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# CHANGES IN EASTERN EUROPE AND THE USSR: IMPLICATIONS FOR AGRICULTURE AND AGRIBUSINESS

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The changes we have witnessed on the world political scene over the past several months are truly monumental. They promise irrevocable changes in political and economic relationships, in place for almost a half a century, which many people had come to regard as permanent.

Fledgling democracies have emerged across Eastern Europe, beginning last May with Poland and then extending throughout the region, peacefully for the most part. The crumbling of the Berlin Wall symbolized the demise of militaristic Communism and the collapse of the socialistic system as nothing else could. The summer summit between Presidents Bush and Gorbachev merely formalized the cold war's end.

The end of that forty-three-year conflict has proven to signal only the beginning of changes for the region. We now are watching a new political drama unfold daily in the Soviet Union as President Gorbachev struggles to hold that nation together while it transforms itself into a more market-oriented economy with greater political pluralism, a process even more difficult after more than seventy years of authoritarian socialist rule.

Other developments of enormous importance are underway. The complete economic unification of the twelve-member European Community (EC) is entering its final stages, a process begun in 1958 with only six nations. Widely heralded as "Europe 1992," the result will be a truly common market with 324 million customers in twelve very different countries.

Taken together, the changes which are still unfolding are so profound that we can only begin to comprehend their ultimate significance to world economic and political relationships. My purpose is to review the major developments and help develop a realistic perspective on implications for agriculture and agribusiness. To that end, I want to review three major topics:

1. The reasons for the intense interest in the socialist revolution in Eastern Europe.

2. The difficulties the formerly socialist countries face in converting to democratic markets and how likely they are to succeed.
3. The short- and longer-run implications for U.S. agriculture and agribusiness, including sales outlook and investment opportunities.

### Why the Intense Interest in the Socialist World?

It is hardly possible to overstate the importance of post World War II East-West ideological differences. On at least one occasion they brought the world to the brink of a nuclear war which could have ended modern civilization. The conflict consumed enormous shares of world wealth and polarized commerce and industry. The collapse of socialism and the attendant reduced global influence of Communism are of immense importance to the world's people, and hold some rather clear implications beyond even the reduced threat of nuclear annihilation and major reductions in world political tensions. The change almost certainly will mean economic restructuring, initially in Eastern Europe, but in many other regions as well. It could mean a "peace dividend" if some of the vast sums now spent for armaments find their way into more productive uses. For example, of the more than \$300 billion U.S. defense budget, \$160 billion are NATO-related, primarily spent for the defense of Western Europe against the Soviet and Eastern European threat. As that threat declines, some of these monies can be redirected to other purposes — to reduce budget deficits, rebuild decaying rural infrastructure, or in other ways that improve the efficiency and competitiveness of our economy.

But, beyond these fundamental concerns, there are other reasons why the European developments are watched so keenly. One simple reason is the *potential* importance of these countries as a *major* new market. The six Eastern European countries (five following German reunification) are important new markets by themselves. With the addition of Albania, Yugoslavia and (ultimately) the USSR, a market of truly monumental size will be created. At the same time, these countries have abundant resources and, with development, will become significant producers (and perhaps even formidable competitors) in many areas.

Some characteristics of these nations are noted below:

Table 1. Eastern European/USSR Market Characteristics.

	Population (millions)	1988 Gross Domestic Total (billions)	Product (1986\$) Per Capita (thousands)
Bulgaria	8.9	64	7.1
Czechoslovakia	15.6	109	7.0
German Dem. Rep.	16.6	114	6.9
Hungary	10.6	50	4.7
Poland	38.0	146	3.8
Romania	23.0	67	2.9
	112.7	550	4.9
USSR	289.0	1.36 trillion	4.9

- The six Eastern European countries have a land mass one-fifth the size of the United States.
- Their population (113 million) plus that of the USSR means a potential market of more than 400 million people, a potential market 60 percent larger than the United States, almost 25 percent larger than the EC, and more than double the size of the Pacific Rim. (A market is people *with* purchasing power, hence the continued reference to *potential* markets.)
- Official statistics show the Eastern European economies to be \$550 billion gross domestic product (GDP), only one-eighth as large as the United States. The USSR economy (\$1.36 trillion) is about one-third that of the United States. The combined economies are about 45 percent the size of the United States.<sup>1</sup>
- Per capita income in Eastern Europe and the USSR is well below the developed countries (United States, Federal Republic of Germany, Japan) which are in the \$17,000 to \$20,000 range, but above the developing countries of Latin American and Africa (\$2,000 to \$3,000). Official statistics show Eastern Europe and the USSR to be approaching \$5,000, on average, with Bulgaria highest at \$7,100 and Romania lowest at \$2,900.

Keen worldwide interest focuses on the enormous pent-up demand of this very large market. The growth potential can be seen simply by comparisons with the high consumption levels of adjacent Western Europe. In addition, by reason of their location, these countries hold the added promise of access to Western European markets. The long-term strategy of many companies includes "positioning," development of a presence in Eastern Europe now to facilitate advantageous access to the entire European market, "the new Europe."

### **Difficulties in Transformation: Common Characteristics**

The economic transformations of these former centrally planned economies are both unprecedented and formidable. The problems of most are similar (with important exceptions). If the economic reforms are to succeed, solutions must be found that take account of:

- High inflation rates, which must be tamed. The rate in Poland (more than 1,000 percent by late 1989) now is down to 50 to 60 percent. Double-digit rates are common in the other countries.
- Nonconvertible currencies. Eastern European currencies are virtually worthless except in the issuing country. This, along with mandatory conversion of foreign earnings and inability to repatriate profits, severely reduces the attractiveness of foreign investment.
- Multiple exchange rates (official, parallel, black market) and various lists and categories of goods which can be traded only at differing rates.
- Internal policies that favor basic goods and heavy industries — little consumer goods industry, and no notion of consumer demand or customer service.

- State ownership of physical assets (except agriculture in Poland which is 75 percent private and a small private sector in Hungary). The absence of any legal framework for private ownership, functioning capital markets, accounting systems, etc. makes privatization a formidable task.
- Huge, inefficient bureaucracies. Government previously served as a major employer and the bureaucracy is very resistant to change.
- Wage and price controls were a basic tenet of central planning. Market forces were little reflected for most goods and services.
- No labor markets — guaranteed jobs, labor stagnation — underemployment, little worker mobility. Economic reforms obviously produce rising unemployment and require adjustment in the labor markets.
- Large fiscal deficits — printing money to finance subsidies, fueling the inflation. Taxes aimed at enterprises, not individuals — new structures required.
- Large subsidies for food, medicine, housing, other basic tenets of socialism. Food subsidies constitute large shares of national budgets throughout the region. Their elimination means higher food prices, reduced living standards.
- Large external debt (except Romania), mostly in arrears. \$91 billion total debt, two-thirds held by Poland and Hungary (\$1,200 per capita).
- Little comprehensive understanding of private enterprise, market economics or of the institutions required to support markets (legal framework supporting private property rights, accounting systems, market news and price reporting systems, etc.)
- Woefully little practical private enterprise talent in areas vital to an efficient market system — legal, accounting, managerial, marketing, customer service, etc.

All of the Eastern European countries now have economic reforms underway, but their goals and pace vary widely. The most ambitious of the reform programs is the “shock therapy” approach undertaken by Poland, which aims for a full market economy. On January 1, 1990, Poland freed retail prices, abolished monopolies and began development of the framework required to undergird the system. The subsequent problems were not unexpected, and most observers agree that progress has been substantial. However, the burden is proving particularly great for some groups, with the worst to come. Unemployment is growing rapidly as inefficient enterprises close, and the social fabric may be beginning to fray. Ironically, however, the pace of the reform is an issue in the upcoming presidential election, with government critics urging even faster reform.

The other countries are taking a more piecemeal approach and may be headed for different outcomes such as “market socialism,” mixed systems modeled after other Western European countries. Hungary had begun incremental reforms in the early 1980s and made some progress but is not moving as rapidly as Poland in some essential areas such

as privatization. In Romania and Bulgaria, for example, the socialist mentality has been slow to fade and the political revolutions there have not yet demonstrated the capacity for serious economic reforms. Many leaders are reluctant to move quickly, opting for a more conservative approach than in Poland and perhaps alternative models, as well.

East Germany is a special case. Although its economy is near collapse, its transition to a market economy is assured because it will be financed largely by West Germany. It has a convertible currency, a strong legal framework and other institutions necessary to facilitate the transition. In many ways, its transition may prove the easiest of all.

The situation in the USSR has parallels to Eastern Europe, but also is very distinct in important respects. It is unlikely to achieve much tangible economic improvement until it frees prices and allows private property, at the very least. President Gorbachev still seems unable to muster the domestic political support to implement tough measures with any strong chance of success.

The reforms being undertaken in these countries also involve food and agricultural policy adjustments which are creating a new environment for agriculture. Most are freeing food prices. This results in big initial price hikes; ending both producer input and consumer food subsidies; outlawing input and processing monopolies; reforming cooperatives; and initiating privatization programs to shift more of the production and processing capacity into private hands. But, despite reform *announcements*, long periods are required for the new environment to develop. The processing monopolies persist, for example, and create price transmission problems, with newly unregulated retail prices not being reflected at the farm gate. The emergence of competitors and competition for the farmers' product requires capital (both local and hard currency), but the lack of capital markets poses a very serious impediment. The development of numerous (smaller scale, better located) meat processors, flour millers, fruit processors, etc. to compete with the huge monopolies requires capital, organizational and managerial skills and other ingredients that take time to develop.

It will require years to build in Eastern Europe a market infrastructure such as we have in the West — efficient farm supply networks, market news systems, consumer service organizations and the like. In the meantime, progress in these countries will be slow until more of that facilitating infrastructure is in place.

### **The Short-Run Implications for U.S. Agriculture**

What will all these changes mean for U.S. agriculture in the next few years? Are there opportunities emerging for U.S. producers and agribusinesses in these unfolding events?

The first possibility concerns expanding sales of agricultural products. These countries have not been major agricultural trading partners for the United States over the past decade. In FY 1989, U.S. agricultural export sales in Eastern Europe amounted to only \$320

million, less than 1 percent of total U.S. sales. At the time, U.S. imports were even less (\$245 million) for a net trade surplus of \$75 million. Our exports are primarily grains (feed grains and wheat) and soybean meal, while the imports are meats, cheeses, tobacco and other specialty products.

Over the short term, these countries will have considerably greater purchasing power than they did in the past decade, largely from external debt relief, foreign economic assistance, and from improving economies in which reforms prove successful. Also, their convertible currency earnings will grow as sales in the West expand. The EC already has concluded Preferential Trade Agreements with Poland and Hungary.

Proponents of reform argue that debt relief is essential. Poland is an example. To service its \$40 billion debt requires several billion dollars each year, an important share of total foreign exchange earnings. Roughly two-thirds of this is owed to other governments and one-third to commercial banks. Substantial forgiveness by the former and liberal restructuring by the latter could free \$2 billion or more annually for critical needs. Hungary, with a \$20 billion debt, would benefit in much the same way.

The magnitude of economic assistance flowing to the region is substantial. For example, the World Bank and IMF will disburse \$2.25 billion there in 1990 and have pledged \$7.5 to \$8.5 billion for the six countries next year. The newly-established European Bank for Reconstruction and Development, with an initial capitalization of \$12 billion, will loan throughout the region and the USSR. The European Investment Bank offers credit guarantees. In addition, there is the substantial bilateral assistance: almost \$1 billion over three years from the United States; over \$400 billion from the EC in 1990; and large amounts from the Federal Republic of Germany (including \$1 billion in debt forgiveness alone), Japan and several other countries.

Overall, it is clear that these countries' purchasing power will grow substantially in the next few years. This then raises the question of what they are likely to buy.

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

These countries, especially the USSR, are starved for consumer goods and the technologies used to produce them in the West. They likely will purchase farm production inputs to get the technology to boost output so as to reduce (or at least stabilize) food prices and to improve food quality and variety. These include fertilizers, pesticides (all types), specialized machinery and livestock feed (especially proteins, but also

feed grains). With a tradition of animal agriculture, these countries are interested especially in livestock production technology — new breeding and husbandry techniques, including artificial insemination and embryo transplants. They also can be expected to purchase some food grains (bread quality wheat for blending), perhaps some meat products and other incidental food products.

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

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

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

### **Implications for the Longer Run**

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

The longer run may prove to be a much different matter. How will Eastern Europe and the USSR develop as trading partners? Will they be self sufficient in grains and meats? Will they be growing protein importers? Will they prove larger or smaller markets for U.S. farm products? It is simply too early to tell. The outcome depends on capital availability and investment patterns as well as policy decisions. The mismanagement, distortions and misallocation of resources were enor-



mous. Prices were set and resources allocated administratively and investments often reflected political more than economic objectives.

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

What about the USSR over the long term? The political situation now is so fluid that economic conjecture is not very meaningful. The political situation will determine long-run economic development progress. The USSR is now a big U.S. market (\$3.4 billion in U.S. imports against only \$20 million in sales). Substantial development over the next decade (implying a tranquil political evolution) means greater opportunity to develop its agricultural infrastructure and to invest in agribusinesses of all kinds. This could reduce total import needs, especially for feed grains, but still could involve substantial trade in both finished goods and inputs (for example, protein feed concentrates). In any event, improvement in the Soviet food situation will require substantial external assistance, whether in raw materials or processing technology. The implications obviously are far different for different subsectors of U.S. agriculture and agribusiness.

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

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

approached with realistic caution and careful assessment of the opportunities.

#### NOTES

1. GDP estimates for Eastern Europe and the USSR may be greatly overstated. The USSR presents a clear example. The spread between the official and unofficial value of the currency is a factor of more than 25: 1 ruble equals \$1.82 (official) or 7 cents (black market). Thus, the average per capita GDP of \$4,900 at the official rate would be only a few hundred dollars at the black market rate.