WPS0636

Policy, Research, and External Affairs

WORKING PAPERS

Development Economics

Office of the Vice President
The World Bank
March 1991
WPS 636

Economic Integration in Eastern Europe

Bela Balassa

Among the alternatives for the future of the Council for Mutual Economic Assistance, its dissolution seems most appropriate in view of differences in the extent and speed of reform among its Eastern European members.

Policy, Research, and External Affairs

WORKING PAPERS

Development Economics

WPS 636

This paper — a product of the Office of the Vice President, Development Economics — is part of a larger effort in PRE to examine reforms in the Eastern European socialist countries. Copies are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Clare Cuskelly-Young, room S9-047, extension 39413 (22 pages).

The Council for Mutual Economic Assistance (CMEA) was established by Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the Soviet Union in 1948 as a response to the Marshall Plan. But unlike the Marshall Plan it provided no financial assistance to its member countries and its activities were limited to trade in the framework of bilateral and multilateral negotiations. Because of centralized decisionmaking, the lack of price signals, and the bilateral balancing of trade flows, the CMEA countries failed to exploit their trade potential. And although the smaller CMEA countries benefited from receiving Soviet energy and raw materials at low prices in exchange for often poor quality manufactured goods, these gains were more than offset by the losses suffered because of insufficient technical change and the straightjacket of the socialist planning system.

For the future of the CMEA, four alternatives present themselves: maintaining the present arrangements, marketizing the CMEA, reforming the CMEA, and dissolving the CMEA. In view of differences in the extent and the speed of the reform efforts in Eastern European countries, the last alternative appears most appropriate. At the same time, the more developed CMEA countries should seek association with the EC, followed by membership.

For the transitional period, proposals have been put forward for establishing payments arrangements among the former CMEA countries. These proposals have little to commend them as they would involve providing credit on the basis of the mutual trade of the countries concerned rather than their total trade. And while clearing arrangements would bring some benefit, the countries in question should pursue the objective of convertibility.

ECONOMIC INTEGRATION IN EASTERN EUROPE

Bela Balassa*

Table of Contents

* The author is Professor of Political Economy at the Johns Hopkins University and Consultant to the World Bank. He is indebted to Alan Gelb anf Martin Schrenk for helpful comments and to Shigeru Akiyama for research assistance.

ECONOMIC INTEGRATION IN EASTERN EUROPE

Bela Balassa

This paper will analyze the principal features of socialist economic integration in Eastern Europe and examine its future prospects. Section I will consider the activities of the Council for Mutual Economic Assistance (CMEA). Section II will examine the issue of subsidization through trade. Section III will review the future possibilities for the CMEA, and Section IV will discuss proposals made for a payments arrangement among CMEA countries.

I. The Activities of the Council for Mutual Economic Assistance

The Communique announcing the establishment of the Council for Mutual Economic Assistance was published on January 25, 1949. The CMEA was created in response to the Marshall Plan for Western Europe. However, while the Marshall Plan provided substantial financial assistance for the Western European countries, CMEA involved no transfer of funds.

The founding members of the CMEA were Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the Soviet Union. Albania joined soon thereafter and East Germany in September 1950, but Albania subsequently ceased to participate in CMEA activities. Mongolia, Cuba, and Vietnam joined in later years but they will not be considered in the following.

Several meetings of the members of the CMEA took place in 1949 and 1950, but its activity ceased in mid-1950 and did not revive until mid-1954. Instead of economic integration, Stalin favored parallel national development, with the Soviet Union exerting a directing influence through the "embassy system" under which major economic decisions by the individual countries required the agreement of the Soviet embassy.

Following Stalin's death, the CMEA called for the coordination of five year plans and for production specialization. In fact, little transpired in a multilateral context in subsequent years and the developments that occurred took the form of bilateral negotiations.

In 1962, the CMEA countries negotiated Basic Principles of the International Socialist Division of Labor as the first major policy statement on regional economic cooperation. However, as Brabant notes "soon thereafter the document was disowned by several signatories. As a result, the CPEs [centrally planned economies] failed to implement the precepts on regional production specialization in the ISDL [international social division of labor] as laid down in Basic Principles" (1989, p. 66).

The failure of implementing Basic Principles had to do with the rejection of Khruschev's proposal for a "superplan" on the CMEA level. While newspaper reports concentrated on the role of Romania in opposing joint planning, Hungary and Poland were opposed also. As Kiss noted, "the joint planning concept proved to be unrealistic, not only because it was cumbersome technically and methodologically, but also in terms of economic and, last but not least, political implications" (1975, p. 747).

For one thing, the centrally planned economies "saw, at best, limited salvation coming from transposing the problems of rigid, physical planning to the regional plane" (Brabant, 1989, p. 70). For another thing, they feared increased Soviet domination if a superplan was to be instituted. In this connection, mention may be made of the fact that Khruschev's proposal for a superplan followed the 1956 events in Hungary and Poland.

In the 1960s, trade among the CMEA countries continued to take place in the framework of bilateral negotiations. CMEA's influence was little felt although there were some specialization agreements, in particular in engineering products and chemicals. These agreements called for specialization in different products of a particular industry.

Specialization agreements were given a push by the Complex Programme for the Further Extension and Improvement of Co-operation and the Development of Socialist Economic Integration, dated 1971. Under this programme, 101 multilateral specialization agreements were signed between 1972 and 1977; there were also 620-700 bilateral specialization agreements (Pecsi, 1981, p. 13).

Specialization agreements assumed the greatest importance in engineering; among 120 multilateral agreements in effect in 1980, 87 concerned the engineering industries (Sobell, 1984, p. 237). They extended to ball bearings, electrical equipment, measuring instruments, medical and health care equipment, textile machinery, agricultural machinery, and machinery for construction and construction material. As a result, apart from Poland and the Soviet Union, a substantial part of machinery trade occured in the framework of specialization agreements. For 1985, the relevant percentages were Bulgaria, 58 percent; Czechoslovakia, 44 percent; East Germany, 54 percent; Hungary, 50 percent; Poland, 21 percent; Romania, 62 percent; and Soviet Union, 22 percent (Brabant, 1988, p. 306).

Another important area for specialization agreements was the automotive industry. An oft cited case is Hungary's specialization in buses produced by Ikarus. In turn, Hungary does not produce passenger automobiles that are manufactured in the Soviet Union, Czechoslovakia, East Germany, and Poland. There is also specialization in light, medium, and heavy trucks. At the same time, Western firms play an important role, with Fiat-s being produced in the

Soviet Union and Poland, and Western licenses being used in the production of trucks and buses.

Chemicals provide another area of specialization. There has been some shift of basic chemicals to the Soviet Union where raw materials and energy are available. The other members of the CMEA have concentrated on more developed and fine chemicals, with further specialization among products.

Specialization agreements have permitted the exploitation of economies of scale in the framework of the CMEA. **At the same time, in the absence of competition, technological progress has not been ensured. The technological backwardness of industry in the CMEA countries is observed across-the-board, and it is particularly important in modern branches of industry such as computers and electronics. The situation is aggravated by the dominance of sellers' markets in the CMEA countries, with the buyer accepting low quality merchandise.**

Also, the extent of specialization should not be overstated. Faced with supply difficulties from their partners, CMEA countries aimed at producing a wide range of products. Thus, it has been reported that Czechoslovakia and East Germany manufacture more than 70 percent of the range of machinery produced in the world (Lavigne, 1990b, p. 6).

And, specialization has been largely limited to final products; it has not extended to parts and components. Apart from the reluctance of the CMEA countries to rely on imported parts and components, which may not have corresponded to their specifications and often experienced delays, the pricing issue looms large in the case of these inputs. According to Lavigne, "a non-resolved problem remains; the prices of parts and components. The establishment of world market prices, already difficult in the case of final products, is practically impossible for parts and componen-, whose characteristics and production conditions are highly variable ..." (1973, p. 264).

At the same time, the CMEA countries have not exploited their market potential. This was first noted by Pryor who concluded that in the years 1956 and 1962, the volume of trade of the CMEA countries was only 50-60 percent of that of comparable Western European countries, while such differences had not been observed in the interwar period. Pryor's conclusions were reached in the framework of a model incorporating trade, per capita GNP, and population figures (1968, p. 164).

In the period following Pryor's calculations the CMEA countries experienced a slowdown in the growth of their trade and Hewett confirmed Pryor's results in calculations made for 1970. Thus, according to Hewett, "typical eastern trade is, ceteris paribus, much lower than typical western trade" (1976, p. 8).

At the same time, a decline occurred the share of intra-area trade. Thus, the share of intra-CMEA trade in the total fell from 71 percent in 1959 to 63 percent in 1971. This involved mostly a shift to trade with developed market economies whose share in the total increased from 21 percent to 27 percent (Balassa, 1976, p. 23).

The share of intra-CMEA trade declined further after 1971. According to estimates by the United Nations Economic Commission for Europe, in 1989 the share of exports and imports in trade among the CMEA countries in their total exports and imports was Bulgaria, 83 percent and 73 percent; Czechoslovakia, 54 percent and 55 percent; East Germany, 42 percent and 38 percent; Hungary, 39 percent and 39 percent; Poland, 35 percent and 32 percent; Romania, 38 percent and 53 percent; and the Soviet Union, 46 percent and 50 percent. These estimates are adjusted further downwards if account is taken of the overvaluation of the rouble.

Various factors account for the lack of full utilization of the trade potential of the CMEA countries. To begin with, the centralization of economic decision-making, reflected in the planners' desire to lessen uncertainty associated with foreign trade, as well as the absence of direct trade relations between firms, tend to limit the volume of trade.

Opportunities for trade may also be foregone because of the lack of appropriate price signals. Domestic prices in the CMEA countries do not reflect resource scarcities and are divorced from prices in foreign trade. In turn foreign trade prices follow world market prices with a lag and often show considerable variations in bilateral relationships (Csaba, 1985, p. 15). Under these circumstances, there is a risk that trade in particular commodities may involve a loss, rather than a gain, for the countries concerned and this risk tends to discourage trade among them.

At the same time, apart from relationships with the Soviet Union, there is an attempt to attain trade balance in individual commodity groups, in particular in "hard goods" and "soft goods" when the former, consisting largely of food, fuels, and raw materials, find ready markets in the developed market economies that is not the case for the latter, consisting mainly of manufactured products.

These developments have reinforced the practice of bilateralism under which countries attempt to avoid having an export surplus that is not settled in convertible currencies. Thus, the transferable ruble is not transferable at all and a surplus earned in trade with one partner cannot be converted into goods from another. Bilateralism, in turn, limits the amount of trade.

Finally, mention may be made of the propositions advanced by Holzman. In his view, the formation of the CMEA led to trade destruction, in part because the CMEA member countries are poorly suited to trade with each other and in part because they greatly increased barriers against nonmember countries (1985).

II. Is the Soviet Union Subsidizing its CMEA Partners through Trade?

Traditionally, it was assumed that the Soviet Union exploited the CMEA partner countries by turning the terms of trade in its favor. According to Holzman, "from the formation of CMEA until at least the difficulties in 1956 in Hungary and Poland, the Soviet Union exercised political power to trade with the Eastern European nations at very favorable terms of trade to itself. In fact, the ex-enemy Eastern nations were exploited ruthlessly (and this includes the exploitation via deliveries of reparations)" (1985, p. 417).

While data for the pre-1960 period are not available, Marrese and Vanous turned this thesis on its head by providing evidence that the terms of trade favor the other CMEA countries vis-a-vis the Soviet Union. Thus, they concluded that "within the CMEA the Soviet Union has been 'subsidizing' certain East European countries by exporting 'hard goods' (fuels, nonfood raw materials, and to a lesser degree food and raw materials for food) at CMEA's ftp's [foreign trade prices] which are below wmp's [world market prices], in exchange for imports of 'soft goods' (machinery and equipment and industrial consumer goods) at CMEA's ftp's, which are above wmp's; subsidization is especially apparent if account is taken of the relatively low quality of East European manufactures in comparison with their Western counterparts" (1983, p. 9).

As the quotation indicates, gains and losses were calculated by comparing prices used in intra-CMEA trade with world market prices, making further adjustments for the quality of "soft goods." Price differences became especially pronouced after 1973 when world oil prices quadrupled and the CMEA countries adopted a five-year averaging of world market prices in intra-CMEA trade. Thus, in 1970 US dollars, the estimated average annual loss to the Soviet Union in trade with its partner countries was 248 million in 1960-63, 398 million in 1964-68, 869 million in 1969-73, and 2840 million in 1974-78 (Marrese and Vanous, 1983, pp. 43-44).

The Marrese-Vanous estimates were criticized on the grounds that the authors used excessive quality discounts to value Soviet imports and exports of machinery and equipment and Soviet imports of consumer goods; the discounts ranged from 25 percent to 60 percent (Marer, 1984). But these discounts are actually used in selling machinery and equipment as well as consumer goods in Western markets.

Objections may also be raised to Marer's argument, according to which the Soviets could not purchase CMEA-quality machinery in the West at the same discount at which the East European's sell in the West. Apart from the fact that CMEA-quality machinery is not available in the West, note that Western exporters offer the Soviet Union a variety of advantages in the form of flexibility, service, and opportunity for product buy back that are not available on the part of CMEA suppliers.

It has also been suggested that relative scarcities differ between the CMEA and the world market, leading to lower relative prices of primary products in the former case (Brada, 1985, p. 89). However, the world market prices offer the relevant benchmark as they represent opportunities foregone for the CMEA countries.

At the same time, there is a source of subsidization of the Soviet Union by the other CMEA countries that lies outside the Marrese-Vanous framework.

This is the provision of capital for joint projects, such as the Odenburg gas pipeline. This subsidization is due to excessively low interest rates of 2 percent, much below Euromarket rates of 9-10 percent that may provide an appropriate benchmark, given the extensive use of convertible currencies in extending credit. In the absence of the necessary data, however, the extent of this subsidization cannot be gauged.

Finally, questions arise about the interpretation of the reasons for which the Soviet Union grants subsidies to its partner countries. According to Marrese and Vanous, the reason lies in these countries providing noneconomic benefits to the Soviet Union in enhancing its security. Thus, "the allegiance of East European countries can serve as a substitute for the use of Soviet labor and capital in providing security services to the Soviet Union. Because the Soviet Union is the dominant power within the CMEA, we contend that it utilizes this trade-off. In other words, the Soviet Union engages in preferential trade with Eastern Europe relative to the rest of the world in order to maintain the allegiance of the East European countrries" (1983, p. 10).

Marrese and Vanous further suggest that the ranking of countries by per capita subsidies also provides a ranking by noneconomic benefits the Soviet Union obtains through subsidization. The ranking is East Germany, Czechoslovakia, Bulgaria, Hungary, Poland, and Romania. One may argue, however, that this ranking is simply the result of the composition of trade between Soviet Union and its partner countries. Thus, East Germany and Czechoslovakia rely largely on Soviet fuels and raw materials in exchange for manufactured goods. In turn, during the period under consideration, Romania purchased practically no Soviet fuel and Poland could limit its reliance on Soviet fuel by reason of its extensive coal deposits.

At the same time, Marrese and Vanous argue that "domestic labor unrest in 1970 and 1976 (as well as the national strikes of 1980-81), the large proportion of the private sector in agriculture, the influence of the Roman Catholic church, the population's deep mistrust of the Soviet Union, and Poland's extensive relations with the West have combined to create an atmosphere of weak political allegiance to the Soviet Union which detracts from Poland's strategic value" (1983, p. 71). Yet, Poland received large financial assistance from the Soviet Union at the time of its troubles, which much exceeded the subsidy calculated by the authors.

Brada further raises the question as to who provides the noneconomic benefits to the Soviet Union in exchange for subsidization. This will not be the population of the Eastern European countries who object to the loss of sovereignty it entails. In turn, the ruling classes in these countries share the political and strategic interests of the Soviet Union. In fact, as the events of the year 1989 indicated, they were kept in place by Soviet power. Or, as Brada expressed it, "to the eyes of East European leaders, many of the intangible benefits provided to the Soviet Union also yield politico-economic benefits to their own nations and enhance, rather than reduce, the political strength and stability of their own regimes" (1988, p. 645).

It may be added that when the governments of these countries deviated from the path of subservience, as it happened in Hungary in 1956 and in Czechoslovakia in 1968, the Soviet Union intervened militarily and changed the governments. One may wonder, therefore, if there was need for subsidization when allegiance could be obtained through military means.

Whatever the reasons for subsidization, the question arises if it has continued beyond the period examined by Marrese and Vanous. This question has been addressed in Soviet Union-Hungary relations by Marrese and Wittenberg (1990). The authors conclude that the Soviet Union continued to provide substantial subsidies to Hungary in 1982, but the extent of subsidization declined to a considerable extent in 1987.

The relevant figures are $4.2-4.4 billion and $250-530 million. The authors further note that the fall in oil prices and in net Soviet exports of oil account for four-fifths of the decrease in the value of the subsidies.

The estimate for 1987 may be on the low side. Thus, according to Hungarian estimates it may cost Hungary $1.5 - 2.0 billion to adopt world market pric·s in its trade with the Soviet Union from January 1991 onwards (Lavigne, 1990a, p. 13 and Le Monde, January 12, 1990).

Brada (1985) and Koves (1983) raised the question if there may be other economic losses that offset the gains to CMEA partner countries obtained from the subsidization of their trade by the Soviet Union. They refer to dynamic losses due to insufficient technological progress, owing to their obligation to supply the Soviet Union with manufactured goods. These dynamic losses, together with the losses related to being forced into the straightjacket of the socialist planned system, will continue for a while whereas the gains from subsidization through trade will disappear in 1991.

III. The Future of the CMEA

The next question concerns the future of the CMEA. Several possibilities present themselves. They include the maintenance of the present arrangement; marketization within the CMEA; CMEA reform; and the dissolution of the CMEA. These will be considered in turn.

Maintaining the present system of the CMEA does not present a desirable option. With the member countries reforming their economies, basing intra-CMEA trade on quota-type bilateral agreements represents a conflict since market elements would coexist with elements of planning.

This conflict has been apparent already following the 1968 Hungarian reforms. While Hungary eliminated plan indicators, allowing firms to establish market relations, exports to the CMEA countries had to be regulated by government orders. Also, problems have arisen in pricing, with domestic prices differing from the prices used in intra-CMEA trade (Antaloczy, 1989).

These problems would be accentuated with the extension of reforms in Hungary and economic reforms undertaken by other CMEA countries. In particular, the transformation of socialist firms into profit-making units and their eventual privatization is incompatible with the maintenance of the present CMEA arrangements.

Marketization within the CMEA was envisaged at the 44th CMEA Council Session held in Prague in July 6, 1988. In this connection one may quote the statement by George Atanasov, Chairman of the Council of Ministers:

> "We believe that the efforts to overhaul the integration mechanism and to construct a qualitatively new model of intra-community cooperation would be centered on the creation of a single market of the CMEA member countries, complete with a free movement of goods, services and other factors of production. The need of such a market stems objectively from the logic of economic reforms in the individual socialist countries, which are centered on the promotion of commodity-money [market] relations" (cited in Schrenk, 1990, p. 1).

Marketization within the CMEA would establish an EC-type integration. But this presupposes that all CMEA member countries undertake far-reaching economic reforms, involving transformation into market economies. This is not in the cards.

While Poland shocked its economy with its January 1990 reform, despite its earlier reforms Hungary is proceeding at a slower pace and

Czechoslovakia envisages a slow transformation of its centrally planned economy. Also, Bulgaria has gone no further than declaring its intention to reform and the situation in Romania remains unsettled.

Finally, the Soviet Union has made little progress in perestroika after five years. While in early 1990 indications were that a major reform effort was in the offing, the announcement made in May 1990 concerned only price increases. These increases were subsequently withdrawn and it is questionable how far the reforms under preparation will go.

If neither the maintenance of present arrangements within the CMEA nor its marketization present a desirable or feasible option, the question arises if the CMEA could survive through a reform. This is the alternative envisaged by Lavigne who argues that it fits in with the regionalization proceeding elsewhere in the world. At the same time, Lavigne expressed the view that "the countries of Eastern Europe deceive themselves if they expect eventually to be integrated with Western Europe" (1980a. p. 9).

This statement relegates the Eastern European countries to an economic backwater. Rather than integrating with Soviet Union, where the prospects for reform are at best murky, the Eastern European countries want to become developed market economies. In so doing, integration into the EC offers an important avenue.

Nor can it be assumed that the EC would reject countries that carry out far-reaching reforms in decentralizing and privatizing their economies. In fact, the EC is prepared to eventually accept European market economies as new members if they agree to adopt its rules and regulations. In this connection, reference may be made to Greece and Portugal that were not more developed economically than the Eastern European countries at the time of their application for membership.

Another argument against the dissolution of the CMEA has been put forward by Schrenk. According to him, "a demise of the CMEA in consequence of a joint decision of all its members can be ruled out as implausible" (1990, p. 23), because it would conflict with the geopolitical objective of the Soviet Union. But if all other member countries were to demand the dissolution of the CMEA, could the Soviet Union resist?

Schrenk, however, rules out the exit of individual countries. In his view, "as this would violate the geopolitical objective of the USSR, it would amount to an 'adversary separation,' and is likely to provoke hostile responses from the USSR. Volume and composition of CMEA trade ... suggest the likely direction of the eminently credible threat of economic retaliation: curtailment of trade with the exiting country to the point of trade embargo" (Ibid).

But one member country, East Germany, is actually exiting from the CMEA without invoking Soviet retaliation. Rather, the Soviets wish to ensure that East Germany will continue to provide the products it had so far supplied to the Soviet Union.

Yet, East Germany is the second largest economy in CMEA and its departure will leave a hiatus in CMEA. Now, if Czechoslovakia, Hungary, and Poland also exited, in practical terms CMEA would cease to exist.

At the same time, the maintenance of preferential ties with their CMEA partners is not compatible with these countries wishing to become developed market economies. In fact, their interest lies in having preferential ties with the EC that combines the majority of European developed countries.

Thus, Czechoslovakia, Hungary, and Poland would favor the demise of CMEA and the establishment of preferential ties with the EC. Initially, this would involve unilateral preferences granted by the EC but full membership could be envisaged in a decade or so.

In awaiting membership in the EC, should the three countries envisage participation in EFTA? This is not recommended since EFTA membership is not a stepping-stone to EC membership. Also, several of the EFTA countries themselves wish to become EC members.

Should, then, Czechoslovakia, Hungary, and Poland envisage establishing a free trade area or a customs union on their own? This may be desirable once these countries have gone far enough in their reform process. Establishing a free trade area or customs union among themselves would in fact help the process of structural transformation in their economies by increasing competition.

The discussion so far has not concerned Bulgaria and Romania. These countries are at a lower level of development and are far behind in their economic reform. They thus provide little attraction to the EC and cannot aspire to participate in a Hungarian-Czech-Polish free trade area or customs union.

Finally, the Soviet Union is a sui generis case. In the foreseeable future, it will be preoccupied with its own economic reforms and with maintaining its political and economic unity. The statement made by the President of the Republic of Russia in June 1990 to drastically reduce contributions to the budget of the Soviet Union and the declarations of several republics as to the supremacy of their laws are indicative of tendencies towards disintegration in the Soviet Union.

But how about the modalities of trade among the former CMEA countries? This presupposes bilateral agreements among the countries in question. Such agreements should call for trade relationships between enterprises instead of between states and the use of current world market prices instead of five-year averages in the conduct of such trade. The introduction of such prices would help the reform process by aligning domestic prices to those obtainable in the world market.

IV. Payments Arrangements Among CMEA Countries

Under present conditions, the CMEA countries carry their accounts on bilateral trade in so-called transferable rubles. As noted above, this is a misnomer, since the rubles cannot be used to purchase goods from third countries. Rather, an export surplus gives rise to a credit that remains frozen.

With the dissolution of the CMEA, trade balances should be paid in convertible currencies. Given the scarcity of convertible currencies in Eastern Europe, proposals have been made for payments arrangements. One such proposal has been put forward by Ethier (1990).

Ethier suggests a monthly clearing of balances among Eastern European countries participating in a payments union, with mutual credit provided up to a certain limit. The clearing would also cover balances with nonparticipating Eastern European countries, assumed to include the Soviet Union.

This proposal draws on the experience of the European Payments Union that also involved a clearing of balances and provided credit up to a predetermined limit. But while in the EPU a third party, the United States, supplied the credits, the Ethier proposal envisages mutual credits by the participants. This provides no incentive for a creditor country to participate in the payments unions since it would use scarce foreign exchange to finance the deficit of the partner countries in their mutual trade.

The conclusion is strengthened if we consider that under the Ethier proposal, credit would also be provided for imbalances in trade with nonparticipating Eastern European countries. Thus, if country A had a deficit and country B a surplus in trade with the Soviet Union, country B would provide a credit.

Apart from the treatment of trade balances with nonparticipating Eastern European countries, the main problem with payments arrangements that involve the granting of mutual credits is that they are based on one segment of the balance of payments rather than on the overall balance. It is for this reason that the idea of a payments union was abandoned by ESCAP. Also, the payments arrangement in the Central American Common Market broke down as Nicaragua ran large deficits in intra-group trade that were financed by Costa Rica and Guatemala, although these countries were in an overall deficit position (Michalopoulos, 1990, p. 10).

A possible argument in favor of a payments union is that it contributes to the expansion of trade. This occurred in the EPU as countries dismantled their quantitative import restrictions. But such restrictions were dismantled vis-a-vis nonparticipating countries as well so that trade with these countries expanded also.

The Eastern European countries would also need to liberalize trade across the board. Such trade liberalization however does not require payments arrangements among particular countries that would focus on their mutual trade rather than on their overall trade.

It may be suggested that, in order to avoid the problems resulting from large and persistent debtor and creditor positions and the need to finance intraregional, as opposed to global deficits, payments arrangements be established starting out from initial trade positions. But in Eastern Europe, it is precisely the initial trade positions of the countries concerned that need to be changed since the price relations on which they are based are distorted (Ibid, pp. 11-12).

But how about the outside financing of credits in a payments union of Eastern European countries? Such an alternative has been put forward, entailing the creation of a fund of convertible currencies from which Eastern European countries could borrow to settle trade debts with each other (New York Times, May 9, 1990).

Outside aid eases the problem of financing debtor positions within a payments union and removes the disincentive of creditors to participate in the union. But the benefit of the financial aid would accrue exclusively to debtor countries within the payments union as it would be based on balance-of-payments positions in mutual trade rather than the overall balance-of-payments position. Yet, it is the latter rather than the former that provides a rational basis for the granting of outside credits.

These considerations indicate that the establishment of a payments union among Eastern European countries would not be desirable, irrespective of whether outstanding balances would be financed mutually or from the outside. One may envisage, however, clearing arrangements under which mutual credit is provided for a short period (say three months), with repayment at the end of the period.

A clearing arrangement would provide some savings in foreign exchange as countries could hold smaller reserves than would otherwise be the case. But the extent of savings through such an arrangement should not be overestimated as trade among the Eastern European countries (excluding the Soviet Union) amounts to only 15-30 percent of their total trade. At the same time, at the end of the three-months period, payment would need to be made in convertible currencies.

While a clearing arrangement provides some benefit to countries with inconvertible currencies, the goal should be to establish convertibility. This will take some time, given the difficult economic situation in which the Eastern European countries find themselves, but they should take measures to pursue the objective of currency convertibility.

V. Conclusions

This paper has reviewed the activities of the Council for Mutual Economic Assistance since its establishment in 1949. While specialization agreements have permitted exploiting economies of scale, technological progress has been slow. Also, the CMEA countries have not exploited their market potential, due to the centralization of decision-making, the lack of price signals, and ilateral balancing.

The paper has further considered the issue of subsidization of the partner countries through trade by the Soviet Union. The evidence supports the existence of subsidization that will come to an end, however, as world market prices will be used in intra-CMEA trade. At the same time, the Eastern European countries have suffered dynamic losses in the form of insufficient technological progress in their trade with the Soviet Union and being forced into the straightjacket of the socialist planning system.

As to the future of the CMEA, four alternatives have been considered: the maintenance of the present arrangement, marketization within the CMEA, CMEA reform, and the dissolution of the CMEA. The paper favors the last alternative and suggests that the more developed CMEA countries seek association with the EC, followed by membership.

The paper also objects to payments arrangement among the former CMEA countries that would involve providing credit on the basis of their mutual trade rather than total trade. And while clearing arrangements would bring some benefits, the countries in question should take measures to pursue the objective of convertibility.

References

Antaloczy, Katalin, "A KGST egyuttmukodesi rendszere es a magyar illeszkedes problemai (The System of CMEA Co-operation and the Problems of Hungarian Adjustment)," Kulgandasag (External Economy) February 1989, pp. 3-13).

Balassa, Bela, "Types of Economic Integration," in Economic Integration, Worldwide, Regional, Sectoral (Fritz Machlup, ed.). New York, N.Y., John Wiley & Sons, 1976, pp. 17-31.

Brabant, Jozef M van, "Production Specialization in the CMEA -- Concepts and Empirical Evidence," Journal of Common Market Studies, March 1988, pp. 282-316.

Brabant, Jozef M. van, Economic Integration in Eastern Europe, A Handbook, London, Routledge, 1989.

Brada, Josef, C., "Soviet Subsidization of Eastern Europe: The Primacy of Economics over Politics?", Journal of Comparative Economics, March 1985, pp. 80-82.

Brada, Josef, C., "Interpreting the Soviet Subsidization of Eastern Europe," International Organization, Autumn 1988, pp. 639-58.

Csaba, Laszlo, "Three Case Studies on the CMEA," Trends in World Economy No. 52, 1989.

Ethier, Wilfred J., "Multi-Country Payments in Eastern Europe," Philadelphia, University of Pennsylvania, May 1990 (mimeo).

Hewett, Edward, "A Gravity Model of CMEA Trade," in Quantitative and Analytical Studies of East-West Economic Relations (Josef C. Brada, ed.), Bloomington, Indiana, International Development Research Center of Indiana University, 1976.

Holzman, Franklyn D., "Comecon: A 'Trade Destroying' Customs Union?", Journal of Comparative Economics, December 1985, pp. 410-23.

Kiss, Tibor, "Nemzetkozi tervezesi egyuttmukodes a KGSTben" (International Plan Co-operation in the CMEA), Kozgazdasagi Szemle (Economic Review), June 1975, pp. 736-53.

Koves, A., "'Implicit' Subsidies and Some Issues of Economic Relations within the CMEA" (Remarks on the Analyses Made by Michael Marrese and Jan Vanous)," Acta Oeconomica, 1983(1-2), pp. 125-136.

Lavigne, Marie, Le programme du Comecon et l'integration socialiste, Paris, Editions Cujas, 1973.

Lavigne, Marie, "Chocs et revolutions dans les relations URSS-CAEM, 1975-1995," L'URSS en transition, 1975-1995 (Jacques Sapir, ed.), Paris, Edition de l'Harmattan, 1990 (cited as 1990a).

Lavigne, Marie, "Economic Relations between Eastern Europe and the USSR; Bilateral Ties vs. Multilateral Cooperation," Paris, Institut de Sciences Economiques et Mathematiques Appliquees, April 1990 (mimeo) (cited as 1990b).

Marer, Paul, "The Political Economy of Soviet Relations with Eastern Europe," in Soviet Policy in Eastern Europe (Sarah Meiklejohn Terry ed.), New Haven, Conn., Yale University Press, 1984.

Marrese, Michael and Jan Vanous, Soviet Subsidization of Trade with Eastern Europe, Berkeley, Cal., Institute of International Studies of the University of California, Berkeley, 1983.

Marrese, Michael and Lauran Wittenberg, "New Insights into Intra-CMEA Trade Subsidization," Evanston, Ill. Northwestern University, June 1990 (mimeo).

Michalopoulos, Costas, "Payments Arrangements in Eastern Europe in the Post-CMEA Area," Washington, D.C., World Bank, June 1990 (mimeo).

Pecsi, Kalman, The Future of Socialist Economic Integration, Armonk, N.Y., M. E. Sharpe, 1981.

Pryor, Frederick, L., "Socialist Industrialization and Trade in Machinery Products: Discussion" in International Trade and Central Planning (Alan A. Brown and Egon Neuberger, eds.). Berkeley, Cal., University of California Press, 1968, pp. 195-64.

Schrenk, Martin, "The CMEA System of Trade and Payments: Today and Tomorrow," Washington, D.C.,World Bank Strategic Planning and Review, Discussion Paper No. 5, January 1990 (mimeo).

Sobell, Vladimir, The Red Market, Industrial Co-operation and Specialization in Comecon. Aldershot, Hants, Grover, 1981.

PRE Working Paper Series

	Title	Author	Date	Contact for paper
WPS620	Have Commercial Banks Ignored History?	Sule Özler	March 1991	S. King-Watson 33730
WPS621	Sensible Debt Buybacks for Highly Indebted Countries	Enrica Detragiache	March 1991	S. King-Watson 33730
WPS622	How Factors in Creditor Countries Affect Secondary Market Prices for Developing Country Debt	Sule Özler Harry Huizinga	March 1991	S. King-Watson 33730
WPS623	World Bank-Supported Adjustment Programs: Country Performance and Effectiveness	Vittorio Corbo Patricio Rojas	March 1991	A. Oropesa 39075
WPS624	Choosing Policy Instruments for Pollution Control: A Review	Gunnar S. Eskeland Emmanuel Jimenez	March 1991	A. Bhalla 37699
WPS625	How Trade and Macroeconomic Policies Affect Economic Growth and Capital Accumulation in Developing Countries	Ramon Lopez	March 1991	K. Cabana 37946
WPS626	The Macroeconomics of the Public Sector Deficit: The Case of Colombia	William Easterly	March 1991	R. Luz 39059
WPS627	The Role of Institutions in Poverty Reduction: A Focus on the Productive Sectors	Sharon L. Holt	March 1991	WDR Office 31393
WPS628	The Indonesian Family Planning Program: An Economic Perspective	Dov Chernichovsky Henry Pardoko David De Leeuw Pudjo Rahardjo Charles Lerman	March 1991	O. Nadora 31091
WPS629	An Atheoretic Evaluation of Success in Structural Adjustment	Patrick Conway	March 1991	D. Ballantyne 37947
WPS630	The Spirit of Capitalism and Long-run Growth	Heng-fu Zou	March 1991	A. Bhalla 37699
WPS631	The Macroeconomics of the Public Sector Deficit: The Case of Morocco	Riccardo Faini	March 1991	R. Luz 34303
WPS632	The Macroeconomics of the Public Sector Deficit: The Case of Argentina	Carlos Alfredo Rodriguez	March 1991	R. Luz 34303

PRE Working Paper Series

	Title	Author	Date	Contact for paper
WPS633	The Macroeconomics of the Public Sector Deficit: The Case of Thailand	Virabongse Ramangkura Bhanupongse Nidhiprabha	March 1991	R. Luz 34303
WPS634	Trends in Developing Country Exports, 1963-88	Bela Balassa	March 1991	WDR Office 31393
WPS635	Exchange Rates and Foreign Trade in Korea	Bela Balassa	March 1991	C. Cuskelly-Young 39413
WPS636	Economic Integration in Eastern Europe	Bela Balassa	March 1991	C. Cuskelly-Young 39413
WPS637	Poverty in Poland, 1978-88	Branko Mil:.novic	March 1991	WDR Office 31393
WPS638	Researching the Trade-Productivity Link: New Directions	James Tybout	March 1991	D. Ballantyne 37947