Transition Economies and Foreign Trade

Jan Winiecki

Routledge Studies of Societies in Transition

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Transition Economies and Foreign Trade

Most books on transition economies concentrate on their internal fortunes. Few have analyzed the effect that the change in system has had on foreign trade and export performance – this new book from Jan Winiecki redresses that balance. Winiecki looks at transition economies from a macro level, in the performance of East–Central Europe, as well as from the micro level, in the performance of enterprises on international markets.

The book's intriguing analyses include:

- the legacy of the communist past upon foreign trade transition;
- the reorientation of exports from the East to the West;
- trade and exchange rate regimes and their impact upon foreign trade performance; and
- post-transition problems associated with potential membership of the European Union.

Transition Economies and Foreign Trade makes the bold claim to have solved puzzles that have hindered the subject for years. By taking the distortions of the communist era into consideration, Winiecki has explained the phenomenon of the decline in output and trade, as well as the disappearance of dual commodity structure of exports in the early transition phase.

This topical and timely book should become essential reading for students and academics with an interest in international economics as well as being of great use to business analysts and policy makers.

Jan Winiecki is Chair of International Trade and Finance at the European University-Viadrina in Frankfurt (Oder).

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Introduction

Although the number of monographs and collections of conference papers on post-communist transition can now be counted in their hundreds, surprisingly few have been devoted to surveying the foreign trade issues emerging during the transition process. And in any case the latter are usually collections of papers dealing with specific foreign trade issues (e.g. foreign direct investment) or foreign trade of particular transition countries. What the present writer finds missing are books generalizing the experience of all, or a specific subset of, transition countries.

This book intends to offer such a wide-ranging overview. Generalizing on the experience of East–Central European countries in transition, it looks at trade determinants, evaluates their export performance during the process at the country and enterprise levels, and assesses the impact of policies upon performance.

The layout of the book is as follows. In Chapter 1 the legacy of the past is examined. It has been one of the central themes of this author's transition writings that the communist economic system, with its structure of incentives and resultant severe distortions, heavily influenced the transition process. An overwhelmingly large part of transition surprises and unresolved theoretical disputes stems from the underappreciation or outright neglect of the impact of the communist past (see e.g. Winiecki 1990, 1991a, 1993, 1995, 1997a, 2000b). Accordingly, Chapter 1 looks at the inherited patterns of output and foreign trade in the transition countries of East–Central Europe and stresses the communist system-specific excess demand for inputs (both of domestic and of foreign origin), demand pressures for imports from the West, strong disincentives to export, and other developments that affected external performance under the communist regime and, at the same time, influenced the transition to a market economy. The last section takes into account the industry-wise differentiation of the impact of the communist legacy. The closer the industries were to the real comparative advantages of these middle-developed countries, the weaker that impact has been and the better the prospects for survival in transition.

Chapters 2 and 3 deal with foreign trade during the transition process. The former tries to address foreign trade developments that most surprised the pundits. Thus, it looks first at the most characteristic transition features: the steep fall of aggregate output and foreign trade, the near disappearance of trade among the former members of the communist quasi-integrative grouping of COMECON, the rapid increase of trade with the West (especially Western Europe), the substantial changes in the commodity structure of these countries' exports, and so on.

As stressed above, behind most deviations from the expectations of observers of the transition process (expectations based largely on the experience of liberalizing developing countries) was the impact of the communist past. From the one-off correction of excess demand for producer goods (including imports from other COMECON countries) to the alleged declining sophistication of transition countries' exports, the past has been at the root of most of the explanations. For although the aims of liberalization in developing countries (LDCs) and those in the post-communist countries have been the same – the establishment of an open capitalist market economy – the paths and particular outcomes have been different. The elimination of distortions in the existing markets in LDCs is not the same as the establishment of non-existent markets in post-communist economies.

Chapter 3 concentrates on enterprise-level determinants of the surprisingly good export performance of East–Central European countries to the European Union. It is stressed that high export growth rates – substantially above the growth rates of world exports – have been accomplished by enterprises pursuing a wide range of strategies.

Some strategies could only be pursued in the short term, such as the 'distressed sales' strategy. Other strategies lasted longer. They also entailed some cases of refusal to adjust as some firms in heavy industries ran down their equipment, while using the depreciation allowances to cover wages and other variable costs. Although, paradoxically, they attained some temporary comparative advantages in the process, they in fact doomed themselves to wither away in the long run.

More optimistically, it is underlined in this chapter that many more already-privatized ex-SOEs (state-owned enterprises), as well as still unprivatized SOEs, in the industrial sector made strong efforts to adjust, successfully finding niches in both domestic and world markets. Liberalization in less- and middle-developed market economies assumed a shift of resources from the protected (non-tradable) to the competitive (tradable) sector. This takes time. As the post-communist industrial (tradable) sector was – by contrast – too large, the resources were already employed (however inefficiently) in the tradable sector; both the speed of reorientation and the number of trials were larger than in LDCs.

It is also underlined that, over time, new players appeared in the foreign trade area. Foreign direct investment (FDI) by multinational firms and smaller companies began increasingly – in some countries, even overwhelmingly – to contribute to both exports and imports. For obvious reasons due to the weaker pull of the domestic markets, the smaller the host country the more pronounced the export orientation has been. These new players were also 'generic' middle-sized and small domestic private firms.

It is noted that different export strategies have had differing impacts upon export performance in different periods of the transition process. For example, foreign affiliates and domestic 'generic' private firms need more time to become established and/or turn outward for expansion. Accordingly they are much more important now than they were in early transition. As they are the most promising export-oriented economic agents, the surprisingly good export performance may be said to have rather solid foundations.

Chapter 4 is different in its concentration on institutions and policies rather than economic agents. It evaluates the impact of trade regimes and policies pursued upon trade, in particular export performance. Interestingly it transpires from the analysis that what matters most for successful performance is the fundamental concordance with the basic stabilizing and liberalizing thrust of the transition program. Fluctuations in the degree of protection of the domestic market during the transition, as long as they stay within certain limits, have been less harmful than might have been expected.

This is not particularly surprising. After all, external economic openness is influencing foreign trade not only directly, but also indirectly. The pressure of foreign competition on the domestic markets also contributes importantly to performance.

An even more interesting conclusion concerns exchange rate regimes, given the lively debates in early transition about the superiority of some regimes over others. But the fact is that the pegged regime, the floating regime, or the fully fixed (currency board) regime may successfully contribute to performance if the overall thrust of transition moves the economy in the desired direction of an open market economy. This has been the experience of Poland, Slovenia, and Estonia, each originally choosing a different regime. Again, as in trade policy, moderation of exchange rate policy within a given regime matters more than the regime itself.

The fifth, and last, chapter deals with post-transition issues as a number of East–Central European countries find themselves at the pre-accession stage, with the prospect of joining the European Union in the not too distant future. Thus, this chapter looks at foreign trade and, more widely, the prospects for foreign economic relations from the perspective of future membership.

The chapter consists of two distinct parts. In the earlier one an economic perspective is considered, looking at the performance of other middle-developed countries that joined the EU earlier to see how much they benefited in terms of trade, investment, and, importantly, reduction of the developmental distance to the mature EU economies. The prospects for post-communist high performers from the region are encouraging. If they do not botch the job (as Greece did), then their performance is going to improve and the distance reduced.

In the second part a political economy perspective is applied. Some trade benefits of being inside rather than outside the EU are considered, with respect to so-called 'sensitive' products. Even more importantly, the effects of the interaction between membership of the strategic/military alliance of NATO and that of the economic one, the EU, are looked at and found to be complementary. Just as NATO membership for some countries of the region reduces the risk of trading with and investing in these countries, thus contributing to economic performance, so EU membership reinforces both strategic interests and economic interests, contributing accordingly to the resolve of NATO members to intervene in case of need.

Having presented the layout, some definitional issues are briefly considered at this point. Thus, transition, transformation, and systemic change are the terms used interchangeably to describe the institutional change from a communist political and economic system to a democracy and market capitalism. The time-spans considered are between 1989 and 1990, the period when transition began, and 1997 and 1998, the period for which the latest trade and related statistics are available.

East–Central Europe is a term that may generate some confusion as it has been defined differently at different times and in different contexts. Here, it applies to those countries stretching from Estonia in the north-east to Slovenia in the south-west. In most comparisons, however, it is limited to post-communist members of COMECON, excluding post-Soviet states and the now defunct German Democratic Republic.

A question may be raised as to why not all the post-communist countries of Europe are taken into consideration. The answer is rather simple. What the present writer considers in this book is foreign trade issues emerging in transition from one economic system to another. Including the post-Soviet and post-Yugoslav states would complicate the analysis by adding the effects of territorial (and economic) disintegration.

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1 The legacy of the communist past and its impact on foreign trade in transition

Introduction

In order to evaluate better the foreign trade potential of post-communist economies in transition it is very important to understand the past, first of all the impact of the structure of incentives upon the performance of enterprises in the centrally planned and administered communist economy. For it is the legacy of that past in terms of dynamics, structure, and quality of output, as well as institutional characteristics of the tradable sector, that strongly influenced the performance of transition economies in their trade reorientation. This influence had been particularly strong in the early transition period, say 1990–94.

Inherited pattern of output

Distorted output growth

The starting point, as stressed by many analysts, is the perennial excess demand and shortage that appeared almost from the start and had become a permanent feature ever since. Analysts point to the *de facto* distorted structure of incentives to execute and exceed plan targets that were positively correlated with volume or value of output but not negatively correlated with production costs. This created a system of financial irresponsibility, called by Kornai (1979, 1980) 'soft' budget constraint, that – in spite of numerous 'reforms' – was not eradicated from the system until its very end.

As every enterprise demanded more and more labour, capital, and inputs to make plan fulfillment easier, shortages emerged and persisted, engendering an overall climate of shortage, with adverse consequences for cost and quality. Persistent shortages, and concomitant pressure for more output, imbued managers and workers with a careless attitude toward everything but quantity. In addition, cost and quality suffered from the time profile of the incentives for enterprises. The perennial chase after monthly, quarterly, and annual bonuses under the conditions of supply uncertainty resulted in intermittent periods of forced idleness (due to the lack of supplies) and rush to fulfill or exceed plan targets, regardless of cost and quality of output.

Shortages, and accompanying – adverse – output characteristics, tended to change their intensity over time but never disappeared from the system. The dynamics of changes in the level (and structure) of shortages was associated with the so-called investment cycles (see e.g. Bauer 1978, Winiecki 1982). Excess demand created the constant pressure to expand capacity and, in this way, output. Investments, however, had to be included in the medium-term (usually five-year) investment plans.

Enterprise managers were usually able to outwit central planners and obtain higher levels of supplies (production factors, inputs) for investment projects relative to the levels of output that these projects actually were able to deliver. Under the reigning informational asymmetry this discrepancy gradually became more obvious to the planners over the period of the first two–three years of the medium-term plan, generating extra tensions between the (by now revealed) much greater demand for supplies needed to complete investment projects and actual capability of these economies to deliver. Shortages of intermediate and capital goods multiplied. That, in turn, necessitated cuts in the number of investment projects (usually the least important politically, not the least efficient!) and in the second part of the medium-term plan shortages subsided somewhat.

It is quite obvious that both the statics and dynamics of economic growth under the communists entailed an inordinate amount of waste. The waste was clearly system specific. One of its manifestations was the much higher use of inputs per unit of output. Table 1.1 presents in comparative perspective the use of energy and steel per \$1000 of GDP that was uniformly 2–2.5 times higher in communist than in market economies.

It should be noted, however, that higher costs and lower quality were only some of the side effects of the workings of the system. Output structure suffered, too. Let us keep in mind that under the general conditions of uncertainty enterprises tried to obtain more and more inputs to ensure easy fulfillment of plan targets. Grossly excessive inventories became the norm. The same applied to investments. In consequence, the shares of intermediate and capital goods industries increased much beyond those in market economies at similar development levels,

Table 1.1 High resource intensity of communist economies in comparison with Western economies: the cases of energy and steel

Countries	*Energy intensity in kg of coal equivalent per US $1000*	*Steel intensity in kg of steel consumption per US $1000*
Communist economies:		
Bulgaria	1464	87
Czechoslovakia	1290	132
GDR	1356	88
Hungary	1058	88
Poland	1515	135
USSR	1490	135
Western economies:		
Austria	603	39
Belgium	618	36
Denmark	502	30
Finland	767	40
France	502	42
Germany	565	52
Italy	655	79
Norway	1114	38
Sweden	713	44
Switzerland	371	26
UK	820	38

Note: In 1979 US dollars; data for 1979 or 1980.

Source: Winiecki (1988).

measured roughly by GNP per capita. And all this without commensurate effects on the output side; the share of 'throughput' (intermediate consumption) in gross output was distinctly higher in communist economies than in market economies to the detriment of the share of newly added value (roughly GDP).

Underspecialization and output structure

Not only system-specific institutional characteristics, such as the structure of incentives and informational asymmetries within the multi-level planning hierarchy, but also policy-specific characteristics affected output structure (as well as quality and cost) in communist economies. Distortionary effects were, firstly, the result of the import-substitution-oriented strategy.

Except for the former Soviet Union, all other European communist