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EASTERN EUROPE AND THE DEVELOPING COUNTRIES

This Briefing Paper examines the reforms that are taking place in eastern/central Europe, and the major problems encountered, as a means of assessing the implications for developing countries (ldcs). It is concerned primarily with Bulgaria, Czechoslovakia, Hungary, Poland, Romania and Yugoslavia; Germany as a western/central European state is a case apart. In many respects the outcome of even the economic reforms underway, and hence their precise external effects, is still unclear. But it is possible to identify the types of potential effect and to indicate probabilities among the many policy choices still to be made.

Summary: the most likely effects on ldcs

The potential repercussions from eastern Europe's change of political and economic system are manifold and may be favourable or unfavourable, depending on the time period considered, the ldcs concerned and the success of the transition. Middle-income ldcs could be *adversely* affected if eastern Europe competes with them for commercial bank loans, foreign direct investment, semi-concessional aid and markets for exports of manufactures. The outcome is potentially *positive* for the poorer ldcs that are still heavily dependent on exports of primary commodities and may not experience serious competition for aid (official development assistance) since most of the assistance to eastern Europe ought to be on quasi-commercial or only slightly concessional terms. And as the income elasticity of demand for exotic fruits and beverages in eastern Europe is believed to be relatively high, growth in that region (when it occurs) could provoke a significant increase in demand for ldc exports, with additional short-term stimulation as liberalisation permits a large existing pent-up demand frustrated by unavailability to be satisfied.

Both sets of effects assume that the political change in eastern Europe will result in economic growth. During 1990, however, it became increasingly clear that stabilisation and structural adjustment measures would dominate. If the outcome is only economic stagnation, its principal effect on ldcs may be migrant worker competition in the western European labour market and greater aid diversion (as the West seeks to mitigate social or political unrest in its neighbours).

Reform in eastern Europe

In the short term, the main factor determining the impact on ldcs is the speed and extent of eastern Europe's economic transformation. Although the countries face a range of common problems (Box 1) their reactions to them have differed. Poland's 'big bang' approach was the first and most dramatic, but Hungary and Czechoslovakia have now also embarked on wide-ranging reform. Bulgaria and Romania were slower to begin seriously to tackle the dismantling of the old economic system, but have been taking the initial steps in this direction since the end of 1990. Yugoslavia is *sui generis*: the federal government has a coherent economic reform package that is being undermined by centrifugal forces.

> **Box 1: Common Problems**
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> Central to the problems of eastern Europe is the sheer pervasiveness of the old system. Attempts to alter one facet may produce unintended consequences elsewhere. In Czechoslovakia, for example, which adopted a particularly comprehensive form of central planning and was very closely integrated into CMEA trade, the unravelling of the economy is an especially complex task. More than 90% of the labour force was employed in the state and co-operative sectors, while the private sector (even including the informal economy) was responsible for only 2% of non-agricultural output.
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> The transition from a centrally-planned to a free market system of allocating resources requires a whole new infrastructure of legal rules and institutions. Property rights and means for enforcing contracts need to be established. Without them, not only will investment be restricted but companies will be unwilling to supply inputs to other firms (since they have no assurance of being paid) and the whole system of economic relations will seize up.
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> Social conventions must also be defined from scratch. Because unemployment did not exist under the command economy there are no agreed rules on the terms under which dismissals can be made and on rights of appeal. Failure to progress in these areas may undermine key reforms. In Hungary, for example, workers lobby against the liquidation of insolvent enterprises which, *inter alia*, is slowing down privatisation. A balance must also be struck between the need to maintain public support (through generous social provisions) and the need to encourage labour mobility.
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> There are also shared problems of a decrepit physical infrastructure. Poor transport and telecommunications systems act as a constraint on the growth of production. Much of the fixed capital in industry is obsolete.

These features (and descriptions of reform implementation) refer only to the formal sector. In parts of eastern Europe there is a thriving informal sector which may respond to the new orientation more quickly than the formal. This adds to the difficulty of predicting the outcome of the reforms and, hence, the impact on third parties.

Reform is resulting in a sharp drop in the standard of living of some people (Box 2) although the decline may be less severe in practice than appears from a comparison with distorted data on the *status quo ante*. There are gainers as well as losers even in the short term. The political pressures thus created have been exacerbated because external shocks have tended to reduce national income. For the time being there appears to be political support for austerity, at least in Czechoslovakia, Hungary and Poland. But popular resistance could re-emerge if people are asked to accept austerity for too long (a common ldc phenomenon too). Governments brought to power on a platform of democratisation are unlikely to be able to ignore indefinitely the wishes of the electorate. Nor, ultimately, is this desirable. Whether this would

Box 2: Costs of Adjustment

Most countries of the region are experiencing chronic difficulties with stabilisation. In Hungary, for example, although the government has been successful in bringing the current account in convertible currencies into equilibrium, this achievement has to be set against the failure of three major policies critical to the success of stabilisation: the government is having difficulty abiding by the stabilisation targets it has set itself; there has been no progress in curbing inflation, which increased to an annualised rate of 25% in the first half of 1990; and the government has so far failed to deter state companies from allowing large intercompany debts to accumulate. Such problems are linked to a lack of international competitiveness which has implications for the possibilities for real wage growth.

Output has slumped in most countries, although official figures have to be interpreted with some care. They may overstate the decline as they do not reflect activity in the informal sector or understate it because they do not take account of running down inventories. In Poland, by June 1990 industrial production was 32% below the level of the previous year. It then picked up, but the improvement faltered in December. The sharpest falls have been in textiles, mining, metals and transport; agricultural output has not fallen. In Bulgaria, by mid-1990 398 out of 572 firms and economic organisations were producing less than in 1989, and it was estimated that half of the decline was due to shortages of imported raw materials and machinery spare parts. Industrial production is down, especially in the chemical, metallurgic and heavy machinery industries, which are on average utilising less than 50% of capacity. Once a substantial agricultural exporter, Romania is now unable to feed itself and is receiving large amounts of emergency food aid. The industrial sector is largely obsolete, highly polluting and uncompetitive even within eastern Europe. Preliminary figures suggest a drop of 10% or more in industrial output in 1989, and of a further estimated 10-15% in 1990.

Unemployment presents a particularly difficult problem. Although generally it has not yet reached levels considered high in the OECD (still only 6% in Poland), the point of comparison is that under the centrally-planned regime, open unemployment did not exist at all. It may be very difficult for eastern European society to accept the substantial unemployment levels that may well occur in the near future, particularly since the shift to a free market economy is predicated on its being an improvement on the past. Such acceptance is more likely to be achieved if there is an adequate institutional environment for unemployment together with a social safety net, but the issue extends beyond welfare provision (Box 1).

derail economic reform is a matter of intense debate in eastern Europe. In Czechoslovakia, for example, a split is occurring in Civic Forum over the economic as well as the political desirability of a rapid introduction of free market principles. The possibility of major changes in policy as a result of popular discontent reinforces the uncertainty for third parties such as potential foreign investors.

Potential competition

The potential competition for financial and trade privileges between eastern Europe and ldcs raises both political and ethical questions. Is the plight of, say, Romania comparable to that of Malawi? The task of locating the position of the eastern European countries in the 'league table of development' is complicated by the low quality of statistical reporting in many areas, by the price distortions which statistics often reflect and by the fact that there may be a difference between eastern Europe and ldcs in the relationship of economic to social development. Subject to these limitations, both economic and social indicators place the eastern European countries, as a group, in an intermediate position between most ldcs and the OECD industrial countries. Estimates of *per capita* incomes in 1988, based on purchasing power parities, give all except Romania average incomes well above those in all but a few ldcs, but well below OECD levels. The position is similar with regard to social indicators (although eastern Europe tends to be closer to western Europe than to ldcs).

Finance

There have been many, varying estimates of the financing required by eastern Europe to restructure and renovate its economy. All must be treated with considerable circumspection until the scale of the exercise is better appreciated and the external shocks suffered by most of the countries in 1990 (Box 3) have been absorbed. Already it is widely recognised that the estimated costs of eastern German integration (where the outcome is clearest) had been set far too low; many observers now feel that the costs of environmental adaptation alone in the region are formidable.

The sources of international finance are likely to be foreign direct investment, commercial bank lending, semi-concessional loans through the World Bank, the EBRD and possibly the IMF, and grant aid. All of these sources of finance have their problems. In particular, the private sector may not be willing to invest as quickly or with such large sums of money as was hoped in the first flush of the revolution. Indeed, figures up to December 1990 from the Bank for International Settlements provide no evidence of a significant inflow: the stock of eastern European loans was barely higher (0.6%) than a year earlier, indicating that any new loans had simply offset the repayment of old ones. If large-scale lending were to occur it could lead to an increase in world interest rates, if not matched by an equivalent increase in the supply of funds, which would affect all other borrowers, developed and developing alike.

In the absence of adequate private finance, will the development agencies begin to divert aid from ldcs? Thus far, almost all OECD donors have been meticulous in insulating financial aid transfers to eastern Europe from their normal aid programmes. In the cases of both the UK and the EC, for example, financial aid to eastern Europe is additional to development aid (and from a separate budgetary line). Only in the USA, Sweden and Italy (which often has difficulty spending all its pledged aid) is there believed to have been an evident diversion of financial aid. But as time passes it will become harder to make a clear distinction between 'additional' and 'diverted' aid.

There is also the potential for a diversion of EC food aid. If diversion does occur in future, its scale could be quite marked. In 1989/90 Poland was the largest recipient of EC cereals Food Aid with 1.4m tonnes (*cf.* 300,000 tonnes to Ethiopia, the second largest recipient). Debt relief offered by official creditors is another case in point (if the relief is financed from the aid budget). Poland was in 1991 offered a 50% write-off of the sort which had proved unobtainable by developing countries, even those in Africa, despite appeals throughout the past decade, although Egypt was offered just such a deal after the Gulf War. Some creditor countries (*e.g.* France) now want this to be used as a precedent for ldcs; others are resisting (*e.g.* USA), with this difference of policy apparent at the 1991 Spring meetings of the IMF/World Bank Development Committee. Middle-income regions such as North Africa, the Middle East and Latin America combined currently receive levels of OECD aid that are not greatly in excess of even the EC's lower estimate of eastern Europe's balance of payment needs. Moreover, there could be a major diversion of technical skills towards eastern Europe. By entering more fully into the world community, it receives part of the world's technical assistance financed by aid and increased attention from organisations such as the UN specialised agencies. Competition for scarce financial and management skills vital to institutional reform will be particularly marked.

International relations

Possibly the greatest impact in the short term on ldcs may arise from changes in political attitudes in the West, with concern for eastern Europe taking precedence over ldcs. It is clearly in the EC's and in western Europe's political interest to have stable rather than unstable neighbours. It is in the West's ideological interest that these neighbours be informed by the same broadly accepted economic and political values. It is in the economic interests of the OECD (and, indeed, the world as a whole) for growth to occur in the East, thus increasing the opportunities for profitable trade. This does not necessarily imply a downgrading of interest in the Third World, but there is a danger of 'crowding out'.

The end of the Cold War and the collapse of the centrally-planned economic model have altered the environment for aid. Some countries that were favoured aid recipients because of their perceived strategic position may find both a drop in the availability of aid and a greater readiness on the part of donors to make it conditional upon human rights or democratic behaviour. Since some such recipients were middle-income states, this reorientation could benefit the poorest states. At the same time, however, the latter may face competition from socialist ldcs which will probably seek aid from the West. And Western donors may be encouraged to extend and reinforce policy conditions attached to aid designed to reduce the role of the state in economic activity.

There is likely to be a decline also in eastern European aid to the Third World. However, this is unlikely to cause widespread hardship. Only a few African and Asian ldcs were substantial recipients of such aid, and its quality has been criticised widely. Under the old Soviet aid policy economic considerations were not uppermost. The removal of military assistance may, however, create power vacuums in some ldcs and regions (as has occurred in the Horn of Africa). The withdrawal of funding for scholarships and training causes an important manpower gap for the handful of developing countries on which Soviet and eastern European aid has been focused, as does the repatriation of migrant labour: an estimated 180,000 Vietnamese were working in the region (including the USSR and GDR) prior to the changes. Only a few donors, notably the Scandinavians, have taken steps to plug some of these emerging gaps from their own aid programmes.

Trade

It is not possible to identify with any precision the manufactured goods in which trade competition between eastern Europe and ldcs will be most severe. The existing composition of eastern European exports is a guide, but a flawed one. Resource allocation decisions and pricing policies are altering fundamentally in most of the eastern European economies. It is unlikely that the region will continue to be able to export competitively many of the goods that currently feature in its trade with the OECD.

Nonetheless, from the fragmentary information currently available it would appear that the sub-sectors in which eastern Europe's continued competitiveness is most in doubt are machinery and equipment and other capital goods; those in which the outlook is more promising include light manufactures, assembly and agricultural products.

If this perception is applied to the analysis of recent trade data, it suggests that the products in which competition in the short term is most likely between eastern Europe and ldcs will be footwear and clothing. Even so, the ldcs do not face too serious a problem of market loss. Even in the clothing items in which they were most competitive the eastern European share of the EC market has been relatively small. Moreover, there could be new export opportunities for ldcs as eastern European states seek (subject to foreign exchange constraints) competitive supplies of goods that they were forced

Box 3: External Shocks

The fragile calculations on which the 1990 reform programmes were based have been hit badly by external shocks. Since mid-1990, for example, Hungary has been plagued by three major shocks which have occurred almost simultaneously: the slump in CMEA trade and the shift to convertible currency accounting, the reunification of Germany (the GDR used to be a major market) and the temporary world oil price rise.

The collapse of the CMEA trade system has hit the exports of all states, especially Czechoslovakia and Bulgaria which had the highest socialist trade intensity. Over 40% of Czechoslovak exports in 1989 went to the Soviet Union, one of the highest concentrations in the world on a single trading partner. CMEA countries accounted for more than 80% of Bulgaria's foreign trade. These traditional links no longer exist but contacts have not yet been established adequately with new trade partners. In Romania during the first quarter of 1990 exports in non-convertible and hard currencies declined by 62% and 58% respectively, partly because of the fall in production and partly because of the break-up of CMEA. As a consequence, it is estimated that the 1990 balance of trade deficit reached US$800m in the hard currency area and 500m roubles within CMEA.

Such concentration on CMEA trade not only make eastern Europe very vulnerable in the immediate term but may also indicate a relatively weak ability to diversify trade relations with the rest of the world in the short to medium term. The structure of exports to the CMEA and western areas is significantly different. In the case of Czechoslovakia, for example, the share of machinery and transport equipment in exports to the CMEA area at 60% is considerably higher than in exports to western markets (21%). Czechoslovakia's international competitiveness in industrial exports, particularly of machinery, has declined over time. Hence, the capacity made idle by the slump in CMEA exports may not be able, without major new investment, to produce goods which are competitive in other markets.

A feature of the CMEA trade collapse that has been especially damaging is the Soviet Union's shift both to pricing its oil exports in convertible currency and ending the so-called friendship prices offered to selected allies. Much of eastern European industry is very energy-intensive because oil imports from the USSR used to be cheap. The problem was exacerbated by the Gulf crisis. The short-lived but substantial hike in world oil prices hit all the states. Some were affected in other ways too. The Bulgarian government had intended to substitute Iraqi for Soviet oil, as Iraq owes Bulgaria approximately US$1.2bn and was one of its leading non-CMEA trade partners, but the Gulf crisis has made this impossible. The direct and indirect losses for the Bulgarian economy have been estimated at US$1.4bn (7% of GDP).

previously to import from their CMEA partners.

For the future, much will depend both on the speed with which eastern European industry can be made competitive and on the degree to which protectionist barriers to export markets are removed. In the past, although the EC imposed an impressive array of quantitative restrictions on imports from eastern Europe, many of these were not effective as the actual flow of competitive exports was too low. But if reform leads to an increase in exports, the barriers could become a serious constraint unless eastern European countries were to be offered preferences over and above ldcs. In particular, there is likely to be added pressure from eastern Europe for modification of the Common Agricultural Policy (CAP). In at least four of the eastern European states — Romania, Poland, Bulgaria and Hungary — the sector most likely to produce an exportable surplus in the short term is agriculture. Many of the potential exports are products that fall under the CAP and, therefore, would probably be excluded from the EC market. Thus far, the EC's trade liberalisation towards eastern Europe has consisted only of the extension of GSP treatment, which excludes almost all sensitive agricultural products, but tough negotiations are now underway for a ten-year transition to mutual free trade. The eastern European states want substantial — and early — liberalisation of their access to the European market for temperate agricultural products and sensitive manufactures. In this connection, the outcome of the Uruguay Round of GATT multilateral trade negotiations (still undecided at the time of writing) is likely to be of much significance to the adjustment efforts of developing and eastern European countries alike.

Labour

If the eastern European economies fail to grow sufficiently to satisfy popular aspirations, there may be a marked increase in migration to western Europe. The main sources of immigrants at present are the countries of the European periphery (which accounted for 75% of legally registered non-EC nationals resident in the Community in 1987). Even though immigration tends to benefit the host economy, at least in the longer term, a resurgence of labour mobility of such a magnitude would probably increase pressure on migrants from ldcs. This could happen both directly through competition for jobs and indirectly if it sustains xenophobic and overtly racist tendencies in Europe. The dangers are the more serious because they arise at a time when, because of 1992 and the free movement of labour within the Community, the member states are being forced to reconsider their immigration policies. The non-EC Mediterranean states would seem to be among those most likely to be adversely affected. However, the six EC signatories of the Schengen agreement have already granted free entry to Polish nationals (though not rights to employment) with relatively little open hostility.

Macroeconomic gains

In the longer term ldcs could benefit along with other regions from the fillip to world growth provided by a more buoyant eastern European economy. Of more immediate interest, however, is that eastern European consumption of tropical products and imported manufactures may rise. Under the twin forces of low incomes and administrative controls, eastern European consumption of many tropical products was extremely low during the centrally-planned era. *Per capita* import levels in 1989 in western Europe were higher than those in eastern Europe by a factor of two in the case of tea, three for cocoa beans, four for coffee, five for bananas and 370 for canned pineapple. As the market outlook for many of these commodities in the OECD is depressed, a rise in *per capita* eastern European imports to western levels could represent a significant improvement for the exporters. The benefits would tend to accrue mainly to Latin America and sub-Saharan Africa, with the latter gaining most relatively as it is still heavily dependent upon the export of traditional primary products. On the other hand, if reform leads to a decline in the energy intensity of eastern European industry sufficient to offset the increase in demand from renewed economic growth it will tend to depress oil prices to the detriment of ldc (and other) petroleum exporters and the benefit of net energy importers.

Conclusion

Developments in eastern Europe are more important politically than economically for ldcs. There has not yet been significant diversion of trade or finance. Despite the initial promise, private investment has not taken off. Public investment bodies such as the European Bank for Reconstruction and Development (see *ODI Briefing Paper*, September 1990) have been created to address problems of finance, though for the first time such regional financial institutions have explicitly political terms of reference too. But the effect on ldcs so far is relatively slight. By contrast, rapid change in eastern Europe has captured the imagination of decision-makers in the West, and revealed new possibilities — and some threats — to the political establishment in many ldcs.

However, the political and economic outlook for eastern Europe — and, by extension, ldcs — still depends critically on events in its much larger neighbour, the USSR. Major reformulations of East-West policy here could have a more direct impact on North-South relations.

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This Briefing Paper draws on a major ODI research project about aid for policy reform in eastern Europe, led by Christopher Stevens, the full results of which will be published later in the year.

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