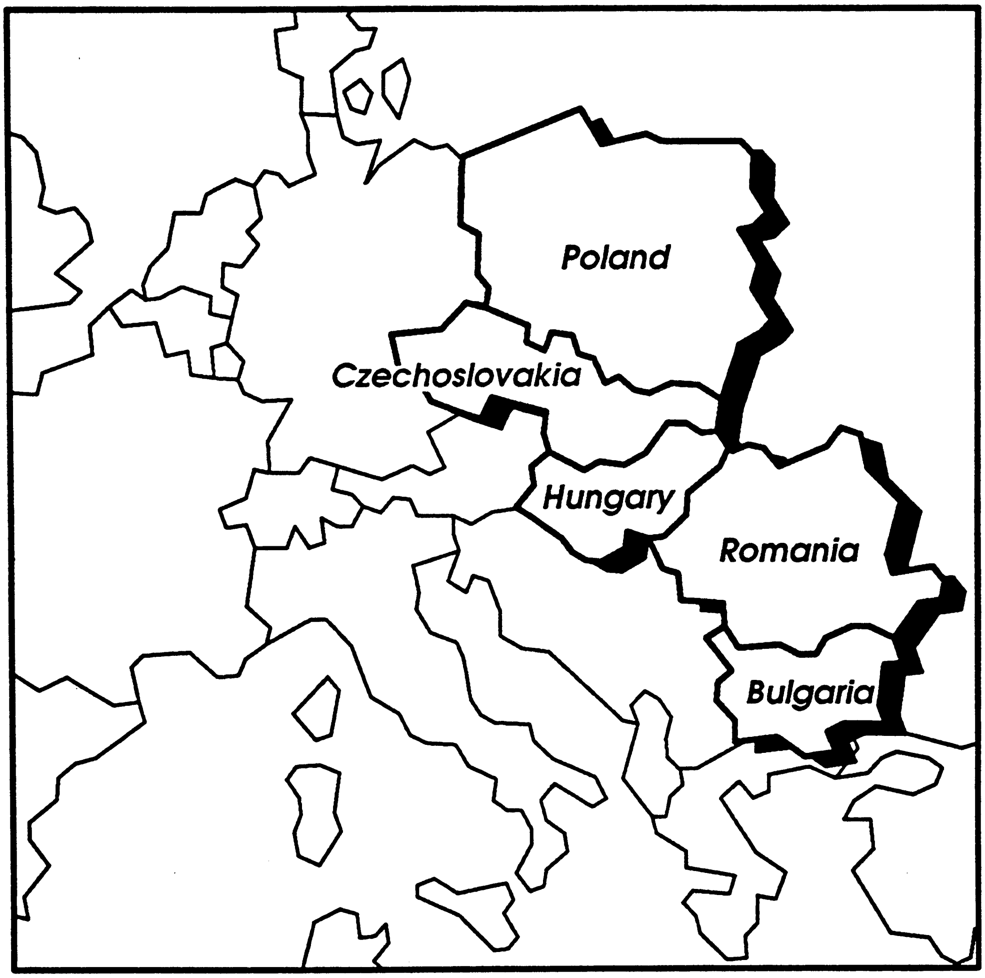
Summary Report

Central and Eastern Europe:



Export Competitiveness of Major Manufacturing and Services Sectors

Investigation No. 332–308

USITC Publication 2452
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United States International Trade Commission · Washington DC

UNITED STATES INTERNATIONAL TRADE COMMISSION

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PREFACE

This is a summary of the study requested by the Office of the United States Trade Representative to assess the export potential of major manufacturing and services sectors in Central and Eastern Europe (CEE).[1] A copy of the full report, "Central and Eastern Europe: Export Competitiveness of Major Manufacturing and Services Sectors" (USITC Publication 2446) is available upon request from the United States International Trade Commission, Washington, DC 20436.

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[1] At the request of the Office of the United States Trade Representative (USTR), the United States International Trade Commission instituted Investigation No. 332-308, "Central and Eastern Europe: Export Competitiveness of Major Manufacturing and Services Sectors" under Section 332 (g) of the Tariff Act of 1930. A notice of investigation was published in the *Federal Register* on Mar. 20, 1991, and a copy of the notice was posted in the Office of the Secretary, United States International Trade Commission.

Introduction

The shift toward market oriented economies in Central and Eastern Europe (CEE)[1] will undoubtedly affect the mix of commodities produced and traded by this region. The future competitiveness of specific sectors in these countries, therefore, is of considerable interest to prospective competitors and consumers in the world market place. At the request of the United States Trade Representative, the U.S. International Trade Commission undertook a study of one aspect of the larger issue of the evolving competitiveness of this region, i.e., the export potential of major sectors in CEE countries. To make that assessment, this study focuses on four crucial areas:

- Economic reform: The status of economic reform in each of the CEE countries is discussed, including important background for the assessment of the competitiveness and export potential of these countries.

- Foreign aid and investment: Recent foreign aid programs and foreign investment patterns are examined to discern the extent and direction of this assistance, which could add to the competitiveness of sectors that are export oriented.

- Infrastructural deficiencies: Particular attention is given to deficiencies in the industrial infrastructure and in business-related services. The purpose of this is to identify those areas that hinder the export potential of the CEE economies.

- Export potential: Summary profiles of 12 select industries, assessing the export potential of each are provided as a conclusion to the report.

The findings of this report are based on (1) published CEE government directives and statistics and (2) information gathered from interviews with and reports by industry experts, independent analysts, government officials, and the staff of international organizations.

Economic Reform Activity In Central And Eastern Europe

All five of the CEE countries have made firm commitments to move from nonmarket to market-oriented economic management.[2] They have promulgated reform measures to replace the institutional framework of central planning with indirect macroeconomic controls. Nevertheless, the implementation of reform measures varies among these countries, and the shape their economic systems will eventually take over time is unknown.[3] Table 1 provides a list of the major elements of the reform programs; and, the current status of the various reform measures in each of the five countries is provided in table 2. Because the timeliness and the sequence in which reform measures are implemented is considered important, figure 1 provides some indication of the estimated time frame opportune for the adoption and implementation of select elements.

This study focuses on the extent of reform in three areas that are crucial to the increased competitiveness of CEE industries:

- directing or managing the economy;

- trade and investment;

- ownership.

Directing the Economy

The extent to which each of these countries has succeeded in demolishing the old and creating a new management system may be determined by (1) the reduction in the state's direct control of the economy and by (2) the progress made in establishing an institutional framework for indirect economic controls.[4] This section assesses the progress made in these two areas.

Reduction in the Direct Control of the Economy

Reduction in the state's direct control of the economy can be evaluated in terms of reduction in the state's ownership of industrial assets and by the reduction in its active management of resource allocation. Reduction in the state's active management of resource allocation is measured in this report by the decline of producer subsidies[5] as a percentage of the national budget, by the increase in market generated prices versus administratively determined prices, and by the decline in the percentage of centrally allocated investment in the country's total investment spending.

The reduction of both state ownership and active management of resource allocation varies among the CEE countries. Poland and Hungary embarked on radical economic reforms during 1990 and

[1] For the purposes of this study, CEE encompasses five countries: Bulgaria, Czechoslovakia, Hungary, Poland, and Romania.

[2] Organization for Economic Cooperation and Development (OECD) analysts, interviews with USITC staff, June 17-18, 1991.

[3] Ibid.

[4] The Commission was aided in the development of the methodology to assess decline in the state's direct control over the national economies of CEE countries by OECD analysts and by a visiting fellow at the Brookings Institution.

[5] The word "subsidy" is a direct translation of the term used in the budgets of the five countries. The "subsidies" here appear to be domestic and not necessarily export oriented. The use of the term in this context should not be interpreted to mean that such subsidies are within the meaning of the U.S. countervailing duty law (19 U.S.C. 1303, 1671 et. seq.).

Table 1
Major Elements of the Economic Reform Programs in CEE Countries

1. *Macroeconomic Stabilization and Control*
   - Implementation of stabilization programs
   - Creation of tools and institutions for indirect macroeconomic control, monetary and fiscal
   - Measures to reduce reliance on state support
   - Dealing with existing problems (monetary overhang, financial system bankruptcies)

2. *Social Safety Nets* (Assistance to alleviate the economic consequences of stabilization and reform policies)

3. *Institutional Reforms: Human Capital and Administrative Capacity*
   - Legal and regulatory institutions
   - Business management, including financial sector
   - Government decision-makers and administrators
   - Information systems (accounting and auditing)

4. *Price and Market Reform*
   - Domestic price reform
   - International trade liberalization
   - Distribution systems for products
   - Creation of market for housing
   - Wages
   - Interest Rates

5. *Small-and Large-Scale Enterprise Restructuring and Privatization*
   - Management system
   - Allocation of property rights
   - Agricultural land
   - Industrial capital
   - Housing stock
   - Social protection and insurance rights for individuals

6. *Development of Financial Markets and Institutions*
   - Banking systems
   - Other financial markets

Source: Paper presented at a conference sponsored by the Organization for Economic Cooperation and Development, Center for Cooperation with the European Economies in Transition, November 1990.

Czechoslovakia during early 1991.[6] Although Bulgaria and Romania have stepped up their reform efforts during 1991, they currently appear to have advanced less than Poland, Hungary, and Czechoslovakia with respect to these measures.[7]

Progress in Establishing the Indirect Control of the Economy

A CEE government's indirect control of its economy can be measured by the progress it has made in creating an extensive commercial banking system and a relatively independent central bank capable of conducting monetary policies as in a market economy.[8] All CEE countries have made important strides in establishing a two-tier banking system, but none of them has fully succeeded in creating the conditions required for conducting monetary policies in a market economy.[9] State ownership is still predominant in commercial banking systems throughout the region, as measured by the overwhelming weight of state-owned banks in holding old loans and extending new ones.[10] Even the new, completely privately owned banks do not yet compete with one another or with other financial institutions (e.g., the savings banks) for deposits.[11] Many unprofitable, state-owned enterprises awaiting liquidation or divestiture have loans at predominantly state-owned commercial banks in all five countries. As a result, these banks are at least partially dependent on budget allocations to carry the non-performing loans.[12] Finally, the central banks in all five countries are heavily involved in the direct financing of the government. Therefore, they cannot be considered independent from the governments in power.[13]

[6] OECD analysts, interviews with USITC staff, June 17-18, 1991.
[7] Ibid.
[8] These preconditions were determined through interviews with a senior IMF economist, a Visiting Fellow at the Brookings Institution, and OECD analysts.

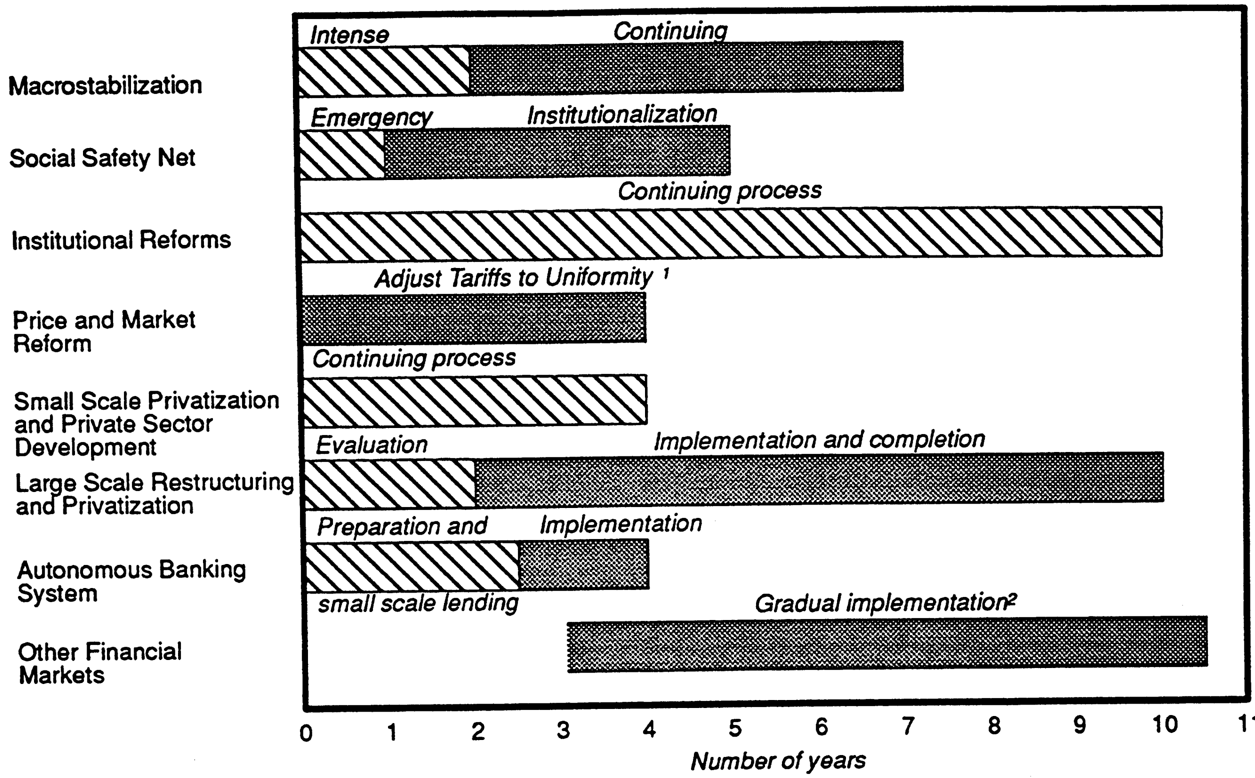
[9] Interviews with the staff at a European-based international bank active in CEE (June 19, 1991), IMF economist (Aug. 30, 1991), analyst at the Institute of International Finance (Sept. 3, 1991), and analysts at a West European central bank with close ties to CEE banks (Sept. 3 and 4, 1991).
[10] Ibid.
[11] Ibid.
[12] Ibid.
[13] Ibid.

Table 2
Status of economic reform activities in Central and Eastern Europe as of June 1991

Country	Legal Reform	Foreign Trade & Investment	New Firm Formation	Sales of State Enterprises	Major Roadblocks
Bulgaria	Restrictions on private firms lifted; ownership of state firms unclear; EC accounting stds., Commercial code, antimonopoly law adopted.	Restrictions reduced, full repatriation allowed, but exchange constraints remain; 100% foreign ownership allowed; currency not convertible.	Thousands of functional private firms,most very small.	Program just starting, leasing most common form.	Restrictions on foreign exchange monopolies of inputs; lack of financial system and poor communications.
Czechoslovakia	Restrictions on private firms removed; commercial code to be approved this month; EC accounting standards adopted.	100% foreign ownership; full profit repatriation allowed.	Thousands of entrepreneurs, some part-time, have started firms; several dozen mid-size private mfg. firms; 1200 joint ventures.	Rules & regulations for privatization not yet fully developed, some reliance on vouchers, slow progress.	Lack of adequate financial system; restitution issues; lack of financing for purchasing firms; trade & investment constraints.
Hungary	Commercial and contract law updated; land purchases possible; accounting & concession laws.	No government approval needed for foreign purchasers; full repatriation allowed; no exchange controls; sizeable investment inflows.	Private sector is 14-30% of GDP; 14,000 new private firms last year alone.	200 sales through spontaneous privatization; State Property Agency in charge with clear ownership rights.	Auctions of state firms delayed by conflicts over receipts between levels of government; high costs of appraising and selling state firms; weak bank capitalization.
Poland	Legal restrictions on private firms lifted, but other laws and bureaucratic ways remain.	Liberal investment law drafted; foreign investment disappointing; permission needed for >10% ownership, readily granted.	A sharp increase in new firms; private sector employment share up to 15.7% in 1990; private share of industrial production 13.4%.	8 large firms and 143 others sold as of 3/91; most retail shops being sold or leased.	Restitution; lack of management skills; possibly excessive antimonopoly laws; lack of banking and credit, business infrastructure; uncertain political and economic environment.
Romania	Most legal restrictions on new private firms lifted; private ownership of farmland established; ownership of other state property uncertain.	Liberal foreign investment law; limits on hard currency repatriation; most import and export licensing automatic and most quotas abolished.	About 98,000 private businesses established in 1990, mostly small service sector firms employing fewer than 10 persons.	No full scale privatization completed; commercialization of state enterprises is proceeding; goal is 50% privatization in 3 years.	Unstable political situation; confusion and bureaucratic inertia; lack of technical and managerial skills; limited access to capital; and inadequate business infrastructure.

Source: Council of Economic Advisors, Executive Office of the President, Task Force on Reform in Central and Eastern Europe.

Figure 1
Estimated time required for economic reform programs in CEE countries



1 Time required for this one aspect of price and market reform.
2 Estimated three-year delay in startup pending implementation of autonomous banking system.

Source: Paper presented at a conference sponsored by the Organization for Economic Cooperation and Development, Center for Cooperation with the European Economies in Transition, November 1990.

Liberalization of Foreign Economic Relations

The liberalization of trade, foreign investment, and currency exchange is critical to the region. Liberalization not only helps ensure its economic recovery but also helps its transition to a market economy.[14] By injecting competition into industries often dominated by a few state enterprises, the expansion of foreign economic contacts stimulate market-oriented conduct in production for both domestic and foreign markets.[15]

Liberalization of Trade Regimes

By granting foreign trade rights to enterprises, all five CEE countries have abolished the state monopoly in foreign trade.[16] Estimates currently available only for Czechoslovakia, Hungary, and Poland indicate that enterprises, although most of them are state-owned, already control roughly four-fifths of all export and import transactions in these countries.[17] There is some evidence that the increase in enterprise autonomy is influencing both the size and composition of exports and imports in Poland and Hungary.[18] In addition, there is evidence that domestic producers in both countries are experiencing competition from imports. The State's absolute control over foreign trade in the five countries has given way to the use of traditional instruments of trade policy, such as the use of tariffs, quotas and licenses to meet goals of national economic policy.[19] These goals include the acquisition of high-technology imports, the prevention of

[14] Interviews with the vice president of a U.S. investment firm active in CEE (June 6, 1991), OECD analysts (June 17-18, 1991), and staff at a European-based international bank active in CEE (June 19, 1991).
[15] Ibid.

[16] World Bank official, interview with USITC staff, June 5, 1991.
[17] OECD official, interview with USITC staff, June 18, 1991.
[18] World Bank official, interview with USITC staff, June 5, 1991.
[19] OECD official, interview with USITC staff, June 18, 1991.

excessive depletion of foreign-exchange reserves, and the prevention of excessive exportation of goods in short supply.[20] In addition, all five countries emphasize commitment to GATT principles and goals.[21]

Liberalization of Foreign Investment

Since the beginning of radical economic reforms in 1989/1990, policy makers in the CEE countries have assigned a key role to foreign capital in the transition process.[22] All five countries have expanded the possibilities of foreign ownership beyond joint ventures to the complete ownership of industrial assets.[23] Despite the liberalization of foreign investment, Western businesses remain cautious in making use of the new opportunities.[24] The region's economic and financial problems, the lack of appropriate business climate, and inadequate infrastructure have been cited as the most general disincentives to commit large sums of private capital to most of the countries of the region.[25] Among the five countries of the region, foreign investments reportedly have begun to exert a significant economic impact only in Hungary.[26] Nevertheless, as the above problems slowly recede, Western investment in the region is projected to grow.

Currency Convertibility

The extent to which national currencies can be exchanged for convertible currencies for the purposes of international transactions clearly marks the progress a CEE country has achieved in the implementation of market reforms and closely associated macroeconomic stabilization policies.[27]

Although all five CEE countries have taken steps toward establishing current account convertibility, some constraints to full current account convertibility still exist in all of them.[28] The full repatriation of earnings on foreign capital is allowed in principle by all five CEE countries, but there is no readily available information on how this is acutally put into practice.[29]

Capital account[30] convertibility appears to be even more restrictive, at least at this time. Western capital invested in each of the five countries may be repatriated subject to procedures of varying length; domestic firms and local residents are apparently unable to exchange the national currency for the purpose of making investments abroad.[31] Some economists argue that convertibility for the purpose of investing abroad requires a larger supply of convertible currency reserves and a higher degree of domestic economic stability than currently exists in these countries.[32]

All five countries consider full convertibility (i.e., unrestricted convertibility for all international transactions) a goal to be achieved as soon as possible. This policy is guided by the recognition that progress in external convertibility increases access to Western capital and strengthens transition to a market economy.[33]

Privatization

For the purposes of this study, privatization is defined as the expansion of the private sector either by the establishment of new, privately owned businesses or by the state's divestiture of its property. To date, most of the expansion of the private sector in all five countries can be attributed to the establishment of new enterprises rather than to the divestiture of state-owned ones.[34] All five CEE countries have enacted legislation to expand their private sector, but progress in this area varies significantly among the countries of the region.

At present, Czechoslovakia, Hungary, and Poland have moved the furthest among the CEE countries in creating the legal framework for the expansion of the private sector and in implementing programs aimed at the divestiture of state-owned industrial assets.[35] The number of private business registrations has increased significantly in all three countries, although information is not currently available on the size, status, and profitability of firms actually brought on line.

The principal method of divestiture in Czechoslovakia, Hungary and Poland is the transformation of the state-owned companies into joint stock companies and the subsequent distribution or sale of their shares to private firms and individuals.[36] The free distribution of assets through vouchers has apparently been assigned a greater role in Czechoslovakia and Poland than in Hungary. The enterprise concerned has to valuate its assets in order to price its shares and has to make a plan for the

[20] Ibid.
[21] Interviews with the respective CEE embassies in Washington, DC, July 1-19, 1991.
[22] Interviews with the vice president of a U.S. investment firm active in CEE (June 6, 1991), CEE analysts at the OECD (June 17-18, 1991), and staff at a European-based international bank active in CEE (June 19, 1991).
[23] Ibid.
[24] Ibid.
[25] Ibid.
[26] Radio Free Europe/Radio Liberty Research Institute (RFE/RL), *Report on Eastern Europe*, vol. 2, No. 21, May 24, 1991, p. 23.
[27] Remarks by Joshua Greene, Senior Economist, International Monetary Fund (IMF) at the Conference on Eastern European Economies in Transition, May 23, 1991.
[28] Ibid.
[29] Ibid.
[30] For items included in the U.S. capital account, see Council of Economic Advisors, *Economic Report of the President*, February 1991, p. 403.
[31] Remarks by Joshua Greene, Senior Economist, International Monetary Fund (IMF) at the Conference on Eastern European Economies in Transition, May 23, 1991.
[32] Ibid.
[33] Ibid.
[34] Interviews with Congressional Research Service, June 10, 1991, and a U.S. investment firm providing assistance in privatization to CEEs under contract to the U.S. Agency for International Development (AID), June 13, 1991.
[35] OECD analysts, interviews with USITC staff, June 17 and 18, 1991.
[36] Ibid.

distribution of shares.[37] By law, Government agencies in all three countries closely control the process of valuation and have the final word about enterprise divestiture plans.[38] Although all three countries underscore the importance of foreign capital in the divestiture of state enterprise and do not put legal limits on the foreign acquisition of divested property, employee ownership plans and other domestic placements of shares do in fact prevent the acquisition of foreign control over a large number of enterprises.[39] A growing political opposition to foreign ownership has also been noted in all three countries.[40]

Thousands of new firms have been established in Bulgaria and Romania. Most of these firms are small service outlets. Both Bulgaria and Romania are engaged in the preparatory stages of divestiture. As in the three other CEE countries, the principal method of divestiture will be the transformation of state-owned companies into joint stock companies and the subsequent sale of their shares to private firms and individuals.[41] The free distribution of assets through vouchers will play a major role in the divestiture process in both countries. The authorities of both countries emphasize the role foreign capital is likely to play in the process.[42]

International Aid And Investment Initiatives

Multilateral and Foreign Government Aid and Assistance

The United States and other OECD countries provide a variety of aid and assistance through both bilateral and multilateral arrangements.[43] These various programs of the member countries of the OECD, or Group of 24 (G-24),[44] are coordinated by the EC Commission.[45] Both bilateral and multilateral aid and assistance was initially provided to only Poland and Hungary, but coverage was extended to Bulgaria and Czechoslovakia in 1990[46] and to Romania in 1991.[47] The EC Commission received the mandate for this role through the PHARE program—Poland and Hungary, Aid for Restructuring of the Economy; and PHARE remains the designation for the aid and assistance programs extended to all the CEE countries.

The coordination role may be shared in the future with the OECD. The OECD announced in June 1991 that it has concluded a major cooperation agreement with Czechoslovakia, Hungary, and Poland, called "Partners in Transition" (PIT).[48] The content of the programs will be determined jointly by OECD's Centre for Cooperation with European Economies in Transition (CCEET) and the partner countries' governments.[49]

During the 18 months from July 1989 through December 1990, the cumulative value of bilateral aid and assistance to the CEE countries by the G-24 and the European Community as a separate organization[50] amounted to $27.0 billion.[51] Aid and assistance by multilateral organizations during the same period amounted to $5.5 billion.[52] At the end of 1990, Poland and Hungary were the major recipients of both bilateral and multilateral assistance (table 3). The distribution of assistance by major types of programs is shown in figure 2. Germany had made the largest commitments of grants and loans or credits to the CEE countries by year end 1990, followed by the EC as a body separate from its member states. Among the G-24 countries, Japan was the second single largest donor, and the United States ranked third (figure 3).

Foreign Direct Investment[53]

All past and recent foreign direct investment (FDI) in CEE virtually has been in joint ventures. Joint venture activity is dominated by German and Austrian firms. Location, culture, and historical ties play a major role in this relationship. Although U.S. ventures are fewer in number than those involving German and Austrian firms, total U.S. capital outlays are proportionately larger.

As of April 1991, Hungary accounted for 46 percent of the region's registered joint ventures, followed by Poland and Czechoslovakia with 24 and

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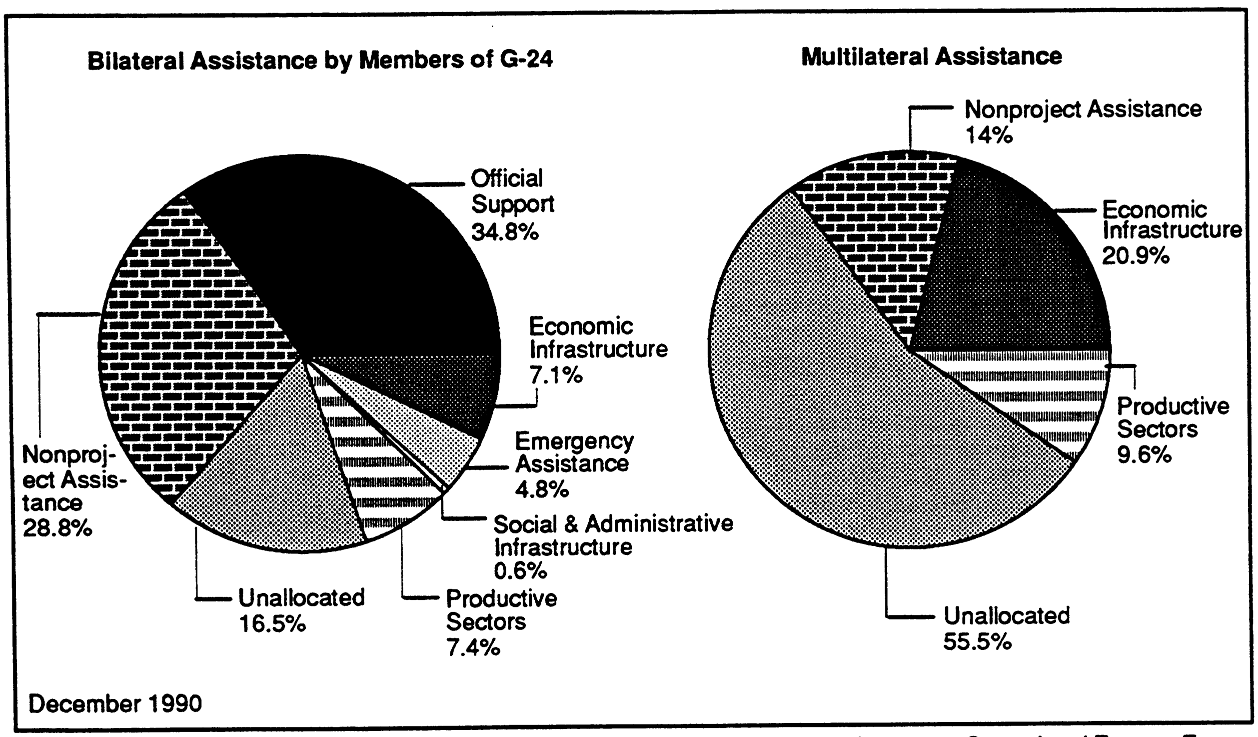
[37] U.S. investment firm active in the CEE area, interview with USITC staff, July 26, 1991.
[38] Ibid.
[39] Ibid.
[40] Ibid.
[41] Prehearing brief submitted to the USITC by the Embassy of Romania, July 10, 1991, pp. 6,7; Task Force on Reform in Central and Eastern Europe, Headed by the Staff of the Executive Office of the President, Council of Economic Advisers, *Designing U.S. Policy to Accelerate Creation of Market-Based Economies in Central and Eastern Europe*, pp. 23-27.
[42] Ibid.
[43] OECD analysts, interviews with USITC staff, June 17-18, 1991; U.S. General Accounting Office, *Eastern Europe, Donor Assistance and Reform Efforts*, November 1990, p. 12.
[44] The 24 OECD member countries are as follows: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.
[45] OECD analysts, interviews with USITC staff, June 17-18, 1991. See also USITC, *1992, The Effects of Greater Economic Integration Within the European Community on the United States: Third Followup Report*, Investigation No. 332-267 (USITC Publication 2369, March 1991), p. 1-29.
[46] Ibid.
[47] Government of Romania, commercial office in New York, interview with USITC staff, June 11, 1991.
[48] OECD, *Press Release*, Paris, June 4, 1991.
[49] Ibid.
[50] The aid and assistance provided by the EC is in addition to that provided by its member states.
[51] Commission of the European Communities, *Progress Report on G-24 Assistance to Central and Eastern Europe*, Jan. 30, 1991, Annex 1, p. 1. Figures provided in ECUs were converted into U.S. dollars at 1 ECU = $1.18.
[52] Multilateral organizations here refer to the European Investment Bank (EIB), the World Bank, and the European Coal and Steel Community (ECSC). See Commission of the European Communities, *Progress Report on G-24 Assistance to Central and Eastern Europe*, Jan. 30, 1991, p. 2.
[53] Data sources on joint ventures and foreign direct investment do not distinguish between equity investments and other types of business arrangements, such as licensing. For this reason, joint ventures and investment in the remainder of this section refer to all types of cooperative business arrangements.

Table 3
Geographic distribution of aid and assistance to Central and Eastern European countries, Dec. 31, 1990
(In percent)

Country	*Bilateral assistance by members of G-24 and the E*	*Assistance by multilateral Corganizations*
Poland	40.6	50.9
Hungary	27.2	30.5
Czechoslovakia	5.2	9.7
Romania	2.1	3.1
Bulgaria	1.1	5.8
Unallocated	23.8	-
Total	100.0	100.0

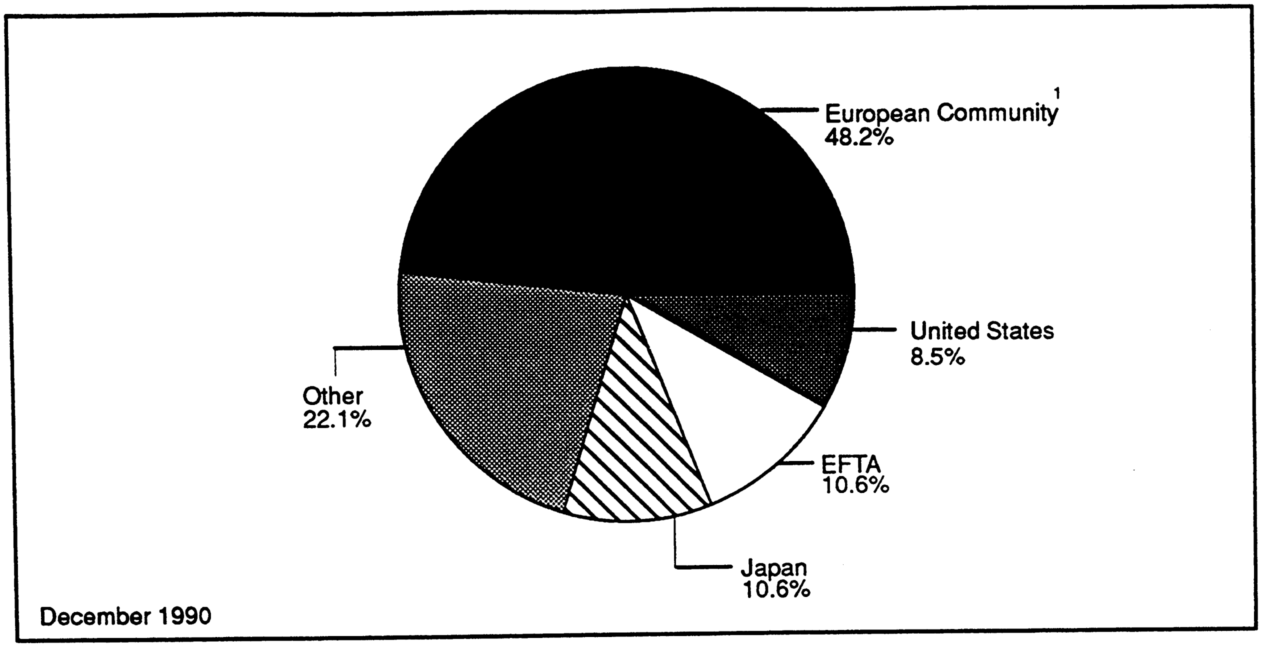
Source: Commission of the European Communities, *Progress Report on G-24 Assistance to Central and Eastern Europe*, Jan. 30, 1991.

Figure 2
Distribution of Aid and Assistance



Source*: Commission of the European Committee, Progress Report on G-24 Assistance to Central and Eastern Europe,* January 30, 1991.

Figure 3
Distribution of Aid and Assistance from Members of G-24



[1] Includes assistance provided by the European Community as an organization and that provided by individual member states. Germany alone accounted for 41 percent of the total assistance from the European Community.

Source: Commission of the European Communities, *Progress Report on G-24 Assistance to Central and Eastern Europe*, January 30, 1991.

19 percent, respectively (see figure 4). Hungary was by far the largest recipient of foreign capital accumulated through joint ventures, followed by Poland and Czechoslovakia (see figure 5). Over 75 percent of the registered JVs were in operation in Hungary by July 1990, compared with only 40 percent in Poland and 20 percent in Czechoslovakia at the end of the year. Out of 600 JVs registered in Romania as of the end of 1990, only 5 were operational.[54]

To date, most of the joint venture activity in CEE has involved small-to-medium-size projects, involving less than $1 million each in start-up capital. However, there have been some major undertakings in the region, including investment by General Electric in Hungary with an initial foreign capital outlay of about $130-150 million. In the region as a whole, the manufacturing sector accounts for the largest share of the registered joint ventures, followed by services. Investment in the services sector tends to be in small enterprises with capital not exceeding $10,000 each.

All of the CEE countries have set up legal frameworks for permitting foreign equity investment. Liberalization of existing guidelines, including restrictions on foreign-ownership equity, management control, and profit repatriation has occurred in most of the countries since the beginning of 1989. Table 4 lists current host country policies toward foreign investment.

[54] *Business Eastern Europe*, Feb. 25, 1991, pp. 60-61.

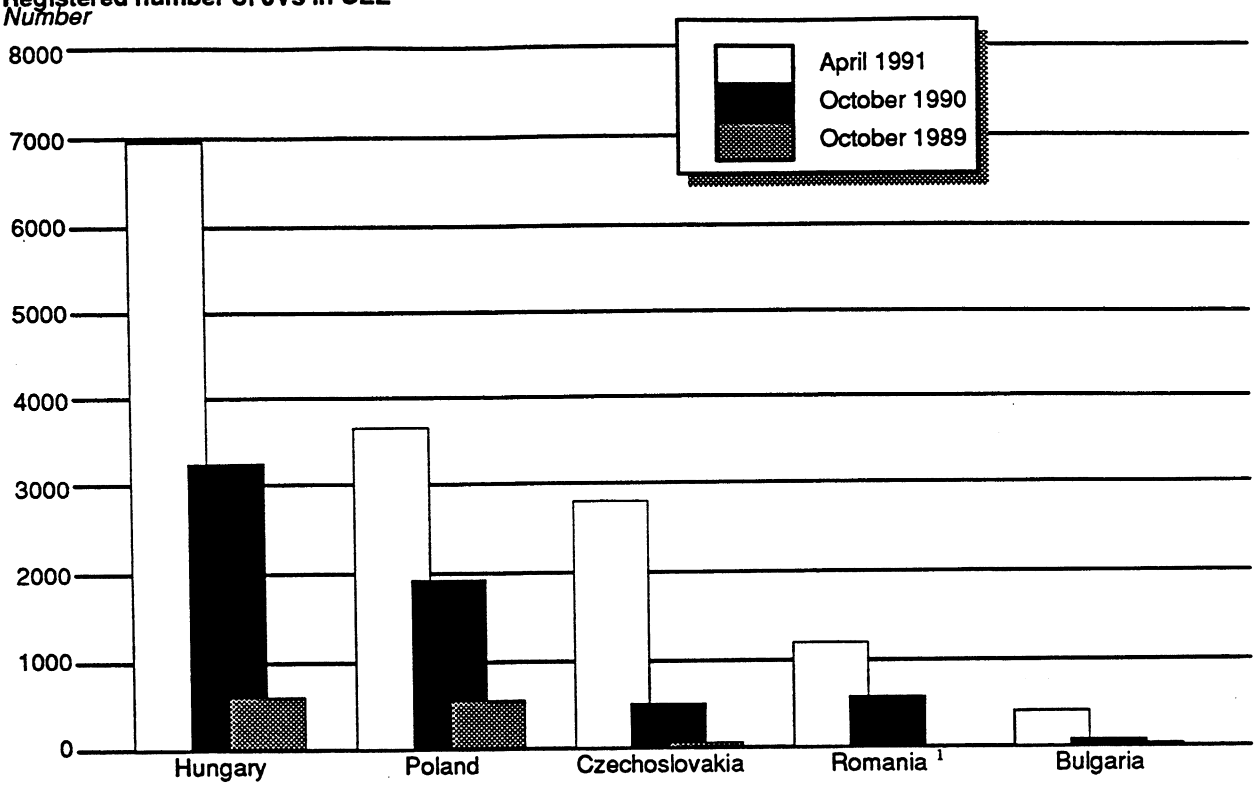
Sectoral Analysis of Central and East European Industries and the Trade Policies of Major OECD Markets for CEE Exports

The transformation of CEE into a market-oriented economy is occurring against a backdrop of rapidly declining economic activity. In fact, output in the region during the past 2 years or so has been arguably the worst in the post-war period. The recent downturn is in marked contrast to the expansion, albeit somewhat slowed growth, in the OECD nations, as shown in figure 6.[55]

This weakness can be traced mainly to deteriorating conditions in the industrial sector. Real industrial output fell sharply in 1990 and has continued on a downward path so far in 1991. The agricultural sector has performed poorly too, though the farm sector still plays an important role in the region, especially as a source of jobs. Traditionally important for most of the CEE countries, agriculture has been overshadowed by mining and manufacturing in the allocation of investment funds as a result of the postwar industrialization drive.

[55] The CEE countries measure national income in terms of net material product (NMP). The NMP is equal to GNP less depreciation and consumer services.

Figure 4
Registered number of JVs in CEE



[1] There were five JVs registered in Romania as of October 1989.

Source: UN Economic Commission for Europe.

Infrastructure and Support Services Deficiencies

The expansion of the economies overall, and the export sector in particular, in all five CEE countries is constrained by deficiencies in the infrastructure and in financial and credit institutions. These deficiencies will take time and, in some cases, considerable capital investment to remedy. The pace of market reforms and recovery from the current region-wide economic downturn will also affect the speed with which these deficiencies are ameliorated and perhaps eliminated.[56]

Infrastructural Deficiencies

Inadequate investment in telecommunications, the computer network, and transportation are often cited as general obstacles to enhancing the competitiveness of industrial exports from the CEEs. Underdevelopment in these three areas raises the costs of exports and discourages foreign investment without which the modernization of the infrastructure and the development of an export competitive industry are impossible.

[56] To illustrate these deficiencies, this section concentrates on data for Czechoslovakia, Hungary, and Poland.

Telecommunications

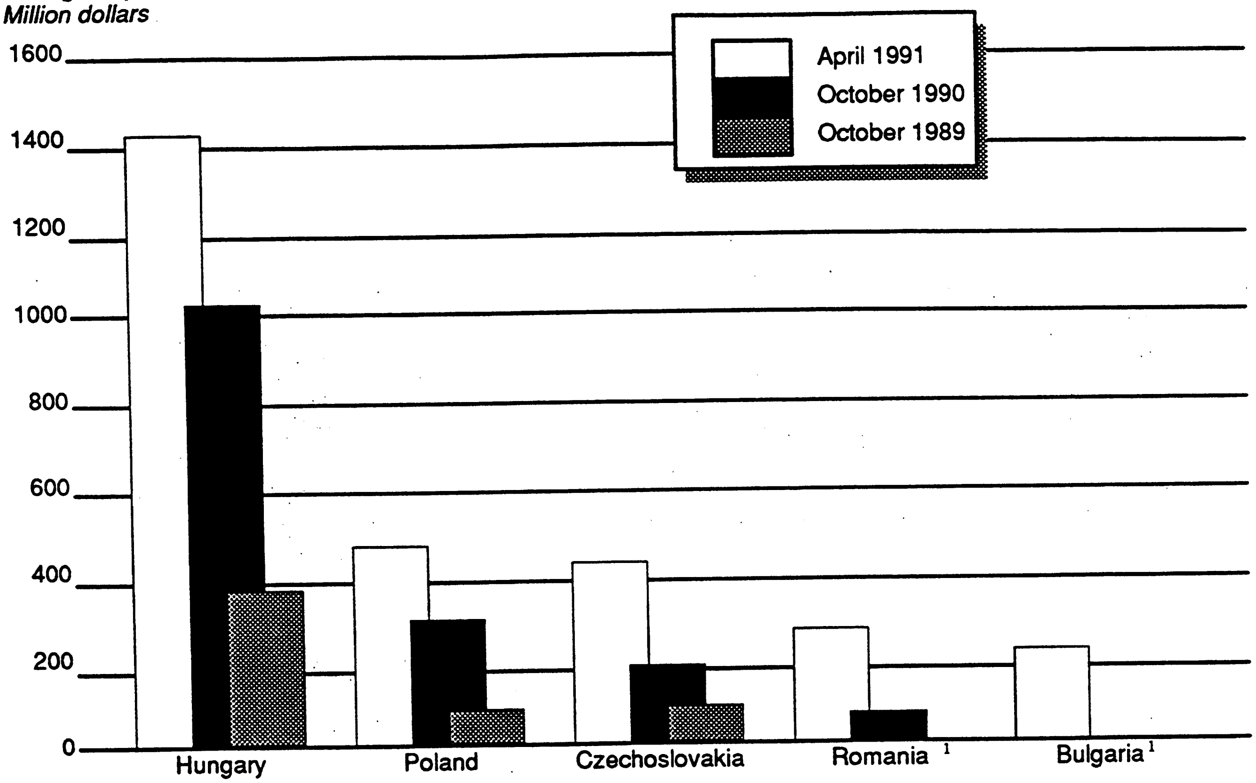
Overall, the communication infrastructure in CEE is inadequate for the current level of business activity. Not only are there insufficient numbers of telephones, but the ones that do exist use outdated switching systems.[57] Newer forms of communication, including cellular and FAX services, are rare or nonexistent. The major reason for the relative backwardness of these services in CEE is the low levels of capital invested to date.

Computers

An integral part of a sound telecommunication system is the availability of a modern computer system. Demand by the business community for automated business systems, accounting systems, and management information systems dictates the availability of modern computer facilities. In most CEE economies these resources are in such short supply that they provide a real impediment for business activity.

[57] See U.S. Department of State, Advisory Committee on International Communications and Information Policy, *Eastern Europe: Please Stand By*, Report of the Task Force on Telecommunications and Broadcasting in Eastern Europe, Spring 1990.

Figure 5
Foreign capital outlay in registered JVs
Million dollars



[1] Estimated capital outlays were not available for Romania in 1989 nor for Bulgaria in 1989 and 1990.

Source: UN Economic Commission for Europe.

The CEE countries lag an estimated minimum 10 years behind the West in computer technology.[58] Moreover, the underdevelopment of the region's telecommunications networks prohibits, at least over the medium term, the linkage of computers at a level that could bring about significant advancement in this sector.[59]

Transportation

The development of transportation services in the CEE countries followed the general development of their overall economies. The transportation sector expanded quickly during 1970-75 and declined in growth during the late 70s, in line with lower overall economic growth and higher fuel prices. This reduction in investment continued into the 1980s as the CEE economies began to constrain their allocation of investment. Insufficient investment in the transport systems resulted in inadequate road and rail networks.[60]

[58] See *Planovane Hospodartsvi*, No. 3, 1988, pp. 69-82.
[59] Ibid.
[60] United Nations Economic Commission for Europe, *Economic Survey of Europe in 1989-90*, pp. 157-182.

Deficiencies in Financial and Credit Institutions

No CEE economy has as yet developed a functional credit system which can provide adequate credit to small- and medium-sized businesses, clear checks, efficiently provide export financing, or compete for savings. Existing CEE banks, although partly decentralized, are as yet poorly capitalized and burdened with nonperforming loans that were previously issued to large state-owned enterprises.[61]

The development of financial markets and private sector financial institutions is an essential step in the transition to a market economy. While a commercial banking system has been created in all of the CEEs, many of the existing CEE financial institutions have no basis for allocating credit according to market criteria, nor for identifying and pricing risk. Credit allocation in such a situation is indeterminate, given that it is neither set by a plan or by the market.[62] Although significant

[61] See Task Force on Reform in Central and Eastern Europe, Headed by the Staff of the Executive Office of the President, Council of Economic Advisers, *Designing U.S. Policy to Accelerate Creation of Market-Based Economies in Central and Eastern Europe*, pp. 9-11.
[62] See David Lipton and Jeffrey Sachs, *Creating a Market Economy in Eastern Europe: The case of Poland*, paper presented to the Brookings Institution, April 1990.

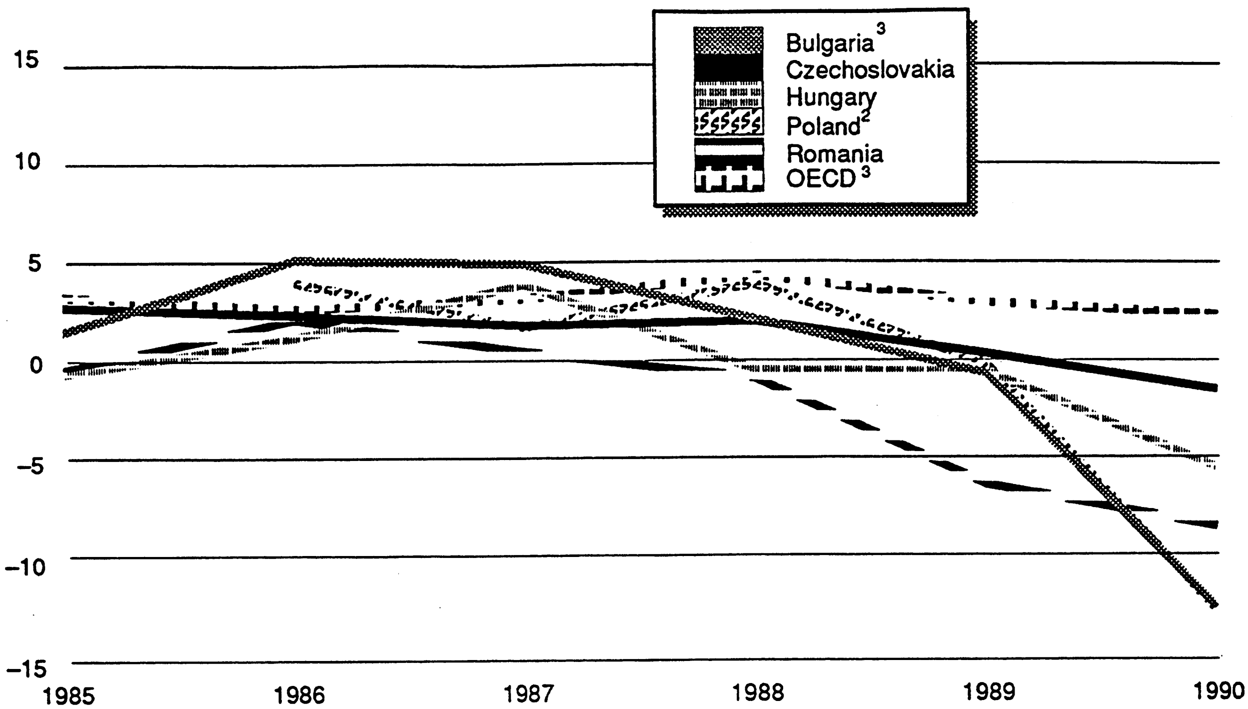
Table 4

Host country policies towards foreign investment as of July 1991

Country	*Foreign ownership*	*Repatriation of profits*	*Field of activity*	*Investment incentives*
Bulgaria	No set limit[1]	Profit transfer in hard currency is allowed.	All economic sectors, except where prohibited by law or similar authority.	No excise duty on imported or capital goods or raw materials to be used for the purpose of the investment (min. level of foreign investment may be required). Some tax holidays, depending on location and industry.
Czechoslovakia	100% permitted with advance approval	Part of foreign currency receipts must be offered to the State Bank; salaries and profits may be transferred abroad from hard currency resources of the JV.	All economic sectors, except those relating to defense or national security.	Selective incentives, depending on investment, including tax holiday and exclusion from antitrust suits.
Hungary	100% permitted	Profit transfer in hard currency is allowed. Conversion of profits into hard currency guaranteed by the government.	All economic sectors.	Taxation incentives available for specific activities.
Poland	100% permitted	100% of hard currency profit remittable; government can authorize remittance of zloty profits.	All economic sectors.	Capital expenditures may be charged against taxable profits. No excise duty on imported capital goods which form part of a shareholder's capital contribution or are purchased within 3 years of the company's establishment. tax holiday.
Romania	100% permitted with advance approval	Partial profit transfer in hard currency allowed.	Foreign investment forbidden if it affects national security and defense or if it would infringe on environmental law.	Tax holidays depending on sector. Foreign contributions in kind are duty free.

Sources: (1) "Building Free Market Economies in Central and Eastern Europe: Challenges and Realities," The Institute of International Finance, 1990, pp. 44 and 45; (2) "Doing Business in Poland," U.S. Department of Commerce, January, 1990; (3) *Eastern Europe and the USSR: A Guide to Foreign Investment Legislation*, Klynvelud Peat Marwick Goedeler, April 1990; (4) *BNA International Trade Reporter*, and (5) *East–West Joint Ventures*, No. 8, July 1991.

Figure 6
Economic Output[1]—Annual percentage rate of real change



[1] Economic output for Bulgaria and Czechoslovakia is measured in terms of NMP (1985 prices); Hungary, Romania, and OECD, GDP (1985 prices); and Poland, GNP (1984 prices).
[2] 1985 data were not available.
[3] Preliminary 1990 data.

Source: The United Nations, *Monthly Bulletin of Statistics*, November 1990 (Special Table I) and July 1991; *International Monetary Fund, International Financial Statistics*, September 1991; The WEFA Group, *CPE Outlook for Foreign Trade and Finance*, Bala Cynwyd, PA, July 1991; The Economist Intelligence Unit, *Hungary—Country Report*, London, No. 3, 1991; "Poland's Economic Situation in 1990 and Medium-Term Outlook," May 1991; Central Statistical Office, Warsaw; OECD, *Main Economic Indicators*, Paris, July 1991; and OECD, *Agricultural Policies, Markets and Trade: Monitoring and Outlook 1991* (Annex V) Paris, 1991.

changes have taken place in the financial sectors of Bulgaria and Romania, these changes are too recent for a comprehensive review.[63]

Trade Policies of Major OECD Markets for Central and East European Exports

In response to the political and economic changes that have taken place in CEE since 1989, the OECD member countries have made tariff concessions, reduced quantitative restrictions, and eased restrictions on the transfer of technology to the countries of the region. Whereas the governments of OECD countries have taken independent actions to reduce import restraints on CEE products, policies aimed at the transfer of technology to the CEE countries have been liberalized on a unified basis through the 17-nation Coordinating Committee on Multilateral Export Controls (COCOM). See tables 5 and 6 for summaries of U.S. and EC trade agreements and policies toward CEE countries.

Still, the level of the CEE trade in 1990 was the lowest in at least 10 years. (See figure 7.) Both imports and exports fell. Intra-CMEA trade has fallen substantially, while trade with OECD countries has increased in importance. The latter now take about half of the exports from CEE countries. Food and raw materials, basic consumer goods, and heavy industry products, each account for about one-third of the exports from this region to OECD countries.

[63] For more information on developments in the financial sectors of Bulgaria and Romania, see Task Force on Reform in Central and Eastern Europe, Headed by the Staff of the Executive Office of the President, Council of Economic Advisers, *Designing U.S. Policy to Accelerate Creation of Market-Based Economies in Central and Eastern Europe*, pp. 20 and 89.

Table 5
U.S. trade agreements and policy towards Central and Eastern Europe

Country	Trade agreement	MFN	GSP	Export credit insurance
Bulgaria	Yes[1]	No[2]	No	Yes
Czechoslovakia	Yes	Yes	Yes	Yes
Hungary	.Yes	Yes	Yes	Yes
Poland	Yes	Yes	Yes	Yes
Romania	Yes	No	No	No

[1] The United States and Bulgaria have signed a trade and financial agreement, which is currently before the U.S. Senate.
[2] It is expected that MFN status will be granted by the end of the year.

Source: Compiled by staff of the U.S. International Trade Commission.

Table 6
EC trade agreements and policy towards Central and Eastern Europe

Country	Trade agreement	MFN	GSP
Bulgaria	Yes	Yes	Yes
Czechoslovakia	Yes	Yes	Yes
Hungary	Yes	Yes	Yes
Poland	Yes	Yes	Yes
Romania	Yes	Yes	Yes

Source: Compiled by staff of the U.S. International Trade Commission.

Assessment of Export Potential of Select Manufacturing Industries And a Select Services Sector

To identify potential export industries, staff first compiled a revealed comparative advantage index (RCI), based on 1989 trade data.[64] The purpose of this index was to rank the CEE countries relative to other exporters in OECD markets. The underlying assumption is that a country's exports reflect its comparative advantage vis a vis its competitors. Since actual trade patterns have been affected in many cases by the central planners in the CMEA countries, the ranking based on the comparative advantage index was reviewed by industry analysts, who researched factor endowments and industry conditions to determine whether there was evidence to support the inferences suggested by the RCI.

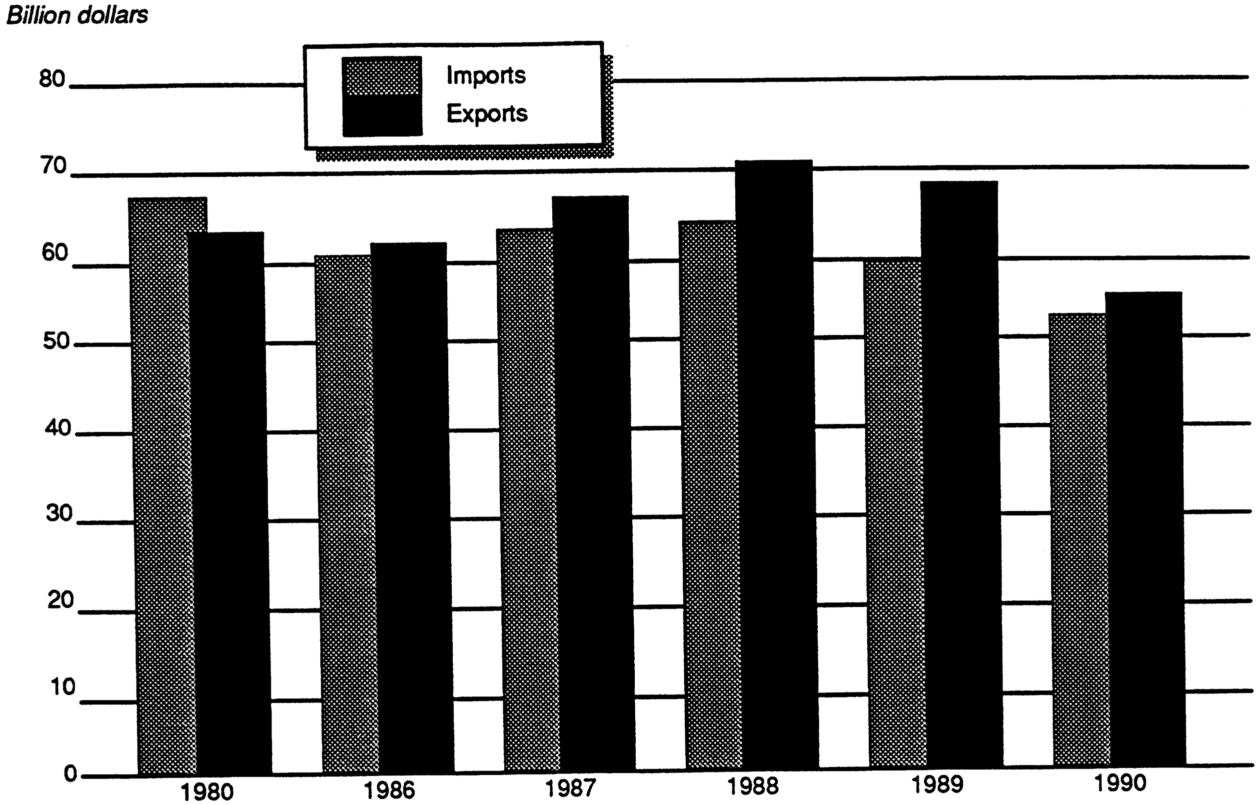
As a result of this process, the following non-services industries were chosen for detailed review in this report: apparel, coal, copper, fertilizers, meat, motor-vehicle parts, metalworking machine tools, poultry, steel, and textiles. Scientific and medical equipment was also included because there was not adequate information available initially to enable us to compute an RCI for this industry. However, several published articles did mention these products as possible exports from the CEE countries. This methodology could not be applied to the services industries, whose data sets are not comparable to other industries. A review by industry analysts lead to the decision to also include tourism, a services oriented industry.

USITC staff then compiled detailed profiles assessing the export competitiveness of these CEE industries. In providing this assessment, staff kept in mind the progress of CEE economic reform, the level of Western aid and investment, as well as structural impediments to industrial development. Conclusions regarding the competitiveness of each industry are summarized below and a summation of the report's finding is presented in table 7.

- Apparel: Central and East European apparel firms, capitalizing on plentiful labor, uniformly low wages, and relatively easy access to modern manufacturing equipment, possess a high potential for increased exports to Western markets. Existing relationships with Western firms, which supply cut parts for final assembly in CEE countries, should facilitate the development of an export-oriented industry—particularly in Hungary and Poland.

[64] OECD country import data was substituted for CEE export data. Although some distortions in the data may be created by exchange rates, this import data is believed to more closely reflect responses to market conditions while providing timely, consistent data sets.

Figure 7
Foreign Trade of Central and Eastern Europe



Source: United Nations, *Monthly Bulletin of Statistics,* June 1987, p. 122 and July 1991, p. 110.

- Coal: Poland, currently the primary coal producer and exporter in CEE, is undertaking a major restructuring and price reform program, which will raise domestic coal prices to world market levels and shut down unproductive mines. Poland's exports of coal are now being negotiated on a hard-currency basis. Exports are unlikely to increase until the domestic market stabilizes.

- Copper: The copper industry in Poland, the only CEE country with sufficient copper reserves to be a major exporter, has little or no potential to increase export volume unless it can attract investment capital to upgrade operating facilities and environmental safeguards. Because investment decisions are based on expected income generated by a project, decreasing world copper prices in recent years provide little incentive for potential investors to commit the funds that would be necessary for the Polish industry to increase exports under a market-based economic system.

- Fertilizers: The change from centrally planned economies to a market-oriented system without government supports has caused a decline in both indigenous CEE fertilizer production and consumption. It is unclear how the CEE fertilizer industry will be rationalized as a result of privatization of both industry and agriculture. However, there is high potential for continued exports of Polish sulfur, moderate potential for significant exports of nitrogenous fertilizers from Romania and Poland, and some potential for nitrogenous fertilizer exports from Hungary, Czechoslovakia, and Bulgaria. There is little or no export potential for potassic or phosphatic fertilizers from any country in the CEE region.

- Meat: Overall, it appears that the CEE countries have moderate potential to increase exports of meat (beef, veal, pork, lamb, mutton, and goat meat). A significant increase in meat exports is unlikely in the short term because of a general lack of infrastructure and investment funds; however, in the longer term (10 years or so) there could be meaningful export increases,

Table 7
Summary of Export Potential for Select Central and East European Industries

Sector	*Export Potential*[1]		
	Low	*Moderate*	*High*
Apparel			X
Coal	X		
Copper	X		
Fertilizers		X	
Meat		X	
Metalworking Machine tools	X		
Motor–Vehicle Parts			X
Poultry	X		
Scientific & Medical Instruments	X		
Steel	X		
Textiles	X		
Tourism	X		

[1] Potential increase in exports or foreign currency earnings over the next 5 years: low = 0-5 percent; moderate = 6-15 percent; and high = over 15 percent.

Factors favorable to CEE industries:
- abundant supply of skilled labor
- competitive wages
- proximity to West European markets
- commitment to modernization and investment
- some experience/relationships with Western markets/firms

Disadvantages faced by CEE industries:
- rising domestic costs
- low productivity
- lag in technology
- limited capital availability
- weak distribution channels
- significant competition in sophisticated products from Western producers
- significant price competition in products from LDCs

especially in Poland and, to a lesser extent, Hungary and Czechoslovakia.

- Metalworking machine tools: The potential for exports from Central and East European countries is low to moderate due principally to product quality problems and weak distribution channels. At present, the metalworking machine tool industries in CEE countries are facing additional financial burdens due to the recent collapse of sales to major markets in former CMEA countries and the high cost of capital.

- Motor-vehicle parts: There is a relatively high potential for the CEE motor-vehicle parts industry to export its products to certain foreign markets. CEE exports of parts should increase because of the industry's cost-competitive wages, skilled workforce, proximity to Western European producers of motor vehicles, adequate reserves of raw materials, and commitment to modernization and investment.

- Poultry: In general, it appears that the short-term potential for CEE poultry exports is low because of unfavorable global market conditions since 1989 and 1990. The long-term potential for the CEE poultry sector is high, as the region has developed relatively modern poultry complexes and has experience, although somewhat limited, exporting to world markets. Once the CEE region has adjusted to economic reforms and the economies are market driven, the poultry industry is likely to recover relatively quickly.

- Scientific and medical instruments: The export potential for scientific and medical instruments that are produced by CEE countries is somewhat limited. For the most part, CEE producers face significant competition from U.S., German, and Japanese producers in terms of technologically-sophisticated scientific and medical products. In terms of low priced, lower technology products, CEE producers may not be able to compete with producers in lower-wage countries that have already gained a share of the international market for lower-technology products. Export opportunities do exist for a limited range of products that currently are produced to meet international standards and have gained a share of foreign markets.

- Steel: CEE steel industries possess a low-to-moderate capability to expand exports to Western markets. While the state-owned enterprises have successfully sold certain types of products to Western countries, rising input costs, inefficient equipment, and low productivity are likely to limit their ability to expand market share. Governments may choose to support exports to Western markets, however, as a means of generating hard currency revenues and as a way to offset reduced exports to other CEE countries and the Soviet Union.

- Textiles: There is some potential for an increase in exports of certain textile products from CEE countries, though total amounts will probably be small. Most CEE textiles are not competitive in terms of cost, style, or quality with those manufactured by major Asian producers and exporters.

- Tourism: There is significant long-term potential for the development of tourism in the CEE countries. The potential for increasing tourism earnings in the short run, however, is limited because of the lack of an extensive tourist infrastructure, including modern hotels and motels, especially outside major cities. Other limiting factors include the absence of adequate foreign-language assistance and the limited range of entertainment choices.

Based upon USITC staff analysis, two CEE industries—apparel and motor-vehicle parts—possess a high degree of export potential. Two more industries—fertilizers and meat products—show signs of moderate export competitiveness. Analysts regard export potential over the next five years as low in the remaining eight industries—coal, copper, metal-working machine tools, poultry, scientific and medical instruments, steel, textiles, and tourism. However, of the latter, export potential is expected to improve significantly in the long term for three of these industries—metalworking machine tools, poultry, and tourism. The long-term potential of these as well as all other industries in CEE, however, will depend on the progress of the economic reforms and the availability of adequate capital investment.