	1,877	2,152	2,410	2,622	2,844
GDP, Total	Bil. Current Leks	48.5	99.7	146	189	240	284	333	378	427
GDP, Total	Mil. 1990 Leks	10,974	12,182	13,418	14,576	15,680	16,598	17,450	18,156	18,847
Real Growth in Percent	Percent	–9.7	11.0	9.6	8.1	7.0	5.3	4.4	3.5	3.2
Non-material Services & Depreciation	Mil. 1990 Leks	2,845	3,162	3,534	3,895	4,251	4,566	4,886	5,175	5,467
NMP Produced	Mil. 1990 Leks	8,129	9,020	9,884	10,681	11,428	12,032	12,564	12,981	13,379
Industry	Mil. 1990 Leks	1,386	1,247	1,297	1,369	1,444	1,531	1,610	1,660	1,707
Agriculture & Forestry	Mil. 1990 Leks	4,401	5,035	5,438	5,737	5,993	6,173	6,358	6,533	6,712
Construction	Mil. 1990 Leks	614	808	968	1,132	1,305	1,427	1,549	1,623	1,688
Transport, Trade and Other	Mil. 1990 Leks	1,727	1,930	2,181	2,442	2,686	2,901	3,046	3,165	3,273
Percent Growth In:										
NMP Produced	Percent	–14.4	11.0	9.6	8.1	7.0	5.3	4.4	3.3	3.1
Industry	Percent	–60.0	–10.0	4.0	5.5	5.5	6.0	5.2	3.1	2.8
Agriculture & Forestry	Percent	18.0	14.4	8.0	5.5	4.5	3.0	3.0	2.8	2.7
Construction	Percent	5.0	31.5	19.8	17.0	15.3	9.4	8.5	4.8	4.0
Transport, Trade and Other	Percent	–8.5	11.7	13.0	12.0	10.0	8.0	5.0	3.9	3.4
Net Exports and Losses	Mil. 1990 Leks	–1,622	–1,768	–1,756	–1,551	–1,113	–947	–886	–822	–763
Utilized National Income	Mil. 1990 Leks	9,751	10,788	11,640	12,232	12,541	12,979	13,450	13,803	14,142
Social Consumption	Mil. 1990 Leks	1,207	1,243	1,243	1,249	1,262	1,281	1,300	1,332	1,359
Personal Consumption	Mil. 1990 Leks	7,328	8,083	8,653	8,942	8,927	9,125	9,358	9,574	9,799
Net Investment	Mil. 1990 Leks	1,216	1,462	1,744	2,041	2,352	2,573	2,792	2,897	2,984
Percent Growth In:										
Utilized National Income	Percent	–1.2	10.6	7.9	5.1	2.5	3.5	3.6	2.6	2.5
Social Consumption	Percent	3.8	3.0	0.0	0.5	1.0	1.5	1.5	2.5	2.0
Personal Consumption	Percent	2.6	10.3	7.0	3.3	–0.2	2.2	2.6	2.3	2.4
Net Investment	Percent	–22.0	20.2	19.3	17.0	15.3	9.4	8.5	3.8	3.0

KEY PRODUCTION MEASURES										
Gross Industrial Output	Index; 1990=100	25.2	22.7	23.6	24.8	26.2	27.7	29.2	30.1	30.9
	Percent Change	–60.0	–10.0	4.0	5.0	5.5	6.0	5.2	3.1	2.8
Gross Agricultural Output	Index; 1990=100	93.3	106.8	115.3	121.7	127.1	129.6	132.2	135.9	139.6
	Percent Change	18.0	14.4	8.0	5.5	4.5	2.0	2.0	2.8	2.7
Crops	Index; 1990=100	78.0	93.6	103.9	112.2	118.3	120.6	123.0	126.7	129.9
	Percent Change	0.0	20.0	11.0	8.0	5.4	2.0	2.0	3.0	2.5
Animal Products	Index; 1990=100	69.6	75.7	79.5	81.8	84.7	86.4	88.1	90.3	93.1
	Percent Change	–6.0	8.8	5.0	3.0	3.5	2.0	2.0	2.5	3.0
Construction Sector Output	Index; 1990=100	73.1	96.1	115.1	134.7	155.3	169.8	184.3	193.1	200.8
	Percent Change	5.0	31.5	19.8	17.0	15.3	9.4	8.5	4.8	4.0
Gross Investment in Fixed Capital	Index; 1990=100	46.8	56.3	67.1	78.5	90.5	99.0	107.5	112.0	115.9
	Percent Change	–22.0	20.2	19.3	17.0	15.3	9.4	8.5	4.3	3.5
ENERGY SECTOR										
Total Primary Energy Production	tbdoe	32.9	33.4	34.1	34.8	35.6	35.8	35.9	36.1	36.2
	Percent Change	–28.5	1.5	2.1	2.1	2.3	0.6	0.3	0.4	0.4
Total Primary Energy Consumption	tbdoe	36.1	34.3	34.1	34.3	34.9	35.5	36.2	36.9	37.6
	Percent Change	–25.3	–5.0	–0.6	0.6	1.7	1.7	2.0	1.9	1.9
Net Energy Exports	tbdoe	–3.2	–0.9	0.0	0.5	0.7	0.3	–0.3	–0.9	–1.4
	Percent Change	NA	NA	NA	NA	40.0	–57.1	NA	NA	NA
PRICES, CONSUMER WELFARE										
GDP Deflator		226	105	34	20	19	12	12	10	10
Avg. Change in Consumer Prices	Percent	226	85	28	16	15	10	10	10	10
Nominal Net Monthly Wages	Leks	2,283	4,672	6,501	8,117	9,941	11,458	13,098	14,840	16,765
Nominal Net Monthly Wages	Dollars	30	45	56	67	78	87	95	103	112
Real Wages	Percent Change	–10.2	10.5	9.1	7.6	6.5	4.8	3.9	3.0	2.7
Retail Trade Turnover	Mil. Leks	44,233	90,359	123,394	148,018	169,936	191,080	215,552	242,566	273,112
Retail Trade Turnover	Mil. Dollars	589	879	1,064	1,213	1,328	1,447	1,559	1,684	1,819
Real Growth in Ret. Trade Turnover	Percent Change	2.6	10.3	7.0	3.3	–0.2	2.2	2.6	2.3	2.4
POPULATION AND UNEMPLOYMENT										
Population (annual average)	Thous. People	3,250	3,266	3,299	3,332	3,365	3,399	3,433	3,467	3,502
Labor Force	Thous. People	1,580	1,540	1,560	1,580	1,601	1,622	1,643	NA	NA
Unemployed Workers (end-year)	Thous. People	393	301	275	250	240	220	200	NA	NA
Unemployment Rate (end-year)	Percent	24.9	19.5	17.6	15.8	15.0	13.6	12.2	11.0	9.9

TABLE 2. Economic Data and Projections, 1992–2000—Continued

		1992	1993	1994	1995	1996	1997	1998	1999	2000
MONETARY & FISCAL POLICY MEASURES										
Govt. Budget Deficit/Surplus	Mil. Leks	–8,435	–11,262	–13,171	–17,054	–24,027	–19,892	–18,333	–7,555	–8,538
Percent of GDP	Percent	–17.4	–11.3	–9.0	–9.0	–10.0	–7.0	–5.5	–2.0	–2.0
Percent of Gov't Expenditures	Percent	NA	NA	NA	NA	NA	NA	NA	NA	NA
Interest Rate	Percent	NA	NA	NA	NA	NA	NA	NA	NA	NA
Exchange Rate	Lek/Dollar	75	103	116	122	128	132	138	144	150
Real Effective Exchange Rate	Index; 1990=100	65	113	102	97	97	100	102	104	107
BALANCE OF PAYMENTS AND DEBT										
Convertible-currency Exports	Mil. Dollars	76.0	95.0	142.5	242.3	411.8	494.2	541.1	581.7	625.4
Convertible-currency Imports	Mil. Dollars	516.0	589.0	645.4	697.4	746.3	785.7	820.4	847.0	877.4
Conv.-currency Trade Balance	Mil. Dollars	–440.0	–494.0	–502.9	–455.2	–334.4	–291.5	–279.3	–265.3	–252.0
Hard-curr. Current Account Balance	Mil. Dollars	–113.0	–139.0	–336.9	–359.5	–292.9	–255.9	–255.4	–87.1	–80.0
Gross Convertible-currency Debt	Mil. Dollars	690.8	901.4	1,118.3	1,256.7	1,256.5	1,155.1	1,026.1	1,113.3	1,193.2
Convertible-currency Assets	Mil. Dollars	67.0	130.0	200.0	279.0	335.8	353.6	369.2	369.2	369.2
Net Conv.-currency Debt	Mil. Dollars	623.8	771.4	918.3	977.8	920.6	801.6	657.0	744.1	824.0

Source: PlanEcon.

SLOVENIA: A COUNTRY STUDY

By Franjo D. Stiblar*

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TABLES

SUMMARY

Early in the 1990s, Slovenia became independent and introduced a multiparty system. The institutional framework for a private market economy was put in place, although with some delay. Macroeconomic stabilization and current economic performance are quite satisfactory, giving way to a relatively optimistic view of the future.

THE POLITICAL SITUATION

First multiparty elections were held in Slovenia in April 1990. On June 25, 1991, Slovenia proclaimed independence from Yugoslavia and full sovereignty. After a "10-days war" against the Yugoslav Army, Yugoslav forces left Slovenia's territory in fall 1991.

*Franjo D. Stiblar is Professor of Economics at the School of Law, University of Ljubljana, Slovenia, and is a member of its Economic Institute.

International diplomatic recognition came for Slovenia at the end of 1991 and at the beginning of 1992. By May 1992 Slovenia was accepted to the UN and established diplomatic relations with all major countries.

On December 6, 1992, the second general parliamentary and presidential elections (the first since independence), were held in Slovenia. With the new constitution adopted in December 1991, the structure of Parliament changed significantly (following the German model). Instead of the previous 3 chambers with 80 representatives each, the new Parliament consists of two chambers; the 90-seat State Assembly (Drzavni zbor), where all major political decision-making is concentrated, and the 40-seat State Council (Drzavni svet) with a predominantly supervisory role (22 of them are representatives of local commune interests; the remaining 18 are representatives of the professions). Competing for 90 seats in the powerful State Assembly were 1,500 candidates on 25 party lists, and 105 candidates ran for 22 seats representing local interests in the State Council. There were 8 candidates running for the Presidency of Slovenia.

Of the 1,492,000 eligible voters 85 percent participated in the elections. Among the voting-ballots, 40,000 were invalid in the presidential elections and 80,000 in the Parliamentary elections.

The results were the following. First, in the direct popular presidential elections, Milan Kucan (proclaimed as an independent candidate), the incumbent President, obtained a large absolute majority (63.9 percent of all votes). Thus, the second round duel among the two candidates with the highest votes (if neither candidate achieves 50 percent majority), was not needed.

Second, in the Parliamentary elections a proportional system of counting was used; modified with a corrected d'Hondt's system (like the German system). Of the 90 candidates, 38 obtained enough votes to be elected directly in the Parliament. The remaining 62 seats were distributed among political parties according to their national lists (1/2) or direct results in the election units (1/2). Only parties with the minimum 3.3 percent of votes cast for them (3 seats in the State Assembly) at the country level entered into Parliament and were thus eligible for the second distribution of seats.

The results of elections in the 90-member State Assembly are shown below.

Party	Leader	Seats
Liberal-Democratic Party	(J. Drnovsek)	22
Christian-Democratic Party	(L. Peterle)	15
Associated List (4 left parties)	(C. Ribicic)	14
Slovene National Party	(Z. Jelincic)	12
Slovene People's Party	(M. Podobnik)	10
Democratic Party	(I. Bavcar)	6
Green Party	(D. Plut)	5
Social Democratic Party	(J. Pucnik)	4
Representative of the Hungarian minority		1
Representative of the Italian minority		1
Total members		90

Third, on the same day, voters elected by popular direct vote 22 representatives of local interests in the second chamber of Parliament-the State Council, while the remaining 18 representatives of professions were elected indirectly by electors on December 10, 1992.

Elections did not bring major changes in the spectrum of political power in Slovenia. In comparison to the 1990 elections, Drnovsek's Liberal Democrats gained seats and a new right-wing national party of Jelincic entered the political scene as the fourth largest party. Major losers were the center parties (Democrats, Greens, Social Democrats), to a certain extent the people's (peasants') party, and three parties that fell out of the Parliament: the National Democrats, Liberals and Socialists. The structure of the political spectrum remained however the same: right and left wings control 37 and 36 seats, respectively, and needed to rely heavily on center parties to form a government. The State Council is supposedly 60 percent controlled by left-wing interests.

After the elections, Janez Drnovsek, the leader of the Liberal Democratic Party, formed a national coalition government with the Liberal Democratic Party (22 seats in Parliament), the Christian Democratic Party (15 seats), the Associated List of Social Democrats (former Communists, 14 seats) and the Social Democratic Party (4 seats) in February 1993. Its majority position—55 out of the total available 90 seats—was strengthened from time to time through tacit support from some opposition parties (the Democratic Party, the Green Party, and the Slovene National Party). This broad coalition (the so-called government of "National Consensus") has survived until now, though differences within the government cause more problems than weak and dispersed opposition in Parliament.

Due to the approaching communal elections at the end of 1994 (based de facto on the majority principle, especially for the mayor of the commune) and the under-developed party structures, small parties need to integrate, formally or according to a program.

In March 1994, the ambitious integration project was realized. The new large center party—Liberal Democracy of Slovenia (LDS)—was formed including three small parties: the Democrats (half of their members of Parliament remaining in the Democratic Party), the Social-Ecological Greens and the Socialists (who have not managed to enter parliament) and the strongest Liberal Democratic Party.

In April 1994 the powerful and influential Minister of Defence Janez Jansa was dismissed from the ministerial post due to clashes between the civil and the military secret services. The Social Democratic Party, where he presided since late 1993, left the government coalition. Jansa became the informal leader of the "right wing" opposition whose major target is President Kucan. That put pressure on the Christian Democrats to leave the coalition too. Their leadership, under Lojze Peterle (currently the Foreign Minister), redirected this pressure onto Prime Minister Drnovsek with a request to him to eliminate the left-wing Associated List from the governing coalition and to form the government from only two parties: the Christian Democrats and the Liberal Democrats. The negotiations are still taking place, being additionally complicated by Minister of

Interior Ivan Bizjak (Christian Democrat) stepping down due to problems in the Ministry. One problem is that the governing majority would be very slim. The final outcome remains unclear, but early elections, required by the opposition, are not probable.

This paper will try to answer some basic questions on political development. Was the Slovenian struggle for independence the right path? Without any deeper analysis, only in view of present events on the territory of former Yugoslavia, the answer is yes. Was Slovenia with its acts, the primal cause of collapse of Yugoslavia? The answer is a qualified no, qualification being that Slovenia's separatist acts were not the cause but the consequence of unacceptable trends in Yugoslavia: political autocracy and economic collapse as it is now seen in Serbia and new Third Yugoslavia. Was there a better (peaceful) way to dismantle Yugoslavia as in the form of Czecho-Slovakia's experience? There may be, although an international intervention for a political solution for separation at the beginning and not for forced unification (as was done) would be necessary. From that point of view, and having in mind the historic experience with the Balkans, the world community could be guilty for some of the current atrocities that happened in the former Yugoslav republics. Has Slovenia passed the major obstacles? To a large extent, yes. The newly independent country has a chance for successful survival, if it can gather all forces for social and economic development and negate self-destructive trends, which are emerging internally after the immediate outside danger and pressures have gone.

INSTITUTIONAL AND SYSTEM FRAMEWORK

SLOW IMPLEMENTATION OF PRIVATIZATION

The estimation that Slovenia would be rather slow in constructing a legal framework of a normal market economy has been undoubtedly confirmed by the implementation of privatization. Formally, being an orderly and legally sanctioned transfer of property from "the people"—the state, or other public bodies, to private entities—persons, partnerships and corporations, privatization has been considered the cornerstone of transition. It has also proved to be its major stumbling block. Slovenia has not been immune in this respect, and, indeed, one could argue that the major advantage the country has in comparison to other countries in Eastern Europe (i.e., decentralized decision making) has turned into a major disadvantage.[1] The Law on Ownership Restructuring of Enterprises

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[1] Privatization began in Slovenia with the federal Amendments to the Constitution (before the break of Yugoslavia) adopted in November 1988, and the codes regulating economic and labor relations adopted in 1988 and 1989. The most important among them, The Enterprise Act, also formally abrogated the "self-management and social property relations" and replaced them by the "capitalist property relations." The Law on the Circulation and Disposal of Social Capital (1989) gave the power to the workers' councils to sell companies to private owners. Finally, the Law on Social Property (1990) enabled gradual transformation of socially owned firms into mixed companies, whereas "internal shares" enabling employee buy-outs through the purchase of shares at a discount were the main instruments of privatization.

During 1990 the privatization was shifted to republics that started to prepare drafts of the privatization laws. In Slovenia, two major concepts known as the Korže-Mencinger-Simoneti code and the Sachs-Peterle-Umek code, competed. The former proposed a gradual, decentralized, and commercial privatization, the latter insisted on a mass, centralized, and distributive privatization. The controversy resulted in a stalemate lasting for a year and a half, until November 1992 when the privatization bill was finally passed.

(the privatization bill) was passed on November 11, 1992. Its implementation has remained slow as privatization required additional regulations that were passed mainly in 1993. The last of the acts enabling privatization, The Law on Investment Funds, was passed in February 1994. Three other laws broaden the scope of privatization. The implementation of the Law on Apartments, which enabled privatization of approximately 100,000 apartments, has been completed. The Denationalization Act, which has introduced restitution in kind as a principle, presents an obstacle to the implementation of the privatization act. Finally, the implementation of the Law on Cooperatives, which assigns 40 percent of shares in chosen food processing enterprises to farmer cooperatives, depends on the implementation of the privatization act.

However, despite or because of delays in formal privatization, spontaneous privatization has flourished since 1990. Different channels enabled legal and hardly understandable patterns of indirect (spontaneous, wild) privatization through transfers of capital from one legal entity to another. Examples have abounded in number and form, particularly in the trade sector. Most often, managers have established companies owned by themselves or by their cronies and transferred the most profitable activity to it, sold assets below market price, used joint ventures schemes, and sided with the potential buyer to preserve their positions and benefits.

The privatization bill itself is a compromise between two very different concepts. According to it, transformation is attained by restitution to former owners; by debt-equity swaps; by transfer of shares to the Restitution Fund, the Pension Fund, and the Development Fund; by distribution of shares to employees; by manager and worker buy-outs; by sales of shares of the company; and by raising additional equity capital. Privatization begins by converting existing enterprises into joint stock or limited liability companies. Restitution, in kind or in value, and debt equity swaps are envisaged as the first step. Ownership certificates are to facilitate free distribution of shares among employees and citizens at large. The certificates with the nominal value ranging between 200,000 and 400,000 Slovene tolars (DEM 2,500 to 5,000), depending on age, were distributed in the last quarter of 1993. The employees can use their certificates to acquire shares in their "own" company, or, together with other citizens, to acquire shares of other companies in public auctions of state-owned enterprises, or investment funds.

The basic approach can be presented by the following "distributional" equation:

$$[10\% + 10\% + 20\% + (1 - x) * 20\%] + [x * 20\% + 40\%] = 100\%$$

Loosely, the equation separates institutional owners in the first bracket from the likely individual owners in the second bracket:

- Ten percent of the social capital left after restitution to the former owners and debt-equity swaps is transferred to the Pension Fund, ten percent to the Restitution Fund (the first two items in the left bracket).
- Twenty percent of the capital (the third item in the left bracket) is transferred to the Privatization (Development) Fund, which is to "sell" the shares to the newly established invest-

ment funds that are still to be set up. They, in turn, will "sell" their shares to citizens in exchange for their ownership certificates.

- Up to twenty percent of the equity of a company (the first item in the second bracket) is to be allocated to employees in exchange for their ownership certificates.
- The remaining 40 percent of the equity is to be sold in 18 months through management and employee buy-outs, public tenders, public auctions, and public offerings of shares, or transferred to the Privatization Fund as preferred or common shares, depending on the decision by the company. If sold through the "internal buy-outs," the employees receive a 50 percent discount on the purchasing price.

"x" determines whether individual or institutional owners will prevail. It depends on the value of ownership certificates of the employees and their readiness to use them to acquire shares in their company, and readiness of the general public to acquire shares of a particular company if it decides to use public auction. If the company decides in favor of the manager-worker buy-out, the workers and managers have to subscribe their shares in five years. They are also entitled to use their ownership certificates for this purpose if their value exceeds 20 percent. A part of the company or the entire company can be sold to a domestic or foreign buyer (if the book value exceeds 20 million ECU and if approval of the government is obtained). In such cases, adequate proportions of revenues generated on the company's transfer to the foreign owner are transferred to the various funds created by the privatization bill.

The government (through the Development Fund) expects income from privatization of about 1.2 billion DEM in four years. This will be used for enterprise restructuring, expenses of the government, the technological fund, the ecological fund and some other uses.

Formally, the privatization procedure begins when the managing body of an enterprise passes the Transformation Program and sends it to the Privatization Agency. The program includes the opening balance sheet under new accounting standards, revisions of all equity transactions over the last two years by the SDK (Social Accounting Service), and other required documents related to potential restitution claims, debt equity swaps, existing capital links, mixed ownership etc. Privatization applications have to be submitted to the Privatization Agency by June 1994 (this date has already been extended to the end of 1994): companies that fail to submit proposals by that date come under the management and ownership of the Development Fund. The program has to be approved by the Agency. When the program is approved, the enterprise then starts to administer it. When all the shares issued by the transformed company are subscribed by the owners, the enterprise presents the documentation to the Agency, which gives its final agreement. This is required for the registration of the transformed company in the court Registry of Companies, which ends the procedure.

Although enterprises have chosen different methods, the "internal buy-outs" of shares that include the obligatory transfer of 40 percent of its shares to institutional owners (three funds) and internal division of the remaining shares, has been by far the most popular method of privatization. This applies especially to profitable small and medium-sized firms. This is in accordance with expectations and legacies of self-management; it has been strengthened by the 50 percent discount in buying the remaining 40 percent shares and the possibility of deferred payments up to five years. The second most chosen method is a combination of public auction and an internal division of shares. This is the method applied by the large, profitable firms, in which majority ownership cannot be assured by the "internal buy-outs;" such firms try to provide for dispersed external ownership over institutional owners. The large loss-making firms with no demand for shares by insiders or the general public will remain in the hands of the Development Fund and will await privatization by conventional methods.

The first round of privatization will not affect the existing management and will add little to the efficiency of the economy. Private property rights provide incentives to save, invest, look for new products, innovate production, use existing resources in an optimal manner, and bear the risks of decisions only if one can find active real owners, those responsible for the proper use and maintenance of capital assets. Internal ownership has, in this respect, clear advantages over sole transfer of ownership rights to formally private institutions established by the state, and/or giving away of shares of these institutions to citizens at large (which amounts to a "paper privatization" that neglects efficiency). The investment funds will most likely be passive rather than active investors. The Pension Fund, the Restitution Fund, and many dispersed owners will probably sell their shares soon after the two-year embargo period of nontransferability of shares, because they will prefer cash to equity. This might seriously affect the new emerging capital market and increase consumption. On the other hand, internal ownership has its own weakness due to known conflicts of interest of insiders who are both employees and employers.

OBSTACLES TO FOREIGN DIRECT INVESTMENT

Among many forms of international economic relations, Slovenia has experienced long-term production cooperation, patents and licenses, and foreign investment. The latter has been in the form of foreign credits (which caused severe indebtedness in former Yugoslavia, of which Slovenia was a federal unit), foreign portfolio investment (for which Slovenia lacks appropriate institutions) and foreign direct investment (FDI).

The size of foreign direct investment has been almost negligible. In the past 25 years, their value amounted to less than 8 percent of one year of GNP for Slovenia, or around 0.3 of 1 percent of GNP per year.

Legal foundations for foreign investment were established in the former Yugoslavia in 1967. The law was very restrictive, allowing only contractual joint ventures with foreigners' shares limited to a maximum of 49 percent. A new Yugoslav Foreign Investment Law was passed in 1988, giving much more room for the expansion of foreign investment. The number of FDIs increased quickly although it was not so with their value. The worsening political situation in the former Yugoslavia which culminated in a war, increased the country risk enormously and badly affected FDIs.

Independent Slovenia adopted the Yugoslav Foreign Investment Law with the Constitutional Law in 1991 as an interim solution. Its major provisions are:

- National treatment,
- Guaranteed rights of the foreign investor (to participate in management, to share profit and transfer it, to repatriate the share of the company and capital),
- All sectors opened to foreigners (except military equipment, rail, and air transport, telecommunications, insurance, publishing and mass media, where wholly foreign owned companies are not allowed),
- Three types of foreign investment (new joint ventures, increase of the capital of an existing local company, acquisition of the share in an existing local company),
- Restrictions on ownership of real estate,
- Possibility of establishing a 100 percent foreign owned company,
- Tax relief (30 percent on profit tax, which can be reduced by 6 percentage points in case of reinvestment; tax relief in the first three years of operation).

To adopt a new foreign investment law, the Slovene government has prepared a strategy paper. It deals with major dilemmas regarding foreign capital inflows and was presented to the Parliament at the beginning of 1994. Most of the provisions discussed above are to be retained. However, the restrictions on foreign ownership of real estate (land, buildings) is a highly debated issue with some foreign countries recently entering the debate with their own interests (Italy). It is supposed to be quite restricted: no foreign ownership of land is envisaged and ownership of buildings would require special permission.

TABLE 1. Foreign Direct Investment in Slovenia, 1968–1991

(Millions of DEM)

Period or Year	Number (*n*)	Foreign Capital (*Kf*)	Total Capital (*Kt*)	*Kf/n*	*Kt/n*	*Kf/t*
1968–1985	31	90.8	617.1	2.9	19.9	0.147
1986	3	3.3	26.2	1.1	8.7	0.126
1987	6	20.6	93.7	3.4	15.6	0.220
1988	4	31.4	161.2	7.8	40.3	0.195
1968–1988	44	146.1	989.2	3.3	22.5	0.148
1989	174	162.5	408.2	0.9	2.3	0.398
1990	616	499.8	1,226.1	0.8	2.0	0.408
1991	462	498.7	684.7	1.1	1.5	0.728
1989–1991	1,252	1,161.0	2,319.0	0.9	1.9	0.501
Total	1,296	1,307.1	3,217.2	1.0	2.5	0.406
(1992–1993) estimate (600.0)						

Source: M. Rojec, *Foreign Direct Investment in Slovenia*, CICD, 1992.

Growth of FDIs followed changes in the legal framework. In the past, ownership joint ventures (JV) prevailed in numbers, contractual JVs in value. The institutional form of FDI was a limited liability company. The predominant sectors for FDI were business services, electric appliances, trade (by number); vehicles, the beverage industry, and electric appliances (by value). The average share of foreigners was approximately 40 percent.

Prevailing among foreigners are investors from neighboring countries (Austria, Italy) or countries with strong trade relations with Slovenia (Germany, France). Investors from the EU (European Union) and EFTA (European Free Trade Association) countries account for 85 percent of all FDIs in Slovenia after 1985. It is speculated that among foreign investors, approximately one-third are Slovenes living abroad or subsidiaries of Slovene companies.

A poll among the 47 largest FDIs in Slovenia in 1991–1992 indicated that the prime motives for forming them were profit, market accessibility, skilled labor, and lower production costs. Comparative advantages of Slovenia in the eyes of foreign investors (with regard to other East European countries, among which Hungary and Czech Republic are the most relevant competitors) seem to be the quality of partners, location, developed infrastructure, better management, and developed market institutions. Liabilities are political, economic, and legal instability. Further developments of the market and financial institutions, and stability of the economic and political situation, were listed as the most desired improvements for further development of FDIs in Slovenia.

TABLE 2. Foreign Investment in Slovenia by Investor Origin, 1985–1991

(Millions of DEM)

Country	Number (*n*)	Share	Capital *Kf*	Share	*Kf/n*
Germany	193	0.187	411.2	0.392	2.1
Austria	269	0.261	274.4	0.262	1.0
Italy	320	0.310	163.2	0.156	0.5
France	5	0.005	114.2	0.109	22.8
Australia	4	0.004	35.9	0.034	9.0
United States	20	0.019	11.6	0.011	0.6
Switzerland	44	0.043	9.7	0.009	0.2
Other	176	0.171	27.7	0.026	0.2
European Union (EU)	559	0.542	692.7	0.661	1.2
European Free Trade Association (EFTA)	333	0.323	290.8	0.278	0.9
Total	1,031	1.0	1,047.9	1.0	1.0

Source: Monthly Report, Statistical Office of Slovenia, June 1944.

It seems that foreign investment will not be a great hit in the short run. In the long run, however, with new legislation, increased political and economic stability, and lower country risk, foreign investors could find Slovenia more attractive. On the other hand, approximately $200 million of FDI in Slovenia in 1993 is about 1.8 percent of its GDP, well above the 1 percent level which, according to Dornbush, should start worrying monetary and other economic authorities in the country with regard to accommodation of the new foreign capital.

THE SMALL BUDGET DEFICIT IN 1994

The former socialist Yugoslavia's budget was always formally balanced, although that was achieved through frequent rebalancing during the year and with the help of direct credits from the central bank. Thus, in fact, big deficits added to inflationary excessive final demand in the economy.

Slovenia started with a restrictive approach to its budget, which cut off all legal possibilities for its financing directly with central bank credits and trying to equilibrate it. But its size was, in the previous three years of independence, unusually large for the achieved level of country development, especially if the total public sector budget is considered with expenditures being well over 50 percent.

In 1991 and 1992, final ex-post results showed a budget surplus, while in 1993, the realized state budget suffered a deficit of only $^1/_{10}$ of 1 percent of GDP, due to a reverse Oliveira-Tanzi effect (because a larger deficit was predicted).[2]

The budget is adopted in Slovenia in two steps: first, the Budget Memorandum has to pass the Parliament (in addition to first budget figures, it includes major economic policy directions for government), and second, the budget needs to be passed by Parliament. While the Budget Memorandum was approved already in November 1993, the budget itself for 1994 is expected to be adopted in May or June 1994. Current discussions have increased its size while retaining its deficit at the 1 percent GDP level. At the same time, in the first quarter of 1994, a budget surplus is occurring again.

In November 1993 the Parliament approved the Budget Memorandum, including its economic policy and a provisional budget for 1994 with projections for 1995–1997. The document was approved after long and extensive deliberations concentrated on the "guns or butter" dilemma. An agreement signed by the parties in the ruling coalition, whereby the law on defense expenditures should be passed before the budget for 1994, represented a compromise breakthrough of the stalemate that threatened the ruling coalition. By this agreement some accounting principles were broken. The opposition boycotted the vote by walking out.

The Budget Memorandum envisages, for the first time, that there will be no renomination and that any rebalancing of the budget would come through the Parliament only. It appears difficult to fulfill this expectation. Some simultaneously passed acts or developments (for example, changes in the regulation of old age pensions or recent increases of wages), are either inconsistent with the document and/or endanger the proclaimed reduction of the

[2] The Oliveira-Tanzi effect states that in high inflation, which is increasing, the real value of the amount of taxes collected decreases, due to the time elapsed between the occurrence of income (as taxbase) and the time of actual tax payment (usually several months). If inflation is quickly decreasing, the same delay causes larger real value of taxes than expected at the emergence of tax obligation, when inflation was much higher.

TABLE 3. The State Budget, 1993 and 1994
(Billions of Slovene Tolars, current prices) [a]

Item	1993	1994	Factor Change from 1993	
			Nominal	Real
Revenues	310.3	382.1	1.23	1.02
Direct Taxes				
Taxes on Personal Income	54.9	58.5	1.07	0.88
Taxes on Profits	5.8	7.4	1.27	1.05
Indirect Taxes				
Sales Tax	158.3	207.5	1.31	1.08
Custom Duties	50.2	62.6	1.25	1.03
Expenditures	324.7	395.7	1.22	1.01
Current	291.3	356.1	1.22	1.01
Wages and Salaries	74.0	85.2	1.15	0.95
Material Costs	13.1	15.9	1.21	1.00
Defense	19.9	34.1	1.70	1.42
Social Transfers	65.9	83.8	1.27	1.05
Services to Government	40.1	45.5	1.13	0.94
Interests and Guarantees	28.2	40.2	1.42	1.18
Subsidies to Economy	30.7	27.1	0.88	0.73
Transfers to Local Governments	14.0	19.8	1.41	1.17
Investments	33.4	39.6	1.19	0.98
Highways	11.0	18.8	1.71	1.41
(Deficit)	(16.8)	(16.5)	0.98	0.81

Source: *Statistical Report of the Ministry of Finance*, Republic of Slovenia.
[a] The figures for 1994 assume year-to-year inflation of 21 percent.

share of public expenditures in GDP from 48.8 percent in 1993 to 46.6 percent in 1994.

The economic policy presented by the Budget Memorandum assumes:

- GDP in 1994 will increase by 1 percent;
- Inflation will be reduced to 13 percent by the end of 1994.
- Increased competitiveness will step up exports and enable modest surplus in the current balance.
- A social safety net will be secured by taxes and social policy.
- An institutional system will be completed.
- Structural changes will lower the inter-enterprise indebtedness and contribute to financial discipline.

With minor changes, the budget for 1994 was passed in early May 1994. Its planned deficit is 0.8 percent of GDP.

SOCIAL PACT SIGNED IN APRIL 1994

The dynamics of wages in 1992 and 1993 were the weakest point in the economic-performance picture of Slovenia. Namely, the average wage level is estimated to be about 50 percent higher than in the nearest follower among post-socialist countries of Central-Eastern Europe. Such a difference (to a certain extent the legacy of the past self-management experience), is difficult to defend on a productivity basis. Among negative consequences are decreasing competitiveness in international markets due to higher costs and a low level of domestic investment.

In December 1993 the government proposed a new social pact (the third in two years); its basic pillars were the same. It was hoped that it would, first, cut real average wages, and second, increase the number of new jobs significantly. The partners of the social pact would have to be the same: trade unions, the government, and the chamber of commerce (the last was not an appropriate representative of employers; therefore, it formed a new association of employers as negotiating partner). The most important characteristics and differences of the latest proposal, if compared to the versions launched at the beginning of 1992 and 1993, are:

- Commitment of the government to cut tax rates of direct taxes and contributions and to switch significantly to indirect taxes (sales taxes);
- Commitment of the employers and trade unions that the cut of direct tax rates would not be used for the increase of wages;
- Execution of operative economic policy measures (not only commitments) for promotion of employment and training;
- Inclusion into the social contract of wages of all workers (those in private and socially owned enterprises), compensation of managers and salaries determined by special laws (e.g., salaries of judges, members of the Parliament, etc.);
- Partial indexation of the wage scheme to be more severe, while wage adjustments could be done quarterly;
- Determination of sectoral equality of the basic (the lowest) wage. Thus, the importance of the special "sectoral" collective agreements is significantly impaired;
- Progressive "punishment" for increasing wages over the limits given in the social pact. Namely, each increase of wages over the limits determined in the pact (either by basic wages or partial indexation scheme) could be made only if the appropriate percentage of such overshooting is paid in a special employment fund.

Most trade unions were, until April 1994 opposed to signing the latest proposed social pact. Their main objections included the level of the minimum guaranteed (basic) wage (they insisted on a 20 percent higher level), the "punishment" for overshooting, and the weakening of "sector" specific collective agreements (equalization of the lowest wages across sectors). Trade unions were also disputing the variance between the starting (lowest) level of wages in the public sector compared to the business sector.

The weakening of sectoral collective agreements and "punishment" for wage overshooting were also issues of contention among employers. Those from enterprises in restructuring supported the proposal (the "demonstration" effect of wage increases in good enterprises pushes wages in their enterprises up), others (in enterprises that perform well) were against it.

After four months of negotiations and with certain compromises made by all partners, the social pact was finally signed at the end of April 1994.

RESTRUCTURING OF ENTERPRISES AND THE FINANCIAL SECTOR

Restructuring

Restructuring of the enterprise and banking sector has only begun. The major action in enterprise restructuring until now has been registration of 98 mid-size companies for restructuring with the State Restructuring and Privatization Fund in October 1992. In May 1993, with the restructuring process under way under new management teams from the Fund, 21 of these enterprises were sold and privatized, 12 were liquidated, while more than two-thirds of them still remain in the Fund's ownership. Until mid-1993 approximately 10 enterprises were liquidated, 10 were already sold, and for another 20 enterprises negotiations are under way to sell them. Rehabilitation decreased losses of these 98 enterprises from 950 Million DEM in 1992 to 150 Million DEM in 1993.

The limited extent of enterprise restructuring is causing a big problem for bank restructuring, which started in January 1993 when the first bank, Ljubljanska banka d.d. was put under rehabilitation by the Agency for Bank Rehabilitation. Bad loans to enterprises, to the central bank of former Yugoslavia (foreign exchange deposits), and to legal entities in other regions of former Yugoslavia are the main causes for the "black hole" in the banking sector. (According to some estimations total financial rehabilitation of the country will create the public debt in the range of one-third of annual GDP of Slovenia). Another two old banks underwent the rehabilitation procedure later on.

Neither cause of financial distress in the banking sector can be solved easily. First, the problem of inheritance of former Yugoslavia is subject to negotiations under international auspices and will take years to be solved. Second, the problem of bad loans to enterprises cannot be easily resolved because the restructuring of enterprises is only at its initial stage. The State Development Fund would like banks to writeoff their claims toward bad enterprises or to swap them for shares. Both solutions are usually not appealing to banks. Instead, the State budget (Ministry of Finance) is swapping bad loans for its 30-year 8 percent securities, denominated in DEM. This will help the cleaning of the balance sheets of banks under rehabilitation, but will raise questions of moral hazard at the same time. Current state budget investment in bank rehabilitation is around 1.5 billion DEM. For its service, the budget needs less than 150 million DEM yearly.

Structure

The structure of the financial sector is changing rapidly. The number of banks operating in Slovenia increased between 1992 and 1993 from 16 to 32 (five of them in mixed ownership with foreign banks); and the number of licensed savings associations increased to 13. Banks are still the predominant institutions of the financial sector. They hold more than 90 percent of its assets, with the remaining 10 percent belonging to insurance companies (some of them with foreign capital) and financial advisory agencies. At the end of March 1993 there were 27 bank main offices in operation with 34 business units, 155 branches, and 693 agencies and with 9,900 employees (1.5 percent of the labor force). Thus, Slovenia probably has the most extensive banking network among all Central and Eastern European countries. To establish a new bank, the minimum required founding capital at the end of 1992 was 350 million Slovene tolars, but this minimum needs to be increased to 60 million DEM by mid-1995.

Three banks were put in pre-rehabilitation procedure in 1992, and all three (Ljubljanska banka, Kreditna banka Maribor, and Goriska banka) underwent regular rehabilitation procedures at the beginning of 1993.

The Ljubljana Stock Exchange (LSE), one of the first and largest in Eastern and Central Europe established in 1989 by 45 shareholders, had a turnover of 244 million DEM in bonds, 181 million DEM in stocks in 1992. The profit was approximately 0.3 million DEM and was transferred to revenue reserves. The LSE had 56 members in December 1992 (22 of them banks). The heaviest trading was with the Bank of Slovenia treasury bills. In 1992, the exchange established a Guarantee Fund and the Exchange central depository. Over-the-counter (OTC) transfers had to be registered with the Exchange from 1992 onward. The precious metals market was formed in February 1993.

CURRENT ECONOMIC PERFORMANCE AND PERSPECTIVES

REVIVAL OF ECONOMIC ACTIVITY

In the second half of 1993, after a prolonged recession, signs of growth appeared. GDP decreased in 1992 by 6.5 percent (previous rates from 1988–1991 were –1.7, –1.8, –4.7, –9.3 percent, respectively), while positive growth of 1 percent is estimated for 1993, and it should be improved in 1994. Among sectors, manufacturing is more than one-third below its peak (only the sector of social ownership is recorded, while the private sector increases its share moderately, more in services than in material production; its share is 10 percent according to unofficial estimations, present predominantly in services), construction dropped even more than 40 percent from its peak in the 1980s. With adjustment of GDP measures to Western standards, manufacturing decreased its share in GDP to one-third, agriculture to 5 percent and all services count for 50 percent of GDP (financial intermediation's share in GDP is over 10 percent).

Significant changes in economic activity can be observed in the cumulative yearly figures. Thus, in 1993 total transportation increased by approximately 4 percent, tourism by over 6 percent, and industrial production fell by only 2.8 percent (compared to 13.2 percent in 1992). As forestry and construction were depressed significantly more than other sectors in 1993, they were the worst performers not only by current dynamics but also by yearly levels; the activity in 1993 was in both sectors 18 percent lower than in 1992!

Inventory figures and survey data regarding business expectations on demand perspectives (new orders) in domestic and foreign markets support an up-trend change in economic activity at the end of 1993, but also at the beginning of 1994. Inventories of completed goods have been decreasing over the past twelve months.

According to the business expectations survey in December 1993, less than 10 percent of enterprises face critically low demand.

TABLE 4. Economic Performance of Slovenia, Selected Indicators, January 1992–January 1994[a]

Month	Manufacturing (1990 = 100)	Employment (thousands)	M1	Inflation (monthly)	(Millions of Dollars) Trade Balance	Reserves	Debt	Exchange Rate (tolars/DEM)
1992/1	73.7	677	39.9	15.2	135	364.7	1,866	37.3
2	79.1	674	41.4	11.0	110	417.9	1,778	47.9
3	84.1	668	42.2	11.5	107	510.4	1,761	50.4
4	76.3	663	50.2	5.1	27	589.5	1,747	51.1
5	77.8	661	48.4	6.5	27	702.9	1,761	51.4
6	78.0	656	52.1	5.9	36	826.9	1,801	50.6
7	71.8	655	55.8	2.0	7	945.6	1,845	51.7
8	66.7	652	61.8	1.4	48	1,094.1	1,833	55.0
9	77.7	650	65.3	2.7	116	1,141.1	1,821	57.5
10	80.3	646	68.8	3.4	18	1,140.7	1,732	58.6
11	76.2	643	70.8	2.8	−41	1,142.3	1,678	60.1
12	71.1	638	82.7	1.1	−50	1,163.2	1,741	61.1
1993/1	70.8	634	80.5	3.7	18	1,204.4	1,746	61.4
2	68.8	632	81.6	1.6	−26	1,169.5	1,742	62.1
3	79.7	638	84.1	1.4	−76	1,135.8	1,751	63.9
4	71.0	634	86.1	1.0	−60	1,208.9	1,765	66.3
5	73.5	632	88.6	1.4	−68	1,230.9	1,786	68.6
6	73.8	630	97.1	1.5	−8	1,201.9	1,740	69.9
7	68.6	626	100.4	0.8	−22	1,242.4	1,692	70.0
8	67.6	622	100.9	1.7	1	1,380.5	1,772	70.3
9	78.7	620	103.8	1.7	21	1,467.7	1,858	71.3
10	81.1	616	108.4	2.9	−32	1,459.2	1,844	73.2
11	78.7	613	108.7	1.6	−50	1,472.5	1,801	74.9
12	74.6	609	117.6	1.5	−98	1,566.3	1,873	76.5
1994/1	70.8	609	112.2	1.5	43	1,654.9	1,887	77.2
2	71.7	609	117.0	1.3	16	1,712.8	1,902	77.8
3	84.5	608	117.0	1.1	−30	1,783.9	1,924	78.5

Source: Statistical data base of the Economic Institute of the School of Law, University of Ljubljana.
[a]Units of measurement: manufacturing = indices, 1990 = 100; employment = thousands of employees; M1 = in Billion of tolars; inflation = monthly growth rates of retail prices; trade balance = in millions of US dollars; reserves = in millions of US dollars; debts = in millions of US dollars; and exchange rate = tolars/DEM.

About half of the surveyed enterprises described their domestic demand problems as modest, while only one-third of them gave the same estimate of demand in foreign markets. It is without doubt that responses were far more optimistic than they were in the same period a year before!

Next, unemployment was increasing and employment decreasing until 1994, but at the beginning of 1994 both trends reversed. The number of employed in the social sector decreased from December 1991 to April 1994 from 680,000 to 620,000 (at its peak it was over 800,000), while the number of unemployed increased from 90,000 to 135,000 at the end of 1993—thus achieving an unemployment rate of more than 15 percent. At the same time, the (official) number of employed in the private sector increased only slightly in that period, from 33,200 to 33,600. But the actual number of workers in the private sector is much higher. They are not registered to avoid social contributions (employers) or to collect unemployment benefits while working (employees). Studies show that using OECD international standards, the number of unemployed would decrease by 40 percent. At the beginning of 1994, for the first time after 8 years, the number of unemployed decreased by about 10,000 to 127,000.

The minimum guaranteed wage for basic unskilled labor is around 400 DEM in the nonproductive sector (not included in the GDP calculation, as for instance non-marketable services in social security, culture, art, and administration) and 500 DEM in the productive sector, where the latter could be decreased by 20 percent. Average net monthly wages are around 650–700 DEM, surpassing 700 DEM in May 1994. These numbers are far too high with regard to the competitive position of Slovenia at home (leading to losses and potential bankruptcies) or abroad (decreasing exports).

Employment has continued to fall steadily in the fourth quarter of 1993, but stopped falling since. At the end of 1993 total employment was 4 percent lower than at the end of 1992. The dynamics of employment in the public sector (health, education, government) and in the private segment of the business sector is positive.

LABOR COSTS THAT OVERTOOK PRICES

Retail prices grew 96.7 percent in 1992, but by only 22.9 percent in 1993 and by 7.2 percent in the first five months of 1994. Until the end of 1993, producer prices grew even slower, which indicated a lowering of inflationary expectations. In 1994 they are growing faster than retail prices. The cost of living is somewhere in between.

After leveling off (from 20 percent monthly rates immediately after the separation of Slovenia and the introduction of new currency) in the second quarter of 1992 at around 2 percent per month, inflation has been decreasing very slowly. Average growth rates of retail sale prices reduced from 2.2 percent in the second half of 1992 to 1.76 percent in the first half and to around 1.69 percent in the second half of 1993. In the last quarter of 1993, inflation dropped to approximately 1.5 percent per month. Although policymakers tried to reduce monthly variation of inflation around the average, they have been even less successful in that than in cutting average inflation rates to less than 1.5 percent a month. The changing sales tax rates, the seasonal increases of prices, and the adjustments of some prices in the public sector (especially gasoline and electricity) have been the most important reasons for both the variability of inflation and the slow reduction of average growth.

Producer prices increased by 9.3 percent in the fourth quarter of 1993 and continue to increase faster in 1994. They overtook retail prices significantly (by 1.5 percentage points) for the first time after June 1992. It seems that sustainable increases of domestic unit costs for more than a year and a half finally gave a decisive push to producer prices and probably inflationary expectations. Wages and custom duties were the leaders among domestic cost increases. Namely, the total business sector wage bill increased from June 1992 to November 1993 by 12 percent (average wages by 25 percent). In real terms, custom duties grew by 11.5 percent, while real direct taxes increased by only 0.7 percent. In the same period, sales taxes increased in real terms by less than 7 percent. The corresponding unit costs (of wages and custom duties) increased by at least 5 percent in real terms from mid-1992 to the fourth quarter of 1993.

INCOME POLICY

Wages are the weakest point in current performance of the economy. In the last quarter of 1993, the wage bill made a further jump in real terms, and stagnation of wages at the beginning of 1994 seems to be just seasonal, because after March their real growth has continued.

In the year ending in the fourth quarter of 1993, the total wage bill increased by 3 percent in real terms. Increases in the government and the social services were larger (more than 6.5 percent in real terms) than in the business sector (1.5 percent in real terms). But, because of significant differences in the dynamics of employment, the differences in growth of average wages were reversed. Thus, in 1993, average wages increased by 7.7 percent in real terms, whereby in the business sector average wages increased by 9.2 percent, and in the public sector by only 3.7 percent.

FISCAL SURPLUS AT THE BEGINNING OF 1994

The consolidated government account achieved a surplus of 2.7 percent GDP in 1991 and 0.3 percent GDP in 1992 (due to reverse Tanzi-Oliveira effect), while for 1993, a deficit of 1.8 percent GDP was planned (state budget is about 25 percent of GDP, total public expenditures close to 50 percent of GDP), but only 0.01 percent was achieved. Officially, public debt does not yet exist. At the beginning of 1994, the state budget is running a surplus, despite the fact that a deficit of 0.8 percent GDP is planned in the adopted budget for 1994.

The expenditures related directly or indirectly to the social security of the population (including the restructuring of the enterprise sector) are becoming a predominant form of budget expenditure. The idea of an integrated budget was introduced to support prudent fiscal policy. At the state level fiscal policy is successful, but problems still exist regarding certain nonbudgetary expenditures (funds) and budgets on the commune level. Some of the 64 commune administrations brought themselves into bankrupt situations by issuing securities that they are not presently able to service.

Due to increased final domestic demand and seasonally strong household consumption, sales taxes and custom duties jumped significantly (by 7 percent and 10 percent respectively) in the fourth quarter of 1993. 1993 was the second successive year of dramatic change in movements of direct and indirect taxes and contributions. Implied structural changes in fiscal revenues are significant; direct taxes and contributions dropped from 73.5 percent of total fiscal revenues in 1991, to 67.8 percent in 1993, while sales taxes and custom duties climbed from 19 percent and 7.4 percent in 1991 to 24.5 percent and 7.6 percent in 1993 respectively! Structural reshuffling on a similar scale also occurred in the revenues for social services. The changes were, however, not so consistent. Namely, health contributions increased from 28.4 percent of total contributions for social services in 1991, to 37.6 percent in 1992, and then dropped to 32 percent in 1993. Similarly, contributions for pensions fell from 65.6 percent of total contributions in 1991 to

57.6 percent in 1992, and then climbed again to 61.5 percent in 1993.

QUIETING FINAL DEMAND AFTER FAST GROWTH?

After the first quarter of 1993, the continuation of a slump, domestic demand rose very quickly in nominal and real terms. It jumped by 19.2 percent in the second quarter, 7.8 percent in the third quarter, and 14.3 percent (7.5 percent in real terms) in the fourth quarter. There were almost no exceptions in this acceleration of domestic demand. Investments increased in every quarter after the first quarter of 1993 by more than 18 percent (over 14 percent in real terms) and increased even more in the last quarter, growing as fast as 32.6 percent per quarter (24.2 percent in real terms). Material consumption of the public sector also increased consistently after the first quarter of 1993. In the last quarter, it jumped by 22.6 percent (15.3 percent in real terms). Starting very fast by jumping 25.5 percent in the second quarter, household consumption's mild increase (5.6 percent per quarter) in the seasonally strong last quarter was perhaps the only unexpected point in the increasing domestic-demand picture!

TABLE 5. Foreign Trade, 1992–1993

(Millions of Dollars)

	Exports			Imports			Surplus/Deficit		
	Total	SFY[a]	Proper[b]	Total	SFY	Proper	Total	SFY	Proper
1992	6,681	1,508	5,173	6,141	1,218	4,923	540	290	25
1993/1	456	72	384	438	60	378	18	12	6
/2	492	80	412	517	65	452	–25	15	–40
/3	558	88	470	634	69	565	–76	19	–95
/4	485	83	403	545	67	479	–60	16	–76
/5	488	73	415	555	57	498	–67	16	–83
/6	547	85	462	554	58	496	–7	27	–34
/7	518	75	442	546	54	492	–28	21	–48
/8	425	100	325	432	47	385	–7	53	–60
/9	538	83	455	516	57	459	22	26	–4
/10	524	74	449	564	57	507	–41	17	–58
/11	484	69	414	529	49	480	–46	20	–66
/12	526	80	446	624	47	578	–98	33	–132
1993	6,088	963	5,125	6,488	692	5,797	–400	272	–672

Source: Statistical Office of Slovenia and Bank of Slovenia, Statisticni Bilten.
[a] SFY = States of Former Yugoslavia.
[b] Proper = All other foreign countries.

As the fourth quarter is seasonally strong for all three components of domestic final demand, seasonally adjusted figures also need to be studied separately. Seasonally adjusted data of final domestic demand revealed another (rather unexpected) unpleasant characteristic of 1993 rapidly increasing domestic demand. Namely, seasonally adjusted domestic demand attained its peak real growth rate in the second quarter of 1993. After that, real growth rates (in all quarters and for all components of the domestic demand) consistently declined, and this continued in the first months of 1994. Thus, seasonally adjusted final domestic demand in the last quarter was stagnant in real terms. Correspondingly, adjusted figures for investments and government material consumption showed increases in real terms by 3.5 percent and 3.7 percent, respectively, while seasonally adjusted household consumption dropped in real terms by 3.2 percent. Obviously, economic activity conclusions made based on seasonally adjusted data on domestic demand are not quite concordant with optimistic business expectations concerning domestic demand for the near future. It seems that seasonally adjusted data give another piece of evidence that the economy with a foreign trade ratio over 1.2 (which is the case of the Slovene economy) cannot be basically driven by tiny and erratic domestic demand.

Exports of goods in the seasonally strong last quarter of 1993 increased by 4.6 percent; they accumulated to $1.6 billion (approximately 58 percent of domestic absorbtion in the same quarter). In the year to the fourth quarter of 1993 exports (in dollars) increased only slightly (by 0.3 percent). However, the continuing war in the rest of the former Yugoslavia caused a drop in exports to that area by another $80 million in the last quarter of 1993 compared to 1992. Thus, exports to newly conquered, mainly EU markets increased approximately by 5 percent in the same period. At the beginning of 1994 trade balance is slightly positive with the volume of trade comparable to the 1993 level. Current balance-of-payment surplus amounts to $180 million in the first quarter of 1994.

Surplus in the balance of nonfactor services topped $100 million in the fourth quarter. Exports of (nonfactor) services dropped from a very high value of $380 million in the third quarter to $350 million in the last quarter. However, exports remained larger than the comparative figure for 1992.

The current balance of payments, traditionally positive for Slovenia, showed a surplus $932 million in 1992 and $196 million in 1993 (without relations with other regions of former Yugoslavia, from 1988 to 1991 the surplus was $1365, $1085, $526 and $190 million, respectively). This enabled foreign reserves to grow from $170 million in October 1991 to $1,900 million by April 1994. Modest external debt at the level of $1,900 million (unallocated federal debt of former Yugoslavia not included) is serviced regularly (for certain problems with a private bank as creditors a temporary compromise was found). By all criteria, Slovenia is only a lightly indebted country with debt service ratio 8.0 percent in 1991, 5.2 percent in 1992 and 5.4 percent at the end of 1993.

A foreign exchange regime is characterized by unhindered payments abroad and free access to foreign exchange markets for current account transactions (including households), meaning full current account convertibility. The official (floating) exchange rate of the tolar is formed as a 60-day weighted average of market exchange rates. It started with 33 tolars per DEM in October 1991, but due to a decreased inflation rate it stabilized at the level slightly below 80 tolars = 1 DEM in May 1994. Due to the current account surplus and inflows of capital (FDI plus credits disbursed) the foreign exchange is in surplus supply, which could lead to a small appreciation of domestic currency in 1994.

A major issue in the debate about the Slovene economy in 1993 was *how to proceed from stabilization to growth*. Separating from the major central market of former Yugoslavia and creating a new monetary space (Slovene currency, the tolar, was successfully introduced in October 1991) for the small regional economy of Slovenia has had a profound negative effect on the economic activity of Slovenia. It deepened the usual "transition recession" experienced by all economies of Eastern and Central Europe in transition.

Production has been decreasing continuously for several years. There was a moderate attempt at revival in the second half of 1992, which was annulled by the significant increase of wages and contributions (i.e., labor costs) by more than 30 percent between summer 1992 and spring 1993. The wage freeze with the intervention law, adopted in February 1992, was temporary, because the law was valid only until the end of June 1993. Some fear that the collective wage bargaining with the trade unions could lead to another real wage increase, which would be disastrous for the economy. Results could be a revival of inflation or further decreasing activity and increasing unemployment.

Increasing unit labor costs (which constitute up to 60 percent of all costs) are decreasing the competitive position of Slovene enterprises in the world markets and causing losses on the depressed domestic market. (These costs are almost twice the costs of the nearest economy in transition and ten times higher than in some other economies in transition.)

Simple expansion of domestic final demand as the measure to stimulate the economy in classical Keynesian tradition is not the proper remedy for the small, open regional economy (Slovenia), which was separated from the central larger market (former Yugoslavia). The domestic market cannot absorb, in a reasonable period, all the production, previously a larger share directed toward the Yugoslav market (and exported). Up to 40 percent of the total (not only final) sales of Slovenia were from the Yugoslav market; exports counted for another 25 percent of sales. The decrease of sales to the rest of the former Yugoslavia by 65 percent could not be substituted by the increasing sales in the domestic market. Increasing exports is thus the imperative and the only solution for the revival of activity in the case of the Slovene economy.

There are two views how to *stimulate exports*: through real depreciation of the domestic currency or through improving the competitive position of the domestic economy by decreasing (or at least stabilizing) production costs, labor costs being the most important.

The proponents of the first approach argue that depreciation of the tolar did not follow Slovene relative inflation. Whether this is true crucially depends on the choice of a starting period.

The argument for the second approach is that real wages in Slovenia were increasing while GDP was decreasing. This has led to a sharp increase of the wage share (now together with related taxes and contributions amounted to almost 60 percent of GDP) and a corresponding decrease of the profit share. In this situation, decreases of real wages (from a current average monthly rate 700 DEM to a competitive "efficiency" wage around 400 DEM) is a necessary precondition for reestablishing a competitive position of Slovenia in Western markets (with regard to competition coming predominantly from Hungary, the Czech Republic, Slovakia, and Poland).

The major difference between the two approaches lies in the fact that the depreciation of the tolar increases the export surplus and—given the amount of national savings—causes higher interest rates (which in turn decrease investment activity) and inflation (increasing costs of imports), while the reduction of real wages with increased savings improves the competitive position of Slovenia and thus enables increasing exports at the stable exchange rate of the tolar, a lower interest rate, and smaller inflation. The latter policy would enable new investment (profitable under lower interest rate), and thus growth, once full-capacity utilization is achieved in exporting industries. The wage decrease is, however, much more "painful" and difficult to exercise, but at the same time much more rewarding and in fact the only way from stagnation to economic growth (higher production and employment).

As empirically shown for Slovenia, the superiority of export stimulation by improving the competitive position through decreasing real wages rather than by depreciating the domestic currency lies in the features of a small (regional) economy, especially if it was separated from the central market. Namely, if costs of production are increased through the real wage increase, prices of exported goods increase, while quantities decrease even more (elastic demand for exports) leading to a decrease of the value of exports. On the other hand, however, increased wages cannot be fully spent on the domestic market. It is inelastic in the short run, especially for luxury goods to which additional income would be directed. (It would require changes in the structure of production of goods and services, some of which—tourism, for instance—could not be increased at home at all.) Thus transitional income, incurred by increasing real wages, would be to a larger share either saved (lack of credibility) or spent for imported luxury goods.

This holds in the short run, while in the long run domestic capacities could be increased to adapt for incremental demand (with a different structure of consumption). For stabilization efforts, as is the present case of Slovenia, what matters at the moment is the short run. While in the small economy (with high external trade ratio) in the process of separation, the domestic market could never fully substitute for the foreign market; in the large major economy (with a lower trade ratio, as it is the case of Russia's separation from the former Soviet Union) the opposite is true.

FINANCIAL DEEPENING

Monetary policy and the role of the central bank of Slovenia is the major stronghold of a relatively successful stabilization policy. Two other relevant preconditions for stability are prudent fiscal policy and a well-established income policy.

With the introduction of the new currency in October 1991, money supply was chosen over the exchange rate as an indirect target of monetary policy for which targeting the high-powered money (monthly money supply) was a primary goal. Reasons for this choice were the relatively stable demand for money, the multiplier, and the lack of foreign currency reserves because of the introduction of the floating exchange rate system.

From introduction of the tolar in October 1991 until the summer of 1992, real money aggregates decreased significantly, indicating intentional draining of the surplus liquidity in the economy as an important measure to decrease inflation. Later demand for money increased due to decreased inflation, and monetary aggregates increased in the framework of a more relaxed monetary policy. Thus, as a result, between December 1991 and 1992 M1 increased by 112.7 percent (more than doubled), short-term credits of commercial banks to the enterprise sector rose by 121.2 percent, long-term credits to the enterprise sector 120.5 percent, credits nominated in foreign exchange by 64.6 percent, while retail prices increased 92.6 percent and producers' prices rose 76.2 percent. Two important factors the Bank of Slovenia had to take into account as a constraint in 1992 were the surplus of the current account (net inflow of foreign exchange had to be monetized) and special liquidity loans made to banks under rehabilitation.

In 1993 monetary policy was less restrictive. Real M1 (real balances) and primary money increased 20 percent (cash 13 percent, demand deposits 25 percent), "quasi money"[3] increased 50 percent in real terms and, thus, real M2 41 percent. The money multiplier for M1 retained the value 2.5 and for M2 increased from 8 to 11. This means that the primary creation of financial aggregates by the central bank was a major cause of the real money increase, not the secondary creation of money and credit by the banking sector. In fact, total credits outstanding from the banking sector remain unchanged in real terms, while saving deposits increased by one-third in real terms.

Yearly inflation of only 22.9 percent indicates that monetary policy was not inflationary. Instead, financial deepening, connected with increased credibility, occurred. These trends continue in 1994, where saving deposits in domestic currency increase quickly. Due to neutralization of excess supply of foreign exchange the Bank of Slovenia needed to increase money supply faster than there was a growth of M1 or bank credits, thus decreasing money multiplier.

Major instruments used by the Bank of Slovenia are obligatory reserves, foreign exchange minimum requirements, Bank of Slovenia bills, liquidity loans, lombard[4] loans, repurchase agreements, and direct intervention on the foreign exchange market. The official (floating) exchange rate of the tolar is formed as a 60-day weighted moving average of realized exchange rates in the inter-enterprise foreign exchange market, while the exchange rate for the population at large is formed freely by the exchange offices. Due to a decreased inflation rate and a stabilized exchange rate (at the level of 78 Slovene tolars = 1 DEM in May 1994) differences among the three exchange rates are minimal.

With decreasing inflation, interest rates also started to decrease, but hedging against inflation risk in the form of the revaluation

[3] Quasi money includes financial instruments like savings deposits, which are a little less liquid than money per se.

[4] Lombard loans and credits are loans and credits given against some kind of merchandise rather than real eastate as collateral. In the Slovene case, foreign exchange (currency) is used as collateral.

clause (R = growth rate of retail prices in the previous month) or the foreign exchange clause remained in place, despite attempts by the government to abandon them.

The central bank nominal discount rate was 25 percent from October 1991 until May 1993, when it was first decreased to 18 percent and is currently 16 percent. Rates for lombard credits fell from 26 percent to 17 percent, the passive rate for obligatory reserves is 1 percent; the legal interest rate for delays was increased in mid-1992 from 50 percent to 155 percent, but later decreased to 45 percent in March 1993. Rates for liquidity loans are R (revaluation factor, calculated as inflation rate in previous month) plus a 6.5 percent–7.5 percent real rate, and rates for Bills of the Bank of Slovenia are R plus 1 percent–8 percent. The interbank rates started to be published in November 1992, when nominal rates achieved 74 percent, but decreased by February 1994 to 32 percent (8 percent in real terms). In March 1994, indicative banking rates were revaluation factor R or foreign exchange clause D plus 7.3 percent–10.9 percent on passive side for time deposits, while it was R or D plus 16.9 percent–17.4 percent on active side for credits. The bank real prime interest rate is 11.5 percent.

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THE CROATIAN ECONOMY: TRANSITION AND STABILIZATION

By Ivo Bicanic*

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SUMMARY

Croatia, as one of Yugoslavia's successor states, has been defining its independent transition path since mid-1991. The economic costs of transition in Croatia have been significantly increased by the war. The main macroeconomic indicators by mid-1994 fell to half of its pre-independence and pre-transition values. Macroeconomic instability was also substantial, and the tripled inflation rate approached hyperinflationary levels.

Nonetheless, Croatia has made significant progress in its economic transition to a mixed-ownership, market economy. The restructuring of economic institutions is almost complete and most new institutions have already proved their effectiveness. The chosen privatization legislation was revenue-oriented, state-dominated with special incentives for small shareholders. Due to lack of capital (domestic, largely due to concurrent housing privatization and declining living conditions; and foreign, due to war-related uncertainty), the state supported privatization by stepping in as a temporary owner—which has resulted in its being the largest owner

* Ivo Bicanic is a Fellow at the Woodrow Wilson International Center for Scholars.

and employer in the economy. The restructuring of economic sectors lags behind other transition-related changes.

The implementation of a rigorous stabilization policy based on monetary austerity, wage control in the state sector, and internal convertibility started in autumn 1993. This policy has successfully lowered inflation rates for an extended period. The continued success of this policy depends on maintaining restrictive monetary policies, the still-untested fiscal discipline, the cessation of hostilities, and external financial support, which until now has been absent.

INTRODUCTION

Since the second half of 1991, Croatia has been "going-it-alone," drafting new economic policies for itself as a distinct economic entity with 4.7 million inhabitants, an estimated Gross National Product (GNP) of $12 billion, and a per capita income in 1993 of $2,644 (in purchasing power parity, $5,310). With economic independence from Yugoslavia, Croatia has attempted to design and implement a transition course and an economic stabilization program best suited to its particular economic structure and circumstances. Now, at mid-1994, policies for both are in force, but neither task has been completed.

The legislation governing a mixed-ownership, market economy is almost entirely in place, the institutions regulating goods, services, and factor markets are functioning, and privatization continues along its defined path. Croatia must still restructure the remaining inflation-generating sectors, but now transition policies can be tackled in a stable, economic environment. Following two failed efforts, the third attempt to develop a coherent, macroeconomic stabilization policy, begun in October 1993, has had unexpected success and lowered inflation rates from a hyperinflationary, 30 percent monthly level in September 1993 to negative rates for the first five months of 1994. The task of lowering the inflation rate was placed on monetary and income policy. Successful monetary policy has since passed the burden of maintaining stability to fiscal policy. This now has the unenviable task of reducing inherited entitlements and managing a balanced budget, which must finance the state apparatus plus defense and economic restructuring.

In the beginning, Croatia had to tackle these very demanding social programs in an extremely adverse economic and political environment. Its political independence was contested internally by a Serbia-inspired and engineered rebellion among part of Croatia's Serb minority. This rebellion required building an army, financing a war (which has now gone into its third year) and caring for numerous displaced persons and refugees. Croatia also implemented these policies without any external financial support and was unable to use a foreign trade deficit to defer any of the adjustment costs. As a result, even if these policies had been flawlessly designed and implemented, the unfavorable environment has made the process much more complex and its inevitable economic and social costs that much higher. The complexity of transition and stabilization and the features of the unfavorable environment have highlighted the dangers of "adjustment fatigue" and the possibilities for back-pedaling, as well as the need for a robust and durable social consensus to back economic policy and, perhaps more important, its implementation.

This paper addresses the two processes currently dominating the Croatian economy. In addition to providing a "progress report," it will attempt to analyze the main features of the processes. The social costs of transition and the war will be the topic of the first section and the second section will examine transition. The third section analyzes the course of the current macroeconomic stabilization policy.

ECONOMIC COSTS OF TRANSITION AND THE WAR

All economies attempting transition have found it to be, in economic terms, a very costly process. Indeed, the costs of transition everywhere, including Croatia, turned out to be much higher than expected. What makes Croatia's position unique is that the post-transition, economic crises ran simultaneously with Croatia's part in the war of the Yugoslav succession. This war, even though intertwined with transition, is a separate, expensive, and costly process.

The cumulative effect of the transition crises and the war has been great at both macroeconomic and microeconomic levels. While their influences cannot be isolated, it seems clear that the lasting effects of the war pose a constraint to successful transition.

MACROECONOMIC COSTS

The benchmark figure for measuring Croatia's economic costs of war and transition is 1990, the last year before independence. Even though use of this date can be justified, in most cases Croatia's economic decline started earlier. The highest values of social product (i.e. net material product), industrial production, and employment were reached in 1987. All three variables have been contracting since.

In 1990 Croatia's GNP was estimated at $16 billion; its per capita income, $4,600. Employment was almost 1.6 million, and the unemployment rate hovered around 10 percent. Three years later, in 1993, Croatia's GNP had dropped and was estimated at about $12 billion; per capita income was $2,505; and employment fell to 1.1 million.[1] The largest drop came during 1991, coinciding with Croatia's entrance into the war of succession from Yugoslavia. Since then, negative growth rates have persisted, but at much lower levels (see Table 1).

The contraction changed the structure of the economy. Industry's share rose because the war had a greater effect on services (tourism and transport, in particular); international trade contracted to adapt to the smaller production and the loss of major markets—the Council for Mutual Economic Assistance (CMEA) and the former Yugoslav market. By 1993 industrial production was half its 1990 value, and productivity fell by one-third. This decline has been asymmetric by sectors, most dramatic in services and shipbuilding and least measurable in textiles and the food industry. The eco-

[1] Data *Basic Macroeconomic Statistics: April 1994*, State Institute for Macroeconomic Analysis and Forecasting, Zagreb.

TABLE 1. Croatia's Post-1990 Macroeconomic Indicators

Date	Nominal GDP (Billions of Dollars)	Industrial production (1990=100)[a]	Employment (in thousands)	Industrial price index[b]	Real wages (1990=100)[a]	Unemployment rate
1990	15.91	84.0	1,569.8	549.0	103.8	9.3
1991	13.62	57.1	1,387.2	246.4	47.6	15.5
1992	12.39	64.0	1,231.0	926.0	30.9	17.8
1993	12.00	56.5	1,180.2	1,612.9	46.9	17.5
March 1994	NA	54.5	NA	660.8	(Feb.) 47.6	NA

Source: *Basic Macroeconomic Statistics: April 1994*, State Institute for Macroeconomic Analysis and Forecasting, Zagreb.
NA = Not available.
[a] Seasonally adjusted indexes, 1990 average = 100.
[b] Year-to-year monthly indexes.

nomic structure has further changed by the time horizon of decision makers. Crises and war shorten the horizon reducing investments (80 percent of depreciation and in seasonally adjusted constant-price indexes 16.2 percent of 1990 values in December 1993).[2]

Croatia's economy is further plagued by major war-related communication problems, which have increased the asymmetric regional costs. The richest agricultural region is temporarily not under government control, nor are the only oil fields and some of the richest forests. Dalmatia, one of the most affluent regions in the past, has been virtually cut off from the rest of the country, and its economy has contracted to one-third of its 1990 values.[3] The main agricultural region, Slavonia, is connected to the rest of Croatia only by roundabout road and rail links. In addition, there is no national energy grid and the oil pipeline is not operating. The total, direct war cost to date is three times the current GNP ($22.5 billion); there have been 45,000 killed, wounded, or missing; 5 percent of the population (230,000) remains displaced; and over 60 percent still live within artillery range of Serb rebel positions.

WELFARE COSTS

The costs of the war and the transition seem even greater when considering the effect on the welfare of the population. In the short term, the population has paid the cost of transition and independence. Household consumption of goods and services is half of 1990 values, real wages are 40 percent of these values, and savings have been wiped away. Since April 1992, household expenditures have statistically exceeded household incomes. Average monthly wages are (after the revaluation of the Croatian dinar) around DM 300, just more than half the DM 545 required for the estimated minimum consumption for a family of four. The average pension of the

[2] *Croatian Economic Trends*, vol. 4, no. 1 (March 1994).
[3] See Iva Dominis, "Dalmatia: A Croatian Resource Divided," *RFE/RL Research Report*, vol. 3, no. 9, pp. 37–42.

800,000 pensioners is under DM 150 per month.[4] Obviously the unofficial economy is increasing.

Changes in aggregates and averages mask major changes in the economic inequality caused by the uneven effects of war and transition. The ranking of regions has changed with the war-induced collapse of Dalmatia's economy (cut-off transportation routes, collapse of tourism, and the influx of refugees). Apart from the changed ranking, the range has widened. Economic inequality in the narrow sense has increased significantly. The ratio of highest to lowest salaries and wages has risen to 67:1[5] (from previous levels of 10:1). At the same time, most wage earners are concentrated in the lower income groups, which now include most of the educated middle class whose salaries are increasingly dependent on public spending. To this is added the increasing inequity resulting from privatization.

This welfare situation is made worse by an inadequate social safety net. Even though a new welfare system was introduced in the summer of 1993, by the end of the year 105,000 families[6] required assistance, and unemployment and poverty remained predominantly a family expense. The general fall of real income makes this an increasingly difficult burden.

Even though transition and war have raised overall costs, the initial benefits of the transition have appeared. The first postwar payments of dividends to shareholders have been distributed. The press[7] reports that, in general, returns will be 6–8 percent, even though one firm has paid a handsome 15 percent.

Progress of Economic Transition in Croatia

During Croatia's transition to post-socialist economic development, policy did not always develop in a straightforward manner. Yet it is useful to explain the evolution of economic transition to date in Croatia.

While Croatia was still part of Yugoslavia it underwent a process of "maturing from reform to transition." This process began in 1983 with a State and Party "marketization reform and survival scenario" and ended in 1989 with an economy facing hyperinflation and instability. During this 1983–1989 period, which coincided with the crises of the 1980s, solutions to crisis management were sought within the socialist system. Anti-inflationary policies and reform scenarios were unsuccessfully attempted three times each. This continuous failure generated a slow but stubborn and accelerating maturity and awareness that socialist reforms had to be replaced by transition to a market economy. The ensuing period was the one characterized by the Yugoslav "federal transition plan." This period started in 1989 and lasted, as far as Croatia was concerned, until mid-1990. During this time a few breakthroughs were achieved. There was a significant change in property rights, where an almost level playing field regarding ownership was created, existing enterprises were made into joint-stock companies, and a pri-

[4] All data from Ivo Bicanic, "Croatians Struggle to Make Ends Meet," *RFE/RL Research Report*, vol. 2, no. 45 (12 November 1993), pp. 29–34.

[5] Calculated from data in *Privredni vjesnik*, 20 August 1993, p. 10.

[6] Interview with the minister of welfare, *Vecernji list*, 5 December 1993, p. 12–3.

[7] *Vecernji list*, 9 March 1994, p. 4.

vatization plan and limited factor markets were introduced. Marketization was changed by eliminating market entry barriers and liberalizing foreign trade, and a new macroeconomic stabilization policy, based on internal convertibility, foreign trade liberalization, and income policy was implemented. The Yugoslav federal transition plan was derailed by its incompletely delineated policies and their halfhearted implementation, the absence of strong political and social consensus, its uneven effects on different regions, and (finally) the results of the 1990 multiparty elections. It was replaced by economic and political fragmentation and the onset of "go-it-alone" policies in all republics. By 1990 inflation had again achieved hyperinflationary proportions.

From these initial conditions, Croatia embarked on the task of attempting to define a transition course best suited to its own, simpler conditions without the constraints of the "convoy effect," "backpedalling from up-front transition costs," "policy sabotage," and "political filibustering." Little of the federal transition path remained, and Croatian policies developed along two lines. The first coincided with the break-up of Yugoslavia, from mid-1990 to 15 January 1992. During this time, Croatia passed legislation for a new privatization program and a stock market and achieved monetary and fiscal independence. The second began after 15 January 1992, and is still ongoing—that is, Croatia's complete economic independence following its international recognition as a sovereign country. The broadly defined transition was modified by legislation that set up the underpinnings of a market economy and broadly outlined a comprehensive plan for achieving macroeconomic stabilization and economic restructuring. The latter was initiated in the autumn of 1993 and is continuing today.

Croatia's transition to a mixed-ownership, market economy can be discussed under two headings: (1) changing property rights ("privatization") and (2) economic restructuring (which includes the introduction of factor markets), outlined as follows.

PRIVATIZATION AND THE STATE SECTOR

Privatization in Croatia has, as in other economies facing transition, a number of components. One is the process of changing the ownership of business assets, which is mistakenly described as "privatization." Another is the establishment of a state sector. Next is the privatization of housing, and the last is restitution. None of these have been completed in Croatia as yet. While the first three components have progressed along well entrenched paths and are beyond the halfway point, the legislation for the last component has not been passed by Parliament.

The main feature of privatization in Croatia is, as elsewhere, the prominent role of the state. In addition to dictating the direction and speed of privatization, the state has (through the privatization fund) emerged as the largest single owner in the general economy and the dominant owner in many privatized companies. Furthermore, a large state sector under direct control of the state has also emerged. Progress must be made to reduce the role of the state as owner/manager in state-owned or -controlled companies. The opaqueness of these relations and the agency problems involved has and will cause inefficiencies, nonmarket behavior, social tensions, and unofficial economic activities (both unreported ones and illegal ones).

Privatization of Business Assets

The privatization of Croatia's business assets[8] ostensibly began while Croatia was still part of Yugoslavia, when the basic "federal privatization plan" was passed in 1989. Due to administrative foot-dragging and political circumstances, it had little effect.[9] As a result, actual privatization in Croatia started when the Croatian Parliament passed its privatization legislation in April 1991. This legislation created a revenue-oriented, state-dominated privatization, which included incentives for "small shareholders" and a time limit. The revenue from privatization is a direct revenue of the state budget. This policy choice was made with the specific intention of using this revenue to ease the burden of the budget deficit and to help finance the war. The role of the state (via privatization institutions) is extensive in that it vets "autonomous" privatization plans, monitors their implementation, acts as a "last resort buyer," manages an extensive portfolio of shares, owns unprivatized enterprises, and defines and manages their privatization. Popular support was not courted through give-away schemes but through offers of discounts and loans to particular categories of possible small shareholders. Current and retired employees of privatizing firms could buy shares up to the value of DM 20,000 at fixed prices plus discounts related to years of employment and five-year payment plans. The aggregate fraction of shares purchased on discount was limited to 49 percent of all assets. An additional incentive for employees was their right to purchase shares above the discount at the accounting (i.e., nonmarket) price. There was a one-year period (from June 1991 to June 1992) during which individual firms could draw up their own privatization schemes and submit them to the state privatization agency, which also had to approve, reject, or return them within a fixed time.

These basic features, as outlined, did not change despite numerous legislated modifications of the privatization procedures. Subsequent legislation has since changed the institutional framework three times and privatization procedures have been amended five times. The institutional framework was simplified so that it is now managed by only one body, The Croatian Privatization Fund. The privatization procedures were changed so as to eliminate some of the influence of inflation (by indexing values in German Deutschmarks), attract foreign buyers (by making direct sales to known buyers easier), protect and attract "small shareholders" (by extending discounts and permiting trading of still unpaid shares bought on loan on the secondary market) and increasing the transparency of the auctioning process.

Of the estimated 3,700 firms eligible for privatization for "autonomous" privatization, 2,873 enterprises submitted plans and, by the end of March 1994, applications from 2,416 firms had been proc-

[8] For a more detailed account see Ivo Bicanic, "Privatization in Croatia," *East-European Politics and Societies*, vol. 7, no. 3 (Fall 1993), pp. 422–439.

[9] During this time enterprises reorganized as shell (daughter) companies around an unprivatized core (parent) company. A few privatizations were worker buy-outs of small enterprises.

essed. By March 1994 privatization has been completed for 2,010 firms, meaning that shareholders' meetings have been held, which is the official criteria for completion. Among the firms which have not submitted privatization plans, an estimated 500 are in Serb-rebel controlled areas, and their privatization has been postponed. There are still 200 state-owned firms, and the remainder has passed into privatization-fund ownership by default. (Privatization plans were not submitted by the deadline). As of March 1994, the privatization scheme attracted 460,000 small shareholders whose average age was 43 years but it is expected that 250,000 small shareholders will eventually sell their shares on the market.[10] The Croatian Privatization Fund, until March 1994, managed its extensive portfolio by offering shares in 450 firms on the Zagreb stock exchange and has published bid applications for 659 firms and 44 applications for "old foreign currency savings" swaps. The net revenue of the state budget from privatization so far has been DM 743.1 million. By allowing the local privatization fund offices to manage only the privatization of small firms, Zagreb has dominated the process. (Fifty-two percent of all privatization plans were processed there.)[11]

TABLE 2. Privatization in Croatia

(Summary Results of 2,158 Completed Privatizations through April 1994)[a]

Measure	Fund Has No Share in Company Assets	CPF is Minority Owner, Less than 50% of Company Assets	CPF is Majority Owner, More than 50% of Company Assets	Total
Number of Companies Privatized	1,041	795	322	2,158
Average Value of Company Assets (DM millions)	1.68	11.59	22.97	8.50
Average Number of Buyers per Company	83	355	276	212
Share of Assets Sold	90.15	55.38	16.99	41.06
Share of Assets Transferred to Funds (percentage)[b]	0.0	32.02	79.30	48.53
Share of Assets Transferred to CPF (percentage)	0.0	21.01	52.87	32.35

Sources: *Privatizacija u Hrvatskoj* [Privatization in Croatia], mimeo, Croatian Privatization Fund, April 1994; *Privredni vjesnik*, No. 2842, May 16, 1994, p. 4.

[a] The Croatian Privatization Fund (CPF) defines a "completed privatization" as that in which the shareholders' meeting has passed the firm's statutes and elected a CEO and members of the board of directors.

[b] Pension funds, War Veterans fund, Reconstruction fund and Croation Privatization Fund.

These facts mask some important features of Croatia's privatization process. Disregarding state-owned firms, privatization of the

[10] *Privredni vjesnik*, 16 May 1994, p. 4.

[11] Regional offices are charged with the privatization of firms whose assets are less than DM 5 million. As a result the central office has dealt with 25 percent of all privatization and the Zagreb regional office with a further 27 percent. Not one of the remaining 13 regional offices had a share higher than 10 percent. *Slobodna dalmacija*, 5 January 1994, p. 19.

largest and most productive firms in Croatia is still incomplete, either under way or pending approval. While privatization has created a transparent ownership structure, this has not led to measurable state divestiture. The state has, overtly through the Croatian Privatization Fund and indirectly through the pensions funds, remained the dominant owner in "privatized" firms. Indeed, the larger the firm, the greater the proportion of state ownership. This is clearly seen in Table 2. Given the government's unwavering commitment [12] to revenue-oriented privatization and the prevailing economic conditions of virtually no foreign capital inflows and limited, available domestic savings, this is the only outcome possible. By transferring shares to the Croatian Privatization Fund, limited privatization could continue and the sale of shares extended into the future. Despite recent efforts, the Croatian Privatization Fund has not managed successfully to sell shares in its portfolio, so it remains the majority owner of many firms, especially the larger ones.

Croatia's privatization was not immune to abuse and malpractice, especially the widely publicized frauds in manager buyouts and insider knowledge. The evaluations of firms were rigged by the managers who had the dual role of designing privatization schemes *and* being the prospective buyer. Loopholes in legislation were easily manipulated. Loans were made to managers for the purchase of shares with dubious collateral via the "old boy network." Firm funds were transferred directly to managers when they cashed in large insurance "claims." There were "phantom buyers," where workers purchased discounted shares as front men. The abuse of insider knowledge was equally brash. In many ways, due to inadequate regulatory institutions and lack of disclosure requirements, the privatization of individual firms, especially the more lucrative ones, was never made public. This was partly by design, to limit the number of prospective buyers, but the beneficiaries seem to have been, besides the managers, some politicians and civil servants.

Privatization is, by definition, a wealth-inequity generating process, and its "equity" aspect is important. Opinion polls show widespread public skepticism regarding the "equity" of privatization, [13] and the press writes increasingly more about its abuses and corruption.[14] Even the government noted privatization as one of the major sources of economic crime, [15] while the bishops' synod declared that ". . . ethics faced great challenges . . . especially in privatization." [16] This aspect, however, remains largely shrouded.

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[12] Opposition parties regularly criticize the concept and course of privatization in Parliament, and the trade unions continuously propose give-away schemes. The government has not heeded these dissonant voices and has continued along its chosen general program.

[13] In an opinion poll conducted in early 1992, 43.6 percent of respondents were dissatisfied with the course and method of privatization and only 18.9 percent were satisfied, as reported in *Vecernji list*, 27 February 1993, p. 5.

[14] The first case noted in the press in October 1992 concerned "managerial loans" in a Split firm.

[15] This occurred for the first time in "Zakljucci Vlade Republike Hrvatske o narusavanju pravnog poretka i suzbijanju kriminala u gospodarskom i pravnom sustavu", *Vecernji list*, 20 February 1993, p. 3 and again in autumn in *Slobodna dalmacija*, 24 September 1993, p. 3.

[16] *Novi vjesnik*, 25 April 1993, p. 4.

Privatization of Housing

Privatization of housing overwhelmingly concerns flats in apartment buildings. It is especially important because of its inherited peculiarities and its subsidies, changes that will have far reaching consequences for the everyday life of the population. Most of the flats earmarked for privatization were either owned outright by the state (as are the flats owned by the former Yugoslav army, which were taken over by the state) or were, in the majority of cases, ceded to the state by enterprises undergoing privatization.[17]

All revenue from privatized housing went to the state budget. Housing prices were determined by accounting procedures (not by market value). Extensive incentive schemes were designed to give tenants the right of first purchase, and discounts were offered as high as 70 percent (for old age pensioners paying "up front" with foreign currency). The state benefited in two ways: it gained direct revenue and reduced the public debt by the sales.[18] This privatization was accelerated by establishing a deadline for applications. This deadline was extended three times because there were too few applications, but it finally ran out on 1 January 1994. By mid-November, the government had sold 151,683 flats, or 63 percent of its initial stock.[19]

Restitution

The restitution law for capital assets, land, or housing has not yet been passed by Parliament. Despite two years of discussions of proposed legislation, no solutions for the complex issues involved have been found. The only decision made was to accept formal applications for restitution by former owners for the return or compensation of property nationalized or confiscated. Almost 30,000 applications for the return of flats and houses have been received. (There are tenants in protected statuses presently inhabiting 13,100 of the contested homes.)[20]

To prevent restitution and denationalization from hampering privatization, legislation requires that privatization plans for enterprises on nationalized or confiscated property set aside a designated fraction of shares for restitution, which may vary (it is larger for hotels, for example). In aggregate, the Director of the Croatian Privatization Fund estimates that the restitution fund equals 15 percent of the value of all assets privatized.[21]

The State Sector

The state sector in Croatia is comprised of three kinds of firms, but only two are part of the state sector in the narrow sense

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[17] Since revenue and all other benefits of privatization accrued to the state, the enterprises had no incentive to hold onto the housing they owned and had built for their current and past employees, yet had an incentive to cede them to the state (rents were controlled, maintenance fees saved, and the assets of the firm reduced, which made privatization simpler).

[18] One of the inherited peculiarities of Croatia is the "old foreign currency savings." (Croatian citizens could have foreign currency accounts which, due to the way the banking system was set up in former Yugoslavia, ended up under the control of the federal government and outside Croatia's reach when it gained independence.) During the government's first attempt of bank rehabilitation it transferred these savings into the public debt. By offering the sale of flats for such savings it reduced the public debt.

[19] *Vjesnik*, 8 January 1994, p. 3.

[20] *Vjesnik*, 7 March 1994, p. 9.

[21] *Slobodna Dalkmacija*, 21 October 1993, pp. 6–7.

(misleadingly called the "public" sector and "public" firms in Croatia). One of these contains firms frequently found in the state sector of many economies. In Croatia, these are the public utilities, railways and roads, post and communications, state television, etc. The second has firms that have been legislated into the state sector in the guise of "protecting national interests." Among these is the oil company (which has the greatest assets and is the largest employer in Croatia) and the largest foreign trading company. Their inclusion in the state sector is very likely due to the war and the need to equip an army in the face of an arms embargo. Parts of the oil company and the foreign trade company are earmarked for privatization, but no progress has been made so far. It is estimated that there are 110 firms in these two categories. The third type of firms are those undergoing privatization, including those where the state is the majority owner and those managed by the Croatian Privatization Fund. Here the state appears as a transitory owner.

The extent of the state sector's ownership can best be seen in the size ranking of Croatian firms. Of the ten largest, the only private company is ranked eighth, one firm is still undergoing privatization, and the state is the majority owner in a third. (Table 2 shows the prominence of state ownership in privatized firms.) Finally, the state is the major employer. In addition to salaries of employees in state-owned firms, the budget is debited for the salaries of employees in education, health, the university, administration, and defense (where military concerns have required a relatively large army).

RESTRUCTURING INSTITUTIONS AND SECTORS

Croatia's inherited economic structure is "deformed" in many ways. Several kinds of deformities prevail: the existence of nonfunctional, socialist institutions and the absence of some crucial ones; and the structural problems in the different economic sectors. Most of the inherited, problem institutions have been eliminated, but what remains are the newly introduced institutions of a market economy that do not yet function efficiently. Their inefficiency is a result both of incomplete institution building and a lack of tradition or familiarity. Few sector deformities have been tackled so far and will not be addressed until the next phase of transition.

Introducing Factor Markets

While Croatia did inherit a market for goods and services (which had been developing in Yugoslavia since the mid-1950s), the capital and labor markets were unofficial and very inefficient. Thus, introducing legislation and creating the institutions for them was an immediate and important task.

At present, the capital market in Croatia operates on several levels. There is an interbank money market, where banks make short-term loans. There are two stock exchanges. The Zagreb Stock Exchange quotes shares of companies that have gone through the usual disclosure procedures. Croatian firms, however, are unwilling to use this stock market, so that it trades only the shares of two companies. The second exchange is the "unofficial market" (first organized in Varazdin and then in Zagreb), which trades any shares submitted to it. The latter two stock exchanges have now coordinated their activities and intend to branch out into all of Croatia's regional capitals. The annual volume of trade on these markets in 1993 was DM 5.4 million (DM 23,900 daily).[22]

The Croatian Privatization Fund has a special place in Croatia's capital markets. Not only is it by far the largest player but it also enters the market under special rules. Its shares on the open market are sold on commission through the Zagreb stock exchange. In April 1994 it offered shares from its portfolio of 659 firms in normal bidding (by March 1994 152 were sold to private buyers) and shares of 44 firms in the recently institutionalized swap for "old foreign currency savings."

The difficulties of organizing labor markets have not yet been solved. This is partly because no labor legislation has been passed (labor legislation remains the only glaring omission in the post-socialist legislative structure), partly because the institutions (or traditions) for collective bargaining do not exist, and partly due to features of the safety net. An added limitation to labor markets has been the wage-fund capping policy of the current stabilization program. The lack of labor legislation has somewhat limited employment policies. (To circumvent this, employee layoffs were achieved by "programmed" bankruptcies in 1990.) The socialist trade union was replaced by four different trade union associations which, apart from soliciting members, are squabbling over the distribution of the socialist trade union's property. Collective bargaining will take place in tri-party negotiations in the Economic-Social Council, with labor represented by trade unions, owners by the Chamber of Commerce (acting as a surrogate owner), and government by elected representatives. The 1993 contract expired in April 1994, after a new agreement on industrial peace was reached in late March.

Strikes as a form of trade unionism have a unique role. Since independence, there have been very few strikes in Croatia, largely as a result of unions agreeing to industrial peace in face of the war and to support economic stabilization. Of the eight strikes in the first quarter of 1994, most were "one company" strikes, and most were in reaction to privatization fraud. Opinion polls, however, show that the trade unions are seen as not aggressive enough, that the government has avoided strikes, and that strikes are justified.[23]

Sector Restructuring

Croatia's "deformed" economic structure has a number of underlying causes: "socialist inheritance," changes in the wider economic environment, and "go-it-alone" policies. Croatia's inherited "structural deformities" were not as pronounced as in other "socialist" economies, given former Yugoslavia's development, but they persisted with the same results as elsewhere. The service sector was underrepresented, especially in producer services. The size distribution of firms showed a "bias to bigness," with a marked absence of medium- and small-sized firms and no "natural" growth path, consequently, for firms. Agricultural production was based on small peasant plots or large agro-business combines. Of 540,000

[22] *Privredni vjesnik*, no. 2827 (17 January 1994), p. 3.
[23] *Vecenji list*, 20 February 1994, p. 5.

peasant holdings, only 1.9 percent are larger than 10 hectares, and all state subsidies went to the agro-businesses. Banks were only nominally independent and supported the "soft budget constraint" policies and investment wishes of politicians. There was excessive pollution, and production was energy extravagant, due to state-controlled and subsidized energy prices.

Changes in the wider economic environment were marked by the collapse of CMEA (Council for Mutual Economic Assistance) trade, which significantly reconfigured Croatia's foreign trade. In 1991, Croatia's exports to CMEA countries were 14.2 percent and imports were 15.9 percent.[24] The breakup of Yugoslavia required structural readjustments. New borders meant previous internal trade was now international. (Nineteen percent of Croatia's goods went to other former Yugoslav republics and 10.8 percent went abroad.) No foreign currency reserves existed, and the wars of the Yugoslav succession abolished most of the former Yugoslav markets (only the Slovenian markets remained).

The common feature of these "structural deformities" was the time required to eliminate them, even if correct policy decisions were made. Such structural readjustment is socially expensive, causing unemployment and labor market segmentation, and regional and social tensions. In addition, these "deformities" are the main cause of economic instability and until they are dealt with, the economy has no prospects for stability or growth. Croatia has a mixed record of dealing with them. Some have been tackled successfully; some efforts have failed; and others still remain in place.

Perhaps Croatia has been most successful in the foreign sector. Even though losses from the collapse of CMEA and the Yugoslav market, and damage to transport services (transit to ports, overland routes to Europe, and the oil pipeline to Central Europe) were major blows to Croatia, the foreign sector was never a major source of transition instability because trade was successfully reoriented to Western markets. Slovenia, which had been Croatia's main trading partner, dropped to second place in both exports and imports in 1993. Foreign currency reserves were built up in excess of needs, exceeding $1.2 billion. Changes in the foreign sector were made easier by the contraction of trade that followed the general economic contraction.

Another success was in the energy sector. During the summer of 1993, the relative prices of energy were increased incrementally and were indexed to the German deutschmark. The effect was rationalized energy consumption and control over the inherited operating losses. These changes were easier, too, because Croatia's energy sector (electricity and oil, no major coal deposits) was run by state-owned firms.

Bank rehabilitation was attempted twice. The first policies in 1991 were interrupted by the escalating war. The second attempt came in spring 1994, as part of the second phase of the current economic program, when an effort focused on privatizing large banks and rehabilitating the medium-sized regional banks. The goal of

[24] Until 1992, statistics do not include trade among former Yugoslav republics as international trade.

this bank privatization was to replace the existing set-up in which the owners were the main debtors.

The remaining structural deformities are in individual sectors. Detailed plans have not yet been made, but the 1994 budget has earmarked funds for shipbuilding, agriculture, and the railways.

Apart from government-managed restructuring, the economy has been overhauled by entrepreneurial activities. Registered firms show vigorous entrepreneurial activity, and many new firms have emerged (although 47 percent are dormant). From December 1990 to December 1993 the number of registered firms rose from 17,350 to 83,788.[25]

ATTEMPTS AT MACROECONOMIC STABILIZATION

Economists would generally agree that the best "synthetic" indicator of macroeconomic instability is the inflation rate. By this marker, Croatia has an extremely unfavorable track record regarding macroeconomic instability. It spans not only the whole period since achieving independence but extends far back into the earlier one as well. Indeed, Croatia has been experiencing moderate inflation rates since the 1960s and high inflation rates since the early 1980s. These high inflation rates, coupled with negative growth rates, have prevailed since the late 1980s. Furthermore, Croatia has experienced four periods of hyperinflation.[26] Conditions were made worse by the consistent failure of numerous attempts of macroeconomic stabilization policies. (The first dates back to 1961.) At best, such efforts have managed to lower inflation rates briefly, but never prevented a new inflationary cycle starting and reaching higher levels than the previous one.

CAUSES OF CROATIA'S INFLATION

Croatia's "real" rate of inflation has its origins in the inherited inflation from "socialism," inflation caused by transition policies, the inflationary financing of the war, and inflationary expectations. All these causes of inflation are well known to economists and none of them are extraordinary or specific to Croatia. The high levels of "inherited" inflation are the ones commonly found in all "socialist" economies: soft-budget constraints for governments and business, overextensive (given the level of development) entitlements, persistent foreign trade deficit, and government controlled pricing. Underlying these economic structures is unwillingness to bear the costs of restructuring. The ways transition leads to inflation are also well known and all economies in transition have had to grapple with them—by introducing price liberalization, factor markets, and market-oriented taxation; reducing subsidies; "learning-by-doing"; and reducing visible social costs of transition. Reverting to deficit financing of a war is a phenomenon accompanying every war. These "real" causes influence the inflation rate together with self-fulfilling, inflationary expectations. As a result of living for over a decade under inflationary conditions (always with a rising

[25] *Croatian Economic Trends*, vol. 4, no. 1 (March 1994).

[26] Given Croatia's experience, it seems more appropriate to define Croatia's periods of hyperinflation as those in which the domestic currency is pushed out of all transactions except the very short-term (weekly) ones. The four periods in question were two in the early and late 1980s and two in the early 1990s.

trend and occasional hyperinflationary episodes), all economic actors, businesses, and households as well as government, have learned to live with inflation. Economic agents have developed (and tested) defenses to neutralize inflation's negative effects and create opportunities to use its advantages. All economic actors in Croatia have shown enviable imagination and entrepreneurship. Persistent and rising inflation levels and the low credibility of numerous, anti-inflationary policies have led to the incorporation of inflationary expectations into behavior. Put simply, all economic agents have come to regard inflation as a lasting phenomenon.

Croatia's inheritance meant that it started its "go-it-alone" policies with monthly inflation levels of almost 20 percent. Understandably, reducing inflation was one of the prime economic policy targets of the first noncommunist government. In mid-1991 a macroeconomic stabilization policy was attempted, which successfully kept inflation rates around 10 percent monthly. During the most intense military campaigns of the war (fourth quarter of 1991) monthly inflation started rising but the deficit financing of the war did not lead to shortages or rationing. In late 1991 inflation passed the 20 percent monthly mark, but fell back in early 1992 to around 15 percent monthly. Even though the plan was quickly abandoned, a further lowering of inflation rates during the second quarter of 1993 was made possible by a wage freeze agreement by government and trade unions. The next rising cycle of inflation rates started in early 1992, but by the end of 1992 monthly rates had risen up to 30 percent and hyperinflationary conditions again prevailed. This rise was followed by Croatia's second stabilization policy, which led to a fall of inflation levels in early 1993 to around 25 percent monthly. By mid-1993 rates again started rising. The final acceleration was in late autumn 1993 when monthly rates reached 40 percent (over 4,000 percent annually) levels by October 1993, and the economy was again facing hyperinflation. These levels for the third time led to a macroeconomic stabilization policy.[27]

THE THIRD ATTEMPT TO ESTABLISH STABILIZATION

Croatia's third attempt to deal with macroeconomic instability began in early October 1993.[28] On 4 October 1994 the government unveiled a complex economic package[29] comprised of three economic policy clusters. The first policy cluster concerns reducing inflation by eliminating in one sweep inflationary expectations (government officials blame the expectations bubble for two-thirds of the inflation). The second cluster concentrates on transition (and

[27] There was another incentive for adopting stabilization policies. Because war does not mix with transition and stabilization policies, these policies could provide a clear signal to the country's commitment to peaceful policies.

[28] For a more detailed description see Ivo Bicanic, "Croatia's Economic Stabilization Program: Third Time Unlucky?" *RFE/RL Research Report*, vol. 3, no. 3 (21 January 1994), pp. 36–42 and Ivo Bicanic, "Croatia's Macroeconomic Stabilization: A Progress Report," *RFE/RL Research Report* (forthcomming).

[29] The program's implementation started on 5 October 1993. The document was published in English as "Summary Report on Anti-inflationary Measures undertaken by the Council of the National Bank of Croatia and the Croatian Government at the beginning of October 1993," National Bank of Croatia, 5 November, 1993. The government claims that the program was written over a six month period by Croatian and foreign economists and that there was IMF support, stated by prime minister on numerous occasions, e.g., *Vjesnik*, 13 October 1993, p. 10.

was discussed previously); the final part of the program deals with growth promotion.

If the causes of Croatia's inflation are not extraordinary, then neither are the main features of policies designed to deal with it: imposing tight monetary policies and monetary austerity, incomes policies regulating wage increases, fiscal policies that will roll back the budget and control the budgetary deficit, and foreign trade liberalization linked to internal convertibility. By deciding that the main source of inflation was inflationary expectations the policies concentrated on convincingly reducing them, a task that can be done at little social cost but requires considerable credibility. This is clearly visible in the policies of the third (and current) macroeconomic stabilization effort. Croatia's stabilization program designed quantity targets for four variables: the discount and exchange rate, changes in money supply and limits on the wage fund increases. The purpose was to reduce monthly inflation rates from almost 30 percent in September to around 10 percent by December. The program, however, was not backed by a wide-ranging social consensus. Opposition parties and trade unions, while understanding the need for reducing inflation, criticize the details, especially the social costs it involves.

The success with which monetary policy reduced inflation rates was remarkable: the negative inflation rates that started in December 1993 continued until May 1994 (the time of this writing). The main target (reducing the inflation rate) was overshot so much that related targets (discount rate, money supply) had to be changed accordingly. The incomes policy held the only area where there was a major discrepancy concerned the exchange rate: instead of the planned devaluation the Croatian dinar significantly revalued. With hindsight, one can say this may have played an important role in extinguishing inflationary expectations. Together the two changes led to an increase in the demand for (now valuable) money, which put further pressures on monetary policy. Other indicators, especially those related to the real sector, did not show such promising changes: industrial production fell, foreign trade contracted further with a deficit in balance-of-payments, real wages rose slightly, etc. The macroeconomic stabilization policy, which heavily relies on monetary policy, was successful. Following the initial impact, monetary policy could revert to maintaining price and foreign exchange stability. Fiscal policy analysts then had to design a 1994 budget that would maintain price stability.

Yet fiscal policy analysts could not hide behind inflation, a budget deficit, seignorage, and an inflationary tax. They had to produce a "transparent" budget and financing for public services. The task facing fiscal policymakers in Croatia is even more demanding than in other economies in transition. Not only must they reduce inherited entitlements and include in budgetary expenditures the costs of restructuring; they must also maintain military capabilities. The 1994 budget attempted all that but in a budget a third larger than the previous one and based on a very optimistic vision of the economy in 1994 (2 percent growth rate, stable exchange rate, annual inflation of 10 percent).

Perhaps more than a "monetary shock," macroeconomic stabilization requires the backing of a social consensus. After tense situations, threatened and actual strikes, and lukewarm government participation in negotiations, a new compact for "social peace" was signed between trade unions and government. Opposition parties have not been involved in the program. They have been completely ignored during the initial stages and by-passed once the program implementation started. The government has showed forms of heavy-handedness and has backed the stabilization program by decrees and extra-market regulation. These techniques have been used both to control wages and to control interest rates and behavior of government-controlled firms. The relationship between government owned and controlled firms and the rest of the economy remains the main void in Croatia's transition. The overt and covert "state" influence on the economy can perhaps support the fiscal policies but in the long run this does not promote transition to a mixed-ownership, market economy.

FORMER YUGOSLAVIA: SERBIA, MONTENEGRO, BOSNIA AND MACEDONIA

By Milica Z. Bookman, Ph.D.*

CONTENTS

SUMMARY

Since the breakup of Yugoslavia, the economies of Serbia, Montenegro, Bosnia-Herzegovina and Macedonia have experienced the effects of the disintegration of the Yugoslav union, the transition to capitalism, and the conversion to a war economy (with the exception of Macedonia). In addition, the international sanctions imposed on Serbia and Montenegro, the war in Bosnia-Herzegovina, and the Greek embargo (coupled with the internal political instability in Macedonia), have all taken their toll on the economies. As a result, the four regions are presently characterized by economic decline and chaos: negative growth rates, high rates of unemployment and inflation, large budget deficits and a growing underground economy.

The future economic outlook for these regions, while bleak, is not entirely hopeless. Indeed, despite the plummeting of the economy of Serbia and Montenegro during 1993, the introduction of a new currency in January 1994 has revived the economy: six months later, inflation has been curtailed, production has increased, consumer goods are once again available, and the New Dinar has retained its parity with the German mark. In Bosnia-Herzegovina, the realization of the Bosnian Muslim/Bosnian Croat federation may be the first step towards cessation of hostilities and the reconstruction of the devastated and fractured economy. Macedonia's

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*Milica Bookman is Associate Professor of Economics at St. Joseph's University, Philadelphia, Pennsylvania. The author is greatly indebted to Professor Ljubisa Adamovic for his comments on a previous draft of this paper.

economic outlook is mixed, and it cannot but benefit from stability on its northern borders.

It is likely that the economies of Serbia/Montenegro, as well as those of neighboring countries, will be vastly improved with the lifting of sanctions. Both Serbia and Montenegro, as well as Bosnia-Herzegovina (whatever its future territorial demarcations), will necessitate a massive infusion of foreign capital. It is in these two areas, sanctions and reconstruction capital, that the West has a role to play if it is to restore and promote long-term economic stability across the entire Balkans.

INTRODUCTION

Yugoslavia, a federation composed of six republics and two autonomous regions, in which three major religions and two historical traditions coexisted, broke up abruptly in 1991. The breakup gave rise to several new formations, of which Serbia and Montenegro (republics in the new Federal Republic of Yugoslavia (FRY)) and Bosnia-Herzegovina and Macedonia[1] (recognized sovereign states), are the subject of this study.

The economies of these four entities (henceforth SMBM) are presently in varying states of decline and chaos, as exemplified by negative rates of growth over several years, high rates of unemployment and inflation, burgeoning budget deficits, and negative trade balances. Such an economic performance is the result of conditions and events both preceding and following the breakup of Yugoslavia. The legacy of the past (1945–1990) includes the plummeting performance of various economic indicators during the 1980s,[2] regional disparities in economic development,[3] and structural imbalances induced by institutions such as "workers self-management" and extensive regional and institutional decentralization. Some post-breakup developments that took place during 1991–1994 are shared by all SMBM, while others are unique to each former republic. Three of the shared developments have contradictory effects on the economy: first, the establishment of a sovereign economy, second, the transition from socialism to capitalism, and third, in some regions, the conversion to a war economy. Each of these developments is accompanied by a set of policy measures, costs, and demands on the economy and population. Their occurrence individually would cause a strain on any society; their simultaneous occurrence has been and continues to be devastating. In addition, the differing experiences of SMBM have molded each particular economy: for example, the war in Bosnia-Herzegovina has *de facto* divided one economy into at least four; the international sanctions imposed on Serbia and Montenegro have contributed to the havoc in their economies; and the Greek response to developments in Macedonia has crippled the Macedonian economy. As a background to all this, there was, in addition, the loss of traditional markets in Eastern Europe following the collapse of communism, as well as

[1] The name by which it is recognized is Former Yugoslav Republic of Macedonia, FYROM.
[2] During 1979–1990, the per capita total output had decreased by 32 percent. *RFE/RL Research Report*, vol. 2 no. 34, (August 27, 1993), p. 21.
[3] While all Yugoslav regions experienced economic growth since 1945, by the end of 1990 the difference in income per capita between Slovenia and Kosovo had grown to 10 to 1.

the withdrawal of foreign investment as a result of war and uncertainty.

This paper contains a discussion of the three processes shared by the SMBM economies, as well as their individual characteristics, all of which have an effect on their future economic prospects (see boxes 1–4). As a result of the confusion created by the breakup and the war, *very few reliable statistics are available* for the entire region.

Box 1.

SERBIA, part of the Federal Republic of Yugoslavia

Area: 88,361 sq. km.

Population: 9.8 million; 41.5% of pre-breakup total; ethno-religious composition (1991): Serbs 66%, Albanians 17%, Hungarians 3.5%, Yugoslavs 3.3%, Muslims 2.5%, Croats 1.1%.

Principal Religion: Eastern Orthodoxy.

Secession / Recognition / War: Federation with Montenegro declared April 1992; not recognized as successor of Yugoslavia; no war on its territory, but has supported Croatian and Bosnian Serbs and as a result, had international sanctions imposed in May 1992.

Political Leadership: The Socialist Party of Serbia, under President Slobodan Milosevic, has been in power since 1990; latest elections in December 1993 gave the party 123 out of 250 seats in Parliament; Mirko Marijanovic is Prime Minister of Serbia; Zoran Lilic is president of FRY, Radoje Kontic is Prime Minister.

Economic Base: Serbia is major producer of agricultural goods, especially in Vojvodina (fruits, vegetables, wheat, corn, oats, and livestock); it has industrial, mining, power and manufacturing plants, as well as plentiful natural resources (lead, zinc, copper, and lignite).

GDP: $300 (per capita, FRY, 1993); economic growth –60% (1989–1993) in FRY; pre breakup, at national average and contributed 35% of total GDP (Vojvodina ranked higher, while Kosovo ranked lower).

Unemployment and Personal Income: Approximately 50% of the labor force is unemployed or on extended leave (1993); 30 DM average monthly income.

Inflation: 3 million % (February 1994); 1% (March 1994). (See section "Monetary Responsibility" below.)

Currency: Dinar (also, "super dinar"), convertible and pegged to German mark at 1 to 1 (as of February 1994).

Concerns: Effects of prolonged international sanctions; secessionist tendencies in Kosovo and Sandzak; insufficient reserves to sustain the new "super dinar" at present exchange rates, so possibilities of future galloping inflation and social unrest; brain drain.

Box 2.

MONTENEGRO, part of Federal Republic of Yugoslavia

Area: 13,812 sq. km.

Population: 0.6 million; 2.7% of pre-breakup total; ethno-religious composition (1991): Montenegrians 62%; Muslims 12.5%; Serbs 9.2%; Albanians 6.5%; Croats 1.0%.

Principal Religion: Eastern Orthodoxy.

Secession/Recognition/War: Declared federation with Serbia in April 1992; no war on its territory; the Liberal Party, under the leadership of Slavko Perovic, endorses secession from FRY.

Political Leadership: Ruling party is the Democratic Socialist Party, since December 1990; President Momir Bulatovic has been in power since 1989; Prime Minister is Milo Djukanovic.

Economic Base: Economy based on industry (aluminium, lead, zinc and coal mining, timber, steel and iron) tourism, shipping, and agriculture (tobacco, fruit, olives, and grapes).

GDP: Pre-breakup, GDP below average and 2% of total.

Unemployment and Personal Income: 17% (mid-1993), presently estimated 30–40%; 20 DM average monthly income.

Inflation: 3 million % (February 1994); 1% (March 1994).

Currency: Dinar, convertible and pegged to the German mark at rate of 1 to 1 (February 1994).

Concerns: Effects of prolonged international sanctions.

Box 3.

Republic of Bosnia-Herzegovina

Area: 51,129 sq. km.

Population: 4.8 million (of which 1.6 million are presently displaced); 18.9% of pre-breakup total; ethno-religious composition (1991): Muslims 39%; Serbs 32%; Croats 18%.

Principal Religions: Islam, Eastern Orthodoxy, Catholicism

Secession / Recognition / War: Declaration of independence in December 1991; international recognition in April 1992, followed by outbreak of war as the Bosnian Serb population refused to secede from Yugoslavia. Four territorial entities emerged during 1992–93: Serbian territories in eastern and northern Bosnia ("Srpska Republic"); Croat territory in Herzegovina ("Croatian Community of Herzeg-Bosna"); Muslim territories in central Bosnia (under the leadership of Alija Izetbegovic) and the secessionist Muslim territory of the Bihac pocket ("Autonomous Province of Western Bosnia"); Muslims began recapturing territory in central Bosnia in late 1993, and in February 1994, under U.S. pressure, reconciliation between Bosnian Croats and Muslims resulted in creation of a federation.

Political Leadership: Alija Izetbegovic of the Muslim Party of Democratic Action is president; Vice President is Ejup Ganic; Prime Minister is Haris Silajdic; Serbian territory is under the leadership of Radovan Karadzic; Croat territory, until the signing of the federal agreement with Bosnian Muslims in February 1992, was under the leadership of Mate Boban; Fikret Abdic is the leader in the Bihac pocket.

Economic Base: Pre-war economy was based on agriculture (grain, potatoes, tobacco, and sugar beets), military industry and mining (it produced 85% of Yugoslavia's iron ore and 40% of its coal and lignite); currently the economy is highly regionalized with small-scale activity; it has a confusing system of petty trade by enemies across front lines.

GDP: Pre-breakup, below average and contributed 12% of total GDP.

Unemployment and Personal Income: Data not available.

Inflation: Pre-war (April 1992) 86% monthly.

Currency: There is no Bosnian dinar, instead, several currencies are in circulation (Croatian dinar, Yugoslav dinar and super-dinar, German mark).

Concerns: Unclear political viability of multiethnic Bosnia-Herzegovina in light of failure of multiethnic Yugoslavia; questionable long-term sustainability of Bosnian Croat-Muslim alliance formed under pressure by the US; repercussions if and when refugees return to their homes; prohibitive reconstruction costs.

BOX 4.

Republic of Macedonia (Former Yugoslav Republic of Macedonia)

Area: 25,713 sq. km.

Population: 2.1 million; 8.9% of pre-breakup total; composition (1991): Macedonians 67%; Albanians 20% (or 40% depending on statistics used); Serbs 2.3%, Muslims 2.1%.

Principal Religions: Eastern Orthodoxy, Islam.

Secession/Recognition/War: Declaration of independence in November 1991, but due to Greek resistance, was not recognized by US until spring 1994.

Political Leadership: President is Kiro Gligorov of the Social Democratic Union of Macedonia; Prime Minister is Branko Crvenkovski.

Economic Base: Agricultural products (including wine, apples, grapes, tobacco, rice, and cotton) and metals and mineral resources (iron ore, lead, zinc, nickel, mercury, and gold); land-locked, but in the future hopes to be linked to Albania and Bulgaria by major highway.

GDP: Pre-breakup, below average and 5% of total GDP; poorest region other than Kosovo.

Unemployment and Personal Income: 35% (1993); 215 DM average monthly income.

Inflation: 15% monthly in 1994 (20–30% in 1993).

Currency: Denar, not convertible.

Concerns: Deteriorating political consensus between Macedonian Slavs and Albanians; economic effects sanctions against FRY; deteriorating relations with Greece that imposed an embargo in February 1994.

SIMULTANEOUS PROCESSES ACROSS FORMER YUGOSLAV ECONOMIES: DISINTEGRATION, TRANSITION AND CONVERSION

DISINTEGRATION OF THE UNION

While the roots of the breakup of Yugoslavia are historical, political, economic, and ethno-religious, the proximate source of the breakup is found in the aftermath of Tito's death, when nationalist forces emerged among the ethno-religious groups in all the republics. For example, in 1986 the Serbian Academy of Sciences composed a memorandum describing Serbian grievances against Titoist Yugoslavia, leading the way for the rise to power of Slobodan Milosevic. Franjo Tudjman emerged in Croatia as the nationalist seeking to enhance the power of Croats within Yugoslavia. The secession of Croatia produced panic among the Serbs in the Krajina region, who refused to live in an independent Croatian state that they perceived as reminiscent of the Ustasha regime during World War II. This led to their own proclamation of independence. The possible secession from Yugoslavia of Slovenia and Croatia raised the specter of Serbian domination over the Bosnian Moslems, Macedonians, Albanians, and other ethnic groups. Thus arose the movements for an independent Bosnia-Herzegovina, Macedonia, and even Sandzak and Vojvodina. Similar perceived Croatian hegemony led to a movement for autonomy in Istria. The result has been a violent breakup, producing some two million refugees, over 200,000 killed, and evidence of rape, impaling, and dismemberment. These horrors occurred against a background of political repression, property devastation, and nationalist frenzy in which the overriding principle seemed to be "cleanse or be cleansed."[4]

The movements for independence that preceded or accompanied the wars occurred at both the republic and the sub-republic level. Slovenia and Croatia declared independence in June 1991, and were followed by Bosnia-Herzegovina and Macedonia. Serbs in Serbia, as well as those in Croatia and Bosnia, favored the retention of a unified Yugoslavia. However, secession of the other republics forced upon them alternative solutions: In April 1992, Serbia and Montenegro declared a new federation under the name of Federal Republic of Yugoslavia, while the Serbian population of Croatia declared an independent Republic of Serbian Krajina (December 1991) while the Serbs of Bosnia-Herzegovina proclaimed the Sprska Republic (March 1992). The Albanians of Kosovo declared independence (September 1991), the Croats in Bosnia-Herzegovina proclaimed the Croatian Community of Herceg-Bosna (July 1992), and Muslims in the Bihac pocket, under the leadership of Fikret Abdic, declared secession from Bosnia and called themselves the Autonomous Province of Western Bosnia. Thus, one state has, so far, given rise to nine entities, of which only four presently enjoy international recognition. One of the lingering puzzles of the dissolution of Yugoslavia is the legal basis and rationale for recognizing some regions and not others. The direct impact on economic performance from what has been perceived as imbalanced recognition procedures is difficult to evaluate. Nonetheless, it is clear that

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[4] This phrase was first introduced by *The Economist* (February 6, 1993), p. 53.

selective recognition has served as fuel for nationalist flames, to the detriment, economically and otherwise, of millions of people.

Whether recognized or not, the new entities had to make economic adjustments. Indeed, the breakup of the old federal system and its replacement by new independent economies entailed a process of destruction, followed by construction. This "period of redefinition" is the period during which a region breaks its ties with the former federal center and formulates new ties to both its former union as well as to the international economy.[5] These include a settlement pertaining to the division of the national and international debts and the division of federal assets including property, foreign currency holdings, etc. The obligations of each side must be calculated with respect to social security, armed forces, pensions and health insurance. In the international sphere, trade agreements, joint ventures, and investments must be renegotiated.

With respect to the division of assets and liabilities in the former Yugoslavia, various principles have been discussed, including territorial, population, and contribution principles. In the first, division takes place according to the location of assets, namely, what is located in any region at the time of the breakup remains there. In other words, "finders, keepers." The population principle entails the division of assets according to population size, clearly favoring Serbia and penalizing Montenegro or Slovenia. The contribution principle entails division according to the magnitude of the contribution to the union. This is difficult to establish given that each region tends to overvalue, relatively speaking, its contribution of hydroelectric power, taxes, etc. Thus far, negotiations among the Yugoslav republics have taken all these principles into account, albeit inconsistently. FRY is claiming all federal property, including that located outside the present boundaries, on the grounds that the other republics voluntarily left the union. Slovenia, Croatia, and Macedonia, on the other hand, are demanding that property should be divided among all republics according to their contribution to the budget. The division of hard currency holdings has been linked to the sharing of the foreign debt, which is estimated to be between \$4 billion and \$7 billion in pre-breakup Yugoslavia. The international community aborted further argumentation by assigning the following responsibilities with respect to the share of foreign debt: the IMF quota of 918.3 million Special Drawing Rights (SDR, an IMF unit of account) is divided such that 335.4 goes to FRY, 261.6 to Croatia, 150.4 to Slovenia, 121.2 to Bosnia-Herzegovina, and 49.6 to Macedonia. The \$217 million debt to the IMF will be split among them in the same proportion.[6] The division of federal assets has *de facto* occurred on the principle of territory, given the war and the hostile relations that preclude a negotiated split. One of the six committees of the Geneva Peace Conference is addressing the question of the division of federal assets and liabilities. The fate of federal assets must be resolved through negotiations, as it would have been done if the war had not occurred. The futility of the lives lost and property destroyed is especially evident in light of the fact that this issue has to be resolved before normalization

[5] M. Z. Bookman, *The Economics of Secession* (New York: St. Martin's Press), 1993.
[6] *Transition*, vol. 3, no. 11, (December 1992–January 1993), pp. 12–13.

of relations takes place. Regardless of which principle is followed, only its consistent application will ensure fairness, given that all regions try to maximize their assets and minimize their responsibilities.

While old economic and political ties were being severed, new economies had to be established. First and foremost this implied the creation of new monetary systems, which entailed new currency, creation of new central banks, and formulation of independent monetary policies. The severing of monetary ties to the union had the effect of shielding the new states from the monetary oscillations of the union, such as inflation, interest rate changes, and undesirable monetary policy (as it clearly shielded Slovenia and Macedonia from the hyperinflation that raged in other parts of former Yugoslavia). Slovenia, Macedonia, and Croatia introduced new currencies, the tolar, the denar and the Croatian dinar (perhaps to be renamed the kuna), while there are at least four currencies presently in use in Bosnia-Herzegovina, the old Yugoslav dinar, the "super-dinar", the Croatian dinar, and the German mark (the Bosnia government did not introduce a new currency at the time of the breakup). The establishment of an independent economy also included the creation of new legal and tax systems, new markets, a new army, new border crossings and regulations, etc. It also entailed acceptance by the international community as a precondition for the integration into the international economy. In this respect, all secessionist states except FRY and Macedonia experienced a smooth transition into the world bodies: FRY did not inherit Yugoslavia's seat at the UN (as Russia inherited the seat of the Soviet Union), but is presently in a semipermanent status, while Macedonia's international recognition and acceptance into world bodies has been problematic due to Greece's objection to the use of the name Macedonia. The remaining Yugoslav republics were admitted to the UN, IMF, and other international bodies in 1992.

TRANSITION TO CAPITALISM

In addition to setting up independent economies, the former Yugoslav republics began altering their economic systems. This process of transition normally entails the following: macroeconomic stabilization (including monetary and fiscal policies that provide the stability necessary for other measures), price reform (including the replacement of centrally planned prices by market prices) and structural and institutional reforms (such as the imposition of hard budget constraints for firms, stimulation of the private sector, reform of the legal system, reform of the banking and financial system and development of a social safety net).[7]

Economic reforms aimed at transition to a market economy in Yugoslavia began at the federal level in the late 1980s and continued into the 1990s until the breakup of the country, setting the stage for further individual reforms. These federal reforms were conceived primarily as stabilization measures, and secondarily as

[7] This organization of the elements of transition is offered by Susan M. Collins and Dani Rodrik, *Eastern Europe and the Soviet Union in the World Economy* (Washington: Institute for International Economics, May 1991), p. 11.

transition measures. The first part, focusing on stabilization,[8] began in January 1990, while the second part, focusing on transformation, followed in July of that same year and consisted of creating an environment of liberalization, including a policy of privatization and institutional changes such as a consistent tax and legal system. Privatization proved extremely difficult given Yugoslavia's unique form of social ownership, fostered by the system of self-management, which necessitated transferring ownership to the state before it could be privatized. Also, bankrupting inefficient enterprises was in conflict with employment policies. Despite numerous hurdles, the assessment of the reforms in mid-1990 was positive; according to Zivko Pregl, "Yugoslavia has now passed the turning point. It is deep in an irreversible but smooth transformation or "soft-landing" into market economy and multiparty democracy."[9]

Following the breakup of Yugoslavia, SMBM took steps toward reform that were determined by their particular political and economic conditions, and some sporadic progress was made, despite the disruptive effects of conversion to a war economy, the lack of political consensus on reforms and the absence of steady foreign inflows of capital. All states, however, lagged far behind other East European and Balkan countries.

An example of this sporadic post-breakup progress is in the sphere of privatization. The privatization process in Serbia and Montenegro was started with legislation in 1990, amid extensive debate on its desirability and extent. By mid-1992 there were 40,000 private trading firms in FRY[10] and by mid-1993, some 20 percent of social ownership was privatized.[11] However, privatization has not proceeded smoothly: first, in December 1992, the tax burden of private businesses was greatly increased, thereby dampening privatization incentives and industrial restructuring. Second, it took place mostly in an illegal atmosphere of war profiteering: some 30 percent of total economic activity is said to be in the black economy.[12] Indeed, legitimate private activity has disappeared because of the lack of capital for investment, and the uncertainty and chaos in the legal and political system, making private entrepreneurship synonymous with war profiteering. Third, given the importance of agricultural products in enabling the population to survive sanctions, plans for privatizing socialized land have not even been implemented yet. However, Yugoslavian agriculture since 1953 was characterized by small private plots, so the issue of agricultural privatization is less of an issue than in other East European countries.

The entire Yugoslav federal program for transition was halted in Serbia/Montenegro due to the breakup and the demands of war. It

[8] The first part was primarily aimed at decreasing the inflation rate (by the end of 1989, 10,000 percent was the annual inflation rate) by introducing a wage and price freeze, as well as complete convertibility of the dinar (which was pegged to the German mark at the rate of 7:1).

[9] Zivko Pregl, "Programme of Reforms in Yugoslavia," in James Simmie and Joze Dekleva (eds.), *Yugoslavia in Turmoil: After Self-Management?* (London: Pinter Publishers, 1991), p. xvi.

[10] *RFE/RL Research Report*, vol. 2 no. 34, (August 27, 1993), p. 27.

[11] There has been debate in FRY as to the benefits of privatization. Some have claimed that it leads to pillage of domestic property by foreigners, while others have criticized it because it was too little. According to Bozidar Cerovic it was "privatization by spoonfuls" (*Intervju*, August 6, 1993, p. 16).

[12] *RFE/RL Research Report*, vol. 2. no. 34, (August 27, 1993), p. 27.

was replaced by a two-pronged economic program adopted in mid-1992 by the government of Milan Panic, which included a program of stabilization, a focus on anti-inflation measures, and a program of marketization and transition of the economy.[13] It entailed a drastic cut in public expenditure, contractionary monetary policy, imposition of wage controls, and state control of some 15 percent of industrial prices.[14] These measures were to last only three months, to be followed by liberalization of prices and foreign exchange transactions in order to achieve a reliable basis of future price and exchange rate stability. However, sanctions were not lifted, the Panic government fell in late 1992, but market mechanisms were nevertheless sporadically introduced across many sectors in 1992–1993.[15] None of these measures were intended for long-term sanctions. During 1993, the government took several ad hoc steps, often reversing its 1992 measures. The latest stabilization measure, adopted in January 1994, was aimed at combating inflation (which reached 60 percent daily in January), as efforts at marketization and privatization had by then little priority. Indeed, the program's linchpin was a new currency aimed at reducing inflation, that is, it was to exist concurrently with the old dinar until the latter could be phased out.[16] The new super-dinar[17] is pegged to the German mark at an exchange rate of 1 to 1. The new currency is to be backed by cash and gold reserves that are said to total $500 million,[18] and can be bought from banks for hard currency. The stabilization program also includes increased fiscal and monetary responsibility: a reduction in the budget deficit and the cessation of printing money to finance expenditure.

Macedonia has been slow but committed in the transition process to a market economy. Preoccupied with the disruption of markets and financial flows due to the breakup of Yugoslavia and the sanctions against FRY, Macedonia has adopted reforms including an anti-inflationary program based on the introduction of the republic's new currency (the denar, introduced in October 1992), new legislation on fiscal policy and trade, and the preparation of new legislation on the restructuring of state-owned enterprises and privatization.[19] The first step in the privatization process was the privatization of state-owned apartments; entrepreneurship flourished after the privatization law passed in July 1993, so that 67,000 private businesses were registered in 1993.[20]. However, by the beginning of 1994, there has been no restructuring of industry or trimming of inefficient firms. Progress on price liberalization has been slow, as the government had to deal with the isolation of its currency from the Yugoslav dinar while, at the same time, liberalizing

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[13] Federal Government of Yugoslavia, *Program for the Macroeconomic Stabilization of Yugoslavia*, (Belgrade), October 1992.

[14] *RFE/RL Research Report*, vol. 2 no. 39, (October 1, 1993), p. 49.

[15] *Vreme News Digest Agency*, no. 87, (May 24, 1993).

[16] Apparently, the new super-dinar has also been introduced in the Serb territories of Croatia (Krajina), a move necessitated by commercial contacts rather than a financial union between the region and FRY (*Politika*, March 11, 1994).

[17] Also known as the "avram," since it was formulated by Dragoslav Avramovic, Serbia's newly appointed bank governor.

[18] *The New York Times*, January 25, 1994.

[19] *RFE/RL Research Report*, vol. 2, no. 3, (January 15, 1993), p. 34.

[20] *RFE/RL Research Report*, vol. 3 no. 1, (January 7, 1994), p. 119.

some prices (such as sugar and cooking oil), and adjusting others (electricity, municipal services).

CONVERSION TO A WAR ECONOMY

The wars of Yugoslav succession have brought billions of dollars of damage, devastated lives, created some two million refugees, dried up external financing, and resulted in a major economic setback for the entire Balkan region. The wars broke out in earnest in July 1991 in Croatia and by the spring of 1992, the location of the fighting had shifted to Bosnia-Herzegovina, where it proved to be more devastating than in Croatia. The waging of these wars brought direct changes in the economies of Croatia and Bosnia-Herzegovina. While the war did not take place in Serbia or Montenegro, these regions nevertheless exhibit characteristics of a war economy: war is being waged at its borders, aid in various forms is siphoned to Serbs in the warring zones, and refugees are a burden to the economy. The internal markets of former Yugoslavia have been disrupted and international sanctions have disrupted the external markets. In Bosnia-Herzegovina a unified economy has ceased to exist and was replaced by a multitude of virtually self-sufficient local economies, coexisting with minimal trade and in the absence of a central infrastructure providing centripetal cohesion. Indeed, the example of Banja Luka, where production has decreased by 65 percent in 1993 over the previous year, and where only 23 percent of production capacity is used, is typical across Bosnia.[21] The most active trading takes place with the FRY, as "sanction busting" proceeds unimpeded by international control. The Serb held territories have thus been linked to the Serbian economy by trade, a relationship that was formalized in March 1994 when Bosnian Serbs entered into a monetary union with FRY and adopted the new super-dinar.[22] In the Muslim controlled territories, local production took place, but territorial isolation prevented trade, especially after the break in the alliance with Bosnian Croats (spring 1993). Given the inability of the economy to produce, demand of food and other necessities was in part satisfied by United Nations aid and U.S. airlifts. Herzegovina was under the control of Bosnian Croats, and the region meshed with Croatia insofar as it adopted Croatia's currency, its schoolbooks, its flag, etc. In the Bihac pocket, economic activity persisted with the least disruption due to trade and cooperation among the three ethnic groups. Indeed, it represents the only region in Bosnia where multi-ethnic tolerance has survived, albeit amidst some intra-Muslim fighting.

As a result of the war, the economies of Serbia, Montenegro, and Bosnia-Herzegovina have undergone changes that reflect partial conversion of a civil economy to a war economy. In addition, Serbia and Montenegro show increased recentralization and state interference in the economy. Elements of these changes are discussed below.[23]

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[21] *Ekonomska Politika*, no. 2163, (September 20, 1993), p. 21.
[22] *The Wall Street Journal*, March 11, 1994.
[23] See Milica Z. Bookman, *Economic Decline and Nationalism in the Balkans* (New York: St. Martin's Press), 1994.

War Production

Civil production was arrested most clearly in Bosnia as a result of the fighting and the concomitant loss of infrastructure and markets. Examples of sustained civil production are the exception rather than the rule: the case of the cookie factory "Mira" in Prijedor is the only factory in Bosnian Serb territory that has continued production throughout the war.[24] Scarce resources are instead being channeled into production to satisfy military demands: in the Muslim territories, the Bratstvo plant in Novi Travnik, the Slavko Rodic plant in Bugojno and the Igman plant near Konjic are all actively engaged in production of various types of military equipment and supplies.[25] Production of strategic goods, secondary to the war effort, have also been encouraged: in the Bosnian Serb territories, the Birac factory in Zvornik has been producing aluminum oxide and granulated zeolite (despite the shortage of raw materials).[26] In the 70 percent of Bosnia controlled by Bosnian Serbs, all industry has been put under military control in early 1994.[27] This is also true of the Muslim territories, where in addition to military intervention in the economy, the United Nations have also stepped in with the provision of goods the government was unable to supply.

The FRY economy altered production to accommodate not only the war that it was indirectly aiding, but also the international sanctions imposed on it as a result of its involvement in the war. The government adjustments to demands of war and sanctions included in its "survival strategy" are the a priori stockpiling of necessities and the development of alternative sources of supply (such as the routes through Serbian areas of Croatia and Bosnia-Herzegovina not subject to sanctions; for example, numerous Serbian businesses have become registered in Vukovar to facilitate imports and exports). Moreover, a plan was made to exert state control over key sectors in the economy, such as food, medicine, and energy. Indeed, fuel and energy production have now become strategic industries so that, despite the closing of half of Serbia's power stations and the lack of repairs, power stations such as the huge Obrenovac station have nevertheless been able to satisfy between one-third to one-half of domestic demand. Also, in the agricultural sector, as of mid-1993, there has been some compulsory procurement of foodstuffs, as well as some raw materials used as inputs in further production. Moreover, strategically important companies have been taken over by the state in an effort to control production, thus making FRY the only country in Eastern Europe to be moving into, not out of, large-scale military production (it is claimed that the defense industry is working at full capacity and even engaging in arms export[28]): indeed, the factory Crvena Zastava has decreased its automobile production but has continued producing small arms, M–84 tanks, and unguided and guided missiles, while

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[24] *Politika*, November 20, 1993.

[25] These areas of central Bosnia were the source of 55 percent of arms production in Bosnia before the war. Production today includes howitzers, mortars, anti-tank missiles explosives, hand grenades, and ammunition. *The Philadelphia Inquirer*, April 21, 1994.

[26] *Ekonomska Politika*, no. 2177, December 27, 1993, p. 12.

[27] This is due in part to concerns about the future of subsidies from FRY given the new monetary policy introduced in Belgrade which includes a reduction of public spending (*The Economist* (February 5, 1994), p. 54).

[28] *RFE/RL Research Report*, vol. 3, no. 1 (January 7, 1994), p. 132.

a machine-building factory in Valjevo has been converted to aircraft engine production.[29]

In Macedonia it was not the war that produced a change in production, but rather the sanctions against FRY. Until the arrival of U.S. troops to monitor sanction busting (1993), the border with Serbia proved to be porous and Macedonia's economy adapted to fulfill the new demands for production of food and small-scale industry. Border towns boomed with petty trade.

Displacement of Competitive Processes

There have been mixed results with respect to the displacement of competition by the war. While there has been a proliferation of small-scale competition, there is no doubt that the governments of Serbia and Montenegro have extended state control of various aspects of their respective economies. Indeed, war and sanctions are forcing the introduction of a command economy similar to what Yugoslavia experienced in the aftermath of World War II, including the renationalization of banks and numerous firms. Popovic predicts the establishment of a command economy "of the Cuban type," which will bring a reversal of stabilization measures and reform that are incompatible with a war economy.[30] The simultaneous growth in minor private activity in services and production has been tolerated and even encouraged because it takes up the slack from the government at a time of great shortages. Indeed, the private supply of items such as medicine and gasoline has greatly reduced the pressure on the government to provide them.

The reinsertion of the state in the economy not only reversed part of the privatization process that took place before the war demands on the economy prevailed, but affected other spheres as well: for example, domestic price liberalization, trade liberalization, and currency convertibility have all been discontinued in Serbia and Montenegro until January 1994. Under conditions of rampant inflation, price liberalization was discontinued and price controls reintroduced for 80 percent of prices (in June 1993). In April and May 1993, the government banned private dealings in foreign exchange. In August 1993, trade of essentials was banned, to be replaced by direct supply by the government of goods to households. The rationing introduced in September 1993 affected goods such as flour, sugar, oil, and detergent. At that time, a price freeze on basic necessities was reimposed, and the authority for control of prices was put to the republican governments. Opening up to trade at world prices is impossible in FRY due to sanctions, and in fact, the country has been paying premium prices for its imports because of the risks associated with sanction busting.

In Bosnian territory under Muslim control there has been no policy of controlling prices of commodities because of the utter confusion and disruption of communication lines that have detracted from the exertion of government power. Prices of consumer commodities have been extremely high, reflecting the closed nature of the local economies and the decrease in local production (in Sara-

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[29] *RFE/RL Research Report*, vol. 2, no. 41, (October 15, 1993), p. 35.

[30] Tomislav Popovic, "Alternativni Scenariji Uredjenja Odnosa Sa Medjunarodnim Okruzenjem i Ocene Njihovih (De)stabilizacionih Efekata," in *Osnove Stabilizacionog Programa* (Belgrade: Institut Ekonomskih Nauka, 1992), p. 4.

jevo in January 1994 gas was $60 per gallon, coffee $40 a pound, ground meat $27 a pound[31]). That prices were set by supply and demand was clear with the opening up of transportation roads to Sarajevo (in February 1994) and the dramatic decrease in prices of goods whose supply is expected to increase. In the Bihac pocket, production and trade with Serbs and Croats is taking place in oil, food, and arms, and the economy is undergoing a minor boom in the absence of government price policy. [32]

War Labor Problems

The Yugoslav wars have depressed the labor markets of Bosnia, Serbia, and Montenegro, where there has been a decrease in both the supply and demand for labor. The supply of labor has decreased because, first, many workers have been drawn into the conflict (army or expanding police force), leaving their enterprises short of skilled labor. Second, there has been emigration of workers out of the warring states in order to escape both a possible draft and dire economic conditions. A significant exodus of the skilled population (brain drain) has affected Serbia especially harshly (it is estimated that some 100,000 to 150,000 professionals left Serbia in 1992[33]). Third, the war has created refugees, as people have been "ethnically cleansed" from their homes (with respect to *registered* refugees, it is estimated that Macedonia had accepted 60,000, Croatia had accepted 515,000, and Yugoslavia had taken in 463,000 by mid-1993;[34] in Bosnia, some 1.6 million people are displaced[35]) These population movements have caused shortages of labor in some locations and an overabundance of labor in others. On the demand side, given the deteriorating aggregate demand and plummeting economic production, workers have been laid off. There is also large-scale disguised unemployment, as workers are requested to take indefinite paid vacations: in 1993 in FRY this kind of disguised unemployment affected some 1 million workers.

Financing the War Effort

The extent of aid supplied to the Serbs in Croatia and Bosnia is not clear, and estimates are hard to come by. One estimate is that the support constitutes 20 percent of gross domestic material product of Serbia. [36] That, coupled with the fact that the Serbian budget for 1993 was altered to include an allocation of 75 percent to the military, points to serious siphoning of funds for the war effort. [37] The government budget, burgeoned by the demands of war, was supplemented when the government froze individual and enterprise foreign currency holdings, which it "borrowed" to finance the war effort (estimates of this amount are hard to come by, although one

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[31] *The New York Times*, March 23, 1994.
[32] *RFE/RL Research Report*, vol. 2, no. 40 (October 9, 1993), p. 19.
[33] *RFE/RL News Brief* (December 28–January 8, 1993), p. 14.
[34] *RFE/RL Research Report*, vol. 2, no. 3 (January 15, 1993), p. 37; *Vecernji List*, Zagreb, January 16, 1993; and Belgrade TV Channel 1, January 18, 1993. The number of unregistered refugees is significantly higher (see the *New York Times*, November 28, 1992).
[35] *RFE/RL Research Report*, vol. 2, no. 3 (January 15, 1993), p. 1.
[36] *Ekonomska Politika*, July 19, 1993, p. 23, cited in *REF/RL Research Report*, vol. 2, no. 34 (August 27, 1993), p. 22.
[37] *FRE/RL Daily News*, June 16, 1993.

source puts it at $12 billion in private hard currency accounts[38]). The FRY government authorized the printing of money to finance expenditure until it was temporarily stopped by Prime Minister Milan Panic in the summer of 1992, and then again in January 1994 with the introduction of the super-dinar. Yet another source of money was the foreign currency reserves that became available when Serbia announced a moratorium on repayments of its foreign currency debt (in March 1992).[39] At the same time, the tax base has disintegrated: income taxes are lost due to the impoverishment of the population, import duties are lost due to sanctions, business taxes have decreased due to the lack of money in nonproducing enterprises, and the sales tax has dried up due to the low consumption rate (nevertheless, the government claims to finance 61 percent of its budget from taxes).[40] Both the rising spending on military and the lack of controlled growth of the money supply are in direct conflict with macroeconomic stabilization measures, such as fiscal policies aimed at controlling the budget deficit, which are part of a transition to capitalism.

While there are no hard facts on the financing of the war effort by the government of Bosnia-Herzegovina, it is clear that the Muslims are receiving aid, both in terms of people and materials. Indeed, there is anecdotal evidence that the Muslim countries have been especially active in procuring fighters as well as arms, during the two-year war. Macedonia is not at war, and is the most vulnerable of the Balkan states: its army did not increase in size since the breakup, it has no air force or navy; and little updated equipment. The government is not rearming at the present time.

FUTURE ECONOMIC OUTLOOK

The macroeconomic picture presented in Boxes 1–4 above indicates the severity of the economic conditions in SMBM. To this must be added microeconomic problems, including the shortage of investment resources, the lack of competitiveness, the lack of new technology (and the erosion of the old), and the lack of know-how. Together these factors depict a deterioration of pre-breakup conditions and raise questions of future prospects and economic viability. The future viability of SMBM is determined both by pre-war conditions, as well as arrangements and events during the "redefinition" phase of secession. Included among the pre-war conditions are resource advantages, levels of economic development, trade dependency on the former union, financial support from the former union, etc. These variables in turn encompass other characteristics. For example, the level of economic development tends to be positively related to the degree of industrialization, business-mindedness, level of education, and nature of the infrastructure. Trade dependency has implications pertaining to the hard currency earning capacity of industrial, agricultural, or raw materials output of the region. Also, the degree of national price deviation from international prices is important in determining the facility with which a region

[38] Sabrina P. Ramet, "War in the Balkans," *Foreign Affairs* 71, no.T4 (fall 1992): 91.

[39] This was done on the grounds that Serbia refused to carry the entire weight of the former Yugoslav debt burden until the regional responsibility for the payment of the debt was assessed.

[40] Enterprises borrow money from the banks in order to pay the tax (*RFE/RL Research Report*, vol. 2, no. 34 (August 27, 1993), p. 23).

can integrate itself into the global economy (clearly, a region accustomed to subsidies will undergo a costly adjustment following independence). With respect to arrangements and events in the "redefinition" phase, SMBM do not share the same international support, the same degree of property and infrastructure devastation, or the same ability to manage their economies independently. These considerations of viability underlie the future outlook for each region, as discussed below.

SERBIA

The Serbian economy has become a closed economy whose population has been driven to poverty: according to the Belgrade Economic Research Center, 97 percent of the population is living at the poverty level.[41] Its levels of production and economic activity are at an all-time low and, until early 1994, the country boasted the highest inflation in history. The reasons for this economic demise are many: not only did the breakup of Yugoslavia result in the loss of markets, but the imposition of international sanctions restricted trade, and thus also restricted domestic production that relies on imports. Moreover, the demands of the war have proved expensive, and domestic mismanagement of the economy has added to the trouble: according to Avramovic, only some 30–40 percent of the economic decline is due to war and sanctions.[42]

The future economic prospects of Serbia are bleak and will remain so as long as the status quo prevails. Below are the crucial problem areas, and how they need to be altered in order to improve future economic prospects. However, first and foremost, in Serbia, as in the entire area, economic recovery rests on the cessation of hostilities and the reestablishment of stability throughout the entire Balkans.

International Sanctions

Sanctions have undoubtedly contributed to the economic woes of Serbia, as well as to crime and social discontent. Indeed, after only one year of sanctions, the loss of revenue in FRY was estimated to be some $25 billion, and the per capita national income has dropped by a factor of ten, from around $3000 to $300. In one year, the price of bread has increased 800 times, while the price of milk increased more than 1,000 times. GNP dropped by $12 billion in that year; the value of foreign trade fell by $9 billion; industrial output fell by 40 percent in the first five months of 1993 over the same period in 1992; and one-half of the labor force became unemployed.

If sanctions were lifted, international trade would resume haltingly: while imports would enable stalled production to resume and exports would increase foreign currency earnings, there is little that FRY can export competitively in the absence of subsidies, given that its technological base has been eroded in the two years of sanctions. Moreover, many of its traditional markets in Eastern Europe have been filled by Asian manufacturers. The lifting of sanctions would also stabilize the entire Balkans that have been

[41] *RFE/RL New Briefs* vol. 2, no. 26 (June 14–18, 1993), p. 10.
[42] *Duga*, February 18, 1994, p. 11.

adversely affected: Eastern Europe and the Balkans have suffered $356 billion worth of damages in mid 1992–93 alone as a result of sanctions.[43] The 1993–94 figures, while not yet available, are certain to be worse. The transportation routes would be opened, trading and tourism among neighbors would resume, and the social hardships due to economic decline would improve. All these stabilizing effects of economic well-being must be calculated against the utility of sanctions as a political lever against the Serbs, a tool that has yet to prove effective.

Monetary Responsibility

Part of the blame for the economic chaos in Serbia lies with the government's fiscal and monetary policies. Most detrimental has been the huge government spending necessitated by the demands of the war and sanctions. Spending was financed by the indiscriminate printing of money (the budget deficit that demanded financing was estimated to be $800 million in the first half of 1993, and rose an additional $700 million in the last half[44]). Such printing of money not only resulted in galloping inflation, but also the new money displaced the dinar as a medium of exchange in favor of the German mark. The galloping inflation that resulted forced the population to exchange their foreign currency holdings for the dinars, thus releasing money to the government through the banking system.

The introduction of the super-dinar in January 1994 has the possibility of imposing monetary responsibility. Indeed, in the words of Finance Minister Vuk Ognjanovic, the goal of the program was to force the government to "live within its means."[45] According to Avramovic, the national budget deficit should be eliminated by June 24, 1994.[46] In addition to this self-imposed responsibility, the plan will improve the standard of living of the population. Indeed, following the introduction of the super-dinar, there has been an indisputable increase in the standard of living of the population as immediate shortages have been addressed: the minimum wage for the population is 20 super dinars, which represents an increase for many workers. In addition to enabling people to purchase goods, the stability and increased demand has resulted in an increase in supply as goods are once again becoming available on the bare shelves of urban Serbia. In February 1994, industrial production was already up by 12% over the same period last year, while in March it was up by 22%.[47] Moreover, in mid-February, the inflation rate in the new Yugoslavia has dropped to 1 percent: just prior to the introduction of the new dinar, the inflation rate was estimated at around 3 million percent.[48]

The success of this plan is questioned by Western economists (that claim there are insufficient reserves to sustain it and that it is yet another ploy to siphon foreign currency from the population)

[43] Romania has lost some $350 million by adhering to the Yugoslav embargo in the first year; Hungary lost $300 million in 1992 alone;. Russia lost $16 billion; Bulgaria lost $1.8 billion and expects to lose $2.5 billion annually; and Albania lost $300-$400 million.
[44] *NIN*, January 21, 1994, p. 10.
[45] *RFE/RL Research Report*, vol. 3, no. 8 (February 25, 1994), p. 2.
[46] *RFE/RL Daily Report*, (May 6, 1994), p. 7.
[47] *The Economist*, (May 7, 1994), p. 59.
[48] *RFE/RL Daily Report*, (February 28, 1994), p. 6.

as well as some leading Serbian economists (such as Tomislav Popovic and Nebojsa Savic[49]). But most important, the plan is not popular among numerous politicians that have much to lose since their interests are threatened: they are the ones that have gained from speculating on the inflation. Yet, this plan, or another like it that combines monetary and fiscal responsibility with decreases in inflation, is a necessary precondition to Serbian recovery.

Foreign Capital

All plans pertaining to the future reconstruction of the FRY economy are based on the massive injection of foreign capital, without which it is highly unlikely that the economy can even begin to reconstruct. Indeed, the utter devastation of working capital through disrepair and the erosion of the technological base that was sustained with international contacts must be addressed. In fact, it is inflows of foreign capital that are most awaited by the lifting of sanctions: the FRY leadership had in mind $2.5 billion in foreign loans in mid-1993, a figure that has undoubtedly greatly increased over the past year.[50]

Refugees

The Yugoslav wars have produced refugees from all ethnic groups, of which some 1/2 million are registered in Serbia. While it is unfortunate that a large-scale planned population swap was not organized a priori (such as between India and Pakistan, or Greece and Turkey, when 17 million and 2.5 million people changed countries, respectively), the fact is that today, all former Yugoslav regions have to deal with refugees. In Serbia, the 1/2 million registered refugees are without employment and are competing against the domestic labor force in a depressed labor market. The majority of the refugees live with family and friends, and some have been received by strangers. They have lost their homes, incomes, pensions, and social security from the republics whence they came, and thus are a tremendous burden to the Serbian government and a source of irritation to the Serbian population.

Such a burden is not sustainable over the long run and greatly limits the reconstruction prospects of the country. In the short run, Serbia desperately needs international aid to care for the refugees: the $45 million given to FRY in 1993 by the UN Commissioner for Refugees represents a small percentage of the needs, and significant additional funds will not be forthcoming given the general feeling of "Yugoweariness."[51] In the long run, resettlement of refugees must occur, either in their place of origin or in new territories. If peace is accompanied by inter-ethnic tolerance, some refugees may return to their homes in Croatia or Bosnia. It is likely that this will not be the outcome of choice for many. Alternatively, integration within Serbia-proper or the Serbian territories in Croatia and Bosnia may occur. In fact, some refugees have already relocated into the homes of departed households in Vojvodina, Krajina, and Bosnia. Efforts are being made to entice refugees to populate

[49] *NIN*, January 21, 1994, pp. 10–16.
[50] *Ekonomska Politika*, July 19, 1993, p. 35.
[51] *The Economist*, (February 5, 1994), p. 54.

regions such as Kosovo, but these are understandably met with great resistance given the political volatility of the region.

Human Capital

The composition of Serbia's population has changed since 1991. The influx of refugees from Croatia, and later from Bosnia, is composed mostly of rural residents whose comparative advantage lies in agricultural activities. Simultaneously, as noted above, there has been a dramatic outflow of urban residents that form the backbone of the skilled and professional labor force. Thus, the human capital accumulated and invested in over the past four decades is now dissipated, and the true costs of that will only be established in the years to come.

The viability of Serbia would be greatly enhanced if the outflow of skilled labor were reversed, and if agrarian refugees could be returned or reintegrated into the agricultural sector. Such a reversal of trends is likely only if hostilities cease and reconstruction across former Yugoslavia provides incentives for the return of migrants. Since it is estimated that roots established by immigrants do not solidify for some five years, the FRY has only a couple of years left to entice its skilled workers back before they settle in their new countries and become a permanent loss.

Crime and the Underground Economy

In the wake of the breakup, the demise of socialism, the wars and sanctions, the Serbian underground economy has expanded to fill the void in income and production. Activities such as the proliferation of local mafias that skim retail and production, crooked banking, sale of war booty, etc., are said to account for some 40 percent of total economic activity (April 1993).[52] In July 1993 Popovic estimated that the value of transactions in the underground economy exceeded that of the official economy.[53]

The future prospects for the Serbian economy will remain dismal as long as rampant crime continues to unsettle and displace legal economic activity. Yet, the underground economy will persist as long as it is profitable to conduct illegal business, and that will continue as long as sanctions are in place (necessitating risky sanction busting) and until an enforceable legal system is introduced.

Inter-ethnic Relations

Within Serbia, both Kosovo and Sandzak are presently unstable political regions whose non-Serb populations are demanding varying degrees of regional independence.[54] Such independence is not likely to be achieved without a bloody struggle (because of the historical meaning of Kosovo to the Serbs and the strategic importance of Sandzak, which straddles and divides Montenegro and Serbia), so other venues for conflict resolution must be explored. Increased tolerance on the side of the Serbs, the Albanians and the Slavic Muslims, coupled with enhanced minority rights, will greatly

[52] *RFE/RL Research Report*, vol. 2, no. 21 (May 21, 1993), p. 53.
[53] Interview with Tomislav Popovic, *Duga*, July 31, 1993, p. 11.
[54] Vojvodina is no longer considered an unstable region: the ethnic Hungarians seem satisfied by the steps toward cultural autonomy that Belgrade has taken, as expressed by the Hungarian foreign minister Geza Jesezensky in the spring 1994.

improve the viability of the entire state as it will enable economic activity and the inflow of investment capital into the regions.

MONTENEGRO

The economic problems plaguing Montenegro are similar to those of Serbia because they share sanctions as well as federal policies. Sanctions were responsible for a loss in revenue of $277 million in 1993; businesses have lost $130 million in exports, $90 million in tourism, and $57 million from shipping; refugees are burdening the government; skilled labor is emigrating; and the underground economy has proliferated (especially in the lucrative business of sanction busting of fuel by ship[55]). These hardships have produced a faint backlash among the population: not only has the government shown some degree of independence from Serbia (especially in foreign relations), but demands for secession from FRY have also been made by those that believe it will accelerate the lifting of sanctions.[56]

The prospects for Montenegro are as dismal as for Serbia, with the following additional considerations. First, the economic lifeline of Montenegro has been and remains the Serbian economy. The republic was a net benefactor of the central budget throughout its post war history and depends heavily on trade with Serbia. Unlike Serbia, it does not have the natural resources, human capital, and diversified economy to be a viable entity on its own, or to emerge from the economic quagmire on its own. This dependence was underscored in the summer of 1993 when the export of items from Serbia to Montenegro (especially food and energy) was licensed, resulting in a cut of supplies. Montenegro's retaliatory response with exports such as aluminum showed its weak economic position. Second, despite its seeming inter-ethnic tolerance, Montenegro is susceptible to a spillover of problems in Kosovo: Albanians reside in regions bordering with Kosovo and Albania, and increased autonomy of Kosovo would unsettle and raise demands of the Albanian population in Montenegro. Moreover, the Sandzak straddles Montenegro and Serbia, and its achievement of autonomy would not only take territory from Montenegro, but also cut off Montenegro from Serbia.

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

In Macedonia the average monthly wage is DM 219, inflation is currently approximately 15 percent a month, unemployment is about 35 percent,[57] and the black market is thought to account for up to 30 percent of the GDP.[58] Industry is operating at less than 40 percent capacity.[59] There is no doubt that the regional economy has suffered over the past three years as a result of the breakup and the Yugoslav wars. Macedonia was a net recipient from the federal budget, and Serbia was its chief trading partner, and both of those links were severed. Given that Macedonia has traditionally

[55] Anecdotal evidence indicates that setting fire on a ship (loaded with fuel) has been a common ploy for obtaining landing rights at a Montenegrian port.

[56] However, while the Liberal Alliance Party has promoted secession from Serbia, others, such as the Serbian Radical Party, demand union rather than federation.

[57] *RFE/RL Research Report*, vol. 3, no. 4 (January 28, 1994), p. 40.

[58] *RFE/RL Research Report*, vol. 2, no. 23 (June 4, 1993), p. 28.

[59] *Radio Voice of America*, "Background Report: Macedonia Embargo," April 29, 1994.

been a producer of raw materials and importer of manufactured goods, it found itself scrambling for new markets: it has recently turned to Slovenia for imports,[60] has entered into contracts with Turkey, and is looking forward to long-term trade benefits from the proposed highway that will link it with Albania, Bulgaria, and Turkey, forming a yet unexploited trade corridor. Adherence to the Yugoslav sanctions has been very costly for Macedonia, given its position as the throughway of trade and tourism between western and eastern Europe and Greece (the border crossing between Greece and Macedonia is said to have been the busiest in Europe; 80 percent of Macedonia's transportation to Europe went through Serbia[61]): the cost to Macedonia is estimated to be $80 million monthly, equivalent to 85 percent of the country's export earnings.[62]

Also relevant in the assessment of Macedonia's economic performance is the position of Greece, which objects to Macedonia's use of the name Macedonia (which Greeks believe should only refer to the Greek province), to its use of the Greek vergina symbol on its flag, and to its constitution that the Greeks perceive to be unclear with respect to territorial ambitions.[63] As a result, Greece was able to postpone recognition (until spring 1994 by the United States) and imposed two blockades against Macedonia: the latest one, in February 1994, precludes shipment of all goods to and from Thessaloniki port except food and medicine and the closing of the Greek consulate in Skoplje. Not only is the embargo costly to the Macedonian economy (it is estimated to cost Macedonia $50 million to $60 million per month,[64] despite evidence of some ongoing trade with Greece[65]) but the postponed recognition resulted in the lack of inflow of capital, which is so necessary to the economy. It is only recently that some capital has been committed: the Macedonian government has repaid the World Bank the $85 million that it owed in arrears, thus opening the way for new loans. It will receive $40 million in World Bank loans and a credit of $40 million from the International Development Association, both approved in February 1994, to help economic reform and stabilization and to be used for imports.[66] Macedonia also has arranged for IMF loans of $38 million.

There are conflicting opinions as to the economic viability of Macedonia. Macedonia received a dismal report from the World Bank Economic Mission in spring 1993.[67] This view is countered by the economist Michael Wyzan, who has stated that Macedonia is unequivocally viable as an independent state on the grounds that the economy is doing better than all other post-Yugoslav states except Slovenia: it has a stable currency, has taken steps toward reforms,

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[60] Trade with Slovenia is more expensive than with Serbia, resulting in a $100 million trade deficit with Slovenia in 1993. *RFE/RL Daily Report* (January 27, 1994), p. 7.

[61] *Ekonomska Politika* no. 2166, October 11, 1993, p. 19.

[62] *Financial Times*, April 6, 1994.

[63] Moreover, for a limited time, the water tower of Thessaloniki was pictured on the Macedonian currency. The issue of Macedonia has so impassioned Greeks that it is largely responsible for the fall of the Mitsotakis government in October 1993, and before that, the breakup of his New Democratic Party and the creation, under Andreas Samaris, of the Political Spring Party (whose platform was a tougher stand against Macedonia).

[64] *Radio Voice of America*, "Background Report: Macedonia Embargo," April 29, 1994.

[65] *The Economist*, (January 29, 1994).

[66] *Transition*, vol. 5, no. 1 (January 1994), p. 18.

[67] *REF/RL Research Report*, vol. 2, no. 23 (June 4, 1993), p. 29.

and has controlled its inflation and unemployment.[68] Moreover, private business is booming, and Macedonians abroad are repatriating much money. Even if one could argue that economically Macedonia will totter along and improve in the aftermath of the lifting of sanctions and the Greek embargo, its future viability should not be measured in economic terms alone. A critical consideration in assessing its future is the inter-ethnic consensus between Macedonians and Albanians. The demands of the Albanians, that account for 20–40 percent of the population (depending on which statistics are used), have increased since 1990, vocalized by Albanian parties such as the Party for Democratic Prosperity that demand greater autonomy, secession, and even union with Albania. The obvious link between stability in Macedonia and events in Kosovo is more pronounced than in Montenegro given the magnitude of the Albanian population: a future detachment of Kosovo from Serbia cannot but intensify irredentist demands by the Albanians in Macedonia, raising serious questions of viability of a severed Macedonia.

THE REPUBLIC OF BOSNIA AND HERZEGOVINA

The economy of Bosnia has been devastated by the war and its infrastructure destroyed. Organized production has halted and largely been replaced by subsistence production, with huge concomitant losses of human capital. The fragmentation of the economy, taking place along the front lines, has combined with the rugged mountainous terrain to create a multitude of local economies that have operated with minimal interaction. Under these circumstances, the future economic viability of Bosnia is bleak in the short run. An analysis of Bosnia's future economic welfare is based on two major considerations: first, the boundaries of the state, and second, the infusion of reconstruction capital. With respect to the first, there can be no discussion of the future economy of Bosnia without a clear delineation of the territory that Bosnia will encompass. There is no doubt that, in the absence of war and with the retention of the Titoist boundaries that were recognized by the international community in 1992, Bosnia could be viable, despite its underdeveloped status, its pockets of extreme poverty, and its lack of access to a sea port. However, nationalism, increased interethnic intolerance, and the reality on the battlefield have largely precluded the retention of those borders. Indeed, the prospects of retaining a unified Bosnia *given a fragmented Yugoslavia*, are as unrealistic as they are dim: there is no reason to believe that a multi-ethnic Bosnia would succeed if a multi-ethnic Yugoslavia did not, especially given that two of the ethnic groups in Bosnia have mother states to which they are attracted, and to a degree, attached. The efforts of the international community in April 1994 seem focused on the formation of a loose confederation among the three sides, coupled with a gradual lifting of sanctions on the FRY. This represents a shift from the earlier U.S. backed Croat-Muslim Bosnian federation (February 1994). Nevertheless, the amount and the nature of the territory the warring sides will claim remains a key question. Bosnian Serbs currently hold some 70 per-

[68] Micheal Wyzan, cited in *RFE/RL Research Report*, vol. 3, no. 4 (January 28, 1994), p. 40.

cent of the territory (and they held property rights to over half of the Bosnian territory before the war[69]). They tend to be rural inhabitants, but the land that they previously held was of poor quality (only one-third (16,734 km sq.) of Bosnian territory was under cultivation). The Muslims have traditionally held the highest quality territory insofar as it includes industrial sites and urban centers such as Sarajevo, Tuzla, Zenica, Mostar, etc. (it is likely the economic significance of the central Bosnian sites that led to the fiercest fighting between the Bosnian Croats and Bosnian Muslims). Rural Muslims have traditionally controlled the more desirable land near rivers and in valleys, since they were granted preferential land rights and other privileges during the Ottoman Empire as a result of their religion. While the final boundaries are unclear, it is certain that without additional continuous territory, the Muslim lands represent a sliver that is scarcely feasible and sustainable. In contrast, the Bosnian Serb and Bosnian Croat territories would be feasible if united in confederal or federal ties to their mother states.

When the boundaries are settled, reconstruction aid will have to flow. There is no doubt that the costs of reconstruction will be high (the Bosnian Minister of Reconstruction, Munever Imamovic, estimated that it will cost $5 billion to $10 billion to reconstruct only Sarajevo[70]) and that the only source for reconstruction aid will be outside the state. While there is no Marshall Plan in the making, verbal commitments have been made by the United States, the Economic Community, and Muslim countries. However, there is no reason to believe that capital infusions will begin if the eventual peace that is signed is not to the liking of the donors.

In conclusion, it is imperative to understand that the economic future of SMBM, as well as the rest of former Yugoslavia and the Balkans, is closely tied to the cessation of hostilities and the return of stability in the region. That primarily requires a concerted effort on the part of the West to develop a *peace* proposal (as opposed to a war proposal such as the incremental escalation of fighting) which will enable the beginning of reconstruction in Bosnia. Moreover, the reconstruction of the Serbian and Montenegrian economies is a necessity for fostering stability in the region: after all, dire poverty of the largest population and territory in former Yugoslavia is very dangerous and cannot but be destabilizing and impede economic development of the entire area. The lifting of sanctions and the resumption of trade will greatly improve the Macedonian economy. Economic development is the best tool for cooling nationalist passions throughout the former Yugoslavia. In the absence of that, the region will retain its destabilizing character, bringing into question also the economic future of Greece, Romania, Albania, and Bulgaria.

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[69] Srdjan Bogosavljevic "Bosna i Hercegovina u Ogledalu Statistike" in Srdjan Bogosavljevic et al. (eds) *Bosna i Hercegovina Izmedu Rata i Mira*, Belgrade: Institut Drustvenih Nauka, 1992, p. 37.

[70] *The New York Times*, March 10, 1994.

EAST GERMANY IN TRANSITION

By Lutz Hoffmann *

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SUMMARY

The East German economy now expands at an annual rate of about 7 percent. However, macroeconomic imbalances and structural distortions are still large. Overall domestic demand exceeds supply; consumption is larger than GNP; wage costs are higher than value-added; and the share of manufacturing in the Gross Domestic Product (GDP) is half of what it once was and also half of the corresponding value of manufacturing in West Germany. The weakness of industrial production is largely the result of costs that are too high. Productivity levels are still too low compared to wages, which are rapidly approaching the West German level. The relatively high overall economic growth results from activities that face little competition and that benefit from the high transfer payments by the federal government—such as local services, food products, construction and the various suppliers of construction materials including construction-related crafts.

East German growth therefore is correctly labelled as transferled growth rather than self-sustained growth. As a consequence,

* Lutz Hoffmann is President of the German Institute for Economic Research (DIW), Berlin.

the East German economy will only be able to maintain its present high growth if transfer payments remain at a high level for some years to come. But even with a growth rate of 7 percent or beyond, the employment situation is unlikely to improve.

Today there are 40 percent fewer jobs in East Germany than there were before unification. The new industrial activities that emerge in East Germany are highly capital intensive and use the latest technology. This is beneficial for productivity increase and economic growth but damaging to the prospects for new jobs.

East Germany's share in German territory is 30 percent; in the labor force, 21 percent; and in GDP, 9 percent (table 1). Real output of the East German economy declined in the year of the currency union (1990) by 15.5 percent and in the year thereafter by nearly 30 percent. In 1992 East Germany staged a strong recovery with a growth rate of over 9 percent. Since then economic growth ranges between 6 and 7 percent.

TABLE 1. Key Economic Indicators of East Germany, in Current Prices

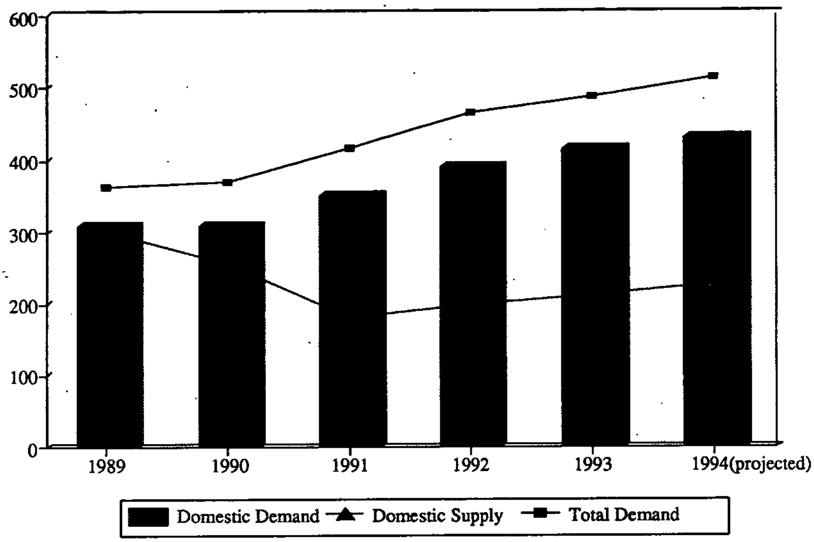
Measure	1993 Values	% of total Germany
Area (km^2)	108,331.8	30.3
Population	15,668,800	19.3
Labor force [a]	7,866,000	21.4
Employment	5,683,000	18.0
GDP (Billion DM)	275.5	8.9
Manufacturing	44.7	5.4
Services	60.2	6.1
Consumption	232.3	13.0
Investment	139.2	19.7
Exports	76.1	6.9
Imports	277.2	25.3

Source: German Institute for Economic Research (DIW), Berlin.
[a] Labor force data only for 1992.

It is now widely acknowledged that the initial economic breakdown of East Germany resulted from the supply shocks of the currency union and the wage explosion. The alternative interpretation that there was a lack of demand due to reduced purchasing power in the region and the collapse of export markets in Central and Eastern Europe cannot be maintained. Over the entire period since the introduction of the deutsche mark as legal tender in East Germany aggregate demand was far in excess of aggregate supply. Demand was not only maintained, but even increased due to the rapid build-up of a large transfer flow from West to East Germany. The currency union and the transfers distinguish East Germany from other formerly socialist countries and make the adjustment pattern of East Germany unique. The subsequent discussion focuses on four issues: macroeconomic imbalance, structural distortions and adjustment, external trade and East Germany's growth potential in the years to come.

FIGURE 1. SUPPLY AND DEMAND IN EAST GERMANY, 1989–1994

(MILLION DM, IN CONSTANT 1991 PRICES)



Source: German Institute for Economic Research (DIW), Berlin.

MACROECONOMIC IMBALANCE

The overall macroeconomic imbalance is illustrated in figure 1. It is seen that over the entire period not only total demand, but also domestic demand exceeded domestic supply. In 1992, domestic demand surpassed supply by 85 percent and in 1994 it will still be almost 70 percent higher.

Even though investment is substantial, it is mainly consumption that accounts for this huge demand overhang. The high disposable income that makes this consumption demand possible results from high wages that rapidly approach the West German level on the one hand, and from large income transfers to public work programs and to unemployed and retired people on the other.

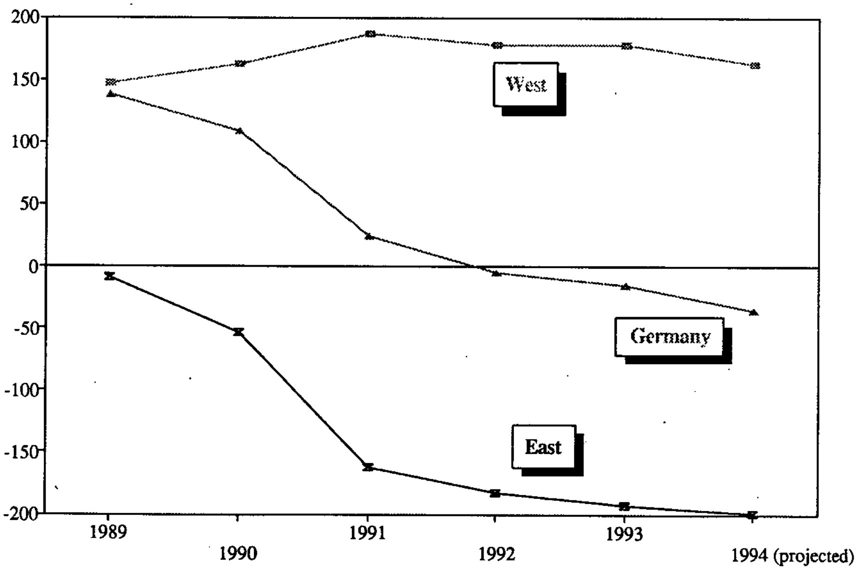
Whereas at the start of the currency union East German effective wages amounted to 40 percent of the West German average, they will stand at 80 percent in 1994. Overall net transfers from West Germany to East Germany rose from 45 billion in 1990 to over 160 billion in 1993, which is three-quarters of East Germany's GDP. It is estimated that about two-thirds of these transfers went into consumption and the remainder into investment. This rapid increase of transfers has been the basic source of recovery in 1992 and 1993. It therefore is appropriate to speak of transfer-led growth rather than self-sustained growth.

As a consequence of the large disposable income as compared to domestic output, the wage share in GDP is extraordinarily high. It has been larger than 100 percent over the past three years and will touch the 100 percent line only this year. That means that the enterprise sector as a whole was unable to make profits up to now. This is the main reason why private investment almost entirely relied on West German sources.

Another implication of the large macroeconomic imbalances was a high negative external balance of the East German region (figure 2). The deficit on current account in 1991 was almost as high as GDP and is expected for 1994 to just fall short of 70 percent of GDP. This is, actually, what explains the swing in the external account position of Germany as a whole.

FIGURE 2. EXTERNAL BALANCE, 1989–1994

(BILLION DM, CONSTANT 1991 PRICES)



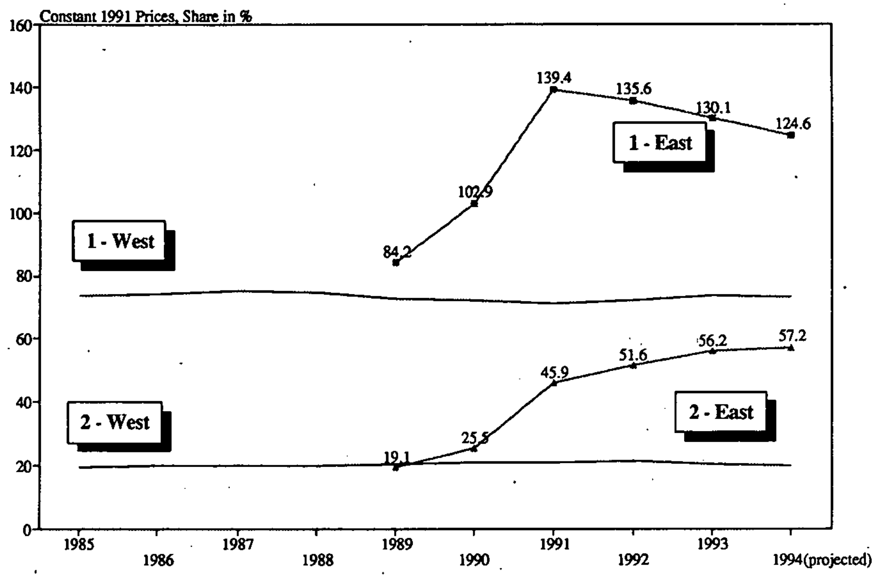
Source: German Institute for Economic Research (DIW), Berlin.

Whereas in 1989 Germany's current account surplus was over DM 100 billion, it turned into a deficit after unification, which now stands at about DM 40 billion. Contrary to the impression prevalent in public discussion, the West German external account position has not worsened, but rather improved.

STRUCTURAL ADJUSTMENT

High aggregate demand and falling supply led to major structural distortions both on the demand and the supply sides. The East German consumption ratio, which in 1989 was almost equal to that of West Germany, shot up to roughly 140 percent in 1991 and has been only gradually declining since then (figure 3). The investment ratio increased continuously since the currency union. In constant 1991 prices the investment ratio overshot the 50 percent mark in 1993. This is the result of rapidly rising private as well as public investment.

FIGURE 3. RATIO OF CONSUMPTION TO GNP (1) AND RATIO OF INVESTMENT TO GNP (2) IN EAST AND WEST GERMANY, 1985–1994



Source: German Institute for Economic Research (DIW), Berlin.

On a per capita basis public investment is now considerably higher in East Germany than in West Germany, while private investment is almost on the same level. Whereas the rise in public investment is due to the political commitment to rebuild the East German infrastructure, private investment was stimulated by very high investment subsidies. A large part of investment went into services, partly to build up the retail system for products delivered from West Germany, but also into banking, insurance, and other service activities that were non-existent or underdeveloped in the GDR (table 2). However, manufacturing and construction also attracted substantial investment. The construction industry, actually, experienced a boom fueled by large public construction contracts. Investment in manufacturing was largely associated with the privatization activity of the Treuhand (the state trust company in charge of privatizing the formerly state-owned companies). With the privatization process now coming to an end and the buildup of a viable service sector tapering off, the investment ratio is unlikely to maintain its high level.

The structural distortions on the supply side were even more severe than on the demand side. The share of manufacturing in GDP halved between 1989 and 1991 and has only slightly increased since then. The share of construction trebled due to the building

TABLE 2. Investment in East Germany by Industry, 1991–1994
(Billion DM)*

Industry	Investment			
	1991	1992	1993	1994
Agriculture/Forestry/Fishing	1.5	1.4	1.5	1.6
Producing Industries	29.7	37.2	42.3	45.5
Energy, Water, Mining	8.9	10.4	12.0	14.2
Manufacturing	17.2	22.3	24.3	24.3
Construction	3.6	4.5	6.0	7.0
Trade	4.4	5.2	5.2	4.7
Transport and Telecommunication	16.2	21.9	23.8	26.3
Other Services	22.4	32.8	46.2	58.4
Residential Housing	15.0	23.0	33.0	42.0
Total Industry	74.2	98.5	119.0	136.5
Government and Nonporfit Organizations	14.3	20.5	23.0	25.5
Overall Total	88.5	119.0	142.0	162.0
Industry without Residential Housing	59.2	75.5	86.0	94.5

Source: ifo institute, Munich; Federal Statistical Office, Wiesbaden.
*Estimates of ifo institute, Munich.

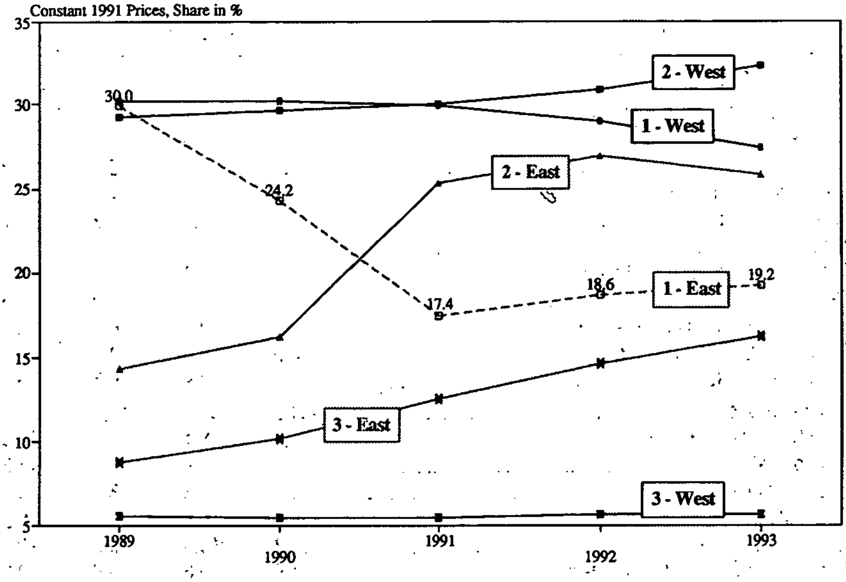
boom, nourished first by public and later on also by private investment. Also services increased their share significantly (figure 4).

If one looks at what had happened within major sectors, the following picture emerges for manufacturing. In the former GDR "investment goods," in particular machinery, had a relatively high share in production (table 3). The earlier hopes that the strength in investment goods could be maintained did not materialize. All tradeable investment goods witnessed dramatic declines in output. The machinery industry saw its share in manufacturing output falling from almost 25 percent at the time of the currency union to 12 percent by the end of 1993. A recovery is not yet in sight. Also industries that survived in East Germany only because they were sheltered from foreign competition—such as clothing manufacturing, textiles, and leather products—shrunk much more than the rest of manufacturing.

If one compares the performance in production industry by industry, the following general pattern emerges. Industries that benefitted from the high consumer demand and that were not exposed too much to transregional competition did relatively well. Food products as well as printing and publishing are cases in question. Industries related to the booming construction activity also showed good performance. To these belong the stones and quarrying industry, the manufacturing of steel and metal structures, sheetglass production, and in particular, all crafts engaged in construction activities.

Until mid-1993 manufacturing as a whole did not recover from the shock of the currency union. Since then, however, significant output increases are visible in a number of activities, whereas in others the decline has been stopped. The output increases largely reflect the shift of earlier investments that went into production.

FIGURE 4. SHARE OF MANUFACTURING (1), SERVICES (2), AND CONSTRUCTION (3) IN GDP IN EAST AND WEST GERMANY, 1989–1993



Source: German Institute for Economic Research (DIW), Berlin.

Given the low base of output, any new production unit that starts operation makes a significant impact on the growth rate. Although it is a great relief that the decline has reversed into an upswing, one has to realize that this is not yet a self-sustained growth emanating from indigenous investment and entrepreneurship. The competitiveness of East Germany's industries is still highly fragile. Wages are high and profits low or negative. Without special efforts from the West German private sector, such as the "buy East German" initiative, the performance of East German industry would probably be much less satisfactory.

The partial recovery in output did not improve the employment situation. On the contrary, even in those industries where output stagnated or increased, employment continued to decline. The pattern of employment development is remarkably similar among industries, almost independent from whether output fell or rose. This suggests that not only economic factors were responsible for employment development, but also the various public support programs and the policy of the Treuhand to maintain companies and jobs even though they were not economically viable any more.

The consequence of the diverging output and employment developments are widely differing productivity changes. With fairly similar increases in wages, this implies very different unit wage cost developments. In some industries, such as plastic products, competitiveness improved as unit wage costs fell, whereas in others, such as ship-building, the machinery industry and steel making,

TABLE 3. Manufacturing Production in East Germany: 1990–1993 Structure
(Share in Percentage)

Manufacturing Category	1990ᵃ	1991	1992	1993
Total Manufacturing	100	100	100	100
Basic and Production Goods Industries	19.2	22.0	23.4	23.4
Petroleum Refining	2.1	4.0	4.3	4.0
Quarrying	4.2	3.9	6.3	8.2
Iron and Steel Products	1.3	1.3	1.2	1.1
Nonferrous Metals	1.3	1.6	1.8	1.7
Foundries	1.8	1.5	1.2	0.9
Drawing Plants, Cold Rolling Mills	0.4	0.4	0.3	0.2
Chemical Products	6.7	8.0	6.9	5.5
Sawmills and Timber Processing	0.4	0.3	0.2	0.2
Pulp and Paper Processing	0.0	0.0	0.0	0.0
Rubber Products	1.0	0.9	0.7	0.7
Capital Goods Industries	54.9	46.7	43.3	43.5
Structural Metal Products	4.9	8.1	10.7	11.4
Mechanical Engineering	25.4	19.9	12.9	11.5
Road Vehicles	4.5	3.4	3.9	5.4
Shipbuilding	0.4	0.3	0.2	0.2
Electrical Engineering	14.2	10.3	10.5	10.1
Precision and Optical Instruments	1.8	0.6	0.8	0.5
Tools, Fabricated Metal Products	1.8	2.9	3.3	3.2
Office Machinery, Data Processing Equipment	1.5	0.8	0.5	0.4
Consumer Goods Industries	12.0	12.6	13.4	13.8
Musical Instruments, Toys, etc.	0.7	0.4	0.4	0.4
Ceramic Products	0.4	0.3	0.3	0.3
Glass Products	0.5	0.7	0.7	0.7
Wood Processing	2.6	2.9	3.1	3.5
Paper Products	0.5	0.6	0.7	0.7
Printing and Publishing	2.2	3.8	4.4	4.0
Plastic Products	0.8	0.8	1.3	2.1
Leather and Leather Products	0.9	0.4	0.3	0.2
Textiles	2.8	1.8	1.4	1.2
Wearing Apparel	0.7	0.4	0.3	0.3
Food, Beverages, and Tobacco	13.9	19.1	20.4	19.7
Food and Beverages	11.5	14.8	17.0	16.9
Tobacco	2.4	4.1	3.3	2.8

Source: Federal Statistical Office; German Institute for Economic Research, Berlin office.
ᵃ 1990 figures are for the last six months of the year.

unit wage costs rose and competitiveness deteriorated. One may conclude that there are positive signs of recovery and improving competitiveness in some industries, but negative ones in others. The de-industrialization that began with the currency union has not yet been overcome. The new emerging industry structure is likely to look rather different from the previous one and from that of West Germany. Earlier expectations—that after a period of adjustment the industrial structures of the two parts of Germany would again look relatively similar—are now less likely to be fulfilled.

The output decline in the construction industry was much less severe than in manufacturing. Part of the explanation is that before the currency union West German construction companies were already active in East Germany in anticipation of the coming construction boom. Only housing construction fell considerably because the first construction contracts came from the public sector and went into infrastructure projects. Investment in housing construction was hampered by unsettled property disputes and the initially very low rents that made investment in housing unprofitable. In the meantime, some progress has been made in clearing property rights, and rents have gone up considerably in East Germany. They now roughly stand at the level of West Germany in the early 1980s. Housing construction therefore has strongly picked up and is likely to further accelerate in the coming years. The shortage is substantial, a fact that partly explains the steep rise in rents.

In most of the service sector, the competitive environment is fundamentally different from that in manufacturing. Transregional competition is of rather limited significance. Production takes place where there is demand. The type of services being supplied therefore largely depends on the type of demand that exists on the spot. The high and rising consumer demand as a result of large income transfers from West Germany generated a wide and growing range of consumer services. Also producer services began to develop initially, but when manufacturing production collapsed, many producer services lost their base of existence.

The dramatic structural change that took place in services can best be illustrated by the developments of the transport sector. Due to the decline in production, the transport of goods also fell significantly. However, whereas road transport began to increase again in 1991, rail transport continued to decline strongly. The railway system was unable to adjust itself fast enough to the change in transport direction, now mainly West-East, whereas formerly it was mainly North-South. In addition, many West German transport companies greatly benefitted from the investment subsidies available in East Germany by registering their new trucks at an East German location. Once established there, they successfully tried to capture a major share of the transport market. East German transport companies had a very difficult stance vis-à-vis experienced and large West German transport suppliers. They also were at a disadvantage due to the fact that, in line with trade flows, much more was transported in the West-East direction rather than the East-West direction.

In passenger transport, the development was similar. Rail transport declined whereas road transport increased. The number of passenger cars per capita has risen rapidly since 1989. Also local public transport companies suffered substantially, whereas private transport increased, both transport by bus as well as by passenger car. It is quite obvious that East Germans had the desire to make up for the long period of freedom deprivation during which they could not move individually by car within and outside East Germany.

EXTERNAL TRADE

During the times of the GDR, East German industry was fully integrated into the socialist trading block. Nevertheless, East Germany also maintained substantial trading relations with Western Europe, in particular West Germany. Its "revealed comparative advantage" as expressed by the trade balance in various commodity categories, was in trade with the East of investment goods and with the West of consumer goods and basic products. That may partly explain why the shock of the currency union had a more severe effect on investment goods as compared to consumer goods and basic products. If one examines the trade performance of individual industries it becomes apparent that East Germany was quite competitive in a number of lines of production under the old trade regime. For these industries it was the cost shock associated with the currency union and the wage equalization that threw them out of the market. One may conclude that if East Germany had maintained its own currency and wage levels only gradually increased, the East German market would not have been swamped by products from West Germany to the extent it was and East German exporters would have been able to maintain some of their exports.

Of course, the developments in the former Soviet Union and its satellites also contributed to the breakdown of export activity. In the first half year of 1991 these exports fell to about one-third of their value a year before. Also exports to Western countries declined. Only deliveries to West Germany increased by about 20 percent.

The government tried to counteract the loss of the Eastern European market by providing export guarantees for a wide range of products. A 100 percent export guarantee was granted for deliveries to the former Soviet Union. Preference was given to supplies from East Germany. In 1991 alone, these amounted to almost DM 10 billion. These guarantees were continued at a lower level over the subsequent years. The exposure of the government resulting from these guarantees accumulated to more than DM 30 billion by the end of 1993. Although important for the survival of a number of companies administered by the Treuhand, the guarantees could not prevent a further continuing decline of exports to the East.

On the import side, deliveries from the East also declined. So did direct deliveries from Western European countries. But deliveries from the West via West Germany increased very substantially. They were only surpassed by the virtual explosion of supplies from West Germany.

EMPLOYMENT AND GROWTH POTENTIAL

The economic performance of a country or a region depends, according to economic theory, on its endowment with resources, such as raw materials, labor and capital, and the productivity of these resources. East Germany is basically a resource-poor region. The economy depends on the availability of labor, its quality, on capital and its technological standard.

The economic decline after the currency union was accompanied by a large flow of people who migrated from East Germany to West Germany. Of a population of 16 million, almost 1 million have left the region. Nearly 400,000 East Germans work as daily commuters in West Germany. More than 800,000 went into early retirement, and 350,000 are engaged in government-financed work or training programs. About 1.2 million are unemployed. Of the earlier work force of almost 10 million, barely 6 million are still actively working in the region. This means a tremendous loss of resources. It is not only the sheer numbers that count, but also the fact that a lot of human capital has left the country, left the labor market, or become obsolete.

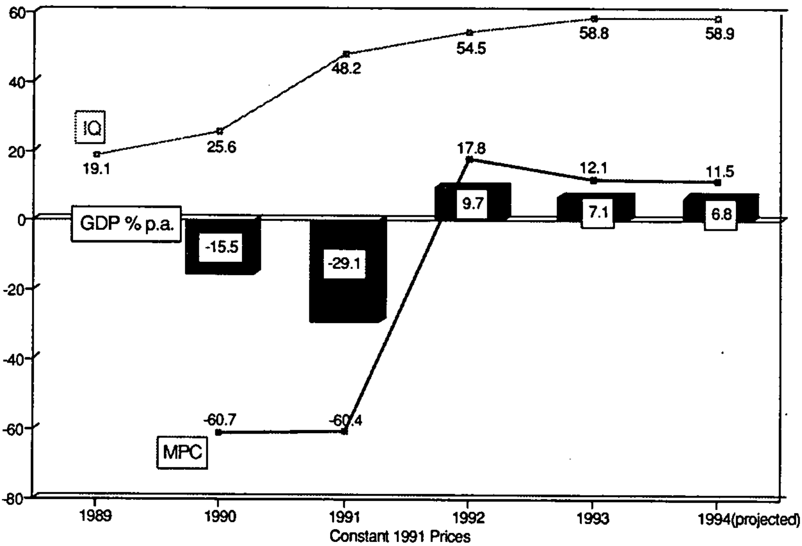
Those who left the country or were taken out of the labor force cannot be reactivated for future growth. They are definitely a permanent loss of valuable human resources for the region. The total future labor force potentially available for production is likely to be closer to 8 million rather than the previous 10 million.

The GDR's endowment with capital in the form of infrastructure, machinery, and equipment was poor in terms of quality, not quantity. The capital stock was run down and technologically outdated. The currency union and the rapid rise in wages made more capital economically unviable, even if it was still operative from a technical point of view. Under these circumstances it was fortunate for East Germany that both public and private investment from West Germany were rapidly forthcoming. The buildup of a modern capital stock, which the investment figures reflect, is one of the major sources of future growth of the East German region. Inasmuch as economic growth can be defined as the product of the investment ratio and the marginal productivity of capital (MPC, the inverse of the marginal capital-output ratio), the future growth potential will depend on whether the present high investment ratio can be maintained and how the MPC might develop. With an investment ratio of 58.8 percent and a measured growth rate of 7.1 percent in 1993, the implied MPC is 12.1 percent (figure 5). An acceleration of economic growth would require a further increase of the investment ratio, the MPC, or both.

The present high investment ratio is due to both a large flow of investment and depressed output. To the extent that output grows and investment does not increase even faster, the investment ratio is bound to come down. This is suggested by international comparisons of investment ratios in high-growth countries. Even the rapidly growing little "tigers" in Southeast Asia, such as Singapore, Taiwan, or South Korea never have realized investment ratios as presently observed in East Germany. Although their investment ratio was high—in the range of 35 to 40 percent—their rapid growth primarily resulted from a high MPC. This raises the question of whether East Germany could also achieve a substantially higher MPC than the present one.

Since 1992 the MPC has been on a level that is quite comparable with values observed for West Germany over the last two decades. To argue for a higher rate, one would have to reason why East Germany's MPC should be higher than that of West Germany. That is not easy because there is little information available on the MPC of various lines of production.

FIGURE 5. MARGINAL PRODUCTIVITY OF CAPITAL (MPC), RATIO OF GROSS INVESTMENT TO GDP (IQ), AND RATE OF GROWTH (GDP % P.A.)[a] IN EAST GERMANY, 1989–1994



Source: German Institute for Economic Research (DIW), Berlin.

[a] GDP percentage per annum.

For industrial output, a significantly higher MPC is not very plausible. The new plants that are now being built in East Germany are highly capital intensive and of the most advanced technology. Labor productivity is likely to be high, but capital productivity will not be more than normal. The old labor-intensive lines of production have been or are being phased out. Therefore, the output structure is shifting toward a higher average capital intensity. At least in the medium to longer run the capital intensity will not differ very much in industry from that in West Germany, and the marginal productivity of capital therefore is also unlikely to be much higher.

The service sector in East Germany has a significantly higher share in output and employment than in West Germany. Because of the high rate of unemployment many job seekers become engaged in services in which they try to make a living in trades with low capital equipment. This phenomenon was observed in the United States in the 1980s and could well become significant for East Germany in the 1990s. The low capital equipment may mean a high capital productivity, higher than in manufacturing. If that is the case, the different sectoral structures could, indeed, imply that the overall MPC in East Germany turns out to be higher than in West Germany.

One may conclude that a somewhat higher marginal productivity in East Germany as compared to West Germany is quite possible. However, it will never reach the levels achieved in the new industrializing countries in Southeast Asia. If one assumes a margin of 25 to 30 percent between the East German and the West German MPC—what would correspond to the MPC of West Germany in the 1960s—and if one further assumes that the investment ratio "normalizes" to a level of 40 percent, a 7 percent medium-term growth rate for East Germany appears to be feasible.

One may well question why the earlier expectations of double-digit growth rates that would imply a rapid catch-up to West-German income and production levels is not feasible. After all, the Southeast Asian countries and more recently China have demonstrated that this is possible in principle. The answer is relatively simple. East Asia has much more labor-intensive production with lower wages and longer working times than East Germany. If capital is combined with large amounts of other resources, such as labor, a high MPC is no miracle. With unification, East Germany reaped all the benefits of the West German welfare state, such as high income and low working times. Applying the same amount of labor in terms of working hours to capital as in East Asia would make production in East Germany unviable, because labor is too expensive. Economic growth in the two-digit range is simply not feasible under these circumstances. This is one of the major lessons from German unification. If consumption and social benefits rank high before productivity and efficiency, economic growth is bound to be slow. Only extraordinarily high investment ratios can compensate for a relatively low marginal productivity of capital. But that cannot be sustained for long.

APPENDIX

EAST-CENTRAL EUROPEAN ECONOMIES IN TRANSITION: A SURVEY OF DATA

By Jonathan D. Kimball *

As a consequence of the previous use of old Soviet categories for exports and production, the states of East-Central Europe needed to redesign their means of statistical reporting in order to correctly assess the direction of their economic transformation. Conditions within these countries, however, have not facilitated accurate calculations of some basic economic indicators. There is a propensity for new private firms to avoid reporting their economic accomplishments and the infrastructure for statistical collection inherited from the centrally planned economies has proved difficult to reform. Unless these discrepancies are corrected, the governments throughout the region will have difficulty calculating basic economic data such as balance of trade figures, domestic investment rates, and net personal income which is necessary for proper tax collection. The following tables provide estimates of basic economic indicators. Major points are as follows:

(a) Poland's 1993 GDP growth rate of 5% is less of a regional anomaly than Slovakia's –6.5%. (Table 2)

(b) The Czech Republic is the only state within the region to maintain a low unemployment rate, 3.5% for end–1993. (Table 3)

(c) Retail price inflation throughout East-Central Europe has leveled off, except in Bulgaria and Romania, to less than 1.5% per month. (Table 4)

(d) Since 1990 the average industrial wage has fallen dramatically in Bulgaria, the Czech Republic, Romania, and Slovakia. In Hungary, Poland, and Slovenia the current average industrial wage is greater than it was in 1990.

(e) Bulgaria is the only state in the region to maintain a positive hard currency balance of trade over the last 2 years (Table 5).

(f) Hungary leads the way in attracting foreign investment with a total of $3.64 billion through the first four months of 1993, followed by the Czech Republic and Poland.

(g) Since 1990, the states of East-Central Europe have attempted to direct their trade towards the West. (Tables 8–14)

*Jonathan Kimball is a research assistant at the Woodrow Wilson International Center for Scholars, Smithsonian Institution.

Basic Indicators

TABLE 1.

Country	Population (millions)	Area (1000 sq km)	Population Density (persons/sq km)	GDP/Capita in PPP[a] (1992 US $)[b]
Bulgaria	9	110.9	80.8	5,064
Czech Republic	10.3	78.9	130.7	7,420[c]
Hungary	10.3	93	110.8	6,245
Poland	38.4	312.7	122.7	4,770
Romania	23	237.5	97	3,000
Slovakia	5.3	49	108.2	7,420[c]

Source: Center for Cooperation with Economies in Transition, "Short-term Economic Indicators: Transition Economies," Paris, OECD (1/1994).

[a] Purchasing Power Parity

[b] Source: Freedom House, "The Annual Survey of Political Liberties," (New York: Freedom House, 1993).

[c] PPP for Czechoslovakia

TABLE 2. GDP

(Change in Percent)

Country	1990	1991	1992	1993
Bulgaria	-9.1	-11.7	-7.7	-3.5
Czech Republic	-1.2	-14.3	-7.1	0
Hungary	-3.3	-10.1	-5.1	1
Poland	-11.6	-7.6	1.1	5
Romania	-7.3	-13.7	-15.4	1
Slovakia	-2.5	-11.2	-7	-6.5
Slovenia	-4.7	-9.2	-6	0.5

Source: PlanEcon

TABLE 3. Unemployment Rates

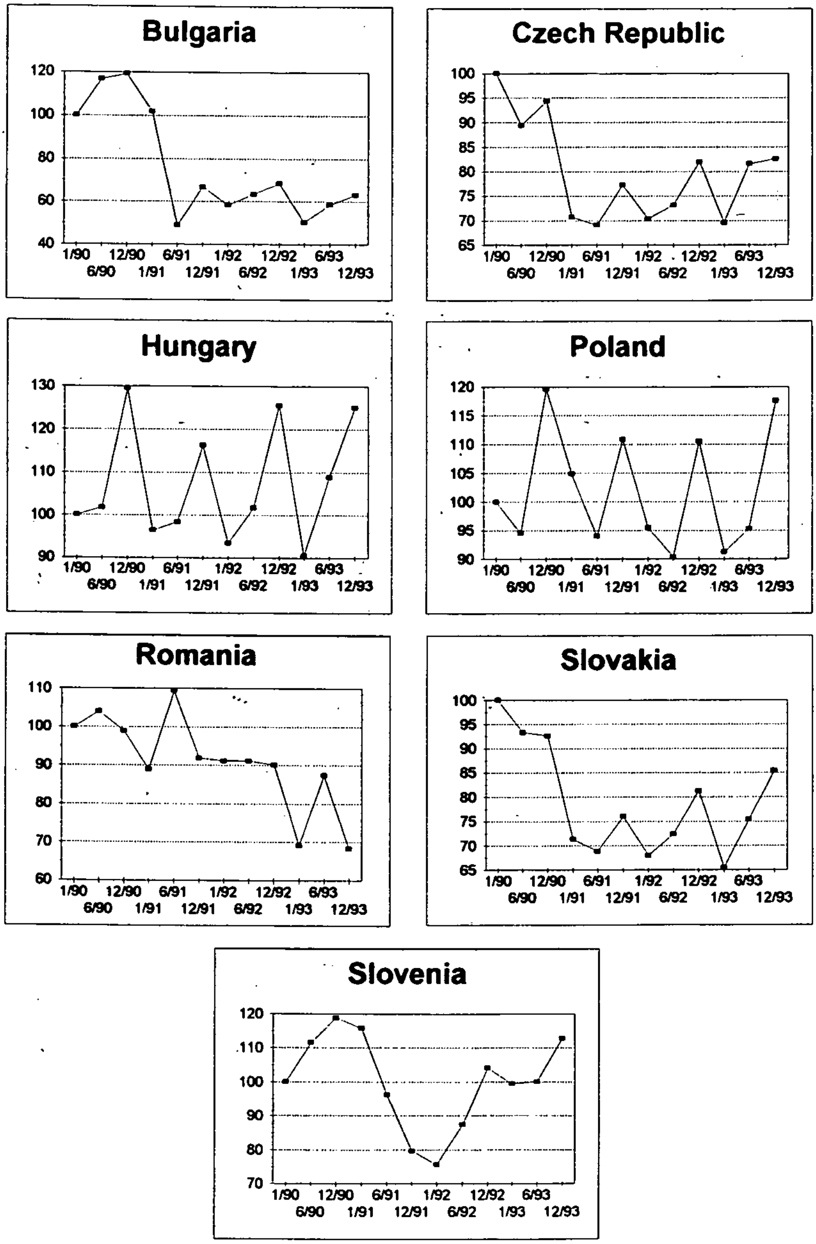
(End Year, in Percent)

Country	1990	1991	1992	1993
Bulgaria	1.5	10.7	15.2	16.3
Czech Republic	0.8	4.1	2.6	3.5
Hungary	1.5	7.5	12.3	12.2
Poland	6.3	11.8	13.6	15.7
Romania	NA	3	9.1	9.6
Slovakia	1.5	11.8	10.4	14.2
Slovenia	4.7[a]	10.1	13.4	15.6

Source: PlanEcon.

[a] Based on a monthly average for the entire year.

Real Industrial Wages
(Base Year =1990)



Source: PlanEcon

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TABLE 4. Retail Price Inflation

(Monthly Averages in Percent)

Country	1990	1991	1992	1993	1994*
Bulgaria	4.7	15.9	5	4.2	3.6
Czech Republic	1.3	3.6	1	1.4	0.8
Hungary	2.2	2.5	1.7	1.6	1.2
Poland	6.2	4	3.1	2.7	1.2
Romania	3	10.3	9.6	12.5	7.8
Slovakia	1.3	3.9	0.7	1.9	1.4
Slovenia	3.3	10.9	5.6	1.7	0.8

Source: PlanEcon.
*Forecasts for 1994.

TABLE 5. Hard Currency Trade Balance

(Millions of U.S. Dollars)

Country	1990	1991	1992	1993	
Bulgaria	–757	–31	484.5	218.8	(1–9/93)
Czech Republic	396	840	–177	–134.6	(1–10/93)
Hungary	348	189	–48	–2,268	(1–9/93)
Poland	2,214	51	512	–2,036	(1–11/93)
Romania	–1,743	–1,266	–1,194	–638	(1–6/93)
Slovakia	–398	–787	–203	–246	(1–8/93)
Slovenia	NA	NA	541.9	–258	(1–10/93)

Source: PlanEcon.

TABLE 6. Hard Currency Account Balance

(Millions of U.S. Dollars)

Country	1990	1991	1992	1993	
Bulgaria	–1,152	–842	–322.9	–463	(1–9/93)
Czech Republic	312	1,644	720	213.9	(1–10/93)
Hungary	127	267	324	–2,483	(1–9/93)
Poland	716	–1,354	–269	–2,267	(1–11/93)
Romania	–1,656	–1,266	–1,506	–807	(1–6/93)
Slovakia	–612	–786	173	392	(1–8/93)
Slovenia	NA	NA	931.8	–5	(1–10/93)

Source: PlanEcon.

TABLE 7. Foreign Direct Investment

(Millions of U.S. Dollars Invested per Year)

Country	Total	1990	1991	1992	1993	
Bulgaria	123.4	4	55.9	41.5	22	(1–6/93)
Czech Republic	2,013	120	511	983	399	(1–9/93)
Hungary	5,522	354	1,459	1,471	2,238	
Poland	605	10	117	284	194	(1–9/93)
Romania	137	NA	37	73	27	(1–6/93)
Slovakia	207	53	82	72	NA	
Slovenia	226.2	–20	41.3	112.9	92	(1–11/93)

Source: PlanEcon.

Foreign Trade

TABLE 8. Bulgaria

(Millions of U.S. Dollars)

	1991	1992	1–6/1993
Exports			
Total Exports	3,432.5	3,499.7	2,957.7
Exports to the EU	437.4	1,082.2	383.5
Exports to the U.S.	115.2	58.2	51.7
Exports to Eastern Europe and the Former USSR	1,981.6	1,459.9	458
Exports to Other	797.4	899.4	393.8
Imports			
Total Imports	2,700.4	3,459.1	1,690.2
Imports from the EU	557.8	1,129.8	489.6
Imports from the U.S.	77.5	102.1	33.4
Imports from Eastern Europe and the Former USSR	1,309.1	1,289.1	782.2
Imports from Other	756	938.1	385.1

Source: PlanEcon.

TABLE 9. Czech Republic

(Millions of U.S. Dollars)

	1990	1991	1992	1-10/1993
Exports				
Total Exports	9,053.3	7,930.3	8,768.3	10,213.7
Exports to the EU	NA	NA	4,630.6	4,456.5
Exports to Slovakia	NA	3,781	3,704	2,148.5 [a]
Exports to Eastern Europe and the Former USSR	NA	2,759.3	1,852.3	1,294.6
Exports to the U.S. [a]	89.1	124.1	413.1	NA
Exports to Other	NA	NA	1,290.7	2,050.5
Imports				
Total Imports	9,898.1	7,087.9	10,276.7	10,030.3
Imports from the EU	NA	NA	4,862	4,097.3
Imports from Slovakia	NA	3,374	3,128	1,834.2 [a]
Imports from Eastern Europe and the Former USSR	NA	2,334.3	2,478.4	1,750.7
Imports from the U.S. [a]	87	144.2	242	NA
Imports from Other	NA	NA	2,279.3	1,727.6

Source: PlanEcon.
[a] U.S. Department of Commerce.

TABLE 10. Hungary

(Millions of U.S. Dollars)

	1990	1991	1992	1-9/1993
Exports				
Total Exports	9,583.3	10,186.9	10,663.7	6,028.4
Exports to the EU	3,595	4,659.4	5,306.1	2,779.7
Exports to the U.S.	338.7	323	343.1	235.2
Exports to Eastern Europe and the Former USSR	3,504.9	2,345	2,451	1,517.4
Exports to Other	2,344.8	2,850.5	2,563.5	1,496.1
Imports				
Total Imports	8,651.1	11,382.2	11,105.4	8,525.5
Imports from the EU	3,201.1	4,676.1	4,745.4	3,575.8
Imports from the U.S.	228.7	297.3	324	418.6
Imports from Eastern Europe and the Former USSR	2,604.2	2,685.5	2,758.9	2,085
Imports from Other	2,617.2	3,723.2	3,277.2	2,446.3

Source: PlanEcon.

TABLE 11. Poland

(Millions of U.S. Dollars)

	1990	1991	1992	1-9/1993
Exports				
Total Exports	14,507.1	15,726.2	13,186.7	10,583.5
Exports to the EU	6,394.6	8,288.8	7,632.3	6,675.6
Exports to the U.S. [a]	409	357	375	400
Exports to Eastern Europe and the Former USSR	3,125.2	2,651.5	2,026.3	1,377.2
Exports to Other	4,279.8	4,785.9	3,528.1	2,530.6
Imports				
Total Imports	10,031.8	16,823.6	15,912.9	13,893.2
Imports from the EU	4,155.5	7,728.9	8,446.2	7,806.8
Imports from the U.S.	406	458	641	650
Imports from Eastern Europe and the Former USSR	2,233.2	3,229.8	2,588.5	1,665.5
Imports from Other	3,643.1	5,865	4,878.2	4,421.1

Source: PlanEcon.
[a] U.S. Department of Commerce.

TABLE 12. Romania

(Millions of U.S. Dollars)

	1990	1991	1992	1-8/1993
Exports				
Total Exports	3,504	3,536	4,286	2,583
Exports to the EU	1,668	1,436	1,399	684
Exports to the U.S.	85	31	83	34
Exports to Eastern Europe and the Former USSR	228	748	1,066	285
Exports to Other	1,523	1,321	1,738	752
Imports				
Total Imports	5,224	5,292	5,886	3,468
Imports from the EU	1,216	1,380	2,212	1,006
Imports from the U.S.	104	46	222	175
Imports from Eastern Europe and the Former USSR	336	1,140	1,229	514
Imports from Other	4,148	3,074	2,582	937

Source: PlanEcon. The data for 1990 and 1991 are based on quarterly averages.

TABLE 13. Slovakia

(Millions of U.S. Dollars)

	1991	1992	1-9/1993
Exports			
Total Exports	6,808	6,607	2,627
Exports to the EU	NA	1,138	NA
Exports to the Czech Republic	3,374	3,128	1,117
Exports to Eastern Europe and the Former USSR[a]	1,489	1,085	NA
Exports to the U.S.	27	44	NA
Exports to Other	NA	944	NA
Imports			
Total Imports	7,389	7,258	2,644
Imports from the EU	NA	1,215	NA
Imports from the Czech Republic	3,781	3,704	975
Imports from Eastern Europe and the Former USSR[a]	1,934	1,459	NA
Imports from the U.S.	40	54	NA
Imports from Other	NA	882	NA

Source: PlanEcon.
[a]Excludes the Czech Republic.

TABLE 14. Slovenia

(Millions of U.S. Dollars)

	1992	1-11/1992	1-11/1993
Exports			
Total Exports	6,681	6,207	5,529
Exports to the EU	3,669	3,408	3,188
Exports to the U.S.	195	179	196
Exports to Eastern Europe and the Former USSR	1,994	1,437	1,860
Exports to Other	823	760	708
Imports			
Total Imports	6,141	5,617	5,833
Imports from the EU	3,078	2,778	3,228
Imports from the U.S.	167	154	152
Imports from Eastern Europe and the Former USSR	1,797	1,681	1,178
Imports from Other	1,099	1,004	1,275

Source: PlanEcon.

CONCLUSION

The economic transformation currently underway throughout East-Central Europe has, in its potential, the ability to bridge the abyss that historically separated the majority of ex-CMEA countries from fully participating in the international market. With this opportunity comes the possibility for future sustained economic growth and the eradication of high unemployment and inflation rates. But this is made difficult by the region-wide shortage of capital needed not only to privatize the economies, but also to purchase domestically produced consumer goods. For this reason, foreign direct investment has been used extensively in Hungary, Poland, and the Czech Republic as a means of obtaining hard currency and freeing the government from the weight of controlling certain industries. Foreign investment will not however, solve all of the problems in these economies.

Efficient domestic policies designed to transform the economy as painlessly as possible, coupled with an accepting and case-sensitive international climate are needed to ease this transformation. The acceptance of East-Central European goods into the West European market has proven an important agent in fostering a positive economic turnaround such as that which occurred in Poland, Hungary, Slovenia, and the Czech Republic. The proximity of these economies to the European Union, and their willingness to work with international lending institutions has also been an important part of the success which these four countries have enjoyed.

The remaining three countries examined in the above tables, Bulgaria, Romania, and Slovakia, all suffer from unstable political systems and economies devastated by the loss of the CMEA markets (Bulgaria has also suffered because of the economic embargo on the former-Yugoslavia). While the rate of decline has been reduced, and in Romania abated, substantial growth will continue to elude these economies unless drastic measures are taken to create an entrepreneurial-friendly environment and inefficient industries are allowed to go bankrupt. The foreign direct investment which has been an important agent in the successful infiltration of the Western markets by Poland, the Czech Republic, and Hungary will continue to ignore the economies of Bulgaria, Romania, and Slovakia until the risk of investment is reduced. This entails the active implementation of market-based reforms designed to create a domestic environment ripe for production and sales. But, as was evident in the 1993 and 1994 elections in Poland and Hungary respectively, the social repercussions of broad-based economic reforms may be the downfall of a democratically elected, reform-minded government.

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