Working Paper
Integration of Eastern Europe into the World Trading System 1/

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Abstract

The sheer size of mandated trade among members of the Council for Mutual Economic Assistance (CMEA), and its composition and quality, means that its reorientation toward other markets entails a whole complex of structural adjustment policies. To be successful, policy reform must be comprehensive, with clarity of purpose and predictability of action. Nevertheless, while gradualism should not be used as an excuse for delay, reforms must be harmonized with the timetable of requisite institutional change. In any case, reform must be accompanied by trade liberalization to help break down domestic monopolies and to gain the efficiencies from division of labor.

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1/ Eastern Europe refers to Bulgaria, the Czech and Slovak Federal Republic (CSFR), Hungary, Poland, Romania and, until mid-1990, the German Democratic Republic.

Summary

The paper focuses on the fundamental question of what integration of these economies into the world trading structure means in policy terms. The sheer size of mandated trade among members of the Council for Mutual Economic Assistance (CMEA) and the fact that its composition and quality did not allow wholesale reorientation toward other markets indicate that integration involves a whole complex of structural adjustment policies. Policy reform, to be successful, must be comprehensive. Clarity of purpose and predictability of action are sine qua non for the success of reform strategies; their absence would carry the seeds of policy reversal. While implementation of socially and politically difficult measures must not be delayed in the name of gradualism, it should not be so fast as to outpace the necessary institutional changes.

Reform must be accompanied by trade liberalization to help break down domestic monopolies and to gain the efficiencies from division of labor. In addition, durable expansion of trade with the rest of the world has become pressing, both to avoid accumulation of unsustainable levels of external debt and because intra-CMEA trade had fallen sharply, a trend which could accelerate with the dissolution of the traditional CMEA and the announced intention to move to trading at world prices and in convertible currencies. Proposals to create "half-way houses" to accommodate continued regional trade links, through payments unions, for example, have been overtaken by events and would not have been helpful in any event.

Trade reform involves the introduction of a nondiscriminatory tariff structure based on market-determined relative prices reflecting comparative advantage domestically and externally. This will provide the basis for full integration into GATT and mandate abolishing special safeguard clauses maintained by other GATT members in the face of nonmarket price state-trading systems.

The external trade restraints that exist in many markets, especially in agriculture, soft goods, and high-tech matters, where Eastern Europe has or could attain a comparative advantage, constitute an impediment to rational resource allocation and to achieving the increase in export earnings that would be crucial to finance the large import-intensive investment requirements. This is an important element in the effort of these countries to negotiate special agreements with the EC. In conclusion, it would be ironic if Eastern Europe, having recognized that "bloc mentality" leads to misallocation of resources and that globalization is the way of the future, were to be pushed back to thinking defensively and regionally by the fact that their role model market economies are not allowing market principles to work.
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One year after the historic decisions of almost all Eastern European countries to change their economic orientation toward guidance through market signals, the stark realities of that decision have become clear. They are the more apparent as the efforts at economic reform break decisively with the past. Previous such attempts generally sought to find ways of cohabitation for what remained essentially different economic systems, including a way to operate within a multilateral trading framework. Today, these countries no longer seek a way to live in a world with a different economic orientation, but rather to adapt themselves to be part of that world and to regenerate linkages that have been stunted during decades of politically determined, inward-looking economic development. In short, they look to political and economic transformation. Thus, the fundamental question no longer is "why cannot they be more like us?" but, now that they have decided to be like us "what is the most efficient, therefore least painful, way of doing so?" This leads to the basic question: how deeply rooted are their present regional links, as manifested in the CMEA, 1/ not only in terms of trading relations, but also in terms of employment and production structures and what rigidities do they bespeak?

This question is virtually impossible to answer with any degree of precision as, in an environment that put a high premium on administrative success, so-called factual information does not necessarily reveal hard facts. Data, thus, are a mixture of fact and fiction. But it is a fact that the CMEA group has traded on the basis of raw material inputs, particularly energy, at below world market prices. This has led to capital stocks and production structures that, in market terms, are wasteful; as capital structures have been maintained well into technological senility, it will not be easy to shift resources from supplying command-economy markets to satisfying market-based demands. Although the breadth of this problem cannot be gauged, indicative numbers show that, for example, Hungary's and the CSFR's output of machinery and engineering products are deeply regionally intertwined, with about 30 percent for use in other CMEA countries. Such numbers show that integrating these economies into the high-tech, highly competitive markets of the West will prove a daunting task.

1/ Council for Mutual Economic Assistance, the regional economic organization charged with monitoring trade and payments and promoting specialization of production. Its members are: Eastern Europe as listed above, the USSR, Cuba, Mongolia, Vietnam and Albania (inactive); Yugoslavia is an associate member; Afghanistan, Angola, Ethiopia, Finland, Iraq, Mexico, Mozambique, Nicaragua and Yemen have cooperative links; in addition there are numerous observers.
Why is this so? First, the sheer size of intra-CMEA trade (between 40 to 80 percent of members' overall trade), which moved largely under long-term contracts, provided a certainty of production runs and, therefore, also of employment, that produced managerial attitudes not well adapted to facing the uncertainties inherent in a competitive situation. Second, production based on these arrangements was not able to earn its way: the trading unit of account, the transferable ruble, was considered by most participants to be highly overvalued against other CMEA currencies; this meant, in many cases, that fulfilling CMEA contracts required varying levels of subsidization from national budgets. Moreover, even though in most countries the price structure floated on low-priced raw material inputs, a large part of output, because of design and quality problems, could not have obtained even the CMEA price in western markets.

Integration of these economies into the world trading structure involves the whole complex of structural adjustment policies, including the need to surface, and then to eliminate, the subterranean inflation and unemployment that have cumulated during more than a generation of command economy management. Thus, the problem is how to do away with multiple pricing, direct and cross-subsidization, absorption of resources by non-economic activity, suppression of inflation and unemployment; in short, stripping away the administrative economic cocoon to reveal the butterfly of comparative advantage. All this, obviously, cannot be achieved overnight, but the risk that opportunity might flutter by is high.

In these circumstances, the main questions are:

(1) What is the best institutional environment in which comparative advantage can be revealed, uneconomic activities weeded out, and policy credibility and public support—the two being essentially mirror images of each other—maintained? and

(2) At what speed should adjustment take place?

In considering these questions, the centrally planned economies in process of transformation often have been viewed as a cohesive group, i.e. a bloc, susceptible to a generalized policy prescription. Clearly, this "bloc mentality" belongs to the past. Each of these countries has different characteristics, e.g. with respect to resource endowment and to the institutional and political capacity to support and sustain change; these differences impact the structure and possible speed of economic transformation. Even so, some general points apply:

First, any policy reform package must be comprehensive. This is so because the main elements of a market economy are interrelated: for example, successful price reform is not possible if channels for transmittal of price signals do not exist or are clogged. This means that wage reform, acceptance of financial responsibility by enterprises and reform of the financial sector must go hand in hand with the move to market prices.
Experience shows that piecemeal reform, such as tried by Hungary and Poland prior to 1989, does not succeed. In fact, a piecemeal approach carries the seeds of policy reversal within itself; such reversal, in turn, progressively undermines effective policy implementation because each such episode erodes policy credibility and, thereby, increases reaction lags by reform-minded entities, while shortening those of vested interests. Thus, clarity of purpose and predictability of policy action are a sine qua non for the success of reform strategies.

Second, it is obvious that comprehensive reforms, particularly when distortions are deeply rooted, cannot be implemented overnight. In fact, Adam Smith already saw this: "The case in which it may sometimes be a matter of deliberation, how far, or in what manner, it is proper to restore the free importation of foreign goods, after it has been for some time interrupted, is, when particular manufactures, by means of high duties or prohibitions upon all foreign goods which can come into competition with them, have been so far extended as to employ a great multitude of hands. Humanity may in this case require that the freedom of trade should be restored only by slow gradations, and with a good deal of reserve and circumspection." While one must agree with Smith that too fast a speed could undermine support for the right policies, it also is true that too slow a driver may cause as many accidents as a speedster. The need to find the realistically safe and sustainable speed for implementation of reforms, however, must not be confused with the tendency to delay politically and socially difficult actions under the name of "gradualism". Thus, the natural uncertainties of the market must not to be compounded by uncertainties about policy action; and the pace of implementation must be sufficiently fast to allow an early harvest, but not so fast as to outpace the institutional change without which operational measures cannot have their intended effect.

The need for the reform effort to move forward on a broad front is rooted in the need to generate an investment structure adapted to today's and to future economic facts. But some imperatives of reform are more equal than others. First, if the reform effort is to succeed, economic accountability at all levels, enterprise management, government and individual, is a must, particularly as sanctity of contracts generally has not been a feature of the command economy. De facto accountability has to be accompanied by the development of a judicial system that governs private sector transactions and provides predictability. These are the preconditions for sound longer-term investment and the generation of investable savings. They are the more urgent as the scarcity of available resources, financial, budgetary and real, leaves virtually no room for mistakes.

Third, reform must be accompanied by trade liberalization to help break down domestic monopolies and to gain the efficiencies from the division of labor across borders. In increasing links to the rest of the world, Eastern Europe has looked to close involvement with the three international economic...
organizations—the IMF, the World Bank and the GATT. Most Eastern European countries are GATT members of long standing. 1/ But their economic systems did not allow them fully to meet the GATT’s requirements on reciprocity, non-discrimination and transparency and, in the absence of market pricing, caused adoption of special safeguards by other members to guard against possible dumping by state-trading organizations. With adoption of price-guidance, these countries should become fully-functioning members.

This raises a set of problems, but also opportunities, some of which are closely intertwined with the reform process, e.g. how fast can subsidies be dismantled and what are the consequences of shifting from essentially barter to trade in convertible currencies? In this respect, a central question is whether half-way houses provide positive help toward making these economies internally and externally competitive. As long as a significant part of the existing capital stock remains in use some sizeable intra-CMEA trade, if only in spare parts, will continue to exist. In addition, the existing infrastructure—transport links, ability to off-load and process raw materials, especially oil—also mandates continuation of CMEA trade. Finally, the shift to market pricing will improve the USSR’s terms of trade and associated potential financial strains could impact the intended move away from countertrade. This potential has given rise to proposals for a Central European Payments Union (CEPU) among a varying number of CMEA countries (excluding the USSR). This is seen as easing the road to external convertibility and maintaining what are thought to be natural economic links among neighboring countries. However, as the main regional payments problems would arise vis-à-vis the USSR and the need is to build channels to markets and suppliers outside rather than within a truncated CMEA, the rationale for a CEPU seems not soundly based; in effect, it might lead to permanent occupation of the halfway house. This in no way means to minimize the financing problems that are likely to arise once normal production levels are re-established and import demand recovers from its currently depressed levels. However, more direct avenues would seem to provide better solutions.

Developments in 1990 bear this out. The fast integration of East Germany into a unified Federal German Republic, which has cut deeply into CMEA flows, efforts by reforming countries to reorient their trade toward western markets and the sharp falls in domestic output and demand, all have cause intra-CMEA trade to contract. Consequently, it is estimated to have fallen by some 20 percent in volume in 1990. This trend could accelerate with the dissolution of the traditional CMEA and the move, in principle, to trading at world market prices and in convertible currencies as of January 1991. In anticipation, a large number of bilateral barter deals are being concluded, both government to government and enterprise to enterprise. However, future trends in intra-CMEA trade are likely to bear little

1/ Bulgaria is in process of accession and the USSR became an observer in early 1990.
relation to current deals as input needs over the medium-term and legal and managerial decision-making ability of enterprises are uncertain and given the past history of elastic interpretation of contracts.

On the whole, anticipation of changes in the regional trade and payments system has aimed to reduce bilateral imbalances, particularly, but not exclusively, vis-à-vis the USSR. This included both exchange rate and administrative measures. The basis for new contracts largely involves cash settlements and supplier credit arrangements, rather than, as earlier anticipated, special clearing arrangements that emphasize regional ties. But, with interenterprise relations still embryonic, barter deals may continue to dominate for some time. Even so, the effects of changes in the relative prices of intra-regional trade will put further pressure on the pace of adjustment: obsolescence of whole branches of production will surface more clearly and, consequently, also the need to restructure capital stocks; but this, in turn, will complicate the digestibility of adjustment efforts as social pressures, particularly those associated with rising unemployment and inflation, will be exacerbated.

At the same time that old trading relationships disintegrate faster than anticipated, integration into the world trading system remains time-consuming. The "early harvest" that followed removal of disincentives to market-oriented trade--particularly in agriculture and consumer goods--probably is beginning to run its course; further export growth, consequently, must rely on restructuring of production, including the ability to respond flexibly to emerging and changing demand stimuli. This is the more urgent as the events in the Persian Gulf have shrunk traditional markets and increased world energy prices. Although the latter should help rationalize energy use, it may overload the adjustment circuits.

As recent developments show, the region cannot really look to intra-regional trade to cushion the process of integration of its production structures into the world economy. This makes a durable acceleration of expansion of trade relations with the rest of the world yet more pressing. Therefore, it is not surprising that these countries, with Poland, Hungary and the CSFR in the vanguard, are seeking special access to the markets closest to them. Thus, they are in the process of negotiating association agreements with the EC and look to free trade negotiations with EFTA. More broadly, adoption of market pricing and abrogation of state-trading, as noted above, provides the basis for full integration into the GATT. This involves introduction of non-discriminatory and largely bound tariffs at economically justifiable levels and, for other GATT members, abolition of their special safeguard clauses. A rational tariff structure for Eastern Europe obviously requires that relative prices reflect comparative advantage domestically and externally. This goal is undercut by the external trade restraints that exist in many markets, as these are an impediment to rational resource allocation, especially important during the transition period.
Equally important, the ability to increase exports in the face of large import-intensive investment requirements is crucial if external viability is not to be compromised by excessive levels of external debt. Eastern Europe has a known comparative advantage in agriculture and in certain soft goods and, once technological bars are lowered, will compete in high-tech areas on the basis of a highly educated labor force. These are exactly the trading areas that are rife with structural barriers in the most promising markets in Europe and elsewhere and where head-on competition is likely to engage producers in both developing and industrial countries. This is an additional element in the effort of Eastern European countries to negotiate special agreements with the EC, which in turn has raised fears on the part of current suppliers—EC-associated, such as Maghreb and non-associated. It surely would be ironic if the Eastern European countries, having recognized that "bloc mentality" leads to misallocation of resources and that globalization is the way of the future, were to be pushed back into thinking defensively and regionally—even if in an expanded way—by the fact that their role model "market economies" are not allowing market principles to work in those areas where their own structural adjustment needs are the greatest.

References
