Staff Papers Series

Staff Paper P90-6 January 1990

The New Modern History of Eastern Europe

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January 22, 1990

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The events of 1989 in Eastern Europe have rung in the New Year with a sense of hope and optimism. I share in that hope, but will argue that we have rather badly misgauged the meaning of these events. Although greeted as a triumph of democracy and capitalism, I believe we have instead witnessed the total failure of totalitarian state planning. This failure is not equivalent to the victory of democracy or capitalism, and may leave instead a great void that must be filled with something else, which we are not presently equipped to provide. That something is money.

State Department policy planner Francis Fukuyama, in his now famous nostrum on the "End of History," suggests that the decline of the East has ushered in a kind of stillness in which the major problem will be to keep from yawning.[1] I find this argument intellectually banal and politically naive. But, it was not me to whom Fukuyama's message was addressed; it was to the Secretary of State, President and the Washington intelligentsia. Many seem convinced that the Soviets and Warsaw Pact have folded their hand, and that all that remains is to rake in the chips.

I would argue that rather than folding, a group of players across the table have in effect fallen off their chairs, dragging the tablecloth,

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[1]Francis Fukuyama, "The End of History," The National Interest 16 (Summer, 1989).

cards and many chips toward them. The collapse of the Warsaw Pact and Iron Curtain is an implosion, a collapse from within, which promises to draw resources out of Western Europe and the capitalist economies without any promise of returning them. Into this hole we can pour aid and investment, but the returns are iffy, at best. Far from counseling the kind of relaxed and modestly informed nonchalance which is the appealing message of Fukuyama on history's end, we are at the beginning of a new modern history. The simple division of world politics and economics that has marked the last seventy years, since Lenin arrived in 1917 at the Finland Station to spark his revolution, is no longer sufficient.[2]

The implosion of the Warsaw Pact thus exerts a pull on Western resources that has important implications for both government and private sector investment strategy. Consider two dimensions of this issue. The first is the impact on Western Europe, and specifically on the European Community's plans for a unified market by 1992. The second is the impact on the United States, and the opportunities and risks for private investment and public policy.

Western Europe, in my view, is much better positioned for reasons of both history and culture to benefit from the developments in the East. Put simply, West and East Europeans know one another better than we do. A recently commissioned study of joint ventures by western companies in Poland indicated that nearly 80 percent were with companies in Western Europe. Of the 40 or so U.S. companies involved in Polish joint ventures nearly every one had some ethnic or family tie that linked them back in

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[2]See Edmund Wilson, To the Finland Station. New York: Farrar, Strans and Giroux, 1972.

some way to Europe and Poland. In Poland, West German companies have formed more than 400 joint ventures, 10 times the number with American companies.

Will such investments pay off in the future? Consider the situation in Poland. This winter, Poland's farmers are demanding a halt to the process of "marketization." In a remarkable convergence, like their U.S. and European farmer counterparts, they have rather grown to like state intervention to stabilize their prices, and fear market-oriented reforms almost as much as they hated the Communist state planning apparatus. The farm groups play a significant role in Solidarity, and will thus likely stall efforts to open up markets for staple commodities advocated by the World Bank and IMF grantors of aid.

This winter will be a hard one in Eastern European agriculture, for three very instructive reasons. First, while foodstuffs are probably adequate to satisfy total demand, chronic shortages are likely. This arises from the propensity, observed by anyone who has lived or worked in a Communist system, for the citizens of these countries to hoard scarce commodities in times of trouble. This hoarding instinct, which can clear shelves of basic commodities faster than a snowstorm in Washington, means that even if pockets of abundance occur, they will be hidden and will not move to pockets of demand.

Second, and related, is the breakdown of the state-controlled marketing and distribution monopolies. While some are nominally "cooperatives", these monopolies are now without force or guarantees. The lack of confidence in them thus makes moving goods from pockets of surplus to pockets of demand inherently difficult. This lack of confidence interacts with hoarding to lead anyone to think twice about putting goods on a train bound for Point A in the expectation that they will be receiving goods in return from Point B.

Third, a similar phenomenon affects liquidity in money markets. Poland's attempt to convert its currency to allow it to fluctuate on internal markets led to a run on the banks, as individuals became convinced that their small hard currency holding in dollars would be replaced by a converted currency that would be worth less.

Together, hoarding, marketing failures and monetary insecurity add up to significant inflation, especially as the prices of commodities are allowed to fluctuate more freely. Having lost confidence in government quantity rationing, no new confidence exists in price rationing either. This is precisely why Polish farmers are in reactionary opposition to marketization. There is, after all, no Polish equivalent to the Chicago Board of Trade on which to hedge next year's crop. Having experienced government failure, Eastern Europe is getting set for market failure.

Western Europeans understand the problems of Eastern Europe better than we do, having lived through very similar problems after the Second War. This is partly why Germany, in particular, so fears inflation, and why greater confidence exists in a mixed system of state planning and market forces in Europe than in the U.S. There is nothing like a winter of hunger or hyperinflation to sap one's confidence in the magic of the unfettered marketplace.

In the face of these problems, Western European investments in the Eastern bloc will expand, but slowly. The emergency meetings of prime ministers in Brussels over the implications of the implosion in Eastern

Europe for the 1992 process is instructive. I believe that a three-tiered structure of trading arrangements will emerge. The first tier, or inner circle, if you will, will be the EC-12, for whom the harmonization toward 1992 will continue. In the second tier will be European Free Trade Area (EFTA) countries, including Austria, Switzerland, the Nordic countries of Sweden, Norway, Finland and Iceland. These countries have already struck a bargain with the EC-12 that amounts to a sort of conditional most-favored-nation status in relation to the 1992 process. By 1992, the EC and EFTA countries hope to allow free movement of goods, services and capital among their 18 nations. Significantly, the only exception for the EC is likely to be agriculture, where duty free imports from EFTA are unlikely to be allowed to breach the wall of the variable levy.

The outer circle or third tier of this European trading zone will encompass the Warsaw Pact and Comecon countries. Together, Hungary, Poland, East Germany and Czechoslovakia have 80 million people. The Soviet Union has 285 million. These countries' 365 million thus exceed the 325 million of the EC. But they do not have much hard currency to spend. The greatest integration will occur between Germany and the regions formerly part of the Bismarck's confederation (such as Pommerania and other parts of Poland and East Germany). These areas, together with parts of the Balkans with historical ties to the West dating from the Hapsburg Empire will be integrated more readily. These include ties from Vienna to Budapest and Prague. In early November, the foreign ministers of Italy, Austria, Hungary and Yugoslavia met as what the Economist (November 18, 1989) called the old Austro-Hungarian "quartet" to advance a regional grouping. This grouping redefines Emperor Franz-Josef's Mitteleuropa, or Middle Europe. The city of Trieste looks on this as a rebirth, and has reopened the old

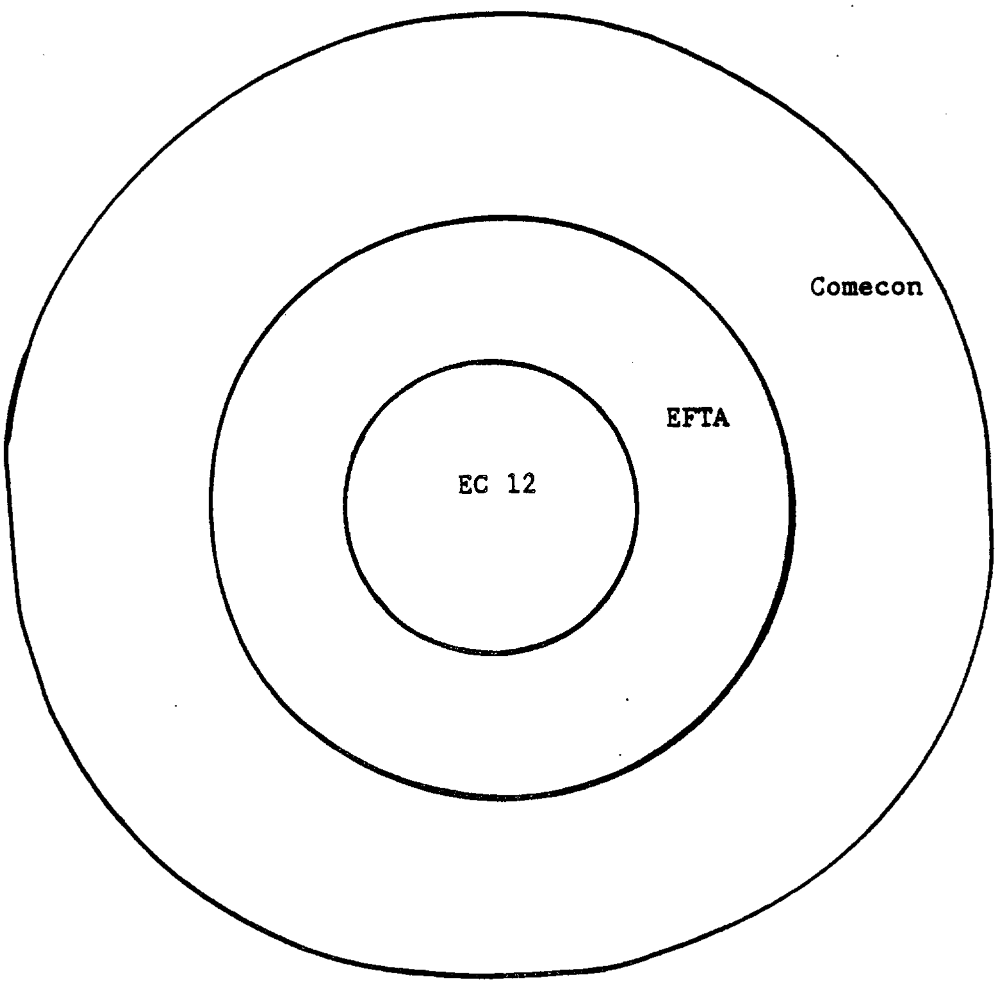
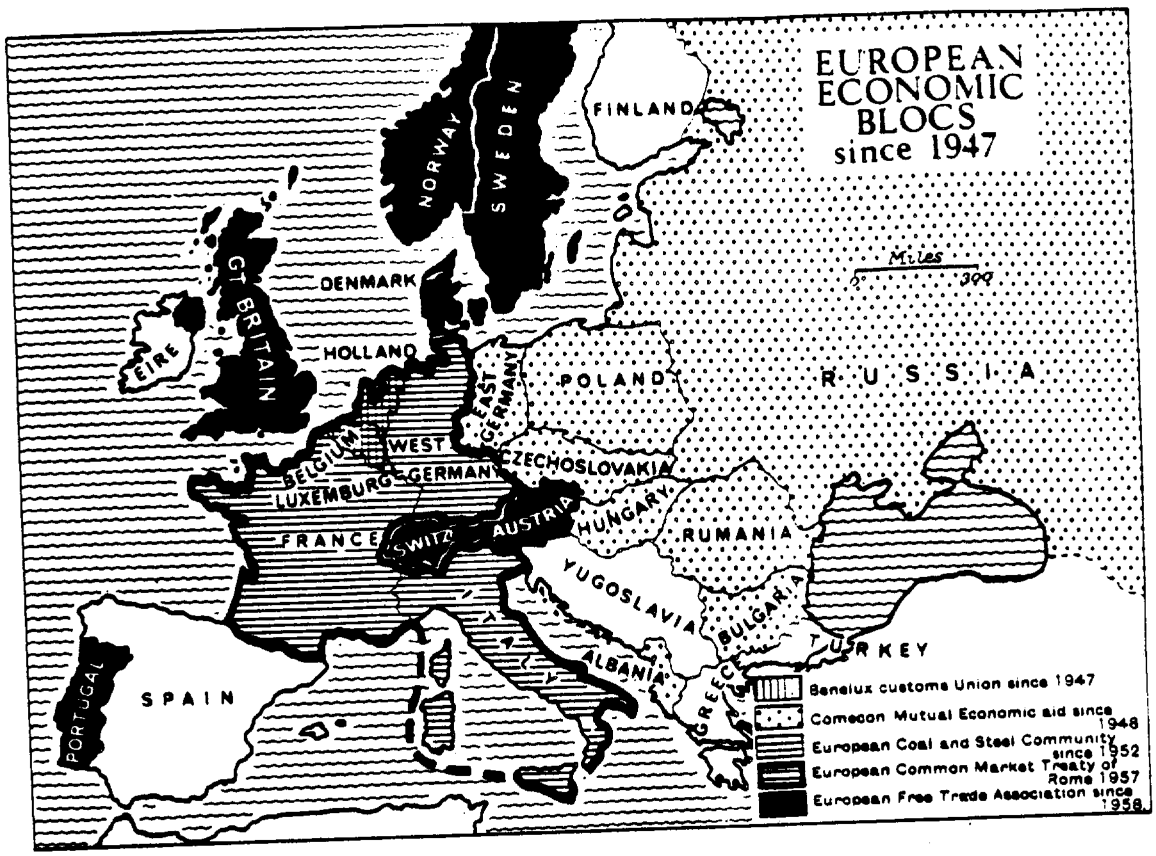


Figure 1.



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Source: Recent History Atlas 1860 to 1960, Martin Gilbert, Weidenfeld and Nicolson, London, reprinted 1974.

Hapsburg Café San Marco. In general, East Germany, Poland and Hungary will be the first countries to become economically integrated into this third tier or outer circle. Weaker forms of reciprocity will be extended to them by EFTA and the EC-12 (Figure 1).

If the bulk of investment opportunities (which, as I have argued, will be limited in the short term) are seized by Europeans, what will this leave for the U.S.? U.S. companies that have done business with communist regimes in the past have been willing participants in at least one aspect of socialism: largely guaranteed profits. Unfortunately, the breakdown of state planning will reduce the capacity to guarantee the new generation of Armand Hammers a tidy return. The more investors there are, the less it is possible to make such guarantees. Hence, the collapse of state socialism will actually raise the risks of investment in comparison with the past.

It will also raise the stakes for joint ventures now underway. Chubb and Son, Inc., the insurance company, has formed a joint venture with the Soviet Union to offer property and casualty insurance to Western companies setting up business there. Let's hope they don't have the experience with Chubb that thousands of farmers did who bought crop insurance against drought with the company in 1988. Insurers sell insurance on the supposition that things won't go wrong -- not that they will. The Soviet Union now has close to 100 joint ventures with American companies.

Some American companies have been unusually aggressive. United Parcel Service has started delivering packages in Moscow, Budapest, East Berlin, Warsaw and Cracow, although it demands payment in hand currency, limiting its market largely to other Western companies who don't trust the mails. General Electric has a light bulb venture with Hungary worth $150 million, and General Motors is working on a deal to buy East bloc automotive parts in return for greater import access for its cars. Because of limited hard currency, many deals will involve forms of countertrade, such as Pepsi's decision to take payment for its sugar syrup in the Soviet Union in the form of Stolichnaya vodka. I am surprised it hasn't attempted to market a Pepsi/vodka concoction, although neither the Pepsi nor the vodka would be likely to be improved in the process. However, the very move to decentralization and "marketization" means that comrade so-and-so in the Ministry of Planning has less to say about arranging countertrade deals than in the past. Bankers are especially wary, recalling the $15 billion dollar debacle of the 1970s in Poland: loans which have not been repaid.

Figure 2 shows a list of current joint ventures, as of July 1, 1989, according to the New York Times of December 18, 1989.

If winning through state-sponsored intimidation by investing in Eastern Europe and the USSR will become more difficult, the losers from the decline in military spending here at home are easier to predict. One of the striking features of the collapse of totalitarian regimes in the East is the tugging at the tablecloth under the piles of chips accumulated by U.S. military suppliers. Thanks to the cold war military buildup, Leslie Wayne of the New York Times recently reported that 85 percent of the General Dynamics $9.5 billion in annual sales comes from government contracts. At Lockheed the figure is 91 percent; at Northrup 92 percent; at McDonnell Douglas 64 percent; at Martin Marietta, 85 percent. At Grumman, the figure is 90 percent, and the proposed cancellation of the Navy F-14 fighter would zero out 20 percent of sales (Star Tribune, Dec. 17, 1989).

Joint Ventures in the Eastern Bloc

Registered joint ventures and key legislation by country.*

Bulgaria — **41 joint ventures**

New decree simplifies the registration process for foreign companies. Tax brackets revised, with many lowered. Profit transfer abroad has been eased. Free-trade zones are now possible.

Czechoslovakia — **20 joint ventures**

Czechoslovaks may not participate in joint ventures, which are limited to national enterprises. All accounts and most profit transfers are kept in nation's currency. Reserve, cultural and social funds must be established from a small percentage of venture's income.

East Germany — **No foreign investment**

Hungary — **628 joint ventures**

Profit transfer in hard currency is allowed. chief executive officer can be a foreigner. Joint ventures with less than 50 percent foreign capital do not need any Government permit. Joint ventures in electronics, spare-parts production for transportation, agriculture and machinery, and pharmaceutical and protein production are tax-free for five years; after that, favorable tax rules apply.

Poland — **170 joint ventures**

Profit transfer in hard currency is allowed. Foreign investors' rights to engage in business match those of Polish citizens. A foreigner can be chief executive. Joint ventures can obtain foreign loans. An import-duty exemption for three years is permitted on contributions to capital stock. Fifteen percent of export proceeds must be sold through Polish exchange bank.

Rumania — **5 joint ventures**

No new joint ventures since 1977.

Soviet Union — **685 joint ventures**

Foreigners may be chief executive. Up to 99 percent foreign capital investment is permitted. State enterprises and cooperatives are permitted to enter into joint ventures. Some custom-free zones exist.

Yugoslavia — **41 joint ventures**

Foreign partners' share of profits can be transferred abroad. Majority foreign ownership is permitted. Joint ventures possible in all areas except insurance, commerce and social services. Tax rates vary regionally.

*As of July 1, 1989

Source: Bloc magazine

Figure 2.

Source: New York Times, December 18, 1989.

This striking dependence on military procurement reveals one of the great ironies of the 1980's buildup in weaponry. As the pressures for democracy and capitalism in Eastern Europe mounted, the U.S. was converting a major share of its industrial base to a form of state socialism through guaranteed government contracts. The inefficiency and waste of $800-toilet seats are hardly news to the East bloc, nor the oft-heard phrase "good enough for government work," each of which tells what happens to incentives when government is the buyer and competition becomes a sham.

Despite the talk about a "peace dividend," I very much doubt that the aforementioned companies will share much enthusiasm for reduced military spending. If I were an investor I would diversify out of these companies, but not before I watched them go to work on Congress to retain their state-sponsored contracts.

Nearly 40 years ago, Joseph Schumpeter asked, in his classic Capitalism, Socialism and Democracy (1943), whether the propensity for increasing size and concentration of industry in the Western democracies would not make these companies wards of the state, indistinguishable from state-controlled monopolies. His question was "Can capitalism survive?" It would appear, in light of recent events, that he might also have asked "Can socialism survive?" But perhaps he was partly right after all. In the new dawn of current history, we must ask whether either capitalism or socialism can survive as we have known them. I believe the answer is "nyet".

*Remarks prepared for a meeting of investors sponsored by Piper, Jaffray and Hopwood, New York City, January 30, 1990.

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