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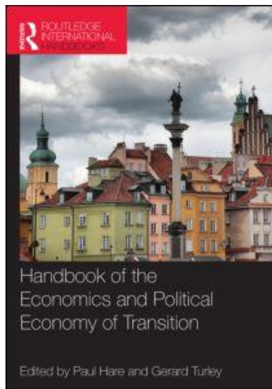

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Trade and Firms in Transition

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TRADE AND FIRMS IN TRANSITION

László Halpern

Introduction

International trade and firms are closely related with each other; exporting and importing firms participate directly in trade, while other firms like suppliers or customers of the trading firms are involved indirectly. International trade in the case of open economies shapes the market competition within the country and has a major impact on the technology as well in the form of importing new technologies and creating capacities to meet foreign demand. The collapse of the former politico-economic system and its associated system of regional integration has led to fundamental changes in both international trade and corporate structures in the post-communist countries.

State-owned firms traded within the socialist regional integration framework Council for Mutual Economic Assistance(CMEA) on the basis of strict quotas, centrally imposed bilateral clearing conditions[1] and detailed technical specifications. There were no incentives to upgrade products as the centrally administered prices rewarded neither better inputs nor new technologies that aimed at producing higher quality output. Primary and intermediate inputs and consumer goods imported from the West were allocated by different rationing schemes as the currencies were not convertible. Moreover, firms selling to developed markets were not allowed to retain their earnings in convertible currencies. Multiple exchange rates and widespread export subsidies and import tax schemes were used to keep under some degree of control the ever-growing appetite for valuable inputs from imports and the easy exports to countries of the Eastern trading bloc.

Ever since the process of transition to the market commenced, new firms and restructured old firms have faced much harder budget constraints; firms are trading under market conditions, imports are mostly unrestricted and tariffs and non-tariff barriers are significantly decreased. These firms are now competing with their domestic peers and newly created domestic and foreign firms, which forces them to keep a close eye on market signals and future profits. Consequently, trade has significantly dropped within the former trade integration area for the socialist bloc, and has risen sharply with new partners, especially with Western Europe. Most of the old export products were either dropped or upgraded; as a result, the export bundle has substantially changed.

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Trade reorientation

The countries of Eastern Europe and the former Soviet Union all belonged to the regional and international integration system that operated under communism and central planning. The CMEA (or Comecon) imposed an excessive degree of specialization in production and a centrally decided division of labour, which hardly paid any attention to cost and efficiency considerations. This system of planned specialization was sustained economically only by maintaining a high degree of self-sufficiency within the CMEA and by conducting little trade with the rest of the world.

The starting point of transition for all the CEE countries was, therefore, the dual structure of their exports, the composition of commodities which were sold to Western markets being quite different from that which characterized their sales to CMEA markets. Many countries had the characteristics of industrially developed economies in their export shares to other CMEA markets but as exporters to the West their products were less processed, less sophisticated. The structure of trade was predominantly characterized by the legacy of inherited capacities in industries that were most heavily dependent upon selling to CMEA markets in the past (Landesmann and Székely, 1995).

While there was a need for a radical restructuring of production and international and inter-regional trade in all post-communist countries following the fall of the Berlin Wall and the break-up of the Soviet Union, the nature and difficulty of the required restructuring differed considerably between countries and regions. Of the eight CEE and Baltic countries that joined the European Union (EU) in 2004, all except Slovenia had been part of the Soviet bloc. Together with Bulgaria and Romania, which joined the EU in 2007, they required a drastic reorganization of their external trade directed towards Western Europe.

The countries of the Commonwealth of Independent States (CIS) also needed to reduce their trade dependence on Russia but the latter would continue to play a significant role as an origin and destination of trade. This was due not only to its geographical proximity but also to the high degree of production specialization in the former Soviet republics, and their economic interdependence as a result of the communist system.

The six former Yugoslav republics were already more integrated into the global trading system prior to the break-up of Yugoslavia. Except for Slovenia, however, their further integration into the regional and global economies was delayed by conflicts and sanctions.

Trade liberalization

While their initial conditions varied, all countries were to gain from liberalization – freeing domestic markets from administered prices and opening them to international trade – following the mis-allocated and wasted resources under the old system. Recognizing this potential and the need to weaken state control, many early reformers relied on comprehensive internal and external liberalization. The pace and scope of this liberalization varied widely, however.

In some cases, the collapse of the old regime and national independence resulted in only limited liberalization of domestic markets and the introduction of new artificial barriers to trade and transit. These barriers were either self-imposed or they were the result of barriers erected by others. For example, much of the regional infrastructure in the CIS, including roads, railways and power grids, has been starved of investment and maintenance, often for reasons of political rivalry among countries. Some of these restrictions are due to legitimate concerns about terrorism and drug trafficking, but mutual mistrust, nationalistic rivalry and trade protectionism have also played a role.

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In contrast to the retreat towards self-sufficiency in some CIS countries, the expansion of the EU has been central to the reintegration into the global economy of many countries of the region. This is clearly the case for the eight post-communist countries that became members in 2004, and for Bulgaria and Romania, which joined the EU in 2007.

Initial phase reforms included price liberalization, foreign exchange and trade liberalization, and small-scale privatization. Second phase reforms included large-scale privatization, governance and enterprise restructuring, competition policy, infrastructure reforms, banking and interest rate liberalization, and the reform (and sometimes the creation) of non-bank financial institutions.

Building on these reforms, the countries redirected their trade towards existing EU members and away from former CMEA members. They increased significantly their overall openness to trade and attracted large capital inflows primarily in the form of foreign direct investment. These processes of structural and institutional reform, greater openness to trade and increased FDI tend to be mutually reinforcing in terms of their impact on overall economic performance, helping to sustain progress in transition and to support integration into the Single European Market.

International integration places significant demands on a country's economic, political and social institutions. Trade across long distances and between new trading partners requires confidence in the enforcement of contracts. The increased competition resulting from participation in global markets can force costly adjustment on some previously protected sectors. Open trade policies need to be accompanied, therefore, by a strong institutional framework that can enforce contracts and support the process of adjustment – particularly in the labour market – if international integration is to be lasting and successful. The challenge is to find a way of encouraging the developing and post-communist countries to undertake the necessary institutional reforms together with the liberalization of trade.

The link between integration and domestic institutional reform is particularly clear in the requirements for EU accession. The enlargement process has played a crucial role over the past decade in supporting far-reaching institutional reforms in the accession countries and strengthening the foundations for their integration into the EU and the world economy. For those countries of the region for which EU membership prospects are either distant or absent altogether, one should ask whether there are alternative modes of interacting with the wider regional and global communities that would trigger similar institutional reforms. In particular, the question is to what extent improved market access to industrialized countries should be conditional on strengthening domestic institutions. Increased integration with regional neighbours could be another option, although the merit of such regional arrangements requires closer scrutiny.

New trade patterns

Transition economies experienced a significant movement of trade away from the CMEA and towards the OECD and other global markets. Excluding intra-bloc trade, openness to the rest of the world increased in all transition economies. Trade with the rest of the world was the driving force behind the increasing openness of the transition countries, particularly in the accession countries.

What patterns of trade specialization were these countries able to follow in the light of this drastic trade reorientation? The countries of the region were thought to be endowed with relatively cheap and well educated labour and a capital stock of rather uneven quality in different industries as compared to countries at a similar degree of development (see Faini and Portes, 1995). However, as Helpman (in Gács and Winckler, 1994, p. 238–39) commented, remarking on the most likely changes in the patterns of specialization and trade in these countries, some of the initial capital stock was inadequate, while some of the human capital was also redundant. Given the education level of the population and the composition of the employees,

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though, it seemed that these countries have had the capacity to learn and absorb Western technologies and organizational methods relatively rapidly.

The degree of integration for each country is influenced by a variety of factors, such as its size, its location, its level of income and its level of reform. The impact of these factors on the extent of integration can be estimated in a so-called 'gravity model'. EBRD (2003) presents an empirical model that relates the level of trade between two specific countries to the size of their respective economies and the costs of shipping goods from one country to another. These costs are influenced by geographical distance as well as the actual costs of transport and any policy-related obstacles to trade.

The observed trade in 2003 was only around 60 per cent of the predicted trade in central Europe and Baltic state (CEB), and only around 25 per cent in south eastern Europe (SEE), Croatia and the CIS. Transition economies on average traded between 40 and 75 per cent less than the average non-transition economy when the above factors are taken into account. Then the following factors were added to the baseline estimation to see whether they could account for at least some of the lack of integration of the transition economies: the size of a country; the number of borders a country has to cross to get to a target market; the quality of transport infrastructure; the extent of trade liberalization; the quality of a country's institutions.

For the CEB, the gap between actual and potential trade was not reduced significantly by taking these additional factors into account. The only significant impact came from the number of borders. This suggested that following accession, trade in these countries – in particular, with the EU and among themselves – was likely to increase further as border controls vanished. There was little for the accession countries to gain from policy improvements since they already had better than average trade policies and governance ratings. Overall, there was some potential for increased trade in these countries which then materialized following EU enlargement in 2004.

For SEE, Croatia and the CIS, the introduction of these additional factors had a bigger impact. Taking all of them into account, the gap between actual and potential trade diminished to around 60 per cent for SEE. For the CIS, the combination of geographical constraints, border controls, restrictive trade policies and weak institutions explained almost entirely its lack of integration in the world economy. As the CIS contains the largest group of landlocked countries in the world, it faces the key challenge of overcoming obvious constraints to transit and transport, particularly in Central Asia.

For the CIS the actual level of trade with other CIS countries has been several times higher than the level predicted by the gravity model, and CIS trade with the rest of the world has been correspondingly much lower than predicted. This indicates that mutual dependencies existed and still exist in the CIS. SEE has been significantly below its trade potential even once all the other factors are taken into account. One possible explanation for this gap might be the continuing impact from the break-up of the former Yugoslavia in 1991. Of course, this gap also suggests that there is a significant potential for increased trade from and within SEE as the regional instability in the western Balkans is overcome. Trade within the region should also increase as bilateral relations improve and a network of free trade agreements was to be established.[2]

Restrictive trade policies and the poor quality of governance are key factors in explaining the low levels of integration in SEE and the CIS. The gravity model shows that CIS trade would have increased by around 20 per cent if countries in the region had adopted trade policies similar to those in the accession countries and became WTO members. Moreover, trade would almost double if the CIS also had the same quality of governance as the accession countries. For SEE and Croatia the impact of these factors would be 10 per cent and 50 per cent respectively. This result suggests that trade liberalization alone may be insufficient to improve the economic prospects of these countries.

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Corporate structure

The classical enterprise in a communist country was by definition state-owned, large and was oriented to a detailed production plan measured in physical units. Meeting the plan was of prime importance and the plan was normally very ambitious. Therefore, production issues dominated entrepreneurship, marketing and cost minimization in managerial concerns. Consistently, the typical manager was a production engineer and not a businessman. Managers faced a mix of monetary and career-based incentives, which were a function of plan fulfilment and political loyalty. Profits and efficiency considerations could not play any significant role as the administratively fixed prices bore no relation to marginal costs, and investment decisions did not depend on future market and profitability prospects. The enterprise was organized along very hierarchical lines in which local and regional units of the communist party had a pivotal role. Workers had virtually no role in enterprise decisions, except in regard to personnel policy and welfare services. Firing rates were extremely low by any standard, as underemployment was widespread within the firm. The enterprise was not only a producer of goods, but also a provider of welfare services to its employees and to its local neighbourhood. For these reasons, efficiency was not considered in determining the scale of employment.

Multi-level bureaucracy co-ordinated the functioning of state-owned firms. The bureaucracy was in charge of setting prices, establishing delivery links between producer and buyer and of providing the credit necessary for the fulfilment of the annual plan. All in all, the general presence of the soft budget constraint for firms and the overall shortage of production inputs and consumer goods and durables characterized the landscape of these planned economies; bureaucratic co-ordination and rationing were in place, leaving a limited, mostly subordinated role to market mechanisms.

This classical and rigid corporate planning system was softened in a few countries, notably Yugoslavia, Hungary and Poland. Decentralizing reforms reduced the scope and detail of bureaucratic decision making. Markets and competition increased in importance. However, formal planning was supplemented with increased bargaining between the bureaucracy and enterprises over diverse aspects of administrative regulation and prices.

Corporate transition

The enterprises initially functioned in communist economies, and their behaviour was a product of the institutions and policies of those economies. In the 1990s those institutions and policies changed radically. These changes compelled enterprises to adapt their behaviour in order to survive, and perhaps to succeed, in a new, liberalized, market environment. The term enterprise restructuring has come to denote the whole process undertaken by enterprises as they adapt for survival and success in a market economy.

During the first decade of transition, more than 150,000 large enterprises in 27 transition economies went through deep changes in every aspect of their political and economic environments (Djankov and Murrell, 2002). Some enterprises have responded to the challenge, entering world markets with great dynamism and becoming indistinguishable from their competitors in mature market economies. Many others remained stalled in the past, undergoing protracted deaths, delayed at times by their slippage into a world of barter and subsidies. Thus, the radical changes in transition economies were matched by enormous variance in the degree to which enterprises restructured their operations and responded successfully to events.

As Carlin and Landesmann (1997) explain, corporate restructuring in a transition economy can take two main lines: defensive–reactive–shallow on the one hand and strategic–active–deep

on the other. Reactive restructuring behaviour, such as labour-shedding or seeking markets for output, so as to contain losses and ensure the survival of the enterprise, took place in enterprises of all kinds in transition. However, deep restructuring involving a forward-looking strategic orientation (e.g. new investment and radical reorganization of product lines and processes) was, at least in the early stages, mainly observed in enterprises owned by foreigners. Further theoretical work suggested that deep restructuring required outside ownership and served to highlight the limitations of privatization strategies based on selling to enterprise insiders.

Corporate performance

Estrin *et al.* (2009) found that the effect of private ownership on corporate performance is positive in CEE but insignificant in the CIS, while there was a strong positive effect of foreign ownership in both the CEE and CIS regions. Privatization to foreign owners was found to result in considerably improved performance of firms virtually everywhere in the transition economies – an effect that is best characterized as a fairly rapid shift in performance rather than a gradual improvement over an extended period of time. The performance effect of privatization to domestic owners was on average less impressive and it varied across regions. The effect was smaller, often delayed, but positive in CEE; it was nil or even negative in Russia and the rest of the CIS. This divergence of findings between CEE and the CIS coincides with differences in policies and institutional development in the two regions, with the former increasingly adopting EU rules and joining the EU, and the latter proceeding more slowly in introducing a market-friendly legal and institutional system.

Firm-level studies suggest that concentrated (especially foreign) private ownership has a stronger positive effect on performance than dispersed ownership in CEE and the CIS. Worker ownership in CEE and the CIS does not seem to have a negative effect. Data from CEE and the CIS suggest that new firms are equally or more efficient than firms privatized to domestic owners and foreign start-ups appear to be more efficient than domestic ones. Contrary to the assumptions of many theoretical models, as well as the evidence from some developing countries, privatization in the post-communist economies is not associated with a reduction in employment. On the contrary, private owners tend to keep employment at higher levels than state-owned firms. Furthermore, macro studies are consistent with micro analyses in that they suggest that privatization, especially when accompanied by complementary reforms, may have a positive effect on the level of aggregate output or economic growth.

Why was the effect of privatization in CEE and the CIS smaller in the case of domestic as against foreign private owners? One reason is the limited skills and access to world markets on the part of the local managers. Domestically owned privatized firms are also the ones where performance-reducing activities such as looting, tunnelling and defrauding minority shareholders have been most frequent. In a number of countries, the nature of the privatization process initially prevented large domestic private owners from obtaining 100 per cent ownership stakes and insiders or the state often owned sizeable holdings. It frequently took these large shareholders several years to squeeze out minority shareholders and in the process the large shareholders sometimes artificially decreased the performance of their newly acquired firms in order to squeeze out the minority shareholders at low share prices.

The importance of good management and corporate governance, access to world markets and the presence of a well-functioning legal and institutional framework were the key factors for success. For the former state-owned firms, restructuring was most easily and effectively achieved by foreign ownership. Foreign firms routinely bring in capable expatriate managers and invest heavily in training local managers. They sell products through their global

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distributional networks, introduce a relatively advanced system of corporate governance and stress the importance of business ethics. Corporate governance of foreign firms hence compensates to a considerable extent for the underdeveloped legal and institutional system that prevailed in many transition economies. However, the spillover effect of foreign firms on the environment may remain rather limited and can compensate for a relatively short period only. In extreme cases foreign firms may even find it more rewarding to accommodate their pattern of behaviour to that imposed by the domestic legal and institutional system.

While some domestic firms also developed good corporate governance, the underdeveloped legal system allowed local managers in many privatized firms to maximize their own benefits at the expense of corporate performance, and hence the welfare of shareholders as well as stakeholders such as workers and the government treasury. This was likely to account for the limited positive performance effects of privatization to domestic private owners as compared to the performance of firms privatized to foreign investors.

Djankov and Murrell (2002) claim on the basis of a large number of studies that product market competition has been a major force behind improvements in enterprise productivity – the most important indicator of success in restructuring – in the transition economies as a whole. Both import competition and domestic market structure are generally significant in explaining enterprise performance. The effects are strong for CEE countries, but for the CIS countries, increased competitive pressures were not associated with enhanced restructuring.

Import competition in the CIS countries does not have a significant effect on enterprise restructuring. In contrast, import competition is significant in explaining enterprise restructuring in the CEE sample. Changes in domestic market structure are important in explaining enterprise restructuring in both the CIS and CEE samples. These results are confirmed in a study of over 3,300 enterprises in 25 transition economies (Carlin *et al*., 2001) that shows strong positive effects of the reduction of market concentration on firm efficiency. The significant effect of changes in domestic market structure on enterprise restructuring in the CIS resonates with recent evidence on high barriers to entry in transition economies.

Carlin *et al*. (2001) found that the power of competition in influencing performance is much more important than the effect of ownership itself. In the growth of sales and productivity, as well as in new product restructuring, the presence of some market power together with competitive pressure, especially from foreign suppliers, strongly and robustly enhanced performance. New product restructuring was in turn an important contributor to firm performance, so this character of competition appeared to have both direct and indirect effects. Transition was an investment-intensive process and the descriptive evidence from the BEEPS survey of the EBRD and the World Bank indicated the presence of financing constraints. This supported the interpretation that retained profits, in the presence of competitive pressure, were important for financing the restructuring that helped firms to succeed. The presence of soft budget constraints appeared to have a broadly negative impact, and a favourable business environment a broadly positive impact, on firm performance.

All in all, the transition process can be successful if market structure nurtures rivalry among firms and removes monopolies; budget constraints become hard; the obstacles facing new entrants are removed; and financial systems support major investments in restructuring.

Firm-level performance and exporting

Transition economies established close trade relations with their neighbours and new partners. The resulting export growth during the first decade of transition was mostly owing to low unit labour costs, the initial massive trade liberalization and high world trade growth. Now these factors are

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unable to ensure the same dynamics of exports in the future. EBRD (2010) presents the results of a regression analysis using annual data for about 130 advanced and emerging-market countries between 1999 and 2009 in order to understand the explanatory factors behind export success. Trade-partner real GDP growth and nominal effective depreciation raise real export growth. The effect of trading partner tariffs is not statistically significant, while non-tariff barriers significantly diminish export growth. Non-tariff barriers are more relevant than tariffs as an obstacle to export growth as tariff barriers are already fairly low, reflecting the trade liberalization that occurred during the 1990s.

Measures of institutional quality also affect export growth. Real export growth is affected by difficulties in clearing customs, lack of corruption, and by the rule of law. It is not the level of these three measures of institutional quality that affects real export growth, but their interaction with non-tariff trade barriers. All three dampen or strengthen the effect of non-tariff trade barriers on real export growth. The rule of law and the lack of corruption mitigate the downward pressure on export growth from non-tariff trade barriers abroad, while cumbersome customs procedures exacerbate their effect.

Based on firm level data, EBRD (2010) endorses the observation that exporters in transition economies are more likely to engage in product innovation, even when the reverse causality from innovation to exporting is stripped out. Lower tariffs and greater export market growth make firms more likely to export, unless markets are very distant. Foreign and larger firms with a better-skilled and educated employees are also more likely to export. Larger firms, younger firms and private firms with better-educated employees are more likely to innovate than their peers. In addition, firms receiving subsidies find it easier to innovate.

After transition

To continue their convergence with advanced economies in the post-crisis world, transition economies will need to rely more heavily on exports as a source of innovation and growth. This will become more difficult as one-off effects from entering free trade areas subside and unit labour costs catch up with those of trading partners. Active policy measures will therefore be necessary to sustain rapid export growth. In particular, policy-makers can support greater export-orientation by lowering non-tariff trade barriers that impede access to new and major existing export markets. They can also improve key aspects of the domestic business climate by reducing corruption and improving the rule of law and customs procedures.

Notes

1 It is worth noting here that within the socialist bloc, the trading currency was the transferable rouble. However, it was in practice neither a rouble – for transferable rouble balances could not be used freely to buy goods for roubles in the Soviet market – nor transferable – since each pair of countries was supposed to maintain (approximate) bilateral balance in their mutual trading accounts. Thus, a firm in Hungary could not freely use a transferable rouble balance to purchase goods in, say, Bulgaria.

2 In the late 1990s and early 2000s SEE saw the establishment of over 20 bilateral free trade agreements. Such a structure of FTAs is administratively cumbersome and not particularly conducive to efficient trade, not least because each agreement tends to have its own list of products where trade remains restricted and rules of origin can be absurdly complicated. Hence the recent agreement to establish a single FTA covering the whole SEE region is greatly to be welcomed.

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