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# EASTERN EUROPE

# Donor Assistance and Reform Efforts

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The Honorable Claiborne Pell
Chairman, Committee on Foreign Relations
United States Senate

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As East European countries move toward democratically elected governments and market economies, U.S. decisionmakers are faced with determining appropriate U.S. assistance for the region. This report provides information on international economic assistance to five East European countries.

Western and Asian democracies, and the European Community, World Bank, and International Monetary Fund, have made commitments of $8.5 billion to Poland and Hungary and are planning assistance to other East European countries. Although conditions in the region vary by country, economic growth in each is highly dependent upon private sector investment.

We are sending a copy of this report to the Secretary of State and other interested parties. Copies will also be made available to others on request.

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# Executive Summary

## Purpose

The extraordinary and rapid developments in Eastern Europe represent a major turning point in Europe's postwar history. As East European countries now move from centrally planned economies to decentralized market-based economies, the United States and other countries are providing assistance. To help decisionmakers in determining appropriate U.S. assistance for the region, GAO is providing information on international economic assistance to five East European countries—Poland, Hungary, Czechoslovakia, Bulgaria, and Romania. Specifically, GAO's objectives were to determine (1) which countries and multilateral donors are providing economic assistance, (2) what assistance is being provided, and (3) what the socioeconomic problems and opportunities are in these five countries.

## Background

Because communist countries have never before made the transition from a planned economy with a one-party political system to a market economy with a democratically elected government, there is no model for doing so. However, East European countries are beginning to take such steps as establishing market-based prices, reviving the private sector, and restructuring the public sector. The United States and other countries are providing assistance to facilitate economic and political change and help maintain peace and stability in the region. Both the public and private sectors in donor countries are providing assistance through bilateral and multilateral arrangements.

## Results in Brief

The United States, Germany, Japan, Italy, France, and the United Kingdom are providing about three-fourths of the $8.5 billion in aid committed to Poland and Hungary as of May 1990. Aid commitments are in the form of grants, loans, credits, advice, and in-kind benefits. This assistance covers a wide range of activities in such fields as economics, finance, education, agriculture, and the environment. In addition, aid is needed to encourage political reform.

Donor countries have moved quickly to provide assistance to Poland and Hungary and to make plans for other East European countries. In addition, multilateral organizations, such as the World Bank, the International Monetary Fund, and the Organization for Economic Cooperation and Development, have begun to provide aid.

Some of the major economic problems facing East European countries are declining gross national products, large foreign debts, antiquated industrial bases, and over-reliance on the Soviet Union. Conditions vary by country, but all have economic growth potential. Growth, however, is highly dependent upon substantial foreign investment. The region has a large and relatively highly educated, low-paid work force and is highly industrialized.

## Principal Findings

### Bilateral and Multilateral Donors Provide Many Types of Aid

Over 30 U.S. government agencies are providing almost $700 million in assistance to Poland and Hungary in areas such as economic stabilization and structural adjustment; private sector development; trade and investment; and educational, cultural, environmental, and democratization efforts.

The European Community and other donor countries are assisting Eastern Europe in the areas of agricultural and environmental development, training, and investment. Multilateral assistance includes establishment of (1) the $1 billion Polish Stabilization Fund to support Poland's currency as the government undertakes economic reforms and (2) the European Bank for Reconstruction and Development, which will provide loans for private sector projects, infrastructure development, and environmental efforts.

Poland and Hungary both have economic stabilization arrangements with the International Monetary Fund. The arrangement with Poland was completed in February 1990 and authorizes purchases up to $723 million to support the government's economic program aimed at decreasing the rate of inflation and promoting a market economy. The arrangement for Hungary, approved in March 1990, authorizes purchases up to $206 million to support the government's efforts to reduce domestic and external economic imbalances during the process of restructuring the economy.

The World Bank has provided $781 million in project loans to Poland, primarily for environmental, energy, and transportation activities and to support private sector export promotion and agroprocessing industries. The Bank has provided Hungary with three project loans, amounting to $366 million, to support Hungary's structural adjustment program and to modernize and expand agricultural enterprises and the banking system.

## Economic Problems and Opportunities

Enterprises in the East European centrally planned economies were organized as large, state-owned monopolies. In the traditional centrally planned economy, virtually all the means of production are turned over to state ownership. The state's central authorities plan for the inputs and outputs of state-owned enterprises, with inputs generally being centrally allocated. Virtually all prices are fixed by the central planners, and foreign trade is controlled by state-owned organizations. These industries suffer from outdated technology, lack of competitive incentives, and shortages of production materials, resulting in low productivity rates. The East European countries have had little experience with commercial banking and securities markets, and their currencies have been nonconvertible, thus limiting trade and investment.

Reforms are underway, but the process of developing the financial systems that can aid domestic economic growth will be slow. Most of the countries in Eastern Europe—particularly Poland and Hungary—have large foreign currency debt levels which severely limit their ability to resolve domestic economic problems.

The countries also face massive infrastructure needs. Roads, telecommunications, railways, and port facilities are inadequate for expanded international trade. Years of depending on heavy industry for development, relying on environmentally damaging high-sulphur coal for power, and refusing to control or treat hazardous wastes have extensively damaged vegetation and water resources and have begun to affect health. Pollution-related cancers and infant mortality are increasing, as are the number of people dying from environmentally induced diseases. Health standards in general are considerably lower throughout the region than in Western Europe.

Per capita gross national product of the East European countries remains considerably below that of the United States, and standards of living are far below those of most West European countries. Key indicators of availability of common consumer goods show that East European standards parallel those of Greece and are a bit ahead of some Latin American countries.

Although conditions vary by country, the combination of comparatively low pay and high skill levels in a large labor pool of relatively highly educated workers offers opportunities to attract development capital.

Despite the immediate socioeconomic costs in undertaking economic structural reform, the East European countries must undertake certain fundamental measures if they are to succeed in establishing and supporting a market economy. The success or failure of donor assistance to these countries depends at least as much on the host governments' implementing economic reform measures as on ensuring the effectiveness of the assistance strategies. The countries must place greater reliance on market-based prices, revive their private sectors, establish financial markets, and improve their infrastructures. Over time, the success of these efforts will undoubtedly vary among the countries, suggesting that a long-term perspective will be needed to assess the success or failure of donor assistance.

## Recommendations

In this report GAO provides information on bilateral and multilateral assistance to five East European countries. GAO is making no recommendations.

## Agency Comments

GAO did not obtain written agency comments on a draft of this report. However, during the course of the work GAO discussed its findings with officials of the Department of State who have been charged with coordinating all U.S. government assistance to East European nations. GAO has incorporated their comments in this report where appropriate.

# Contents

| | | |
|---|---|---|
| **Executive Summary** | | 2 |
| **Chapter 1 Introduction** | | 8 |
| | Objectives, Scope, and Methodology | 10 |
| **Chapter 2 Donor Assistance and Investment** | | 12 |
| | U.S. Bilateral Programs and Efforts | 14 |
| | European Community Assistance | 20 |
| | Other Multilateral Programs and Efforts | 22 |
| **Chapter 3 Socioeconomic Conditions and Reform Efforts in East European Countries** | | 27 |
| | Economic Overview | 27 |
| | Economic Potential | 35 |
| | Future Steps Necessary | 36 |
| **Appendix** | Appendix I: Major Contributors to This Report | 40 |
| **Tables** | Table 2.1: Donor Aid Commitments to Poland and Hungary | 13 |
| | Table 2.2: Type of Donor Aid Commitments to Poland and Hungary | 13 |
| | Table 2.3: SEED Fiscal Year Appropriations and Authorizations | 15 |
| | Table 2.4: Western Joint Ventures in Eastern Europe | 20 |
| | Table 3.1: Annual Growth in Real Output | 30 |
| | Table 3.2: Hard Currency Debt of Five East European Countries | 33 |
| | Table 3.3: Availability of Consumer Goods | 34 |
| | Table 3.4: Estimates of 1989 Per Capita Gross National Product | 34 |
| | Table 3.5: Measures of National Health | 35 |
| **Figures** | Figure 1.1: Five East European Countries | 9 |
| | Figure 3.1: Gross Domestic Product Growth in Five East European Countries | 28 |
| | Figure 3.2: Labor Productivity in Five East European Countries | 29 |

## Abbreviations

| | |
|---|---|
| AID | Agency for International Development |
| CMEA | Council for Mutual Economic Assistance |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Community |
| ECU | European Currency Unit |
| GAO | General Accounting Office |
| GDP | gross domestic product |
| GNP | gross national product |
| IMF | International Monetary Fund |
| OECD | Organization for Economic Cooperation and Development |
| OPIC | Overseas Private Investment Corporation |
| SEED | Support for East European Democracy |
| U.N. | United Nations |

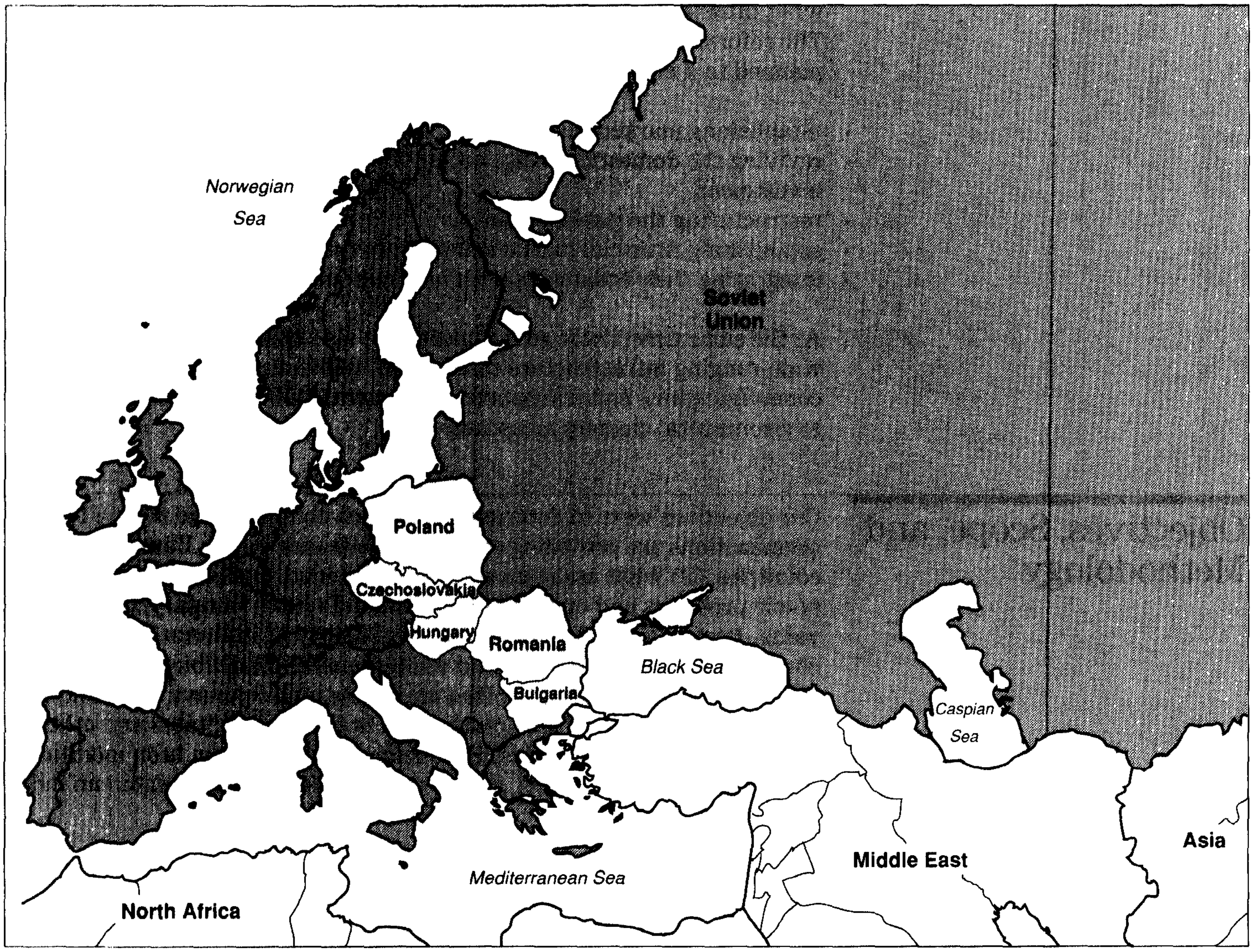
# Introduction

The long-term goal of U.S. policy in Eastern Europe is to encourage the region's economic and political integration into the democratic world and thus end the division of Europe that followed World War II. The policy is being pursued by providing assistance to East European governments on an individual basis.

The extraordinary and rapid developments in Eastern Europe (see fig. 1.1) in 1989-90 constitute a major turning point in Europe's postwar history. Most of the peoples of Eastern Europe have made it clear that they wanted a radical and decisive change in the way their political and economic affairs were conducted. As a result, the ruling Communist parties were compelled to share or to relinquish power in Poland, Hungary, Czechoslovakia, Bulgaria, Romania, and East Germany, which are now moving, at varying rates of progress, towards pluralistic forms of government and decentralized, market-based economies.

At the beginning of 1989, only the governments of Poland and Hungary were committed in principle to far-reaching changes, and even they were hesitant to implement significant aspects of the reforms they had promised. Governments in the other countries either had promised reforms that were only being implemented on a piecemeal basis or had denied the need for reform whatsoever. By the end of 1989, the drive for reforms had accelerated rapidly in Poland and Hungary, and most of the other countries were committed to some transformation of their economic and political structures. Economic and political changes in Eastern Europe occurred for many reasons, including declining standards of living and disappointment in the progress of economic reform; a desire for democratic, pluralistic governments; and the withdrawal of Soviet political and military support for the indigenous Communist governments.

Figure 1.1: Five East European Countries




Note: The U.S. government has not recognized the incorporation of Estonia, Latvia, and Lithuania into the Soviet Union. Other boundary representation is not necessarily authoritative.

Throughout 1990, the East European countries faced a formidable array of problems, including the need to restore political and social stability while implementing economic stabilization and structural adjustment programs. While the political changes were dramatic and rapid, the pace of economic change is inherently slower. Because of variances in their economic and political situations, each government undertook a somewhat different approach in implementing necessary economic reforms. The reforms generally included a number of measures to convert from a planned to a market economy, such as

- establishing market-based prices,
- reviving the domestic private sector while encouraging foreign investment,
- restructuring the public sector,
- establishing financial markets and improving financial systems, and
- integrating their economies with international markets.

At the same time, these governments are also faced with the needs of wide-ranging infrastructure restoration, which includes rebuilding telecommunications and transportation systems and undertaking costly environmental cleanup measures.

## Objectives, Scope, and Methodology

Our objectives were to determine (1) which countries and multilateral organizations are providing economic assistance to five East European countries, (2) what assistance is being provided, and (3) what socioeconomic problems and opportunities exist in Poland, Hungary, Czechoslovakia, Romania, and Bulgaria. The availability of information concerning donor assistance and socioeconomic conditions varies for each country. Statistics are often unreliable and/or unavailable and are gathered and reported differently than in the United States and other industrialized countries. East European data have often been modified for political considerations. However, we believe that the data can indicate general trends and thus are of some use.

We did not include East Germany in our review since German reunification makes its economic and political situation unique. Also, we have retained the term "Eastern Europe" rather than the frequently used "Central and Eastern Europe" because Germany is part of Central Europe and would be an exception to virtually every generalization about the economic condition of the region.

In undertaking our assessment, we reviewed documents and interviewed officials of the Departments of Commerce, State, and the Treasury and the Agency for International Development (AID) concerning their involvement in setting policy and planning and coordinating assistance for Eastern Europe. We also interviewed officials of the Federal Reserve Bank of New York to determine their assessment of western financial institutions' investment in the region. We obtained information from U.S. embassy officials in Bonn, Warsaw, Budapest, and Prague. In Budapest, we interviewed Hungarian officials to obtain their opinions on their reform efforts and assistance needs.

We interviewed officials of the European Community (EC) in Brussels, the Organization for Economic Cooperation and Development (OECD) in Paris, and the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (World Bank) in Washington, D.C., to determine what assistance is needed by European nations and what role and aid their respective organizations are providing. We also spoke with officials from the U.S. missions to the EC and the OECD to obtain their assessment of the economic and political changes occurring in Eastern Europe and to get information on U.S. efforts to coordinate donor assistance to the region.

Representatives of U.S. and West German institutions and foundations provided us with their opinions on U.S. and West European geopolitical and economic goals in Eastern Europe and shared the results of their research on the economies and reform efforts of the region. Similarly, representatives of U.S. commercial and investment banks provided their views on the outlook for lending and investment activities in Eastern Europe. We analyzed documents, studies, books, and reports on the East European economies and reform efforts.

We did not obtain written agency comments on a draft of this report. However, during the course of the work we discussed our findings with officials of the Department of State, which has been charged with coordinating all U.S. government assistance to East European nations, and incorporated their comments where appropriate. Our audit work was conducted from November 1989 through July 1990 in accordance with generally accepted government auditing standards.

# Donor Assistance and Investment

Eastern Europe is receiving many types of assistance from public and private sectors in the United States and other countries through bilateral and multilateral arrangements. The aid takes the form of grants, loans, credits, advice, and in-kind benefits and covers a wide range of activities in economic, financial, educational, training, food, medical, agricultural, and environmental areas. While most of the aid is currently being provided to Poland and Hungary, other East European countries are expected to be eventual recipients as well.

In addition to the United States, many major industrial nations have given aid to Eastern Europe; multinational organizations and institutions such as the Organization for Economic Cooperation and Development and the European Community have been instrumental in developing and coordinating assistance programs. As of May 21, 1990, the donor countries had committed $8.51 billion in assistance to Poland and Hungary, and the EC had committed $1.02 billion (see table 2.1). In addition, of the approximately $8.51 billion committed, $3.94 billion, or 46 percent, is in the form of export credits and project financing (see table 2.2). Although overall U.S. assistance is less than that being provided by Germany and Japan, State Department officials noted that other bilateral donors are providing most of their assistance in the form of loans or tied aid and that the United States is the largest donor of grant assistance. A high-level U.S. official said that the United States is attempting to convince other bilateral donors to provide more grant assistance.

**Table 2.1: Donor Aid Commitments to Poland and Hungary** (as of May 1990)

Dollars in millions[a]

| Donor nations | Commitments for Poland | Commitments for Hungary | Commitments for Poland and Hungary[b] | Total |
|---|---|---|---|---|
| Germany | $1,729 | $1,134 | $22 | **$2,885** |
| Japan | 742 | 643 | 18 | **1,403** |
| United States | 261 | 37 | 377 | **675** |
| Italy | 484 | 146 | 28 | **657** |
| France | 581 | 0 | 0 | **581** |
| United Kingdom | 161 | 28 | 0 | **190** |
| Others[c] | 621 | 310 | 170 | **1,100** |
| European Community | 236 | 761 | 26 | **1,023** |
| **Total** | **$4,815** | **$3,059** | **$641** | **$8,514** |

[a]The aid commitments represent amounts reported to the European Community.

[b]This category consists of commitments made jointly to both Poland and Hungary and is separate from commitments made solely to Poland or Hungary.

[c]The 18 other countries contributing aid to Poland and Hungary are Australia, Austria, Belgium, Canada, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey.

Source: European Community Commission Directorate General for External Relations, May 21, 1990.

**Table 2.2: Type of Donor Aid Commitments to Poland and Hungary**

Dollars in millions[a]

| Donor nations | Grants and loans | Percent of total aid | Export credit/ project finance | Percent of total aid | Other aid[b] | Percent of total aid | Total |
|---|---|---|---|---|---|---|---|
| Germany | $1,528 | 53 | $1,331 | 46 | $25 | 1 | **$2,885** |
| Japan | 144 | 10 | 1,258 | 90 | 0 | 0 | **1,402** |
| United States | 371 | 55 | 143 | 21 | 161 | 24 | **675** |
| Italy | 260 | 40 | 290 | 44 | 107 | 16 | **657** |
| France | 83 | 14 | 383 | 66 | 115 | 20 | **581** |
| United Kingdom | 157 | 83 | 17 | 9 | 16 | 9 | **190** |
| Others[c] | 264 | 24 | 514 | 47 | 322 | 29 | **1,100** |
| European Community | 793 | 77 | 0 | 0 | 230 | 23 | **1,023** |
| **Total** | **$3,601** | **42** | **$3,936** | **46** | **$977** | **11[d]** | **$8,514** |

[a]The figures below represent aid commitment amounts reported to the European Community.

[b]This category represents foreign assistance not specified in the form of grants or loans, such as some forms of environmental assistance and technical training.

[c]The 18 other countries contributing aid to Poland and Hungary are Australia, Austria, Belgium, Canada, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey.

[d]Percentages may not total 100 due to rounding.

Source: European Community Commission Directorate General for External Relations, May 21, 1990.

## U.S. Bilateral Programs and Efforts

The Support for East European Democracy (SEED) Act of 1989 authorized funding for U.S. aid to Poland and Hungary. With the Department of State coordinating efforts, a council of more than 30 agencies is focusing on aid to Eastern Europe. Some U.S. government agencies are also reassigning staff to activities related to East European needs. Given the scale of these needs, it is generally believed that private sector investment will be a necessary complement to official assistance. The U.S. government has instituted some programs to provide funds and information to the private sector to facilitate investment.

## SEED Act of 1989

The SEED Act was enacted "to promote political democracy and economic pluralism in Poland and Hungary by assisting those nations during a critical period of transition and abetting the development in those nations of private business sectors, labor market reforms, and democratic institutions; to establish, through these steps, the framework for a composite program of support for East European Democracy." The SEED Act authorized over $900 million in funding for fiscal years 1990-1992. Congress appropriated up to $418 million and provided $240 million in guarantees for 1990, as shown in table 2.3.

**Table 2.3: SEED Fiscal Year Appropriations and Authorizations**

Dollars in millions

| Program | 1990 Appropriation | 1990-92 Authorization |
|---|---|---|
| Polish Stabilization Fund | 200.0 | 200.0[a] |
| Polish Enterprise Fund | 45.0[b] | 240.0 |
| Hungarian Enterprise Fund | 5.0 | 60.0 |
| Private farmer aid to Poland | 10.0 | 0 |
| Farmer-to-farmer program for Poland | 1.0 | 0 |
| Educational and cultural programs | 3.0 | 12.0 |
| Student exchanges | 2.0 | 10.0 |
| Labor support | 1.5 | 5.0 |
| Technical training | 2.0 | 0.5 |
| Democratic institutions | 4.0<br>10.0[b] | 12.0<br>0 |
| Medical supplies for Poland | 2.0 | 4.0 |
| Environmental programs | 3.3 | 10.0 |
| Energy programs | 10.0 | 30.0 |
| Food aid for Poland | 125.0 | 125.0[a] |
| Peace Corps | 2.0 | 6.0 |
| Trade and Development Program | 2.0 | 6.0 |
| **Total** | **417.8[c]** | **720.5[c]** |

[a]Fiscal year 1990.

[b]The Urgent Assistance for Democracy in Panama Act of 1990 (P.L. 101-243) authorized $10 million for democratization efforts in Eastern Europe. These funds were reprogrammed from the $45 million appropriation for the Polish-American Enterprise Fund.

[c]Does not include (1) $40 million in guarantees for an Overseas Private Investment Corporation program for Poland; (2) $200 million in guarantees under the Trade Credit Insurance Program; and (3) December 1989 emergency aid to Romania in the form of $500,000 through the International Red Cross and $250,000 for medical supplies.

The SEED Act focuses on five elements of assistance: (1) economic stabilization[1] and structural adjustment[2] programs to assist implementation of economic reforms; (2) private sector development through loans, grants, guarantees, equity investments, technical assistance, and training; (3) trade and investment programs to encourage U.S. private sector investment; (4) educational, cultural, and scientific activities, which

[1]Policies that are designed to lead to short-term internal (employment and inflation targets) and external (equilibrium in international payments) balance, such as the adjustment of the exchange rate.

[2]Policies that lead to long-term internal and external balance, such as divestiture of unprofitable public sector enterprises.

include publicly and privately funded scholarships; and (5) other programs, to include environmental, health, food aid, and development of democratic institutions.

The administration has proposed a new policy standard that would tailor U.S. assistance to the specific needs of each East European country as it shows progress toward political pluralism and economic reform, enhanced respect for internationally recognized human rights, and a willingness to build a friendly relationship with the United States. To achieve these objectives and to concentrate U.S. efforts on areas where the United States can have maximum impact, the administration sees the need for assistance in four general areas:

- Democratic initiatives. This effort would support institution building, including parliamentary structures, political systems, and free media coverage.
- Technical training and assistance. This effort would include support for market-based financial and economic institutions.
- Environment. This category would provide assistance in cleaning up the environment and establishing model projects.
- Transitional economic support. This category would include stabilization and structural adjustments as well as support for privatization through public sector-sponsored funding mechanisms as a means of aiding investment in the private sector.

In some cases, U.S. assistance has been part of multilateral assistance programs. For example, the SEED Act authorized $200 million, which was appropriated, to support Poland's Stabilization Fund,[3] seeking to lessen the variability of the Polish currency after a sharp devaluation and to encourage its convertibility into western currencies. The IMF endorsed the creation of this fund, and other industrial countries joined the United States in contributing to it.

Domestic changes in Eastern Europe have prompted a reevaluation of U.S. export control policy. Before the dramatic changes in these countries, the United States, in cooperation with allied countries, severely limited the export of a variety of equipment and technology that could be of military or economic benefit to communist countries or other "unfriendly" nations. These restrictions have been enforced through the

[3]An internationally supported fund to support the Polish currency.

Coordinating Committee on Multilateral Export Controls.[4] Committee members have agreed to significantly relax licensing requirements for machine tools, telecommunications, and computers. Most commonly available personal computers and some mainframes are now decontrolled. In addition to aiding the nations in Eastern Europe, relaxing export controls will also benefit U.S. companies that manufacture these items by providing a new market for their products.

## Coordination of U.S. Assistance

The Department of State is the lead agency for coordinating U.S. assistance to Eastern Europe. The Deputy Secretary of State is the coordinator for the U.S. program and chairs the coordinating council of the over 20 government agencies providing assistance to Eastern Europe. The U.S. effort focuses on technical training and assistance, environmental assistance, democratization efforts, and support for private sector development. Every 2 weeks, the State Department publishes a periodic update of U.S. assistance efforts to Eastern Europe, called Focus on Eastern Europe.

## U.S. Agency Funding and Staffing

Most of the funds under the 1989 SEED Act were allocated to specific programs and, within particular programs, to particular projects. As a result, some agencies that either did not receive SEED act funding or received funding only for specific purposes are using funds from their own program budgets for projects they view as important but that were not identified in the SEED act. Some agencies, such as the Departments of State, Commerce, the Treasury, and Agriculture, are also reassigning staff to handle East European assistance needs. For example, the State Department reported that it has reassigned over 100 staff to Eastern Europe from other posts. The Department of Commerce is sending Foreign Commercial Service officers to Eastern Europe and has reassigned Washington, D.C., staff from other areas to East European initiatives. The U.S. Information Agency is using some of its own funds to promote democratization efforts, and the Departments of Commerce and Labor are using their own funds to encourage private sector investment and to provide training programs for Eastern Europe.

## The Enterprise Funds

To promote the development of the private sector in Poland and Hungary, the United States has established the Polish-American Enterprise

[4]Committee member countries include Japan, Australia, and North Atlantic Treaty Organization countries except Iceland.

Fund and the Hungarian-American Enterprise Fund. These funds are intended to provide assistance through grants and loans, equity investments, support for feasibility studies, training, and technical assistance. In general, the funds will act as development banks and will engage in various activities, such as making direct loans to private entrepreneurs, lending to venture capital funds, taking an equity position in private companies, issuing bonds, buying stocks and bonds, and working with retail banks.

The 1989 SEED Act authorized $240 million dollars for the Polish-American Enterprise Fund and $60 million for the Hungarian-American Enterprise Fund over a 3-year period. The fiscal year 1990 appropriation was $45 million for Poland[5] and $5 million for Hungary. Polish- or Hungarian-owned firms or proposed joint ventures with U.S. firms may apply for funding, and the funds will support establishing new firms as well as privatizing existing firms. The funds will operate under the overall supervision of a binational board of directors, while day-to-day activities will be handled by professional management teams, hired by and responsible to the respective boards.

## The Overseas Private Investment Corporation

The Overseas Private Investment Corporation's (OPIC) purpose is to promote economic growth in developing countries by encouraging private investment. The agency assists U.S. investors by (1) insuring investment projects against a broad range of political risks and (2) financing investment projects through direct loans and/or loan guarantees. The agency also sponsors investment missions that are designed to introduce senior U.S. business executives to key business leaders, potential joint venture partners, and high-ranking government officials in the host country.

In October 1989, OPIC signed bilateral agreements with Poland and Hungary and has since sent several investment missions to those countries. In January 1990, OPIC issued political risk insurance covering General Electric's joint venture with a Hungarian lighting company and is considering other investor-proposed projects. The agency has developed several new initiatives to better serve the needs of Eastern Europe, including (1) the East European Growth Fund, which has a target funding level of $200 million and is designed to raise private capital to fund new enterprises and make equity investments; (2) the Small Business Loan Guaranty Program, which will provide loans up to $500,000

[5]$10 million was reprogrammed under Public Law 101-243 for support of democratic institutions in Eastern Europe.

to small business investors; and (3) the Environmental Investment Fund, which has a target funding level of $100 million and which is directed toward investments in environmentally sound, natural resource enterprises.

## The Eastern Europe Business Information Center

In an effort to provide interested investors with data on Eastern Europe, the Commerce Department established an information center in January 1990. The Eastern Europe Business Information Center serves as a central clearinghouse for information on business opportunities in Eastern Europe and on U.S. government programs supporting expanded private enterprise, trade, and investment.

The Center has received thousands of inquiries from potential U.S. investors and receives, on average, about 200 calls per day. Most of the information the Center provides consists of economic reports, some market research, and lists of contacts within the various countries. The majority of the information provided is on Poland and Hungary, although information on other East European countries is available. The Center is preparing a bulletin with lists of contacts at OPIC, AID, and other relevant agencies, along with reference information on investing in the region.

The Center also provides information on joint ventures between U.S. and Central or East European firms or enterprises. According to Commerce officials, the majority of investments in Eastern Europe will be joint ventures. Most countries in the region have laws that stipulate that companies must invest in, or with, East European firms.

As an indication of the importance of foreign investment in joint ventures, table 2.3 shows the numbers and types of joint ventures, as of May 1, 1990, in Eastern Europe, as well as the legal conditions governing them. Currently, Hungary has the most liberal investment laws in the region in the areas of currency, exports, taxation, and repatriation of profits laws. While Poland has the most joint ventures with western partners, Hungary has the most joint ventures with U.S. partners.

**Table 2.4: Western Joint Ventures in Eastern Europe**

| Country | Total JVs[a] with western partners | Total JVs with U.S. partners | Major sectors | Legal conditions |
| --- | --- | --- | --- | --- |
| Poland | 866 | 60 | Food processing and construction materials | 100 percent repatriation of export earnings. 100 percent foreign ownership allowed. Access to foreign exchange. |
| Hungary | 600–700 | 140 | Consumer goods, services. Light manufacturing | 100 percent foreign ownership allowed. Easy licensing procedures. 100 percent repatriation of domestic and foreign profits. |
| Czechoslovakia | 32 | 1 | Manufacturing, tourism | Repatriation of profits for hard currency exports only. Allows for majority ownership. JVs have lower tax rate. |
| Bulgaria | 60 | 10 | Food processing, footwear, chemicals, electronics | Repatriation not guaranteed, must be through export earnings. 100 percent foreign ownership allowed. |
| Romania | 5 | 1 | Data processing, chemicals | Romanian partner must have majority ownership. |

[a]JV denotes joint venture.

Source: Eastern Europe Business Information Center, Department of Commerce, May 1, 1990.

## European Community Assistance

The European Community[6] Commission, the executive arm of the EC, is leading efforts to coordinate international assistance to Eastern Europe. To do so, the EC Commission has begun hosting a series of meetings with donor countries and organizations such as the IMF, the World Bank, and the OECD. The State Department is the primary U.S. representative at these meetings, although representatives of other agencies also attend as appropriate.

In July 1989, the donor countries signed an agreement to provide assistance to Eastern Europe and at the same time gave the EC Commission the role of acting as a clearinghouse for this international assistance. According to one U.S. official, the EC is well suited for this role because, as an institution, it has (1) authority and prestige, (2) funds and resources, (3) skillful administrators, and (4) a nonmilitary orientation.

The EC Commission has two roles with regard to aid to Eastern Europe: (1) to direct and oversee specific EC assistance to Eastern Europe and (2) to act as a clearinghouse for bilateral assistance to the region. As a result, the Commission has direct authority over EC assistance but relies on voluntary cooperation in coordinating bilateral aid.

[6]The EC consists of 12 member states: Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, the United Kingdom, and Germany.

As donor countries move from providing emergency aid to longer-term, more complex technical assistance, the EC clearinghouse approach is proving less effective, according to EC and U.S. officials. EC officials stated that a natural tension exists when a multilateral organization attempts to coordinate bilateral assistance efforts. For example, some countries do not report all their assistance projects to the EC working groups.

## EC Working Groups

The EC Commission has established working groups on agriculture, training, environment, and investment to (1) develop priorities for assistance, principally to Poland and Hungary, (2) act as a clearinghouse for bilateral assistance from the donor countries, and (3) develop and implement EC assistance programs. The EC Commission provides aid to Eastern Europe using criteria that require recipient countries to have pluralistic political systems with no institutionally favored party, to make movement toward free market economies, to have free labor unions, and to demonstrate respect for human rights.

In late 1989 and early 1990, the working groups sent fact-finding missions to Poland and Hungary to assess the two nations' needs. Based on the missions' assessments and other information, each working group began planning assistance efforts for the two countries.

## Working Group on Agriculture

The agriculture working group, established in August 1989, has primarily focused on Poland but has provided some aid to Hungary and some emergency food assistance to Romania. Agricultural assistance to Poland consists of immediate food aid and longer-term agricultural help. The working group has coordinated donor assistance by matching bilateral aid to Polish requests.

Donated food provided to Poland is sold through state stores at market prices. Revenues from these sales are given to the Polish government to help fund technical agricultural projects that will improve and expand Poland's agricultural sector.

Hungary has a surplus of agricultural products, so food aid has not been needed. Instead, Hungary has requested technical assistance to update and improve its agricultural sector. Hungary is particularly interested in sending students to the West to study advanced agricultural methods and practices.

## Working Group on Training

The training working group was established in September 1989 because of Polish and Hungarian requests for training in a wide range of areas—banking, agriculture, language, civil service, environment, and vocational training. The EC has proposed the creation of a European Foundation for Vocational Training in West Berlin and a university exchange program for teachers and students. The university exchange program will target teachers and students in key fields, such as management and business administration, applied economics, applied technologies, languages, agriculture, and environmental protection.

## Working Group on the Environment

The environmental working group began meeting in September 1989. It serves primarily as a clearinghouse and coordinating mechanism for assistance provided by donor countries through bilateral agreements to Poland and Hungary. These two countries have requested help with air pollution reduction, hazardous waste removal, waste management, and water treatment. Potential projects include developing a hazardous waste incineration plant, a water desalinization plant, and an energy conservation plan for the Polish food processing industry.

## Working Group on Investment

The investment working group was convened in November 1989 in response to Polish and Hungarian requests for assistance. The group has two major objectives: (1) to act as a clearinghouse on foreign private investment activity in the two countries and (2) to develop a data base that will include information on tax and investment treaties, national commercial laws, and issues, concerns, and successes of foreign corporations doing business in the region. This information will be made available to private investors interested in the investment climate in Eastern Europe.

# Other Multilateral Programs and Efforts

Donor countries have used other multilateral organizations and institutions, in addition to the EC and the EC Commission, to provide assistance to Eastern Europe. This multilateral assistance takes the form of supporting economic stabilization and structural adjustment programs, providing vocational and management training, assessing environmental concerns, and promoting foreign investment. Two primary examples of multilateral aid are the Polish Stabilization Fund and the European Bank for Reconstruction and Development (EBRD). While Poland and Hungary have received the bulk of donor aid, the European Community, the OECD, the IMF, and the World Bank are also providing assistance to other East European countries.

## The Polish Stabilization Fund

Under the 1989 SEED Act, Congress authorized a $200 million contribution to the Polish Stabilization Fund. The Fund was endorsed by the IMF and supported by other donor countries. The U.S. Treasury took the lead in conducting negotiations with Poland on how the Fund would work and on establishing rules concerning its use, repayment schedules, and initial contributions.

The $1 billion fund was established to accomplish two reforms: (1) to support a relatively fixed exchange rate for the zloty (the Polish currency) after sharp devaluation and (2) to help ensure that the zloty is convertible for current account transactions, i.e., to allow residents to freely purchase currency through authorized foreign exchange banks. These reforms officially went into effect January 1, 1990.

When the Stabilization Fund was set up, there was neither a foreign exchange market nor any way to transfer funds from one bank to another, unless the currency was physically transported from one bank to another. Therefore, in order to implement the Stabilization Fund, Poland must thoroughly restructure its banking system.

International donors have provided various types of contributions to the fund. For example, the United States and the United Kingdom have provided grants; Germany and France have provided lines of credit; Japan has provided a loan with a below-market interest rate; and Canada has provided a "no interest, reimbursable grant." Before the monies could be deposited in an account (held by the New York Federal Reserve Bank), Treasury negotiated specific agreements with the donor nations to account for their laws and the fluctuations in the various exchange rates.

## The European Bank for Reconstruction and Development

In 1990, the French proposed creating a multilateral development bank, the European Bank for Reconstruction and Development. The purpose was to demonstrate the commitment of the donor countries to East European countries committed to making political and economic reforms.

The Articles of Agreement establishing the bank were signed on May 30, 1990. With up to 42 members, the bank is headquartered in London, its president is a former adviser to the French President, and it is scheduled to be operational in 1991. The United States will be the largest individual shareholder, with a 10 percent share. The EC countries individually, the European Community as an organization, and the European

Investment Bank will together control 51 percent of the shares; other European countries, 12 percent; the Soviet Union, 6 percent; the East European countries, 7 percent; and other nonregional countries, 14 percent. The capital base will be 10 billion in European Currency Units (ECU)[7] ($11.7 billion in U.S. dollars), with 30 percent in paid capital and 70 percent on call.[8]

For the first 5 years, at least 60 percent of the bank's lending (in aggregate and by country) will be devoted to projects in the private sector. The balance will be available for infrastructure or environmental loans that support the development of the private sector or for public enterprises that operate in a competitive fashion. It is intended that the bank coordinate its efforts with the IMF and the World Bank.

## The International Monetary Fund

The International Monetary Fund is a multinational organization with 151 member countries. If a member country is having balance of payment problems, it can request a standby arrangement with the Fund, which typically lasts 12-15 months. Under the standby arrangement, the IMF provides to a country a line of credit in return for the country's agreement to undertake economic reform. The IMF emphasizes policies that reduce demand, focus on increasing exports and hard currency balances, and promote currency stabilization. The IMF sets quarterly goals and criteria in order to monitor a country's performance and timely compliance with the program.

Poland and Hungary both have standby arrangements with the IMF. The arrangement with Poland was signed in February 1990 and authorizes purchases up to $723 million over 13 months to support the government's economic stabilization program. This program aims at decreasing the rate of inflation and promoting a market economy. Hungary has had four arrangements since May 1988. The arrangement approved in March 1990 authorizes purchases up to $206 million over a 12-month period. This arrangement supports the government's economic and financial program, which hopes to reduce domestic and external economic imbalances during the process of restructuring, reforming, and liberalizing the economy.

[7]The ECU serves as a common basis for determining exchange rate parities and as a means of settlement for the 12 member nations of the EC.

[8]With a 10 percent share of the EBRD, the United States will have a funding commitment fixed in dollars of $350 million for paid-in capital and $817 million available on call. This sum translates into an annual commitment of $70 million of budget authority for paid-in capital and $163.4 million of program limitations for subscriptions to callable capital.

The IMF also provides economic assistance through an extended fund facility, which is designed to be of a longer duration (3-4 years) than standby arrangements. It is expected that the current standby arrangement with Poland will evolve into an extended fund facility, due to the ambitious nature of the economic changes that Poland is making.

## The World Bank

During fiscal year 1990, the World Bank extended five project loans totaling $781 million to Poland. The projects focus on (1) providing technical assistance for dealing with environmental problems; (2) restructuring the transportation sector; (3) improving energy conservation, pricing, and environmental impact; (4) supporting private sector export promotion; and (5) modernizing and expanding agroprocessing industries.

The Bank has provided Hungary with three project loans amounting to $366 million to (1) support Hungary's structural adjustment program, (2) modernize and expand the export capabilities of agricultural enterprises, and (3) modernize and expand the banking system.

During fiscal year 1990, no project loans were extended to the other East European countries. However, Czechoslovakia has applied for membership in the Bank, Bulgaria has expressed interest in joining, and Romania has been a member since 1983.

## Organization for Economic Cooperation and Development

The Organization for Economic Cooperation and Development is an international group of 19 European countries,[9] the United States, Canada, Japan, Australia, and New Zealand. Its mission is to achieve high economic growth and development, and financial stability among member nations and, thus, to contribute to the development of the world economy.

All East European countries except Albania have requested OECD assistance in one form or another. For example, the government of Poland has asked that the OECD undertake a detailed review of its economy, including identifying what measures are needed for reform. As a result of these requests, the Secretary General of the OECD organized a special task force to address issues related to increased involvement with

[9]European membership consists of Austria, Belgium, Denmark, France, Finland, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, and the United Kingdom.

Eastern Europe and, in September 1989, issued a series of options on how the organization could respond to requests for technical assistance.

The OECD is also developing the Center for Cooperation with European Economies in Transition. The Center will be the focal point for all OECD contacts with East European countries, will respond to requests for information and documentation from these countries, and will initiate and coordinate OECD analyses and activities related to Eastern Europe. In addition, the Center will organize visits from, and OECD expert missions to, Eastern Europe; will organize or help arrange seminars, workshops, and conferences on issues related to social and economic reform; and will coordinate the OECD's efforts with those of other international bodies, such as the EC, IMF, and World Bank.

# Socioeconomic Conditions and Reform Efforts in East European Countries

The East European countries have been undergoing severe economic difficulties since the early 1970s and are now in a state of economic decline. Poor growth in gross national product (GNP); economic isolation from the international economy; an antiquated industrial base and infrastructure, and environmental problems; and large foreign debts are some of the major problems confronting the region. Standards of living remain far below those of most Western European countries.

The East European countries vary in their natural, capital, and human resource bases but all have growth potential if the requisite economic structural adjustments are undertaken. There appears to be general agreement that the primary catalyst for growth in the region must be through domestic private sector initiatives, supplemented by private sector investment from industrialized countries and by economic assistance from the United States, Western Europe, Japan, and international financial institutions.

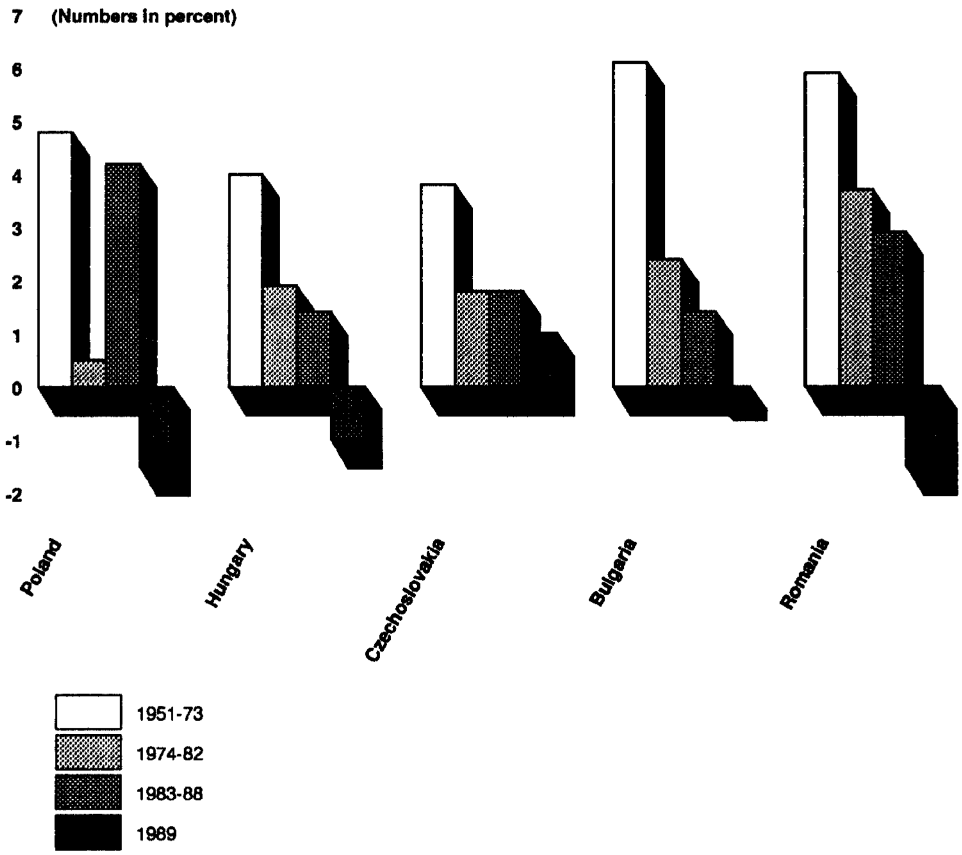
## Economic Overview

Enterprises in the East European centrally planned[1] economies were organized as large, state-owned monopolies. These industries suffer from outdated technology, lack of competitive incentives, and shortages of production materials, resulting in low productivity rates. In most of these countries, central planners controlling the state firms failed to properly coordinate supplies of labor, material, and productive capacity. Long production lead times meant that equipment was outdated by the time it was actually installed and operating.

For the most part, economic expansion in state-owned industries was brought about by massive increases in material and labor inputs and not by improvement in productivity. These production inefficiencies were hidden by massive government subsidies and by arbitrarily set prices that masked true costs. The subsidies created a large "hidden inflation" that strained national budget and banking resources when central governments had to increase subsidies to cover rising real costs. In addition, the central planners, lacking profit incentives, imposed no hard financial discipline on the state-owned operations, and unprofitable firms were not allowed to go bankrupt. (Fig. 3.1 shows the average gross domestic product (GDP) growth for the periods 1951-73, 1974-82, and 1983-88, and the annual average for 1989 in the five countries we reviewed.)

[1] In the traditional centrally planned economy, virtually all the means of production are turned over to state ownership. The state's central authorities plan for the inputs and outputs of state-owned enterprises, with inputs generally being centrally allocated. Virtually all prices are fixed by the central planners, and foreign trade is controlled by state-owned organizations.

**Figure 3.1: Gross Domestic Product Growth in Five East European Countries**

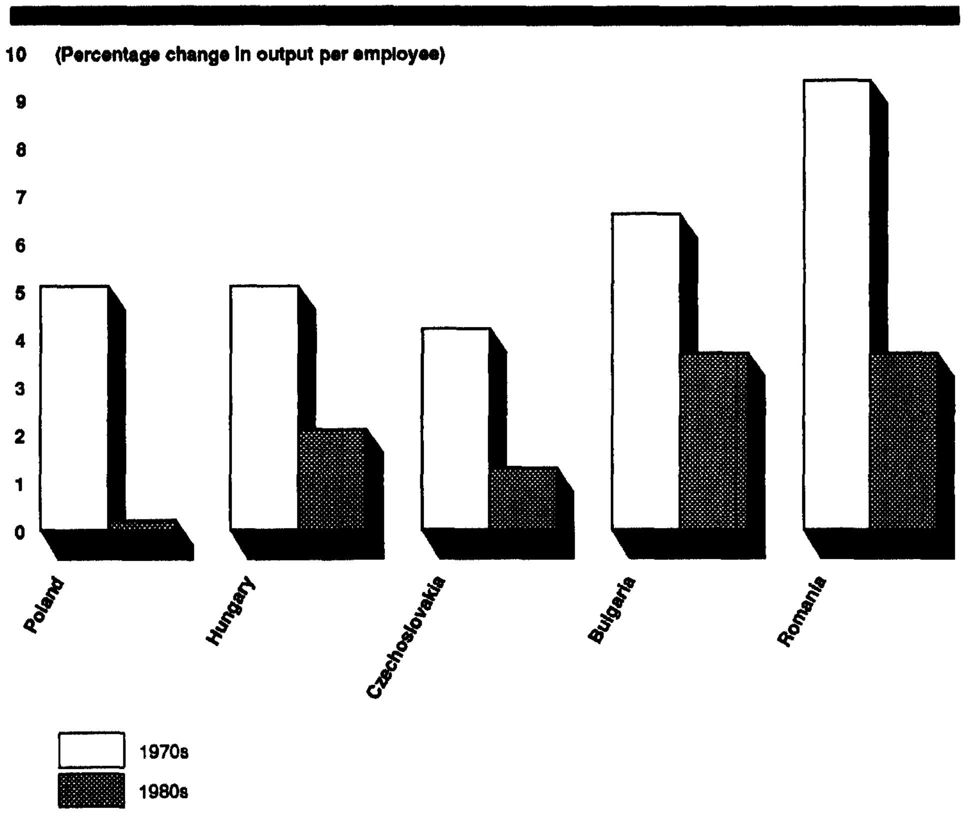



Source: International Monetary Fund. 1989 figures are from Central Intelligence Agency estimates of gross national product.

Lacking a pricing mechanism that properly related supply to demand, producers could not make rational decisions about what to produce. Instead, the central bureaucracies made decisions based on their preferences for producing specific goods and services and used prices as a method for redistributing income. This system led to inefficient pricing decisions and a sometimes seemingly irrational waste of resources. For example, it has been reported that some East European farmers ended up selling grain to the state, then buying subsidized bread to feed livestock because bread was cheaper to use than the unsubsidized grain from which the bread was made.

While it is difficult to measure economic output in these economies, there is general agreement that absolute productivity was lower than reported and that the labor productivity trend, as defined as percentage of change in output per worker, had been declining throughout the region. (See fig. 3.2.) For example, a steel plant in Poland employed 30,000 workers to manufacture the same amount of steel as a U.S. plant employing 7,000 workers.

Figure 3.2: Labor Productivity in Five East European Countries




Source: Institute of International Finance.

As table 3.1 demonstrates, the annual growth rates for the economies of East European countries have varied greatly during the mid- to late 1980s. Estimates of their growth in 1989 indicate that many of these countries actually suffered declines or minimal growth in real output.

**Table 3.1: Annual Growth in Real Output**
(Percent Change)

| Country | 1985 | 1986 | 1987 | 1988 | 1989[a] |
|---|---|---|---|---|---|
| Poland[b] | 3.6 | 4.2 | 2.0 | 4.1 | −3.0 |
| Hungary[b] | −0.2 | 1.5 | 4.1 | 0.4 | 0.8 |
| Czechoslovakia[b] | 3.0 | 2.6 | 2.2 | 2.5 | 2.0 |
| Bulgaria[a] | 1.8 | 5.3 | 5.1 | 2.4 | −0.4 |
| Romania[b] | 5.5 | 6.1 | 4.6 | 3.3 | 1.7 |
| United States[c] | 3.6 | 3.0 | 3.5 | 4.4 | 2.8[d] |
| France[c] | 1.7 | 2.1 | 2.3 | 3.4 | 3.5[d] |
| Italy[c] | 2.9 | 2.9 | 3.1 | 3.9 | 3.1[d] |
| West Germany[c] | 2.0 | 2.3 | 1.9 | 3.4 | 4.9[d] |

[a]Estimates.

[b]Gross national product.

[c]Gross domestic product.

[d]Figures for second quarter 1989, year-to-year change.

Source: Figures for East European countries from the Institute of International Finance. Figures for other countries are from the U.N. Economic Commission for Europe.

## Economic Isolation

The East European countries largely isolated themselves from the international marketplace by trading primarily among themselves for the past 40 years. Much of their trade occurred within a single trading bloc, the Council for Mutual Economic Assistance (CMEA), also known as Comecon. As a result, their economies lacked the dynamic impetus of competition provided by the world economy.

Trade within the CMEA relied upon barter-style arrangements to balance trade among its members. When forced to obtain goods outside their trading bloc, most East European countries developed unfavorable trade balances, exacerbated by their nonconvertible currencies.[2] One result for some of these countries was a serious external debt problem that persists today.

Another result of the relative isolation from the international trading community was the insulation of East European industries from foreign competition. This insulation reduced the availability of consumer goods and lessened the incentive for improving product quality. This insularity also reduced opportunities for obtaining economies of scale available to higher exporting countries, as well as the general benefits of international trade, such as access to greater quantities of goods and services or the opportunity to benefit fully from specialized production. Moreover,

[2]A nonconvertible currency cannot be freely exchanged against another currency.

diminished contact with the international trade and finance centers limited East European countries' access to foreign sources of capital.

Another problem resulting from past reliance on trade within the CMEA is that moving away from the former trade patterns will be costly for the East European countries. Initially, the CMEA trade system was advantageous to the Soviet Union, since it was able to receive goods from other CMEA countries at prices that were lower than prices prevailing outside the trading bloc. Following the increases in oil and energy prices in the 1970s, however, the advantage shifted, and East European countries were able to buy Soviet oil and natural gas below world prices.

Recently, however, the Soviet Union has proposed that CMEA countries pay world prices for oil, using hard currencies. It will be difficult for the East European countries to raise hard currencies, however, since many of their potential exports are not competitive.

In addition, East European countries have had little current experience with commercial banking or with securities markets. Until recently, for instance, private ownership of the means of production generally was not allowed, so the need for stock markets did not exist. Banking was conducted by state institutions. In addition, the currencies of these nations were nonconvertible, thus limiting trade.

Reforms are underway, but the process of developing the financial systems that can aid domestic economic growth will be slow. Poland, for instance, has introduced a banking system that includes privately owned banks under central bank regulation. The absence of an efficient mechanism to clear checks or transfer money between banks, short of physically withdrawing money from one bank and redepositing it in a second, however, will limit the development of financial markets. Hungary has introduced a stock exchange, but few trades occur.

## Inadequate Infrastructure

Roads, telecommunications, railways, and port facilities in Eastern Europe are not adequate to aid greater levels of trade with Western Europe. Transportation systems, for instance, are oriented to trade within the CMEA bloc, principally the Soviet Union. Also, telecommunications systems generally cannot easily be adapted to more modern Western technologies.

## Environmental Situation

Eastern Europe has severe environmental problems. Years of depending on heavy industry for development, relying on environmentally damaging high-sulphur coal for power, and refusing to control or treat wastes have extensively damaged vegetation and water resources and have begun to affect health. Throughout the region, forests and croplands have been heavily contaminated. For example, it is reported that one-third of Bulgaria's forests have pollution-related damage, one-half of Czechoslovakia's forests are damaged or dying, and much of Poland's farmlands have been hurt by high acid levels and metals.

Eastern Europe's air and water resources have been similarly devastated. Much of Hungary's population breathes air with pollution levels higher than its own national maximum safe-level limits, and drinking water in the southern part of the country is reportedly seriously contaminated with arsenic. Poland produces a reported 6 times more air pollution per unit of output than does Western Europe, and 95 percent of its rivers are severely polluted. Seventy percent of Czechoslovakia's rivers are polluted.

The health of East Europeans has also suffered from ecological mismanagement. It is reported that pollution-related cancers and infant mortality are increasing in Czechoslovakia, a growing number of Hungarians die from environmentally induced diseases, and pollution-related heart disease and infant mortality are at high levels in Romania.

The World Bank estimates that 10 percent of Poland's gross national product is lost through employee illness and industrial problems related to contaminated water. Officials in Hungary calculate that illnesses caused by pollution take up over 13 percent of that nation's health budget. The West German Institute for Economic Research has projected that $200 billion would be needed over the next 20 years to clean up industrial pollution in Eastern Europe.

## External Debt

Most of the countries in Eastern Europe—particularly Poland and Hungary—have large hard currency debt levels, as shown in table 3.2. These debts severely hinder their abilities to resolve their domestic economic problems.

**Table 3.2: Hard Currency Debt of Five East European Countries**

Dollars in billions U.S.

| Country | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988[a] | 1989[a] |
|---|---|---|---|---|---|---|---|---|---|---|
| Poland | 25.0 | 25.5 | 24.7 | 26.4 | 26.8 | 29.3 | 33.5 | 39.2 | 38.5 | 39.5 |
| Hungary | 9.1 | 8.7 | 7.6 | 8.2 | 8.9 | 11.8 | 15.1 | 17.8 | 18.0 | 20.7 |
| Czechoslovakia | 5.0 | 4.6 | 3.9 | 4.0 | 3.6 | 3.8 | 4.5 | 5.8 | 6.1 | 7.8 |
| Bulgaria | 3.5 | 3.1 | 2.8 | 2.4 | 2.3 | 3.7 | 4.9 | 6.2 | 7.5 | 10.0 |
| Romania | 9.4 | 10.1 | 9.7 | 8.7 | 7.1 | 6.6 | 6.4 | 5.1 | 2.2 | 0.4 |

[a]Estimate.

Source: U.S. Central Intelligence Agency.

During the 1970s, the East European countries borrowed heavily on the international financial markets to finance industrial investment. However, poor investment decisions, economic inefficiencies, mediocre export competitiveness with resulting low foreign exchange earnings, and high interest rates on their external debt created severe economic and financial difficulties. Problems were compounded after 1985 when East European countries tried to shift domestic polices toward economic growth and investment that relied heavily on imports from nonsocialist countries. Their current account balances[3] worsened, and external debts rose.

## Standards of Living

Standards of living throughout Eastern Europe remain far below those of most West European countries. Key indicators of availability of common consumer goods show that East European standards parallel those of Greece and are a bit ahead of some Latin American countries. (See table 3.3.)

[3]The difference between exports and imports of goods and services, minus net transfer payments made to foreigners.

**Table 3.3: Availability of Consumer Goods**

Number per 1,000 persons

| Country | Automobiles | Telephones | Television sets |
|---|---|---|---|
| Poland | 105 | 118 | 85 |
| Hungary | 145 | 134 | 275 |
| Czechoslovakia | 173 | 226 | 122 |
| Bulgaria | 120 | 200 | 96 |
| Romania | 11 | 130 | NA[a] |
| United States | 572 | 650 | 621 |
| Japan | 235 | 535 | 250 |
| Germany | 446 | 641 | 377 |
| Argentina | 127 | 100 | 213 |
| Brazil | 76 | 90 | 184 |
| Mexico | 65 | 90 | 108 |
| Greece | 127 | 373 | 158 |

[a]NA denotes not available.

Source: Building Free Market Economies in Eastern Europe, Institute of International Finance.

Per capita GNP of the East European countries remains considerably below that of the United States. Table 3.4 shows that only Czechoslovakia has achieved as much as one-third the estimated 1989 U.S. per capita GNP of $21,036.

**Table 3.4: Estimates of 1989 Per Capita Gross National Product**

U.S. dollars

| Country | Per capita gross national product | Percent of U.S. per capita gross national product |
|---|---|---|
| Poland | $4,565 | 22 |
| Hungary | 6,108 | 29 |
| Czechoslovakia | 7,878 | 37 |
| Bulgaria | 5,710 | 27 |
| Romania | 3,445 | 16 |

Source: U.S. Central Intelligence Agency.

Health standards are considerably lower throughout Eastern Europe than in the more industrialized nations. The relatively high mortality rates, which recently have increased for the first time since World War II, are a manifestation of the generally low quality of health care. However, East European statistics do compare favorably with those of Latin America. (See table 3.5.)

**Table 3.5: Measures of National Health**

| Country | Persons per physician | Annual mortality per 1,000 population | Infant mortality per 1,000 population |
|---|---|---|---|
| Poland | 490 | 10 | 18 |
| Hungary | 310 | 14 | 17 |
| Czechoslovakia | 280 | 12 | 13 |
| Bulgaria | 280 | NA[a] | 15 |
| Romania | 570 | 11 | 25 |
| United States | 470 | 9 | 10 |
| Japan | 660 | 5 | 6 |
| Germany | 380 | 7 | 8 |
| Argentina | 370 | 9 | 32 |
| Brazil | 1,080 | 8 | 63 |
| Mexico | 1,240 | 6 | 47 |
| Greece | 350 | 10 | 13 |

[a]NA denotes not available.

Source: World Health Organization, 1989 World Health Statistics; World Bank, World Development Report 1989; and International Institute of Finance.

## Economic Potential

While the East European countries confront an array of economic problems, they all have economic growth potential. This growth, however, is highly dependent upon substantial foreign investment. Although conditions vary by country, the region generally offers a large labor pool of relatively highly educated but low paid workers. The region is highly industrialized, but these industries need considerable modernization.

For the present, the combinations of comparatively low pay and high skill levels of East European workers offer opportunities to attract development capital. A leading economic forecasting group reports that the average hourly manufacturing wage in Hungary, Poland, and Yugoslavia in 1988 was between $1.35 and $1.71, including fringe benefits and pension costs; in Czechoslovakia, it was between $2.05 and $3.08. The group also reports that the percent of the labor forces in Hungary, Poland, and Czechoslovakia with secondary/high school educations or industrial equivalents was 23.9, 21.9, and 21.9 percent, respectively. In addition, between 7.0 and 9.9 percent of these countries' workers had a college or university education, and highly skilled personnel, such as scientists and engineers, are available at relatively low costs.

## Future Steps Necessary

The East European countries need to take numerous measures to transform their centrally planned economies to functioning market economies. Economic experts generally agree on the steps needed for reform, but there is no consensus on how to approach implementation. Some countries in the region have started to establish the foundations for market-based economies, but they differ in regard to their commitment to reforming their economies, the type of reform measures needed, and the status of these reform efforts.

Assistance from donor countries, including the United States, will probably be an essential element in the success or failure of these reform efforts. Investments in Eastern Europe by domestic and foreign private investors will also be essential, according to most experts. In providing assistance and making investment decisions, however, it is important that the donor countries and investors understand the nature and magnitude of the changes that the East European countries must undertake.

Economic reform in the region is not new. For much of the 40-plus years in which centrally planned economies dominated the region, governments experimented with different approaches for reforming central planning mechanisms and introducing some elements of free markets and private ownership. There was a general realization that the traditional model of the centrally planned economy had been unsuccessful. The changes made to economies during these previous attempts at reform have modified most East European systems so that they no longer have planned economies as classically defined.

The economic reform movement currently under way in Eastern Europe is a complex process. The OECD reported, for example, that the reforms combine previous efforts at modifying centrally planned economies with a new principle of liberalizing the economy while concurrently democratizing the government. While retaining certain elements of previous attempts at reform, the new process is more radical in that its objective is the complete transformation of the system's economic and political structures. At the same time, these reform efforts impose costs on the East European countries. Phasing out administrative allocation of resources, closing inefficient operations, and removing guarantees of employment are difficult steps.

Experts agree, however, that the countries of Eastern Europe must undertake certain fundamental measures if they are to succeed in establishing and supporting a market economy. While there is no agreement on the ideal way to undertake the reform efforts or the order in which they should be implemented, the success or failure of donor assistance to these countries depends at least as much on implementing these measures as on ensuring the effectiveness of the assistance strategies. Necessary steps that the OECD and others have identified are

- Greater reliance on market-based prices: Under central planning, prices are not based on true costs or scarcity of goods. Frequently, prices of key goods, such as food or housing, reflect the subsidies provided by the state rather than the ability of companies or nations to produce goods efficiently. As subsidies and price controls are removed, increased prices for many goods and services are inevitable. In the view of most experts, essential components of these reforms will be breaking up inefficient state-owned monopolies, eliminating subsidies, and removing or substantially reducing the power of the central planners, thereby transferring the ability to make decisions to the individual firm or enterprise. Furthermore, as prices become efficient market signals, it will be important that economic policies avoid inflation that would distort these signals.
- Revival of the private sector: While there remains considerable debate over the future role of governments in the economies of Eastern European countries, most experts believe that it will be necessary to turn a large share of production over to a revived private sector. The governments of these countries will have to take a number of steps to do this, including establishing the legal basis for private ownership, encouraging private investment, and altering their tax systems to reflect these changes. Most experts also believe that restrictions on foreign investment will have to be relaxed or removed. Foreign investment will bring needed capital as well as access to western technology and innovations in management and worker training.
- Improvements in infrastructure: Eastern Europe now lacks the infrastructure needed to transform its economies. Current telecommunications systems, for instance, must be upgraded to support advances in financial services. Transportation and goods-handling systems, such as roads and port facilities, must also be improved.
- Establishment of financial markets: In economies with a greater reliance on markets to set prices, financial markets and systems will be more important. Investment and business decisions depend largely on access to capital and on the ability to receive timely payment for the goods and services that are produced. These decisions also depend on knowledge that the institutions that provide capital and a payments mechanism are safe and sound. Finally, financial markets are essential to development of market-based interest rates, the mechanism by which capital can be

allocated most efficiently, replacing current reliance on central planners to allocate investment funds.

The outcome of these reform efforts will likely be uncertain for several years to come. Changing political leadership and differing economic concerns and reform goals will influence the ultimate results. Over time, the success of these efforts will undoubtedly vary among the countries, suggesting that a long-term perspective will be needed to assess the success or failure of donor assistance.

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