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Distant relations: Central Europe and Australia

Introduction

2.1 Austrade believes Australian trade and investment with Central Europe suffers from a traditional 'market failure'.[1]

2.2 In Austrade's words "market failure is the core issue. Business people in both Australia and Central Europe were ignorant of the emerging opportunities. The Central Europeans did not understand the maturing and depth of the Australian economy…" and Australia viewed Central Europe broadly as a communist era hangover.[2]

2.3 Although this view was to some degree borne out by the inquiry, the Committee found that there was some trade and investment going on between Australia and the region, and that information between the two markets was reasonable.

2.4 The view that the Committee did find inhibitive in terms of trade and investment, was the general perception in Australia of Central Europe as a closed, backward set of societies. This view contrasted dramatically with the dynamic reality on the ground in Central Europe. By the end of the inquiry the Committee were surprised more Australian firms had not taken advantage of the obvious opportunities in Central Europe.

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[1] Austrade, Submission No 18, p 5. In economic terms, market failure occurs when a market does not efficiently allocate resources to achieve an optimal level of economic satisfaction. (www.amosweb.com).

[2] Austrade, Submission No 18, p 5.

2.5 One of the main roles of this inquiry and this report therefore is to address the issue of imperfect information and what Austrade refers to as 'market failure'. It will do so by recommending measures which will address the lack of understanding between Australia and the region.

Snapshot: Central Europe

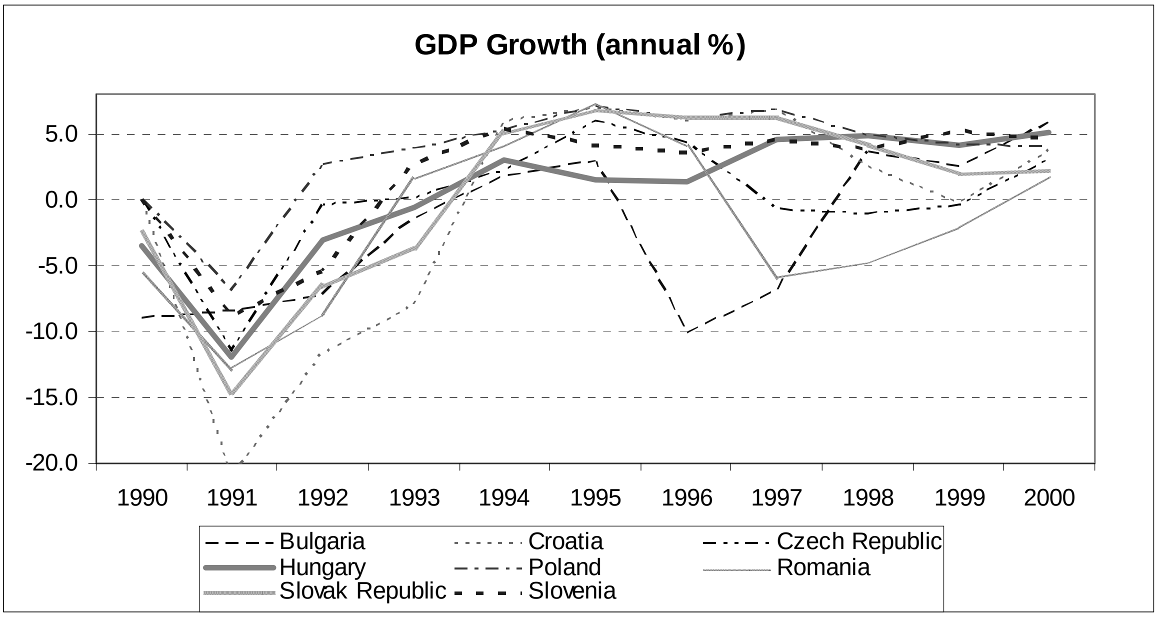
Economic indicators for the countries of Central Europe

2.6 Since the early 1990s the countries of Central Europe[3] have been in 'transition' from planned economies under authoritarian control to liberal democracies and market based economies.

2.7 In assessing the potential opportunities for Australian trade with these nations, the first step is to gauge their relative success in transition and make an assessment of the potential of these nations.

2.8 The following series of economic indicators provides a rough sketch of economic conditions and progress in the countries of Central Europe.

Graph 2.1 Central European Countries GDP Growth[4]



[3] 'Central European countries' in this report refers to the eight subject countries covered by this inquiry.

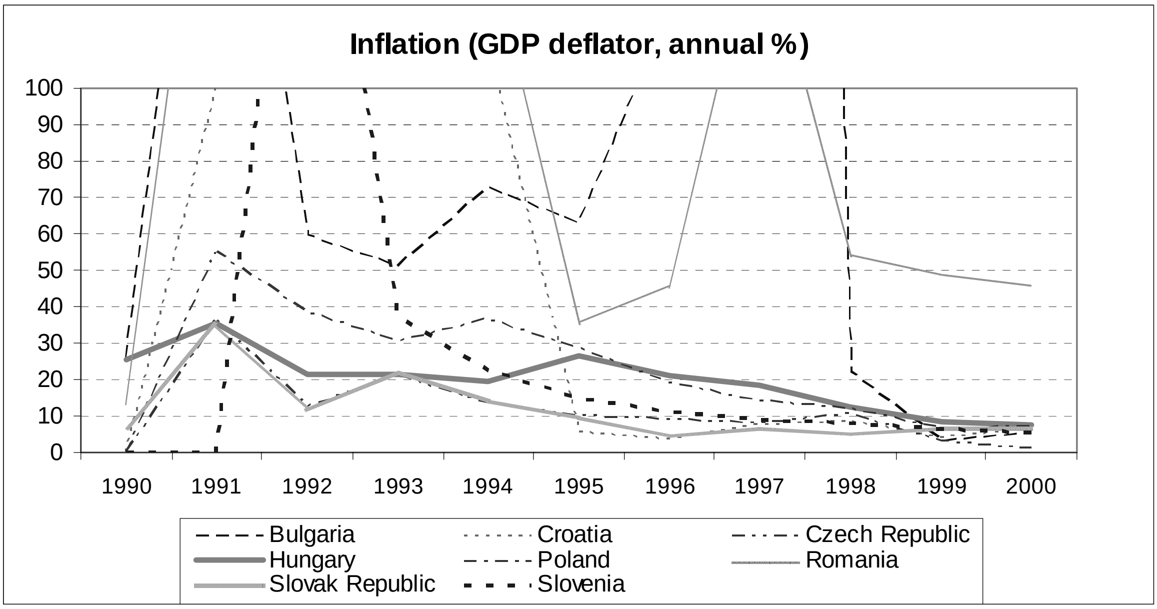
[4] The data from the following 5 tables and those in Appendix E are from the World Bank's World Development Indicators 2002 database (WDIs) and has some weaknesses: the figures reach only until 2000 and movements in some of the figures suggest weaknesses in in-country data collection mechanisms. Therefore these tables and the supplementary information in Appendix E are only general indicators of *economic trends.*

2.9 Tables 2.1 to 2.5 (below) provide graphs of key economic indicators for the 8 subject countries of this inquiry.

2.10 The tables, drawn from the World Bank's World Development Indicators, indicate several important points:

- Growth in the transition period has been varied, but generally high and trending up;
- Inflation has been volatile in several countries but stabilizing and trending down;
- Foreign direct investment (FDI) has varied, with Poland, the Czech Republic and Hungary showing outstanding FDI growth;
- Unemployment has varied and is trending up;
- Real interest rates have been steadily and modestly rising (while in Croatia and Bulgaria they have been volatile).

Graph 2.2 Central European Countries Inflation



2.11 Appendix E lists a range of other economic indicators. They suggest several things:

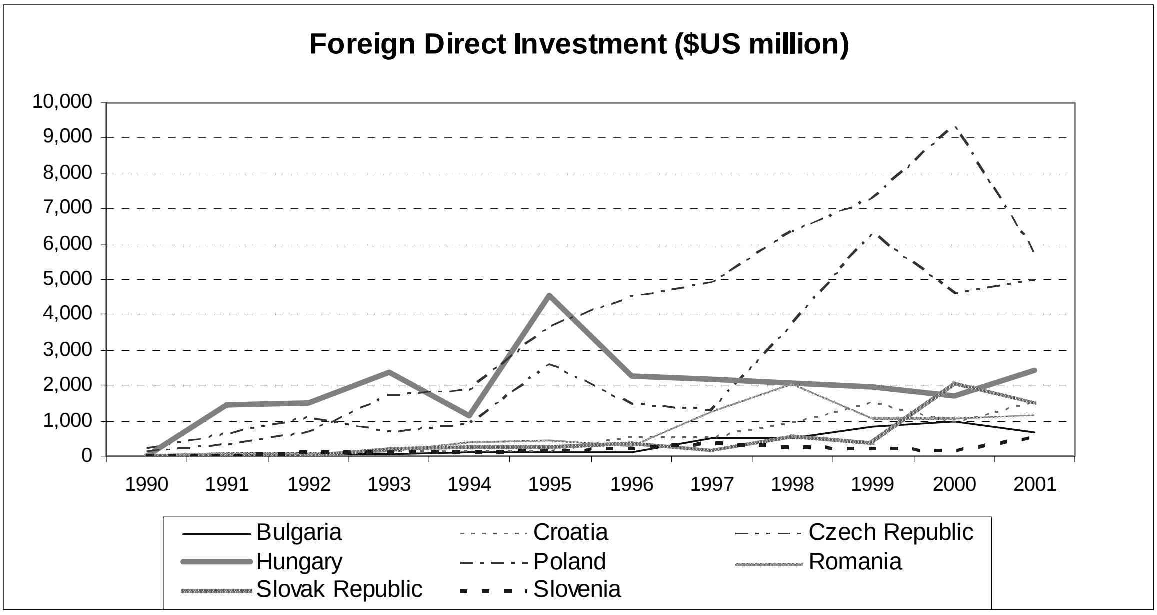
- Information and telecommunications (ITC), and household expenditure are growing;
- Goods and services imports are growing steadily; and
- ITC take-up is growing dramatically

Transition: from planned to market economies

2.12 While most of the Central European economies were implementing some economic reform prior to 1989, the fall of communism brought on a period of major structural reform. While the process of transformation has been different for every country, all of the Central European countries have been through the following stages of economic transition:[5]

- stabilisation and liberalisation
- privatisation and restructuring
- institutional reforms

Graph 2.3 Central European Countries Foreign Direct Investment



2.13 DFAT explains in its submission that the ease of the transition process was often dependent on the extent to which the individual country's economy was linked to that of the Soviet Union and the Council for Mutual Economic Assistance (CMEA), the type of government elected in the immediate post-communist period, and the extent to which it had the necessary economic and administrative institutions in place.

2.14 In the initial stages, this transition process was facilitated by the provision of funds by, amongst others, the Group of 24 donor countries and the European Bank for Reconstruction and Development. Australia assisted with funding through its involvement with both of these groups.[6]

2.15 In the Central European countries these reforms were substantially motivated by their desire for integration into the European Union (EU). This process began for the larger economies of the Czech Republic, Poland and Hungary in 1991 with the signing of the Visegrad declaration[7] and

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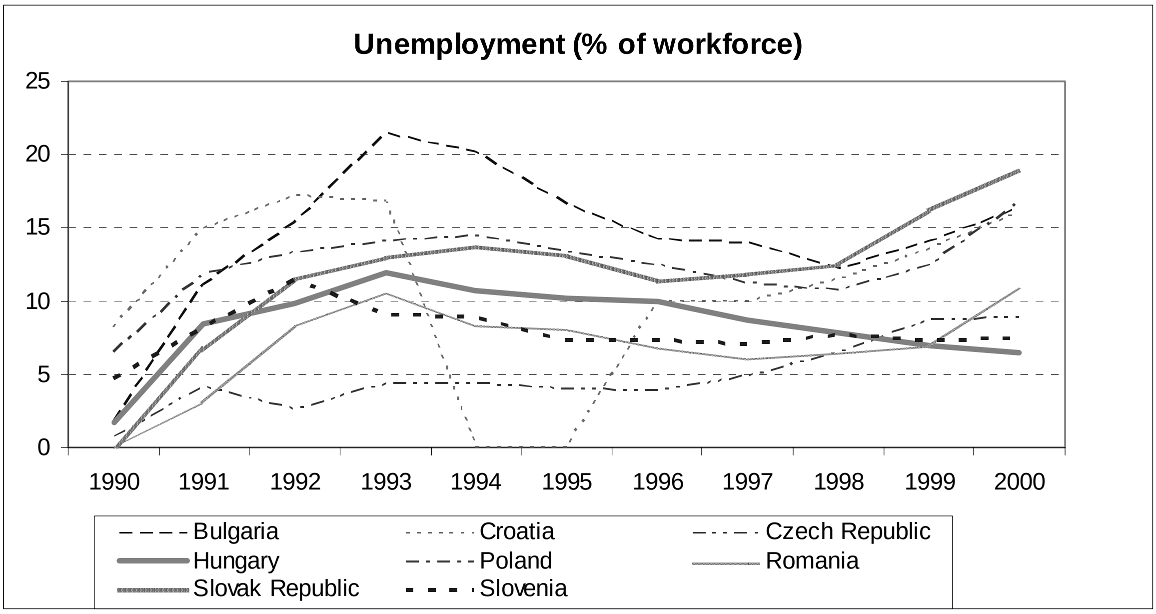
[5] DFAT, Submission No 16, p 7.
[6] DFAT, Submission No 16, p 7.
[7] The Visegrad Four is an unofficial name given to the four Central European post communist countries, the Czech Republic, Hungary, Poland and Slovakia, that was formed in 1991 to work

later the Europe Agreements[8]. The latter were crucial in assisting the Central European countries to identify the economic and political reforms necessary for EU accession.

Graph 2.4 Central European Countries Unemployment Rate



2.16 According to the European Commission,[9] all the countries covered by this inquiry, with the exception of Bulgaria, Romania and Croatia, will be ready to accede to the EU in 2004, having all made sufficient progress in macroeconomic stabilisation and economic reform to meet EU membership criteria. Bulgaria and Romania are likely to follow in 2007. Croatia has signed a Stability and Association Agreement (SAA)[10] with the EU. It will start accession negotiations in 2004 and has set 2008-10 as a target accession date.[11]

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together in a number of fields of common interest.

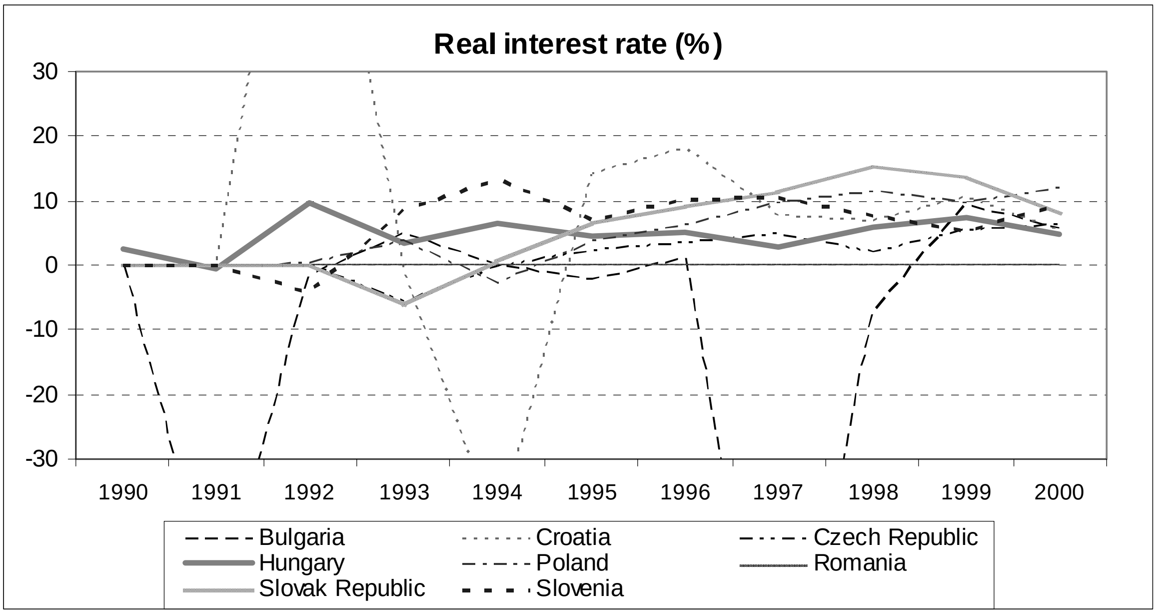
[8] The Europe Agreements form the legal framework for association between the applicant countries and the EU. They cover trade-related issues, political dialogue, legal approximation and other areas of cooperation, including industry, environment, transport and customs. Their objective is to provide a framework for the applicant countries' gradual integration into the EU. Europe Agreements have been concluded with Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. Cited in DFAT, Submission No 16, p xi)

[9] Quoted in DFAT, Submission No 16, p 8.

[10] The SAA between the EU and Croatia, establishes a framework for political dialogue, economic and trade relations aimed at the establishment of a free trade area after a 6 year transition period, followed by negotiations on EU accession.

[11] DFAT, Submission No 16, p 15.

Graph 2.5 Central European Countries Real Interest Rate



2.17 In contrast to the communist era, integration into the world economy through membership of international organisations such as the World Trade Organisation, the International Monetary Fund and the World Bank, has been a priority for the Central European countries. All are now members of the WTO and IMF. The Czech Republic, Hungary, Poland and Slovakia are members of the Organisation for Economic Cooperation and Development (OECD).[12]

Snapshot: trade and investment relations between Australia and Central Europe

Past trade and investment with Central Europe

2.18 DFAT notes Australia has traded with the Central Europe region for many years. This trade has never been large in comparison with our other trading partner regions, but it has been valuable for some individual sectors of the Australian economy,[13] such as wool, coal and meat.

2.19 Prior to 1989, Australia's trade with the Central European countries reached moderate levels, particularly with the larger economies such as Romania, Poland and the then Czechoslovakia. During the 1980s, exports to the region were valued at approximately A$250 million per year and

[12] DFAT, Submission No 16, p 8.
[13] DFAT, Submission No 16, p 5.

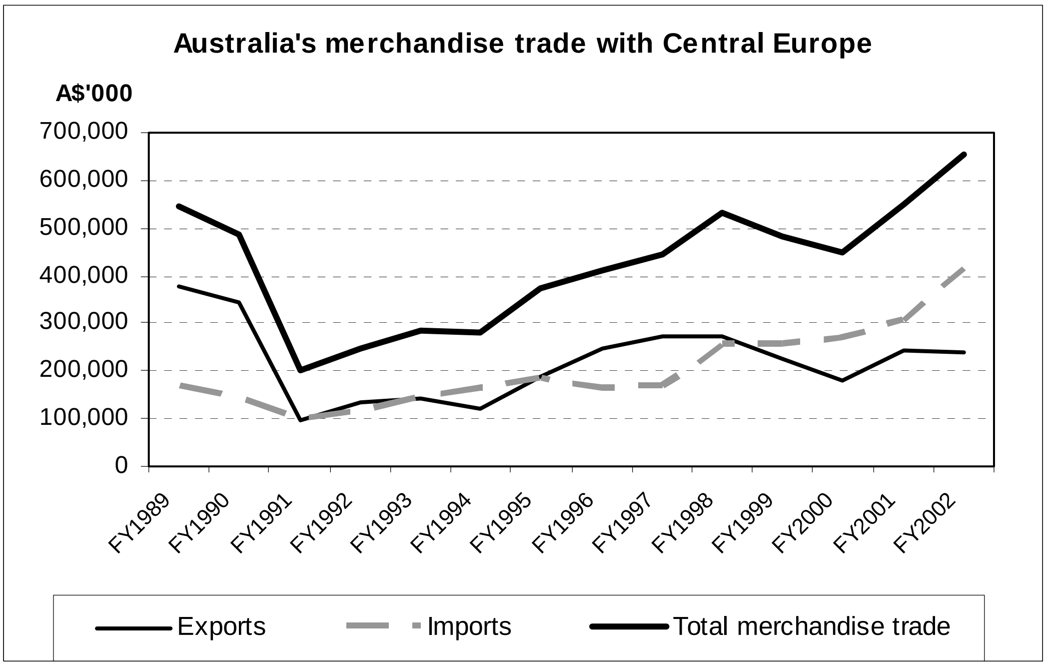
consisted mainly of wool and coal. In 1988, two-way trade with Central Europe peaked at A$505 million.[14]

2.20 Trade fell away sharply from 1989 and only began to pick up again slowly after 1992 (Graph 2.6[15]).

2.21 As is clear from Graph 2.6 in the late 1980s Australia enjoyed a large trade surplus with Central Europe, while in the last few years the reverse has been the case.

2.22 For numerous reasons, Central European involvement with international financial and trade organisations, such as GATT and the WTO, prior to the collapse of communism was difficult and relatively limited.[16]

Graph 2.6 Australia's merchandise trade with Central Europe (region)



Transition and its effect on Australian trade and investment

2.23 Australian exports to Central Europe have yet to return to the level they reached prior to 1989. In the immediate post communist period (1989-91), the region experienced a deep recession which was associated with restructuring of the Central European economies.[17] The highly inefficient

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14 DFAT, Submission No 16, p 6.

15 The trade figures used here and in the following graphs in this chapter include all of the countries covered by the present inquiry, with the exceptions for FYs 1989-90, 1990-91 and 1991-92 of Croatia and Slovenia, which, prior to 1991 were part of the Socialist Federal Republic of Yugoslavia; and Estonia, Latvia and Lithuania, which prior to 1990-01, were included in figures for the USSR.

16 DFAT, Submission No 16, p 7.

17 DFAT, Submission No 16, p 9.

planned economies, when opened up in the early 1990s, contracted dramatically setting off a series of events culminating in a major recession.[18]

2.24 Australia, which had been a major supplier of textiles and raw materials, was badly affected by the slump in the domestic manufacturing sector as the subsequent demand for its products dropped. Total Australian exports to the region dropped from A$344.7 million in 1989-90 to A$97.5 million in 1990-91.

2.25 The economic situation in Central Europe improved in 1992, as a result of liberalizing reforms.[19] Tighter monetary policy brought down inflation and competitive private enterprises emerged, leading to increased exports. Australian merchandise exports to the region started to grow in 1992, rising from A$132.2 million in 1992 to A$273.9 million in 1998.

2.26 Australian trade diversified during this period to include services. By 1999, services exports to the region equalled A$60 million.[20]

2.27 The second major decline in Australia's trade with the Central European countries was prompted by the 1998 Russian financial crisis. Central European manufactured exports to Russia dropped dramatically, as did the linked demand for Australian manufacturing in-puts, such as iron ore, coal and wool.[21]

2.28 Trade increased in 2000-01 and 2001-02. Despite this renewed growth in exports, total merchandise exports to the region in 2002 were just over half the 1988 levels.

2.29 Until Central European manufacturing industries are fully restructured and demand increases, it is unlikely that exports of Australian commodities will return to the levels of the 1980s. In some cases, economic restructuring may mean that some manufacturing or heavy industries in the Central European countries may never regain their former levels.[22]

2.30 Additionally as the Central European countries go through economic transition, DFAT feels Australia may well face new competition to supply Central European markets in the traditional commodity areas.[23]

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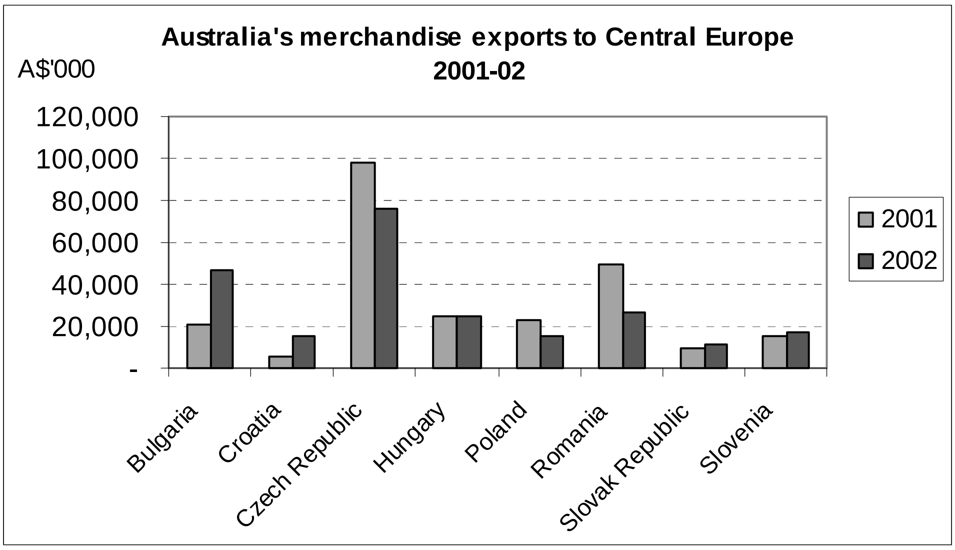
18 DFAT, Submission No 16, p 9.
19 DFAT, Submission No 16, p 9.
20 DFAT, Submission No 16, p 9.
21 DFAT, Submission No 16, p 9.
22 DFAT, Submission No 16, p 10.
23 DFAT, Submission No 16, p 10.

2.31 Balancing this negative trend however, is the diversification of Australian exports to Central Europe (see Graph 2.9),[24] based on the increasing sophistication of their economies.

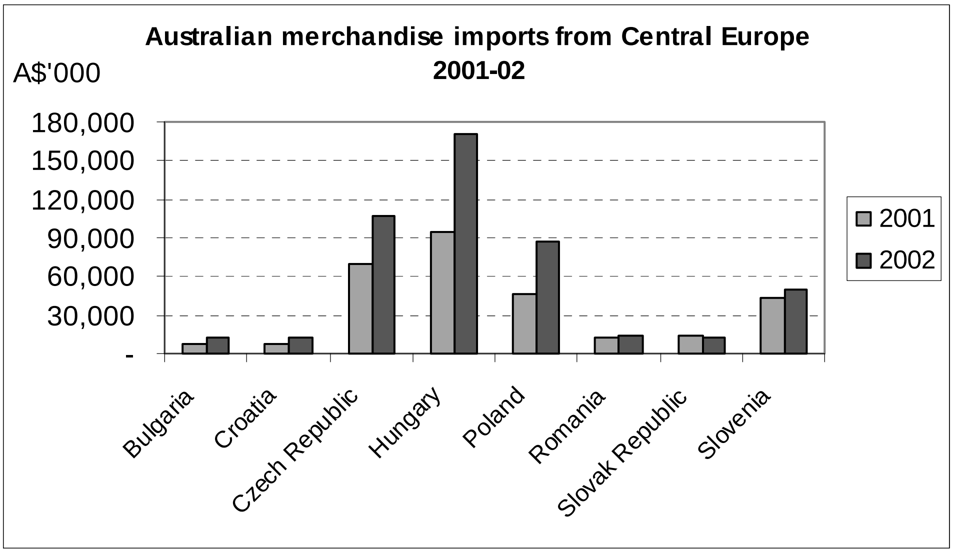
2.32 Clearly Australian Simply Transformed Manufactures (STMs) and Elaborately Transformed Manufactures (ETMs) have grown and stabilized to some degree through the 1990s, as have 'other exports'.

Graph 2.7 Australia's merchandise exports to Central Europe by country 2001-02



Source DFAT, Submission No 16, p 10.

Graph 2.8 Australia's merchandise imports from Central Europe 2001-02



Source DFAT, Submission No 16, p 10

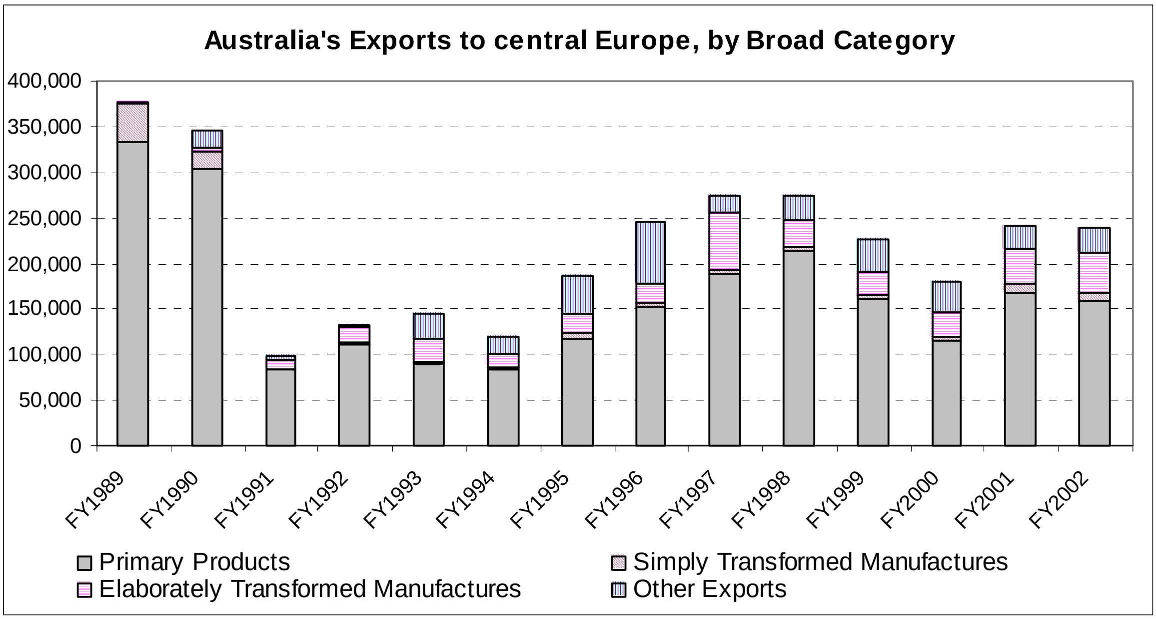
24 DFAT, Submission No 16, p 11.

Investment in Central Europe

2.33 Investment in Central Europe during the communist era was almost non-existent because of the government imposed restrictions on all inflows.[25]

2.34 DFAT makes several points about how at the beginning of the transition period, investment in Central Europe was widely seen as risky and cumbersome. A perception which has diminished only slowly.

Graph 2.9 Australia's exports to Central Europe by broad category



Source *DFAT, Submission No 16, p 10*

2.35 It also notes that Australian investment levels have picked up since the mid-1990s with the implementation of further reforms and restructuring in the context of EU accession.[26]

2.36 Australian foreign direct investment in Poland totalled A$113.6 million by the end of 2001 and is concentrated in areas such as manufacturing, services, infrastructure and mining. In the Czech Republic, total Australian foreign direct investment has reached A$112 million.[27]

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[25] DFAT, Submission No 16, p 7.
[26] DFAT, Submission No 16, p 11.
[27] DFAT, Submission No 16, p 11.