Economic Transformation in Eastern Europe: Its Genesis, Adjustment Process, and Impact on Developing Countries

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ABSTRACT

Increasing strains on self-sufficiency within the block of East European command economies resulted in the dramatic decision to change over to an economic system largely based on market forces. The painfulness of the ensuing transformation process will be mitigated somewhat by supportive economic policies of the West, including the European Community which is itself aiming at complete economic integration by the end of 1992. The consequences for the developing countries of these far-reaching policy changes in East and West are likely to be negative, at least in the immediate future. This is true for the volume of development assistance given by East and West, as well as for the export prospects of developing countries. Favourable effects might at best be expected in the longer run.

INTRODUCTION

The evolution of a new economic order in East European countries atop the edifice of the old one, which was built with great effort over a period of four decades or more is, indeed, baffling. This is all the more so, when one notes the relatively high level of development achieved and reasonably equitable socio-economic gains ensured to different strata of these economies as compared to any of the newly independent countries outside this block during the comparable period of history. This development raises a large number of important questions. Four broad, interrelated questions interest us:

1. Were the forces leading to the transformation of these economies inherent in the development path pursued by these economies?

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2. Is the transformation of these economies from the 'socialist' order to a market economy going to be relatively smooth and painless?
3. How do these happenings influence the vision of an integrated Europe which the twelve member states are set to realize by 1992?
4. How will the EC reorder their economic relations with East European countries to enable them to get firmly entrenched in the world market economy and how is such reordering of economic relations going to affect the economic interests of developing countries which the EC attempted to protect in the process of integration?

Answering these questions is obviously not easy, nor can answers be based on hard facts (which simply do not exist). What is more, the challenge offered now is as unprecedented as it was at the time that a socialist order in these economies was initiated. The treatment of these questions is, therefore, inevitably speculative in nature and can rightly be called an exercise in possibilities. The excitement inherent in the attempt to predict the future, has prompted us to take up these questions for discussion here. We have organized our discussion in four sections. Sections I and II deal with the first two questions successively and Section III discusses the remaining two questions in an integrated manner; Section IV sums up the discussion.

I

The upheavals that have swept all of Eastern Europe in rapid succession over a short span of time are undoubtedly beyond anyone's immediate grasp. The question arises: with hindsight can one explain in objective terms why these countries have come to reject, one after the other, the 'socialist' structure built up so tenuously over the last four decades? To put it the other way round, can one discern internal contradictions in the economic development strategy which precipitated the collapse of the old order?

To start with, it should be recognized that the major policy thrusts of these economies constituted in building a society based on so-called scientific humanism. In concrete terms, it probably meant that resources were allocated — by command but also by social *fiat* — to make available at low or no cost to every section of the society food, clothing, shelter, health services, education facilities,

social security and the like. These policies created 'for the first time a largely urban society and perhaps for the first time a large middle class (not just a nomenclature), conditions which favour the rise of a democratic, decentralized, not to say bourgeois, society' (Stolper, 1990: 6). What is more, this class of population can also be expected to have an ever increasing appetite for better and greater varieties of consumer goods and consumer durables, particularly in the context of a more liberal environment in which there is increasingly more exposure through various media of communication to the life-styles of their counterparts in developed market economies. In a situation like this, the credibility of an East European economic system crucially depends on its capability to keep pace with the aspirations of the people.

We broadly review the development process in these economies over the past forty years to indicate the hindrances to continual economic progress, that necessitated a sharp shift in their economic system.[1]

The socialist countries initiated their development process under the basic premise that because their economic order was fundamentally different from those based on free market forces, they would have to aim at achieving economic growth not through organic integration into the world-wide division of labour but through strengthening economic complementarity among themselves. This premise remained unchanged even during the period of international detente and rapid growth of East-West trade. Thus, with the objectives of accelerating economic development and ensuring a rational division of labour, the socialist countries established as early as 1949 an economic grouping known as the Council for Mutual Economic Assistance (CMEA/COMECON) — its present members being Albania, Bulgaria, Czechoslovakia, the German Democratic Republic (GDR), Hungary, Poland, Romania, the Soviet Union and three developing countries, namely Cuba, Mongolia and Vietnam. It may be noted, however, that the regional economic integration was in practice confined to the European members of CMEA excluding Albania.

The economic development strategy based on this premise aimed at collective self-sufficiency.[2] This meant an organization of the production structure of the block economies so as to satisfy the largest possible part of internal demand, and subordinating external economic relations to achieve this end. This strategy of economic development also implied that priority had to be given to the

development of heavy industries, even if it involved import of plant and machinery from the developed market economies. The assumption of permanent hostility between the two worlds — capitalist and socialist — which lay at the root of the above development strategy also implied a very high priority on developing defence technology to the detriment of technological progress for non-defence industries. The priority assigned to the defence sector in technological research (and in the allocation of resources in general) created in the course of time an increasing need to import technology and capital goods from the West to develop and modernize the import-substituting consumer goods and consumer durables industries for domestic consumption and/or intra-CMEA trade. Foreign exchange required to meet such import needs was expected to be obtained by exporting the excess over domestic consumption requirements. In reality, however, it was often necessary to suppress domestic consumption to increase exports. Imported technology and machinery was primarily meant to cater to domestic demand or to export to CMEA countries but not to build up export potentials. This scheme neglected the modernization of agriculture and light manufacturing industries which essentially supplied exports to the West.[3] This had major consequences in the subsequent period when imports from the West had to expand substantially.

In this scheme of rational division of labour among the socialist group of countries, the USSR supplied the required raw materials and fuel while the smaller CMEA countries exported agricultural goods and light manufactures to the Soviet Union. In the earlier phase, up to the mid-1970s, the Soviet Union was quite generous in setting prices for exports to its CMEA partners. Given the diverse resource base of the Soviet Union, together with enormous opportunities for investment and employment, this strategy for economic development can be said to have worked well during the 1950s, even if autarky was costly: the economies recorded steady growth resulting in a rise in living standards. They could maintain this record of achievement even in the 1960s and in the early 1970s when they imported much more from developed market economies to maintain dynamism of growth following the scientific and technological revolution in the West. This was possible because in this period, exports of smaller CMEA countries grew and the terms of trade for their exports were favourable.

Several important developments that took place at the global level in the mid-1970s had far-reaching consequences for the smaller

CMEA countries. Firstly, the oil price explosion led to a substantial increase in the cost of imports. It also resulted in global recession which in turn affected the prospects of their exports. They also faced growing competition from the newly industrializing developing countries in their export markets. Worse, following the price revision of raw materials and fuel by the Soviet Union in 1975,[4] they had to divert a larger volume of exports to the latter to pay for purchases from the USSR, leaving less to export to the West. Still worse, with the progress in the West-European economic integration, discrimination against the CMEA countries was tightened by strengthening protectionism. Further, in years of unfavourable weather conditions they were compelled to import large amounts of grain. The CMEA economies also shared heavy defence burdens. Despite attempts to divert some of their intra-CMEA countries' exports to the West, they could not avoid increasingly adverse balances of payments and the consequent indebtedness.[5] Facing this situation, the CMEA countries turned inwards again. They had to cut back imports, thus affecting adversely modernization of industries since in this matter CMEA countries were not capable of assisting each other. Again, the supply of fuel and raw materials at low cost could not be maintained by the USSR because lack of modernization of these sectors hindered productivity growth. The net effect has been that growth slowed down in these countries after the mid-1970s, resulting in a stagnating (if not a lowering) of the standard of living.

The substantial easing in the global Cold War in the past five years, the very premise of autarky or at least of collective self-reliance as a guiding principle of the economic development strategy of the CMEA countries had been rendered weak. In such a situation readjustment of their economies according to a rational division of labour in the world economy was warranted. But the large middle class, with their preference for decentralized and democratic decision making processes, could realize their preferences even in terms of the economic system, which is to be based on market economy instead of 'command economy'.

II

Having made decisive steps towards replacing their socialist system with a market economy, the East European countries[6] will have

to dismantle the existing superstructure and install in its place new institutions and rules consistent with the market mechanism. Such transition will certainly raise a large number of adjustment problems. In this section we attempt to identify some of these and their probable consequences, particularly those relating to external economic relations.

It is widely recognized that there are two fundamental problems of economic transformation: the replacement of public ownership of economic units by private ownership and the associated switch from centralized to largely decentralized production decisions, and the introduction of a price system based on market forces in place of one based on political decisions and administered prices. It should be noted that public ownership of economic units together with administratively controlled pricing often has introduced serious distortions hindering efficiency as understood in common economic parlance. However, at the same time they have ensured full employment and also easy accessibility of wage goods to the people. In contrast, market-based prices which reflect preference patterns and the relative scarcity in an economic system guarantee neither full employment nor easy accessibility to wage goods and essential services. Such consequences will be discussed later at a little greater length.

The macro adjustment process in East European countries can be viewed by examining the effects of free market reforms on product, labour and money markets, and by relating them to the standard National Accounting and Balance of Payments equations.

Let us begin with the rather special case of the GDR. For this country the macro consequences of the economic transition may not become clearly visible because of the unification of the two Germanies. Firstly, East Germany will account for no more than just over one-fifth of the total population of the unified Germany. Secondly, the prosperous and dynamic West German economy should be able to modernize East Germany's industry, agriculture and infrastructure, which were not able to keep pace with the technological progress in the West in the period of inward-oriented economic development. Finally, East Germany as part of the unified Germany automatically becomes a member of the European Community (EC) and is entitled to enjoy all the advantages that go with economic integration. For these main reasons, GDR stands apart from the rest of the East European countries in regard to adjustment problems in the economic transition. It does not amount

National Accounting Equation

$$CA = (GDP + NFP + NTR) - (C + I)$$
$$= (C + S) - (C + I)$$
$$= [(C_g + S_g) - (C_g + I_g)] + [(C_p + S_p) - (C_p + I_p)] \quad (1)$$

Balance of Payments Equation

$$(T - G) + (S_p - I_p) = (X + NTR + NFP) - (M) \quad (2)$$
$$= \Delta NFA$$

$$\Delta DS = \Delta K + L - I_f - CA \quad (3)$$

where

CA	= Current Account Balance
$GNP = GDP + NFP + NTR$	= Gross National Income
$GDP = C + I + X - M$	= Gross Domestic Product
NFP	= Net Factor Payment
NTR	= Net Transfers
C	= Consumption
I	= Gross Domestic Investment
S	= Gross Domestic Savings
$T = C_g + S_g$	= Government Income
$G = C_g + I_g$	= Government Expenditure
X	= Exports
M	= Imports
ΔNFA	= Change in Net Foreign Assets
ΔDS	= Change in External Debt
ΔK	= Change in Reserves
L	= Repayment Liabilities
I_f	= Direct Foreign Investment

Subscript g refers to government; subscript p to private sector.

to maintaining, however, that there will be no adjustment problems. On the contrary, despite the above advantages, there will be several adjustment problems which essentially owe their origin to the economic systems being different and the levels of development being wide apart in the two Germanies. The directions in which major problems may arise in the adjustment process of the GDR even as part of the unified Germany may be indicated below.

The first problem to confront policy makers at the initial stage of

unification talks was the determination of the ratio at which the Ostmark should be exchanged against the Westmark. Depending on the ratio determined, important economic consequences ranging from inflationary pressures to the closing down of many GDR production units might follow. It should, however, be recognized that the determination of the exchange rate between the two currencies is not entirely a matter of economic wisdom. The issue is charged with political and emotional overtones which led eventually to the decision of a 1:1 exchange rate. This is a quite 'favourable' rate for large segments of the GDR population, but at the same time it further undermines the already weak competitive position of the East German economy.

A related issue is the development of an efficient capital market which is an important requirement for the efficient functioning of a market economy. One of the preconditions for the development of a strong market is the transfer of numerous public-owned enterprises to private hands. But this transformation is fraught with a number of problems. For example, it can be argued that East Germans, accustomed to serving as disciplined workers rather than as entrepreneurs, are unlikely bidders for these enterprises; therefore, East German enterprises can be expected to be taken over by the more experienced industrialists or industrial houses operating already in a market economy. Such developments might well result in a sharp dualism, with one part of Germany providing capital and entrepreneurship while the other part supplies only labour.

In addition, a large part of the at present state-owned enterprises suffers from lack of modernization and frequently also from overstaffing because the previous regime emphasized maintaining full employment. If these enterprises are taken over as suggested above, modernization and/or reorganization of inefficient units will receive high priority; a number of production units will simply be closed down. This may give rise to large-scale unemployment, at least until the dynamic adjustment works through.

This leads us to the question of wage determination. Although reasonably well-trained, East German workers have at present a lower productivity and a lower (real) wage than in West Germany.[7] Will they in future receive the same level of wage as their western counterparts? If they do, production costs will become too high; if they don't, social disenchantment will follow. In many highly skilled professions, East German salaries are much lower than those in the West; if a large brain-drain exodus of, for example, engineers,

doctors and nurses to the West is to be avoided, substantial wage increases for such professions will be needed.

Another important requirement of switching from an administrative to a market-type system is freeing prices and abolishing various subsidies. Such a step would certainly alter the relative prices of various goods depending on their demand and supply conditions. In a socialist regime basic goods are highly subsidized, and thus people are accustomed to paying lower prices for these goods. The withdrawal of subsidies would certainly raise prices to the levels obtained elsewhere in the country. More expensive basic goods, particularly if there is also large unemployment, would lead to much hardship and even injustices unless the social security system is adequately extended. But the need for social security in a situation of mass unemployment ultimately cuts into budgetary funds much needed for improving the badly neglected infrastructure and for upgrading and modernizing technology in different sectors.

The extension of the coverage of social security leads us to the question of reforms of the tax system. As is well known, in the Soviet-type economies the government budget is financed by consumption taxes and profits (if any) from public enterprises. In practice, however, many public enterprises instead of yielding a profit are heavily subsidized. In such a system, income tax is virtually non-existent. Therefore, extending the market-type economy to East Germany will involve tax reforms as well as the abolishing of subsidies on various basic goods, thus resulting in price rises.

The above discussion suggests the following. Switching East Germany to a market-type economy within the framework of a unified Germany will probably entail less economic but more social stress, at least until the dynamic adjustment process leads to a complete and organic integration of the East and West German economies. However, the solidarity of the German population, together with the fact that the socialist system was imposed from outside and hence does not have deep social and economic roots in East Germany, may make the stresses and strains of economic transformation bearable, and perhaps more so with a dream for a more prosperous future. With these broad observations on the transition process of the GDR, we may move on to the possible adjustment problems that are looming large on the rest of the East European economies, which don't enjoy the advantages that the GDR does.

As noted earlier, it is the inability of the East European economies

in the broad framework of collective self-sufficiency within the socialist block to keep pace with the scientific and technological progress of western non-defence industries, and the consequent failure to meet the aspirations of the newly emerging middle class by delivering a variety of new and better quality goods which led to the ultimate collapse of the economic system. The question which follows is: can the switching over to a market-type economy make the goal of a more vibrant and dynamic economic growth attainable without causing severe strain on the society as a whole?

Keeping in view the sources of breakdown of the system as suggested earlier, we will highlight the strains that are likely to be inflicted by modernization in the process of dismantling the earlier superstructure and establishing a market-type economy. Where the effects of replacing certain institutions with new ones are common both to East Germany and the other East European countries, they will not be discussed again unless they have a different effect on the latter economies.

We begin with the transfer of ownership of enterprises from the state to the private sector, which will have an effect in these economies different from the GDR. The national income equation (1) stated earlier shows that the current account surplus/deficit is equal to the budget surplus/deficit plus the private savings-investment gap. Therefore, when public enterprises are 'sold to the public' in some way, there will be a monetary surplus in the public sector although in the first instance the current account balance remains unaffected.[8] With rigidity on the supply side, if the government spends these large savings there will be a severe inflationary effect on the economy which might eventually lead to exchange rate adaptation. This type of monetary surplus could probably be absorbed more easily in a more buoyant, unified Germany.

Once enterprises are transferred to private hands, prices are freed, subsidies abolished and inefficient enterprises modernized, the following macro effects can be expected. Prices of the subsidized goods, which are usually basic goods, go up when prices are freed. With the abolition of subsidy, the government budget improves. With the improvement in government budget, the current account improves. On the other hand, when modernization programmes are undertaken, private investment may well exceed private savings. The effect will be felt on the current account. As can be noticed, two opposite effects — a positive effect through improvement in

government budget and a negative effect through a higher saving-investment gap — are felt on the current account. Since the change in the private saving-investment gap effect is likely to dominate, the current account imbalance will increase. It should be noted that the budget improvement may be negligible or even negative if the social security system is strengthened to neutralize the undesirable effects of the modernization process (such as lay-offs). In this case, the budget gap and the saving-investment gap will move in the same direction, deteriorating further the current account deficit.

The balance of payments equation (2) shows that the current account deficit (i.e. a negative value of $\Delta NFA = CA$) is equal to the excess of outflow over inflow, i.e. the difference between payment in foreign exchange for imports, interest on foreign loans and the like, on the one hand, and foreign exchange receipts in terms of exports and invisibles, on the other. The excess of outflow over inflow can be met through capital inflow, i.e. new external borrowing, or through running down foreign currency reserves (if available). To this external borrowing has to be added the amount of debt to be repaid (L = amortization) to get the full measure of external borrowing during a year. However, to the extent direct foreign investment (I_f) is available, the amount of external borrowing required is reduced (equation 3). This favourable effect of direct foreign investment on the basic balance has to be considered in the light of its influence on factor payments abroad at a future date.

Given the above interrelations, what can be said about the East European countries in question? Modernization programmes which were initiated in these countries — particularly in Hungary and Poland in the 1970s — were related to the industries which produced goods to meet the domestic demand. Since autarky defined economic policies, little attempt was made to enhance productivity in export industries which largely consisted of light manufactures and goods produced in an agricultural sector which was also characterized by low productivity. As a result, the pace of modernization lagged behind the technological progress in the West. What is worse, the modest modernization which was carried out in the face of several exogenous shocks in the 1970s resulted in heavy indebtedness. It may be worth noting that the burden of debt was heavier particularly because these countries were compelled to borrow commercially without the concessional credit which is accessible to developing countries.

Now that the shift has been in favour of the market economy, the premise underlying the strategy for economic development also has to be altered from autarky or collective self-reliance to the organic integration of the economies in the international division of labour. In the changed framework, many of the import-substituting industries developed for ensuring self-sufficiency regardless of cost will be eliminated by open world competition. Efforts have to be made continually to raise productivity of those sectors with competitive advantage. For this purpose heavy investment has to be made on a continuous basis, both in modern equipment and in human capital, to keep them competitive at the global level. For such investment to yield the desired result, major investment must also be made in the improvement of infrastructure, particularly non-tradables. Moreover, combating the high levels of pollution and environmental degradation in most of these countries will further increase the investment needs. Consumer goods and consumer durables which are no longer available from the fast-disappearing inefficient domestic industries developed in the era of autarky will also have to be imported to meet domestic demand.

It is inevitable that import demand will far exceed the feasible export level, at least until the export industries gain in competitive strength. The net outcome will be a large increase in external debt, mitigated only to the extent direct foreign investment is available. It also follows that the inevitable consequences of the free exit of costly import-substituting industries following the process of freeing prices and withdrawing subsidies will be mass unemployment and high inflation — as has indeed been witnessed recently in Hungary and Poland. Thus it may be concluded that the major adjustment problems in these smaller CMEA countries will generate an enormous demand for capital inflows as well as inflation and unemployment at least in the short to medium term.

Faced with such transitional challenges small East European countries will have no alternative but to sink or swim. Swim they would, perhaps effectively in the context of two new realities. First, there has been a perceptible change in international political and economic realities in the recent past which may ease the transition or rather contribute to the reconstruction and development of these economies. The extent and direction of such possibilities will be covered a little more closely in the subsequent section. In any event, the availability of such assistance is a necessary but not sufficient condition. Successful use of such assistance will depend on the

creation of the necessary preconditions which involve certain important internal reforms.

This leads to our other point. Limits to continued growth of these economies were set by exogenous forces which they did not control, and by the failure of the strategy of economic development based on collective self-sufficiency. In contrast, given the switch to the new strategy, the performance of their internal economies will ultimately determine how well they surpass the external barriers to the integration of their economies in the international division of labour. After all, the capability to develop export potentials, which crucially determines the extent of stress accompanying the opening up of an economy, is closely linked, directly or indirectly, with 'almost all elements of economic policy (mainly development policy), socio-economic mechanisms and institutional systems' (Köves, 1985: 153) which all fall in the realm of internal control.

III

It must be recognized that the East European countries have opted for a new economic order based on free market forces at a time when two important international developments are taking place. The first, already referred to above, is that at the global level the international environment is shifting from the hostility/Cold War between two worlds to a climate of peaceful co-existence and constructive co-operation. The other is that twelve nation states in Europe have made a decisive step towards achieving complete economic integration by the end of 1992 — a step which has given birth to a new vision of Europe: a common European House. Both developments are ideally suited to support and buttress the East European countries' desire to transform their economies. This is already reflected in talk of a Marshall Plan for the reconstruction and development of Eastern Europe. Already it has been decided to establish in London a European Bank for Reconstruction and Development of Eastern Europe with a fund of $12 billion (10 billion ECU). The EC has made it clear that it will improve the conditions for the exports of Eastern Europe to enter the EC market. Existing trade agreements are being revised in this spirit. In May 1990 this policy resulted in a new co-operation agreement between Czechoslovakia and the EC which concerns all industrial and agricultural products except those for which there are sectoral

agreements, for example certain textile and agricultural products. The Community has agreed to accord most favoured nation (MFN) treatment to Czechoslovakia on a reciprocal basis and to abolish all specific quantitative restrictions on imports by the end of 1990. One day later, similar agreements were signed by the EC with Bulgaria and the GDR and shortly after that an agreement was initialled with Romania. Hungary, Czechoslovakia and Bulgaria have indicated their desire to start negotiations with the EC on association agreements. The Commissioner for External Relations has responded that the EC is willing to negotiate agreements which, once concluded, will lead to a free trade area among all countries of West, Central and Eastern Europe (probably excluding the Soviet Union, for the time being). No doubt, more steps will follow to promote the economic transformation of Eastern Europe and to prevent socio-economic hardships that might otherwise endanger the entire transformation process.

In this context the pertinent question that arises is: will all-out support of the West for the reconstruction and development of the East European economies hinder the developing countries in their development efforts? If so, in what areas are they likely to be hurt? We propose to examine these two questions considering the effects on developing countries generally of the reordering of economic relations by the EC vis-a-vis Eastern Europe. Since we are considering the effects of transitional adjustment in Eastern Europe, our discussion will essentially be confined to short-term static effects.

We may begin with the obvious one, which is development aid. It should be recognized that the limit to the amount of development aid given by a donor country is set by the taxpayers' willingness to sacrifice for a cause which does not affect them individually even remotely. For development aid, this limit is not too flexible, although it may be somewhat higher in future years in view of the likely cuts in the various defence budgets, and perhaps also in the context of a widely felt preference for an integrated Europe. But then it should also be noted that the reconstruction of the East European economies would involve large capital transfers for a number of years (say, five to seven years). It is, therefore, quite conceivable that additional development aid (i.e. beyond the present level) would go to East European countries or that even a certain diversion from developing countries to Eastern Europe will take place.

The above type of adverse effects on the developing countries

would also result from the CMEA countries themselves while they are engaged in restructuring their own economies. As is well known, there has been (sometimes considerable) trade, technical and economic co-operation on bilateral and multilateral basis between the European CMEA countries (including the Soviet Union) and three groups of developing countries, namely:

1. socialist developing states, i.e. Cuba, Mongolia and Vietnam;
2. developing states of a socialist orientation such as Ethiopia, Angola, Mozambique, Benin, Guinea-Bissau, the Seychelles, Burma, Grenada (until the American raid upon the island with the subsequent change of government) and South Yemen; and
3. developing countries that are considered important to the East European countries for economic reasons.

Understandably, the first group of states, which are also CMEA members, received two-thirds of the development assistance given by Eastern Europe, preferential prices for their exports and favourable prices for some of their imports from the European CMEA members. The developing countries with a socialist orientation occupied the second position in the hierarchy of preferences.[9] In the changed circumstances, such economic aid will probably be curtailed, thus affecting the beneficiary countries.

More pernicious effects on developing countries can be expected when the existing trade policies towards the East European countries are altered to reflect changed circumstances. The extent of such effects will obviously depend on the type of arrangement the EC works out with the CMEA countries. We can think of three alternative arrangements. They are, in order of increasing degree of integration of East and West European countries:

1. The EC could simply remove the measures which have resulted in trade discrimination against the East European countries;
2. The EC and the CMEA countries could come to an agreement facilitating free trade between them as in the case of the six EFTA countries;
3. The EC could have association agreements with the market-oriented CMEA countries with the ultimate goal of economic integration (as in the case of Turkey).

In any of the above alternative scenarios, the trading interests of developing countries will be adversely affected, though the extent

will vary depending on the degree of economic cooperation between the West and East European economies.

The above point becomes clear when we note that 69 per cent of the exports of the East European countries to the EC in 1983 were affected by the EC's policy of discrimination (Köves, 1985: 226), and that in important commodity groups such as clothing and footwear the developing countries compete directly with the East European countries in the EC market.[10] A brief discussion of the EC's trade policy towards the CMEA countries and developing countries will throw further light on this question.

Although each EC country used to give formally the most-favoured-nation treatment to the East European CMEA countries, the preferential relationships that were established between the EC and particular (non-CMEA) countries covered almost every eligible competitor of the CMEA countries. This, in effect, resulted in discrimination against the latter. Similarly, the common tariff in the European market discriminates between commodities even if it does not between countries. For example, tariffs are lowest on fuel and raw materials. Among the manufactures, highest tariffs are levied in the category of miscellaneous manufactures (clothes, footwear, etc.), and rates decline as they move from material manufacture to machines. They are also high on foodstuffs. East European exports to the EC are concentrated precisely in the categories of miscellaneous (often simple) manufactures and foodstuffs. Thus, the EC's tariff structure discriminates against the exports of East European countries.[11]

Given the preponderance of low-valued manufactures which can easily be substituted, the effective discrimination against the East European countries increased as the EC expanded from six member states to twelve. It also increased following the free trade agreement regarding manufactures concluded with the EFTA in 1977. In fact, every improvement in trade conditions between the EC and outside countries, whether by way of providing association status or any other form of trade preference, intensified discrimination against the CMEA countries.

Even more than tariffs, quantitative restrictions and anti-dumping measures were and are used to discriminate against the CMEA countries. In fact, almost every product exported by the CMEA countries to Western Europe was subject to import restrictions until the early 1960s because economic policy of the West European countries was hostile to the socialist countries. In the

subsequent period trade in a large number of products was completely or partly liberalized by the EC countries. In fact, by 1974 only 77 per cent of the items imported from Bulgaria, Czechoslovakia, Poland, Hungary and Romania and 59 per cent of those from the Soviet Union by the EC countries were completely liberalized (Köves, 1985: 221). It does not follow, however, that the discrimination against the CMEA countries declined to the same extent, because quantitative restrictions could remain fully operative in the case of the commodities which were (actually or potentially) dominant among the exports of the CMEA countries. Therefore, it can be concluded that the effects of the remaining restrictions continued to be much more severe than what is suggested by the number of products that were yet to be liberalized (Bethkenhagen et al., 1976 as cited by Köves, 1985: 221).

Similarly, under the Common Agricultural Policy (CAP), the agricultural exports of the CMEA countries, except for those which are deficient in internal supply, could not reach the EC markets because of the skimming system.[12]

In contrast to such discrimination against the CMEA countries, the developing countries have been provided trade preferences as part of the commercial policy by the EC. Three sets of preferences — Lomé, Mediterranean countries and the Generalized System of Preferences (GSP) — are in operation for different groups of developing countries; they represent the level of privileges in a hierarchical order: Lomé with sixty-eight countries of the African, Caribbean and Pacific (ACP) group is at the top, while the GSP beneficiaries are at the bottom.

Under the Lomé Convention the EC has provided several privileges in the form of tariff preferences, aid, stabilization funds (Stabex fund), and production funds (Sysmin Scheme) to the ACP countries. Accordingly, ACP countries' exports have free access to the EC market except for the products that fall under the CAP. Even in regard to agricultural products, the exports from these countries receive favourable treatment as compared to those from third countries. For products such as sugar, beef, rum and bananas, special arrangements have been made. As a result, about 95 per cent of the ACP countries' exports have free access to EC markets (Faber, 1990: 198).

Next in the order of trade preferences of the EC come a few Mediterranean countries. The EC has concluded three types of agreements with some of these countries. There is a preferential

agreement with the Maghreb, the Mashriq and Yugoslavia, a reciprocal free trade agreement with Israel, and an association agreement with Cyprus, Turkey and Malta. However, the preferences provided under these agreements are similar: they all generally provide for duty-free access of industrial products to the EC market although some of the products are subject to ceilings. As regards agricultural exports, they are entitled to tariff reductions subject to reference prices, time tables and quotas.

The remaining developing countries are entitled to still fewer preferences under the GSP developed by the EC in 1971. The GSP is applicable to manufactured goods and a limited number of agricultural products. For the purpose of the GSP, manufactured goods are classified as either sensitive or non-sensitive. While non-sensitive goods have duty-free access to EC markets, the tariff-free access of sensitive goods is subject to the ceilings fixed by the EC for each beneficiary country. Again, the dominant exporters of very sensitive products are restricted by individual tariff-free quotas which are agreed bilaterally between governments or industries as Voluntary Export Restraints (VERs). For example, the import of competitively priced textiles from developing countries is limited under the Multi-Fibre Arrangement (MFA).[13] Thus, the GSP ensures tariff-free access of sensitive commodities to the EC market within the limits of the VERs concluded. It should be noted, however, that the least developed countries do not face such quantitative restrictions. Because of these restrictions, only a quarter of the dutiable exports of the developing countries to the EC market is covered by the EC-GSP (Hine, 1985: 201).

Now the most pertinent question that arises is: if the EC has covered all developing countries under one or the other set of preferences, thus protecting their trade interests, why should the dismantling of the discriminatory trade practices that are in force against the East European countries so far (or, more positively, some new realignment of economic relations with these countries in the changed circumstances as suggested earlier) have any adverse effect on the developing countries?

This question should be examined considering both the thrust and the actual working of the preferential structures that have been developed by the EC vis-a-vis the developing countries over the years.

To start with, it should be recognized that in the evolution of the preference structure and its differential margins, the economic

interests of member states, historical ties and geographical proximity, in that order, played their respective roles. It is apparent that the scale of preferences varies from member states to EFTA countries to ACP members to Mediterranean countries to the countries benefiting from GSP, in descending order. It follows that the promotion of trade on the basis of comparative advantages is not the principle which has motivated the preference structure that has evolved in the EC. It can, therefore, be argued that the same geo-political considerations will determine the eventual economic relations of the EC with the East European countries. The present enthusiasm of the EC as reflected in its role in the establishment of the European Bank for Reconstruction and Development clearly indicates that whatever the form, the East European countries can look forward to a very positive preference by the EC ranging from zero-tariff access to eventual membership.

It can generally be argued that preferences provided by the EC have been greatly eroded as the number of beneficiary countries increased under various agreements. In fact, the coverage of preferences expanded from the original six members to twelve member states, six EFTA countries, all the Mediterranean countries except Libya, all sub-Saharan African countries except Namibia and South Africa, and the developing countries in the Caribbean and the Pacific areas. All the remaining developing countries except for Taiwan are offered the GSP. Any preferences offered to the East European countries will further widen the coverage.

A free trade agreement or some such arrangement with East European countries will result in much keener competition in the EC market between these countries, on the one hand, and the developing countries benefiting from the GSP, on the other. This is all the more so since their exports are to a large extent similar. It is obvious that with greater competition, the benefits of preference accruing to the latter group of countries will dwindle for the simple reason that East European countries enjoy geographical proximity to the EC market, especially in comparison with the countries in Asia and Latin America that qualify under the GSP.

Furthermore, if the exports of East European countries are of the sensitive type, the developing countries enjoying preferences under the GSP will be more adversely affected. As pointed out earlier, exports in the sensitive category are subject to quantity restrictions under a VER. Tariff-free East European exports of textiles to the

EC market, for instance, would strongly affect some of the developing countries.

If free trade agreements with East European countries cover both manufacturing and non-competing agricultural commodities, as in the case of ACP, the latter group of countries may face much tougher competition in the EC market: once agricultural operations in Eastern Europe are carried out in a free market system, their agricultural production can be expected to be far more efficient than in most ACP countries. If European economic integration would be extended to include these economies, their duty-free trade encompasses even agricultural products which are protected at present by skimmings.

The remarks made above are intended to indicate broad directions of change. The actual effect of the extension of free access to the EC market, if in fact given, will undoubtedly vary from country to country depending on the composition of their exports and their capability to face competition.

As stated already, the above discussion focuses on the short to medium-term consequences for developing countries of the opening-up and restructuring of the East European economies. In the somewhat longer run, more favourable effects might also manifest themselves. A successful restructuring in Eastern Europe is likely to shift its comparative advantage in world trade away from labour-intensive goods directly competing with developing countries' exports (although this might be a mixed blessing for the industrially most advanced developing countries trying themselves to upgrade their manufactured exports). Also, as soon as the foreign exchange situation relaxes, the import of tropical commodities such as beverages and fruits will increase considerably in view of the at present restrained consumption levels of such products. And, finally, a higher pace of economic expansion in Eastern and Western Europe resulting from increased co-operation will stimulate the region's import demand as well. However, the possibility of such positive effects in the longer run offers little comfort to countries that may expect to be faced with negative consequences in the first place.

IV

The broad picture that emerges may be summed up as follows. It is argued that the collective self-sufficiency within the socialist block

on which the CMEA countries based their economic development may have served them well until the early 1970s. Until then they could take advantage of enormous opportunities for investment and employment; smaller CMEA countries had easy access to fuel and raw materials from the Soviet Union; and even the external economic conditions were propitious for them. But the policy of modernizing with western technology the consumer goods and consumer durables industries for meeting domestic demand while at the same time neglecting agriculture and export industries led to heavy indebtedness when they met with a number of exogenous factors such as the oil price explosion, global recession, etc. As a response to heavy indebtedness, they cut back imports of capital goods which led to a technological lag and a setback in growth.

On the other hand, the policies in the socialist countries led to the emergence of a middle class which desired democratic and decentralized decisionmaking processes. With their exposure to the western world, they also desired a continuous rise in the standard of living comparable to their counterparts in the West. But the economies organized within the framework of autarky failed to keep pace with the aspirations of this class — because the civil sector could not keep pace with western technological developments, probably as a result of the priority accorded to defence technology — nor could they build up export potentials allowing them to import such goods. Thus, increasing strains on self-sufficiency within the socialist block eventually led to the choice in favour of an economy based on market forces.

The transition from a socialist economy to a modern market economy is fraught with many problems. Inflation, large unemployment, huge external capital requirements, loss in economic growth and considerable socio-economic sacrifices seem inescapable — at least in the near term.

How effectively and how soon such problems can be overcome will depend on the availability of substantial foreign capital and, more importantly, on their capability to create the preconditions for the efficient utilization of such funds, if available. As part of a unified Germany, the required support for the reconstruction of the GDR will be forthcoming primarily from the dynamic West German economy, although many adjustment problems are inevitable. On the present reckoning, it looks as though the required aid for reconstruction and development of even the other economies will be available from the EC. But the crucially important question

as to whether they will be able to bring about the socio-economic mechanisms for the efficient functioning of a market economy still looms large. However, in contrast to the sources of the present crisis, which were outside their control, the creation of the required institutions and conditions is entirely within their control.

In its efforts to contribute to the reconstruction of these economies, the EC can be expected to steer clear of the tariff and non-tariff measures that formerly discriminated against the exports of the CMEA countries to the EC market. More positively, the EC may even conclude agreements with these countries making way for free trade. In that case the developing countries — even if they enjoy preferences under the GSP — will face wider competition; more so when their exports are similar. However, the magnitude and the intensity of such effects will vary from country to country depending on the composition of their exports to the EC market as well as on the types of preferences offered to these countries.

We should add finally that the entire discussion has been carried out leaving an impression that all the East European countries are homogenous. We know that they are not. They differ in terms of tradition and heritage, resource endowments and constraints — in fact, in terms of all elements which make up the whole set of objective conditions. We are also aware that the magnitude of transitional problems that will develop and the solutions that will be sought will depend on the specific conditions, including socio-economic complexities, characteristic for each individual country. In such a situation our intent was to discern a broad pattern in the workings of these economies and to follow their trails, so to say, in an interrelated world.

NOTES

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1. For an elaborate discussion on historical development, see Köves (1985).
2. Even before the East European countries turned socialist, the USSR adopted the strategy of self-sufficiency although she was carrying on trade with the West.
3. CMEA countries' trade performance suffered from the following deficiencies: 'lack of ability to compete with existing products in highly competitive markets, lack of ability to generate new products and processes for exports and extremely limited capability to commercialize advanced technology for domestic markets and, in particular, for exports' (Drabek,1989: 246).

4. The Hungarian terms of trade deteriorated between 1970 and 1980 by 6 per cent with respect to the developed market economies and by as much as 20 per cent with respect to the socialist countries, presumably more so with respect to the Soviet Union (see Köves, 1985: 141). Moreover, 'Whereas all the small CMEA countries ran up an accumulated trade surplus with the Soviet Union in 1971-75, and the five-year combined trade surplus of the six European CMEA countries exceeded 1 billion transferable roubles, there was a fundamental change in this situation in 1976-80. Largely as a result of the changes in price relations, a Soviet surplus of 5.4 billion was accumulated; except for Romania which was not yet importing Soviet oil at that time, the payments balances of all the European CMEA countries fell into deficit.' (Inotai, 1983: 86).

5. As was observed by Bognar, 'The establishment of external economic links [during the 1960s and the early 1970s], promoting increasing productivity and more rapid technical progress, resulted fundamentally in fast-growing import demand and led to a higher degree of integration into the world economy on the import side (Inotai, 1983: 81).

6. While Czechoslovakia, GDR, Hungary and Poland can be said to have made the move, the situation is not yet as clear in Bulgaria and Romania.

7. The productivity in East Germany is estimated at 30-40 per cent of that in West Germany (Stolper, 1990: 24).

8. It is probable that such monetary surplus existed in the household sector in the previous regime as well. Apart from creating a 'black market' for some commodities, its effect was limited or negligible in an administrative type economy.

9. For further details, see Bloed and Faber (1990) and Bloed (1990).

10. For some empirical evidence on this point, see Nambiar et al. (1990).

11. Discriminatory measures have unequal effects on different CMEA countries. It may be noted in this regard that Romania enjoys some preferences as a developing country does. Again, the case of the GDR in her trade with the FRG is a very special one; see Hine (1985: 249-50).

12. Skimming equalizes the difference between lower external world market prices and higher internal prices on importing the most important agricultural products into the EC market.

13. The EC negotiated VERs with twenty-five developing countries.

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