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REGIONAL COOPERATION IN THE ECONOMIC, SOCIAL
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Summary of the survey of economic conditions in the region
of the Economic Commission for Europe, 1993-1994

OVERVIEW OF THE TRANSITION ECONOMIES IN THE PERIOD 1993-1994

The level of output: depression and recovery

1. Nearly four and a half years after the collapse of the communist regimes in eastern Europe and the former Union of Soviet Socialist Republics, most of the region is still in a deep economic depression. However, in most of eastern Europe the fall in output last year was generally much smaller than in 1992 and for a number of countries there are clear signs of a recovery in activity. In Poland, gross domestic product (GDP) rose by 4 per cent last year, thus extending the recovery that had begun in 1992. There was also a significant recovery of total output in Albania where there has been a sharp increase in agricultural production. 1/ GDP also increased, albeit modestly, in Romania and Slovenia, while the data on industrial production suggest that the recession is levelling out in the Czech Republic and that output has been rising in Hungary. However, output has continued to fall with little respite in the southern European transition economies (except Slovenia and Albania) and especially in Yugoslavia and the former Yugoslav Republic of Macedonia. Altogether, total output in eastern Europe last year probably fell at a rate of the order of 3 per cent, which was less than half the rate of decline in 1992.

* E/1994/100.

2. In the Russian Federation and the other members of the Commonwealth of Independent States (CIS), the collapse in output continued virtually unchecked last year, with an average fall of some 13 per cent following a 20 per cent drop in 1992. In CIS the depression has been greatly intensified by the collapse of trade among the highly interdependent Member States. This was largely the result of a failure to overcome the monetary and payments problems that arose in the wake of the breakup of the Soviet Union and which finally led to the breakup of the rouble zone in the latter half of 1993. Most of the CIS members are thus facing an additional "trade shock" in the form of a large deterioration in their terms of trade with the Russian Federation and other suppliers of energy, as the latter raise their prices to world market levels, as well as interruptions in deliveries (especially of oil and gas) because of non-payment of debts and bureaucratic confusion in the inter-State distribution systems.

3. Similar problems, of higher prices and interruptions of oil and gas deliveries from the Russian Federation, were also disruptive in the Baltic States in 1990-1991, but since their departure from the rouble zone in 1992 production has been badly hit by the loss of markets in the successor States of the former Soviet Union. With the introduction of tough stabilization policies, the Baltic States have experienced some of the most severe depressions of all the transition economies. Nevertheless, there does appear to have been some levelling out of the decline in total output in Estonia last year.

4. Although not a single post-communist country has been able to avoid the long and deep recession 2/ that followed the political and economic revolution of 1989, there are very large differences among them in the extent to which they have suffered. In eastern Europe the recession has been relatively less prolonged in the Czech Republic, Hungary, Poland and Slovenia and, on current indications, a gradual recovery may now be emerging. These countries have progressed further in the transformation of their economies and in their integration within the larger European economy in terms of trade and foreign investment. However, despite the considerable progress that has been achieved, this "advanced" group of transition economies still faces considerable problems in the areas of macroeconomic stabilization, the privatization of large State-owned enterprises (see below) and the reform of the banking system. Moreover, it should be emphasized that many of the achievements so far are more likely to impress professional economists and international officials than the long-suffering electorates of the countries concerned. Even in this group, with the possible exception of the Czech Republic, there is still widespread disillusionment with the transition process and dissatisfaction with the fall in living standards: the essentially political task of organizing and maintaining popular support for the ultimate objectives of market-based economies and democratic institutions remains as urgent as ever. 3/

5. Although the present Survey focuses on economic questions, it should be emphasized that for many people in eastern Europe and the successor States of the former Soviet Union, the transition process appears to be a social crisis. In seven out of nine transition economies monitored by the United Nations Children's Fund (UNICEF), the crisis appeared most pronounced and general in the fields of poverty, mortality (particularly for males in the age group 40-59), marriage and birth rates, preschool education and youth, and overall crime, the data showing clear and sizeable deteriorations in each of these areas. The

situation appears to have stopped deteriorating in Hungary, Slovakia and the Czech Republic, but only in the last-named country are there any signs of a return to normal conditions. 4/

6. The recent recovery of activity in some of the transition economies must also be kept within the perspective of the depth of the recession: if Poland is able to maintain its current growth rate of some 4 per cent a year, still it will not be before 1997 that the 1989 level of output is surpassed. This is but a crude piece of arithmetic which ignores changes in the quality of output (and of consumption), but it nevertheless provides a broad indication of the scale of the problems facing national Governments.

7. In the other transition economies, the range and intensity of problems are somewhat greater, although the problems themselves are difficult to place in neat categories. Some of them (Albania, Bulgaria, Romania and the Baltic States, for example) have initiated major reforms and made significant headway, but their problems of adjustment and stabilization are such that they are even more vulnerable to set-backs than the "advanced" group discussed above. In many of the successor States of the former Soviet Union and the former Yugoslavia, the problems of economic transition have had to take second place while problems of political stability and national identity are addressed. Consequently, institutional transformation is held back and problems of economic stability tend to become acute.

8. It is sometimes tempting for observers in the Western market economies (and in international institutions) to conclude that the considerable variations in progress towards achieving a market economy reflect the degree of determination and consistency with which rigorous programmes of macroeconomic stabilization and structural reform are pursued. Political leadership and determination are of course very important ingredients in a successful reform, but the variation in performance among the transition economies is also greatly - if not predominantly - affected by more fundamental factors such as the weight of economic and political history, by geopolitical situations, and by the initial conditions under which the reform process began after 1989. The composition of the "advanced" group of transition economies might just as well have been predicted from their pre-1989 history as from their post-1989 efforts. Hungary and Poland had experimented with partial reforms oriented towards more market-based incentives long before 1989; the former Czechoslovakia (and later Slovakia and the Czech Republic) started the transition with the most balanced macroeconomic situation of any of the transition countries, 5/ an inheritance of the conservatism of the communist regime; while Slovenia, always the most prosperous of the Yugoslav republics and well known for the entrepreneurial drive of its population, also began the transition under relatively favourable macroeconomic conditions. The "leaders" were thus already ahead before the collapse of the Berlin Wall.

Changes in the structure of output

9. The transformation of the former centrally planned economies involves not only a radical restructuring of institutions and behavioural patterns, but also considerable changes in the distribution of economic activities. 6/ The liberalization of foreign trade and the adoption of decentralized price-setting

in free markets have led to large changes in the relative prices facing actual and potential producers of particular goods and services. Parts of the existing capital stock will be rendered unprofitable and will have to contract or be retired, while other, potentially more profitable, activities will attract new investment, domestic and foreign, which will lead to an expansion in productive capacity. This process is still in its early stages, and although the limitations of the statistical data prevent any detailed examination, some of the changes are already visible.

10. In terms of the broadest sectors of the economy the most apparent change in eastern Europe is the expansion of services. In the space of just two years (1990-1992) their share of GDP has risen by 7-8 percentage points in Hungary and Poland, and by even more in Bulgaria. The expansion of the services sector constitutes one of the most conspicuous breaks with the former, centrally planned regime and reflects not only the growth of small-scale enterprise in retail trade, restaurants, and so on (in part a result of successful privatization), but also the creation of new financial, legal and business services which have an essential role to play in a market economy. It is noticeable that in Belarus and Ukraine, for example - two countries where the transition process has made little progress - the share of services in total output is under half that in the more "advanced" reform countries of eastern Europe.

11. Changes in the relative importance of other sectors - agriculture, construction and industry - are more variable and it is difficult to generalize. That the construction industry has tended to contract rather faster than the economy as a whole in most countries is a reflection of the general collapse in fixed investment, the pressures to cut public expenditure (which in practice usually have a disproportionate effect on public investment), and the fall in house-building. In the medium term, this decline in the construction sector can be expected to be reversed given the potential for industrial restructuring, the need for extensive infrastructure investment, and the social pressures for a renewal of the housing stock. The sector is also suited to small- and medium-sized enterprises of which a very large proportion are already under private ownership. In the meantime, the construction sector continues to be restrained not only by the continuing weakness in total fixed investment, but also by the familiar transition problems of uncertain property rights, especially on land, continued price controls on private housing and office buildings, weak financial institutions, and bureaucratic delays in obtaining construction permits.

12. Agricultural output throughout eastern Europe and the successor States of the former Soviet Union has fallen every year since the transition process got under way. Apart from the vagaries of the weather, which hit output particularly hard in 1992, delays in land privatization and uncertainty surrounding property rights have had a depressing effect on output in a number of transition economies. Lack of financial resources for farmers as well as monopolistic distribution systems, which prevent producers from benefiting from higher retail prices for food, are also among the factors that are holding back the restructuring of agriculture and the expansion of private farms. In CIS, a highly mechanized and energy-intensive agriculture has been deeply vulnerable to the adjustment of prices to world levels: large price increases for

fertilizers, fuel and fodder have contributed to a considerable reduction in the output of meat and dairy products. 7/ Some eastern European agricultural exporters have also lost market share to heavily subsidized exports from western Europe and from the European Union (EU) in particular. The withdrawal of export subsidies on Western European exports to the transition economies would be a helpful initiative on the part of the EU 8/ and the opening of Western Europe's markets to agricultural products from the eastern countries would be an even more helpful one. Demands for agricultural protectionism are already strong in eastern Europe and tariffs on imports have been raised in a number of countries, including the Russian Federation. A more liberal approach by EU might therefore help eastern European Governments to avoid following the Western path to agricultural protectionism, which would effectively place a heavy tax on the newly emerging activities in the industrial and service sectors.

13. Within the manufacturing sector in the transition economies, there has been a general collapse of output in all industries, but some have clearly suffered much more than others. Among the hardest hit have been some of the traditional "heavy" industries - iron and steel, parts of mechanical engineering and chemicals, and so on - but also a number of "high tech" activities such as telecommunications. Among those relatively unscathed have been printing and publishing, clothing and processed foods. This general impression from the output figures is supported by the data on international trade. Exports of textiles, clothing and other labour-intensive products have done better than average, as have certain foodstuffs, chemicals (for example, fertilizers), timber products and other resource-based manufactures. Czech and Polish exports of machinery and electro-engineering rose strongly last year, and such exports also did relatively well in Hungary.

14. These observations refer to so short a period that to use them to draw strong conclusions about changing comparative advantages would not be justified. Nevertheless, the changes do suggest the following developments in the structure of industrial production in eastern Europe and the Baltic States: first, a shift away from excessive production of heavy capital goods towards more consumer goods; and second, an increased share in total output of labour-intensive and/or internationally standardized, intermediate products in the production of which the eastern European countries are relatively competitive on international markets. 9/ These changes are also likely to have been supported by changes in the pattern of domestic demand, since both relative price changes and falling real wages in most countries have probably led to the allocation of an increasing proportion of household expenditure to food and clothing.

15. The contraction of both traditional heavy industries and new, high-technology industries is not so surprising, since both were "protected" by the former central planning systems and by "soft markets" in other Council for Mutual Economic Assistance (CMEA) countries, particularly the former Soviet Union. However, the contraction of the more advanced activities has come as an unpleasant surprise for some eastern European policy makers who frequently emphasize the high quality of their educational systems. However, the production of high-tech products invariably requires not just high-level research and technical skills, but also a high degree of managerial competence and the ability to adapt products quickly to consumers' requirements. The production-driven culture of the centrally planned economy, where managers were

protected from outside competition by the planning system and from their own shortcomings by the soft budget constraint, simply did not favour the evolution of such managerial skills or the continuous interchange between producers and consumers with respect to both capital goods and "new" products that is characteristic of the Western market economies. Restrictions on Western technology exports may have had a negative impact on eastern European competitiveness in high-tech sectors but in comparison with the above-mentioned managerial shortcomings their effect is likely to have been minor. This conclusion, however, in no way condemns the eastern European economies to a low- or medium-tech future. Comparative advantage is a dynamic phenomenon which evolves in line with changes in the composition of the human and physical capital stock. Those changes are brought about by investment, the composition of which can of course be influenced, inter alia, by industrial policies.

The collapse of fixed investment

16. The restructuring of output in the transition economies has so far been largely a "negative" process, in the sense that some activities have survived the onslaught of depression better than others. The principal exception to this generalization has been in the rapid growth of services. Even "negative" restructuring has been limited in so far as many State-owned enterprises have survived with the continued supply of central government subsidies, and inter-enterprise credits, and through the reluctance of Governments to accept the employment consequences of illiquidity or a more rapid privatization (or closure) of large enterprises.

17. Eventually, restructuring must imply the expansion of activities in which the transition economies can develop existing and new comparative advantages, but this development will require a significant upturn and changes in the composition of investment in fixed and human capital. In general, economic growth in middle-income countries tends to be boosted by investment in plant and equipment, and supported by inflows of foreign direct investment. 10/ Recent research has also focused attention on the positive link between investment in machinery and economic growth, 11/ as well as on the positive role of public infrastructure investment in raising productivity, profitability and fixed investment in the private sector. 12/ In many of the transition economies, and especially in central and eastern Europe, the stock of human capital and skills is relatively high for current levels of income per head; but, as noted above, owing to the nature of the former regimes gaps have been left, particularly in the area of management skills. Also, although the formal qualifications and production skills of the labour force in many of the transition economies may be high, many of those qualifications and skills will become obsolete with the retirement of large parts of the capital stock and the introduction of market-oriented behaviour on the part of enterprises. Training or retraining of many sections of the labour force, from managers to operatives, is therefore needed in order to encourage a recovery of investment and the optimal exploitation of new technologies in a competitive market setting. Nevertheless, the development of investment in new plant and equipment is a fundamental requirement for the long-run restructuring of the transition economies and for a creating of the basis for a sustained expansion in economic activity.

18. For most of the transition economies, however, fixed investment remains in the deep slump into which it has sunk since 1989. Since then, gross fixed investment has fallen in eastern Europe by an average 40 per cent, and in the Russian Federation and Ukraine, and the Baltic States, by much more (56 per cent in the Russian Federation and Ukraine, and 80 per cent in the Baltic States). The data for 1993 are still in a very poor state and far from complete, but there does appear to have been some recovery of fixed investment in Poland (both in construction and equipment) and Hungary and perhaps of investment in machinery in the Czech Republic. Investment also rose by about 11 per cent in Slovenia.

19. Most of the available data refer to total investment and it is difficult to separate machinery and equipment from housing and other construction. However, the trade figures show a substantial increase in the dollar value of machinery imports into Poland (23 per cent) and the Czech Republic (23 per cent) in 1993. Imports of capital goods into Slovenia also rose by some 10 per cent. Since the dollar prices of machinery exports from the principal Western exporters were virtually unchanged or even falling for much of 1993, these changes in import values also indicate significant increases in volume. There was also a large increase in Hungarian imports of machinery last year, but as cars and other transport equipment were included in the figure the implication for fixed investment in Hungary is less clear. Statistics on the sectoral distribution of fixed investment are not easily available, but recovery does appear to be taking place in industry as well as in the new service sectors, and in the Czech Republic, Hungary and Poland there have been large increases in investment in telecommunications. If a revival of fixed investment is a litmus test of whether or not the reforms are beginning to yield concrete results, then these figures for machinery imports are an encouraging development for the "advanced" group of transition economies; but in all the other transition economies - that is to say, in the majority of them - fixed investment continues to fall rapidly, especially in the Russian Federation and in the other successor States of the former Soviet Union.

20. It should of course not be surprising that fixed investment in the transition economies has fallen to such an extent and that the signs of a recovery are still limited to the small group of "advanced" reformers in eastern Europe. The rapid breakdown of the old command systems and their only gradual replacement by the institutional framework of the market economy have created a situation of pervasive uncertainty in which the risks of investment are very high. In many of the transition economies there is still a lack of clarity about property rights and their enforceability and, in general, the legal framework is still too weak to support a sustained expansion in private economic activity. In addition, high rates of inflation, and uncertainty over the willingness or ability of the Governments of some transition economies to take the necessary measures to lower them, will discourage all but the most short-term investments. Political instability and the perversion of "market" activities and behaviour by crime and corruption will have a similar effect. Thus, if by the "transition process" is meant the creation of the basic legal and institutional infrastructure of a market economy and the appropriate alterations in the behaviour of economic agents, then private investment is unlikely to pick up until that process is complete or at least until business expectations show reasonable confidence that the end of the process is in sight

and unlikely to be reversed. It is precisely the strengthening of such expectations that distinguishes the "advanced" group of transition economies from the others.

21. There is also a general "development" problem that arises in countries where the total capital stock is either too small or too obsolete to generate significant external economies among competing enterprises. The international competitiveness of a modern enterprise depends to a large degree on its having access to a wide range of independent and specialized producers of components and materials and of business services, and where these do not exist new investments will be discouraged and, indeed, will tend to move to other locations where they are well established. A problem with virtually all of the transition economies is that the former regimes prevented the spontaneous development of the highly specialized division of labour that characterizes the Western market economies. 13/ This implies not only a considerable loss of efficiency gains in the past but also a major obstacle to a sustained revival of investment in the future. One way around this problem of externalities would be to encourage the simultaneous expansion of a number of activities in order to achieve a critical mass of demand which would then "extend the market" for other producers throughout the economy and thus encourage a general expansion of investment. An earlier example of such an approach was Monnet’s plan for the post-war reconstruction of the European coal and steel industries, but any suggestion of "indicative planning" is unlikely to get very far at the present time. Alternatively, investment demand could be increased via an expansion of public expenditure on the physical infrastructure (roads, railways, telecommunications, environment, and so on) which is in need of considerable improvement in all the transition economies and currently a source of major bottlenecks to investment and economic activity in general. However, this way forward is also heavily circumscribed because, partly, of pressures to reduce government budget deficits and, partly, of ideological antipathies to the States playing a significant role in economic development. However, the latter reaction may now be starting to change in response to the slow rate of transition in many countries (see below).

Foreign direct investment

22. One of the assumptions made by Western Governments and some international institutions was that private foreign direct investment (FDI) would play a key role in the transition process and that this would obviate the need for official assistance on the scale of, say, the Marshall Plan. So far this has not proved to be the case. The net inflow of FDI into eastern Europe has been much less than was expected - or hoped for - by both Western and eastern Governments. Last year the total is estimated to have been some $3.5 billion, and since 1990 the total inflow has been under $10 billion (for nine countries). Moreover most of the investment is concentrated on just a few countries: the four "advanced" transition economies have received over 90 per cent of the total since 1990, with most of it (80 per cent) going to Hungary and the Czech Republic. Negligible amounts, if any, have gone to other transition economies - successor States of the former Soviet Union. Not all FDI necessarily adds to productive capacity: in the first instance, foreign investors often buy existing assets, but there is a reasonable presumption that this will eventually lead to restructuring, fixed investment and increased capacities.

23. What is surprising about this performance is anyone's having thought it should have been so much better. Private investors do not normally get heavily involved in "transition processes" of the type under way in eastern Europe until the outcome is virtually assured. Foreign investors are deterred from making investments in the transition economies for many of the reasons noted above as holding back investment in general. In addition, foreign investors encounter a range of operational problems 14/ which, given the high risks and uncertainty of investment at present, may tip the balance against most eastern European countries as a location for FDI. Also, uncertainties over the macroeconomic outlook and the future level of demand in the transition economies add to the risks of long-term investment. 15/

24. Once the uncertainties over the market infrastructure are removed, the flow of FDI is likely to strengthen and, depending on the extent to which problems such as training are overcome, may play an important role in sustaining growth over the medium term. Nevertheless, foreign investors will be reluctant to move in before they see a reasonably high probability of success for the transition. Even in the countries that have received most of the FDI so far, a cautious "wait and see" approach is suggested by the fact that most individual investments have involved the commitment of only small amounts of capital. This limits the exposure of the foreign company to current risks while securing a market position on which expansion can be based when the outlook becomes less uncertain. The exceptions to this pattern usually occur when foreign companies are able to "buy" dominating positions in the domestic markets of the transition economies, the attractions of monopoly or oligopoly reducing the risks of current investment. 16/

25. One reaction by individual countries to the "disappointing" inflow of FDI into the transition economies might be to offer special incentives for attracting foreign investors. Such a response would almost certainly be a mistake. Numerous Organisation for Economic Cooperation and Development (OECD) studies of tax incentives for attracting FDI have failed to show any clear impact, although many countries believe that they have to introduce them for reasons of self-defence because other countries are doing the same. The main beneficiary in such a situation is usually the foreign investor who receives a windfall profit. Another "incentive" offered to foreign investors is protection in the host country's market with import quotas or high tariffs. This has already occurred in some of the transition economies and has sometimes been negotiated after the foreign investor proved to have been overoptimistic about sales. Clearly such action undermines the basic objective of the transition process which is to create efficient market economies. Moreover, such measures are likely to create costly distortions which will be difficult to remove once the foreign company is installed. The most appropriate response to weak FDI flows is to concentrate on the basic task of creating the essential infrastructure of the market economy, including an appropriate, non-discriminatory legal framework for foreign investment. 17/ Also, as many transition economies are relatively small, the foreign investor is drawn not so much by the size of the host country's domestic market as by its attractiveness as a base for reaching the much larger markets of eastern Europe and the successor States of the former Soviet Union as a whole. The avoidance of restrictions on, as well as measures to facilitate, intraregional trade can

therefore have an important influence in attracting FDI into the transition countries.

Official development assistance

26. In the absence of a significant boost to domestic fixed investment from FDI, it might be expected that official assistance and development bank lending would step in to fill the gap and offset the lack of private foreign investment in individual countries. Since 1990, official multilateral flows of new finance to the transition economies have in fact generally been larger than private capital, although last year private funds to eastern Europe were much larger than official flows. In the four years since 1990, the development banks' lending to eastern Europe has totalled some $5 billion, to which some $5.4 billion in official grants from Western Governments can be added. So official flows, excluding bilateral credits, were roughly equal to the total for FDI into eastern Europe. However, although details of disbursement are not available, just over 70 per cent of development bank commitments to eastern Europe were to the four "advanced" transition economies. The only "compensation" for FDI flows occurred mainly within this group, in so far as Poland received the largest share of the development banks' funds. Very few resources have gone to the successor States of the former Soviet Union. In other words, the countries that have achieved the most progress in the transition process have succeeded in attracting not only most of the private foreign investment available for the transition economies but also most of the official funds as well. They are also the eastern European countries with the highest levels of income per head. However, the needs of the less well-off countries are just as urgent and much less likely to be met by private investment. If the argument that their difficulties in getting an effective transition programme under way only reflects a lack of political will or determination is rejected, then a review of the scale and distribution of official assistance is urgently needed. It should also be remembered that the International Monetary Fund (IMF) approval of short-run stabilization programmes is usually necessary before development bank funds can be released for essential infrastructure investments.

Macroeconomic stability

27. The weakness of fixed investment in the transition economies is both a reflection and a cause of many of the rigidities that are holding back or slowing down the transition process in many of the eastern European economies. Without a strong recovery in fixed investment it will not be possible to achieve the extensive restructuring of the supply side of the economies which is essential for a sustained reduction of inflation to rates broadly comparable with those in Western Europe. At the same time, investment and the expansion of new activities are essential for creating new jobs to replace those destroyed in the course of restructuring uncompetitive, State-owned enterprises. Labour mobility is often low and so adjustment will require the help of training programmes and other active labour-market policies, as well as a socially acceptable level of unemployment benefits. However, because the traditional instruments of fiscal and monetary policy are still deficient or inadequate in most of the transition economies (a reflection of their transitional state), most of the burden of stabilization policy is being placed on reductions in

government expenditure. Given the absence or narrow scope of domestic bond markets and limited access to foreign borrowing, large budget deficits are therefore likely to exacerbate inflationary pressures. Increasing tax revenue is inhibited by underdeveloped tax-collection systems and widespread tax avoidance, especially by the new private sector. However, cutting expenditure presents Governments with painful dilemmas: public infrastructure investment is already very low and further cuts would reduce the contribution of the international development banks' expenditure in this area; 18/ reducing social security benefits at a time of sharply rising unemployment is politically dangerous; and a sharp cut in subsidies to ailing State-owned enterprises will lead to a large increase in unemployment with further demands for unemployment benefits and the risk of social instability. The challenge for both domestic and international policy makers is thus to find ways of spreading the burden of adjustment among a wider range of policy instruments and of easing the resolution of some of these dilemmas.

Unemployment

28. There was a slow reaction in terms of unemployment to the introduction of reforms in 1989 and 1990, but since 1991 unemployment has risen sharply and is now a major economic and social problem in the transition economies. In eastern Europe there were about 7.6 million persons unemployed at the end of 1993, and this figure represented nearly a threefold increase since the end of 1990. As a proportion of the labour force, the average unemployment rate is around 14 per cent, although individual values range from 3.5 per cent in the Czech Republic 19/ to 30 per cent or so in the former Yugoslav Republic of Macedonia and in Albania.

29. In the Russian Federation, in the other CIS countries, and also in the Baltic States, official unemployment rates are still exceptionally low given the large falls in output although unemployment has started to increase sharply in the Baltic States. These low levels of official unemployment, which range between 0.2 and 1.3 per cent in CIS (except in Armenia where the rate was 6.2 per cent), reflect to some extent the slow rate of structural change in many parts of the successor States of the former Soviet Union, 20/ but there are also grounds for believing that the statistics are greatly distorted. In the Russian Federation, the official unemployment rate at the end of last year was 1.1 per cent of the labour force, but an alternative official estimate puts it at just over 5 per cent, while unofficial "guestimates" yield a figure of over 10 per cent.

30. Unemployment on the present scale in eastern Europe would be a serious problem in any country, but it is particularly disturbing in that previous experience of it was virtually non-existent and Governments are still without an effective strategy for industrial and labour-market restructuring. At the same time, Governments are being forced to reduce the social protection given to the unemployed because of the macroeconomic pressures to reduce overall spending. Not only has unemployment benefits as a proportion of the average wage fallen considerably in all the transition economies since 1991, but the proportion of the unemployed actually entitled to benefits has also been sharply reduced. Rough estimates for six eastern European countries suggest that, on average, only about 30-40 per cent of the unemployed are entitled to a benefit that is

equivalent to about one third of the average wage. 21/ In the Russian Federation, the unemployment benefit is equivalent to about 30 per cent of the official minimum subsistence income. This helps to explain why workers are prepared to accept periods of unpaid leave, since they remain attached to the labour force and retain access to the social support system of the enterprise, 22/ and why the Government is reluctant to face the social consequences of a more rapid restructuring of the large State-owned enterprises.

Inflation

31. The slow pace of restructuring and privatization of large State-owned enterprises is one of the factors behind the persistence of high inflation rates in all the transition economies. Price liberalization generally went ahead rapidly while monopolistic structures remained in place to provide a persistent source of inflationary pressure. At the same time, the range and efficacy of the instruments available to transition economy Governments have been limited. Nevertheless, there has been some success either in avoiding hyperinflation 23/ (Poland in 1990, Estonia and Latvia in 1992-1993) or in containing the after-shocks of price liberalization (most notably the Czech Republic). However, inflation rates still remain high even in countries that have had the most success in lowering them, and in none of the transition economies have annual rates been established in single digits. With respect to the four "advanced" transition economies, prices rose by just over 20 per cent last year in both the Czech Republic and Hungary, and by some 37 per cent and 33 per cent in Poland and Slovenia respectively. The figure for Poland represents a slight improvement, but that for Hungary hardly any. Slovakia was the only other transition economy with an inflation rate within this 20-37 per cent range. Changes in the trend of inflation are difficult to establish because of the introduction of or increases in value-added taxes during the course of 1993, in some cases accompanied by temporary price controls, but for the Czech Republic, Slovakia, Hungary, Poland and Slovenia the underlying rate has perhaps stabilized at around 15-20 per cent a year, and at a maybe somewhat higher figure in Poland. This stickiness of the rate of inflation raises the question - or the dilemma - whether to continue attempts to further reduce it at the cost of more unemployment or to try to revive growth and investment in the hope that rising productivity and a faster rate of structural change will help to reduce inflationary pressure. To some extent Poland has attempted to follow the latter course, with some success, although how far the acceleration in the rate of inflation towards the end of 1993 was due to seasonal rather than more fundamental factors is unclear. One important aspect of the current situation, particularly in the "advanced" group of reformers, is that having seriously underestimated both the costs and the duration of the transition period, Governments now have an increasing credibility problem with respect to workers whose resistance to further cuts in real wages is growing.

32. In all the other transition economies the inflation problem was markedly worse than in the central European countries and in general tended to worsen during the course of 1993. In Yugoslavia, hyperinflation continued unchecked. Inflation in the other Balkan States, for which data are available, ranged last year from just over 70 per cent in Bulgaria to 350 per cent in the former Yugoslav Republic of Macedonia.

33. Despite widespread fears a year or so ago, the Russian Federation has managed to avoid the descent into hyperinflation. The monthly rate of inflation during much of 1993 ranged between 20 and 26 per cent per month, although there was a sharp deceleration at the end of the year as a result of a tightening of monetary policy. In virtually all the other CIS States, inflation in 1993 was over 1,000 per cent and was generally deteriorating throughout the year, especially in the second half after the collapse of the rouble zone. Although in some cases special factors such as price liberalization created sharp jumps in the price level, by the middle of the year a number of republics, including Georgia and Ukraine, had passed or were dangerously close to the threshold of hyperinflation.

External balance

34. An unexpected development in 1993 was the sharp deterioration in the current account balances of all the central and eastern European countries except the Czech Republic. The principal source of the deterioration was located in the trade balance where, in general, export growth fell while imports grew, in many cases substantially. 24/ All the eastern European exporters were faced with much weaker demand in western Europe, now their largest single market, but the variation in performance (from falls of 13 and 16 per cent in value for Bulgaria and Hungary respectively to growth of 7 and 17 per cent in Poland and the Czech Republic respectively) suggests that domestic supply-side factors, including the extent of exchange rate overvaluation, have played a major role. 25/

35. The growth of imports also varied considerably, from under 1 per cent in Bulgaria to about 25 per cent in Poland, but here the changes are more closely related to differences in the growth of output and domestic demand. The growth of imports of capital goods has already been noted in a number of countries but there was also a rapid growth of consumer goods as well, particularly in Poland and Slovenia where personal consumption grew by some 10 per cent or so.

36. With the exception of the Czech Republic, all the eastern European countries had current account deficits last year, the largest belonging to Hungary ($3.5 billion), Poland ($2.3 billion) and Romania ($1.5 billion). In the immediate future there does not appear to be an urgent problem in financing those deficits, although Hungary may find it difficult to finance another deficit of the size of last year’s. The recent debt reduction arrangements for Bulgaria and Poland should make it easier for them to obtain financing. However, the question of sustainability is likely to become more urgent in the course of 1994, particularly for countries where export performance has been weakening and private consumption pulling in increasing volumes of consumer goods. For countries entering a period of restructuring and development it is perfectly normal, indeed desirable, to run current account deficits, and as long as the foreign borrowing is seen as being used to expand productive capacity there should be few difficulties in sustaining the deficit over a number of years. However, perceptions of country and area risk may still deter private lending and so the international financial institutions must be ready to move quickly to meet any shortfall in funding. In assessing the justification of particular deficits some sensitivity to the needs of the domestic population is required. Not all consumer goods can be regarded as "unnecessary" for promoting

development, but eventually some of the transition economies will have to give greater attention to policies designed to shift domestic demand in favour of investment.

37. The situation in the Russian Federation is very different from that in eastern Europe. Russian exports continued to rise a little last year while imports fell by some 27 per cent, and the current account moved into a surplus of some $15 billion. A number of factors were behind the fall in imports, including weak domestic demand and the depreciation of the rouble, but the main reason for the fall was a large reduction in "centralized" (and subsidized) imports owing to the squeeze on government expenditure. It is likely that the implied sharp cuts in the supply of subsidized imports to Russian enterprises had a significant negative effect on the level of domestic output.

Restructuring and privatization

38. The process of privatization is central to the entire process of transforming the former centrally planned economies into decentralized market economies. (Although a market economy without private ownership is possible, this has never been considered politically feasible in the transition economies.) "Privatization" is a description as much of the objective of the transition process as of a means of achieving that objective. The progress of privatization - and especially of privatization policies - has closely reflected the changes in mood and thinking that have marked the transition programmes since 1989: an initial euphoria and expectations of rapid change based on an oversimplified analysis of the likely obstacles, followed by disappointment and disillusion when progress proved to be much slower and the costs of adjustment more painful than expected, leading gradually to a more pragmatic approach to highly complex and interdependent problems.

39. In the immediate aftermath of the revolutions of 1989 the quickest route to the market economy was seen in the rapid transfer of State-owned enterprises to private owners. The Government's role would be to ensure macroeconomic stability - employing "shock therapy", if necessary to deal with inflation and government deficits - and the construction of the legal and institutional framework required for a market economy to function efficiently. In this framework, the Government would promote allocative efficiency by cutting subsidies to enterprises, liberalizing prices, and opening the economy to foreign trade and competition. The improvement of productive efficiency within individual enterprises would result from the restructuring and investment activities of the new private owners among whom, it was hoped, would be a significant number of foreign companies bringing with them new technology, a new managerial ethos, and capital to supplement the limited supply of domestic savings. Thus, from the point of view of government, privatization and restructuring were regarded as virtually synonymous.

40. This non-interventionist approach to restructuring former centrally planned economies, with a strategic role for FDI, was widely supported in the early stages of the transition by both eastern European and Western Governments. The presumption that the creation of new incentives for capital, labour and management would be sufficient to lead to rapid change was naturally attractive to the new Governments in eastern Europe which, not surprisingly, wished to

distance themselves as quickly as possible from the institutions and behaviour patterns of the former regimes. Even when advisers were less sanguine about the likely rate of progress, there was considerable reluctance to contemplate an active role for government in the restructuring process: the bureaucracy was deemed at best incompetent to judge the future viability of individual enterprises and the nature and scale of the required restructuring; at worst, it might be tempted to frustrate the reforms and turn the clock back. These attitudes reflected the more general antagonism between the official and private realms that characterized the former communist regimes throughout eastern Europe and the former Soviet Union. 26/ Western Governments also found this approach attractive: not only did it agree with the anti-interventionist spirit of the 1980s but it also played down the need for large amounts of official financial assistance. The emphasis would, instead, be on technical assistance, especially for creating the institutions and skills required for the private business sector to operate, which in turn would increase its attractiveness to foreign investors.

41. Thus the initial approach to privatization in the former German Democratic Republic, the Czech Republic, Hungary and Poland, 27/ was to sell State-owned enterprises as quickly as possible, preferably as entities, and to keep the State out of any form of micro-economic intervention. The mood was caught by a Polish minister when he declared that the best industrial policy was no industrial policy.

42. There is no doubt that considerable progress has been made with privatization in most of the transition economies. "Small" privatization, together with the creation of new private businesses (many of them small family concerns), has led to a rapid expansion of private enterprise. In terms of total output and employment the share of the private sector is somewhat smaller than its share in the number of enterprises, but its growth is still impressive: from 29 per cent of GDP in Poland to 47 per cent in 1992; and from virtually zero in the Czech Republic to around 50 per cent in 1993.

43. Although attention is often focused on the "advanced" group of transition economies, this should not disguise the fact that there has been significant progress elsewhere, although it is often uneven. In Albania and Romania, a significant proportion of agricultural land has been returned to private ownership; and in Albania, about half the number of State farms have been privatized; but in neither country has there been any significant progress in privatizing the industrial sector, although in Romania the legislative framework is in place. In Bulgaria, land reform has moved slowly and few State-owned enterprises have been privatized although, as in Romania, the relevant enabling laws have been passed. In all three countries, private ownership has progressed quickly in retailing and services, although most concerns are very small; in the industrial sector, however, privatization has been slow. A major reason for this apart from fairly common problems such as the high levels of indebtedness of many State-owned enterprises is lack either of popular support or of agreement among the governing parties.

44. Although there has been much pessimism over the progress of reforms in the Russian Federation, the privatization programme has in fact been moving very quickly and is one of the most successful elements in the transformation

process. The first wave of privatization in 1992 concentrated on small enterprises (the ones employing less than 200 people) and 85 per cent of these are estimated to have been privatized by the end of 1993. 28/ In 1993, the mass privatization of medium- and large-sized enterprises got under way on the basis of voucher auctions 29/ and more than 2,200 were auctioned in the first half of the year. Many of the enterprises are now owned by their managers and workers who obtained their companies' assets at very low prices. This may eventually give rise to problems of corporative governance, but for the present the privatization agency 30/ is achieving its objectives of a rapid transformation of property rights.

45. The success of "small" privatization in the transition economies has had a major impact on the lives of private citizens and on the appearance of public places: the availability, range and quality of goods in the shops and of personal services have greatly improved, even if a significant proportion of the population is unable to afford them; and encouragement has been given to the emergence (or re-emergence) of an entrepreneurial middle class. Nevertheless, the share of output and employment accounted for by large State-owned enterprises remains considerable and they continue to dominate the industrial sectors. While the initial, "model" approach to privatization worked well enough with small enterprises, it has had relatively little success with large State-owned enterprises: the problems of turning them over to private ownership are proving exceptionally difficult and this is one reason for a general slow-down in the overall pace of privatization. The slow-down, in turn, has complicated the problems of macroeconomic stability, not least in the area of public expenditure, and is a brake on the recovery of fixed investment.

46. The original plan to sell or close down State-owned enterprises quickly ran into a number of major obstacles: first, it proved difficult to find buyers for large enterprises, many of which were unwieldy conglomerates, with high levels of debt and considerable structural problems; second, the application of Western-style bankruptcy and liquidation procedures, even when the necessary legislation had been passed, turned out to be inappropriate in a situation where the bankruptcy of one enterprise could set off a chain reaction of failures because of the high levels of inter-enterprise debt; finally, and in any case, the number of potentially non-viable enterprises was often so large that Governments were simply unwilling - or rather unable - to accept the political and budgetary implications of a sudden and massive rise in unemployment. Given the specialized regional division of labour under many of the former communist regimes, single enterprises often dominated a town or a locality so that their bankruptcy would threaten to devastate a region. Since most of the large State-owned enterprises were also the biggest clients of the banks under the old regime, the latter now have balance sheets that are so full of bad debts that many of them would probably be declared insolvent under Western banking rules. The banks are therefore unable to play a constructive role in the restructuring of industry and of the economy as a whole.

47. Governments (or the relevant privatization agencies) have tended to run into these problems one after the other and consequently have been drawn, often reluctantly, into a direct and active role in the financial restructuring of individual enterprises and, from there, into broader industrial and regional policies. The Hungarian and Polish Governments and the German Treuhand (the

public trust authority charged with reorganizing and selling what had been State-owned enterprises in the former German Democratic Republic to domestic and foreign investors) have all travelled down this road. The dangers of a piecemeal approach to the problems of restructuring is that Governments will become too responsive to political and sectional pressures and thus risk undermining reforms by sustaining non-viable enterprises and non-entrepreneurial behaviour. On the other hand, if government policy is too tough, the hard-budget constraints will still be put at risk by the threat of too many bankruptcies and the encouragement of management and labour to stiffen their resistance to change. The experience of the Treuhandanstalt (the establishment, of the Treuhand) in privatizing State-owned enterprises in the former German Democratic Republic is both instructive and salutary for the other transition economies. Among the important lessons appear to be the following: first, financial restructuring is necessary before privatization, but debt reduction should not go beyond the normal gearing ratios in a market economy; second, clear and specific policies are needed to identify the potentially viable components of large State-owned enterprises; third, persistent effort to examine alternative routes to viability is important in order to retain employee support for restructuring and can lead to innovations such as the Management KG (limited partnership); fourth, a clear distinction needs to be made between the minimal degree of financial and organizational restructuring required to find buyers for the enterprise and strategic restructuring (decisions about net investments, new products, and so on) which should be the responsibility of the new owners. The Treuhand experience demonstrates not only that the hardening of enterprise budget constraints is not synonymous with the absence of government involvement but also that effective restructuring is unlikely to occur without the intervention of government or its agents. 31/

48. Restructuring and privatization have been much more extensive and been carried out more quickly in the former German Democratic Republic than in any other transition economy; but the lessons for other countries may also be difficult to apply. That the Treuhand’s efforts were supported by massive infrastructure investments in the eastern Länder (States) by the federal Government improved the locational attractiveness of the east for firms of the former Federal Republic of Germany; furthermore, financial restructuring involved a shift in a proportion of enterprise debt to the federal budget and the German taxpayer, but even in Germany, the Treuhand has had to face a shortage of managerial talent. Of course, the scale of the problems facing the Treuhand was greatly increased by the speed at which German monetary union took place: German wages in the former German Democratic Republic rose rapidly towards Western levels while productivity remained at the previous, relatively low level, thus making much of the capital stock unprofitable. Nevertheless, the success of the Treuhand, as well as the current difficulties of other transition economies, suggests the need for a coordinated strategy incorporating a clear, depoliticized policy towards enterprise and industrial restructuring, including specific measures to reduce the burden of accumulated enterprise debt; a programme to recapitalize the banks and to privatize them; and a significant increase in infrastructure spending on transport and communications. Since most of the transition economies would need outside help to pursue these objectives, they effectively constitute a set of priorities for revised programmes of official assistance.

The outlook for 1994

49. The recovery that got under way last year in several countries of eastern Europe now seems very likely to continue in 1994. Growth is set to continue in Poland at around 4 per cent and a recovery is expected to emerge in Slovenia and the Czech Republic with growth rates of perhaps 1-2 per cent. The outlook is more problematic for Hungary, where forecasts range between a continued fall in output and a mild recovery, and for Romania where the recent austerity programme agreed with IMF seems likely to produce zero growth this year. In Bulgaria and Slovakia, large domestic imbalances imply at best a year of stagnation or even another fall in output. In the successor States of the former Yugoslavia, other than Slovenia, the fall in output is likely to continue, although, in Croatia at least, at a lower rate than last year. Altogether, aggregate output in eastern Europe might rise in 1994, perhaps by a modest 1 per cent, but it would be the first year of growth since the collapse of the old system.

50. There seems to be little chance that the decline in output in the Russian Federation and most of the other CIS countries will come to an end in 1994. In the Russian Federation, the key question is whether the paralysis in macroeconomic policy, which has characterized most of the past year, can be overcome in order to provide some chance of meeting the targets, recently agreed with IMF, for reducing inflation and the federal Government's budget deficit. If the deficit target is met, the probable reduction in subsidies to State-owned enterprises might lead to a much larger cut in output than the 6-7 per cent reduction currently envisaged by the Government. If the deficit target is not met, the chances of a significant fall in the inflation rate are reduced and the continued supply of IMF funding is placed at risk. In Ukraine and Belarus there seems little prospect at present of any effective macroeconomic stabilization programmes being put into place and neither the fall in output nor the extremely high rates of inflation - which were moving across the threshold of hyperinflation in the last quarter of 1993 - are likely to be halted in the near future.

51. In eastern Europe, the economic recovery in a small group of countries is a great relief to policy makers, but it must also be recognized that it is still very fragile and, given the depth of the recession, very modest as well. Inflation rates and budget deficits remain high and government policies are still constrained by the need to reduce them. Moreover, the recovery of domestic demand has led to a rapid deterioration in the external accounts of many countries. There are a number of reasons for this, including in some cases an overvalued exchange rate; but it also seems likely that in the early stages of recovery a transition economy will have a high propensity for importing both capital and consumer goods, because of the limitations of domestic production capacity. At the moment the countries most affected do not appear to be facing immediate difficulties in financing their current account deficits, but typically this is a situation that can change very quickly.

52. As far as the external economic environment is concerned, there should be some improvement in 1994. In Western Europe, economic growth is expected to pick up to some 1.5 per cent after falling by 0.1 per cent in 1993. Although there is quite a wide range of forecasts for Germany, GDP growth in this all-important market for eastern European economies is likely to be some

0.5-1 per cent this year, and this would represent a modest but distinct improvement over the 1.3 per cent fall last year. Although the recovery in the Western market economies is exceptionally slow compared with previous upturns, there should nevertheless be a recovery in import demand; also, inflationary pressures are expected to remain weak and, together with continuing intense competition in world markets, this should help keep the dollar prices of machinery and other imports into the transition countries fairly stable. Economic recovery in the West may also help to weaken the forces demanding protection from eastern European imports - or to stiffen the resistance of the authorities to such demands.

53. A major improvement in the external economic environment was the successful completion last December of the Uruguay Round of multilateral trade negotiations. 32/ Its major achievements were the creation of the World Trade Organization (WTO), which finally provides the third pillar of the international institutional framework envisaged by Maynard Keynes at Bretton Woods in 1944; and the extension of the General Agreement on Tariffs and Trade (GATT) rules and disciplines into new or previously exempt areas. GATT's coverage is now much more extensive, in the coverage both of trade and of trading countries.

54. The transition economies will benefit from the strengthening of GATT rules and authority, especially if this leads to much stricter control of anti-dumping procedures and other forms of contingent protection.

55. Previous issues of the Survey and the Economic Bulletin for Europe have expressed repeatedly the view that both the volume and the coordination of international assistance for the transition economies have not been commensurate with the scale and complexity of the problems to be overcome. That view is now shared by a growing number of observers, many of whom have expressed increasing concern over the past year at the rapid deterioration of the economic situation in a number of transition economies, especially among the successor States of the former Soviet Union, and the associated risks of social and political instability. However, these outbursts of anxiety often lead to hasty promises of action and assistance which either fail to materialize or fall considerably short of expectations. The perception of a growing gap between the rhetoric of assistance and its reality is a source of disillusion for much of the population in many of the eastern European countries and provides useful ammunition to the various groups opposed to the transition process itself.

56. A proposal that addresses some of the concerns expressed by the Economic Commission for Europe (ECE) secretariat was made recently by the Director-General of GATT. Emphasizing the need for a new, high-level framework to coordinate communication and cooperation on economic matters, he stated the issue by posing the question why discussions in the Group of Seven, OECD, GATT, the World Bank, IMF, the European Bank for Reconstruction and Development (EBRD) and so on, on the problems of the Russian Federation, for instance, should occur simultaneously but in comparative isolation from each other. The Director-General of GATT added that this might be reasonable if it were particularly effective; but he did not think - especially on the trade side - that those discussions had done much to answer even the Russian Federation's problems. 33/

57. Another indication of increasing concern at the inadequacy of existing arrangements and policies is that the Commission of the European Union is currently engaged in a fundamental reassessment of its policies towards central and eastern Europe. Among the proposals apparently being discussed are the following: one to channel more aid into infrastructure projects and another to reduce or eliminate subsidies on EU exports of foodstuffs to transition economy markets. 34/

58. However, it is vitally important that improved mechanisms for international coordination address not only the question of avoiding duplication among the many sources of international assistance but also the more fundamental issues of coordinating short-term stabilization with long-term structural adjustment programmes and of targeting aid within coherent national programmes for economic reconstruction and development. Such programmes are needed not only to demonstrate coherence in a Government's various policies for effecting the transition, which is inevitably a long-term operation, but also to generate a better understanding of the aims of the transition process on the part of national electorates whose support is essential for success. It is also vital to insist, thereby echoing the wisdom of the Marshall Plan administrators in the late 1940s, that such programmes for economic transformation are the primary responsibility of the countries themselves. This acknowledges not only that national administrators are usually better informed about local economic conditions than outsiders, but also that such programmes are political and social ones reflecting national preferences for one set of social and institutional arrangements over another. To regard the transition process simply as an economic problem that can be left to technical experts is to risk the loss of popular support for the entire process of reform. Nevertheless, to obtain international assistance, national programmes will need to be seen as coherent and as having a good chance of success. Such evaluation should be transparent and carried out in an international framework, such as that noted above, and along the lines of the peer-group examination of the post-war Western European programmes that took place within the Organisation for European Economic Cooperation (OEEC).

59. Another advantage of an improved international structure to coordinate the efforts of all the actors, both national and international, in the transition process, would be the promotion of a more rapid adjustment of assistance in order to confront key problems and bottlenecks as they arise. A number of problems have already been mentioned that require urgent attention. These include the interrelated issues of enterprise indebtedness, the solvency of the banks and the restructuring of large industrial enterprises, as well as the need to improve the physical infrastructure. Not all of these were anticipated four years ago and it is reasonable to assume that unforeseen obstacles to the transition will continue to arise. A framework in which an annual review of progress in the national transition programmes could be conducted in an open and rigorous manner would help not only to improve coordination but also to increase the flexibility and speed of response to the changing needs of the transition countries.

60. It would be unwise to assume that these proposals are now unnecessary for those countries where a recovery of output is under way. As is stressed in the present Survey the problems of structural change and macroeconomic stability are

still considerable in these economies, and the fragility of the recovery could soon be tested by the increasing resistance of the labour force to further reductions in real wages. It would be more prudent to assume that new problems will arise rather than that they have all been overcome.

61. The signs of a serious reappraisal of the policies of international assistance for the transition economies are well timed and very welcome: if they lead to concrete action in dealing withe the broader issues of coordination raised in the Surveys published over the past four years, they will help to consolidate the fragile recovery of the leading transition group of countries and improve the chances of the others, eventually joining it.

Notes

1/ Albania, probably the poorest country in Europe, was in a catastrophic state just two years ago and largely dependent on humanitarian aid for essential food supplies. Radical reforms were introduced very rapidly after the elections of March 1992 and Albanian farmers appear to have responded quickly to price liberalization and privatization of most of the country’s agricultural land.

2/ There are many reasons for doubting the accuracy of the output and other statistics in the transition economies at present, and it is possible that the official figures overstate the depth of the fall in output. Until the national statistical offices revise the data, the extent of the errors will essentially remain unknown, but it seems unlikely that the slump in output will be revised statistically to constitute a mild recession.

3/ On the weakening support for economic reforms, see Economic Commission for Europe, Economic Survey of Europe in 1992-1993 (United Nations publication, Sales No. E.93.II.E.1), chap. 1.

4/ UNICEF International Child Development Centre, Central and Eastern Europe in Transition - Public Policy and Social Conditions. (Florence, November 1993), p. 3.

5/ Students of the longue durée (long view), will note that the Czech Republic emerged from the collapse of communism in 1989 in much the same condition as it escaped from the wreckage of the Austro-Hungarian Empire in 1918, namely, with low inflation, small foreign debts and a balanced budget.

6/ Some aspects of changes in the structure of ownership are discussed later in this summary; and a detailed review of four countries’ experience in privatizing State-owned enterprises is contained in chapter 5 of the present Survey.

7/ However, livestock production, based on subsidized, imported fodder, had been boosted to artificially high levels in the successor States of the former Soviet Union by the policies introduced under Brezhnev. The withdrawal of central government subsidies on imports of feed grains was therefore bound to lead to a fall in meat production.

8/ A small step in this direction is the Economic Commission for Europe's decision to temporarily withdraw subsidies on EU exports of apples to the Czech Republic. An extension of such a policy to other products and markets is apparently under discussion. See Financial Times (London), 7 March 1994.

9/ Until more detailed statistics are available, it is difficult to tell whether the growth in machinery exports, noted above, conforms to this pattern of characteristics or is an exception to it.

10/ See Magnus Blomström, Robert Lipsey and Mario Zejan, What Explains Developing Country Growth?, National Bureau of Economic Research (NBER) Working Paper, No. 4132 (Cambridge, Massachusetts, 1992).

11/ See J. Bradford de Long and Laurence H. Summers, "Equipment investment and economic growth: how strong is the nexus?", Brookings Papers on Economic Activity, 2 (1992), pp. 157-211.

12/ Alicia Munnell, "Infrastructure investment and economic growth", Journal of Economic Perspectives, vol. 6, No. 4 (fall 1992), pp. 189-198; also, the same author's "Why has productivity growth declined? productivity and public investment", New England Economic Review (January/February 1990), pp. 3-20.

13/ This is reflected, for example, in the fact that the level of intra-industry trade among the members of CMEA remained very much lower than that among the countries of Western Europe and, especially, of EU. See Z. Drabek and D. Greenaway, "Economic integration and intra-industry trade: the CMEA and the EEC compared", Kyklos, vol. 37 (1984). A political scientist has remarked that "unlike liberal capitalist democracies, Leninist regimes 'parcel' rather than 'divide' labour ... The net effect was a division of labour that in important respects resembled Durkheim's mechanical division of labour, a 'ringworm' division of labour in which each institution attempted to replicate the self-sufficiency of all the others" (see Ken Jowett, New World Disorder. The Leninist Extinction (California, University of California Press, Berkeley, 1992), pp. 289-290).

14/ These differ considerably from country to country. For a very useful survey of the problems facing foreign companies in eastern Europe, including an attempt to weight the various factors increasing the risk of investment, see Pietro Genco, Siria Taurelli and Claudio Viezzoli, "Private investment in central and eastern Europe: survey results", European Bank for Reconstruction and Development Working Paper, No. 7, July 1993.

15/ The uncertainty over the level of demand was one factor that was removed in the former German Democratic Republic by massive transfers from the federal Government, and this provided an incentive to invest, especially in activities devoted to the local market.

16/ Some foreign investors, however, might be deterred from entering countries where domestic investors are thin on the ground, since this would make them more vulnerable to possibly hostile action by Governments. This consideration might be more important for long-term bond markets where the absence of domestic holders may increase the risk of default.

17/ A warning of the dangers of encouraging inflows of foreign investment before the basic structures of the market economy were in place and functioning was given in the Economic Commission for Europe, Economic Survey of Europe in 1989-1990 (United Nations publication, Sales No. E.90.II.E.1), sect. 1.2.

18/ The banks usually fund 50-60 per cent of infrastructural projects, but the balance has to be met from domestic resources. Of their total commitments to eastern Europe since 1990, about 25 per cent has been for infrastructure projects in roads, other transport and telecommunications.

19/ The low rate of Czech unemployment, given the fall in aggregate output, continues to intrigue observers, but no one has yet provided a fully satisfactory explanation. Among the factors suggested are a loss of jobs among a large number of workers already above retirement age, who then left the labour force rather than join the unemployment register; very tight eligibility rules for unemployment benefits, as well as the introduction of youth-training schemes, which have also kept down the numbers on the unemployment register; low real wages and the slow rate of restructuring large State-owned enterprises, which have encouraged enterprises to retain labour; and a substantial increase of output and employment in small private enterprises (in services, tourism, and so on) which may not be fully reflected in the official statistics.

20/ But for evidence that the changes in Russian industry have been greater than is often assumed see Guy Standing, Labour Market Dynamics in Russia in 1993: Results from the Third Round of the Russian Labour Force Survey (RLFS) (Budapest, International Labour Organization, Central and East European Team, February 1994).

21/ Although not strictly comparable, this fraction is considerably lower than the replacement ratios (of unemployment benefit to previous disposable income) to be found in the countries of Western Europe and North America. See Economic Commission for Europe, "The cost of unemployment, 1972-1982", Economic Bulletin for Europe, vol. 35, No. 3 (1983), pp. 289-306, table 3.1 (Oxford and Elmsford, New York, Pergamon Press for the United Nations).

22/ See Economic Commission for Europe, Economic Survey of Europe in 1992-1993 (United Nations publication, Sales No. E.93.II.E.1), chap. 1. Unpaid leave, rather than unemployment, also carries with it the hope of regaining one’s job (see Guy Standing, op. cit., p. 22). There is also the prospect of participating in the distribution of free shares in the event of privatization.

23/ Conventionally defined as a monthly rate of increase of 50 per cent.

24/ There are still considerable problems surrounding the collection and estimation of trade data in the eastern European countries, and the published figures have been subject to considerable revisions in the past year.

25/ The exports of a number of countries - especially Bulgaria, Romania, Hungary and Slovenia - were also adversely affected by international sanctions against Yugoslavia.

26/ See Ken Jowett, op. cit., pp. 284-294.

27/ These are the four countries for which case-studies of restructuring are presented in chapter 5 of the present Survey.

28/ PlanEcon Report, vol. IX, Nos. 44 and 45, p. 39.

29/ For a description of this programme, see Bozidar Djelic and Natalie Tsukanova, "Voucher auctions: a crucial step towards privatization", Free Europe/Radio Liberty (RFE/RL) Research Report, vol. 2, No. 30 (23 July 1993), pp. 10-18.

30/ The State Committee for the Administration of State Property (Goskomimushchestvo).

31/ On the need for transparent industrial policies in transition economies, see Economic Commission for Europe, Economic Survey of Europe in 1992-1993 (United Nations publication, Sales No. E.93.II.E.1), chap. 1.

32/ For a review of the negotiations and an analysis of the Draft Final Act, see Economic Commission for Europe, Economic Bulletin for Europe, vol. 45 (1993) (New York and Geneva, 1994), chap. 6, pp. 3-5.

33/ "Global trade - the next challenge", address by Peter D. Sutherland to the World Economic Forum, Davos, 28 January 1994. The text was published in GATT, News of the Uruguay Round (NUR 082), Geneva, 28 January 1994.

34/ As reported in Financial Times, London, 7 March 1994.
