

**THE TRADE RECORD OF
EASTERN EUROPE AND THE
FORMER SOVIET UNION
SINCE THE TRANSITION**

Introduction

For centuries, greater openness to the international marketplace has been a central element of economic development. Nations that have integrated into the world economy through market-oriented means have benefited in a multiplicity of ways. International integration has meant greater export access for the output of a country's firms, leading to increased opportunities at home for business expansion, new investment, and job creation. Increased access to imports of goods and services has allowed consumers to enjoy greater choice of products, generally purchased at lower cost and often embodying new technologies that enhance product quality. Through greater exposure to interenterprise competition, enjoying the transfer of advances in technology, and adopting modern management practices, the businesses of countries that have vigorously engaged in the international marketplace have become more efficient and induced to keep pace with—indeed outperform—counterparts located in trading partners' countries. Indeed, country participation in international trade has borne much fruit: significant improvements in the allocation of domestic resources, enhanced productivity, and more rapid and sustained growth.

Since the early 1900s, the world economy has been increasingly integrating—the result of modern industrialization and significant technological breakthroughs that, among other consequences, have

led to steadily decreasing transportation and communications costs. In the past two decades, especially, the pace and extent of the world economy's integration have accelerated greatly, ushering in the age of "globalization." In fact, global trade has expanded much more quickly than has world output.¹ The process under way since the late 1980s of transition from command and control regimes to market-based incentives and institutions and open trade regimes in the countries of Eastern Europe and the Former Soviet Union (the Region) epitomizes in many respects the dramatic increase in international economic integration that recently has been taking place worldwide. Indeed, without the liberalization of trade policies that many of the countries in the Region have undertaken, the transition would not have taken place.

For decades, most of the 27 "transition" countries that currently make up the Region constituted in varying degrees an almost unified trade and investment bloc that functioned separately from, had dif-

BOX 1.1

Trade under Central Planning

Trade within the Council for Mutual Economic Assistance (CMEA)² was conducted as an outgrowth of the central planning process. Under the planning mechanism, in Eastern European countries and the Soviet Union, enterprises were given quantity targets, and prices played more of a redistributive than an allocative role. Imports and exports were coordinated, since trade according to market forces would be disruptive to the plan, given that prices were so misaligned with world prices. Foreign trade organizations (FTOs) were established and given a state monopoly on the import and export of goods, which prevented arbitrage on the distorted prices.

The essential feature of trade within the CMEA was the bilateral agreements (or protocols) between the countries that participated in the CMEA. These negotiated agreements obligated the two signing governments to export and import to each other specified quantities of particular goods. Trade was planned to be balanced in TR ("transferable rubles") and the prices of goods were denominated in TR. (The TR was an abstract unit of account, which had no physical presence.) Prices were negotiated at the government-to-government level. In principle, these negotiations started with a Western market world price of the product and were adjusted for quality. Then, starting from a list of import demands and export possibilities from its own economy, each government negotiated the most desirable package of imports in return for exports that would bilaterally balance its import demand. A bilateral surplus in TR with country A could not be used to finance a bilateral deficit with country B within the CMEA.

Enterprises were required by their governments to supply goods for the purpose of meeting the export requirement of the protocol. Upon delivery of the goods, the "commercial" bank account

ferent rules from, and had limited access to the rest of the international marketplace.² With the collapse of many of these countries' central planning systems—notably the Council for Mutual Economic Assistance (CMEA), which these countries used to manage international trade with the rest of the world and with each other—this isolated trade and investment bloc largely disintegrated; box 1.1 describes how trade was conducted under CMEA.

These changes were supported by or reflected in concomitant changes in political institutions and regimes. They included the fall of the Berlin Wall; the formal termination of the Soviet Union, which led to the establishment of 15 new independent countries; and the dissolution of Yugoslavia into 7 states. The result was a breakdown—at least *de jure*—of the many links between businesses and economic institutions located in the territories of the new states that, for the most part, were rooted in the political events of 1917 and in those during the decades immediately thereafter.

of the exporting enterprise was credited in domestic currency by its own central bank. Consequently, the customer of the producing enterprise was not a foreign firm in the conventional Western manner, but was so in a partial sense because its own government, which would pay the enterprise independent of the receipt of payment from abroad, made the final decision on which enterprises would have the right to export. Moreover, if the firm was obligated under the plan to provide goods for export, it felt justified in asking for subsidies if it incurred losses in production.

Each country had an exchange rate between the TR and its domestic currency, which implied a price in domestic currency for its exports in the CMEA. If the exporting enterprise received a higher price (in domestic currency) for exporting than the price of the good on the domestic market, it was taxed to equalize the export and domestic price. Similarly, it was subsidized if the export price was below the domestic price. Moreover, a similar tax and subsidy scheme for imports applied, so that enterprises were insulated from price differences on all trade within the CMEA.

Clearly the CMEA was not a customs union like the European Union (EU), since the essential feature of a customs union is that trade barriers are either eliminated or preferential within the union. Trade between firms in the customs union occurs according to decentralized optimizing decisions by firms, where the preferential tariff structure encourages intraunion trade. CMEA trade, however, consisted of trade that was quantity managed by the central government. The lack of access to hard currency by importers necessarily involved the government in the import decision.

Source: World Bank 1991.

a. The CMEA was founded in 1949 by Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Romania, and the Soviet Union. Cuba, Mongolia, and Vietnam joined in later years.

The ensuing transformation of these countries has increasingly unfettered production, investment, and consumption decisions by firms and consumers and engendered incentives for trade flows to be determined more by market forces than by administrative fiat. The result is an international reintegration of the Region—both on an intraregional and an extraregional (or global) scale. Today, the Region as a whole (albeit with some important exceptions, an issue that is one of the focal points of this study) is characterized as generally comprising formally open economies and exhibiting trade flows that are reoriented toward the “outside” world, especially, but not exclusively, toward the advanced countries of Europe.

In some respects, the pattern of integration that is emerging portends a return to a unified Eurasian continent, whose centuries-long economic history of international commerce dates back to the Silk Road. From this perspective, the Region’s 70-year period of central planning, in which almost half a billion people were isolated from the world economy, can be thought of as an interruption. Yet, at the same time, “new” patterns of integration are being forged both among the countries in the Region and with those outside. The disintegration of the Region’s isolated trade bloc has been followed by both reintegration and new patterns of integration.

Scope of the Study

As the world marketplace becomes increasingly globalized, much is at stake for the prosperity of hundreds of millions of people in Eastern Europe and the Former Soviet Union, now in their second decade of transition. Understanding the dynamics shaping the contours of international integration that have emerged—and will continue to emerge—in the Region is a crucial challenge for the medium-term development agenda, not only for policy makers in the Region’s countries themselves, but also for their trading partners, the international financial institutions, the donor community, and the future of the world trading system as a whole.

Addressing this challenge raises several questions:

- Why have some countries in the Region integrated internationally more and in different ways than others, and what do the current trends suggest for the future? How have the commodity composition and factor intensity of trade changed among the countries over the course of the transition, and what are the implications for competitiveness and growth?

- How does trade performance in the Region today compare with that in other parts of the world? What factors in the Region are most important in conditioning the relationship between greater international integration, geography, policy reforms, and growth?
- Which policy reforms are likely to be most effective in using trade as a lever to enhance growth and reduce poverty in the Region? Is the Region's trade policy too restrictive? What is the impact of developed-country protectionism? What are the priority issues that policy makers in the Region should focus on, and what can the international community do to be most effective?

This monograph seeks to answer these questions.

Structure of the Study

The study is structured into four parts. Part I comprises this chapter—the Introduction—as well as chapter 2. Chapter 2 analyzes the nature and extent of the international integration of the Region's countries that has been taking place since 1993 and assesses determinants of countries' trade performance in a variety of dimensions. In so doing it develops the context and sets the stage for the analyses in the succeeding chapters of the study. As the chapter indicates, today, most of the countries in the Region are significantly reintegrated into the global economy, far more so than at the start of the transition. The Region now sends and receives more than two-thirds of its goods and services to and from the rest of the world.³

Despite these changes, chapter 2 also suggests that the pace, nature, and extent of the Region's international reintegration—both among the constituent countries and with the rest of the world—differ strikingly from the earlier pattern of integration and are characterized by pronounced variations across the Region. Two “new” trading blocs are emerging: one—a “Euro-centric” bloc—largely comprising the eight new members of the European Union (EU-8); and the other—a “Russia-centric” bloc—largely comprising the 12 Commonwealth of Independent States (CIS) countries.⁴ Most of the seven countries in South Eastern Europe lie somewhere in between these two blocs, but are increasingly aligning themselves with the former.

As illustrated in the chapter, and as buttressed by further evidence presented in later chapters, these two blocs have begun to coalesce in terms of a variety of dimensions of trade and trade-related institutions and activity: direction of trade flows; commodity and factor intensity of

trade; export competitiveness; development of trade facilitation institutions and infrastructure; extent of intraindustry trade and participation in global production-sharing networks through foreign direct investment (FDI); and the extent to which open trade enhances domestic competition and governance. Of course this admittedly sharp binary prism masks the more complex realities, and the chapter discusses the qualifications to this “two-bloc” paradigm. Still, taken together, the evidence suggests a clear trend that the countries in the Region that have integrated more effectively into international commerce are those that have also achieved a greater level of development. At the same time, the countries that have remained relatively closed and continue to embrace the old structures are less developed and are being left out of the global economy’s modern “division of labor.”

Chapter 2 closes with an analysis of how “open” the Region’s economies have become. The econometric evidence suggests that the “reintegrated” Region has largely become a more “typical” region regarding trade, with most of the economies registering merchandise trade flows as a share of gross domestic product (GDP) largely in line with other countries around the world of comparable levels of development, size, and geographical characteristics (the only exception involves some of the SEE countries). In other words, the observed differentials in trade performance among the Region’s countries are not rooted principally in artificial factors leading the countries to either “overtrade” or “undertrade.”

To what extent do differences in trade policies account for the variation in trade performance observed among the Region’s economies? How have the countries in the Region been opening their trade regimes? These are the questions addressed in part II, which comprises chapter 3. As that chapter indicates, at present, the Region as a whole comprises economies with fairly open formal trade policies, with average “Most Favored Nation” (MFN) tariffs for the Region’s transition countries ranging from about 3 to 12 percent. These rates compare favorably with the tariffs of high-income developing countries worldwide. More important, much of this tariff liberalization was carried out autonomously by countries in the Region, albeit with the encouragement and support (and discipline) of the international development community in the early years of the transition. Notwithstanding the progress made in tariff liberalization, in many countries in the Region there still remain nontariff barriers (NTBs) and biases against exports.

In addition to lowering tariffs and NTBs, trade policy liberalization by most countries in the Region has also been proceeding along other lines. Beyond the eight countries in the Region that already have joined the European Union (on May 1, 2004), three other countries

in the Region are poised for EU accession.⁵ At the same time, a myriad of other regional trade agreements (RTAs) has been forged, including, for example, the 29 bilateral RTAs among the SEE economies. In addition, 17 countries in the Region have become members of the World Trade Organization (WTO), with most of the other 10 countries—all in the CIS—in various stages of the WTO accession process. Nonetheless, a few countries in the Region, such as Belarus and most of the Central Asian Republics, are still relatively closed and have yet to implement even basic trade policy reforms.

Overall, despite the level of openness achieved Regionwide, most countries in the Region are in need of “second-generation” trade policy reforms. Reducing trade protectionism thus remains a priority on the agenda for the Region, and chapter 3 closes with a list of policy recommendations to that end. These focus on, among other things, further tariff reform, elimination of NTBs and disincentives to exporting, aggressive pursuit of multilateral liberalization, and rationalizing and modernizing RTAs.

The upshot of the analysis in part II is that, without open trade, the Region’s transition to market economic systems would not have transpired. However, trade liberalization is only a necessary and not a sufficient policy reform to enhance international integration. Indeed as part III, which comprises chapters 4, 5, 6, and 7, demonstrates, the countries in the Region that have pursued *both* trade policy reforms and complementary domestic structural and institutional reforms (the so-called “behind-the-border” reforms) have been the most effective in leveraging greater international integration into more rapid growth. The critical behind-the-border challenges that need to be addressed in most of the Region’s countries are the focus of part III.

Chapter 4 concentrates on the ways in which international integration is influenced by the extent of domestic interenterprise competition, the state of the national business climate, and the institutions and incentives for sound governance. Using new firm-level survey data, numerous case studies of businesses located in the Region, and other sources, the chapter shows how high barriers to entry and exit, unchecked market dominance by incumbent firms, excessive state involvement in the commercial business sector through subsidies and other forms of “soft budget constraints,” and weak governance and protection of property rights can impede international integration and reduce the ability for the countries of the Region to capitalize on the efficiency and productivity growth effects of trade.

As the chapter indicates, there is a “two-way street” between increased trade openness and domestic structural reforms that bring about a competitive business environment and good governance. The

countries in the Region that have integrated substantially into the world economy, especially through commitments under international trade agreements, have been the most effective in “locking in” hard-won domestic institutional reforms, with the result that they exhibit more vigorous interenterprise competition and greater discipline to adhere to the “rule of law.” At the same time, evidence presented in the chapter suggests that the more competitive the domestic economy, the greater the ability of firms to penetrate foreign markets and thus integrate internationally; in other words, success at home breeds success abroad. Chapter 4 closes with a set of policy recommendations that emphasize reforms that could enhance competition and governance in the Region’s markets so as to help leverage the effects on growth of increased trade flows.

The challenges to enhancing trade flows of the Region’s countries where underdeveloped national trade facilitation infrastructure networks and weak related institutional capacities, such as in customs, remain, is the focus of chapter 5. The chapter describes in detail the extent and nature of the differences among the EU-8, the SEE, and the CIS in terms of the development of such infrastructure and institutions. The core of the chapter is a simulation analysis of the gains to trade that would arise from improvements in trade facilitation capacity and institutions within the Region. The empirical results suggest there would be significant gains if the Region’s countries made improvements that brought the quality and capacity of their trade facilitation systems up to 50 percent of the current average EU-15 level. Although a common overall agenda for reform across the Region would include streamlining and reforming customs services and border clearance procedures; improving capacity to meet international standards; and investing in infrastructure, especially in ports and transport and telecommunications networks that facilitate trade, the empirical evidence presented in chapter 5 shows that the priorities for reform differ significantly across the Region.

The topic on which chapter 6 concentrates is the crucial role played by domestic services sectors in fostering international integration, both through trade and investment in services per se, as well as the ways in which the regulatory and ownership regime that governs domestic services sectors affects trade in goods. While an increasing number of countries in the Region—notably the EU-8 and, to a much lesser extent, most SEE⁶ countries—have come to recognize that greater and more sustainable growth will come from liberalization of their services sectors, other nations in the Region—typically the less-developed ones in the CIS—still treat services as “nonproductive” activities, a legacy from the mind-set during the era of central planning.

Empirical evidence presented in the chapter suggests that policy developments (or the lack thereof) help explain the differences in services-related trade performance. However, the reform challenges today are not as simple in many services sectors as they used to be. Scale economies and high sunk costs of investing in infrastructure or banking do not necessarily call for regulated monopolies. New technologies often either make large fixed investment reversible or allow for a separate role of service provision (for example, in telecommunications). The ensuing policy challenge is the need for achieving a balance between traditional regulation and the introduction of competition. The chapter concludes with an assessment of the roles played by international trade commitments, especially the EU *acquis* and WTO accession, in bringing about behind-the-border liberalization and deregulation of the services sectors in the Region and makes recommendations for reform.

Chapter 7 focuses on the ways in which attracting multinational corporate investment into the national economy through FDI can affect the Region's countries' abilities to participate in high value added global production-sharing networks and intraindustry trade. Such trade, an outgrowth of the increasing globalization of the world economy and the fragmentation of production processes, is changing the traditional economic landscape of interindustry trade facing the nations, industries, and individual firms in the Region, as it is in much of the rest of the world.

To this end, chapter 7 analyzes the characteristics of "buyer-" and "producer-driven" networks and the degree to which countries in the Region have been involved in network trade. The analysis shows that the countries that have experienced the largest FDI inflows have also seen the largest increase in exports of network products, components, and parts. However, there is significant heterogeneity within the Region between those countries that have been able to be active in "buyer-driven" production chains versus those that are involved in lower value added "producer-driven" supply chains and those that are not involved in network trade at all. Chapter 7 concludes with a discussion of the policy implications of how the different performances in terms of network trade can be attributed to the large variation in the amount of FDI attracted by different countries in the Region and recommends actions that the countries can undertake to improve this increasingly important aspect of trade performance.

Absent certain policy changes—which are the focus of this study—the differences in the present patterns of international integration of the Region's countries are likely to continue for the foreseeable future and with them their influence on growth and poverty reduction in

the Region. Part IV is the study's conclusion, which contains chapter 8. This chapter summarizes the principal policy recommendations that were detailed in the individual chapters. Although many of the countries in the Region have achieved much in the way of formal liberalization of their trade policy regimes, a number of important reforms are still needed in this area. Yet, in light of the study's conclusion that reform of trade policies is necessary but not sufficient to ensure sustainable growth, there is, not surprisingly, a significant unfinished behind-the-border reform agenda. For both areas, chapter 8 discusses the interrelationships, sequencing, and priorities among the suggested reforms. There is also an outline of a "reform action plan" and a "division of labor" for the various stakeholders, including the international donor community, the developed countries, and the Region's countries themselves, to use in implementing the reforms. The chapter closes with a policy matrix, which briefly summarizes the policy recommendations.

Endnotes

1. See, for example, International Monetary Fund 2004.
2. In addition to the 27 countries of Eastern Europe and the Former Soviet Union in "transition" from Communism to capitalism listed below—which we define as "the Region"—the analysis in this monograph also covers Turkey. This coverage is done to be consistent with the World Bank Group's organizational definition of the "Europe and Central Asia Region," which includes the full set of 28 countries. When we use the term "transition countries," we are referring only to the group of 27 countries.
3. EBRD 2003.
4. The EU-8 are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia. SEE comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and Serbia and Montenegro. Kosovo, although part of Southeastern Europe, is not covered in the analysis. The CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
5. Bulgaria and Romania are "EU accession countries"; Croatia is an "EU candidate country." Turkey is also an "EU candidate country."
6. However, as shown below, services trade has grown fastest in the Region in some SEE countries.