The Outlook for Central and Eastern Europe

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In this fall of 1991, as the former constituents of the Soviet Union struggle to define new political identities and to avert economic disaster, it is worth considering the situations of some of the countries that emerged earlier from behind the Iron Curtain. Czechoslovakia, Poland, and Hungary have renounced communism. Their citizens enjoy freedom of speech, assembly, and travel. As prices are permitted to change in response to market conditions, currencies exchanged, and foreign businesses welcomed, their economies are improving. East Germany no longer exists as a separate country, but as part of the democratic, market-oriented Germany. The Czechs, Poles, Hungarians, and former East Germans have a future full of hope.

This hope was recognized by the international community in the awarding of the Karlsprize to Vaclev Havel in Aachen in May. Both President Mitterand and Aachen Mayor Linden, in their laudatory remarks, referred to the ideals of a free, democratic, and united Europe. Havel, in his acceptance speech, recognized the value of freedom and democracy in moral terms and also emphasized that the freedom of Czechoslovakia was part of a historic trend: „the self-liberation of the populations of Central and Eastern Europe from the chains of totalitarian systems, and the return to the values from which they were forcefully separated....“

The awarding of the prize to Havel is significant not only because of his moral leadership, but because it highlights the fact that some countries in Central and Eastern Europe are on the road to improved political, social, and economic conditions, while others are not. In the reform-oriented countries of Czechoslovakia, Hungary, and Poland, both the political leadership and the people are pursuing visions of improved societies. These visions may not be clearly defined, but, judging by the political and economic liberalization that has taken place, they are far from blurry.

As part of Germany, Eastern Germany is a full-fledged part of the European Community (EC) and, of course, democratic and market-oriented. Although conditions in this part of Germany are significantly different from those in Western Germany, special programs have been initiated by the German Government to close the economic gaps between the western and eastern parts of the country.

In other countries – Bulgaria, Romania, Albania, and Yugoslavia – whatever positive change may have occurred is hardly noticeable. Ethnic tensions are tearing Yugoslavia apart; refugees are fleeing Albania; and communists remain in power in Romania, while both Bulgaria and Romania continue to suffer economic and political stagnation.

In this article, we review some of the positive changes that have taken place recently in Central and Eastern Europe, outline Western efforts to support reforms, and suggest likely future developments – as well as concerns.

Positive Changes

In evaluating the progress of Central and Eastern European countries, it is important to note that there is no accurate set of economic indicators to chart trends over a long period of time. While it would be nice if there were such indicators, and it is often convenient for economists to assume that past indicators are accurate, in fact:

• GNP data have been political fiction.

• There have been significant black market economies that cannot be estimated properly.

• High party officials have stashed away uncounted but certainly significant sums.

• Even now, as significant reforms have been undertaken in various countries, the statistical machinery is not capturing much private-sector activity.

Nevertheless, there have been several positive developments. Most important, the reform-oriented countries are permitting private ownership of property and productive enterprises. Furthermore, they are creating formal legal and economic frameworks to support a competitive economic environment. As a result, in all these countries one can find operations ranging from mom-and-pop stores through small computer and bicycle stores to large-scale automobile ventures such as that between Skoda and Volkswagen in Czechoslovakia. In Poland, some 80 percent of all retail trade is conducted by private enterprises. Western businesses flocked (and were welcomed) to Hungary in 1989-90 in such droves that the period was commonly referred to as a „gold rush.“ And in Czechoslovakia it has been estimated that the number of small businesses has increased from 15,000 to 300,000.

Why are Western firms eager to set up businesses in these countries? There are several reasons:

• Labor costs in the former East Germany, Poland, Czechoslovakia, and Hungary are significantly lower than those in Western Europe, while the motivation of the labor force is significantly higher.

• There are generous tax relief and/or investment subsidies available for Western businesses that come to the former East Germany and the other reforming economies. In Eastern Germany, for example, a combination of investment grants, subsidies, and tax relief programs can save businesses up to 33 percent of their initial start-up costs. For a summary of programs in other countries, see Exhibit 1.

Exhibit 1

Regulations Governing Foreign Investment in Eastern Europe

Country	*Legal framework*	**Types** ***of business permitted***	***Foreign participation permitted***
Soviet Union	Resolution of December 2, 1988, by the Council of Ministers of the Soviet Union „on the further development of foreign trade activities by state-owned, cooperative and other collective operations, associations and organizations“ Order No. 203 by the Council of Ministers of the Soviet Union of March 7, 1989, „on measures for state regulation of external economic activities“ Law of the Soviet Union of June 14, 1990, on the taxation of companies, associations, and organizations Decree of October 26, 1990, by the President of the Soviet Union on foreign investment in the Soviet Union	No distribution-sector companies, except if expressly permitted by the Ministry of Foreign Economic Relations; joint ventures may export only products they manufacture and import goods only to cover their own needs	No upper ceiling; single proprietorships also permitted
Poland	Law on economic activity involving foreigners passed on December 23, 1988, and amended in December 1989 Order issued by Minister of Foreign Economic Cooperation on December 23, 1988 Draft amendments of February 19, 1991, awaiting decision by the *Sejm* (parliament)	All types of economic activity; no restrictions whatsoever (manufacturing, construction, trade, and services) Target: to lift all instances of required approval, with the exception of sectors such as transportation, energy supplies, real estate trading, and mining	Companies only, no single proprietorships; foreign share must be at least 20 percent; no upper ceiling; minimum overall foreign capital contribution of 25 million zloty Target: to lift all restrictions
Yugoslavia	Law on companies dated December 29, 1988 Law on Foreign Investments dated December 30, 1988	Virtually all areas	No upper ceiling; single proprietorships also permitted

Profits, taxation, tax relief	*Tax exemptions*	*Profit transfers*	*Special provisions*
Joint ventures with a foreign share of up to 30 percent: 45% of annual profits; with foreign share of over 30 percent: 30 percent of annual profits (10 percent in the far east of the U.S.S.R.). These provisions apply within the profitability standard set by the Supreme Soviet. Special rates apply to profits that exceed these levels: 80 percent for less than 10 percentage points; 90 percent for more than 10 percentage points. In the future, special regulations will apply in individual constituent republics of the U.S.S.R.	For joint ventures with a foreign share exceeding 30 percent, for the first two years after recording a profit (three years in Far East economic regions)	Transfer of profits earned in hard currency permitted; 15 percent withholding tax on profits transferred abroad	Joint ventures with a foreign share exceeding 30 percent enjoy losses carried forward for five years, assuming their reserve fund does not suffice to cover the losses.
40 percent tax relief on export profits; minimum tax rate of 10 percent Target: 30 percent	Three to four years; up to six years for activities in preferential areas as designated by the Council of Ministers Target: tax exemption only for investments exceeding 2 million ECUs and for specific industries	No restrictions on hard-currency profits resulting from exports; staged plan permitting unlimited profit transfers to be phased in from January 1, 1993, through January 1, 1998 Target: to lift all restrictions on profit and dividend transfers	
Profits taxes vary from region to region (35 percent, 16 percent, 15 percent, 14 percent, and 10 percent). In the case of reinvestment of up to 50 percent of distributed profits, tax relief varying by region from 50 percent to 90 percent is granted.		No restrictions on profits earned by the company itself *(con*	Debt/equity swaps possible; investment incentives in some federal republics *(continues on following pages)*

Exhibit 1 (continued)

Regulations Governing Foreign Investments in Eastern Europe

Country	***Legal framework***	**Types of business *permitted***	***Foreign participation permitted***
Romania	Law No. 3/1979 of July 6, 1979, amending and supplementing Law on economic agreements No. 71/1969 Law passed on March 13, 1990, concerning measure to attract investment of foreign capital in Romania	Industry, agriculture, construction, tourism, scientific and technological research, banking services, insurance, and all other areas of economic significance	No upper ceiling; no single proprietorships
Czechoslovakia	Law passed on November 23, 1988, concerning companies with foreign capital participations Amendment of April 1990	No restrictions	No upper ceiling
Hungary	Law No. XXIV of December 22, 1988, regulating investments by foreigners in Hungary Amendments passed in 1990, in force since January 1, 1991 Law No. VI of October 1988 on business enterprises	No restrictions	No upper ceiling; single proprietorships also permitted
Bulgaria	Decree No. 56 of January 9, 1989, concerning economic activity Implementing regulations for Decree No. 56 of February 15, 1989	No restrictions	No upper ceiling; single proprietorships also permitted

Source: Rebuilding Eastern Europe, *Deutsche Bank*

Profits, taxation, tax relief	*Tax exemptions*	*Profit transfers*	*Special provisions*
30 percent Profits are tax-free for the first two years; tax relief of up to 50 percent may be granted in the third to fifth years of business. Tax reductions of 50 percent are given on profits reinvested (also in third companies) for at least five years.	A company is not subject to tax for a period of two years after first recording a taxable income.	The foreign partner's Leu-denominated profits may be converted into foreign exchange and transferred in the order of up to a maximum of 8 percent of his share in the paid-in capital.	No customs duties are levied on non-cash capital contributions by the foreign partner. Up to 5 percent of pretax profits may be placed in a reserve fund each year until the amount set aside equals 25 percent of capital invested.
20 percent tax on income of up to 200,000 Czech crowns; 40 percent on any additional income above this figure, 55 percent for banks and insurance companies. The Ministry of Finance may approve tax relief for a maximum of two years.	The Ministry of Finance may approve tax exemption for a maximum of two years.	No restrictions on profit transfers from a company's foreign exchange	Reserve fund to be set up from after-tax profits, with a minimum annual contribution of 5 percent until equal to 10 percent of overall assets. Part of the reserve fund must be covered by foreign exchange.
Tax relief of 60 percent for the first five years, 40 percent for the second five years if foreign share is at least 30 percent and original capital exceeds 50 million forints	Tax exemption for five years, 60 percent exemption for the following five years for industries of national significance (such as vehicle construction, machine building, packaging, pharmaceu-ticals, and pesticides)	No restrictions	No approval procedure; sole requirement is local commercial registration and duty to report to Ministry of Finance Exception: business activities in specified areas, such as the finance sector Real estate can be acquired if needed for business operations.
30 percent on joint ventures and corporate subsidiaries 40 percent in the case of self-employment or commercial agencies on behalf of foreign persons 20 percent on activities in free economic zones	Five-year tax exemp tion for joint ventures in „areas of advanced technology"; five-year tax exemption on activities in free economic zones	No restrictions on profits earned in foreign exchange	Five-year timeframe for accumulated losses carried forward

• Setting up operations in one of these countries is an excellent way to enter other European markets. For example, setting up a business in the former East Germany means having access to both the European Community and former COMECON countries. General Electric entered into a joint venture in Hungary with Tungsram in part to position itself in Eastern Europe. And although the economies of Eastern European countries are underdeveloped, as they grow stronger, consumer demand will grow.

While the governments in these countries have been successful in permitting the funding of private enterprises, they have been sluggish in transforming state companies into private enterprises. Hungary was the first country to bring about this transformation through a process of „spontaneous privatization“ that enabled company management boards to turn state-owned companies into joint stock corporations and sell them to interested buyers. However, this effort was not very successful. Similarly, Czechoslovakia’s and Poland’s efforts to convert state companies into private companies have met with only limited success. Poland, for example, has converted only nine firms. In Yugoslavia, Albania, Romania, and Bulgaria, although there are scattered instances of private activity, a firm commitment to privatization has not emerged. Either the governments are not taking the necessary measures, or the countries are near civil war.

Germany, in contrast, has had considerable success with such conversions. By the end of August, 1991, 3,378 formerly state-owned companies had been privatized, as had nearly all 30,000 retail outlets.

Monetary Reform. In order for the Central and Eastern European economies to participate fully in the world economy, it is necessary for these economies to have convertible currencies. This feature enables foreign firms to conduct transactions efficiently and also enables domestic firms to sell their goods efficiently in world markets. In the past two years, nearly all the Central and Eastern European countries have taken steps toward currency convertibility. As in other developments, Poland, Hungary, and Czechoslovakia are ahead of other countries in this area.

Poland has had since early 1990 a single uniform zloty exchange rate for convertible currencies that applies to both commercial and noncommercial transactions. This rate was the result of a devaluation program that was designed to bring the exchange rate down to a realistic level. After this devaluation, exports to the West rose by 28 percent. As of April 1991, the official and black market exchange rates were virtually identical – a sign that the transaction rate is close to market equilibrium. Companies and individuals are permitted to exchange zloty at the official rate for hard currency. There are plans to maintain a constant exchange rate against the dollar for an unspecified period.

In Czechoslovakia, the crown is now convertible after several devaluations. In the future, exchange rate policies are likely to be based on a basket of five currencies, weighted primarily toward the deutsche mark (40 percent share) and the dollar (30 percent share). Also included will be the Austrian shilling, the Swiss franc, and the pound sterling. While companies may be permitted to maintain foreign exchange accounts, there are restrictions on the amounts that private individuals can exchange for foreign currency per year.

Hungary’s official rate for exchanging the forint for Western currencies is based on a basket of 10 currencies. This exchange rate has been devalued on various occasions. The Hungarian forint is less convertible than the Czechoslovakian crown or the Polish zloty, and this is reflected in black market rates exceeding official exchange rates by 15 to 20 percent. However, in late 1990, the Government adopted a program designed to achieve complete convertibility by the end of 1993. At present, commercial banks are permitted to accept and maintain foreign exchange deposits from domestic and foreign individuals. Exporting firms are still required to transfer their foreign exchange earnings to the national bank, although foreign firms with operations in Hungary are permitted to repatriate their profits in hard currency.

Price Reforms. An essential element in any economic program designed to bring about increased efficiency and ultimately a higher standard of living is a price structure that reflects supply and demand dis equilibriums. Without such a price structure, an economy is prone to chronic shortages and oversupplies, as demonstrated by the experience of all communist economies. Removing all price controls immediately, however, can lead to severe poverty in the short run. In Hungary, for example, where prices increased 17 percent in 1989 and 29 percent in 1990, an average Hungarian family with two children spends some 85 percent of its income on basic living expenses (rent, municipal rates, food, and transportation).

In 1990, general price increases in Central and Eastern Europe ranged from 14 percent in Czechoslovakia to 800 percent in Poland. In Czechoslovakia, prices of non-basic food items have been permitted to flow freely, although basic food prices have not been liberalized. We anticipate that losses of purchasing power will be only partially compensated for by wage increases. Because of the various subsidy cuts and price liberalizations, inflation rates of 30 to 40 percent are expected for 1991.

In Hungary, drastic cuts in price subsidies for foods, fuels, and public services – coupled with increasing unemployment – are creating hardship. The Government is also in the process of turning state enterprises into private operations. Further cuts in agricultural subsidies and consumer goods are expected in an effort to fulfill an International Monetary Fund (IMF) mandate to limit the budget deficit. The Hungarian Government has forecast that, as prices continue to be decontrolled, inflation will reach 35 percent in 1991.

Price controls in Poland have been largely eliminated except in the housing and energy sectors. A strict program has been implemented to reduce the budget deficit, virtually eliminate all price controls, and establish a consistent anti-inflationary monetary policy. Economists monitoring the situation in Poland report there are no longer shortages of goods. Furthermore, inflation, which at one point had reached close to 80 percent per month, is now less than 10 percent per month. The budget has also been balanced. These factors point to a stabilizing of the Polish economy.

As controls are lifted, price surges and high inflation levels may diminish popular support for reform efforts. On the other hand, prices that reflect consumer demand and actual costs are needed in order to realign inefficient economies. It is easier to produce needed goods with a profit motive than without a profit motive.

Western Efforts to Enhance Reform

As the economies in Eastern and Central Europe encourage foreign investment through formal legal frameworks, a loosening of restrictions, and various tax and investment subsidies, Western businesses have shown interest in establishing operations in these markets. Western governments also have taken measures to enhance reform efforts through financial assistance, foreign debt relief, and the establishment of the European Bank for Reconstruction and Development.

During the transition to a market economy and integration into the world economy, these countries need Western capital. But hard currency debts totaling an estimated $140 billion at the end of 1990 make it difficult for these governments to meet balance-of-payment obligations. This, in turn, diminishes their creditworthiness and discourages foreign investments.

The debt situation in Poland has improved dramatically due to a decision among leading industrialized countries to forgive half of Poland’s $3 5 billion debt; the United States agreed to forgive 70 percent of Poland’s official debt. As Poland complies with IMF mandates, continues to increase its exports, and continues to increase its current account balance, it should be able to service its remaining debt.

Hungary, which has not had a major debt relief program, has nevertheless made progress in improving its ability to service its debt. One reason for this is the sharp increase in its hard currency earnings. In 1989, Hungary had a deficit in its current account of $1.4 billion. In what Deutsche Bank economists have described as a „stunning reversal,“ Hungary achieved a $1.6 billion turnaround in 1990 and ended with a surplus of $160 million. Hungary has adopted measures that strongly suggest that its debt service position will improve even further.

In other countries, the situation varies. Debts are low in Czechoslovakia and Romania, where the ratios of net debt to exports of goods and services in 1990 were 0.2 and 0.7, respectively. In Bulgaria, which has stopped servicing its debt, this ratio is very high at 4.4.

In view of the financial difficulties facing these countries during their transition, the Group of 24 industrialized countries (G-24) and multinational organizations have committed close to 27.6 billion European Currency Units (ECUs), or approximately $37 billion, to various Eastern European countries. Exhibit 2 contains a breakdown of the amounts. The EC is in charge of coordinating the aid commitments of the G-24 countries and is assisting the Eastern European countries in improving their food supply situation, expanding technical expertise in their economies, and protecting the environment. But just as important are the trade agreements that the EC negotiates with respective Eastern European countries. Lowering trade barriers gives firms more markets for their goods. Poland, Czechoslovakia, and Hungary hope for eventual admission into the EC.

A third approach by Western governments to help these countries is the establishment of the European Bank for Reconstruction and Development. Founded in May 1990, this bank’s mandate is to promote investment in the reform-oriented Eastern European countries and improve their competitiveness. Thirty-nine countries are members of the bank, which plans to support private companies and to help privatize state-owned enterprises.

The Outlook

Of the states discussed in this article, the new German federal states will be the first region to attain a standard of living similar to that in Western Europe. This is because of the investment initiatives that the economically powerful Federal Republic of Germany has undertaken to assist this region and the fact that these new German federal states are fully included in all aspects of the European Community. Both these facts make Eastern Germany an attractive investment site for Western firms that hope to position themselves in Eastern and Western Germany.

Hungary, Czechoslovakia, and Poland have also undertaken concrete measures to improve their economies. Hardships in these countries are due in large part to the economically disastrous situation in the Soviet Union. These countries were closely tied to the Soviet economy, both as a market for their exports and as a source of raw materials, so that its decline has meant a decrease in Hungarian, Czech, and Polish exports. On the other hand, the opening of these markets to the West means that Western firms can avail themselves of the advantages of establishing operations in these countries. The outlook for these countries is very good, if current trends persist.

Exhibit 2

Economic Assistance to Eastern European Countries

	Commitments mid-1989 to January 30, 1991 (ECU billions[1])		
Recipients	***Members of G-24***	***Multilateral organizations***	***Total***
Poland	5.9	1.8	7.7
Yugoslavia	0.2	1.2	1.4
Romania	0.3	0.1	0.4
Czechoslovakia	0.8	0.3	1.1
Hungary	4.0	1.1	5.1
Bulgaria	0.2	0.2	0.4
Unallocated	11.5[2]	—	11.5
Eastern Europe	22.9	4.7	27.6
Of which: loans	9.1	4.7	13.8
grants	13.8[2]	—	13.8

[1]*ECU 1 = approximately $1.35, early March 1991*
[2]*Including ECU 8.2 billion in share capital from the European Bank for Reconstruction and Development*

Source: "Rebuilding Eastern Europe," Deutsche Bank Economics Department

In sharp contrast, Yugoslavia, Bulgaria, Albania, and Romania offer little reason for optimism at present. Social unrest, coupled with the rigidity of inefficient structures, makes it impossible to attract enough serious investors to fuel the economy.

Future Concerns

Europe stands today on the brink of a new arrangement. The first question facing Europeans is whether this arrangement will be a peaceful and democratic one; the second is whether this arrangement will be a prosperous one that enables all European citizens to share a decent standard of living.

The governments of the Group of Seven leading industrial countries need to make a strong commitment to providing political and economic support to the developing democracies in Eastern and Central Europe during the transition to democratic institutions and free economies. Such a commitment would help these countries avoid the conditions that permit demagoguery to flourish. In the past century, both communism and fascism have failed. Active Western involvement in the transition process can help prevent them from emerging again.

A first step that Western governments must take is to further incorporate the reforming countries into world markets. In addition, political and economic support should be contingent on respect for human rights and commitment to market-based economic systems. The moment to assist the populations in these countries is now. Failures in this region of Europe have had disastrous worldwide ramifications twice during this century. A success in this region of Europe could have worldwide ramifications of a much happier sort for the next century.

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