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WHAT EASTERN EUROPE NEEDS

NOW *Involvement by the West is in its own best interests.
But what is the best way to help?*



THE EUPHORIA RESULTING from the fall of Communism in Eastern Europe¹ has evolved into the somber realization that a long, difficult period lies ahead. Conditions left by the previous regimes will make it hard for the various countries to make the transformation to a market economy. Without substantial help from the West, the gains made thus far may be lost. Yet the level of help that is needed may be higher than Western governments are willing to support. The best long-term hope for the region lies in the creation of a business climate and infrastructure that can attract foreign private-sector investment.

At the moment, the business climate is too risky and the business infrastructure too underdeveloped to attract sufficient foreign participation. Given these constraints, substantial technical assistance and advice can provide a low-cost method of preparing the countries for the needed foreign investment. In the meantime, greater access to Western markets and continued financial assistance would provide some relief to the region.

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The communist inheritance

The new governments of Eastern Europe inherited a number of major problems from the previous communist regimes. Four of these problems come immediately to mind.

First, most of the countries have a large foreign debt. Poland's \$49-billion debt was reduced to \$34 billion by the Paris Club in 1991, but its recent decision to raise public spending could jeopardize the reduction. Either way, Poland's debt remains high. Hungary's \$21-billion debt is the highest in the region per capita, and Bulgaria has defaulted on its debt of \$12 billion. Romania and Albania pursued policies of no foreign debt, but destroyed their economies by refusing the foreign financing that might have been used for modernization.

Second, each country still has large, state-controlled monopolies that are highly inefficient. In each case, the state has controlled all aspects of production—usually organized under a few large, inflexible government ministries. Incredible inefficiencies developed out of the central planning system and in the absence of market competition. Nearly all the state enterprises carry excess workers as part of the government's full-employment policy.

Third, the countries all lack the modern equipment and technology needed to operate competitively. The old regimes failed to modernize the physical infrastructure, choosing instead to direct additional resources toward industrial production. Today, lacking a modern industrial base, the Eastern European countries find themselves unable to produce competitive products that could be exported to the West and generate badly needed hard currency.

Finally, Eastern Europe's emphasis on industrial production has come at the expense of the environment. Vast stretches of river are dead—so polluted that the water is unsuitable even for industrial use. Massive air pollution has resulted from coal-burning power plants and metallurgy

industries that have no emission controls. Under the previous regimes, environmental laws were routinely ignored, and the low fines for polluters provided no incentive for them to change their practices or clean up the mess. In East Germany,

Hungary, Poland, and Czechoslovakia, these serious environmental problems were a major motivation for social and political change

Under the burden of this inheritance, the Eastern European countries will have a hard time making the transition to free-market economies. Modernizing infrastructures and cleaning up the environ-

"The previous regime, with its arrogant and intolerant ideology, reduced man to a production force and nature to a production tool."

— Vaclav Havel,
Former President of
Czechoslovakia

ment will be very costly, while the enormous debt and limited domestic capital in these countries will make financing these activities very difficult. In addition, breaking up and privatizing the large monopolies is already proving to be tricky. One reason is that many of these industrial dinosaurs hold limited appeal for investors; another is the fact that longstanding accounting methods failed to place accurate values on assets and exports. Moreover, few of the people who are trying to carry out economic transition have any clue about how to operate in a market economy.

The increasing social unrest brought about by economic hardships may further complicate the transition. In the past, the government took care of people's basic needs. Now, they worry about being on their own. With the economies now in depression, unemployment has risen from less than 1 percent in 1989 to 16 percent or more in several countries. Inflation—throughout the region, where prices used to be stable—rose past 100 percent in 1991. The absence of a social safety net has created fears of deprivation and social unrest. The secret police are no longer feared, and cuts in police

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strength, along with hard economic times, have resulted in rising crime and gang violence.

If the experience of the former East Germany is any indication of things to come, life in Eastern Europe will get much worse before it gets better. East Germany had the strongest economy of the communist countries. Yet even with the deep pockets of its western brother and free access to Western Europe's markets, its unemployment rate has topped 16 percent and may rise to 35 percent. Over half of eastern Germany's state-owned companies are not economically viable and will not survive the privatization process.

Why should we help Eastern Europe?

The West's attention to Eastern Europe has been somewhat diverted in the last year by the breakup of the former Soviet Union and the chaos in the Balkans. While problems in these areas are a global concern, a number of reasons could be advanced for continuing to focus on the emerging Eastern European countries and helping them to create strong and stable market-oriented economies.

First, strong and stable Eastern European economies could provide a large market for American goods. The 100 million people² in the region want and need just about everything, and many prefer U.S. products to those of other countries. They have a huge need for things the United States can provide, including environmental protection technology, modern telecommunications equipment, energy production equipment and technology, and energy-efficient industrial products. Eastern Europe's appetite for U.S. goods is already growing: U.S. exports to the region have nearly doubled since 1987. In 1991, exports exceeded \$1.2 billion, creating a \$210-million trade surplus.

Second, strong Eastern European economies could help diminish the need for the arms industries that played

a key role in the Warsaw Pact economies. The nations of Eastern Europe want to convert their arms industries to civilian purposes, but they cannot afford to do so when their other industries are closing because their products are not competitive. Poland has about 80 plants that produce military equipment and parts, primarily for export; Slovakia, with unemployment three times that of the Czech republic, was the leading manufacturer of tanks, armored cars, and artillery guns for the Warsaw Pact countries. The decreased need for these items by the successor republics of the former Soviet Union—their largest customer—has put a squeeze on their arms industries. The upshot is that they continue to look for customers in the developing world, including Libya, Iran, Yugoslavia, and Pakistan. Czechoslovakia, for instance, has offered Iran a radar system reportedly capable of detecting Stealth aircraft.

Third, strong economies in Eastern Europe could help slow the expected mass migration into Western Europe. A European Community survey taken earlier this year indicated that 30 percent of those polled in Eastern Europe have seriously considered emigrating to Western Europe for work. Based on this poll, an estimated 13 million people could end up migrating west; other estimates have ranged as high as 40 million. In Germany, the first Western European country most immigrants reach, large-scale migration has already led to housing shortages and higher rents.³ It has also caused extremism to raise its ugly head again: Over the past year, right-wing and neo-Nazi movements in Germany have grown with the number of immigrants.

For years, people in Eastern Europe have looked to the West as a beacon of hope, and today they are counting on the United States to play a key role in helping them create a new way of life. Just as strong Eastern European countries might help build the new world order, weakness and instability in that region could diminish U.S. trade potential, keep the arms flowing to radical regimes, lead to massive westward migration, and ultimately promote the scapegoating and nationalism so

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widely feared on the continent. Therefore, involvement by the West is in its own best interests. But what is the best way to help?

How the West can help

Support for Eastern Europe requires a balanced approach. There is a need to:

- provide better market access as an outlet for the region's few products that are competitive in the West;
- provide financial assistance to lessen the transition pains until foreign investment picks up;
- provide technical assistance to increase the region's capacity to absorb foreign capital and investment; and
- increase the level of foreign investment, which will have to provide the lion's share of the capital, technology, and know-how necessary to revive the Eastern European economies.

Let's look at each more closely.

Better market access

Former Czechoslovakian President Vaclav Havel recently said that what Eastern Europe needs most is trade, not aid. The remark points to one of the keys to Eastern Europe's future economic growth: access to Western markets. According to Jacques Attali, President of the European Bank for Reconstruction and Development (EBRD), which was established specifically to help with the transformation of Eastern Europe, much of the region's recovery depends on an open door on trade.

Market access is vital because Eastern Europe's traditional trade patterns have all but disintegrated, wreaking economic havoc in the various countries. The Council for Mutual Economic Assistance (CMEA),¹ the primary trade body in the former communist world, was essentially dissolved in 1991. At that time, Eastern European regional trade switched to world market prices and hard-currency exchanges. However, that trade has been

cut significantly by hard-currency shortages, the breakup of the former Soviet Union (Eastern Europe's principal trade partner), and the redirection of trade to the West by the eastern Germans. In 1991, exports between Europe's members of CMEA declined by over 50 percent. The U.N. embargo on Iraq also depressed exports, since Iraq had established weapons-for-oil barter deals with several Eastern European countries. The U.N. embargo on Yugoslavia is having a similar effect.

The drop in export demand is a major reason for the region's economic depression. The International Monetary Fund (IMF) estimated that the decline in traditional exports accounted for half to three-fourths of the total output decline for all Eastern European countries except Hungary. Given the impact of reduced trade and weakened economic activity throughout the region, most of these countries need to stimulate economic growth by expanding their exports in alternative markets. The most promising of these markets is, of course, the West.

But the job of increasing exports will not be easy. Since most Eastern European products are not competitive by Western standards, thus far only a portion of Eastern Europe's trade decline has been offset by exports to Western Europe. One of Eastern Europe's problems has been the shortage of hard currency, which limits Eastern Europeans' ability to purchase the imports they need to produce higher-quality goods. Another factor has been lack of experience: It will simply take time for them to develop the products and marketing skills necessary to compete in Western markets.

In the meantime, Eastern Europe is having problems exporting to the West its few competitive items, such as steel, textiles, and agricultural produce. Although the G-24 nations² identified Western market access as a priority area from the beginning, they agreed that access should be determined on a bilateral basis. As a result, Western countries have blocked more generous trade terms on some key commodities. For example, free trade between Hungary and the European Community (EC) is to start in 2001, but will exclude agricultural products. The EC has lifted all quotas

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on about 60 percent of Hungarian exports, but has excluded textiles. That Western countries should preach free trade while closing their markets to Eastern Europe's few competitive products is widely seen in Eastern Europe as the height of Western hypocrisy, and market access remains a hot issue in East-West relations.

The United States is not a major importer of the East's goods,⁶ but could still take additional steps to improve the market-access situation. If, for example, the United States were to drop its tariffs and other barriers to trade, Western Europe might be encouraged to do the same. This might eventually lessen the Eastern European inclination to fill the trade void by exporting arms.

Financial assistance

The Eastern European countries do not have the financial resources to address their own problems, and the Western private sector is reluctant to invest as much as the Eastern Europeans would like. Therefore, Western governments and international agencies, such as the World Bank and the IMF, will have to provide the bulk of the financial assistance for a while. Financial assistance will help soften the economic hardships, address problems of debt and soft currencies, and ultimately help preserve the progress made so far. Without it, many people in the region may have second thoughts about the new economic systems and begin longing for the "good old days" of Communism; people can at least survive on rotting tomatoes, but they will starve looking at nice, juicy ones that cost too much to buy.

The financial needs of the Eastern Europeans are overwhelming. The cost to modernize will run into the trillions of dollars since their infrastructures have been badly neglected and since tougher standards will need to be met if the countries want to join the European Community. For example, it will cost \$200 billion over the next 20 to 30 years just to modernize the power generation, transmission, and use systems in five Eastern European countries. The former Soviet Union will need five times that amount for the same purpose. A German research institute estimated that it will

cost \$200 billion to clean up industrial pollution in Eastern Europe; this does not, by the way, include the cost of cleaning up the substantial pollution left behind by the Soviet armed forces. The Congressional Budget Office estimates that \$15.5 trillion will be required by the year 2020 for Eastern Europe, including eastern Germany, to reach rough comparability with western Germany.⁷ (See Table 1.)

Obviously, the amount of assistance needed far exceeds the amount that other nations may be willing or able to provide. Germany, Japan, and the United States—the three great economic powers—all have serious financial problems. The German government, the most logical source of aid, is already looking at over \$1 trillion in unification costs. Capital

Table 1

ESTIMATED GROSS CAPITAL¹ NEEDED BY EASTERN EUROPE² TO REACH ROUGH COMPARABILITY WITH WESTERN GERMANY

(in billions of dollars³)

	By the year	
	2020	2040
Eastern Germany	2,384	4,006
Bulgaria	1,135	1,926
Czechoslovakia	2,307	3,996
Hungary	1,270	2,120
Poland	5,476	10,162
Romania	3,013	5,289
TOTAL	15,585	27,499

¹ The gross capital needed includes (1) the change in the net stock of capital required to bring a rough estimate of 1990 capital stocks up to 80 percent of that of western Germany's capital-to-labor ratio in the arbitrary year, and (2) the cumulative flows of capital needed to cover depreciation of the physical capital stock.

² Projections were not made for Albania, but because it is the nation with the smallest economy in the region, its gross capital requirements are estimated to be small compared with those of the other countries listed.

³ Measured in 1989 prices using 1989 purchasing-power-parity exchange rates.

Source: *How the Economic Transformation in Europe Will Affect the United States*. Congressional Budget Office, December 1990.

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requirements among the states of the former Soviet Union will put further demands on the pot of funds available for assistance. How much money has been made available so far? According to the G-24, the Western industrialized countries committed over \$39 billion to Eastern Europe in the 1990-1991 period. (See Table 2.) In addition, the World Bank, the IMF, and the EBRD have committed another \$14.4 billion, bringing the total to nearly \$54 billion. Some of this assistance has taken the form of export credits tied to the import of a specific country's goods, but these credits have not been widely used by Eastern Europe because they would increase foreign debt.

The U.S. policy of providing assistance in the form of grants has been well received in Eastern Europe. Grants do not tie aid to a country's exports, do not create debt, and can get there fast. Seventy percent of U.S. assistance to Eastern Europe is in the form of grants, with only 6 percent in the form

of export credits. As a result, U.S. assistance is arriving quickly.

Considering another Marshall Plan

When the discussion turns to financial aid for Eastern Europe and the former Soviet Union, thoughts of another Marshall Plan often come to mind. This makes good sense; after all, there are many similarities between the post-World War II era and the situation currently facing Eastern Europe. But significant differences exist as well. Here are some that ought to be kept in mind:

- The Marshall Plan assistance program ran officially for less than four years—from April 1948 to the end of 1951. Most experts believe the severity and scope of the problems facing Eastern Europe will require a much lengthier assistance program.⁹

Table 2

G-24 ASSISTANCE COMMITMENTS FOR EASTERN EUROPE,¹ 1990-1991

(in billions of dollars)

	Grants	Export Credits	Other Assistance	Total
European Community ²	6.5	5.9	11.3	23.7
Other European Countries ³	1.3	.8	1.4	3.5
United States	4.7	.4	1.6	6.7
Japan	.7	.7	1.5	2.9
Canada	1.5	.2	.1	1.8
Other ⁴	*	.6	.1	.7
TOTAL	14.7	8.6	16.0	39.3

¹ Includes \$ 15 billion for Estonia, Latvia, and Lithuania.

² Includes both bilateral assistance and contributions to collective European Community efforts.

³ Austria, Finland, Iceland, Norway, Sweden, Switzerland

⁴ Australia, New Zealand, Turkey

* Less than \$.05 billion.

Source: G-24 Documents, April 1992.

- Western Europe received a total of \$12.4 billion during the period, an amount equivalent to \$65.4 billion in 1989 dollars. International debt was low in the 1940s, and most of the aid was in the form of grants. Today, foreign debt is high and there is a worldwide shortage of capital. The amount of aid needed this decade will be many times greater than the amount provided under the Marshall Plan.
- When the Marshall Plan began, the economies of Western Europe were already starting to recover, allowing the aid to build on that momentum. However, today's Eastern European economies are still in decline, and except for Hungary and perhaps the Czech republic, the bottom is not yet in sight.
- The Western European countries had a long history of market economies and behaviors, and a tradition of democratic political institutions, when the Marshall Plan began. However, with the possible exception of Hungary (which was allowed to start dabbling in capitalism in 1968), the Eastern Europeans are building their market economies from scratch. Their inexperience will limit their ability to put financial assistance to its quickest and most effective uses.
- The number of potential donors now far exceeds the number who provided aid in the 1940s. While this might seem to increase the available resources, it also makes coordination more difficult. For instance, the EC personnel responsible for coordinating the G-24 response have had difficulty learning what the member countries are doing in the region. This is partly due to the fact that, for competitive reasons, some countries do not want others to know what they are planning or doing. Rather than coordinate assistance, the G-24 usually acts as a clearing-house for information after actions have already been taken.

These differences between the late 1940s and the early 1990s are significant. But they do not constitute sufficient reason to forego financial aid to Eastern Europe—or, for that matter, to the former Soviets. In fact, in light of the huge sums owed by the West's former adversaries and their

continuing search for markets for their military products, the rationale for providing financial assistance may be stronger today than it was then. But providers and recipients alike need to be realistic about what financial assistance can

“Whereas the Marshall Plan was long on grant aid and short on technical assistance, Western aid to Eastern Europe, at least initially, should reverse their relative importance.”

—U.N. Economic Commission for Europe

accomplish: It cannot, by itself, come close to providing the capital, technology, and know-how needed to ensure a permanent economic transition in Eastern Europe.

The need for financial assistance will continue for years, even with improved market access. Given the region's economic decline and political uncertainties, it is likely that private

investment in the near term will be far less than the amount required. So financial assistance must be an important, although proportionately minor, part of the West's overall strategy to support Eastern Europe.

Technical assistance

In my discussions with various Eastern Europeans, a constant theme has been the need for management training and technical advice: “We want to change, but don't know how. Send us people who can teach us how to make our lives better.”

Compared with many other kinds of aid, technical assistance is relatively cheap, and it increases Eastern Europe's ability to absorb financial assistance. It also helps lay the groundwork for attracting the foreign investment that will have to supply or finance the majority of the necessary capital, technology, and training. And it can lead to better opportunities for foreign trade, as Eastern European countries become more aware of the various technologies available in the West. Foreign advisors can help Eastern Europeans

- develop management skills, such as accounting and budgeting;

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In the long run, foreign investment will have to be the main source of funds for revitalizing the Eastern European economies. And companies, not banks, are the most promising source of foreign capital.

- learn the marketing and related skills required to improve exports and compete in a global economy;
- create the institutions necessary to a market economy, such as stock markets, modern banking systems, and social safety nets;
- develop a legal framework that reduces business risks;
- learn how to make use of computer and other modern technologies;
- learn English, the international language.

While the U.S. government has provided well-focused technical assistance in a variety of areas, it has not contributed much to the multilateral institutions that could generate trade opportunities. For example, the U.S. contribution to EBRD's technical assistance fund amounts to less than 1 percent of the \$119-million total, ranking just ahead of contributions from Switzerland and Finland. Contributions from Western European countries amount to \$99 million.¹⁹

Foreign investment

In the long run, foreign investment will have to be the main source of funds for revitalizing the Eastern European economies. And companies, not banks, are the most promising source of foreign capital. Eastern Europe needs foreign investment to create jobs, make consumer goods available, and produce exports that will generate badly needed hard currency.

Although statistics on the number of joint ventures in Eastern Europe are scarce (and often somewhat misleading), the level of Western investment has been minimal to date. A lot of private investors would be more ready to provide capital if the business climate in Eastern Europe were more inviting. Even Hungary, which is considered to have the best business climate in the

region, has major problems. For example, the banking system in Hungary is so primitive that General Electric has to pay its Hungarian employees not by check or electronic transfer, but by bringing trucks full of cash to the plant. As the Chairman of the Hungarian National Bank recently said, "The use of cash in Hungary is at the level of the 1930s in America. Almost all employees take their pay home in their pockets."²⁰

One often-overlooked impediment to foreign investment is Eastern Europe's psychological aversion to making a profit. Many in the region fear and distrust the West's methods and profit motives. For decades, Eastern Europeans were taught that profits were evil, and the effects of 40 years of propaganda cannot be erased overnight. Private consultants in Budapest told me that German firms, despite the temptation to focus on eastern Germany, where there is a common language and currency, are still very interested in Hungarian business opportunities because of Hungary's 25-year experiment of "goulash capitalism" and profit orientation. Firms in eastern Germany simply lack the necessary experience with a market economy.

U.S. firms are generally unfamiliar with Eastern Europe and therefore do not recognize the investment opportunities it offers. Unfortunately, many people in the U.S. business community don't know the difference between Bucharest and Budapest, nor could they name more than a city or two in Romania or Hungary. Some U.S. investors are held back by the belief that the Western Europeans—particularly the Germans—have the inside track. True, German and other Western European firms are active in Eastern Europe. But it is also true that many Eastern Europeans fear a renewal of German domination and welcome American investment. Many American firms, with their traditional focus on domestic markets, fail to adequately appreciate a potentially huge one in Eastern Europe.

To attract foreign investment, the Eastern Europeans themselves will have to resolve a

number of troublesome issues, such as property ownership and environmental cleanup liability. But Eastern Europe is actively taking steps to correct the impediments to foreign investment, and there are opportunities specific to each country. In addition, the regional labor force includes trained engineers, scientists, and other technical personnel, and labor costs are low given their level of education. Furthermore, the U.S. government has put in place a number of programs to help reduce the business risks and encourage investment. It remains to be seen, however, whether the U.S. private sector expands its vision to include this potentially fertile but unfamiliar terrain.

Hope deferred could lead to chaos

Freed from communist propaganda, the people of Eastern Europe are now very much aware of the gap between their standard of living and that of the West. For a while, they had high hopes that democratization and the move to market economies would quickly narrow the difference. But now many are starting to question the political and economic changes that have taken place, and some are concerned with maintaining social cohesion in the face of continuing decline.

Without an effective approach on the part of West, the gains of the past three years could be lost. Better access to Western markets, continued financial and technical assistance, and significant foreign investment will be needed for a much longer time than many once thought. For any of these measures to be effective, the Eastern Europeans will have to persevere in their reforms. Without some reasonable progress in a reasonable amount of time, a return to the totalitarianism is not out of the question. As the

American poet Langston Hughes wrote years ago, a dream deferred can explode. •

1. In this article, Eastern Europe refers to Albania, Bulgaria, the Czech and Slovak Federal Republics, Hungary, Poland, and Romania. It does not refer to the former Soviet Union or Yugoslavia.

2. Including Yugoslavia and its former republics and the former Soviet Union, the population for the entire region is 400 million.

3. Germany's constitution allows any victim of political persecution the right of asylum. Immigrants declare themselves to be victims of oppression, and once a person is in Germany, it can take years to validate these claims. In the meantime, an asylum seeker has access to generous government assistance. Only about 7 percent of the applications for asylum are ultimately determined to be genuine cases for political asylum, according to the latest statistics. This percentage is similar to those in other European Community countries.

4. The CMEA was also known as COMECON. At the time of its collapse, the European members of CMEA consisted of Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the Soviet Union. The CMEA also included Cuba, Mongolia, and Vietnam. East Germany had previously been a member. In addition, Yugoslavia was an associate member, and China and North Korea were observers.

5. The Group of 24 was established to coordinate assistance to Eastern Europe. It includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

6. U.S. imports from Eastern Europe were less than \$1 billion in 1991.

7. *Energy Reforms in Central and Eastern Europe—The First Year* (Geneva: United Nations Economic Commission for Europe, 1991).

8. The western Germany standard is determined by projecting out to an arbitrary end date the level of real capital per worker in western Germany in 1990, and then applying the same standard to the projected size of the labor force in the country in question.

9. In its May 1992 report *Poland and Hungary: Economic Transition and U.S. Assistance* (GAO/NSIAD-92-102), GAO noted the widespread belief that Poland will require at least another 10 years of U.S. assistance.

10. Country contributions as of September 1, 1992, were provided by EBRD's Project Enquiries Unit.

11. Hungarian press interview with Peter Bod in *Magyar Nemzet*, March 24, 1992, translated and reported by the Foreign Broadcast Information Service in the *Daily Report—East Europe*, March 31, 1991.

