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Jan Winiecki*

Competitive Prospects in Eastern Europe

A Parting of the Ways

Among the former CMEA countries, some are moving faster and more radically toward the market system than others. Prof. Winiecki shows that the former will in future be in a better position to compete on world markets than those countries whose transition to the market system is incomplete or distorted.

Fast moving developments in countries that began shifting away from the Soviet-type economic system toward the market-type one (referred to below as post-STEs) signify a parting of the ways between Poland, Hungary and Czechoslovakia on the one hand and other countries of the region which are only tinkering with their economic system on the other. Nowhere is the difference between post-STEs and STEs more visible than with respect to international competitiveness. The establishment of a market system is expected to improve post-STEs' competitive position through both the ascertaining of proper comparative advantages and the attracting of more direct foreign investment. An analysis of the foreign trade and investment prospects of both STEs and post-STEs is followed in this article by an analysis of the internal and external threats to post-STEs' performance. It is posited that much greater threats stem from a possibly incomplete or distorted transition to the market than from anything else.

Let us begin by looking at the lack of competition in STEs in terms of the Burenstam Linder preference-for-similarity hypothesis,¹ for it is here that an inherent weakness of STEs is revealed. Burenstam Linder stresses the role of domestic demand in shaping a strong production and marketing base for future export expansion. Without the domestic market test, by and large non-existent in permanently disequibrated economies,

STE enterprises manufacture goods of inferior quality, often technologically obsolete, that are not easy to sell even at a discount. It should also be noted that STE goods also cannot be measured by the next Burenstam Linder test, the similar markets test. This is the case because all STEs – under pressure of persistent excess demand – are equally lenient with respect to quality requirements. It is only at the third stage, that of dissimilar markets, that STEs are really submitted to the test.²

It is with respect to competitiveness that the parting of the ways between STEs and those countries of the region that are transforming, or have already transformed, to the market system will reveal itself most clearly. The former will continue to maintain their costly pattern of production and trade, and will sell more and more abroad in return for less and less, while the latter, freed from the shackles of the Soviet economic system, will search rationally for new competitiveness (new in the sense that proper relative prices will quickly reveal which are the wrong exports).

New Competitiveness

Now, new competitiveness is to begin with most probably going to mean *old* competitiveness, that is the competitiveness these countries possessed in the past (before communist rule). And because adjustment under competitive conditions is the easier, the less sophisticated

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¹ Staffan Burenstam Linder: *An Essay on Trade and Transformation*, Stockholm 1961.

² More on the subject in J. Winiecki: *The Distorted World of Soviet-Type Economies*, London 1988, Chapter 5.

the product, it can be expected that the traditional exports of light industry manufactures will expand first. Thus, textiles and clothing from Hungary and Poland, shoes and glassware from Czechoslovakia, pottery from Poland etc. will increase their shares in both these countries' exports and EC imports.

This should be relatively easy, as even under the disadvantageous STE conditions these countries were able to improve, often markedly, the relative prices obtained on the EC market. While unit (kilogram) prices of engineering goods sold to the EC have been falling decade after decade, the prices obtained on the same market for many light industry product groups improved in relative terms. This is partly reflected in Table 1, where unit (kilogram) prices obtained by all former CMEA countries are shown as a percentage of prices obtained by other competitors on the EC market.

What is also interesting is the fact that the more sophisticated the product group, the lower the price obtained by STEs. This is probably one of the strongest indictments of the Soviet economic system, which has been designed to catch up with and surpass the capitalist system.

The question of competition with developing countries is often raised at this point. Undoubtedly the attempt to regain old competitiveness in traditional light industry manufactures will increase the already strong competition on the EC market, and in fact on the entire west European market, in these products. There are some areas where finer distinctions reveal parallel specialization rather than competitive ones (e.g. STEs and post-STE in woollen clothing and LDCs in cotton clothing) but some displacement of remote LDCs' products seems

unavoidable. Locational advantages also matter: for example, recent Austrian research shows that 40% of exports are shipped no further than 400 km.³ The short distance from markets may present certain advantages to Czech and Hungarian producers, as well as to other producers in post-STE.

It is probably with respect to skilled labour-intensive products of medium technological sophistication that the shift to the market system will create the greatest opportunities for expansion. The comparative advantage of a relatively well educated labour force coupled with distinctly lower wages (relative to both the level of education and to productivity levels elsewhere) will show themselves not so much at the level of industries but at the level of "niches": products and three or four digit product groups, more often than not labour-intensive intermediates requiring the "right" level of skills for their manufacture.

Marketization and (hopefully) fast privatization should increase the number of medium-sized firms performing well under the conditions of infinitely greater openness and new opportunities arising therefrom. They would be the first beneficiaries of the shift to the market system.

Foreign Investment

Up to this point we have considered the search for comparative advantages in the context of mobile goods and immobile production factors. It should be immediately obvious that also in the case of inward foreign investment fast liberalizing post-STE will have strong advantages

³ Data quoted at the recent conference on East European reforms, Laxenburg, April 22-23, 1990 by Professor Gerhard Fink.

Table 1

Unit (Kilogram) Prices of Engineering Goods Obtained by East European STEs on the EC Market Relative to Prices Obtained by Others, 1965-1985

(in percentages)

Country	1965	1970	1975	1977	1980	1985
Bulgaria	32	39	36	34	30	25
Czechoslovakia	47	45	38	36	32	25
GDR ¹	58	47	48	44	37	33
Hungary	77	72	52	53	47	35
Poland	36	36	36	44	34	23
Romania	37	39	38	45	38	29
USSR	46	43	30	30	29	23
East European STEs (weighted average)	50	45	37	38	35	28

¹ Without intra-German trade.

Source: E. D. Winiecki, J. Winiecki: Intra-Branch Structural Change in Poland and Other COMECON Countries and Specialisation for the World Market, Institute for Economic Development, Main School of Planning and Statistics, 1988, mimeo (in Polish).

over STEs that only tinker with the existing economic system. Import substitution oriented economies can count on only two types of foreign investment. The first is natural resource extraction. If the natural resources are not available at comparable cost elsewhere, foreign investment will (reluctantly) flow in if it is allowed to do so. The second type of foreign investment is the home market oriented manufacturing subsidiaries of foreign multinational firms. Given enough incentives in the form of high tariff protection for their small-scale/high-cost production and the right to repatriate profits, foreign multinationals may consider it advantageous for them to establish a subsidiary (or even a joint venture).

Both these types of foreign investment in non-liberalizing (or slowly liberalizing) STEs face strong obstacles, however. Since STE growth is highly resource intensive, untapped deposits are usually located in not easily accessible areas. Therefore investment there has to be combined with investment in the necessary physical infrastructure (roads, bridges, transportation, water, sewage, heating systems etc.) Decaying Soviet-type economies are clearly unable to finance these tasks, which means that they must be a part of foreign investment deals. These extra burdens play an important role in the clearly visible reluctance of Western multinationals or multinational consortia to enter into deals with the resource-rich Soviet Union. They were reluctant to do so in the 1970s and in the 1980s, and there do not appear to be any factors which would tend to change that attitude at the present. The smaller countries of Eastern Europe face similar handicaps, although these are not as severe due to the size and geographic location of those countries.

Host country oriented subsidiaries will not be very numerous, either, because almost all countries suffer from convertible currency shortage and indebtedness. Obviously, the extent to which they can agree on profit repatriation cannot be very large. The USSR is here in a relatively better position but its overall economic performance is deteriorating fast.

Liberalizing post-STE economies are in a different and much more advantageous position. First of all if they opt for currency convertibility that extends to at least direct foreign investment (and as a necessary complement also the repatriation of profits), they can expect not only host country market-oriented direct foreign investment (DFI) but also a DFI that is a part of the multinational firm's integrated network of subsidiaries: a source of supplies for other units in the firm's network. For this to happen, liberalization resulting in the greater transparency of the post-Soviet-type economy is a must. Without freeing domestic prices and making currency convertible, these economies would not be able to attract the kind of DFI

under consideration. For it is not so much various concessions but a transparent economy with a stable regulatory framework that matters most for potential foreign investors.

Not only is outward-oriented DFI with export potential made possible by liberalization, but also host country market oriented DFI is made more advantageous for a host country economy. Openness eliminates the tendency to set up subsidiaries producing small volume/high cost products because these products can simply be supplied from a home base or from another subsidiary. Thus it is only those DFI which require a strong local marketing base that tend to be established in open economies. Obviously, the latter do not need high profit rates to compensate multinationals for the low volume of output combined with relatively high level of investments necessary to put such a low volume/high cost subsidiary into operation. Thus, the efficiency of DFI increases in liberalizing economies.

Consequences of Incomplete Liberalization

As seen from the above, the handicap of non-liberalization is so severe that those countries that have not liberalized will sooner or later reconsider their decision. An alternative is the continuation of the accelerated decline observed since the late 1970s, and only a neo-totalitarian putsch could conceivably stop their societies from demanding such a change. This assessment does not cover another case, namely that of half-hearted liberalization, i.e. one that stops at the stage at which the fundamental efficiency benefits of liberalization remain unrealized. There are many ways in which post-STE economies could shoot themselves in the (collective) leg and therefore damage their ability to perform efficiently on the world market.

One such way, with a relatively high probability of occurrence, is the postponement of convertibility till the last part of the transition programme. But as long as at least domestic economic agents are unable to compete on an equal footing with foreign agents on the world market by choosing a supplier (domestic or foreign) on the basis of price and quality considerations only, structural change along the lines of comparative advantage is unlikely to take place. Poland, for example, opted for limited currency convertibility, i.e. one limited to domestic economic agents. But it would be even better to extend convertibility to at least long-term capital flows, as was stressed above. Then structural change would accelerate, since DFI would flow more easily to a country that puts no impediments on profit repatriation.

Another, somewhat lesser, damage may result from supporting the newly liberalized exchange rate with

protective measures (high tariffs and other forms of import taxes). These drive a wedge between the export exchange rate and the import exchange rate and limit imports unnecessarily. The disadvantages of this type of support for the exchange rate are at least twofold. First, by raising the price of imports it reduces the pressure on domestic producers and thus does not allow all the benefits of liberalization to be implemented. Second, by making some output (that based on imported inputs) costlier in relative terms it distorts structural adjustment along the lines of comparative advantages. If this lasts long enough, a new output structure emerges which is also suboptimal from the efficiency viewpoint.

Industrial Policy

Another major threat to the prospects of increased efficiency and competitiveness may be the attempt by STEs to achieve by indirect means what they failed to achieve by direct means, namely the creation of a "modern", "advanced" industrial structure. The lure of a new generation of "sophisticated" industries: electronics, biotechnologies etc., may become too strong for those who were for decades brought up in the belief that industrial structure can be shaped and reshaped from above.

The first forty years of such attempts ended in the creation of a unique class of backward machinery producers. But there are still many who believe in industrial policies. Their ideal is not Marx but MITI, the Japanese Ministry of Trade and Industry. It used to be French indicative planning but with the obvious failure of the latter Japanese industrial policy became a useful fallback for the new interventionists in East Central Europe.

The new interventionists, however, somehow forget the awkward fact that industrial policy, policy planning etc. have been in operation elsewhere and produced rather disappointing results. Thus, what makes Japan different is not MITI's industrial policy of supporting this or that industry in this or that way but something else. This "something else" seems to be Japanese competition policy, which always stressed the need for strong competition on the domestic market. Even if the domestic market has been temporarily (or not so temporarily) shielded from foreign competition, protected and often supported indirectly, industries were told to compete. For MITI rightly believed that only those who survive the Burensam Linder domestic market test stand a chance of competing successfully on similar, and later dissimilar (more demanding), markets.

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Therefore, the Japanese market is fiercely competitive. There are many more domestic car-makers in Japan than there have been in the last quarter of a century on the much larger American market. Examples abound. Thus, competition policy, together with other market-enhancing measures, should be in the forefront of eastern central European concerns. This in the post-STE context means demonopolization and privatization domestically and openness internationally. There will be a lot more need to address the structural legacy of the Soviet-type economic system by means that could pass under the name of industrial restructuring than there is usually in mature industrial or even middle-developed Western economies. But certainly the mistake of deciding on who will probably be the winners in competitive rivalry should be carefully avoided.

Problems due to EC '92

Even this limited overview of possible self-inflicted wounds points to considerable problems that post-STE's may make for themselves. Are the problems possibly created by the EC '92 unification drive of the same order of magnitude? The question is not easy to answer but we shall attempt to point out some uncertainties with respect to the future. Let us look at import restrictions first.

Paradoxically, it is the fast liberalizing post-STE's that would suffer most if the EC were to turn more towards a "Fortress Europe". STE's have rarely been able to fill the quota allotted to them by the EC, except in the case of agricultural products, so that a protectionist EC would not hurt them much, if at all.

The same applies to post-STE's which try to regain part of their old comparative advantages in traditional light industry products (see above). It is the countries which try to correct past structural distortions that may be faced with EC barriers to imports.

The future path of the European Community may affect not only foreign trade but also foreign investment in eastern central Europe. If the EC is really turning toward the increasingly open European economic space embracing the EC, EFTA and the market-oriented, liberalizing eastern central European countries, then the latter may expect an inflow of foreign investments from North America and the Far East (not only Japan), which

could come there on the same basis as it has been coming to Ireland for quite some time and at an accelerating rate to Spain and Portugal recently.

Of course, the volume of flows would not be comparable, given all the problems referred to above. Nonetheless locational and cost advantages would draw some non-European foreign investment to these countries. This investment will take place, however, only if the European Community does not turn inward.

Finally, it seems worth exploring whether eastern central European countries have alternatives to closer integration with the unified European Community market. They certainly cannot apply a policy of strategic threat, as the United States did with the USA-Canada Free Trade Zone (FTZ), to indicate that there are more attractive alternatives to GATT.⁴ But even with Mexico also ready to join the FTZ, this is not a strategic threat credible enough to push the European Community off its chosen course.

If the USA does not appear to hold strong enough cards in this respect, alone or as a free trade grouping, then small post-STE's are in an even weaker bargaining position. The CMEA is dead for all practical purposes, and in any case it never was a serious alternative to the EC. The idea of a smaller integration or even free trading area composed of Czechoslovakia, Hungary and Poland was not seriously considered by anybody. Although the reasons for the cold reception it received varied, the main obstacles to such an arrangement are related to the structural legacy of the Soviet economic system. All these economies have highly similar industrial structures and as a result very little inter-industry specialization would be likely to take place within such a grouping. And their similar development (in fact: underdevelopment) level makes intra-industry specialization along the lines of comparative advantages also rather unlikely.

Thus, alternatives – if there are any – do not lie outside Western Europe but within it. An interesting proposal by Kostrzewa and Schmieding⁵ that the transition of post-STE's should be assisted through their incorporation into EFTA and – through the extension of EFTA to trade in services and production factors – into a wider all-European market⁶, has already found some follow-up. Not only has EFTA signed cooperation agreements with Poland, Czechoslovakia and Hungary, but the idea of a European economic space also points in the same direction. It may be said there are alternative routes to Europe for post-STE's but no alternative Europes any more. The term "Eastern Europe", invented after the Second World War to stress the satellite status of the smaller countries of the region, is disappearing from discussions on the future, and deservedly so.

⁴ Cf. S. Ostry: The Completion of the Internal Market, Symposium 1989, Kiel Institute for World Economics, 1990.

⁵ W. Kostrzewa, H. Schmieding: The EFTA Option for Eastern Europe: Toward an Economic Reunification of the Divided Continent, Kieler Arbeitspapiere No. 397, Kiel Institute for World Economics, October 1989.

⁶ Ibid.