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INTRODUCTION

The changes that have taken place in Central and Eastern Europe since the fall of the Berlin Wall in 1989 have tremendous significance for all the peoples of Europe, both in the East and the West. They are also vitally significant for the process of integration centered on the European Union and for the strategies and prospects of Western European businesses.

Central and Eastern Europe is not a homogeneous area. The countries of the region differ widely with regard to income levels, industrial structures and economic policies, as well as embodying broader political, social and cultural differences. At the risk of oversimplifying, three main groups of countries can be distinguished. Firstly, there are the Central European countries which have relatively high income levels, a strong orientation towards economic integration with the West and fairly stable political systems. These countries include the so-called **Vise grad Four** (named after an agreement signed in the Hungarian city of Visegrad in February 1991) of Poland, Hungary, the Czech Republic and Slovakia, as well as the former Yugoslav republic of Slovenia, and possibly Croatia. The Baltic states of Lithuania, Estonia and Latvia are also often lowering included in this group. Secondly, there is the there rest of Eastern Europe, typified by lower income levels, a more volatile political environment and a more protracted and difficult transition process towards a market economy. Relevant countries here are Bulgaria, Romania and Albania, as well as the remaining Yugoslav republics, notably Serbia. Thirdly, there are the European parts of the old USSR; most importantly Russia, but also the Ukraine, Belarus and Moldavia. In this assignment I will concentrate my discussions on the first group, and in particular on the Vise grad countries, since these have the closest links with the European Union and are almost certain to be the first Central and Eastern European countries to join the EU.

Trade in Central and Eastern Europe

Under Communist rule the Central and Eastern European countries showed two main characteristics with regard to trade and foreign relations. Levels of trade were low, and were very much centered on the Eastern European region, with little integration into the world economy.

The intensity of a country's trade with another country is defined as the share of the country's total trade with the other country divided by the share of the second country in world trade. If the trade intensity ratio is greater than unity it means that the trade of the two countries is more centered on each other than we would expect given the pattern of world trade. If it less than unity the reverse is the case .intensity ration are taken to be better indicators of trade patterns than simple trade shares because they are not affected by factors like size of country and income. For example, we expect trade within North America and in Africa to be relatively low compared with Western Europe because in the first case there are only two large countries, and in Africa the countries are poor and cannot afford large import bills.

The intra-regional trade intensity for Eastern Europe in the late 1970s was considerably higher than anywhere else in the world, while the intensity of Eastern European trade with the rest of the world was lower than elsewhere. At the same time, trade in Eastern Europe was relatively limited in total size. In 1990s, Eastern Europe had only a 5 per cent share of world trade, as compared with 46 per cent for Western Europe, 16 per cent for North America and 21 per cent for Asia.

The reasons for this pattern have been extensively analyzed. It has been argued that centrally planned economies **(Lavigne 1991)**. Trade is seen in such systems primarily as a way of overcoming difficulties in achieving nationally determined plans: plans are not drawn up with international considerations in mind. In addition, the Eastern European countries were limited in their trade by the fact that much of what they produced was not competitive in Western markets. During the late 1970s and the 1980s, Hungary and Poland, in particular, faced debt .political problems also played a role in limiting trade, especially the ′Comecom′ restrictions on export of military or technologically sensitive materials to the East **(Govan 1990).**

Despite the fact that trade within Central and Eastern Europe was very much centered on trade within the region, no successful multilateral trading framework was developed prior to 1989 between these countries . The Eastern European trading organization, the Council of Mutual Economic Assistance, remained essentially a framework for bilateral trading relationships between its members. Of these relationships the most important were those between the individual Central and Eastern European countries and the USSR. These took various forms, but generally involved the supply of manufactured products to the Soviet Union in return for fuel and raw materials; with Soviet oil exports to the CEECs in particular being fairly heavily subsidized.

Various attempts to deepen the Comecon machinery to encourage economic integration did not succeed .the level of political involvement in the planning process made such integration made such integration an intensely political matter, subject to fierce agreements. This was made worse by the requirement that Comecon decision-making be unanimous. In addition, Comecon members had markedly divergent interests along tow main lines of division. One division was between those countries implementing economic reform, particular Hungary, which saw integration as involving a greater use of market mechanisms in foreign trade, especially in the area of currency convertibility, and those countries such as the USSR, which saw integration being based on extending the planning mechanism across national frontiers. a second division was between countries whose trade was primarily orientated towards Eastern Europe and those with wider international links, which where more skeptical of integration. For example, in 1980 the share of trade with socialist countries in total trade was 74.8 per cent for Bulgaria, 69.9 per cent for Czechoslovakia, 53.1 per cent for Hungary, 55.7 per cent for Poland and 41.2 per cent for Romania **(Wallace and Clarke 1986)**. Comecon did not appear institutionally strong enough to handle these differences and was finally dissolved in June 1991.

Foreign investment in Central and Eastern Europe before 1989

Not only trade but also foreign investment was rather limited in the CEEs(Central and Eastern Europen Countries) before 1989. As can be seen, despite increasingly favorable conditions for joint ventures from 1971 onwards, the sums invested were relatively small. **Lavigne (1991)** quotes the soviet author Rodina as finding for the period 1972-87 that for Eastern Europe (excluding the USSR) FDI amounted to only $0.5 billion, i.e. 0.2-0.2 per cent of total capital invested in those countries. For the USSR the sums were large with approximately $5oo million being invested in 1987-88. in the first seven months of 1989, immediately before the collapse of the communist regimes, more Western money was invested, but this money still amounted to only 22.3 per cent of the investments in question **(Lavigne 1991)**. In Poland, 500 investment authorizations were granted in the first nine months of 1989, compared with 52 in the previous two and a half years, but the total FDI inflow was only $110 million **(Kilmister 1990).**

Problems involved with setting up joint ventures included the complexity of legislation, an insecure environment (shortages of materials due to planning problems and labor unrest in the Polish case), relatively high taxes, the requirement to pay wages t more than local levels, confusing accounting systems, and poor communications and infrastructure. Against this the CEECs offered both a large market and a highly trained workforce.

Trade relations between East and West after 1989

The magnitude of change required by the transition to a market economy involved major disruption of trading relationship for the CEECs after 1989. this was accentuated by two further developments. Firstly, in their eagerness to underline the depth of the changes taking place, the new Central and Eastern European governments dismantled the old trading arrangements in the region, such as the Comcon structures, with considerable speed. Secondly, the economic crisis in the USSR from 1990 onwards and the break-up of the Soviet Union into its constituent republics after August 1001 had a dramatic impact on the CEECs. The effect of all these factors was to orientate Central and Eastern European trade decisively towards Western Europe. This both opened up important opportunities for western European producers, as a result of the new markets, and posed major challenges stemming from the possibility of a new source of cheap imports competing with EU countries.

It can be seen that Central and Eastern European exports tended to be concentrated in a number of areas where western European producers were facing quite sever difficulties in the 1980s, notably agriculture, steel, chemicals, textiles and clothing. Indeed most observers agreed that Eastern European trade would have been even more centered on those areas had there not been protectionist barriers, notably in textiles. At the same time, Central and Eastern Europe offered new markets for a number of industries where market growth was relatively low in the west and where consumer demand was previously pent-up in the East, e.g. motor vehicles and food, drink and tobacco.

The potential extent of trade between East and West

There have been a number of attempts to estimate the likely potential growth of trade between Eastern and Western Europe. One very influential approach has been to use what is known as the 'gravity model' to estimate the expected growth of trade flows. This model stems originally from work done by **Linnemann (1966)**; the application of it to Eastern Europe is due to a number of writers, such as **Hamilton and Winters (1992**), **Baldwin (1994**) and **Winters and Wang (1994**). The account is based on **Hamilton and Winters (1992**), which has been widely adopted as a benchmark study in this area.

Hamilton and Winters used a version of the gravity model which stipulated that for any two countries the level of trade between the two countries would depend positively on the level of GNP of each country, the existence of a common border between the countries and the existence of trade preferences between the two countries; and negatively on the population of each country and the distance between the two countries. Using data for 76 market economies accounting for about 80 per cent of total world trade average over 1984 to 1986, they estimated coefficients for this model. They then applied the estimated model to data for the USSR and the CEECs for 1985 to derive estimates for potential trade with other regions of the world, which they then compared with the actual situation obtaining in 1985.

It can be seen that, according to this approach, the potential growth in trade is very significant. The largest absolute predicted growth is between Germany and the CEECs; however, in proportional terms this is not so large because of the existing high level of trade between Germany and the East. When the Soviet Union is added to the picture the results are even more striking. **Hamilton and Winters** found that in 1985 for the Soviet Union and Eastern Europe taken together, actual exports to the European Union were $27.2 billion and imports from the EU were $22.2 billion; while the gravity model predicted that exports could have reached a potential level of $14.7 billion. Other estimates using the gravity model have been similar in magnitude.

The gravity model has been criticized for lacking an explicit theoretical underpinning. An alternative approach is that followed by **Collins and Rodrik (1991),** who estimated aggregate equations for exports and imports based on levels of GNP and population and then applied these to the CEECs to obtain an overall estimate of trading potential. They then estimated the breakdown of this overall potential between particular countries by updating a trade matrix for 1928. They did this by looking at a sample of six countries (Austria, Finland, Germany, Italy, Portugal, and Spain) and by using their experience to estimate a relationship between the trade flows recorded in 1928 and 1989 trade flows. They than applied these estimates to the CEECs and to the USSR.

The result arrived by **Collins and Rodrik** are fairly similar to those based on the gravity model. In the medium term, exports from the Czech and Slovak Republics to the 12 EU member states were predicted to rise from $3.8 billion in 1988 to 12.6 billion. For Hungary the predicted rise was from $2.4 billion to $5.9 billion and for Poland from $4.3 billion to $20.1 billion **(Baldwin 1994)**. However, the study has been criticized for assuming that one can predict on the basis of the changes that have been taken place elsewhere in 1928 trading patterns. **Hamilton and Winters** argue that the countries used as a reference group by **Collins and Rodrik** have all been strongly affected by the process of Western European integration. Using their experience as a benchmark leads to an exaggeration of the extent to which Eastern European trade will centre on Western Europe.

Trade within Eastern Europe after 1989

The initial effect of the collapse of communism led Eastern European countries to trade much less amongst them and more with the West in general and the EU in particular. However, in recent years there has been a modest revival in trade within Central and Eastern Europe. One factor that has encouraged this has been the formation of the Central European Free Trade Agreement (CEFTA). CEFTA (Central European Free Trade Area) was founded by Czechoslovakia, Hungary and Poland in 1992. Slovenia joined at the end of 1995. Romania and Bulgaria have been negotiating membership. The Ukraine, Croatia and the Baltic states have also expressed interest in joining CEFTA.

The aim of CEFTA was to abolish all mutual tariffs by 1 January 2001. However, it consists of a group of bilateral trade agreements, reviewed twice a year. Most industrial goods and about half of farm products are free of tariffs, but there is no CEFTA bureaucracy and no proposals to harmonize product standards or liberalize capital flows **(Lyons 1997).** Including Romania, CEFTA represents a market of 89 million people with a combined GDP of just $280 billion. However, if all prospective members do actually join, the market could increase to 160 million people.

Intra-regional trade is rising. Polish exports to CEFTA raised from 3.6 per cent of its total in 1993 to 5.8 per cent in 1996. On the other hand, trade within CEFTA is dominated by trade between the Czech Republic and Slovakia. In 1994, Czech exports to Slovakia totaled $2.4 billion. Each of these flows was over four times as large as the next largest set of trade flows within the CEFTA region for that year (that between the Czech Republic and Poland).

Asea Brown Boveri

Asea brown Boveri (ABB), the Swiss-Swedish engineering combine, has been one of the most active investors in Central and Eastern Europe since before 1989. By 1996 it had built a network of 60 companies in the region, the largest manufacturing operation of any Western group.

ABB operations in Eastern Europe 1996

County	number of subsidiaries	number of employees
Poland	13	7000
Czech	6	7000
Russia	14	3000
Romania	4	2000
Ukraine	5	1500
Hungary	4	600
Slovakia	4	500
Croatia	2	500
Latvia	2	400

ABB began negotiating with the Polish government about possible investments in 1988 and completed its first acquisitions in 1990. these were of Zamech, the only turbine maker in Poland, and of Dolmel, the largest generator manufacturer in the country. This was the basis for further expansion in the region, especially in the area of power engineering, particularly the renewal and replacement of out-dated power stations. ABB bought a large power engineering complex in Brno in the Czech Republic. Orders in the region grew from $225 million in 1990 to $1.65 billion in 1994. by 1996 ABB employed almost 30 000 people in Eastern Europe, out of a total of 211 000 world-wide.

Eastern Europe is an attractive location for ABB because of both cost considerations and market-related factors. Components like turbines and switchgear are up to 40 per cent cheaper there than from Western suppliers. Acquisition costs are kept low|; the company rarely spends more than $20 million on a single company and its whole Eastern network is estimated to have cost just $300 million. In the first nine months of 1996, ABB reported a 47 per cent increase in net profits, to a figure of $651 million.

While cost are important, they are not the sole reason for ABB investment in the East. After all, while revenue per worker in the company's Czech plants doubled between 1994 and 1996 it remained four times lower than the ABB average, as a result of lower productivity and lower value-added production. In some ways more important than costs are growing markets as the region builds some ways more important than costs are growing markets as the region builds up the infrastructure of railways, airports, factories and energy supplies.

The group has had some problems; it lost $1 million when a joint venture in Russia had to be abandoned when the partner company was found to be involved in criminal activities. More importantly, the Eastern European activities have demanded a large commitment of management time and energy. The chief executive of ABB, Percy Barnevik, is estimated to spend about a fifth of his time in the region and ABB has had to train thousands of Eastern managers and technicians. In 1995, for example, ABB trained 17 000 workers in Poland and the Czech Republic. It has founded training centers in both Brno (Czech Republic) and Warsaw.

The company has committed itself to a common level of quality in both Western and Eastern plants, and to managing its Eastern factories with managers from the region. Eastern European managers were paired individually with Western counterparts to learn management and marketing skills. This approach has now been developed so that Polish and Czech employees of ABB are training Russians and Ukrainians. In addition to management expertise the company has transferred technology, such as machine tools, computer programs, technical drawings and sales manuals.

There has been some suspicion within the company about the Eastern European policy, focusing on claims about the 'export of jobs' from the west. Between 1990 and 1994 the Western European workforce of ABB decreased from 141 000 to 125 000, with further large job losses in North America. At the same time the Czech and Polish subsidiaries gave taken over production work from factories in Germany and Switzerland. The ABB Kraftwerke plant in Mannheim, Germany orders sat least DM35 million of suppliers from ABB plants in Poland, while the company has replaced an engine-starter production line in Germany with one in Brno and has moved the production of air-cooled generators from Switzerland to Gdansk (Poland). ABB management argues that this was inevitable anyway and that the Eastern investment safeguards jobs through-out the company making it more competitive. Around half the components in the Asian power plants built by ABB come from Central Europe.

It is also the case that ABB plants in the East have even seen restructuring and cost-cutting. At Zamech in Poland the workforce was cut from 4300 to fewer than 3200 by 1993 through retirements and the outsourcing of services such as cleaning to new private companies. Production costs fell as labor; raw materials and factory space were used more intensively. In the early years of the Zamech investment, funds were concentrated on computerizing and modernizing existing equipment. By 1996, however, total investment in the subsidiary had risen to $70 million and the workforce was rising once again. Between 1992 and 1996 Zamech increased its profits from $2000 per employee to

$16000. **Source adapted from Wagstyl, S. (1996) Woven into the fabric, *Financial Times*, 10 January; Business Central Europe survey on Foreign investment, April 1996.**

Central and Eastern European external debt

The debt crises have not passed by the CEECs. Poland was one of the first countries which could not meet its debt obligations (in 1982) and requested the rescheduling of its debt. Most of this debt is owed to western governments with only around 20 per cent owed to Western banks, mostly Western European ones.

For the region as a whole the external debt situation of the CEECs deteriorated rapidly in the late 1980s. the total gross debt of the region reached $ 142 billion at the beginning of 1991, with the most heavily indebted countries being the then Soviet Union, Poland and Hungary, Bulgaria ran into debt service ratio of 25 per cent is a critical figure, the figures for 1990 for Bulgaria, Poland and Hungary of 77 per cent, 71 per cent and 65 per cent, respectively, show the extent of these countries difficulties. In addition, by early 1990 the Soviet Union began to accumulate sizeable amounts of external debt.

The strategies used to overcome the debt problems in the CEECs included measures by Western creditors to reduce their exposure to debt together with increased direct and equity investment. For specific countries the period of the early 1990s saw both Poland and Bulgaria continuing to seek debt relief measures, increased borrowing from international financial organizations by Poland, the former Soviet Union and Bulgaria, and debt rescheduling by Bulgaria.

Within the CEECs it has been appreciated that their debt issue problems cannot be solved in the short term. The transformations that have been taking place with these countries require greater export growth, and growth in their economies. At the same time the question needs to be raised concerning the creditworthiness of these countries.

EU enlargement

Part of the transformantion of the CEECs has come about through adopting Western European practices. However, the CEECs do not see themselves as simply following their larger Western European neighbors but envisage that they will play a full part in the future development of Europe and the EU. As such, a number of them have made applications to join the EU. As a response to this the European Commission published agenda 2000 in July 1997. this dealt with three main issues:

- The future of the Union’s main policies;
- The EU’s financial perspectives for the years 2000-2006;
- The enlargement of the Union.

As an indicator of the degree of competitiveness, the EU considered the degree of trade integration of the country with the EU before enlargement, and the proportion of small firms. In considering where the countries are now it is also important to bear in mind the position expected of the countries by the year 2005. in the Commission's view, Hungary and Poland come closest to meeting the two economic criteria taken together, whilst close behind come the Czech Republic and Slovenia. Estonia meets the first criterion, but has still got some way to go to meet the second. Slovakia meets the second criterion but is not regarded, at present, as a functioning market economy. In addition to these transitional economies, Malta and Cyprus have also been included in the first wave group.

For the successful applicants the move towards full membership of the EU is somewhat different to the accession issues faced by earlier Western European economies. They are poorer, they are in a transitional phase to a market economy, they face an EU that is undergoing change, and they may have to accept agreements, such as monetary union, which are far greater than those experienced by other applicant countries before. For those countries unsuccessful in the first wave there is a need for the EU to make sure that they are not sidelined and that a major distinction should not be drawn between those that are 'in' and those that are 'out'.

Privatization in Central and Eastern Europe

The growth in FDI into the CEECs can come through a variety of means: the establishment of Greenfield sites, the development of joint ventures and strategic alliances between Western companies and those in the CEECs and through the process of privatization.

For the CEECs privatization could be seen as an important step towards the creation of a market economy. It allows state monopolies to be broken up, creates a property-owning middle-class, provides the motivation for managers, increases external funding, brings in new technology and new management where the company privatized is sold to Western businesses, and develops a share-owning society. The process of privatization is not without its difficulties, however. Firstly, there is a need to consider how the process of privatization will take place. It is possible that free shares can be distributed to everyone. Although this returns state assets to the private sector it does so without providing the state with new money. A variation on this approach is for the free shares to be in large investment trusts or funds, which in turn hold shares in Polish government. Alternatively, share could be given or sold to employees and managers in organizations, thus providing an incentive for employees to make sure that the business operates effectively. This approach adopted in Russia. The use of vouchers is another approach adopted by the Czech Republic and Russia. These may be given to individuals, as was the case in Russia, or sold to them as in the Czech Republic. Foreign investors are also encouraged to purchase vouchers. A similar voucher system has been used in both Poland and Romania.

The privatization process could also include the restoration of assets to previous owner, and this has been important in East Germany. Hungary has also ownership. Finally, privatization in the CEECs can also follow the approach adapted by Western European governments where shares are sold, at a fixed price, to both domestic and foreign investors. This method was used by former East Germany and Hungary.

One thing that distinguished the state sector in the CEECs from that in the West is the sheet size of the sector and the speed with which privatization was anticipated to take place . in many Western economies it took a number of years for privatizations to take place and this was with sophisticated financial and legal institutions. In the CEECs the process of privatization has not been as rapid as expected, and on a number of occasions, the privatization process itself has been halted. The Czech Prime Minister, Vaclav Klaus, has explicitly warned against the “family silver”.

> In Hungary, opposition to privatization through foreigners has been growing. Polish privatization minister warned against giving foreigners too much preference in the privatization process; former Prime Minister argued that he had tried his utmost to prevent foreign investors taking over Polish companies. Polish trade unions accuse foreign investors of employing ‘salve labor ‘ and taking away the ‘family silver’. Russia has restricted the shares of assets that can be sold to foreigners and has made little attempt to withdraw discriminatory regulations that exclude foreign investors. **Sinn Weichenrieder 1997, page 182**

It can be argued that this is a rather one-side view of the current attitude in Eastern Europe, given the prevalence of large-scale privatization programs and the expressed desire to join the EU. In fact, the role of state ownership has diminished somewhat in the CEECs.

It is important to note that the process of privatization can be divided into small scale and large scale. The privatization of small-scale enterprises has been fairly successful, transferring ownership to the private sector of small state-owned enterprises or co-operatives. It is with large-scale privatizations that the problems have occurred. Because of the lack of financial markets in their countries, the lack of resources, and the lack of management expertise, large-scale enterprises either have been difficult to sell or the government has looked to foreign capital. As result of these difficulties, privatization in the various CEECs has advanced at different speeds.

CONCLUSION

The past decade has seen a major changes in the economies of many CEECs as they have moved from centrally planned economies through transitional phases and on towards the market-based economies of the West. This move has been brought about by the demise of communism and the realization that in terms of economic development and sound finances the Western European model for all its deficiencies has much to offer. Part of the move towards transition was prompted by the level of external debt occurred by some of the Eastern bloc countries. In addition to debt issues, the last decade has seen the CEECs become more heavily integrated with the EU, not only through trade but also through the role of Western FDI and the selling-off of state-owned assets. Many CEECs now perceive that they would like to take the next step to greater integration with the west by becoming members of the EU. Integration into the EU is not without its problems for both the CEECs and current EU members. If all proceeds to plan, by the year 2010 the EU will be seen to cover a region from the Arctic to the Mediterranean and from the Atlantic to the Baltic

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