CHANGES IN EUROPE AND THE USSR: AN OVERVIEW FOR SOUTHERN AGRICULTURE AND AGRIBUSINESS

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INTRODUCTION

The world was astonished in 1989 by the initial collapse of socialist institutions and subsequently by the pace at which change swept across the Eastern European region. For a time, even the Soviet Union seemed to be moving toward greater political pluralism, market orientation and the effective end of the Cold War. It is now approaching two years since this political convulsion began (in Poland). This is sufficient time to enable the transition programs to take form, and to permit informed speculation about the potential for their success and, ultimately, how the Eastern European and Soviet situations could affect the farming and food sectors of our economy.

The purpose of this paper is to review recent economic developments in Europe and the Soviet Union and examine some of their implications for U.S. agriculture and agribusiness. The body of the paper is organized into four sections. The first section presents the region in perspective, to indicate the magnitude of both potential markets and problems being confronted. The second section briefly assesses progress in Eastern Europe and comments on what appears to be the end of Perestroika in the Soviet Union. The third section suggests how the region's recent developments could affect U.S. farmers and agribusiness, both in the short term and in the years ahead. The fourth and final section contains some summary observations.

I. PROBLEMS AND POTENTIALS

Until the outbreak of hostilities in the Persian Gulf, there was intense and building interest throughout the business community (and especially agribusiness) in Europe and the Soviet Union. The reasons are clear; the region has enormous potential business opportunity.

The first aspect of this potential is simply size. The six countries plus the former East Germany have a population of 136 million people. Add to that the almost 290 million people of the USSR, and a potential market of over 425 million people emerges. That is a market nearly 70 percent larger than the United States, about 31 percent larger than the European Community market, and more than double the size of the rapid growth markets along the Pacific Rim.

Table 1. Populations of East European Countries and Soviet Union.

	1989 Population (millions)	1989 Gross National Product: Total (billions)	1989 Gross National Product: Per Capita (thousands)
Bulgaria	9.0	51.2	5.7
Czechoslovakia	15.6	123.2	7.9
German Dem.	16.3	159.5	9.6
Hungary	10.6	64.6	6.1
Poland	37.8	172.4	4.6
Yugoslavia	23.0	79.8	3.4
Romania	23.7	129.5	5.5
	136.0	780.2	5.7
USSR	288.8	2.66 trillion	9.2

Source: Central Intelligence Agency, *The WorldFact Book 1990.*

Although the region is a *potential* market in that purchasing power is still sharply constrained by low productivity, there is a strong pent-up demand for goods and services to help improve living standards. Some notion of the market's potential can be seen from a comparison of the high consumption levels of adjacent Western Europe. While incomes in Eastern Europe are well above those of the developing world, they nevertheless are but a fraction of those in the industrialized countries of Western Europe and the United States (less than $6,000 per capita per annum in Eastern Europe versus about $20,000 in Western Europe and the United States).[1] Any growth in incomes can be expected to be accompanied by

[1] GNP estimates for Eastern Europe and the USSR may be greatly overstated. The USSR presents a clear example. The spread between the official and unofficial values of the currency is a factor of over 25: 1 ruble equals $1.82 (official) or 7 cents (black market). Thus, the average per capita GNP of $9,200 at the official rate would be only a few hundred dollars at the black market rate.

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increasing consumption in attempts to quickly improve living standards.

Besides interest in the region as a market, many firms are considering strategic business positions in Eastern Europe as a "backdoor" means to avoid being locked out of the EC by the 1992 unification. It is almost certain that most of these countries (and perhaps eventually even the USSR) will be granted preferential access to the enlarged EC market (if not full EC membership), and companies located there will be well-situated to participate in all European markets including the EC. Also, location in an Eastern European country may prove to be beneficial for taking advantage of opportunities emerging in the USSR.

Agribusiness companies also are interested in other business possibilities in the region. Direct product sales are important, but both joint ventures and direct investments are being considered as a means to establish manufacturing and sales facilities, to source products, to assemble and package, and to conduct trading and other operations. Companies see the opening of these countries as presenting cheap assets, cheap labor, and cheap raw materials, which, combined with western technology and business management expertise could produce efficient, competitive business operations.

While the business potential in Eastern European countries is considerable, very formidable obstacles must still be overcome in the transformation to create environments in which that potential can be realized. All of the economies were stagnant or in decline when the process started, suffering from decades of gross mismanagement which were compounding the inherent weaknesses of central planning itself, so that the problems were virtually overwhelming. And there are no economic road maps. There is no precedent whatsoever for the shift from central planning to a market economy. The very process itself must be invented even as it is being carried out.

The economic problems plaguing most of the countries, and which must be successfully overcome, include: high inflation; non-convertible currencies; multiple exchange rates; state ownership of physical assets; huge, inefficient bureaucracies; wage and price controls; no labor or capital markets; large fiscal deficits; large external debts; huge subsidies throughout; no notion of consumer demand or customer service; little comprehensive understanding of private enterprise or market economies, and woefully few private enterprise skills (legal, accounting, marketing, managerial).

Successful economic transformation requires more than abstract policy changes; it also requires the development of an environment conducive to free enterprise. There must be creation of the infrastructure required to support and facilitate a market economy. For example, privatization cannot be carried out without a legal framework allowing private property to be held and freely transferred, without a capital market of some kind, without free prices to enable valuation of the assets to be privatized, etc.

The magnitude of the adjustments required throughout the economies and the dislocations that affect specific groups are simply enormous. The governments must be sensitive to the burdens of the various groups as they simultaneously design and implement new systems that support growth and economic expansion—a very formidable task indeed.

II. PROGRESS TO DATE

The euphoria that accompanied the decline of Communism and the coming of greater personal freedom and democracy soon gave way to more somber moods when the sheer enormity of the needed economic transformation became clearer. And it became obvious fairly quickly that not all the countries were as prepared as others to endure the economic misery of a lengthy transition period. And there is wide diversity in approaches being used as well as in the extent to which market economics is being embraced. Moreover, the political revolutions are not fully complete in some countries (Bulgaria, Romania, Yugoslavia) so that the economic shifts have barely begun.

The pace of economic reform has been most rapid in Poland, followed by Hungary and Czechoslovakia with the other countries lagging much further behind. [This excludes the special case of the former German Democratic Republic which was absorbed into the FRG and thus had available immediately the supporting systems (legal system, convertible currency, accounting standards, etc.) rather than having to develop those.]

While there has been considerable concern about conditions in Eastern Europe, the situation there is not nearly as bleak as the impression often left by the western press. Much of the press reports reflect what people are saying. However, it has been noted that public complaining has grown enormously with the advent of a free press, something not possible under the previous repressive government. The most ambitious of the reform programs is the "shock therapy" approach undertaken by Poland, with its ultimate objective of a full market economy. Accordingly, it is being very closely watched by the other countries and by the Soviets as well.

On January 1, 1990, Poland adopted a far-ranging strategy including: freeing retail prices, abolishing subsidies, terminating state monopolies, devaluing the greatly overvalued currency and unifying the exchange rate, ending foreign exchange rationing, and cutting tariffs. The results have been largely as predicted. Output has fallen, real wages are down, unemployment continues to rise, inflation remains high (at 5 percent per month, but greatly slowed from the hyperinflation of late 1989 and early 1990), all inflicting considerable economic pain on the Polish people. Once freed, prices generally rose quickly. The higher prices greatly dampened demand, and goods soon began appearing on store shelves. The initial upward spurt in prices accelerated inflation, but the accompanying collapse in demand helped temper that and induced the subsequent recession. As production declined, many of the state enterprises folded, finding they could not operate without their former subsidies (especially when producing shoddy goods that no one really wanted). Unemployment rose rapidly, but has fallen to only about 7 percent of the workforce, close to the current U.S. rate.

However, there is a brighter side to the bad economic news about Eastern Europe. Things are not nearly as dismal as often reported. Again, the case of Poland is instructive.

Since the anti-export bias was removed from Polish economic policies at the beginning of 1990, exports to the west have grown rapidly to $11.4 billion, up from $8.5 billion in 1989, with some increase coming from all sectors of the economy. At the same time, imports fell as enterprises economized on raw material use in response to budget constraints and a higher valued currency. The zloty, which was devalued by two-thirds, was pegged at PLZ 9,500/U.S. $1 and maintained at that rate throughout the year. With the establishment of stabilization funds, it also became convertible on the trade account.

The rising unemployment numbers also merit some explanation. In the first place, they began from a very low level (the theoretical zero unemployment of a socialist system), rising to the current estimate of about 1.25 million workers. However, the estimates may overstate the actual change. Many of the workers registering had been unemployed already in the previous system. Registrations were also spurred by expectations that benefits would be available, prompting the enrollment of many housewives entering the labor force for the first time and of traders seeking to augment their unreported income. Overall, layoffs have actually been fewer than expected. Only a small proportion of the unemployment is a result of "collective dismissals" from entire or partial plant closings. Some estimates suggest that only about one-half of the registered number has actually been laid off. Many workers are leaving the state sector voluntarily to find better jobs in the fast-growing private sector. There is, in fact, a shortage of labor in some big cities at this time.

Reports from Poland indicating severe production declines (said to have fallen almost one-third last year) also are probably significantly exaggerated. First, the benchmark estimates had likely been considerably inflated by Communist managers who padded their output figures to get bonuses or promotions. (Now, there are incentives to under-report to avoid taxes.) Second, the measure of national industrial output is seriously flawed since it captures only the activity in the state-owned industrial sector. It does not include non-industrial or private firms. A substantial amount of production has shifted from state to private firms, and from industry to the services sector. Some estimates suggest that perhaps only one-third of the reported decline is real.

Poland has paid especial attention to its trade sector. It made the zloty convertible on the trade account from the outset, and, since the infrastructure did not exist for instant domestic competition to develop, it has viewed free trade as the most effective means of importing competition. Free trade allows the importation of a rational price structure, and stimulates contacts with western firms which bring their new technology and improved products.

Finally, reports of huge declines in living standards also appear exaggerated. When prices were freed and the subsidies were removed, purchasing power was reduced. But the oft-mentioned 30 percent decline is a comparison of 1990 with 1989, a year of hyperinflation when wages were growing rapidly. If the comparison is with 1987, the decline in real wages is seen to be much smaller. And there are intangible changes that are not reflected in the measurement. For example, Polish housewives no longer have to spend two to three hours each day in queues only to be presented with few choices among inferior products. The increased dollar purchasing power of the now stable zloty also has a little-noticed positive effect on the standard of living. At the black market rate for the dollar, the average monthly wage was $40 in late 1987. In late 1990, it was $131, making available many foreign goods that were formerly unattainable.

To be sure, there are many difficulties with the Polish reform program. Even though much has been accomplished in little more than a year, the pace still proved unsatisfactory to many voters who elected Lech Walesa on promises of even faster reforms.

Privatization, especially, has been slow, and the 5 percent monthly inflation continues to be a major problem. Shifting the productive assets into private hands is the immediate challenge. The new Prime Minister and his government favor an accelerated program, and new steps are expected before spring. But the task is formidable. Some five to seven thousand enterprises must be privatized, likely by some unique large-scale means since the absence of credit institutions and share markets precludes typical approaches.

Another continuing major problem for Poland is the huge external debt, now at almost $45 billion. Its mere existence stifles critically-needed foreign investment. Increasing calls are being made for forgiveness of much of that debt, especially the part (about two-thirds) owed to foreign governments. Proponents argue that this was money loaned to Communist governments for political reasons (to try to draw Poland closer to a consumer society), and that it should not now be an impediment to the successful transformation to democracy and market economies.

Problems of other countries in the region are similar to those of Poland. Their relatively slower pace in instituting reforms relates to practical politics, cultural differences, and their individual situations. The Polish people thus far have been unwavering in their willingness to bear economic hardship during the transition. Citizens of the other countries are not thought to be as willing as the Poles to give their leadership the political mandate to move so quickly. Thus, the reform process in Hungary and Czechoslovakia is not proceeding as rapidly as in Poland, and it is certainly much slower in Romania, Bulgaria, and Yugoslavia (where the ethnic divisions among other things undermine obtaining political stability required to effect reforms).

III. IMPLICATIONS FOR U.S. AGRICULTURE AND AGRIBUSINESS

The Central and Eastern European countries traditionally have been relatively large agricultural producers and traders. But their farming and food systems suffered heavily during the Communist era, largely isolated from new technologies and made increasingly inefficient by central planning. Also, it is important to note that while the region maintains a large livestock sector, it is a deficit protein producer.

The central question, of course, is what the production patterns of the future will be, once market prices rather than centrally set quotas and goals allocate resources and guide farmers' production and consumers' purchase decisions. Will these countries be expanding markets for U.S. farm products, food products, farming technologies and production inputs, and food processing technology and equipment? Or will they become direct competitors, not only in their own and third country markets, but will they also seek much greater direct access to the U.S. market?

Examination of these questions involves two time periods: the transition during the next two to four years as the agriculture and food sectors adjust to free market systems; and the longer run after the transitional adjustments are complete.

The Short Term Outlook

The first possibility concerns expanding sales of U.S. agricultural products. It is noteworthy that these countries have not been major agricultural trading partners for the United States over the past decade. In calendar year 1989, U.S. agricultural export sales in Eastern Europe amounted to only $320 million (less than 1 percent of the U.S. total). At the same time, U.S. imports were even less ($245 million), for a net trade surplus of $75 million. Our exports are primarily grains (feed grains and wheat) and soybean meal, while the imports are meats, cheeses, tobacco, and other specialty products.

The trade picture with the Soviet Union contrasts sharply with that of the rest of the region. In calendar year 1989, we sold $3.4 billion to the Soviets (9 percent of total sales), while importing less than $20 million.

There was some initial euphoria that these countries would be rapidly expanding markets for U.S. grain, oilseed, and livestock products. Although that expectation vanished quickly, there may well be some expansion of their imports over the next few years as their purchasing power increases over levels of the past decade. Additional income sources will be economic assistance from the West, external debt relief, and perhaps some improvement in their economies as the transformation programs begin to take hold (growing convertible currency sales to the West accompanying their already greater access to these markets, for example. The EC already has concluded Preferential Trade Agreements with Poland, Hungary, and Czechoslovakia, and the U.S. has now granted Most Favored Nation status to three of the countries and is in the process of doing so for the others.

Proponents of reform argue that debt relief is essential. Collectively, their outstanding debt approaches $100 billion, with the most (two-thirds) owed by Poland and Hungary ($1,200 per capita). Several billion dollars are required each year for Poland to service its almost $45 billion debt, an important share of total foreign exchange earnings. Roughly two thirds of the debt is owed to other governments, and one third to commercial banks. Substantial forgiveness by the former, and liberal restructuring by the latter, could free several billion annually for critical import needs. Hungary, with a $20 billion debt, would benefit in much the same way.

The magnitude of economic assistance flowing to the region is substantial. The group of 24 industrialized nations (G-24) has pledged and contributed $38 billion in grants and loans to Eastern Europe over the last 18 months. Originally targeted to Poland and Hungary, the program now extends to Czechoslovakia, Bulgaria, Yugoslavia, and East Germany. (Earlier plans to include Romania were scrapped when demonstrations were violently suppressed in Bucharest last June. However, the political situation there is viewed as improving, and aid could be granted soon.)

Of these funds, about two-thirds have gone to Poland and Hungary, and 5 percent to Czechoslovakia (with nearly one-quarter still unallocated). The $38 billion includes $11 billion capitalization for the newly-established European Bank for Reconstruction and Development which will loan throughout the region and the USSR, $8 billion in grants, and $12 billion in loans and credits including over $1 billion in European Investment Bank credit guarantees. The World Bank and the IMF have made available $6 billion.

About 35 percent of all the aid has been export credits and investment support, while macroeconomic aid (such as stabilization loans) accounts for 29 percent. About 4 percent has gone to food aid and 2.4 percent to the environment. (The 12 member states of the EC individually have provided 48 percent of all aid, the EC budget accounts for 18 percent, Japan 11 percent, and the United States 9 percent).

Overall, it is very apparent that these countries' purchasing power already has grown and likely will grow substantially more in the next few years. This then raises the question of what they are likely to buy.

Food (and agriculture) can be expected to figure prominently, because of their special political significance in all these economies. Food availability and prices are barometers of economic progress and the success of the economic reform programs. The economic reforms that freed food prices (and ended subsidies) also raised consumer prices and increased the income share required for food (already one half or more of the disposable income in most of these countries.) For reasons closely related to political stability, food product purchases will receive high priority.

Without exception, these countries (especially the USSR) are starved for consumer goods and the technologies used to produce them in the West. They likely will purchase farm production inputs to boost output quickly so as to reduce (or at least stabilize) food prices and improve quality and variety. These inputs include fertilizers, pesticides, specialized machinery, and livestock feed (especially proteins, but also feed grains). With a tradition of animal agriculture, these countries are interested especially in livestock production technology—new breeding and husbandry techniques, including artificial insemination and embryo transplants. They can also be expected to purchase some food grains (bread quality wheat for blending), perhaps some meat products, and other incidental food products.

These countries likely will consider the maintenance and improvement of their livestock sectors very important. Greater efficiency and expansion are associated with improved animal nutrition, which depends upon protein feed supplements. The region is deficient in protein production, largely owing to climate. Thus, it is reasonable to expect increased protein imports, at least in the short run.

Beyond this, another high-priority area is food processing machinery and equipment and improved packaging materials. The centrally planned systems are notorious for post-harvest losses, commonly 30 percent or more. Most processing technology is antiquated, consisting of machinery long discarded by the West. Even the newer facilities have had little maintenance or upgrading for a decade or more. Improved processing capacity and more modern packaging will not only reduce losses and increase the quantity of food available, but should also improve quality and presentation to consumers.

To summarize, the Eastern European countries can expect increased purchasing power in the next few years, and likely will increase their purchases of farm inputs, feedstuffs (including feed grains and soybean meal), food processing machinery and technology.

The Long-Term Outlook

But what about the longer term? What kind of trading partners will these countries be in five or ten years? Since the changes have only begun, it is simply much too early to tell. Much depends on how productive they become, and what they can afford. After decades of mismanagement, administered prices, and artificially determined resource allocation, today's production and consumption patterns may bear little relation to those which market forces will dictate. Substantial production adjustments will occur in the next few years, and likely will be accompanied by expansions in output because of greater access to improved inputs. (Much of the planned OECD assistance will be production-sector oriented, i.e., promoting greater output.) These short-run shifts are unlikely to alter trade patterns fundamentally.

The longer run may prove to be a much different matter. How will Eastern Europe and the USSR develop as trading partners? Will they be self sufficient in grains and meats? Will they be growing protein importers? Will they prove larger or smaller markets for U.S. farm products? Again, it is simply too early to tell. The outcome depends on capital availability and investment patterns, as well as policy decisions. The mismanagement, distortions, and resource misallocations have been enormous, developed by powerful forces over long periods of time. And they will be expensive and time consuming to overcome.

Now that internal prices will reflect world market prices (to varying extents, but certainly more than previously) and will allocate resources, the emerging production and investment patterns may prove far different from those under central planning. These patterns will also be influenced by non-agricultural factors, such as labor costs which will be relatively low, at least for such a while. This might suggest that competitive positions could be improved by focusing on relatively labor-intensive production, such as fruits and vegetables, livestock and meat, and value-added products (if enough hard currency capital is available to upgrade production facilities to produce export quality products). Exports will be of special interest, because of the proximity of Western European markets, and perhaps others, as well. For example, meat exports to the USSR for hard currency could be attractive since trade among the COMECON countries is shifting quickly to a convertible currency basis.

What about the USSR over the long term? The political situation now is so fluid that economic conjecture is not very meaningful. The political situation will determine long-run economic development progress. The USSR is now a big U.S. market ($3.4 billion U.S. imports). Substantial development over the next decade (requiring a tranquil political evolution) means greater opportunity to develop its agricultural infrastructure and to invest in agribusinesses of all kinds. This could reduce total import needs, especially for feed grains, but could still involve substantial trade in both finished goods and inputs (for example, protein feed concentrates). In any event, improvement in the Soviet food situation will require substantial external assistance, whether in raw materials or processing technology. The implications obviously are far different for different subsectors of U.S. agriculture and agribusiness.

Beyond product sales, U.S. agribusinesses have critical interests in unfolding potential opportunities across the European continent. While opportunities vary depending upon strategic interests, many U.S. agribusinesses are contemplating investment in the region. The motivations are varied. Some wish to establish operating entities that can take full advantage of relatively inexpensive assets to combine them with their modern technology and management to create highly efficient and competitive businesses for the *entire* European market. Others are more interested in sourcing raw material for key market opportunities, while still others simply position themselves for access to the enlarged European market—Eastern Europe and the USSR, but certainly the Western European market as well—a response in part to "Europe 1992."

Eastern Europe and the USSR are the new business frontiers of today. The first investors and operating firms to become established likely will be the most advantageously situated. But while the region holds vast potential, it also involves enormous risks suggesting it be approached with realistic caution and careful assessment of the opportunities.

Summary

Much of the euphoria that accompanied the initial emergence of democracy in Eastern Europe and the USSR has faded, now that the enormous task of restructuring these economies is underway. And, while the potential longer-term impacts of these shifts on U.S. agriculture remain far from clear, they likely mean greater short-term market opportunities as economic reform, development assistance and revitalized economic growth permit Eastern Europe to buy more from the West.

The picture is much less clear in the USSR where imports of U.S. products were already large. Even in the short term, their needs for western agricultural products will be very large. The primary concern is whether growing political uncertainty and currency problems will encourage the credit and support the level of imports necessary to meet domestic needs and increase productivity.

The region's longer-term potential continues to be enormous. The six Eastern European countries plus the USSR create a potential market much larger than do the United States, the EC, and the Pacific Rim. Incomes and consumption levels are low, compared with levels in Western Europe and the United States. Consumption can be expected to grow rapidly, commensurate with income growth. These countries are wealthy in resources and have a well-educated labor force. Their growth potential now is limited primarily by the pace of the reforms and the availability of longer-term investment capital.

In general, economic reform is progressing more rapidly than has been reported by the western press. Poland is an example; recent elections strengthened their commitment to economic reform. And, while the economic shocks of free market prices have been severe, they are far smaller than indicated by the press.

Unemployment in near western levels in Poland, exports are growing, the currency has stabilized, and investment is increasing. Declines in living standards, while serious, have been much smaller than initially indicated. Perhaps the greatest problem is the huge external debt, much of which is held by western governments, and which could be restructured/reduced to increase capital available for trade and investment.

Problems of other countries in the region are similar to those of Poland, although the approach and pace of reform varies widely. In general, the reform process in Hungary and Czechoslovakia is not proceeding as rapidly as in Poland, and it certainly is much slower in Romania, Bulgaria, and Yugoslavia (where ethnic divisions, among other things, undermines political stability required to effect reforms).

The implications of these changes for U.S. agriculture over the longer term simply cannot be seen as yet, since they have only begun. Future production and consumption patterns may bear little resemblance to those of today, which reflect the mismanagement, administered prices and artificially determined resource allocation of the last four decades.

These shifts depend on both political and economic relationships, especially the critical question of market access for these countries. And the pattern will depend on capital availability and investment patterns over the longer run. The mismanagement, distortions, and resource misallocations have been enormous, developed by powerful forces over long periods of time. They will be both expensive and time consuming to overcome, now that internal prices will reflect world market prices rather than arbitrary administrative decisions.

Initially, cheap labor could lead to concentration on labor intensive, high value added production (fruits and vegetables, livestock and meats), assuming capital to bring facilities to export quality can be found. And much of the eventual outcome will depend on the resolution of the fluid political situation in the USSR. There, substantial short- and long-term economic assistance will be required. Whether or not the internal situation in the USSR permits that, investment will have a major role in determining the future shape of U.S. markets in the region.

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