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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

INDUSTRIAL COOPERATION WITH CENTRAL AND EASTERN EUROPE
WAYS TO STRENGTHEN COOPERATION

Information Memo P/90/46 attached

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1. SUMMARY AND CONCLUSIONS

1.1 The purpose of this memorandum is to propose a series of measures for strengthening industrial cooperation with the countries of Central and Eastern Europe. The concept of "industrial cooperation" is taken here to include action ranging from measures to promote industrial activity, e.g. by helping to establish the right framework conditions, to joint activities between industrial firms in the Community and in the countries of Central and Eastern Europe. The industrial sector is broadly defined as covering both manufacturing and service activities. Scientific and technological cooperation in general with Central and Eastern European countries and cooperation in the field of telecommunications were the subject of recent communications (**) to the Council and to the European Parliament. In the same way, the Commission recently issued an information note giving an overall view of the ecomonic aspects of the reforms process in these countries (***).

The political and economic reforms that are being carried through with increasing vigour in the countries of Central and Eastern Europe offer them a unique opportunity to become integrated into the European and world economy. They bring to an end a period of relative economic autarky within Comecon. This process will also open up new possibilities for trade between the Community and the countries concerned.

The year 1990 is being heralded as a turning-point in international economic relations. The meeting of Heads of State or Government in Paris at the end of November 1989 had already reasserted the Community's determination to support the reforms now under way with all the means at its disposal. Adoption by the CSCE Conference on Economic Cooperation in Europe on 11 April 1990 of a document acknowledging the importance of market mechanisms bears witness to the resolve of the participating countries to speed up the liberalization of their economies and to strengthen cooperation throughout Europe.

In order to support the on-going reform process in Poland and Hungary, the Group of major industrialised countries (G-7) decided at the Summit of the Arch in Paris in July 1989 to launch an operation of economic assistance to these countries (PHARE operation) to which 24 industrialised countries now participate (G-24).

Major Community initiatives have already been launched to develop industrial cooperation with the countries of Central and Eastern Europe

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* For the purposes of this memorandum, the group of countries under discussion comprises Poland, Hungary, Czechoslovakia, Romania and Bulgaria. This paper also discusses possibilities of cooperation with the USSR.

** COM (90) 257 and COM (90) 258 final

*** SEC (90) 827

Section 3). As part of the PHARE operation, which the Commission is coordinating, an initial support programme has been launched to assist Hungary and Poland. The operation has been extended by the G-24 to other countries (Czechoslovakia, Bulgaria, the GDR, Yugoslavia) and financial resources will soon be increased.

The priorities identified include in particular the opening up of markets in the West, investment and restructuring aid, and vocational training.

The Community has concluded or is negotiating trade and cooperation agreements which are also designed to improve the framework for industrial cooperation and which should, therefore, be put fully into effect pending the conclusion of association agreements with these countries.

At the same time, initiatives such as the establishment of the EBRD (European Bank for Reconstruction and Development), the granting of ECSC loans and the increase in EIB resources will make it easier for the countries of Central and Eastern Europe, most of which are saddled with heavy debts, to finance structural improvement in their economies.

1.2 The impediments to rapid expansion of industrial activity which the countries of Central and Eastern Europe have inherited are beginning to be better understood (Section 2).** The first of these impediments is the extent to which industrial competitiveness in these countries lags behind. The transition from planned economies - most of which have a large industrial base - to market economies will have major implications for subsidized and structurally unprofitable industries. The speed of transition will, it is true, vary from one country to another but the risks of inflation and unemployment are present everywhere and may jeopardize the process. The success of the economic reforms depends largely on support being provided by the industrialised countries, notably by businesses in those countries that are capable of improving through cooperation the technological content, performance and structures of the economies making this transition. Alongside poor competitiveness, there is a serious problem of transparency as regards the real industrial situation which is deterring foreign investors. Lastly, considerable headway has been made recently in developing cooperation between firms in Western Europe and their counterparts in Central and Eastern Europe although it has not been sufficient to create inter alia the legal, tax and banking frameworks necessary for vigorous industrial expansion.

1.3 Major programmes have already been decided, that aim at reviving productive activity in these countries. However, given the prevailing economic situation in these countries, more needs to be done in order to improve investments climate and transparency, as well as to promote an entreprise culture. In the framework of the cooperation agreement, the Community should offer technical assistance on the basis of its own experience and regulations.

This could also add to the fostering of a coherent development of the legislative framework in the countries of Central and Eastern Europe and would limit the risk of distortions in competition.

** For further details, see the recent Commission Communication on the economic situation in the countries of Central and Eastern Europe (SEC(90)827).

The practical measures to be taken must involve as far as possible Community industry and must complement those already taken or should strengthen certain initiatives that have already been launched in Poland and/or Hungary under the PHARE operation (Section 4). Such measures should take account of each country's specific char acteristics and situation, it being understood that the GDR is a special case that will have to be dealt with in a different context.

Measures should be taken for:

- improving the investments climate, conditions and transparency;
- assisting furthermore SME development, the creation of a more favourable business environment and cooperation in the field of standards;
- developing exchanges of industrial experience.

The implementation of the outlines of the present communication in projects to finance within the framework of an extended PHARE action (article 966 of the 1990 budget), will be subject to the procedures of the Council Regulation EEC/3906/89. Other possible actions which have not the characteristic of economic assistance or which do not correspond to the framework of this regulation would have to be accounted for on the appropriate budget line, notably article 990 of the budget (actions in the framework of trade and economic cooperation with third countries).

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2. CONSTRAINTS AND LIMITATIONS AFFECTING THE PRESENT INDUSTRIAL COOPERATION FRAMEWORK

2.1 Lack of competitiveness

2.1.1 The economic reforms under way provide a better insight into what industrial structures in Central and Eastern Europe are really like. Basically, we find:

- a high percentage of obsolete capital goods in the industrial and energy sectors - some of which date back to the pre-war period - and of antiquated buildings; hence the very high levels of energy consumption and pollution;
- the virtual absence of any measures to combat pollution;
- an inadequate and ill-adapted infrastructure which, while already deficient in the capital cities and the major economic centres (e.g. telephones, fax machines, buildings, market services), is now beginning to cause concern in the outlying regions (road infrastructure, railways, energy, telecommunications, etc.);
- a structural mismatch between supply and demand for most basic necessities and consumer durables;
- overmanning, a workforce largely demotivated by the absolute guarantee of employment, and a wage structure which does not adequately reflect real productivity;

- managements poorly equipped to work in a decentralized business environment and lacking appropriate management tools (e.g. accountancy).

2.1.2 Apart from the excessive industrial specialization of its members involved by the principles of COMECON as they existed until now, the high degree of centralization of the economies, the importance of heavy industry and the excessively concentrated integration of industry in the countries of Central and Eastern Europe are largely responsible for the lack of competitiveness in those countries relative to the West.

Industrial specialization taken to the extreme represents an incomplete and misunderstood application of the principle of the international division of labour. By setting in place an arrangement whereby one country was responsible for the entire output of a particular product within Comecon (e.g. Hungary for buses and lorries, the GDR and Czechoslovakia for certain capital goods and the USSR for the bulk of supplies of oil and other raw materials) while being isolated from the rest of the world, these countries were largely shielded from the effects of international competition and created monopoly situations within Comecon.

Taking trade in industrial products, 70% goes to other COMECON countries whereas only 15% can be sold to the industrialised countries (the remainder being accounted for by the developing countries).

This isolation from the world market goes a long way towards explaining the technology gap between East and West and the lack of international competitiveness. As the pace of technological progress, characterized essentially by the diffusion of microelectronics, picked up in the early 1980s, the gap in productivity and living standards continued to widen between the developed countries and the countries of Central and Eastern Europe.

For most of them, the loss of international competitiveness has led to a chronic shortage of foreign exchange and to greater interdependence in trade. This has contributed to a further deterioration in competitiveness since capital goods appear on Comecon markets ten years or more later than in the West.

The energy market in the countries of Central and Eastern Europe is characterized mainly by a precarious balance between supply and demand, overdependence on a single source and, in many cases, supplier and domestic prices bearing no relation to international market prices. These countries are having to contend with a yawning technology gap, a manifest shortage of energy resources, and inadequate and ill-adjusted infrastructures at all levels of energy supply and consumption. Need for adjustment will be considerably increased by the shift to hard currencies for the financing of trade between COMECON countries in the energy sector.

2.1.3 The needs as regards modernization of the capital-goods infrastructure in the countries of Central and Eastern Europe are enormous. However, while managements and governments would like to purchase capital goods abroad, they are hampered in this by the shortage of foreign exchange and by the high level of indebtedness.

Under the circumstances, if purchases of capital or consumer goods were replaced by industrial cooperation projects (notably in the form of joint ventures), this would be an inexpensive and efficient way of gaining access to technology. However, it is not without its difficulties.

2.2 Lack of transparency

2.2.1 The changes taking place in the countries of Central and Eastern Europe are entailing upheavals which, for the time being, will change the reference framework for potential investors.

The situation is compounded by debt-related constraints and by a lack of knowledge of international markets, both of which may cause potential investors to be somewhat wary.

2.2.2 The dearth of statistics and information on trade makes it difficult to assess the changes that are taking place. A large number of economists in the countries of Central and Eastern Europe themselves admit that many statistics, including those on industrial output and GDP, were often influenced by political considerations. In estimating GDP, for example, the results may differ by a factor of two.

While it is true that statistics are still a useful indicator of the level of industrial output, they still do not depict correctly the inadequate relationship between supply and demand. Lastly, the statistics do not take account, for example, of the inefficient use of energy and raw materials or of the quality of production.

The lack of reliable and accurate statistics on the economy and market conditions in these countries may hamper foreign investment. For want of adequate accounting data, the same uncertainties complicate any attempt to evaluate the competitiveness of possible partners as regards industrial cooperation.

2.3 Industrial cooperation with Central and Eastern Europe: a difficult undertaking

Foreign investment in the COMECON countries is still limited, being put at some $ 2 bn (the bulk of which in Hungary and the USSR), an inadequate figure when compared with any assessment of what is needed to bring about economic recovery in the countries of Central and Eastern Europe.

Direct investment in these countries rose prior to the second oil crisis, when they were building up their stock of capital goods and had few, if any, financing problems. However, most firms had reckoned on industrial cooperation bringing rapid results and, disappointed by the worsening industrial cooperation climate, shied away from investing there, notably on account of:

- the scale of countertrade and the difficulty of obtaining the foreign exchange necessary for imports or for transferring part of their profits elsewhere;