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INTERNATIONAL TRADE DEVELOPMENTS

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The U.S. surplus in trade with Mexico, attained in 1991 for the first time in years, grew to $5.7 billion in 1992 but contracted sharply thereafter. In 1994, bilateral trade was virtually balanced, with only a $531 million U.S. surplus recorded. Nonetheless, the volume of trade surged vigorously in both directions during the first NAFTA year.
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INTERNATIONAL ECONOMIC COMPARISONS

Summary of U.S. Economic Conditions

The record rise in the U.S. trade deficit in 1994 was a major reason for the record increase in the U.S. deficit on the current account.

U.S. Current Account

The U.S. current account deficit rose to $155.7 billion in 1994 from $103.9 billion in 1993, a 49.8-percent increase. The soaring merchandise trade deficit, a sizable shift to a deficit on investment income, and an increase in net unilateral transfers were all behind the surge in the deficit on the current account, according to the Department of Commerce (table 1).

The deficit on goods and services increased by 40.5 percent to $106.4 billion in 1994 from 1993. The merchandise trade deficit increased to $166.4 billion in 1994 although merchandise exports, both nonagricultural and agricultural, increased to a record of $502.7 billion. Merchandise imports, however, increased substantially to more than $669.1 billion. Nonpetroleum imports more than accounted for the increase, whereas petroleum imports decreased slightly. Moreover, the surplus in services increased to $60.0 billion, with services receipts rising to $195.3 billion. Nearly all categories of exports increased, the largest increases occuring in travel and passenger fares and royalties and license fees. Service payments increased to $135.3 billion, the largest increases being in travel and passenger fares and in other private services.

Because of increased income payments on investment over receipts, the balance on investment income shifted to a deficit of $15.2 billion in 1994 from a surplus of $3.9 billion in 1993. Receipts of income on U.S. assets abroad increased to $134.8 billion from $113.9 billion, but payments of income on foreign assets in the United States increased to $150.0 billion from $109.9 billion. Increased receipts on U.S. direct investment abroad reflected higher earnings, whereas other private receipts largely reflected higher interest rates. Increased payments on direct foreign investment in the United States reflected a shift to profits from losses on U.S. operations. Other private and U.S. Government payments reflected higher interest rates and larger liabilities outstanding.

Net unilateral transfers were $34.1 billion in 1994, compared with $32.1 billion in 1993. The increase was attributable to private remittances and other transfers.

Capital account

Net recorded capital inflows increased by $188.9 billion in 1994 from $82.8 billion in 1993. Increases in foreign assets in the United States were sharply higher than the increases in U.S. assets abroad largely as a result of sharply lower net U.S. purchases of foreign securities.

U.S. assets abroad increased by $125.7 billion in 1994, compared with an increase of $147.9 billion in 1993. Sharply lower U.S. purchases of foreign securities more than accounted for the slowdown. Net U.S. purchases of foreign securities were $60.6 billion in 1994, one half the exceptionally high net purchases of $120.0 billion in 1993. In 1993, net U.S. purchases of foreign stocks were $43.0 billion from $60.6 billion, and net U.S. purchases of foreign bonds were $17.6 billion from $59.4 billion.

Net capital outflows for U.S. direct investment increased slightly, or by $58.4 billion, in 1994, compared with a $57.9 billion increase in 1993. Although reinvested earnings and intercompany debt outflows increased, these increases were partly offset by a decline in equity capital outflows.

Foreign assets in the United States increased by $314.6 billion in 1994, compared with an increase of $230.7 billion in 1993. The increase in foreign capital inflows was attributable to sharply higher inflows for foreign direct investment in the United States and to a very large increase in U.S. liabilities reported by U.S. banks to finance domestic loan expansions. Increases for foreign official assets slowed.

Net foreign purchases of U.S. securities other than U.S. Treasury securities were $58.6 billion in 1994, compared with $80.1 billion in 1993. Net foreign purchases of U.S. stocks were $2.8 billion, down from

Table 1
U.S. international transactions, seasonally adjusted

(Billion dollars)

	1993	1994p	1993.IV	1994.IV
Exports of goods, services & income	755.5	832.9	195.1	223.0
Merchandise, adjusted, excl. military[1]	456.9	502.7	119.7	134.7
Services[2]	184.8	195.3	46.6	50.8
Income receipts on U.S. assets abroad	113.9	134.8	28.8	37.5
Direct investment receipts	57.5	66.61	4.4	18.0
Other private receipts	51.3	64.2	13.2	18.3
U.S. Government receipts	5.1	4.0	1.2	1.1
Imports of goods, services, and income	-827.3	-954.4	-215.7	-257.2
Merchandise, adjusted, excl. military[1]	-589.4	-669.1	-152.9	-177.7
Services[2]	-128.0	-135.3	-33.4	-34.5
Income payments on foreign assets in the United States	-109.9	-150.0	-29.4	-45.0
Direct investment payments	-5.1	-25.2	-2.3	-9.1
Other private payments	-63.2	-77.8	-16.5	-22.7
U.S. Government payments	-41.6	-47.0	-10.6	-13.2
Unilateral transfers, net	-32.1	-34.1	-10.0	-10.6
U.S. assets abroad, net (increase /capital outflow (-))	-147.9	-125.7	-63.6	-44.1
U.S. private assets, net	-146.2	-130.7	-62.6	-45.2
Direct investment	-57.9	-58.4	-22.7	-14.0
Foreign securities	-120.0	-60.6	-30.4	-13.9
U.S. claims reported by U.S. banks, not included elsewhere	32.2	-2.0	-9.3	-17.3
Foreign assets in the United States, net (capital inflow(+))	230.7	314.6	90.2	89.9
Foreign official assets in the United States, net	71.7	38.9	24.0	-1.0
U.S. Government securities	52.8	36.4	23.8	8.9
U.S. Treasury securities	48.7	30.4	22.9	7.4
Other	5.8	8.5	1.8	2.1
U.S. liabilities reported by U.S. banks, not included elsewhere	14.7	2.3	-.6	-10.8
Other foreign official assets	2.6	-2.3	-.1	.2
Other foreign assets in the U.S., net	159.0	275.7	66.2	90.9
Direct investment	21.4	60.1	8.1	27.9
U.S. Treasury securities	24.9	32.9	8.0	26.0
U.S. securities other than U.S. Treasury securities	80.1	58.6	-21.5	14.2
U.S. liabilities to unaffiliated foreigners reported by U.S. non-banking concerns	14.3	n.a.	4.7	n.a
U.S. liabilities reported by U.S. banks, not included elsewhere	18.4	106.2	7.4	27.1
Statistical discrepancy (sum of above items with sign reversed)	21.1	-33.3	4.0	-1.0
Memoranda:				
Balance on merchandise trade	-132.6	-166.4	-33.2	-43.0
Balance on services	56.8	60.0	13.2	16.3
Balance on goods and services	-75.7	-106.4	-20.0	-26.7
Balance on investment income	3.9	-15.2	-.6	-7.5
Balance on goods, services, and income	-71.8	-121.6	-20.6	-34.2
Unilateral transfers, net	-32.1	-34.1	-10.0	-10.6
Balance on current account	-103.9	-155.7	-30.6	-44.8

[1] Adjusted for timing, valuation, and coverage to balance of payments basis; excludes exports under U.S. military agency sales contracts and imports of U. S. military agencies.
[2] Includes some goods that cannot be separately identified from services.
Note.—Details may not add to totals because of rounding (credits +, debits -).

Source: U. S. Department of Commerce, Bureau of Economic Analysis.

$18.6 billion, and net foreign purchases of U.S. bonds were $55.8 billion, down from $61.5 billion. Net foreign purchases of U.S. Treasury securities were $32.9 billion in 1994, compared with $24.8 billion in 1993; most of the net purchases in 1994 occurred in the fourth quarter.

U.S. liabilities reported by U.S. banks increased by $106.2 billion in 1994, compared with a $18.5 billion increase in 1993. Strong inflows in the first half of the year reflected heavy borrowing from abroad by U.S. banks to finance domestic loan expansion in the United States and a shift by foreigners into short-term assets as

a result of uncertainties associated with sharp changes in U.S. stock and bond prices. In the second half, the demand for borrowed funds remained strong, and inflows reflected large interest rate differentials in favor of U.S. short-term assets.

Net capital inflows for foreign direct investment in the United States were $60.1 billion in 1994, compared with inflows of $21.4 billion in 1993. Foreign official assets in the United States increased by $38.9 billion in 1994, compared with an increase of $71.7 billion in 1993. Assets of both industrial and developing countries increased by substantially smaller amounts than those in 1993, with the slowdown much greater for developing than for industrial countries.

U.S. Economic Performance Relative to Other Group of Seven Members

Economic Growth

Real GDP—the output of goods and services produced in the United States measured in 1987 prices—grew at a 4.6-percent rate in the fourth quarter following a 4.0-percent seasonally adjusted annual rate in the third quarter of 1994. Real GDP increased by 4.0 percent in 1994 overall, compared with an increase of 3.1 percent in 1993.

The annualized rate of real economic growth in the fourth quarter was 3.1 percent in the United Kingdom, 5.9 percent in Canada, 2.4 percent in France, 3.0 percent in Germany, and -3.4 percent in Japan. In the third quarter of 1994, the annualized rate of real economic growth was 4.0 percent in Italy.

Industrial Production

Industrial production rose by 0.5 percent in February, following a 0.2-percent increase in January 1995. Manufacturing output increased 0.4 percent in February and increased by 6.9 percent from a year earlier. Industrial production in February 1995 was 6.1 percent higher than that of a year earlier. Industrial capacity utilization edged up 0.2 percent in February to 85.7 percent over the figure of January and increased by 2.9 percentage points over that of a year earlier.

Other Group of Seven (G-7) member countries reported the following annual growth rates of industrial production for the year ending January 1995: Japan reported an increase of 4.9 percent, and the United Kingdom reported an increase of 3.7 percent. For the year ending December 1994, Germany reported an increase of 7.3 percent; France, 6.4 percent; Italy, 6.1 percent; and Canada, 9.7 percent.

Prices

The seasonally adjusted Consumer Price Index (CPI) rose 0.3 percent in February following the same increase in January 1995. The CPI advanced by 2.9 percent during the 12 months ending February 1995.

During the 1-year period ending February 1995, prices increased by 0.6 percent in Canada, 1.7 percent in France, 2.4 percent in Germany, 4.3 percent in Italy, 0.6 percent in Japan, and 3.4 percent in the United Kingdom.

Employment

The Bureau of Labor Statistics reported that the unemployment rate fell back to 5.4 percent in February from 5.7 percent in January 1995. For comparison with other G-7 countries, the unemployment rate in February 1995 was 8.1 percent in Germany, 9.6 percent in Canada, 12.3 percent in France, 12.2 percent in Italy, 2.9 percent in Japan, and 8.4 percent in the United Kingdom.

Forecasts

Forecasters expect real growth in the United States to slow to an average of 2.8 percent (annual rate) in the first half of 1995 and of 2.3 percent (annual rate) in the second half of the year. Factors that may restrain the recovery in 1995 include the impact of rising interest rates on new investment, output, and incomes, and the contractionary impact of the decline in governmental spending. Table 2 shows macroeconomic projections for the U.S. economy for January to December 1995, by six major forecasters, and the simple average of these forecasts. Forecasts of all the economic indicators except unemployment are presented as percentage changes over the preceding quarter on an annualized basis. The forecasts of the unemployment rate are averages for the quarter.

The average of the forecasts points to an unemployment rate of 5.7 percent in the first quarter of 1995 and of 5.4 percent in the fourth quarter. A rise in factory orders during the previous quarter and a mounting backlog of manufactures unfilled orders will induce factories to sustain their hiring in 1995. Inflation (as measured by the GDP deflator) is expected to remain subdued at an average rate of about 3.0 percent in 1995. Gains in labor productivity and a slow rise in labor costs, wages, and compensation are expected to hold down inflation rates.

Table 2
Projected changes of selected U.S. economic indicators by quarters, Jan.-Dec. 1995
(Percent)

Period	Conference Board	E.I. Dupont	UCLA Business Forecasting Project	Merrill Lynch Capital Markets	Data Resources Inc. (D.R.I.)	Wharton WEFA Group	Mean of 6 forecasts
			GDP current dollars				
1995:							
Jan.-Mar.	6.4	6.1	7.5	4.9	5.9	5.1	6.0
Apr.-June	6.0	6.4	5.3	5.4	4.5	4.6	5.4
July-Sept.	7.3	6.7	5.5	4.9	3.0	5.3	5.4
Oct.-Dec.	6.6	6.8	4.7	5.3	4.0	4.9	5.4
			GDP constant (1987) dollars				
1995:							
Jan.-Mar.	3.0	2.9	3.9	2.3	3.0	2.4	2.9
Apr.-June	4.8	2.8	2.1	2.6	2.0	2.3	2.8
July-Sept.	4.1	2.2	2.0	2.2	0.6	2.1	2.2
Oct.-Dec.	3.3	2.1	1.9	2.5	1.8	2.1	2.3
			GDP deflator index				
1995:							
Jan.-Mar.	3.3	3.1	3.6	2.8	2.8	2.7	3.0
Apr.-June	3.2	3.5	3.1	2.7	2.4	2.3	2.9
July-Sept.	3.0	3.5	3.4	2.7	2.3	3.1	3.0
Oct.-Dec.	3.2	3.4	2.8	2.7	2.2	2.7	2.8
			Unemployment, average rate				
1995:							
Jan.-Mar.	5.5	6.5	5.5	5.4	5.8	5.6	5.7
Apr.-June	5.4	6.3	5.4	5.4	5.3	5.6	5.6
July-Sept.	5.1	6.4	5.3	5.5	5.3	5.7	5.5
Oct.-Dec.	5.0	5.5	5.3	5.6	5.5	5.8	5.4

Note.—Except for the unemployment rate, percentage changes in the forecast represent compounded annual rates of change from preceding period. Quarterly data are seasonally adjusted. Date of forecasts: March 1995.

Source: Compiled from data provided by the Conference Board. Used with permission.

U.S. TRADE DEVELOPMENTS

The U.S. Department of Commerce reported that seasonally adjusted exports of goods and services of $60.7 billion and imports of $72.9 billion in January 1995 resulted in a goods and services trade deficit of $12.2 billion, 67.1 percent more than the December 1994 deficit of $7.3 billion. The January 1995 deficit was $4.4 billion more than the deficit registered in January 1994 ($7.8 billion) and $3.3 billion more than the average monthly deficit registered during the previous 12 months ($8.9 billion).

The January 1995 trade deficit in goods was $17.2 billion, $4.3 billion more than the December 1994 deficit of $12.9 billion. The January 1995 services surplus was $5.0 billion, approximately $700 million less than the December 1994 surplus of $5.6 billion.

The total deficit on goods and services for 1994 was a revised $106.6 billion, $30.9 billion more than the 1993 deficit ($75.7 billion). Exports totaled $697.9 billion and imports totaled $804.5 billion. Table 3 shows seasonally adjusted U.S. trade in goods and services in billions of dollars, as reported by the U.S. Department of Commerce.

Exports of several commodity categories declined in January 1995 from December 1994. The December to January change reflected decreases in exports of ADP equipment and office machines to $2.5 billion from $3.3 billion, airplanes and airplane parts to $1.2 billion from $2.4 billion, general industrial machinery to $1.8 billion from $2.0 billion, scientific instruments to $1.3 billion from $1.5 billion, and telecommunication equipment to $1.3 billion from $1.6 billion. Other commodity categories showed negligible or no declines.

Changes in imports in January from December reflected increases in several commodities, such as organic chemicals, whose imports increased to $1.1 billion from $.9 billion and specialized industrial machinery $1.6 billion from $1.4 billion. Imports of several other commodities increased by smaller margins.

The United States incurred trade surpluses with few countries in January 1995. The U.S. trade surplus with Australia declined to $0.5 billion from $0.7 billion in December, but with Argentina increased to $0.3 billion from $0.2 billion in December. Deficits were recorded in January 1995 with Japan, China, Canada, Western Europe, Mexico, and OPEC. The U.S. trade deficit with Japan declined to $4.9 billion in January 1995 from $5.6 billion in December 1994, with China increased to $2.7 billion from $2.0 billion, with Canada declined to $1.4 billion from $1.6 billion, with Western Europe grew to $1.3 billion from $0.2 billion, and with OPEC declined to $0.8 billion from $1.0 billion.

Table 3
U.S. trade in goods and services, seasonally adjusted, Dec. 1994-Jan. 1995

(Billion dollars)

Item	Exports		Imports		Trade balance	
	Jan. 95	Dec. 94	Jan. 95	Dec. 94	Jan. 95	Dec. 94
Trade in goods (BOP basis):						
Current dollars—						
Including oil	44.0	46.5	61.2	59.4	-17.2	-12.9
Excluding oil	44.1	46.7	56.8	55.0	-12.7	- 8.3
Trade in services:						
Current dollars	16.7	17.1	11.7	11.5	5.0	5.6
Trade in goods and services:						
Current dollars	60.7	63.6	72.9	70.9	-12.2	- 7.3
Trade in goods (Census basis):						
1987 dollars	43.1	45.9	58.6	57.1	-15.5	-11.2
Advanced-technology products (current dollars, not seasonally adjusted)	9.2	11.5	8.5	9.3	0.7	2.2

Note.—Data on goods trade are presented on a Balance-of-Payments (BOP) basis that reflects adjustments for timing, coverage, and valuation of data compiled by the U.S. Census Bureau. The major adjustments on BOP basis exclude military trade but include nonmonetary gold transactions and estimates of inland freight in Canada and in Mexico not included in the Census Bureau data.

Source: *U.S. Department of Commerce News (FT 900)*, Mar. 22, 1995.

INTERNATIONAL TRADE DEVELOPMENTS

During the First NAFTA Year, U.S.-Mexican Bilateral Trade Was Virtually in Balance

U.S.-Mexican two-way trade reached a record level of $97.7 billion during the first year of the North American Free-Trade Agreement (NAFTA), which became effective on January 1, 1994. Mexico continued to rank third, after Canada and Japan, as a U.S. trading partner on both the export and import side, accounting for 10.2 percent of overall U.S. exports and 7.4 percent of total U.S. imports. Trade increased in most product categories both on the U.S. export and import side, its broad composition repeating largely established patterns of recent years.

The U.S. surplus in this trade—which was attained as recently as in 1991 for the first time in years and reached $5.7 billion in 1992—narrowed considerably in 1993, and virtually disappeared in 1994 (figure 1). U.S. Census data, with imports calculated on a customs value basis, show a U.S. merchanise trade surplus of only $531 million for the year (figure 1).

U.S. merchandise exports to Mexico surged by 21.8 percent in 1994, to $49.1 billion. This compares with a similar surge of exports in 1992 (23 percent) but with an only 1.8 percent increase in 1993 (figure 1). Machinery and transportation equipment, which accounted for almost half of total U.S. exports to Mexico (figure 2), were responsible for much of the increase, even though U.S. exports were up in virtually all major product categories.

The machinery product class includes automotive equipment and parts which, as in pre-NAFTA years, topped the list of exports as well as export growth. A large portion of automobile parts is destined for U.S.-owned production facilities in Mexico. (The Mexican automobile industry consists principally of subsidiaries of the Big Three U.S. automakers, besides Volkswagen and Nissan.) In response to NAFTA provisions, 1994 U.S. exports to Mexico of finished passenger vehicles jumped from $72 billion in 1993 to $354 billion.

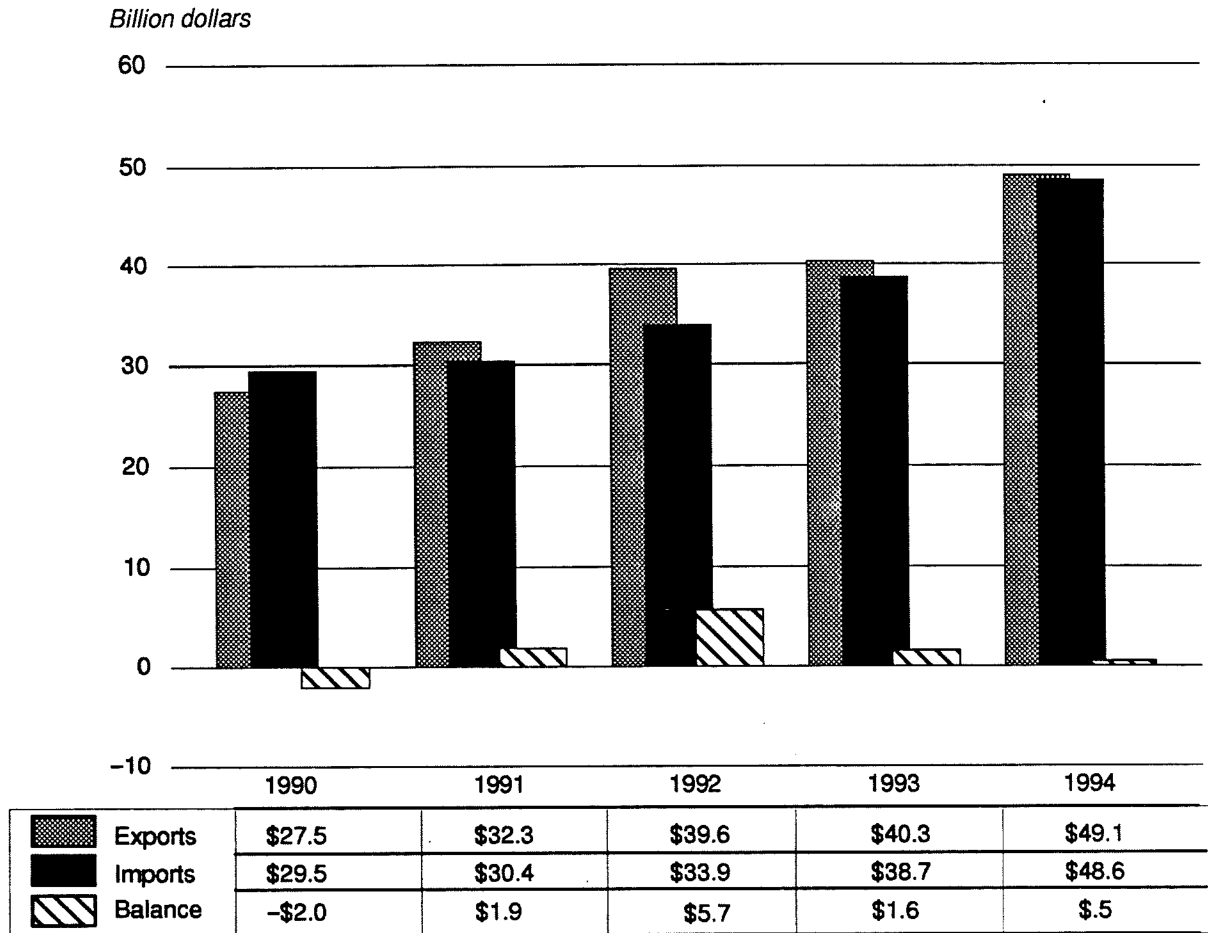
As before, office machinery (for instance, computers and accessories) and telecommunications equipment sold mainly to TELMEX, Mexico's privatized telephone monopoly, were leading U.S. exports in the first NAFTA year. In addition to passenger vehicles, other consumer durable goods, such as microwave ovens and washing machines, in fact, all being categories of consumer goods, contributed significantly to the rise of U.S. exports to Mexico in 1994.

Soybeans and grain sorghum were leading agricultural exports during the year, both up considerably from their 1993 level. Certain agricultural exports surged in direct response to the removal of trade barriers under NAFTA. Fresh and frozen cuts of beef, benefited from the removal by Mexico of 20 to 25 percent duties, although Mexican officials imposed new inspection and labeling requirements for these imports, which the U.S. packing industry saw as new barriers to trade. Similarly, U.S. apples exported to Mexico benefited from the elimination of tariffs and import licenses under NAFTA. Exports topped the level set in tariff-rate quotas under NAFTA.

The surge of U.S. imports from Mexico surpassed the growth in U.S. exports, which explains the virtual disappearance of the U.S. trade surplus during the first NAFTA year. Despite the overvalued peso, which made Mexican exports relatively expensive, growth of U.S. imports from Mexico has accelerated in recent years. Imports rose 11.5 percent in 1992, 14.2 percent in 1993, and 25.6 percent in 1994. Imports amounted to $48.6 billion during the first NAFTA year, compared with $38.7 billion in 1993.

Crude petroleum continued to be the leading U.S. import item from Mexico, but more than half of the total import value consisted of machinery and transportation equipment (figure 2). As on the export side, this dominant product category was principally responsible for the accelerated growth of all U.S. imports from Mexico. Automotive items accounted for a major part of machinery imports. U.S.-Mexican trade

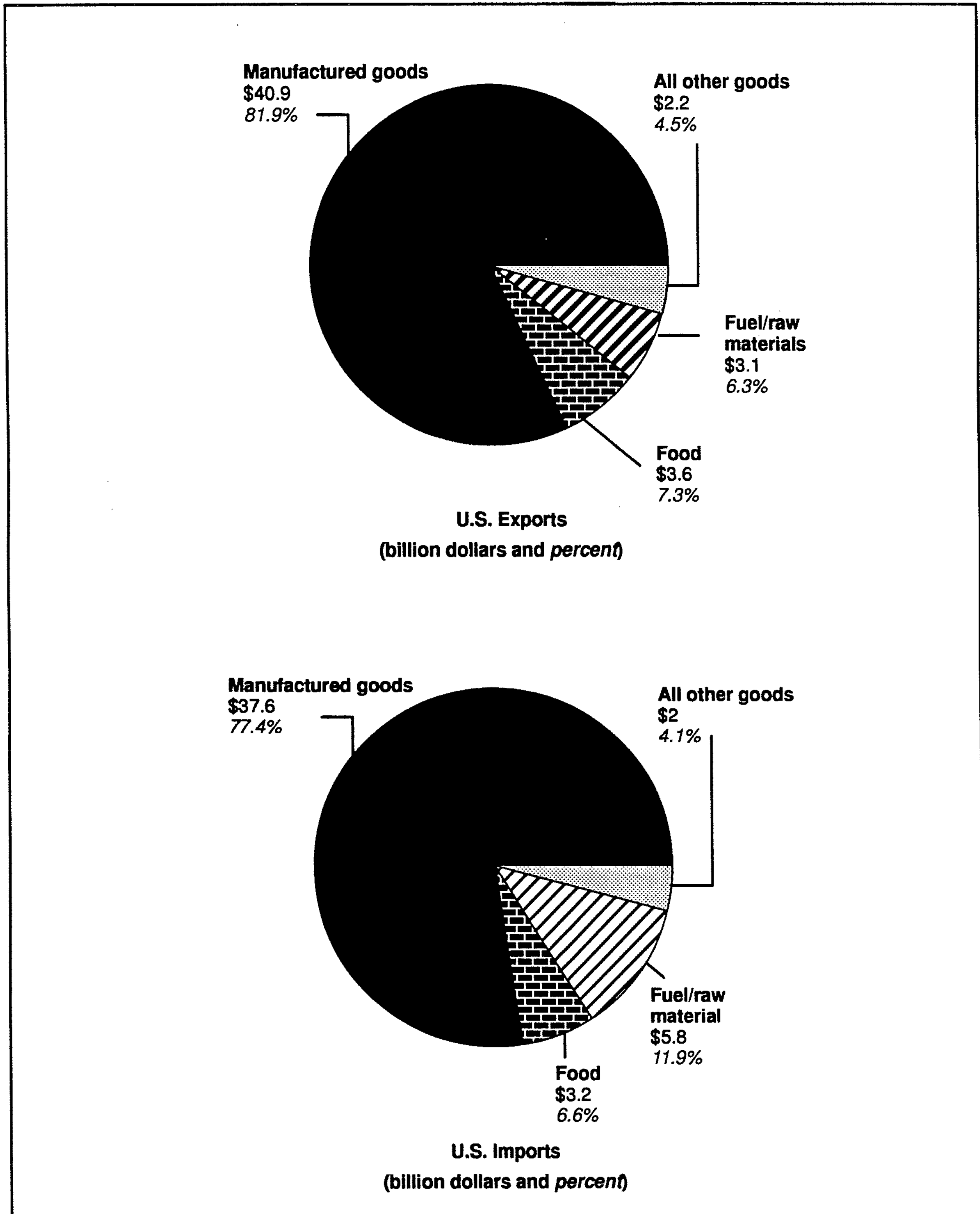
Figure 1
U.S. trade with Mexico: Exports, imports, and trade balance, 1990–94



	1990	1991	1992	1993	1994
Exports	$27.5	$32.3	$39.6	$40.3	$49.1
Imports	$29.5	$30.4	$33.9	$38.7	$48.6
Balance	–$2.0	$1.9	$5.7	$1.6	$.5

Source: Official U.S.Census data.

Figure 2
U.S. trade with the Mexico by product sectors, 1994



Note.—Because of rounding, figures may not add to totals shown.

Source: Compiled from official statistics of the U.S. Department of Commerce.

within the automotive industry—in fact, the entire machinery and transportation category—and still such other manufacturing areas as textiles and apparel can be characterized as largely "intra-industry trade" since a considerable portion takes place in both directions.

A significant portion of intra-industry trade (47.5 percent of all U.S. imports and 23.6 percent of all U.S. exports) is generated by production sharing between U.S. and Mexican plants. Having U.S. materials processed or U.S. components assembled in Mexico, where wages are lower, helps many U.S. producers of labor intensive articles to compete with Asian imports on the U.S. market. At the same time, this arrangement benefits Mexico by creating jobs for Mexicans and by transferring U.S. managerial and technological know-how to Mexican establishments. The facilities involved in production sharing on the Mexican side are generally "maquiladoras," that is, in-bond production-units, established since 1965 under Mexico's Border Industrialization Program.

Products of production sharing reenter the United States under chapter 98 of the *Harmonized Tariff System (HTS)*. Since the United States levies duties only on the value added in Mexico but the U.S. input enters duty-free, the overall rate of duty in this import category is reduced. Half of these imports (which, as mentioned, constituted 47.5 percent of total 1994 imports from Mexico) were accounted for by U.S. content returned after further processing or assembly. Therefore, U.S. content returned accounted for 23.6 percent of all U.S. imports from Mexico. It should be pointed out that, by contrast, U.S. imports from East Asia are made largely from components produced in Asia. For example, in 1993, the share of U.S. imports from Korea and China containing U.S.-made components was only 10 and 1 percent, respectively.[1]

Production sharing with Mexico did not change materially in the first NAFTA year. The share of U.S. exports to Mexico going into production sharing and of imports resulting from it was negligibly lower in 1994 than in 1993, when these ratios were 24.5 and 49.1 percent, respectively.

The United States plays a dominant role in Mexico's foreign trade, both as an export market and as a source of imports. During the first NAFTA year, Mexico depended on the U.S. market for an estimated 83.5 percent of its exports and sourced an estimated 71.3 percent of its imports from U.S. suppliers. As shown, however, despite such a commanding U.S. role, the United States played virtually no part in Mexico's 1994 trade imbalance, which is largely blamed for the peso crisis that erupted at the end of the year.[2] The trade deficit Mexico registered with Canada in 1994 was equally negligible. Under Secretary Jeffrey E. Garten, U.S. Department of Commerce, addressing the Americas Society on March 10, 1995, said, "In fact, I find it remarkable how balanced NAFTA trade was in its first year of operation."

It may come as a surprise for many that Mexico's $18.5 billion trade deficit in 1994 resulted mostly from trade with countries other than NAFTA partners. According to Bank of Mexico data, the European Community was responsible for more than one third, and Asian countries accounted for about one third on a January-November basis. The large increase in the deficit in 1994 is also attributable predominantly to these two trading regions.

[1] See U.S. International Trade Commission (USITC), "NAFTA Update: Steady U.S. Bilateral Trade Growth With Mexico Faces Mixed Prospects in 1995," by Ruben Mata, in Industry, Trade, and Technology Review, Mar. 1995.

[2] See USITC, "Financial Crisis in Mexico," by Magdolna Kornis, in IER, Mar. 1995.

U.S.-Japan Reach Financial Services Agreement

In June of 1994, the United States and Japan agreed to elevate financial services to priority status under the U.S.-Japan Framework Agreement. Financial services joined automobiles and auto parts, insurance, and telecommunications and medical equipment and services as priority sectors for negotiation during 1994.

According to the U.S. Trade Representative (USTR) Michael Kantor, Japan's huge financial services markets were "highly segmented and heavily regulated, as evidenced by the variety of laws, administrative regulations, and institutional arrangements governing all aspects of financial activity." U.S. companies had alleged that they were systematically excluded from Japan's financial services market by far-reaching regulatory and structural barriers. Negotiators from the Office of the United States Trade Representative urged Japan to deregulate its financial services market, especially its pension fund, investment trust management, securities underwriting, and trading and banking sectors. U.S. negotiators also sought the liberalization of Japan's restrictions on the management of public annuity funds, the relaxation of restrictions on cross-boarder capital flows and on new security products such as derivatives, the modification of its rules restricting the management of underwriting services to only four securities firms, and the transparency of all regulations governing financial services. According to the Nikkei Weekly, a major priority for U.S. negotiators was the deregulation of Japan's private and public pension fund management system. The paper reported that,

during 1994, "less than 0.2 percent of Japan's pension assets were managed by foreign firms," as compared to 8 percent of those in the United States.

In Japan, reactions to the deregulation of the financial services market were mixed. Japan's Ministry of Finance opposed any extensive deregulation of Japan's pension market to shield Japan's trust banks and insurance companies from foreign competition in this highly lucrative portion of their business. The Ministry of Health and Welfare and the Pension Welfare Service Public Corporation (Nenpuku) called for the liberalization of Japan's public pension fund market and the Ministry of International Trade & Industry backed the deregulation of the corporate securities market. By the end of December, U.S. and Japanese negotiators were able to agree on an outline for an agreement.

On January 10, 1995, the United States and Japan reached an agreement on financial services. The agreement will give U.S. and foreign fund managers access to Japan's $1 trillion public and private pension fund market and will expand opportunities in Japan's $500 billion corporate securities market. U.S. and foreign firms will gain unrestricted rights to compete and manage the nearly $200 billion in public pension funds, and the approximately $130 billion in the private pension market will be opened to international competition. However, other parts of the private pension market continue to remain off limits to foreign participation.

According to the U.S. Treasury Department, the provisions of the agreements include: "the elimination restrictions on cross-boarder transactions, the elimination of the balanced fund requirements on the bulk of pension assets open to IACs; a commitment to move toward market value accounting for pension liability calculations and disclosure, and the disclosure of fund manager performance on a market basis; deregulation of the investment trust business; liberalization of restrictions on the introduction of new financial instruments; a commitment to introduce a domestic asset-based securities market in Japan; transparency in government regulations; elimination of restrictions on securities offerings by residents and nonresidents; and unlimited access by resident corporate investors to virtually all financial instruments available outside Japan." The agreement also establishes procedures for evaluation and compliance by using a comprehensive set of qualitative and quantitative objective criteria.

SPECIAL FOCUS

U.S. Economic Relations With the Countries of the Central European Free Trade Agreement (Visegrad Group)

Introduction

The four signatories of the Central European Free-Trade Agreement (CEFTA), that is, the Czech Republic, Hungary, Poland, and Slovakia, play a unique role in European affairs. In addition to linking Western Europe and the former Eastern Bloc[3] to the East and to the Southeast geographically, they also represent an intermediary stage of economic organization between the mature market economies to the West and the rest of the former Eastern Bloc that lags behind them in building a market economy. The CEFTA countries often act—and are regarded —as a bloc in the international political arena.

The four countries share many historical and cultural traditions. They were the first among the former socialist states to embrace the principles of multiparty democracy and market-based economic organization. Because they could draw on more experience within living memory than the rest of the former Eastern Bloc in both domains, they had an earlier and stronger commitment to political and economic transformation than the rest of these countries when the socialist epoch ended. Since the CEFTA countries started earlier, they are ahead of the former Eastern Bloc in the interrelated process of transition to a market economy and macroeconomic stabilization.

The determination to establish a free-trade zone among Czechoslovakia (which split into the Czech Republic and Slovakia in 1993), Hungary, and Poland first emerged at the Visegrad, Hungary, meeting of their heads of state in February 1991. (Hence the name the "Visegrad Group" or "Visegrad countries," often used in reference to the region.) The agreement, signed in Krakow on December 21, 1992, went into effect on March 1, 1993. Immediately after signing the agreement, the signatories declared their intention to accelerate its implementation. According to current plans, some 90 to 95 percent of trade among the four countries, including trade in agriculture and services, should be completely liberalized by the end of 1997. The growing cooperation among the Central European states has a major motive beyond facilitating regional trade. All four countries have association agreements in effect with the European Union (EU), with membership in the Union as the ultimate goal. Increasingly free interaction between the EU and each of the Central European states requires the elimination of trade barriers among the Central European states themselves.

The economic strength of the potentially duty-free CEFTA region is impressive. The combined population of the four countries is 65 million, about one-fourth of the U.S. population. Their combined territory is about 206,000 square miles, exceeding the combined territory of Germany, the Netherlands, Austria, and Switzerland. Their combined GNP is $311.8 billion. Their total exports and imports, including trade among themselves, are about $86 billion.

The United States welcomes and supports the growing regional cooperation among the CEFTA countries, as well as their integration into the EU. These developments signal the consolidation of the political and economic institutions that developed in the wake of the collapse of Marxist-Leninist ideology and institutions in Europe. They promise the extension of the sphere of prosperity from Western Europe eastward and, consequently, an improvement in the world economy.[4]

These developments also endanger U.S. business interests to some extent. The emergence of duty-free trade in the CEFTA region and between the region and the EU is expected to moderate the expansion of U.S.-CEFTA trade during the rest of the decade. The growing interindustry cooperation among EU and CEFTA firms might also place EU investors in a uniquely advantageous position to evaluate and acquire the most promising industrial assets that CEFTA countries can offer in the course of privatization.

Nevertheless, U.S. economic ties with the CEFTA countries are expanding and U.S. businesses should have increasing opportunities in the region. This article looks, in some detail, at three facets of U.S. economic relations with the region: commercial relations, trade, and investment. It is the initial installment of a series of articles on the Visegrad Group.

[3] The Eastern Bloc includes, in addition to the CEFTA countries, Albania, Bulgaria, Romania, the Baltic states, and the successor states to the Soviet Union.

[4] Several nations have expressed the wish to join CEFTA. Slovenia appears to be the best candidate for membership.

U.S. Commercial Relations With the Region

Since 1989, U.S. commercial relations with the CEFTA countries have been completely normalized. Following the break-up of Czechoslovakia on January 1, 1993, agreements with the dissolved federation remained in force between the United States and each of the two sovereign successor states.

The four countries have permanent most-favored-nation tariff status with the United States, and many of their products enter the U.S. markets duty-free under the U.S. Generalized System of Preferences (GSP).[5] All CEFTA countries have bilateral textile agreements with the United States, which secure the possibility of further increases in their textile shipments to U.S. markets. Under the Uruguay Round Agreement on Textiles and Clothing, these quotas will be further liberalized and completely phased out by the end of 2004. The United States has eliminated practically all controls on its high-technology exports to the CEFTA region. At present, all four countries belong to country group "V," under the classification system of the Export Administration of the U.S. Department of Commerce. This group used to be called the "free world group" during the Cold War.

The United States has bilateral investment treaties with the Czech Republic and Slovakia. These treaties guarantee that U.S. investors in the respective countries will enjoy the same treatment as domestic or third-country investors. They provide for the unconditional repatriation of capital, the protection of intellectual property rights, and the arbitration in commercial disputes by international forums. The United States and Poland have signed and ratified a bilateral business and economic treaty, which in addition to ensuring the benefits provided under the above cited bilateral investment treaties, also provides for the expansion of bilateral commerce. Hungary has concluded agreements with the United States for the protection of intellectual property rights.

The entire range of services of the Overseas Private Investment Corporation (OPIC), the Export-Import Bank (Eximbank), and the U.S. Trade and Development Agency (TDA) is extended to all four countries.[6] In addition, the U.S. Government has taken the following steps to help U.S. firms trade with and invest in the CEFTA region: (1) It established the Eastern Europe Business Information Center (EEBIC) to serve as a permanent source of detailed information for U.S. firms wanting to do business in the region.[7] The EEBIC created a computerized system that matches U.S. companies with interested CEFTA partners. To date, the EEBIC has provided information to more than 150,000 U.S. companies. (2) It launched the Consortia of American Businesses in Eastern Europe (CABEE) program to provide technical assistance to U.S. firms that want to establish operations in the region. (3) It set up an American Business Center in Bratislava, Slovakia, to help develop U.S.-Slovak economic ties, which lag behind U.S. economic ties with the rest of the CEFTA countries. (4) It created the Commercial Law Development Program for Central and Eastern Europe to provide technical assistance to the former Eastern Bloc countries in modernizing their legal systems. This effort is expected to help U.S. companies by reducing the difficulties and risks of doing business in the region.

The U.S. Agency for International development (AID) maintains representatives in each CEFTA capital. During 1990-94, total U.S. aid and assistance to the CEFTA countries in the form of loans, grants, humanitarian and technical assistance amounted to an estimated $1.2 billion.[8] In January 1995, at the White House Conference on Trade and Investment in Central and Eastern Europe, the Administration pledged to increase support for U.S. businesses that want to invest in the region by increasing contributions to government-sponsored investment funds operating there. Further measures to catalyze the expansion of economic ties with the CEFTA countries are expected to emerge from the upcoming "Muenster Conference" later in 1995. This series of cabinet-level meetings of the G-7 countries began in Germany in 1991. The stated goal of these meetings is to focus the attention of leading industrialized democracies on expanding economic contacts with the former Eastern Bloc countries.

A potential problem that looms on the horizon of U.S.-CEFTA relations is the GSP status of these countries. U.S. companies may suffer material injury as a result of the gradual merger of the CEFTA economies into the EU. If the injury suffered by U.S.

[5] During 1994, 86.2 percent of the total U.S. imports from the Czech Republic eligible for GSP treatment entered duty-free under the program. The comparable figures were 92.1 percent for Hungary, 90.0 percent for Poland, and 91.1 for Slovakia.

[6] OPIC is a self-sustaining, U.S. government agency that provides investment information, financing (loan guarantees and direct loans), and political risk insurance for U.S. companies wanting to invest in the countries eligible for its support. The Eximbank is an independent

33—*Continued*

U.S. Government agency that provides loans, loan guarantees, and export credit insurance for U.S. firms. The TDA promotes U.S. exports through financing feasibility studies and related services in the eligible countries.

[7] EEBIC provides information for U.S. businesses about the entire former Eastern Bloc.

[8] This figure does not include benefits from U.S. contributions to multilateral organizations.

companies in the process is deemed significant, the CEFTA countries could lose their GSP status with the United States. Section 502 (b) (3) of the Trade Act of 1974 says that the President shall not designate any country a beneficiary developing country "if such country affords preferential treatment to the products of a developed country, other than the United States, which has, or is likely to have a significant adverse effect on the United States commerce. . ." A number of U.S. firms have already complained to the Office of the United States Trade Representative that they have lost business to EU suppliers in the CEFTA region as a result of the Europe Agreements. Some analysts have suggested that in order to allow U.S. firms to remain competitive in the CEFTA countries, the United States should consider negotiations toward free-trade accords with them.

All four countries are members of the General Agreement of Tariffs and Trade, as well as signatories of the Uruguay Round agreements, establishing the World Trade Organization. Consequently, they subscribe to the accepted code of conduct in international trade and support further efforts at trade liberalization.

U.S. Trade With the Region

U.S. trade with the CEFTA region has expanded rapidly following the collapse of European communism in 1989. U.S.-CEFTA merchandise trade (exports plus imports) expanded from $1.5 billion in 1990 to $2.8 billion in 1994. However, U.S.-CEFTA trade did not grow from 1993 to 1994 (table 4). Whereas imports from the region grew unbroken over the years, U.S. exports declined from 1993 to 1994.[9] Analysts are not sure that U.S.-CEFTA trade expansion will continue in the coming years.

In bilateral trade, Poland is the region's largest U.S. trading partner. Machinery and transport equipment (with aircraft and parts as the most important subgroup) and processed food products were the leading items in U.S. exports to Poland during 1994. The decline in U.S. exports to Poland from the first half of 1993 to the corresponding period of 1994 is primarily due to the decline in shipments of machinery and equipment, and grains. In particular, U.S. shipments of large aircraft (exceeding 15 metric tons, *Schedule B* subheading 880240) declined from $140,441 (four planes) during 1993 to $67,235 (two planes) during 1994. In imports from Poland, machinery specialized for particular industries, articles of apparel and clothing accessories, nonferrous metals (such as copper), nonmetallic mineral manufactures (such as glassware), and iron and steel products were the leading commodity groups. With the exception of articles of apparel and clothing accessories, U.S. imports of these Polish goods grew in all of the above-mentioned commodity groups. For the first time since 1989, Poland shipped metallurgical coke to the United States. The reemergence of Poland as a coke supplier to the U.S. market confirms an earlier assessment by the USITC. As a result of the anticipated decline in Poland's steel capacity during the remainder of the 1990's, the country is expected to have relatively significant amounts of surplus coke.[10]

Machinery and transportation equipment was the leading group of U.S. exports to Hungary during 1994. A drop in shipments in this category explains the decline in exports. U.S. shipments in the category of large aircraft, exceeding 15 metric tons (*Schedule B* subheading 8802.40) declined from $154,858 (two planes) during 1993 to $32,890 (one plane) during 1994. Among U.S. imports originating in Hungary in the first half of 1994, parts and accessories of motor vehicles, electric light bulbs, articles of apparel and clothing accessories, iron and steel products, organic chemicals, and processed food (mainly fruit juices and prepared meat), and iron and steel were the leading product groups. Shipments to the United States increased in all these groups from 1993 to 1994.

In trade with the Czech Republic, machinery and transport equipment (with office machines and data processing equipment, and telecommunications equipment as the most important subgroups), and miscellaneous manufactured articles were the leading U.S. exports. In imports, manufactured goods classified by material (such as textile yarn, fabrics, glassware, iron and steel), machinery and transport equipment, and miscellaneous manufactured articles were the largest groups. U.S. imports from the Czech Republic increased for a broad range of products in the first half of 1994. The most significant increase occurred in iron and steel products.

In trade with the Slovakia, metalworking machinery was the leading U.S. export during 1994; iron and steel products, articles of apparel and clothing accessories were the most significant imports. Although U.S. exports increased from 1993, U.S. imports from Slovakia increased even faster. The most significant increases in imports occurred in iron and steel.

Overall, decreased shipments of aircraft to Poland and Hungary and grains to Poland explain the decline in U.S. exports to the CEFTA region from 1993 to

[9] Official statistics may understate U.S. exports to the region, because some companies ship products to the region through their West European subsidiaries or warehouses.

[10] See USITC, *Metallurgical Coke: Baseline Analysis of the U.S. Industry and Imports*, Mar. 1994, USITC publication No. 2745, pp. 5-7 to 5-11.

Table 4
U.S. Trade with the CEFTA Countries, 1990-94

(Millions dollars)

Year	CSFR	Czech Republic	Slovakia	Hungary	Poland	CEFTA total
1990:						
Exports	85.3	(1)	(1)	151.6	395.9	632.8
Imports	79.0	(1)	(1)	345.3	401.3	825.6
Total	164.3			496.9	797.2	1,458.4
1991:						
Exports	119.8	(1)	(1)	246.9	441.0	807.7
Imports	145.7	(1)	(1)	367.2	350.8	863.7
Total	265.5			614.1	791.8	1,671.4
1992:						
Exports	399.1	(1)	(1)	282.0	628.0	1,309.1
Imports	237.1	(1)	(1)	347.7	367.7	952.5
Total	636.2			629.7	995.7	2,261.6
1993:						
Exports	(1)	241.6	33.0	424.6	898.3	1,597.5
Imports	(1)	278.1	67.4	400.9	446.7	1,193.1
Total		519.7	100.4	825.5	1,345.0	2,790.6
1994:						
Exports	(1)	276.7	41.8	302.0	609.0	1,229.5
Imports	(1)	314.3	126.7	469.0	647.1	1,557.1
Total		591.0	168.5	771.0	1,256.1	2,786.6

[1] Not available.
Source: Compiled from official statistics of the U.S. Department of Commerce.

1994. U.S. imports from the region increased as a result of larger shipments of a broad spectrum of goods. Increases in U.S. imports were registered in 45 out of 64 commodity groups at the 2-digit SITC level of classification, or for 70 percent of these groups. Some of the trade was the result of growing U.S. direct investment in the CEFTA countries. U.S. exports included shipments of machinery and equipment to U.S. investment sites in the region. U.S. imports, such as light bulbs produced by General Electric Corp. in Hungary, included goods produced by U.S. firms in the region.

During 1994, the relative share of the CEFTA countries in U.S. trade was negligible (less than 0.5 percent.) The relative share of the United States in the trade of the CEFTA countries was less than 5 percent. The EU, the dominant trading partner of the CEFTA countries, continued to increase its weight in the trade of every country of the region. At present, the EU accounts for roughly one half of the region's trade.

Mixed Outlook for the '90s

Good economic growth prospects and expanding U.S. investment in the CEFTA countries,[11] and the excellent commercial relations between the United States and the region's national governments suggest that U.S.-CEFTA trade could grow rapidly during the remainder of the decade.

The main factors that could hamper the expansion of U.S. trade with the CEFTA countries are the dismantlement of tariffs among them and their integration into the EU. As tariffs in the CEFTA region and between the region and the EU are gradually eliminated, suppliers in the combined EU and CEFTA area, who are still protected by tariffs against nonpartner suppliers, are expected to capture market shares from these suppliers. For example, if a U.S. exporter sells a product for $100 in a given CEFTA country and the duty on the product is 5 percent, the domestic price in the CEFTA country may be approximately $105. If duties are eliminated among the CEFTA countries, and between them and the EU on this product, an exporter from the EU or from another CEFTA country could outcompete the U.S. exporter as long as his price was less than $105. (If the new supplier gains the market with a price that is above $100, i.e., he is less efficient than the displaced U.S. supplier, the phenomenon is called "trade diversion.")

U.S. companies should be aware of quantitative quotas that might hamper the full realization of business opportunities provided by the elimination of tariffs. Internal economic difficulties in the member

[11] See section C for details on U.S. investment in the CEFTA countries.

states may also prompt them to introduce temporary import surcharges that would be applicable against all imports, including those from the CEFTA partners. At present, Slovakia applies a temporary, 20-percent import surcharge on selected commodities. Furthermore, several reports indicate that, despite the customs union between the Czech Republic and Slovakia, which is one of the fundamental premises of CEFTA, the movement of goods between the two countries is far from being smooth. Shipments from the Czech Republic to Slovakia, or vice versa, face long delays at the customs houses on the new border. Some U.S. companies in Prague are reportedly finding it easier to export to Slovakia via Austria than via the new Czech-Slovak border.

Trade Will Grow Over the Long Term

Despite the initial decline, trade between a free-trade area and outside partners is expected to increase over the long term. Good examples of this are U.S. trade with Germany, the EU's economic linchpin, and Austria, a country that has become increasingly integrated into the EU. During 1994, U.S. trade with Germany is $569 per capita of the German population and U.S. trade with Austria is $333 per capita of the Austrian population. In comparison, U.S. trade with the CEFTA countries was only $43 per capita. As a result of long-term economic development and concomitant rise in per capita income in the CEFTA countries, per capita U.S. trade in these countries should gradually move toward that of the mature market economies of Central Europe.

U.S. Investment in the Region

In contrast to the widespread view in the United States that U.S. firms, preoccupied with short-term profits, are easily outcompeted by the far-sighted West Europeans and Japanese abroad, the CEFTA countries recognize U.S. firms as the most dynamic investors of long-term capital in the region. At the end of 1994, with a cumulative investment of $6.1 billion, the United States led other countries in making foreign investments in the region. Germany was in second place, followed by Italy and Austria. Whereas the CEFTA region has attracted mainly large manufacturing investments from the United States, it has attracted both large- and small-scale investments from the EU.

U.S. brand names are making headway in the CEFTA countries. Subsidiaries of traditional U.S. rivals (for example, General Motors Corp. and Ford Motor Co., Coca-Cola Co., and Pepsico, Inc.) continue to compete in this new, emerging market place. Many prestigious American law firms and accounting offices have set up operations in the CEFTA countries. Typically, subsidiaries of U.S. companies in Western Europe establish and supervise spin-off subsidiaries in CEFTA capitals. From a statistically negligible level in 1989, per capita U.S. direct investment in the CEFTA region increased to an estimated $95 by the end of 1994. (The comparable number for the EU was $578.)[12]

The CEFTA countries are, and for some time will remain, in the forefront of attracting private U.S. foreign investment in the former Eastern Bloc. The relatively higher tariff rates imposed on non-European suppliers, coupled with possible nontariff barriers against them, at least partially explains the inflow of U.S. capital into the region. One way outside suppliers can mitigate a loss in their current market shares is to establish a presence inside the CEFTA region.

The integration of the CEFTA countries into the EU offers new strategic possibilities for U.S., as well as other nonregional firms, to serve the EU market.[13] The CEFTA countries are also ideally located to serve as bases for exports to the currently dormant, but potentially gigantic market represented by the rest of the former Eastern Bloc. On a bilateral basis, each of the CEFTA countries is expanding its commercial relations with the countries of this area.

County-by-country

The following is a country-by-country description, indicating the level of total and U.S. investments at the end of 1994, and the major characteristics of the local investment environment.

Hungary.—With $3.6 billion of the total $8.5 billion foreign investment, U.S. investors were in the lead. Germany was in second place and Austria was in third place. The largest U.S. investors are Ameritech, ($875 million), General Electric Co. ($550 million), U.S. West International ($330 million), General Motors Corp. ($300 million), Alcoa ($165) million), and Ford Motor Co. ($123 million).

Most foreign investment initiatives were replaced by national treatment on January 1, 1994. But the corporate income tax rate was reduced from 40 to

[12] Foreign Direct Investment (FDI) is defined as capital sent abroad to a firm in which the investor owns at least 10 percent of the shares. FDI takes the following forms: In-kind investment (the delivery of machinery and equipment to the site of operations), equity investment (the purchase of shares), and working capital deposited through the banking system.

[13] *Business Eastern Europe*, Jan. 23, 1995, p. 1.

36 percent in January 1994, and companies can still apply for tax reductions on reinvested funds.

The prevalent opinion among Western financiers is that much of Hungary's remarkable success in attracting foreign investment stems from its long-standing presence on the international bond market. They suggest that foreign investors view Hungary's familiar presence and track record of payments as highly attractive features in its investment environment. Hungary is particularly open to allowing foreign participation in the ongoing divestiture of state-owned utilities.

Poland.—U.S. firms, accounting for $1.3 billion of the $4.2 billion total foreign investment, were in the lead, followed by firms from Italy and Germany. The largest U.S. investors are International Paper Co. ($315 million), Coca-Cola Co. ($230 million), Polish-American Enterprise Fund ($227 million), Procter and Gamble Co. ($190 million), and Curtis International, Inc. ($100 million).

Poland emphasizes the national treatment of foreign firms. The corporate profit tax is 40 percent for all companies, regardless of foreign participation. Nevertheless, tax exemptions are granted to wholly or partially foreign owned companies on a case-by-case basis. The criteria to obtain preferential tax treatment are that foreign investment must exceed 2 million ECUs and that the company should either promote the transfer of technology, or export at least 20 percent of its total output, or be located in a region where unemployment is relatively high. Among the CEFTA countries, Poland represents the largest national market.

Czech Republic.— With $1.1 billion of the $3.8 billion total, U.S. investors were a close second behind Germany. The largest U.S. investors are Philip Morris, Inc. ($215 million), K Mart Corp. ($120 million), and Procter and Gamble Co. (44 million).

The Czech Republic also emphasizes national treatment of foreign companies. The corporate income tax was reduced from 45 percent during 1993 to 42 percent during 1994, and the Government plans to reduce it to approximately 35 percent in the future. Business executives from the industrialized countries praise the Czech Republic's new commercial code that affords them a legal environment comparable with that of their respective home countries. International financial experts consider the Czech Republic the most creditworthy among CEFTA members.

Slovakia.—With roughly 10 percent of the total foreign investment of $0.5 billion, U.S. investors stood in third place behind investors from Germany and Austria. The largest U.S. investors are K Mart Corp. ($30 million), Pepsico Corp. ($5 million), and Philip Morris, Inc. ($5 million).

Slovak officials say that they intend to attract $2.5 billion in foreign investment by the end of the decade. To achieve this goal, they have created special incentives for foreign investors. Foreign firms locating in areas where there is a concentration of heavy industry enjoy a 2 year complete tax holiday. If foreign capital in a mixed firm in such an area exceeds 70 percent, 70 percent of the tax liabilities are waived during the following 2 years. Firms in areas, excluding those specified above, that have at least 1 million DM foreign capital and/or foreign participation exceeding 30 percent, enjoy a tax holiday of 1 full year and a 30-percent reduction in tax liabilities during the following 2 years. Firms with less than 30 percent foreign capital and less than 1 million DM foreign capital get 1 full year of tax holiday. In each of the above categories, banks with foreign participation receive more tax relief than do manufacturing firms.

The U.S. Investor and CEFTA

U.S. subsidiaries with investments in the CEFTA countries welcomed the free-trade agreement and showed an increasing interest in exploring its implications for business strategies in the region.[14] The elimination of a number of tariffs has already permitted some U.S. companies to rationalize and expand their sales in the CEFTA countries. For example, General Motors Corp., which used to sell Opel Kadett/Vauxhall Astra cars to the Czech Republic from Western Europe, began to serve the Czech market from its Hungarian manufacturing plant (Szentgotthard). (GM does not export this product from Hungary to Poland, since it has set up manufacturing facilities in Poland too.) Making use of the elimination of tariffs on chemical products, Procter and Gamble, with its distribution facility located in Prague, has expanded its sales of detergents to Poland.

Business executives point out that, once the tariffs are completely out of the way, the decisions about where to produce would be made strictly on the basis of where one could obtain the best raw materials and produce most efficiently. Primarily, the location of capital-intensive manufacturing will be affected. In labor-intensive sectors, such as food-processing and textiles, local production is more profitable than regional distribution. For instance, the food processor subsidiary of Philip Morris, Kraft Jacobs Suchard (Switzerland), has manufacturing plants in each CEFTA country.

[14] *Business Eastern Europe*, Mar. 7, 1994, pp. 1 and 2.

Some Business Considerations

Thorough due diligence.—Business advisory publications repeatedly recommend that U.S. firms must not cut corners in assessing all aspects of investment projects in the transition economies. The growing presence of Western credit rating agencies makes this task easier in the CEFTA countries. For example, Dun and Bradstreet has offices in the Czech Republic, Hungary, and Poland.[15]

Specifically, business analysts recommend that U.S. firms conduct environmental audits before making acquisitions or entering into joint ventures with local partners. Firms should adjust their offers in accordance with their findings, otherwise they might have to carry a disproportionate burden in financing the elimination of ecological damages that occurred before their arrival. U.S. investors also have been advised to obtain as many warranties and indemnities as possible from local sellers.[16] Some goods produced in the CEFTA countries have ISO 9000 certifications (the internationally recognized quality assurance standard). A number of U.S. investors, for example, General Motors, Corp. in Hungary, require such certifications from some of their major local suppliers.[17]

Business analysts advise firms to consider the growing regional differences in income levels in each country into consideration before making their decisions. To locate retail operations in high income areas, and manufacturing operations in low income areas is evidently profitable. Data on regional income differences became available in the CEFTA region.[18]

Union issues.—Companies must pay close attention to union issues. By law, investors in all CEFTA countries must have either a union agreement or an internal policy that provides minimum employment standards. If dealing with a union, companies must create an umbrella agreement with the relevant union and an addenda containing individual operations.[19] Agreements include action items, such as establishing an obligation to publish performance trends in an annual report, allowing union representation at all company-employee meetings, providing an office and conference room for union meetings, allowing fee collection, and discussing safety conditions.[20] Diversification among countries and unions forces companies to deal with each case separately. Firms have indicated both good and bad surprises.[21]

Hedges against currency and inflation risks.—Business analysts often advise investors operating in the transition economies to hedge against unexpected changes in the value of the local currency. For example, investors concerned about the devaluation or depreciation of the local currency keep their earnings on foreign currency accounts to the extent possible. Business analysts also recommend the use of cash-flow hedging methods, such as "invoicing," "lagging," and "netting." The "invoicing" method entails the requirement to be paid in a convertible currency. "Lagging" means to time exports and imports according to expected changes in the value of the local currency. For example, if nominal devaluation is sure, the company should front-load its imports and end-load its exports for a given period. "Netting" means to keep the companies' exports and imports in balance to avoid risks involved in exchanges altogether. Analysts recommend the use of the limited but expanding forward currency markets in the CEFTA countries. Forward contracts for the delivery of foreign exchange might be expensive, given the still prevailing high interest rates, but might still be a good hedge against a large-scale devaluation.[22]

Despite improving macroeconomic stability, increases in inflation rates could occur in all the transition economies. Increases in utility prices and wages would be the most likely causes for such temporary reversals. Borrowing in foreign exchange might be a good hedge against inflation risks as long as the real interest of the foreign exchange loan (for example, nominal interest on a DM loan minus inflation in Germany) exceeds real interests on a local currency loan (for example, nominal interest on a Czech Koruna loan minus the rate of inflation in the Czech Republic). However, some businesses in the CEFTA countries have found that real interest rates paid for loans in local currency were less than real interest rates paid for those in convertible currencies. In such cases, the hedge against inflation risks entails investment in local currencies, for example, by buying local government securities. Investors must thus weigh inflation risks against exchange risks.[23]

Sources of financing.—The lack of capital is considered a major source of constraints to finance ventures in the former Eastern Bloc. However, according to some analysts, this assessment is losing validity in the CEFTA region. An increasing number of U.S. and West European commercial banks provide financing services in the CEFTA countries for long-term corporate clients. Moreover, as a result of

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[15] *Business Eastern Europe*, Sep. 5, 1994, pp. 1 and 2.
[16] Ibid., Aug. 22, 1994, p. 1.
[17] Ibid., July 11, 1994, p. 11 and July 25, 1994, p. 11.
[18] Ibid., Mar. 6, 1995, pp. 6 and 7; and July 25, 1994, pp. 6 and 7.
[19] Ibid., Feb. 28, 1994, p. 1 and 2.
[20] Ibid.
[21] Ibid.
[22] Ibid., June 13, 1994, pp. 1 and 2.
[23] Ibid.

economic recovery and reforms, local commercial banks in the CEFTA countries are increasingly able to accommodate foreign investors. Finally, public sources of capital fill a growing portion of the gap between the total demand for, and supply of liquid capital from private sources. U.S. firms seeking loans and loan guarantees are advised to consider U.S. and other officially-sponsored investment funds and become familiar with the investment support programs of the European Bank for Reconstruction and Development (EBRD), the World Bank and its affiliates, such as the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC).[24]

[24] Ibid., Feb. 13, 1995, pp. 6 and 7.

STATISTICAL TABLES

Industrial production, by selected countries and by specified periods, Jan. 1991-April 1995

(Total Industrial production, 1985=100)

				1993							1995			
Country	1991	1992	1993	I	II	III	IV	Oct.	Nov.	Dec.	I	Jan.	Feb.	Mar.
United States[1]	104.2	104.3	109.2	115.7	117.4	118.8	120.4	119.4	120.3	121.7	122.1	122.2	122.3	121.9
Japan	127.7	120.4	115.3	90.3	90.6	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
Canada[3]	113.8	114.9	118.0	100.1	105.5	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
Germany[4]	100.0	98.1	91.5	92.6	94.6	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
United Kingdom	109.0	108.6	111.1	104.9	101.4	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
France	114.2	112.9	108.6	100.2	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
Italy	116.8	115.3	112.8	101.1	107.1	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)

[1] 1987=100.
[2] Not available.
[3] Real domestic product.
[4] 1991=100.

Source: *Main Economic Indicators;* Organization for Economic Cooperation and Development, November 1994, *Federal Reserve Statistical Release*; April 14, 1995.

Consumer prices, by selected countries and by specified periods, Jan. 1992-February 1995

(Percentage change from same period of previous year)

				1993	1994									1995	
Country	1992	1993	1994	Dec.	I	II	III	IV	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.
United States	3.0	3.0	2.6	2.7	2.5	2.4	2.9	2.7	2.9	3.0	2.6	2.7	2.7	2.8	2.9
Japan	1.6	1.3	0.7	1.0	1.2	0.7	0.0	0.8	0.0	0.2	0.7	1.0	0.7	0.6	0.2
Canada	1.5	1.8	0.2	1.7	0.6	0.0	0.2	0.0	0.2	0.2	-0.2	-0.1	0.2	0.6	1.8
Germany	4.0	4.2	3.0	3.7	3.3	3.0	3.0	2.8	3.0	3.0	2.8	2.7	2.7	2.3	2.4
United Kingdom	3.7	1.6	2.5	1.9	2.4	2.6	2.3	2.6	2.4	2.2	2.4	2.6	2.9	3.3	3.4
France	2.4	2.0	1.7	2.1	1.7	1.7	3.8	1.6	1.7	1.6	1.6	1.6	1.6	1.7	1.7
Italy	5.1	4.4	1.0	4.3	4.3	3.9	3.8	4.0	3.8	3.8	3.8	3.9	4.2	4.0	4.5

[1] Not available.

Source: *Consumer Price Indexes, Nine Countries*, U.S. Department of Labor, April 1995.

Unemployment rates, (civilian labor force basis)[1] by selected countries and by specified periods, Jan. 1992-January 1995

				1993								1993	
Country	1992	1993	1994	I	II	III	IV	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.
United States	7.4	6.8	6.1	6.6	6.2	6.0	5.6	5.9	5.8	5.6	5.4	5.7	5.4
Japan	2.2	2.5	2.9	2.8	2.9	3.0	3.0	3.0	3.0	2.9	3.0	2.9	3.0
Canada	11.3	11.2	10.3	11.0	10.7	10.2	9.7	10.1	10.0	9.6	9.6	9.7	9.6
Germany[3]	4.6	5.8	6.5	6.4	6.5	6.5	6.5	6.5	6.5	6.4	6.4	6.4	6.4
United Kingdom	10.0	10.4	9.5	9.9	9.7	9.6	9.0	9.4	9.1	9.0	8.8	8.7	8.6
France	10.2	11.3	12.3	12.3	12.4	12.4	12.3	12.4	12.4	12.3	12.3	12.2	(2)
Italy	7.3	10.3	11.4	11.2	11.9	11.4	12.0	(4)	12.0	(4)	(4)	12.2	(4)

[1] Seasonally adjusted; rates of foreign countries adjusted to be comparable with the U.S. rate.
[2] Not available.
[3] Formerly West Germany.
[4] Italian unemployment surveys are conducted only once a quarter, in the first month of the quarter.

Source: *Unemployment Rates in Nine Countries*, U.S. Department of Labor, April 1995.

Money-market interest rates,[1] by selected countries and by specified periods, Jan. 1992-March 1995
(Percentage, annual rates)

Country	1992	1993	1994	1994 I	II	III	IV	Sept.	Oct.	Nov.	Dec.	1995 I	Jan.	Feb.	Mar.
United States	3.7	3.2	4.6	3.4	4.3	4.8	5.8	5.0	5.5	5.7	6.2	6.2	6.2	6.2	6.1
Japan	4.4	2.9	2.2	2.2	2.1	2.2	2.3	2.3	2.3	2.3	2.3	(2)	2.3	2.3	(2)
Canada	6.7	5.1	5.5	4.0	5.7	5.8	5.9	5.6	5.6	5.7	6.7	(2)	7.8	8.4	(2)
Germany	9.4	7.1	4.0	5.7	5.1	4.8	5.1	4.9	5.1	5.1	5.2	(2)	5.0	5.0	(2)
United Kingdom	9.5	5.8	5.4	5.2	5.1	5.3	6.0	5.6	5.8	5.9	6.3	(2)	6.5	6.7	(2)
France	10.1	8.3	5.7	6.1	5.5	5.5	5.5	5.5	5.5	5.4	5.8	(2)	5.7	5.7	(2)
Italy	13.9	10.0	8.4	8.3	7.9	8.5	8.8	8.6	8.8	8.7	8.9	(2)	9.1	9.1	(2)

[1] 90-day certificate of deposit.
[2] Not available.

Source: *Federal Reserve Statistical Release*, April 3, 1995 *Federal Reserve Bulletin*, April 1995.

Effective exchange rates of the U.S. dollar, by specified periods, Jan. 1992-March 1995
(Percentage change from previous period)

Item	1992	1993	1994	1994 I	II	III	IV	Nov.	Dec.	1995 I	Jan.	Feb.	Mar.
Unadjusted:													
Index[1]	97.0	100.1	98.5	101.6	100.0	96.5	95.9	95.5	97.4	96.0	97.0	96.0	92.4
Percentage change	-1.5	3.1	-1.6	.4	-1.6	-3.5	-.6	.7	1.9	.1	-.4	-1.0	-3.6
Adjusted: Index[1]	100.9	104.2	101.5	104.7	103.5	99.9	98.0	97.8	99.3	95.1	98.4	96.8	92.9
Percentage change	-.1	3.3	-2.7	.6	-1.2	-3.6	-1.9	-.4	1.5	-2.9	-.9	-1.6	-3.9

[1] 1990 average=100.

Note.—The foreign-currency value of the U.S. dollar is a trade-weighted average in terms of the currencies of 18 other major nations. The inflation-adjusted measure shows the change in the dollar's value after adjusting for the inflation rates in the United States and in other nations; thus, a decline in this measure suggests an increase in U.S. price competitiveness.

Source: Morgan Guaranty Trust Co. of New York, April 1995.

Trade balances, by selected countries and by specified periods, Jan. 1992-February 1995

(In billions of U.S. dollars, Exports less Imports (f.o.b - c.i.f), at an annual rate)

				1994						1995	
Country	1992	1993	1994	I	II	III	IV	Nov.	Dec.	Jan.	Feb.
United States[1]	-84.5	-115.7	-151.3	-129.1	-152.4	-164.5	-157.1	-169.1	-139.7	-190.9	-159.0
Japan	106.4	120.3	(2)	127.0	121.9	113.5	(2)	(2)	(2)	(2)	(2)
Canada[3]	12.1	13.3	(2)	13.4	14.7	19.3	(2)	(2)	(2)	(2)	(2)
Germany	21.0	35.8	(2)	34.4	51.7	40.2	(2)	(2)	(2)	(2)	(2)
United Kingdom	-30.8	-25.5	(2)	-25.5	-21.4	-15.3	(2)	(2)	(2)	(2)	(2)
France[3]	5.8	15.8	(2)	10.6	14.8	15.6	(2)	(2)	(2)	(2)	(2)
Italy	-6.6	20.6	(2)	25.9	21.6	27.6	(2)	(2)	(2)	(2)	(2)

[1] Figures are adjusted to reflect change in U.S. Department of Commerce reporting of imports at customs value, seasonally adjusted, rather than c.i.f. value.
[2] Not available.
[3] Imports are f.o.b.

Source: *Advance Report on U.S. Merchandise Trade*, U.S. Department of Commerce, April 19, 1995; *Main Economic Indicators;* Organization for Economic Cooperation and Development, January 1995.

U.S. trade balance,[1] by major commodity categories and by specified periods, Jan. 1992-February 1995

(In billions of dollars)

				1994						1995	
Country	1992	1993	1994	I	II	III	IV	Nov.	Dec.	Jan.	Feb.
Commodity categories:											
Agriculture	18.6	17.8	19.0	4.4	3.6	3.8	6.9	2.6	2.3	1.9	2.2
Petroleum and selected product--(unadjusted)	-43.9	-45.7	-47.5	-9.6	-11.9	-14.0	-11.5	-4.1	-3.6	-3.8	-3.5
Manufactured goods	-86.7	-115.3	-155.7	-29.1	-33.8	-44.3	-47.5	-17.0	-12.4	-15.0	-12.3
Selected countries:											
Western Europe	6.2	-1.4	-12.5	-.1	-2.3	-5.4	-3.6	-1.9	-.2	.1	-.5
Canada[2]	-7.9	-10.2	-14.5	-2.7	-3.0	-3.7	-4.8	-1.7	-1.5	-1.0	-.9
Japan	-49.4	-59.9	-65.6	-15.0	-15.4	-16.8	-18.2	-5.5	-6.1	-4.6	-4.6
OPEC (unadjusted)	-11.2	-11.6	-13.8	-1.6	-3.7	-4.8	-3.2	-1.1	-.9	-.3	-.7
Unit value of U.S. imports of petroleum and selected products (unadjusted)	$16.80	$15.13	$14.22	$11.80	$13.98	$15.70	$14.95	$15.31	$14.71	$15.05	$15.50

[1] Exports, f.a.s. value, unadjusted. Imports, customs value, unadjusted.
[2] Beginning with 1989, figures include previously undocumented exports to Canada.

Source: *Advance Report on U.S. Merchandise Trade*, U.S. Department of Commerce, April 19, 1995.

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