East European
Economic Handbook

EAST EUROPEAN ECONOMIC HANDBOOK

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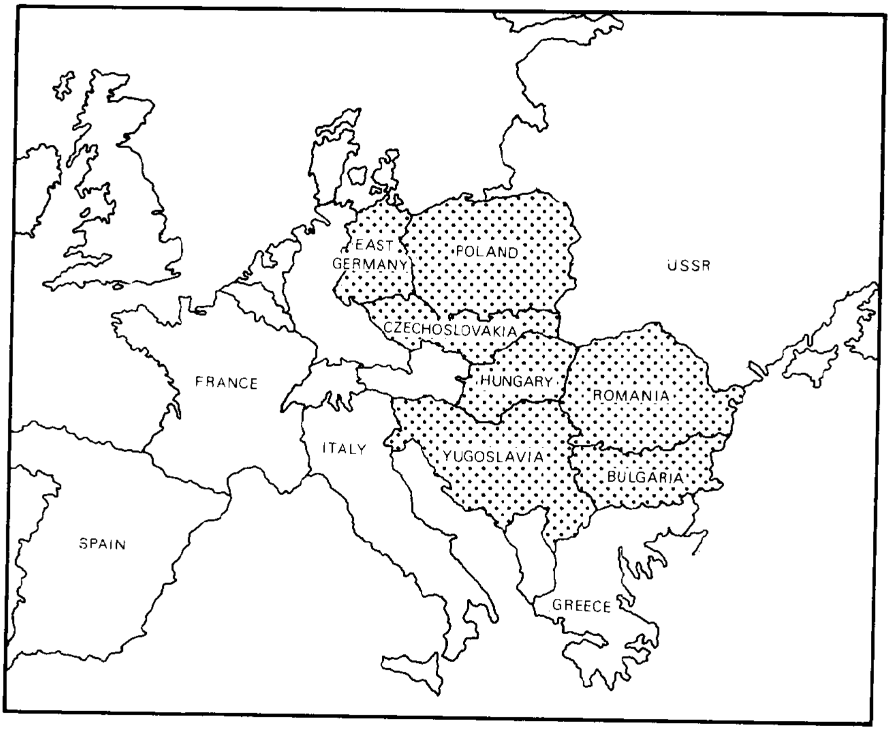
FOREWORD

This is the first economic handbook in a new series of economic studies to be published by Euromonitor. Each handbook will contain an economic overview of a major region of the world, its role in the world economy, its prospects for the future and an in depth analysis of the major countries in the region. Forthcoming titles in this series include the CARIBBEAN ECONOMIC HANDBOOK and the AFRICAN ECONOMIC HANDBOOK.

The main contributor to the EAST EUROPEAN ECONOMIC HANDBOOK is Alan H.Smith, Lecturer in the Economic and Social Studies of Eastern Europe at the School of Slavonic and East European Studies, University of London. Mr Smith has written the first two chapters of the book *The East European Region in a World Context* and *A Regional Overview* and also the final chapter *Outlook*. The individual country chapters have been written by a team of economic journalists.

East Europe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CONTENTS

Chapter One

THE REGION IN A WORLD CONTEXT

Introduction

Although this handbook is concerned with the performance and prospects of the individual economies of Eastern Europe rather than of the Soviet Union, the economic importance of the USSR as the region's major supplier of raw materials and as the major market for industrial goods means that some analysis of Soviet economic prospects and trade relations is essential to any analysis of the prospects of the region in general.

It should also be noted that although some sections of the Soviet leadership would like to see the socialist bloc reduce its trade links with the West, an expansion of trade *within* the region need not necessarily take place at the expense of trade with the West. In many cases in the past an expansion of trade within the region has been accompanied by an expansion of trade with other countries. Many schemes to develop Soviet energy and mineral resources for bloc consumption have required initial imports of capital goods from the West, while some Soviet-East European co-operation ventures have been based on East European supplies of inputs that have been initially obtained from the West.

An illustration of this process, which may be an indication of the nature of things to come, is the Orenburg pipeline. This was one of the largest Soviet-East European joint ventures undertaken in the 1970s and involved the construction of a pipeline to transmit natural gas from the Urals-Volga region in the USSR to European Russia and then on to Eastern Europe. Each participant (with the exception of Romania) was to be responsible for the supply and construction of a fixed amount of the pipeline (approximately 550 kilometres) and is repaid by imports of natural gas. John Hannigan and Carl McMillan of Carleton University, Ottowa have shown that in practice most of the participants were unable to produce the pipe themselves and had to import it from the West. As a result nearly 80% of the materials for the largest joint CMEA venture to date were in fact imported from the West. Similarly, Soviet-East European co-operation ventures in such areas as car production, animal feedstocks and chemicals involve the active participation of Western companies and Western capital and technology.

The Role of the Region in the World Economy

The Council of Mutual Economic Assistance (CMEA)

Six of the East European countries that are the focus of this handbook, together with the Soviet Union and three developing countries, Mongolia, Cuba and Vietnam, are members of the Council of Mutual Economic Assistance (known by its acronym CMEA, but often referred to in the West as Comecon). Albania was a founder member of the organisation in 1949, but has played no active part in its proceedings since 1962. Yugoslavia was not a member of CMEA at its inception, as its formation was partially a response by Stalin to the rift with Tito. It was admitted as an observer from 1956-58, but did not proceed to full membership following a further round of disagreements with the Soviet leadership. Yugoslavia signed a special agreement with CMEA in 1964, allowing it to participate in certain of the organisation's activities, but is not a full member, a status that it enjoys to this day. It is difficult at the moment to foresee any closer relationship.

The CMEA is not a supranational organisation, although the USSR has made unsuccessful attempts to increase its powers in the past. It is in essence a combination of centrally-planned economies which attempt to improve their economic co-ordination (the word integration was not used officially before 1971) by drawing up joint agreements concerning industrial co-operation, specialisation in production, joint investments and attempt to co-ordinate the results through trade agreements.

CMEA decisions are implemented in the member countries by the national authorities of the countries themselves. Members need not participate in projects or proposals that they do not consider to be in their national interest. Thus a country that does not wish to join a specialisation agreement (e.g. to limit the production of steel) can simply continue to produce the commodity in question. The only sanction that other members can put in its way is to refuse to provide inputs for the item in question or to receive the outputs of the industry. Thus if the non-co-operating nation cannot supply the necessary inputs from domestic sources, or if the output of the plant exceeds domestic demand, the non-co-operating nation may be able to obtain alternative supplies or customers in world markets.

Trade within CMEA: The Importance of Energy Supplies

CMEA is capable of imposing less economic discipline on its members than might be expected to result from economic pressures alone and has been less capable of instituting economically rational specialisation than the EEC, the recent difficulties of the latter notwithstanding.

CMEA is in effect a trade-diverting customs union in which preference is first given to domestic suppliers and then to suppliers from other CMEA countries. The most important aspect of intra-CMEA trade is the exchange of Soviet supplies of energy and raw materials for East European machinery and equipment and agricultural produce.

As the more accessible Soviet energy sources in the European sector of the USSR have become depleted, the USSR has been forced to go eastwards into Siberia and northwards into the Arctic Circle to develop alternative sources of supply for both its own and its satellites' consumption. It is frequently difficult to comprehend the sheer scale of Siberia and the logistical problems involved in its development. Siberia itself stretches across 130 degrees from the Urals in the West to the Bering Straits in the East. The distance from the Urals to the border between Eastern and Western Europe is only half the distance from the Urals to its easternmost point.

There are therefore substantially different costs involved in developing the different sectors of Siberia, with considerable implications for the role of the region in the world economy. Construction costs in the westernmost regions of Siberia are only approximately 20-80% higher than those prevailing in the central Moscow regions, but as development moves northwards and eastwards costs escalate rapidly and can be as much as 7-8 times higher than those in the Moscow region. Consequently the capital costs of prospecting and developing East Siberia are substantially higher than those of developing West Siberia, although the richer deposits are probably located in East Siberia.

The development of the region on an optimum scale is beyond the physical capacity of the USSR alone and requires additional inputs from Eastern Europe and/or capitalist countries. Logically, however,development involved in exploiting East Siberia would necessarily involve Western suppliers and markets, but would imply a greater trade orientation towards the Pacific Coast.

In the mid 1970s the USSR proposed to develop natural gas resources in both East and West Siberia, involving importing Western equipment and technology on credit with repayment to be made in natural gas. East Siberian deposits were to be developed principally with Japanese and US participation and the products were to be piped to the Soviet east coast at Nakhodka and then shipped to Japan and the American west coast. West Siberian resources were to be developed with West European and US co-operation with the products to be piped to European Russia, Eastern Europe and then to Western Europe and even possibly to be shipped to the US East coast. The size of the projected development of East Siberia and the volume of Western capital required, made it commercially and politically risky and the project would have required official government supported credits. The Jackson-Vanik amendments to the 1974 US Trade Act limiting official Government credit support on lending to the USSR on energy projects to $40 million, prevented US co-operation in the development of East Siberia. The USSR cancelled its trade agreement with the USA and concentrated its attention on less ambitious proposals to develop West Siberian gas deposits with European and Japanese co-operation, including the construction of a pipeline from Urengoi to supply both East and West Europe.

Scenarios for the Region in the World Economy

Three possible scenarios for the nature of the region's relations with the world economy may be considered:

a) The region could meet less of its demand for energy and raw materials from Soviet sources, while East European countries attempt to meet a greater proportion of domestic energy consumption from the Middle East and other regions. This would require those countries either to increase their volume of exports to hard-currency sources to pay for increased imports and/or develop joint ventures and bilateral deals with suppliers of energy and raw materials. In this context the countries of the region would effectively be competing with Western producers both for markets and for sources of supply of raw materials.

b) The region could become more inward looking, seeking to balance the domestic supply and demand for energy by curtailing domestic consumption and expanding domestic output purely to meet those needs. It is unlikely that this could be achieved without considerable co-operation from the West in the short run in establishing less energy-intensive production technologies and in the development of alternative energy supplies (e.g. nuclear power, hydro-electric power, etc.).

c) The region could seek to expand its energy production to the maximum physically or economically possible, continuing to export energy and raw materials. This would involve continued Western co-operation and trade as in b) but also in the supply of machinery, equipment, pipelines, etc., for which the main method of repayment would either be in the form of energy products themselves, or in the form of hard currency obtained through the sale of energy products in the West. This option would therefore involve either joint production ventures with Western firms or, alternatively, direct Western lending to the region to finance the ventures concerned.

It could, however, be argued that these forms of co-operation would result in a long-term complementarity of the economic interests of the region with those of the Western industrial nations, particularly in Western Europe, with the West obtaining markets for large-scale capital ventures and supplies of fuel and materials.

The Economic Performance of the Region compared with other Areas of the World Economy

Background

By most conventional economic indicators, the performance of the Soviet and East European economies in the period from the end of the Second World War to approximately the mid 1970s has been quite impressive. High rates of growth of industrial output were achieved with low or even zero rates of price inflation in state retail stores, while full employment was maintained in most sectors of the economy. In most countries a satisfactory balance of trade and payments on current account was maintained until at least the late 1960s or early 1970s.

While there is no doubt that the industrial capacity of the region expanded considerably during this period and it is probable that the material living standards of a large proportion of the working population also improved considerably, the events in Poland since 1980, and the current economic situation in Romania, suggest that official statistics give a slightly misleading impression of economic performance and of the underlying economic situation. Although economic performance in the rest of the region has not reached the crisis proportions that it has in

Poland and Romania, there are some indications of worsening economic performance in the early 1980s, including negative economic growth in Czechoslovakia and Hungary and a disturbing level of indebtedness in Yugoslavia, to call into question some of the apparent successes of earlier periods.

International Comparisons of Economic Growth

Although the growth performance of the Soviet and East European economies in the period up to 1975 was quite impressive when compared with growth rates achieved in the more industrial regions of Western Europe, and in particular that of the UK, this can largely be attributed to the lower initial living standards in Eastern Europe, while comparisons with less industrialised European countries and, in particular, with Asian countries with similar per-capita income levels to those in the region, do not indicate that the region's growth performance has been exceptional.

The growth of gross domestic product in Hungary and Czechoslovakia since the Second World War has been no faster than that of Italy, while the growth of total output in Bulgaria has been broadly comparable to that of its neighbour Greece. The growth of the less developed East European states in the Balkans, Romania, Bulgaria and Yugoslavia, in the 1960s was no higher than that of Japan, South Korea or Spain.

It is striking that the rates of growth of labour productivity in both Eastern and Western Europe throughout the period up until the mid 1970s were remarkably similar and that the major differences that can be observed between their industrial growth rates can be almost entirely attributed to differences in the growth of industrial employment, involving increased employment of women in the industrial labour force and labour moving out of agriculture into industry.

Thus, although high rates of growth of industrial labour productivity and output were achieved throughout the region, there has been nothing unduly exceptional about this performance.

The Slowdown in Economic Growth since 1978

It is clear that this growth of industrial output and national income had been subject to a secular decline and that this decline could only be partially explained by the slowdown in the rate of growth of the industrial labour force. Throughout the region both labour productivity and capital productivity have also been subject to declining growth rates. Initially the slowdown in the growth of industrial output and national income was only perceptible over five-year plan periods, but in the second half of the 1970s the deceleration can be detected on an annual basis and in the period from 1978-1982 the growth performance throughout the region was exceptionally poor in comparison with preceding years. The year 1978 appears, therefore, to have marked some kind of watershed in the growth performance of the region and no country in the region has since achieved the rate of growth of gross industrial output realised in 1978, while that rate itself was below the average annual rate achieved by each country of the region in 1971-1975.

Thus the rate of growth of industrial output in the region as a whole has declined annually since 1978 and only the GDR appears to have succeeded in stabilising its industrial growth rate at just under 5% per annum. Not surprisingly in Poland, industrial output has actually declined each year since 1980, but industrial output growth was also negative in Hungary in 1980. In Bulgaria the rate of growth of gross industrial output has fallen from an annual average of around 9-10% to just under 5%, while in Czechoslovakia, Romania and (with the exception of 1979) the USSR, the growth of industrial output declined in each year from 1978-1982.

The impact of the decline in the rate of growth is more apparent when net material product (the value of all material output, excluding services, measured on a value added basis) is considered. This measure, which is the nearest East European equivalent to the Western concept of gross national product, has fallen in Poland in each year since 1980 and fell in Hungary in 1980 and in Czechoslovakia in 1981 and 1982. Net material product for the East European area as a whole (excluding the USSR) actually declined in both 1981 and 1982, although these figures were heavily influenced by the virtual collapse of the Polish economy where production levels in 1982 were only three-quarters of those achieved in 1978. The critical feature of this decline in net material product which will be of considerable importance to future output growth in the region is that it has been largely concentrated on the construction sector as the East European economies have been unable to maintain their planned levels of investment.

The Improvement in Growth Performance in 1983

Preliminary figures indicate that growth performance for the region as a whole in 1983 was the best so far in the current five year plan. Net material product for each country in the region in 1983 was, with the exception of Yugoslavia, greater than in 1982. A more detailed analysis of the causes of the slowdown and decline in output and an assessment of whether the improved performance of 1983 can be considered as a turning point, is provided in Chapter 2.

Recent Growth Performance in International Perspective

Many industrialised nations have experienced greater slowdowns or declines in the rate of growth of output over the same period as the Western recession has taken hold. In Eastern Europe however, the stagnation and decline in output growth has occurred at far lower levels of living standards and presents a far more serious problem for the central authorities. Furthermore, the technological level of much East European industry remains substantially below that of not just the USA, but Western Europe and Japan. There is, therefore, a clear possibility for increased growth if investment levels could be maintained and the technical level of the capital stock increased.

The slowdown in economic growth therefore bears some superficial resemblance to that experienced in Latin America and the Third World, although the scale of the problem is much smaller. The major effect of Western recession on all these countries has been to limit their potential to export to the West, simultaneously limiting their ability to purchase Western machinery and equipment. The problem has been aggravated by increased interest rates in Western financial markets in the early 1980s, which currently appear to show little sign of a permanent fall in view of US budget deficits, which have increased the cost of new capital investment and caused available hard currency earnings to be diverted to debt repayment rather than be used to purchase new equipment.

Balance of payments constraints have therefore required the East European countries (but not the USSR) to contract domestic output in the early 1980s. The contraction has not been as severe as that experienced in Latin America and although some civil unrest has been experienced (conspicuously in Poland, concealed in Romania), the degree of public disturbance cannot be compared with the current situation in some Latin American countries.

External Indebtedness in International Perspective

Net CMEA borrowing, including the USSR and the CMEA Banks, reached $71.1 billion at the end of 1982, while Yugoslavian net indebtedness to the West stood at $18.5 billion. Alternative measures of gross debt (including credits granted but not fully taken up and not netting off holdings of East European and Soviet Banks in the West) indicate that gross debt at the end of 1982 for CMEA as a whole was $86.4 billion and for Yugoslavia was $20 billion.

The seriousness of the Polish debt situation, which at the end of 1979 stood at $20 billion (net), involving a debt service ratio in excess of 100%, resulted in the need to reschedule repayments in March 1980. In the autumn of 1981 Romania was faced with a virtually impossible cash-flow situation, aggravated by the cost of its oil imports from OPEC and a severe bunching of its scheduled repayments and also had to reschedule its repayments, while a few months later Hungary negotiated a package with a number of Western banks assisted by the IMF which enabled it to avoid an actual rescheduling. Yugoslavia did likewise in January 1983.

The inability of these three countries to meet their scheduled repayments, and the apparent reluctance of the Soviet Union to (openly) come to their assistance, appears to have caused many Western banks to lose confidence in the credit-worthiness of the region as a whole, while US banks in particular may have been influenced by political pressures following the Soviet invasion of Afghanistan. As a result, the East European countries found themselves subject to a credit squeeze and were forced to cut imports from the West in the early 1980s, although the USSR as a substantial net exporter managed to avoid this problem, it did face some cash flow problems in 1982.

Western estimates of Soviet and East European indebtedness vary, but the general consensus is that net indebtedness of the region peaked at the end of 1981 and was reduced in 1982 and 1983. The Vienna Institute for Comparative Economic Studies estimates that total CMEA net indebtedness had been reduced to $64.5 billion by the end of 1983. (Gross debt was reduced from $86.4 to 75.2 billion.)

In view of the increasing concern that has recently been expressed over the indebtedness position of the Latin American countries and the rumoured formation of a 'debtors club' in that region, it is important to look at this level of indebtedness in an international perspective. Total net indebtedness to the West for the region as a whole (including Yugoslavia) was \$84 billion in 1983, equivalent to just over 10% of total international lending of \$700 billion and approximately one-quarter of Latin American foreign borrowing. Within this total figure, the borrowing of the USSR at about \$40 per head causes no grounds for concern, although at the other extreme, Yugoslavia's indebtedness at about \$800 per head does give some reason for anxiety. The comparative position of the other East European countries is assessed in Chapter 2, but it may be worth noting here that the most seriously affected, Poland, had a per-capita debt of under \$700 in 1983, equivalent to approximately 20% of GNP.

This position must be contrasted with that of Latin America, where two countries, Brazil (\$93 billion) and Mexico (\$89 billion), had levels of indebtedness larger than that of the entire region combined. These two countries do, of course, have substantially larger populations than the East European countries, but indebtedness per-capita in Brazil is still around \$750 and in Mexico \$1,250. Furthermore these amounts constitute over a third of GNP, while the austerity measures introduced to facilitate repayment are likely to reduce GNP more rapidly than foreign borrowing, thereby increasing the proportion. As far as the other Latin American countries are concerned, Venezuela (total indebtedness \$34 billion), Argentina (\$43 billion) and Chile (\$18 billion) all have a per-capita indebtedness level approaching \$2,000.

The position of the Latin American countries is therefore substantially worse than that of the East European countries and the latter do not really merit consideration in the same breath. Furthermore, while the so-called 'Band-Aid' solution involving new loans and further austerity measures may be of doubtful economic and social value in Latin America, the East European countries are already pursuing a programme of constraint, which if anything appears to be over-rapid.