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Article

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Strategic Trade Policy for Eastern Europe

The integration of the former state-trading countries into international free trade may, on the one hand, sensibly complement the reforms now under way towards their becoming market economies; on the other hand, this move harbours the risk of perpetuating and indeed aggravating the economic backwardness of those countries. The detrimental effects can be avoided if a product-cycle-oriented economic policy is pursued which makes a deliberate point of utilizing the relatively rich endowment of human capital available in these countries.

In order to shore up their reforms towards operating market economies, the Eastern European countries are now placing their faith in the advantages of international trade. They not only expect this to allow them to obtain goods and services which are unavailable at home (which had been the prime motive for trading with capitalist countries while they were still centrally planned economies), but also to enhance the benefits of reform as economic welfare is increased thanks to the international division of labour.

A market economy system requires that government bodies should refrain from exercising direct control over the economic activities of private entities and individuals. If reforms are carried out in a half-hearted manner or if markets are regulated this tends to give rise to undesired counter-effects relative to the original policy intent of such measures.[1] It is therefore important that policy-makers should largely confine their activities to creating and safeguarding a proper economic framework, while accepting the decisions made by private entities and individuals on how resources are deployed, both nationally and internationally. This unaccustomed degree of autonomy poses problems of a new kind, induced by the external economy, which are of major significance for the long-term development of these economies under reformed conditions. These are the problems to which this article will be devoted.

The following analysis is based on the assumption that firms are free to determine the object, scale and orientation of their domestic and external economic activities. It is further assumed that their short and medium-term business objective is to earn profits. In other words, the interests of the economy as a whole will not come into consideration when business strategies are developed unless appropriate market-based incentives have been given by economic policy. Nevertheless, the market economic system does not prevent government authorities from exerting influence indirectly by implementing economic policy measures.

The analysis begins by considering the implications for the overall perspective of economic reform when trading relations with the free world market are opened up. Subsequently, that analysis will be used as the basis for outlining a strategic trade policy tailored to the specific needs of the reforming countries of Eastern Europe. The article will not discuss the various conceivable forms of market economy[2] nor the concrete problems involved in implementing them in previously centrally planned, socialist economies.[3]

Comparative Advantage

According to the theory of comparative cost advantage, it is profitable to engage in foreign trade provided that certain politically determined conditions have been met.

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[1] Cf. F. P. Lang: The Counter-effects of Market Regulation, in: INTERECONOMICS, Vol. 25 (1990), No. 2, pp. 72-76.

[2] Cf. J. Thieme and R. Steinbring: Wirtschaftspolitische Konzeptionen kapitalistischer Marktwirtschaften, in: D. Cassel (ed.): Wirtschaftspolitik im Systemvergleich, Munich 1984, pp. 45-67; D. Cassel: Wirtschaftspolitik als Ordnungspolitik, in: D. Cassel, B.-T. Ramp and J. Thieme (eds.): Ordnungspolitik, Munich 1988, pp. 313-333.

[3] Cf. F. P. Lang: Short-run Effects of Economic Reforms in Eastern Economies, in: INTERECONOMICS, Vol. 26 (1991), No. 5, pp. 223-229.

The rational path is then for economies to specialize in whichever goods their production possibilities allow them to manufacture most productively in relative terms, on the basis of an international comparison.[4] Each country then produces the goods it is able to make relatively most efficiently, regardless of whether there may be other countries able to produce the same goods more efficiently in absolute terms. To that end, countries will either cease producing other goods (total specialization), or cut back such production (partial specialization).

If these relative productivity advantages are unevenly distributed among nations, and each nation specializes in the area(s) appropriate to it, thus developing an international division of labour according to the principle of comparative advantage, this will always lead to a maximum level of world production and to the most economic use of scarce resources around the world.

By entering into international trade, economies are thus still able to procure the goods which they have ceased to produce in order to specialize in others. By exporting a portion of the now increased production of goods they have chosen to specialize in, countries are able to obtain a portion of other countries' increased production of their own specialities in exchange. In the form of trade known as inter-industrial trade, different countries' national product ranges complement one another as goods from one sector (e. g. raw materials or foodstuffs) are exchanged for goods from another (e. g. manufactures). This pattern is typical of the trade between developing countries or newly industrializing countries on the one hand and highly developed industrial countries on the other. In contrast to this, the latter countries tend to trade goods from within the same sectors (e. g. imports and exports of manufactures) among themselves, and this pattern is referred to as intra-industrial trade. Since trading relations of this type are not expected to play a major part for the reforming countries in the first instance, they will be omitted from the current analysis.

The trends to date in trade in the western world appear to bear out the optimistic prognosis put forward by the pure theory of international trade. Between 1953 and 1963, growth in world trade averaged 6.1% per annum, whereas world output grew by 4.3% per annum. The equivalent figures for the decade from 1963 to 1973 were 8.9% and 5.1%.[5] That pattern of expansion has continued up to the present day.[6] There would therefore appear to be a positive correlation between the levels of world trade and world economic welfare (as measured in terms of world output). Thus if the former state trading countries were to open up their markets to participate in international trade this might indeed contribute towards strengthening the process of economic reform. In this respect, a combination of economic reform and the move to an open economy may be regarded as constituting a sensible package.

Terms of Trade and Successful Reform

On the other hand, one by no means incontroversial point is whether, in the long term, the gains from trade flowing from increased world production benefit all trading nations or just a small number of them. Participation in international trade is only relatively more advantageous than autarky if the terms of trade offered by the world market (i. e. the ratio of export to import prices) are higher than the relative prices in the same goods if they were all to be supplied at home; after all the point of trading is for the economy to obtain more units of imported goods in exchange for exported goods than would be possible if it produced everything by itself.

The gains from trade increase with the positive difference between the terms of trade and the relative prices which would prevail under autarky (the domestic cost ratio). Changes in the terms of trade will also therefore cause an improvement in the gains from trade for some countries and a deterioration for others. Gains which may exist during one period can therefore diminish or even turn into losses over time.

In any situation in which changes in the terms of trade are directly triggered off by the market mechanisms of international trade and prove to be systematically detrimental to individual participating countries, it is necessary to reassess the forecast of welfare gains made on the basis of the theorem of comparative advantage.[7] If, for example, the reforming countries suffer a sustained deterioration in their terms of trade by entering into the international trading system, their citizens will see a depletion in their purchasing power with regard to foreign goods and services. Every unit imported will require a greater amount of exports to pay for it. Thus a change triggered off by the operation of the market economy may jeopardize the external benefits which it was hoped would stabilize the fruits of reform. Indeed, over the longer term a reforming country's international position may even deteriorate relative to the initial situation.[8] The analysis will therefore turn first to this set of problems.

[4] Cf. D. Ricardo: Principles of Political Economy and Taxation, London 1817, chap. VII.

[5] Cf. UN: Statistical Yearbook, Vol. I, New York 1988.

[6] Cf. GATT: International Trade Statistics, Paris 1991.

[7] Cf. J. Sparos: Inequalising Trade, Oxford 1983.

[8] Cf. G. Myrdal: Economic Theory and Under-developed Regions, Stuttgart 1959.

Foreign Trade and Structural Change

Before it is possible to share in the gains from a higher level of world production thanks to international trade, it is necessary to accept certain structural changes in the course of specialization. This effect is especially marked in Eastern Europen countries, since their present sectoral structures are still oriented to a huge extent to the centrally planned foreign trade relations conducted in the former COMECON. These, in turn, were not in tune with the requirements of western international trade.

Because they are now relatively backward in technological terms when compared with western industrial nations, the Eastern European countries are only able to become involved in world trade at a level similar to that of a newly industrializing country. That implies that they primarily have to produce and export raw materials, foodstuffs and standardized industrial products for a profit, while having to import sophisticated industrial products. Producers are exposed to tough competition from capitalist NICs, some of which have considerably more modern real capital at their disposal. Thus joining the western countries' foreign trade gives rise to especially serious adjustment problems.

Sectors which were maintained in the past for political reasons of ensuring autarky, yet which had excessive costs when compared on an international basis, will then be forced to yield to import competition. Sectors which previously supplied other COMECON countries are losing their export markets as the importing countries now have the choice of purchasing from other countries where they can obtain better value. Finally there is also an absolute or relative shrinkage in new sectors producing import substitutes in favour of other new sectors producing for export.[9]

This structural change inevitably goes hand-in-hand with a substantial amount of friction. As far as labour is concerned, it involves changes of job, retraining and relocation, while as far as capital is concerned it entails disinvestment, new investment elsewhere, and changes to the infrastructure. Jobs also tend to be lost in sectors which are in decline or cease to exist for political reasons (e. g. the planning bureaucracy, state security and armed forces). Existing production facilities become unprofitable and need to be modernized or restructured. Infrastructure facilities need to be extended, modernized or even established in the first place. All of these effects of engaging in foreign trade give rise to substantial adjustment costs.

Apart from the above considerations, there is also an increase in the reciprocal dependence among different economies as trading relations grow more intense. That in turn gives rise to constraints countries may not have previously been accustomed to, which also have repercussions for the political sphere, where they may lead to conflicts of interest and tendencies towards protectionism.[10]

Technical Potential

Assuming that factors of production are rewarded via a properly functioning market (i. e. in accordance with their relative scarcities), the economy will have comparative advantages in those sectors which make particularly intensive use of the factors which are relatively abundant. Their abundance leads to relatively low prices enabling low-cost production. Thus, in an open economy, market forces inevitably bring about inter-industrial specialization reflecting the pattern of comparative advantages.

However, such specialization generally entails concentrating economic activity in traditional areas of growth potential within the economy, for these will be the areas promising the best chance, from the microeconomic point of view, of earning profits in the short and medium terms. In labour-rich countries a greater use will tend to be made of labour-intensive technologies, and more effort devoted to developing them. In many cases, that entails expanding raw materials extraction and/or agriculture. These are both sectors in which the chief means of increasing productivity is one of using more effective machinery (e. g. improved conveyor equipment, tractors, etc.) or of using complementary or quality-enhancing inputs such as artificial fertilizers, etc. In normal experience, a relatively labour-intensive mode of production only allows limited scope for innovative work inputs which might increase productivity. Operative tasks predominate rather than directive or innovative ones. Thus, under labour-intensive forms of production, the growth impetus given to the potential of labour in terms of its technical abilities tends to be relatively small. Whatever highly-qualified personnel are available will not find suitable employment in expanding sectors such as these. Similarly, specialization in technical products occupying a low level in the product cycle tends to preserve outdated technical abilities. This impedes innovation by focusing the economy's skills and abilities upon imitation.

Thus the restructuring of the economy in a labour-abundant country in order to orient activities to

[9] Cf. F. P. Lang, R. Ohr: Realwirtschaftliche Anpassungszwänge der monetären Integration, in: Kredit und Kapital, Vol. 24 (1991), pp. 36-49.

[10] Cf. F. P. Lang: Protektionismus, in: Der Bürger im Staat, Vol. 41 (1991), pp. 111-115.

complementary structures in world trade does relatively little to encourage the development of skills and abilities. On the other hand, it generates an increased demand for specific capital goods and inputs, the supply of which in fact depends on capital-intensive technologies which are not available.[11]

If, by contrast, a country is relatively richly endowed with capital, inter-industrial specialization promotes the concentration on capital-intensive technologies such as those used to produce modern capital goods and inputs. Dealing with highly developed technology encourages patterns of qualification which imply the capacity for innovation. In this type of environment, educational and training potential and the facility to pass on technical skills develop particularly well. As a consequence, not only are continual changes and improvements made to export products, but others are also developed which are suitable as substitutes for raw materials and other natural products.

Inter-industrial world trade, then, is coupled with an unequal distribution of innovative potential and the ability to conduct research and development. This has to be appreciated by Eastern European reforming countries as they develop their trade strategies for the future.

Consumption and Capital Formation

The increase in the price of the relatively abundant factor improves the position of those in possession of that factor within the national distribution of income. Thus, in capital-rich countries participating in inter-industrial trade, owners of capital gain an increasing share of the national product. On the other hand, in countries relatively poorly endowed with capital but rich in labour, the distribution of income will shift in favour of wage earners.[12]

If income earned by labour is largely spent on consumption whereas that earned by capital is used for further investment, one result of inter-industrial specialization will be that a country with a relatively weak capital endowment will tend to be more consumption-oriented in its aggregate demand. This effect has been visible among the early reforming countries, such as the People's Republic of China.[13] Increasing incomes are used primarily to satisfy pent-up consumer demand. If the general public is oriented to foreign patterns of consumption, the demonstration effect will focus the increasing consumer demand upon imported goods. In contrast to imports of capital goods, however, that will not generate any long-term improvements in productivity and capacity which might otherwise be expected to be favourable to economic development and help achieve balance-of-payments equilibrium in time. Similarly, the limited capacity to save which accompanies this tendency is not only an indicator of the relative deterioration in the position of capital-owners but also of a reduced capacity for capital formation in the economy as a whole.

In a capital-rich country, on the other hand, the distributive effects generated by engaging in international trade also serve to improve the conditions for further capital formation. Simultaneously, there is a relative reduction in the scope for consumption. This applies particularly to countries in which a tendency towards demand saturation reduces the income elasticity of demand and raises the public's capacity to save. Demand is often directed towards products provided domestically, thus further reducing import demand.[14] The latter phenomenon is especially prevalent in highly developed industrial countries where demand increasingly shifts to domestic leisure and cultural services.

Hence inter-industrial specialization in international trade also leads to an unequal distribution of the potentials for consumption and investment among nations. Here again the reforming countries of Eastern Europe are more likely to fall within the disadvantaged group.

Equalization of Factor Prices

In the course of structural change oriented to inter-industrial trade, the factor abundantly available in the economy concerned will not only be used with greater intensity. It will also become relatively more scarce, allowing its owners to assert a higher factor price. In low-wage countries there will therefore be a relative increase in wage levels, and in high-wage countries a relative increase in interest rate levels.[15] Thus complementary foreign trade encourages the establishment of international equality among factor owners.

The above tendency for factor prices to be equalized is considered to be a positive side-effect of striving for an open economy to back up reform policies. On the one

[11] Cf. P. B. Kenen: Transitional Arrangements for Trade and Payments among the CMEA Countries, in: IMF Staff Papers, Vol. 38 (1991), pp. 235-267.

[12] Cf. W. F. Stolper and P. A. Samuelson: Protection and Real Wages, in: Review of Economic Studies, Vol. 9 (1941), pp. 333-357.

[13] Cf. F. P. Lang: Hat die chinesische Wirtschaftsreform noch eine Zukunft?, in: Institut für Entwicklungsforschung und Entwicklungspolitik (ed.): Materialien und kleine Schriften, Vol. 122, Bochum 1989.

[14] Cf. F. P. Lang: Exportboom und Deindustrialisierung, Hamburg 1988.

[15] Cf. B. Ohlin: Interregional and International Trade, in: Harvard Economic Studies, Vol. 39 (1933), pp. 15-47; E. F. Heckscher: The Effect of Foreign Trade on the Distribution of Income, in: H. S. Ellis and L. A. Metzler (eds.): Readings in the Theory of International Trade, Philadelphia 1949, pp. 272-300.

hand, it is a signal of a convergence of living conditions internationally. On the other, however, it leads to a reduction in the economic advantage of utilizing labour in countries which are relatively well endowed with that factor. Conversely, it becomes more attractive to employ capital within the context of the relatively labour-intensive technology applied, and that incentive will be all the greater, the greater the international equalization of factor prices. However, capital transfers from capital-abundant countries lead to an increase in foreign debt on the part of those with capital shortages. That in turn places a long-term burden on the invisibles and capital accounts of their balances of payments.

Conversely, as capital becomes more expensive in the relatively capital-rich countries it becomes attractive for them to make greater use of the scarce factor of labour, the price of which is falling relative to that of capital. Capital-intensive fields of production call for labour which is highly productive and highly qualified. Hence there is an incentive to invest in training and further training, which increases the economy's innovative capacity. Increased investment is made in human capital, and the infrastructure necessary to achieve this (e. g. universities, polytechnics etc.) is expanded. Given that there are already pronounced international divergences in the qualification levels of labour, this effect only adds to the unequal distribution of growth potential generated by inter-industrial trade.

Specialization in capital-intensive products favours the development of human capital, which has increasingly been emerging as a major factor in economic growth alongside fixed capital formation.[16] The environment in which innovations are made is thus improved and the scope for increasing productivity and production volumes is broadened. At the same time, the distribution of income provides better material preconditions for the creation of both real and human capital. Not only is it easier for innovative potential to develop, but policy-makers are also in a better position to stimulate such developments in the economy. The resulting new products serve to further expand the export base of a country in this situation, while reducing import dependence via the development of substitute products.

By contrast, restructuring in favour of labour-intensive products will not create much innovative stimulus. Thus structural change oriented to the inter-industrial pattern of exchange will provide little incentive to improve qualification levels in the labour force. At the same time, a deterioration in the conditions for capital formation diminishes the material basis for making any transition towards building up more human and real capital. To sum up, inter-industrial foreign trade conducted under market conditions has specific effects upon the participating countries.

Alterations in the Terms of Trade

Terms of trade which at the time trading relations were first entered into may have been beneficial to all participants, will inevitably change as a result of the shifts within the trading partner economies outlined above. On the world market for capital-intensive goods, the products exported by the capital-abundant countries are both differentiated and subject to continual technical improvement. On the demand side, meanwhile, there is a

[16] Cf. P. B. Kenen: Nature, Capital and Trade, in: Journal of Political Economy, Vol. 73 (1965), pp. 437-460; D. B. Keesing: Labour Skills and International Trade, in: Review of Economics and Statistics, Vol. 47 (1965), pp. 287-294.

great call for sophisticated capital goods coupled with a release of pent-up demand for consumer products.

During the course of economic development, the increasing need for modern capital equipment may even mean that demand for such products rises faster than income in the importing countries.

In contrast to this, the supply side of the world market in labour-intensive products typically involves homogeneous products such as raw materials, foodstuffs and standardized industrial goods. Moreover, demand for such products is influenced by tough competition from potential substitutes and hence by low income elasticities of demand in the importing countries. Under these circumstances, prices are unlikely to rise very much and may indeed fall.

Consequently, the capital-abundant countries' terms of trade (i. e. the ratio of prices of modern industrial products to those of raw materials, foodstuffs and standardized industrial products) will improve over time whereas those of countries with a relatively small capital endowment (i. e. the converse ratio) will deteriorate.

Thus the continual renewal of their range of products and the steady expansion of demand from their trading partners due to high income elasticities place the capital-abundant countries in a relatively favourable trading position. Countries with a low capital base, on the other hand, face keen competition on a homogeneous world market with a relatively low rate of demand growth for their products. Thus contrasting changes occur in the market positions of trading nations exchanging on an inter-industrial basis. Hence a strategy of opening up one's economy to the world market does harbour certain long-term risks.

A number of empirical investigations have indicated that the terms of trade faced by developing countries in free international trade persistently deteriorate, or in other words that trade is only really advantageous to the industrial countries.[17] Given that Eastern European countries tend to have similar structures of production to those of semi-industrialized developing countries,[18] they might find themselves confronted by similar trends. However, other empirical research has also been conducted which does not confirm these findings.[19] It suggests that phases of deteriorating terms of trade tend to be followed by other phases in which they are more stable or improve. That in turn suggests that the parameters underlying inter-industrial trade are subject to dynamic changes.

Product Cycle

In the real world of a dynamic world economy, the patterns of trade do indeed undergo perpetual change. One of the factors giving rise to such changes is that technical goods all have a typical life-cycle.[20] During a product's development and gestation phases, the dominant aspect is the level of qualification of the labour employed. During this phase, countries which are rich in human capital enjoy a comparative advantage for "young" products. During the first half of this century, for example, the situation applied to automobile manufacturers in Western Europe and North America. If the goods produced are adequate to meet world demand, the manufacturers involved are provided with a monopolistic position in the world market, allowing them to profit accordingly from the trade. A technically determined monopoly therefore exists on the supply of the product.

Once the product has gone through the standardization phase in which it attains technical maturity, the level of qualification of those who make it becomes progressively less important. In this phase, wage cost advantages due to the relative abundance of labour take on greater significance. Thus the comparative advantage in manufacturing relatively mature, standardized industrial goods passes to relatively labour-abundant countries. The temporary monopoly on product availability is broken down by competition from imitation goods produced in countries less well endowed with capital. Automobile manufacturing is a good example of this too. The production of standardized models has tended to shift to newly industrializing countries such as South Korea and Mexico. The original manufacturing country will eventually have to abandon such production altogether as it is unable to make up for the wage cost advantages enjoyed by the imitating countries.

The product cycle applies especially to the goods typically manufactured in industrial countries. In 1988, 77.4% of industrial countries' exports consisted of manufactured products. The equivalent figure for the state-trading countries was 51.8% and that of the developing countries 44.1%.[21] The product cycle, then, is also of substantial significance for the reforming countries of Eastern Europe.

[17] Cf. R. Prebisch: The Economic Development of Latin America and its Principal Problems, New York 1950; H. W. Singer: The Distribution of Gains between Investing and Borrowing Countries, in: American Economic Review, Vol. 40 (1950), pp. 473-510.

[18] Cf. P. B. Kenen: Transitional Arrangements ..., op. cit., pp. 235-267.

[19] Cf. J. Sparos, op. cit.

[20] Cf. S. Hirsch: The United States Electronic Industry in International Trade, in: L. T. Wells (ed.): The Product Life Cycle and International Trade, Boston 1972, pp. 39-52.

[21] Cf. UN: Statistical Yearbook, Vol. 1, New York 1988.

The phases of the product cycle characterize the dynamic change occurring in inter-industrial foreign trade. They demonstrate that the gains from trade are by no means tied in a static way to any single group of countries. Although the capital-rich countries are indeed favoured in the first instance, whether or not they will be able to maintain their trading position depends on the extent to which they are able to sustain the innovative development of their product ranges over longer periods, and upon how willingly they adjust to the demands for structural change imposed by the world economy. If they lose their developmental momentum and thus also their trading advantage, their capacity for further capital formation – an essential precondition for being able to maintain a favourable world trading position – will inevitably also deteriorate. If countries which have been accustomed to advantageous positions in the past are not sufficiently adaptable to changing structures in world trade, this offers dynamic newcomers an opportunity, even if they are relatively lacking in capital, to imitate at an early stage and thus to realize trading advantages. Thus foreign trade does indeed offer a positive perspective in the long term if a country is able to establish itself in the product cycle and rise up the scale.

Short and Medium-term Strategies

Given their present structures of production, the Eastern European reforming countries will only be able to enter into inter-industrial foreign trade if they are prepared to undergo wide-ranging adjustment processes, and then only at a relatively low level in the product cycle. Thus the gains from trade in the early stages will inevitably be limited, and will also be in danger of going into sustained decline. Yet, on the other hand, international trade has not been conducted to any very substantial degree in these countries,[22] which has led to major supply shortages in a number of areas. When set against the *status quo*, therefore, there are by all means benefits to be gained from entering into this "unequal" trade in order to ensure a basic provision with technical supplies.

The best opportunities are available to the reforming countries in fields in which their intermediate position between the highly developed industrial nations and the developing countries allows them to enter the market as suppliers of standardized, cheap industrial products. Vis-à-vis the developing countries, they will be able to adopt the more advantageous position of the relatively capital-rich countries. The best-suited trading partners in this case would be the developing countries with abundant raw material supplies. Other areas which also have potential, though, are the former COMECON markets. This is a matter of maintaining or restoring old trading relations.

COMECON, too, had established an international division of labour in which the gains from trade were unequally distributed. The former German Democratic Republic, for example, was highly industrialized relative to other Eastern European countries.[23] Now that it has been incorporated into the Federal Republic, however, this region's economy has become uncompetitive in Eastern Europe and the Third World. This opens up short-term opportunities for other countries to plug the gap. Similar considerations also apply to market segments in which the former West German economy is no longer able to assert its position now that it is more preoccupied with domestic challenges, and because of its inappropriate fiscal and wage policies.

Conversely, when trading with developed industrial countries, they will find themselves at the disadvantageous end of the relationship. The best the reforming countries can hope for is profitable trade activities in agricultural produce, tourism and a small number of standardized industrial products. The economic and technical preconditions for successful trade outside this relatively confined area cannot be fulfilled in the short or medium terms.

During the initial opening-up phase, therefore, it will be important to use political means to channel the relatively scarce capacity for engaging in foreign trade into the most promising market segments, particularly as market allocation mechanisms will not yet be completely operational during that phase. Of course, in the new, market-directed environment this can no longer be a question of taking active control as in the former command economy. Such political encouragement would have to be confined to helping those wishing to engage in external trade to find their way towards profitable markets by providing information on foreign standards and customs, by explaining the wider trade policy context and by advertising particular foreign trade deals available. Those in the political sphere can, however, provide further assistance via diplomatic activities, inter-governmental agreements and the provision of active support in the form of advisory or agency services in foreign markets. The Eastern European countries' relatively good human capital endowment, as compared with capitalist NICs (especially as far as foreign languages and engineering know-how are concerned), will stand them in good stead in this respect. At the same time, this stock of human capital

[22] Cf. P. B. Kenen: Transitional Arrangements ..., op. cit.

[23] Cf. W. F. Stolper, K. Roskamp: Input-Output Tables for East Germany with Applications to Foreign Trade, in: Bulletin of the Oxford Institute of Statistics, Vol. 23 (1961), pp. 379-392.

harbours the opportunity to rapidly overcome their initially disadvantageous positions in inter-industrial trade.

Long-term Strategies

One major problem, however, is that the existing qualification patterns are tailored to the needs of the centrally planned economy and are based on outdated technologies. On both of these counts, putting human capital to good use raises serious problems in the short term. Nevertheless, in the medium and long terms it is indeed possible to fill the knowledge gaps in the fields of management techniques and modern engineering sciences. Indeed, priority has to be given to retraining the intelligentsia. However, that also means that, under market conditions, they will have to be motivated to undergo such training by means of appropriate incentives. The material disadvantages at which members of the intellectual élites have so far been placed relative to those doing less qualified work, which act as a disincentive to perform, need to be rapidly overcome. This might serve as a point of departure for growth-oriented distributional and educational policies. Above all, however, it will need to be an essential element of wages policy that more pronounced earnings differentiation should be asserted.

In order to encourage the necessary development of human capital, the present consumption orientation will need to be suppressed. The stock of human capital can only be modernized if substantial savings are accumulated, which in the Eastern European countries, with their low levels of production and growth, would entail renouncing a considerable amount of consumption. Yet there is no point in improving human capital resources unless the stock of real capital is modernized at the same time. If it is not, the result is simply an unemployable, highly qualified proletariat, whose members tend to emigrate, thus generating a brain drain which will only impair the country's chances of development.

Hence the profits and incomes achieved in inter-industrial trade need to be protected from being used for consumption purposes. In particular, the consumption of imported goods must be minimized, channelling consumers' wishes towards domestic products. That in turn will provide further encouragement to the development of domestic industries. The political instruments which might be used for this purpose include taxation, subsidies and import tariffs. Temporarily, import products for which substitutes are available on the domestic market ought to be discriminated against by means of taxation or tariffs. That will simultaneously raise the willingness of foreign investors to become involved in a country's own economy. This kind of policy is a variant of import substitution policy, which can contribute towards a strengthening of domestic capital formation. Temporary controls on capital movements also ought not to be ruled out.

When it comes to treating the profits earned by the companies engaging in foreign trade, a system of incentives needs to be created to ensure that they are put to worthwhile uses in the domestic economy with regard to the overall trade strategy. One way of doing that would be to exempt or relieve sectors from taxation if they play an important part for trade strategy, and also to subsidize complementary, trade-promoting activities in the environs of such companies. Research and development policies are necessary which initiate training and further training programmes both inside and outside the business community.

In order to ensure that the necessary funds are available, policy-makers need to restrain largely consumption-oriented government expenditure. The implication is that, for the time being at least, the state ought to do without an all-embracing system of social services and/or to cut down on or privatize the social facilities prevalent in Eastern Europe such as holiday hostels and recreational centres. Social welfare policy will need to confine its attention to securing the basic needs of individuals, and to follow a restrained course for a longer period of time.

If the profits earned from entering into inter-industrial foreign trading relations are used to a considerable degree to expand and develop an industrial structure oriented to a high stock of human capital, it is possible to create the necessary conditions for a country to improve its foreign trade position and to move further up the product cycle. It ought then to be able to enter new segments of the world market in which the gains from trade are higher.

It is only as a result of such a process that more scope for wage increases can be generated, thus also allowing higher levels of consumption and living standards. Until that has occurred, wage policy ought to be restrained, in the interests of supporting the reform process via foreign trade. A historical example of this type of development strategy is provided by Japan. In more recent years, Taiwan, South Korea, Singapore and India may be regarded as successful proponents of the same policy.

A combination of market economic reforms and an opening up towards foreign trade may, then, prove to be a successful development concept for the Eastern European reforming countries. However, the process of gaining greater efficiency by mobilizing personal initiative and exploiting the benefits of the international division of labour has to be properly integrated into a rational economic policy which lays particular emphasis on the strategic requirements of foreign trade.