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Rolf Alter\*

## The New Challenge in Eastern Europe: Investment and Restructuring

*The reform programmes of most Eastern European countries have liberalized prices and taken on the task of macroeconomic stabilization, but the formation and implementation of structural policies has largely been neglected so far. What steps should the governments of Eastern Europe take to encourage the necessary restructuring of their economies and to attract the urgently needed foreign investment?*

Restoring the growth potential of an economy requires positive investment decisions. If, when, and how the resources in Eastern European countries are put to use again efficiently, will largely depend on creating conditions conducive to domestic and foreign investment. A balanced and integrated mix of sound macroeconomic and prospective structural policies is crucial to encourage domestic investors and to promote inflows of private foreign capital urgently needed to provide investment capital and human competence. Only in a competitive economy will opportunities for stable employment be created.

While most Eastern European countries have grappled with the tasks of macroeconomic stabilization and price liberalization from the outset of their reform programmes – and, with the support of international institutions, they have been relatively successful on the macroeconomic front – a deficit in structural policies appears to be becoming the major bottleneck for progress in restructuring and growth. Further delays in designing and implementing such policies could also easily imperil the moderate macroeconomic achievements. Moreover, the decline in the population's acceptance of austerity policies in some countries seems to be an indicator that governments have been preoccupied with macroeconomic stabilization.

Of course, transformation is a massive undertaking. The sheer magnitude of the privatization in these countries is a challenge in itself; the creation of the legal framework is time-consuming, and the institution-building process cannot be completed "overnight". But there also seems to exist some reluctance and difficulties in defining

the role of the government beyond macroeconomic stabilization and in designing policies that support the market mechanism where it is not (yet) sufficiently developed.

### Output, Employment and Investment

In 1991, the economic decline continued throughout the region. On average, output declined by 10 per cent in the five countries of Eastern and Central Europe, ranging from a fall of 20 per cent in Bulgaria to one of 7 per cent in Hungary. Unemployment rates have risen rapidly throughout the year, reaching 12 per cent in Poland, about 8 per cent in the CSFR and Hungary, and 6 per cent in Romania.<sup>1</sup> Net fixed investment was expected to decrease by 40 per cent against 1990 in the CSFR; gross investment was down by 15 per cent in Hungary.

So far, companies seem to be refraining from investing, selling off part of the assets, and accumulating company debt rather than reducing the workforce. Shorter working hours and temporary lay-offs may also precede massive reductions of the workforce. As these measures reach their limits, a further growth of unemployment can be expected. More importantly, however, maintaining the present structures does not contribute to building competitive, profitable, private enterprises.

Small private industry is not yet included in the data. Since it is a very dynamic sector in all countries, official data may tend to exaggerate the bleakness of the situation. Preliminary estimates for Poland indicate that the private sector accounts for about 70 per cent of domestic trade and 44 per cent of construction, and that it may have

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\* OECD, Paris, France. The views expressed are the sole responsibility of the author and do not necessarily reflect those of the OECD.

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<sup>1</sup> OECD Economic Outlook, No. 50, Dec. 1991.

reached about 20 per cent of output in industry. Taking into account that the privatization process has only just begun in many countries, at least the outlook may appear more favourable.

Nevertheless, it would seem highly speculative to assume that Central and Eastern Europe will hit the bottom of the recession this year. Domestic uncertainties and problems will be exacerbated by external factors; the global recovery has just been "postponed", and it will take quite a while before the republics of the former USSR become stable trading partners again.

### **Tremendous Restructuring Needs**

The magnitudes of restructuring are enormous. The inefficient sector—generally the state sector—accounts for about 90 per cent of resources. Four major lines of structural adjustment can be identified in most Eastern European countries:

- ☐ the industrial sector must be fundamentally restructured and modernized, particularly with a view to reducing high material and energy intensity; in some cases, conversion of military production weighs heavily on any change;
- ☐ the share of services in relation to total employment and output is expected to increase, while agriculture is likely to decline;
- ☐ the previous administratively organized exchange of goods within the CMEA must be reformed towards external trade in goods and services with the rest of the world;
- ☐ the environmental damages and liabilities must be assessed and dealt with.

General economic wisdom in the stabilization programmes of Central and Eastern European countries stipulates that strongly reduced price inflation, a balanced government budget and competitive real exchange rates provide the basis for future growth, with investment and export growth as the main engines. However, the transition from central planning to a market economy is without any precedents and the issues are more complicated than in developed economies.

Privatization – at the centre of the transformation – faces a number of conceptual, administrative and political challenges. It is still unclear which of the different strategies is likely to yield the desired results most effectively; probably a variety of approaches will have to be pursued, which includes the risk of slowing the process down further.

Even under very favourable circumstances for

privatization, a large part of the economy will remain under government ownership for quite some time. Where the management of public enterprises does not know how to act in a market environment, where the government as owner has not yet defined the objectives of its enterprises, and where incentives for management to assume a more active role do not exist, maintaining the status quo and "muddling through" become rational attitudes for managers; their initiative will not be encouraged if privatization could sweep them out of office tomorrow.

Incomplete system transformation – e.g. undeveloped or underdeveloped financial markets, a lack of satisfactorily functioning labour markets especially with respect to the determination and differentiation of salaries, persistent monopolistic/monopsonistic markets, state ownership, uncertainties due to restitution – implies the persistence of structures and rigidities unsuitable for market signals to emerge or be received and responded to effectively. The regional dimension of sectoral adjustment problems adds another complication. The challenges of internal adjustment have been aggravated by the complete collapse of the external trading system.

In this imperfect market environment, is it enough to concentrate on stabilization, to decree the introduction of free markets and then wait for market forces to do the job, i.e. primarily to restore the growth potential of the country? Will the positive impact of the emerging private sector be strong and fast enough to compensate for the decline in the former state-owned companies? Is there not the need to monitor and analyse the situation, to look for new solutions, and, most of all, not to neglect economic policy at a time when it is needed more than ever?

### **The Role of Government**

Discussing the role of government in contributing to conditions for embarking on a virtuous circle of growth is not an ideological issue, but one which has to do with market imperfections and the overall objectives of the economic welfare of a country. Falling from one extreme – the command economy – into the other extreme of a minimal state approach is neither an economically reasonable nor a sustainable attitude. Experience indicates that in recessionary situations the political pressure to do "something" mounts and policy-makers are becoming more inclined to give in to the demands of particular interest groups. Interventions of this kind will be particularly tempting where ailing state-owned enterprises exist next to private firms, either newly created or resulting from privatization; the state's direct control of the management will easily be turned into a "special" responsibility.

The question arises, how can the scope for government

policies beyond the macroeconomic sphere be defined? What should be done to stimulate a lethargic industrial structure, to develop industries that do not yet exist, to teach skills that are not available in the country, to create a social climate propitious to entrepreneurship, innovation and risk-taking?

Following the experience of industrial countries in the 1980s, structural policies are defined as actions that raise productive capacity and increase the flexibility of the economic system. They can raise potential output by improving the allocation of resources, by improving administrative efficiency, by promoting technological change, by improving the quality of factors of production and by eliminating financial market rigidities and tax distortions. By enhancing the flexibility of key prices, and particularly wages, structural policies can influence the way the economy is able to eliminate unemployment.

Similar ideas can be identified in the industrial policies of OECD member countries. They "favor policies with the potential of broadening the scope and increasing the effectiveness of markets while recognising that the primary responsibility for industrial development rests

with enterprises. Put another way, the policies are aimed at 'helping industry help itself'.<sup>2</sup>

Within this framework a variety of policies are pursued. Fiscal instruments are used to promote industrial investment. Public infrastructure investment raises the productivity of the private sector. Training and retraining measures are central in labour-related policies. Policies directed towards industrial sectors are primarily designed to improve the infrastructural environment within which firms operate and to reduce market distortions, rather than to be aimed at direct support. Nevertheless, some industries continue to be supported for social reasons or in an attempt to assist in restructuring. Deregulation and competition policies aim at focusing, clarifying and simplifying government policy. Trade liberalization and tariff restructuring ensure a competitive environment, and access to markets of industrialized countries allows export growth.

Their reconstruction needs are beyond the means of Central and Eastern European countries – in terms of

<sup>2</sup> OECD: Industrial Policies in OECD Countries, Annual Review 1991, p. 18.

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Rasul Shams

# INTERESSENGRUPPEN UND ANPASSUNGSKONFLIKTE IN ENTWICKLUNGSLÄNDERN

Fallstudie III Jamaika

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At the HWWA-Institute case studies are being conducted within the framework of a research project supported by the Deutsche Forschungsgemeinschaft (DFG), which are intended to enable statements based on empirical data to be made regarding the extent to which the conception and implementation of adjustment programmes tends to reduce or sharpen conflicts. The studies are based on the assumption that the success or failure of the adjustment programmes is determined decisively by the activities of interest groups. This third case study deals with Jamaica, which as a small island economy is particularly suited for an exemplary examination of the usual arguments regarding the conflict potential of adjustment policies. (Only available in German.)

VERLAG WELTARCHIV GMBH – HAMBURG

physical as well as human capital. Mobilising domestic savings must not be forgotten, but estimates and projections for the “needs” of Eastern Europe – without discussing their “realism” in detail – indicate that it is highly unrealistic to assume that the economies in transition can generate the flows necessary on their own. Privatization, investment and reconstruction will have to rely on the participation of foreign investors, which ultimately must be the main bearers of the technology and know-how needed for the transformation.

### **Foreign Direct Investment**

With respect to privatization, foreign direct investment (FDI) can contribute to financing and effective management decisions. Making a present of the state’s assets to its population will not provide the capital needed for replacement investment nor for the reconstruction over the next few years. Voucher privatization can easily lead to atomized ownership, preventing effective control of the companies with negative consequences for investment decisions.

FDI is also an efficient, perhaps even the best, way of overcoming quickly the lack of experience in Eastern European countries of acting in a market economy. The most important competence FDI could bring has to do with the capacity to organize large-scale production and international marketing. It can induce learning at all levels, allocate factors within the firm efficiently, reorganize production facilities and delivery systems and create a local subcontracting industry. Product design will be improved, quality control reinforced, and marketing channels and knowledge become readily available.

The impact of restructuring will not only be felt in those enterprises that have become the objects of FDI, particularly in the process of privatization. In a competitive environment, organizational competence will be diffused throughout the economy, for example by forcing other enterprises to learn quickly and to adopt, if they want to survive, or through labour mobility.

### **Policies to Attract FDI**

What is the best way to attract FDI? There is no such thing as a single theory of FDI that would allow us to determine what has to be done in the host country to make FDI happen. The various hypotheses emphasize different macroeconomic and microeconomic factors; although political stability, tax policy, and government regulations have sometimes been incorporated into the hypotheses, these factors have still received particular attention. Putting them into the perspective of the unique changes in

the economic, social and political situation in Eastern Europe, it seems rather obvious that the conditions for attracting foreign investors are largely identical with those that encourage domestic investment and rapid growth of the private sector.

FDI can easily become a source of mainly political controversy about issues such as national sovereignty and economic independence; there are numerous examples of similar discussions in developing and developed countries. Although still very small in actual numbers of projects and capital flows, FDI has started to cause some debate in Eastern European countries, too, where some early investment projects have been perceived as particularly favourable to foreigners.

Based on the notion of the important contribution FDI can make to economic development and growth the OECD has, over the years, developed instruments to facilitate the relationship between host countries and multinational enterprises. At the June 1976 Ministerial Meeting, OECD member countries adopted the Declaration on International Investment and Multinational Enterprises. Ever since, work in this framework has continued:

- ☐ The National Treatment Instrument requires that enterprises operating in a member country’s territory and controlled by nationals of another member country be no less favourably treated than domestic enterprises in like situations, i.e. that national treatment be accorded.
- ☐ The Guidelines for Multinational Enterprises are recommendations jointly addressed by the OECD governments to multinational enterprises operating in their territories. In setting voluntary standards of behaviour and practice, their objective is to provide guidance to multinational enterprises and to help ensure that the operations of these enterprises are in harmony with the policies of the countries in which they operate.
- ☐ The International Investment Incentives and Disincentives Instrument asks member countries to strengthen their cooperation in this field, to respect the interest of other member countries and to make such measures as transparent as possible.

The conditions related to the initial foreign direct investment and establishment in a country are subject to another OECD Instrument, the Code of Liberalization of Capital Movements, promoting the liberalization of international trade in goods and services and the freedom of capital movements. The Code is a legal instrument through which member countries are committed to maintain the existing degree of freedom for international capital movements and to pursue further liberalization in this field.