FOOD RETAILING IN EUROPE - POST 1992

PROJECT II
THE COCA-COLA RETAILING RESEARCH GROUP
EUROPE

THE OPENING UP OF EASTERN EUROPE : THE IMPLICATIONS FOR WEST EUROPEAN BUSINESSES

A study prepared for

**THE COCA-COLA RETAILING RESEARCH GROUP
EUROPE**

by

Professor Bruno Tietz
University of Saarbrücken, Germany

October 1991

The Corporate Intelligence Group Limited

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SUMMARY OF MAIN FINDINGS

In most East European countries purchasing power remains low, currency conditions are still uncertain and the facilities for money transfer are somewhat limited. In some cases the import of goods is made conditional upon exports, which means that commercial companies from Western Europe are required to participate in offset transactions.

The key role in the opening up Eastern Europe will probably be played by wholesalers. It will be wholesalers that pass orders to domestic companies in Eastern Europe and become responsible for import functions.

For some time to come it will be less of a problem to start a retailing operation - provided that the market for selling exists. A variety of retailing options are available: in particular, the establishment of new independent outlets, the renting of shops and "the shop-in-a-shop" concession.

Commercial companies from Western Europe will also be required to become heavily involved in the sale of domestic goods. This means that these Western companies will have to have much closer links with production sources in Eastern Europe.

Any wholesale or retail company interested in doing business in an East European country should take action as quickly as possible. It should appoint specialists familiar with the countries in which the company wishes to do business. These specialists are essential because the conditions in individual countries in Eastern Europe vary considerably. Moreover, the speed of progress towards a market economy will also vary.

These specialists must have an in-depth knowledge of the wholesale and retail trade in the countries concerned. In particular they must be able to integrate themselves and the operations of the company for which they are working into existing logistical systems.

There are different ways to develop those specialists. First level management should go to the Eastern countries one year or more before starting an economic link-up, to learn how the respective economy is functioning and developing. It would be advantageous from the beginning to build up a tandem-organisation with highly educated people with international business experience actually living in that country.

Second and third level management should then be transferred to the West European Company, to get a three to six months practical and theoretical crash course.

Any company considering business links with Eastern Europe must have good staying power. Apart from activities involving a small number of specific products which require only a minor commitment, e.g. selling coffee or a narrow product range, companies must accept a lean period of between 3 and 5 years.

To earn respect and trust in Eastern Europe a company will have to show that its commitment to that East European country is serious and is likely to remain so for some considerable time.

Mental attitudes in Eastern Europe, the commercial ideology and the main emphases in the business world are very different from those in Western Europe.

1. BACKGROUND - INITIAL SCENARIO

Never before in history has there been anything remotely comparable to the complexity of variables which companies are now being asked to master. These include:

- the completion of the Single European Market;
- the creation of a market economy in the new German Federal States;
- the economic and political opening up of Eastern Europe;[1]
- the increasingly global dimension of trade;
- the North/South problem and, with it, the problems of developing countries.

Two main events have put their stamp on action for the 1990s; firstly, the quantum leap precipitated by the signing of the Single European Act on the 1st July 1987, which paved the way for the Single European Market and the elimination of barriers within Western Europe; secondly, the ideas of perestroika introduced by the USSR in 1985 which, in principle, were the catalyst for the opening up of Eastern Europe in the first place. From July 1992 it is possible that residents of the USSR may even have the right to travel abroad - although the initial draft legislation to implement this freedom has been rejected.

What are the implications for the business community?

- firstly, companies must re-examine their vision and strategy of their own future.

- secondly, companies must identify the markets in which they would like to be active in the future.

Companies may decide to restrict their activities to a national or a regional level. They may equally decide to be active in several or many countries in Western Europe. However, they may decide to look towards Eastern Europe. The opportunities for trade are particularly good in what was East Germany and in Czechoslovakia. West German companies have already moved into the former East Germany. In the immediate future Czechoslovakia is likely to be the most attractive country for retailing, more so than Hungary or Poland.

This is so because the quality of products stemming from Czechoslovakia is above average. In view of its industrial tradition and earlier experiences with democracy and the principles of a free-market economy, the CSFR will have fewer adaptation problems than other countries. In addition, it is more attractive because it is a low-wage country.

The principles of a Planned Economy and a Market Economy

The differences between the two basic options (i.e. a socialist society and one based on democratic pluralism) stem from a different conception of the fundamental rights which the State considers important and therefore worth protecting and from the influence which the State exerts on its citizens.

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1 For the purposes of this report Eastern Europe also includes the USSR.

In the Marxist-Leninist ideology basic attitudes to human interaction are pre-determined and irrevocable. They form an integral part of the system, although no attempt has been made to assess whether these attitudes have any link with reality.

In a socialist society there is a universal assumption that the individual is prepared to do something for the common good without the need for tangible motivation. It is expected that the individual will subjugate himself/herself willingly to the dictates of the State. The opportunities for choice in all walks of life are either reduced or eliminated completely.

In contrast, in a society based on democratic pluralism there is general freedom for the individual to think and act as he/she wishes within a framework of basic constraints. Political parties are in competition. They vie with each other for the political support of their electorate. Press freedom guarantees in-depth information on diverse subjects, thus contributing towards the development of public opinion. To restrain egotistical traits and to ensure an acceptance of social responsibility and commitment, the State will fix parameters. In addition human interaction, which is in a permanent state of friction, means that compromise solutions, which are compatible with the requirements of society, will have to be found for any problem.

In a centrally-planned economy citizens and consumers are treated as children. It is Utopia to think that the individual will act for the common good. Man is not altruistic; on the contrary he is strictly egotistical. The pressure exerted by bureaucracy on its citizens alters the inherent strength of individuals. It numbs their ability to achieve. A market economy established within a democracy respects decisions made by the individual. In terms of politics, however, this respect of an individual's decision will only exist if that decision is supported by the majority.

In the centrally-planned economy decentralised bodies are primarily agencies to enforce the authority of the State. Individual initiative can only move within narrow bounds between preset political and economic parameters.

2. THE DYNAMICS OF EAST EUROPEAN SOCIAL AND ECONOMIC SYSTEMS

The reform process in all Eastern bloc countries started in the 1960s. However, until the end of the 1980s the following inalienable principles existed in all of the countries:

1. the automatic leadership right of the Communist Party;

2. the retention of basic elements of centralised planning despite greater participation, greater freedom of action for individual companies and a certain market orientation.

In particular the entrenched power structures were strongly resistant to fundamental changes. The unwillingness of the authorities to adapt was significant.

Problems common to all Eastern European countries include:

1. the major lack of a sound infra-structure;
2. serious environmental pollution;
3. serious supply problems - in the main;
4. major currency problems;

5. in most cases high inflation rates;
6. high - and increasing - budget deficits;
7. in most cases significant pent-up demand which cannot be met;
8. generally high rates of subsidies (e.g. in 1980 subsidies accounted for 60.7 per cent of the Polish national budget and in 1988 41.9 per cent);
9. high budget-financed investments;
10. recession brought on by restructuring.

Eliminating fears

Those living in Eastern Europe have wide ranging fears about the reform process. These include:

- the fear of job losses;
- for those on low incomes, the fear of a reduction in the necessities they can afford following the elimination of subsidies and the resultant price increases;
- the fear of losing their savings;
- the fear of reduced state welfare benefits.

These fears go hand in hand with the dismantling of unsuitable, though sensible, structures. The perceptions of a market economy are lacking. People find it difficult to sort out problems which, in a market economy, would be clearly defined (e.g. the question of ownership). There is a general belief that viable alternatives can be established reasonably quickly, but this actually encourages chaos. On top of this there are the issues of political uncertainty and mutual insecurity.

The problem of excessive demands

Western Europe must be clear as to what can be expected from Eastern Europe in the medium term. It must be able to recognise if the economy or society of a country is being subjected to excessive demands. Environmental and energy problems are examples of this. Despite the catastrophic conditions which exist, economic development cannot be stimulated if, in the short term, the demands on Eastern European countries in terms of, for example, anti-pollution measures are equal or greater than those which would be considered reasonable in EC states such as Portugal or Greece.

Any attempt to establish priorities and achieve a consensus in Eastern Europe will remain influenced by efforts to safeguard the supposed achievements of the welfare state. In contrast to a more open and more ruthless market orientation these influences will inhibit development to a greater or lesser extent. In such circumstances the price mechanism will not be effective because of the subsidies that are available.

The major differences between East and West European societies are highlighted in the table on page 5.

Summary 1

Selected differences in East and West European societies

Western Europe	GDR (1990)	Eastern Europe
	- Market and Democracy -	
Well - established understanding of the synthesis between democracy and a market economy	Growing understanding of the relationship between democracy and a market economy	Start of the democratisation process with a move away from the one party system including, by necessity, the end of the primacy of the communist party, the practice of plurality of offices and the end of patronage and nepotism
	- Market versus Plan -	
Ever increasing importance of marketing, even if the proportion of marketing value and product value of any market output varies depending upon the development stage of the economy	Rapid change from a planned to a market economy Inadequate knowledge of marketing and management	Difficult process and resistance to the ideological rejection of a third way which would combine elements of collectivism and market principles and a movement towards the market economy
Clear ownership structures	Still serious difficulties on the question of ownership; no clear understanding of central issues; Treuhandanstalt (trustee body) badly structured	Trend towards several forms of ownership - state - collective - co-operative - private
Companies have wide discretion in decision making	Attempts to protect domestic companies	As before more (USSR, Bulgaria) or less (Czechoslovakia, Hungary) in the way of Guidelines and Central Directives
	- Price Formation -	
Despite considerable price regulation in many sectors, internal and external price freedom with prices playing a market role	Laborious elimination of subsidies and price levies with a trend towards market prices in the absence of pricing principles, pegged to West German price levels (advantage and disadvantage)	Repeated postponement of price liberalisation, gradual approach often with a half-hearted linkage to the freedom of factor prices i.e. wage support for social reasons, continuing lack of understanding between pricing, decentralised decisions and ownership structures

Differences in Reform Policies

It is a mistake to assume that all East European countries are at an identical stage of development. Differences in social and economic structures within individual East European countries (e.g. comparing Czechoslovakia with Rumania) are greater, at least in psychological terms, than those within Western Europe, (e.g. comparing West Germany with Portugal or Greece). Similarly, there are significant differences in the reform policies adopted by the various countries within Eastern Europe.

Take, for example, the differences in privatisation policies:

Czechoslovakia: There is a great fear of foreign domination. For this reason price reform and restructuring have taken priority over privatisation and the encouragement of foreign companies.

In 1991 Czechoslovakia started to privatise the retail sector, which had previously been under state control, together with thousands of small companies such as taxi firms and restaurants. Privatised companies cannot be resold for a specified period - currently two years. The first auction was held in Prague in January 1991 at which 17 food and electronic shops went under the hammer. About 100,000 retail outlets, previously under state control, are scheduled to be privatised in Czechoslovakia on a gradual basis.[2] Larger companies are to be offered for sale after April 1991. Foreign applicants may be considered when these come up for sale.

Hungary: In Hungary an attempt has been made to counter the dangers inherent in a sell-off of national assets by the creation of a Commission which will monitor the privatisation of state property (the State Assets Agency). This Commission is answerable to Parliament and not to Government.

Hungary has passed legislation providing compensation for earlier expropriations. This has created the framework for an acceleration in the rate of privatisation and should increase the interest of foreign investors.

In September 1990 the State Assets Agency drew up an initial privatisation programme covering 20 large Hungarian state-owned organisations. These privatisations - which include the Centrum chain of department stores with 36 shops and a turnover of 18.6 billion (thousand million) Forint and the Danubius hotel chain - are scheduled to be implemented after June 1991.

As a further step about 600 smaller Hungarian companies are to be transferred to private ownership.[3]

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2 See non-attributed article: "Czechoslovakia - 100,000 shops under the hammer" published in the "Textil-Wirtschaft", 46th Year, 1991 No. 6, page 51.

3 See non-attributed article: "Budapest adopts a step-by-step approach to the stony path of privatisation", published in the Handelsblatt, 46th Year, No. 83, 30 April 1991, page 8.

Poland: The radical economic policy introduced in Poland is bearing fruit. In 1990 more than 500,000 companies were established, exports increased by 34 per cent to about DM 9 billion (= thousand million), and the trade surplus was US$ 4.7 billion. However, unemployment has increased to 17 per cent of the working population and is currently standing at 2.7 million.

3. THE FUTURE SOCIAL AND ECONOMIC SYSTEMS OF EASTERN EUROPE

The current transition period in Eastern Europe is characterised by a series of fundamental weaknesses: social, economic but above all psychological.

In Eastern Europe, unlike Western Europe, industrial leaders are often also the political leaders. Many of these individuals are unable and unwilling to come to terms with the facts that for their entire lives they have supported a system which was not tenable in the long term and that they have identified themselves 100 per cent with the system. It is extremely difficult for them to accept the superiority of a system adopted by their former class enemy. Struggles for both self- affirmation and a substantiation of their own professional positions are perceived as difficult by many managers involved in the process of converting to a market economy. Changes to the economic system generated from within remain limited. The half-measures adopted for economic reforms remain the major problem in the process to transform Eastern Europe.

Thus, there is a so-called "as well as" economy to be found in the USSR, which is still trying to combine communism and a free-market economy despite the coup on 19 August 1991.

Despite the new processes of democratisation and decentralisation leading to the sovereignity of the Soviet republics or even their total independence from the USSR, the democratic forces are still being confronted by a powerful "Nomenklatura" trying to jeopardise reforms. The development in Russia will most of all depend on Jelzin's power to assert himself.

There are two possible scenarios for developments in Eastern Europe:

Scenario A: a rigorous switch to a market economy;

Scenario B: an attempt to find a new social order within the market economy incorporating democratic features with strong collectivist elements.

It is still not absolutely clear which countries will opt in the long run for Scenario A and which for Scenario B. As far as can be ascertained at present Poland, Czechoslovakia and Hungary have so far opted for Scenario A. If a country seeks to pursue an option on a long term basis for Scenario B, further delays to the process of social and economic restructuring are inevitable. The recession brought on by structural changes will be extended and an economic resurgence prevented.

In the search for a new, third path the lack of a clear understanding of the functions of the market will result in objectives which are both contradictory and incompatible.

1. They will be seeking to combine a better supply of goods and services at cheap prices with measures to protect existing jobs and to pay high wages. Live as under capitalism and work as under socialism.

2. Despite a hesitant and vague approach, the establishment of independent companies will have to be implemented through the ownership mechanism.

3. Because of the desire to remain independent, which in some cases is deeply entrenched, countries may reject co-operation with Western companies although they lack the ability to operate their own market-based economy.

A realistic interpretation of the future in Eastern Europe is that an attempt will be made to follow Scenario B for several more years, until it is realised that the various constituent parts of the system which they have adopted are incompatible. There is incontrovertible evidence that countries which opt for Scenario B will gradually be forced to go over to Scenario A.

The overall conclusion has to be that each and every East European country will have extreme difficulty in finding its new social, political and economic path.

The new fragmentation of Eastern Europe should strengthen market forces since smaller independent states are probably more capable of adaptation to changed conditions. The former economic structure will, however, make sure that the republics of the Soviet Union continue to depend on each other. The deterioration of foreign trade after giving up the RGW (Rat für Gegenseitige Wirtschaftshilfe) inflicted damage on all parties concerned.

Developments in Yugoslavia will be characterised by the need to opt for federative solutions.

The rejection of the plan and its replacement by the market and marketing

The switch in Eastern Europe from a planned economy to a market economy has confirmed the realisation that the market, which by definition includes the process of marketing, is more than just an element in economic control. The process of perestroika will be characterised by a growing acceptance of the principles of freedom and democracy and a greater understanding of the principles of a market economy. The following are said to be the major features of a market economy:

- personal freedom;
- supremacy of the rule of law;
- acceptance of private ownership;
- a realistic perception of human nature with its strong ambivalence between egoism and altruism;
- opportunities for choice and variety in all walks of life;
- management conducted by decentralised companies;
- trade conducted by decentralised institutions.

The realisation that the countries of Eastern Europe must restructure their economies from the bottom upwards requires a:

1. rapid and intensive development of marketing expertise;

2. development of management practices based on market economy principles.

One of the main challenges is the need to awaken the instincts required for a market economy. This will necessitate immediate changes to the educational system in Eastern Europe.

An important part of the learning process in Eastern Europe must be the realisation that the means of production must undergo a fundamental rationalisation so that production costs can be reduced. In addition it must be accepted that the switch to a market economy will almost inevitably result in rapidly increasing transactional and marketing costs. Accompanying this will be a willingness to attach far greater importance to the trading function.

Chaotic developments

The possibility that developments in some East European countries may take a chaotic course, which would delay the profits anticipated by Western investors, cannot be excluded with absolute certainty.

The reason for this is that inevitably the old/new managers in the East have no basic trust in the market. It is difficult for economists formerly schooled in the ideology of the planned economy to change their behaviour to accord with the principles of the market economy and yet at the same time retain their authority to make decisions.

The dynamics of the social and economic systems in Eastern Europe are summarised in the table on the following two pages.

Summary 2

The Dynamics of Social/Economic Systems in Eastern Europe

Initial position 1985	Current Situation	Future Scenario A	Future Scenario B
		- Basic Elements of the Social Order -	
Strict or very strict centralised economy	Switch to a market economy but with major efforts to retain elements of the planned economy	Development of a clearly identifiable market economy despite major friction during the 5-10 year conversion period	Attempt to "plan" the conversion to the market economy with an attempt - probably unsuccessful - to avoid friction
Rather slow and leisurely changes	In some cases contradictory policies and measures	Rapid awakening and a new beginning	Serious delays to the process of economic development
One party system with the parties dominating social policy	Several parties allowed to operate, Communist Party renounces its monopolistic right to govern	Switch to a parliamentary democracy	Attempts to anchor fundamental elements of the communist system within a multi-party system
State and co-operative ownership, hardly any private ownership, suppression of private companies continued in some cases well into the Eighties	Conditions for domestic private ownership increasingly based on legal principles, serious administrative problems remain	Extensive privatisation of companies & combines, including the basic privatisation or de-collectivisation of land, co-operatives maintained	Limited privatisation of productive assets, collective farming retained but with variations in the level of collectivisation
Foreigners only allowed minority shareholdings	Foreigners allowed to hold majority shareholdings in commercial companies	General acceptance of foreign ownership and entrepreneurs	Foreign ownership and entrepreneurs only allowed on a controlled basis
		- Basic Features of the Economic System -	
Weak economic growth	Economy fluctuates between negative and slow growth, high inflation	After an initial transitional period marked by continuing negative growth GNP grows rapidly and in real terms	The new system will mean major transitional problems with little economic growth
Productivity ranging from very poor to average	Productivity ranging from very poor to average; unemployment high	Rapid increase in productivity; gradual reduction in certain sections of unemployed population	Only limited increases in productivity because of the superimposed social network

.../continued

Summary 2 (continued)

The Dynamics of Social/Economic Systems in Eastern Europe

Initial position 1985	Current Situation	Future Scenario A	Future Scenario B
Planned production with fixed prices and control of price characteristicsand increasingly volume characteristics	Reduction in the planned element; in some cases completely (Poland) but sometimes retaining considerable elements of planning, subsidies and price adjustments	Switch to price control with management decisions decentralised	Mixture of planning and price mechanisms; however, no historical model and effects difficult to gauge
	- Role of market mechanisms -		
Markets not based on consumer requirements	Beginnings of a deliberate orientation to customer/consumer requirements	Adoption of the marketing philosophy of Western industrial countries	An attempt to follow a path of socialist market principles
Distribution and rationing	Intense awareness of undersupply compared with Western industrial countries	After a transitional period convergence of supply and demand	Attempt to organise demand and in some cases demand controlled by non-market mechanisms
Pent up purchasing power	Reduction in pent up purchasing power by cross border shopping forays and imports	Shortages overcome by market mechanisms and the beginnings of an affluent society; development of new marketing and transaction companies	Market orientation slow to develop with supply bottlenecks
No knowledge of the workings of the market	radual build-up of knowledge on the workings of the market; black market	Rapid development of a market philosophy and marketing knowledge	Protracted search for a separate market/ marketing ideology
Apart from a few Western export companies foreign trade run on a monopolistic basis	More decentralisation in foreign trade as an important core process in the acquisition of marketing expertise	Foreign trade unrestricted, desire for a freely convertible currency and membership of international institutions	Obligation to control currency and foreign trade policy because policies of liberalisation incomplete

The trend is for all East European countries to strive towards:

1. Privatisation by:

   a) the sale of state companies and agricultural units;
   b) the leasing of state companies and agricultural units.

2. Creation of an independent banking and monetary system, with a central bank and commercial banks competing with each other.

3. Creation of competition by allowing new companies to enter the market.

4. Foreign capital admitted and Western external trade encouraged.

Even so, the problems which still exist are diverse:

1. All countries have a sizeable black or parallel economy which in some cases - as in the USSR - is run by permanent criminal organisations closely linked to the official economic system.

2. The principles of a market economy have been adopted either half-heartedly or not at all. This has led to major problems, particularly high inflation rates and unstable markets.

3. The time before any up-turn in the economy can be expected has been seriously under-estimated.

4. The effects of inadequate infrastructure are underestimated.

5. It is difficult to dismantle existing power structures.

6. The question of the division of power between politicians, civil servants and industrialists has not yet been resolved in Eastern Europe.

7. The outstanding question of how to safeguard the democratic framework remains unresolved.

8. The serious structural problems in Eastern Europe will take several decades to solve. Solutions will require priorities to be agreed by those in power and for a consensus to be found. In the initial stages it will be impossible to achieve this through the mechanism of the market.

9. Even if Western institutions are copied (e.g. the creation of a two tiered banking system and separation of party and government), the actual results will differ from those in Western democracies and market economies because Eastern Europe has been locked into a completely different social structure for many decades.

Future problems for East European societies

It can be assumed that for the foreseeable future it is unlikely that many of those in positions of authority in Eastern Europe within the ranks of the civil service, industry and other institutions will be discriminating or subjected to fundamental changes. There will be no radical breaking down of the existing informal network of decision makers in government and industry - at least not in the immediate future. The strength of personal relationships will be crucial in determining which aspects of the market economy succeed. The previous situation of complex alliances between decision makers in industry, politics and the civil service will still be encountered.

New decentralised solutions in connection with private property will have to be developed by managers holding important positions in public authorities and private enterprises. The development of a new kind of interaction between democratic partners, parliament, administrators, and private enterprise and other institutes must be broadly supported by the public. There is a high risk of social unrest if the economic development remains unstable.

Implications for companies from Western Europe

The Western investor in Eastern Europe is confronted with numerous barriers, in particular:

- the legislative framework is still unsuitable for foreign investment;
- at the local level authorities lack experience; diplomatic representatives abroad lack experience; communication networks are inadequate; telephone links are particularly poor.

Enormous reconstruction work remains to be done in Eastern Europe to bring it up to West European levels of affluence. Politicians, civil servants and industrialists in both East and West must, therefore, co-operate.

When the economic upturn occurs and the satisfaction level of the population has increased, discrimination against those foreign organisations, which were instrumental in bringing this improvement about, cannot be excluded. It is possible that the only way to counter the expected debate in Eastern Europe on foreign domination will be for the complete integration of Western managers employed locally. Ultimately this may have to include the adoption of the nationality of the host country. In addition joint undertakings or joint ventures may act as an antidote to hostility towards foreigners.

If companies from Western Europe are to succeed in Eastern Europe it is essential that they integrate into the strong informal network of transaction control.

4. COUNTRY BY COUNTRY ANALYSIS OF EASTERN EUROPE

The Gross National Product of the entire East European market is only 40 per cent that of the EC despite the fact that its population of some 410 million inhabitants (1990) is about 30 per cent higher than the comparable figure in the EC. At present Western business in Eastern Europe is minimal: Western countries account for only about 1.4 per cent of Soviet foreign trade and 3 per cent of Poland's foreign trade.

In 1990 population figures for selected countries and economic regions were estimated to be:

EC	342 mn
USA	250 mn
Eastern Europe	120 mn
Japan	124 mn
USSR	290 mn

Using the parameters of population, economic strength, degree of economic liberalisation and acceptance of foreigners, countries in Eastern Europe can be divided into three groups:

Top group	Middle Group	Bottom group
Czechoslovakia	Poland	Rumania
Hungary	Bulgaria	Albania
	USSR	

The efforts to fragment the Republic of Yugoslavia mean that it must be considered separately. It was previously in the top group but has fallen back. Its economic decline will only be replaced by a economic up-swing when the already existing economic constraints are allowed for and federative or confederative solutions adopted.

The basic statistical data on the East European countries are set out in Tables 1 and 2 below:

Table 1. Statistical Data for East European Countries, 1988

Item	Albania	Bulgaria	Czech.	GDR	Yugoslavia
Area ('000 sq m)	29	111	128	108	226
Population (mn)	3	9	16	16	24
National Product (US$ bn)[1]		14	92	154	61
National Product per capita (US$)[1]		1,500	5,900	9,200	2,600
Exports (US$ bn)		17.2	24.9	31.1	12.6
Imports (US$ bn)		16.6	24.3	32.2	13.1
Exports to OECD countries[2]		0.7	3.8	2.7	5.7
Imports from OECD countries[2]		2.4	3.6	3.0	7.3
Debt/Exports (%)[3]		45	21	62	63
Industrial production[4]				3.5	2.0
Inflation rate[4]		11	10	10-15	1256
Per capita income, (EC average = 100)[5]		45	65		45
Econ. growth in %[6]		-11	-3		-3

Table 1. Statistical Data for East European Countries, 1988 (continued)

Item	Poland	Rumania	USSR	Hungary
Area ('000 sq m)	313	238	22,400	93
Population (mn)	38	23	285	11
National Product (US$ bn)[1]	68	28	685	28
National Product per capita (US$)[1]	1,800	1,200	2,400	2,600
Exports (US$ bn)	14.0	12.9	110.6	10.0
Imports (US$ bn)	12.2	9.5	107.2	9.4
Exports to OECD countries[2]	5.7	4.0	23.7	4.1
Imports from OECD countries[2]	5.0	1.2	24.8	4.0
Debt/Exports in %[3]	279	21	36	173
Industrial production[4]	-4.0	-	3.5	-1.0
Inflation rate[4]	270	-	>10	18
Per capita income, (EC average = 100)[5]	30	20	35	55
Econ. growth in %[6]	-12	-12	-4	-5

Notes:

1) in some cases estimates
2) in US$ billion (thousand million)
3) gross, less credits with Western banks
4) 1989, % change compared with previous year, in some cases estimates
5) estimates based on comparisons of purchasing power
6) 1990

Source: Dresdner Bank; quoted in article by Grassau, Gunther. "Full steam ahead to the East" published in Industriemagazin, 1990 No. 9, pages 98-102, page 101, see also non-attributed article " I am an eternal optimist" in Der Spiegel, 1991, No. 17 pages 149 - 158, page 151.

Table 2. Changes to selected external trade indicators
in the seven European COMECON countries, 1986-1989

Item	1986	1987	1988	1989
	(US$)	(US$)	(US$)	(US$)
Balance of trade with:				
OECD countries	-1.082	+1,491	-2,502	-2,816[1]
Current account balance	+0.449	+5,251	+3,885	-1,900[2]
Gross debt	113,249	129,603	133,335	148,200[2]
Net debt	83,886	97,899	98,910	114,574[2]
Net interest payments	5,466	6,385	7,255	8,153[2]
	(%)	(%)	(%)	(%)
Net debt/exports	152	158	153	169[2]
Net interest payments/ exports	10	10	11	12[2]
Debt service quota[3]	33	33	35	35[2]
Reserves/imports	58	62	59	53[2]

Notes:
1) January to September
2) Forecast or estimate
3) All interest and amortisation payments to service the medium and long term debt as a proportion of annual exports.

Source: OECD Financial Market Trends No.45; quoted in non-attributed article: Germany feels the Upheaval in Eastern Europe, sobering OECD analysis in the Neue Zurcher newspaper, Year 211, Foreign edition No.50, 2.3.90, page 16.

The COMECON Common Market

The trend which predominated well into 1989, that of transforming the economic bloc formation of COMECON into a political entity, was terminated by the process of liberalisation in East European countries. For all practical purposes COMECON has ceased to exist.

Recession in Eastern Europe

In 1991 the WIIW, the Vienna based Institute for International Comparative Economic Studies, published a research report which contained estimates of the industrial production in and the Gross Domestic Product of Eastern Europe and the USSR in 1990. According to this report industrial production in East European countries, including the Eastern part of Germany but excluding the Soviet Union, had dropped by 20 per cent. The drop in GDP was estimated at 14 per cent. Compared with the situation in Eastern Europe the recession in the Soviet Union was "modest". Industrial production dropped by 5 per cent and GDP by 3 per cent. For the entire region including Yugoslavia the WIIW estimated that in 1990 industrial production had dropped by 9 per cent and GDP by 6 per cent.

It is probable that the recession brought on by the need to adapt, as currently being experienced by East Germany and other East European countries, is a necessary element of the process to convert from a planned to a market economy. The recession acts to create the new economic basis from which the upturn will emerge.

Most countries in Eastern Europe must expect the recession to continue in 1991 and in some cases into 1992 as well; in Czechoslovakia it is likely to get worse and in Hungary, the Soviet Union, Rumania and Bulgaria it will probably remain the same. In addition, all countries will have to cope with deteriorating world economic conditions. The collapse of COMECON, high energy costs, recession in the West and rising interest rates on the world Financial Markets will put a burden on their current account balances and reduce growth potential.

Taking Eastern Europe as a whole the recession in 1991 is likely to be similar to that in 1990 (see Table 3). Attempts to stabilise economies, particularly in the Soviet Union and Yugoslavia but to a somewhat lesser extent in the remaining East European countries as well, will have little chance of success because of political, social and ethnic tensions.

Table 3. Eastern Bloc Economies, 1990

Country	Industrial Production	GDP
Bulgaria	-13.0	-12.0
Czechoslovakia	-3.5	-3.0
Hungary	-10.0	-5.0
GDR	-29.0	-22.0
Poland	-25.0	-17.0
Rumania	-21.0	-15.0
Eastern Europe	-19.5	-13.8
Soviet Union	-5.0	-3.0
Yugoslavia	-10.6	-10.0
Region as a whole	-9.3	-6.3

Source: Institute for International Comparative Economic Studies, Vienna; quoted in non-attributed article in "Dramatic Recession in Eastern Europe - Production minus in the Soviet Union still moderate: published in the Saarbrucker Zeitung, No. 31, 6th February 1991, Page 7.

In March 1991 Jacques Attali, President of the New European Bank for Reconstruction and Development, stated that 2,000 billion ECU would be required to bring East Europe living standards, including the USSR, up to those in Western Europe.

Debt figures for Eastern Europe

According to an OECD survey debts levels in the seven European countries of COMECON increased rapidly between 1986 and 1989 and they now have a negative current account balance. In Poland the ratio between net indebtedness and annual exports is similar to that in the worst countries of Latin America. Similarly the debt limit is considered to have been reached in both Bulgaria and Hungary. Inflation has accelerated and the Net National Product has scarcely risen. Trade with OECD countries was weaker in 1989 than in 1988.

In 1990 the external indebtedness of the USSR exceeded US$ 54 billion; the foreign trade deficit was US$ 4.7 billion.

By 1990 the combined indebtedness of Czechoslovakia, the Soviet Union, Hungary, Poland, Bulgaria and Rumania totalled US$ 123 billion, i.e. an 85 per cent increase on 1985. The hard currency debts of the above countries amounted to 211 per cent of their export revenue.

Table 4. Net Hard Currency Debts of East European Countries, 1990

Country	Debt figure (US$ bn)	Interest paid as % of export revenue (%)
Bulgaria	9.8	43
Czechoslovakia	6.3	10
Poland	41.8	41
Rumania	1.3	1
Hungary	20.3	35
USSR	43.4	14
Total	122.9	-

Source: OECD; German Economic Institute, Cologne quoted in non- attributed article: "Chronic shortage of foreign exchange" published in Handelsblatt, 46th Year., No. 81, 26/27th April 1991, Page 12

Generally speaking, private banks in the West are cautious in the credit policy adopted towards these countries because they are unable to gauge the inherent risks. This compounds the problem further and the conditions required for growth are impaired because of lack of investment resources. Several countries such as Bulgaria and the USSR have already stopped paying or have asked for a moratorium. The position is similar to that in developing countries; i.e. lenders are being forced to make value adjustments. This creates a further problem, because the inflow of money is reduced whereas it needs to be increased. The World Bank, the International Monetary Fund, the new East/West Bank and other institutions have been under pressure for some time to tackle growing recession by taking appropriate counter-measures.

In some cases the conditions imposed on loans to East Bloc countries have been unrealistic. For example, the International Monetary Fund makes funds conditional upon the introduction of a free market economy and the elimination of import restrictions despite the poor state of the balance of payments. This cannot succeed. Because of this, credit is being reduced and interest increased.

This highlights the dilemma confronting the growth policy adopted in Eastern Europe. Despite the validity of demanding a process of liberalisation, Eastern bloc countries will be forced to continue a policy of restricting imports for many years. This means that it will be almost impossible for them to buy capital goods from the West. It will be impossible to develop conventional industrial locations in Eastern Europe producing goods of a standard comparable to that in the West.

Balance of payments problems are forcing Hungary and the other small countries in Eastern Europe to adopt a stop-go policy as part of their reform process.[4]

The situation in Hungary is an example of the balance of payments dilemma which has confronted East European countries following the liberalisation of economies in socialist countries. In 1988 the gross debt in convertible currencies was US$ 17 billion from an annual debt service of only US$ 3 billion. This is more than 50 per cent of its export income. The expected trade surplus of about US$ 500 million for 1989 would only cover about one third of its interest liabilities of US$ 1.5 billion.

Future prospects

The economic prospects for countries in Eastern Europe remains adverse. The efforts to convert economies will take longer than was previously expected.

There are variations in the speed of change to a market economy in Eastern Europe. The switch to market principles in Eastern Europe is first apparent in the export of goods and services for Western currency and in the existence of wage and salary differentials. For example, wages paid by Hungarian companies which have entered into joint ventures with the West are about 50 per cent higher than the norm for that country.

The confusing policies for reform in Eastern Europe, including the USSR, are creating difficulties for all foreign investors. Western companies are, however, still well advised to prepare themselves for co-operation in the future.

Reliable and topical information on the changing legal and economic structure has to be available on all those countries of interest to Western enterprises. A consistent information programme, as well as reliable sources to be contacted locally, are essential requirements.

5. DIFFERING MARKET CONDITIONS IN EASTERN AND WESTERN EUROPE

In the early stages the transition from a scarcity/supply economy in Eastern Europe to an affluent society will be achieved by established products and services and by using established marketing methods. Any fears that markets might become saturated are superfluous for several decades.

Established products will be required to bring Eastern Europe up to a Western standard of living. In addition known and well-practised marketing strategies will be required once these countries have overcome their inherent ideological and psychological resistance to change.

By contrast, in the Single Market the existing range of marketing tactics used by suppliers and retailers will continue to develop; innovations will be needed to meet the steadily increasing demands made by increasingly affluent customers. Moreover, high living standards and low population growth, combined with high standards of education in Western Europe, will increase the international potential for both products and for retail operators.

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4 See also Schenk, Karl-Ernst: "Perestroika: Opportunities for the World Economy?", published by Volkswirtschaftliche Korrespondenz by the Albert-Weber Foundation, 28th Year, 1989, No. 9, no page numbers.

There is a clear polarisation between the situation in Western Europe and that in Eastern Europe, where economies are less well developed and population growth is comparatively buoyant. The main requirements in Eastern Europe are for basic mass-produced products and for clearly defined niche products for a small elite. A mass market for quality goods with the import of products sold internationally will not appear until a middle class has become established and middle income levels achieved.

The dynamics of consumption and demand

In Eastern Europe the dynamics of consumption and demand are likely to follow a specific wave-like pattern.

Riding on the crest of the wave will be communication products; for example, consumer electronics and modern photographic equipment and related products such as books. Rising demand for records, tapes and CD discs will follow the acquisition of basic equipment. The quality of that basic equipment will be determined by how fast incomes grow.

Another important factor will be mobility, with a strong demand for cars. An international study of car ownership in 1986 revealed the following number of cars per 1000 head of population:[5]

USA	570	Hungary	145
West Germany	446	Yugoslavia	125
France	388	Bulgaria	120
Japan	235	Poland	105
East Germany	204	USSR	42
Czechoslovakia	173	Rumania	11

Donald Petersen, the former Ford boss, has forecast that 60 per cent of growth in the motor industry over the next 20 years will be accounted for by Eastern Europe.

At the same time demand for housing and household goods will be stimulated, resulting in opportunities for the building and furniture sectors. The increase in demand for clothing and foodstuffs will be more tentative. As consumers will be unable to afford everything at the same time savings will be made in these areas. It is likely that in the short term demand will be for high quality products, at least in the new German Federal States, Czechoslovakia and Hungary. This will arise, not just because of environmental factors, but because of the desire for things which will retain their value.

The polarisation of demand will be much more evident in Eastern Europe than in Western Europe.

Brand awareness

Because the quality of their own products leaves much to be desired and because Western goods, despite their limited availability, are already well known, brand and quality awareness already exist in Eastern European countries. International brands such as Coca Cola, Levi jeans and Canon cameras, for example, are already well known in Eastern Europe. In addition

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5 CIA (publisher) Handbook of Economic Statistics 1988.

and for historical reasons former brand leaders such as Meinl coffee and Bata shoes are very popular.

Brands known in the West and introduced to the East quickly become well known and accepted. As symbols they soon gain acceptance in Eastern Europe. Branding is a vital way of building up market share.

Experiences in Eastern Europe show that the demand for high quality products very quickly follows Western trends.

6. TRADE IN EASTERN EUROPE

I. Overview

The disregard of both consumer demand and the production of consumer goods which is prevalent in East European economic systems is, for all practical purposes, associated with a disregard of trade. It is important to understand the historical doctrines which brought about the development of attitudes towards trade and its role in a centrally-planned economy.

In the Marxist-Leninist system trade has its roots in:

1. The mercantile system, which was the prevalent economic policy in European countries in the age of absolutism after the year 1500 and which at its extreme manifested itself in bullionism (i.e. attempts to maximise the difference between exports and imports);

2. The physiocratic system and the theory of an inherent natural order developed by Francois Quesnay in 1758, in which the trading class and dealers were seen as a sterile class.

The Marxist ideology is based on a separation of production and distribution. As the trading class is unable to provide any added value it is seen as unproductive.

The administrative and control structures imposed on the trading sector are still having an effect. The trading function was fully integrated into the system of parameters, guidelines and controls operated by the state planning system.

The trading function in Eastern Europe has been based on the following principle: "The role of the trading sector is to sell whatever agriculture can produce, mining can extract and industry can manufacture". Industry was organised primarily on the basis of monopolies and insufficient attention was paid to market conditions.

International Comparison of Employment in the Trading Sector

The neglect of trade in East European countries is evident from a comparison of employment levels. In 1985 about 15.4 per cent of the working population in EC countries was employed in the distributive sector. The equivalent percentage in East Germany was only 10.2 per cent, while in the USSR it was only 6.9 per cent.

Table 5. Changes in Employment Levels in the Retail/Wholesale Trade in Selected Economic Regions, 1985-1988

Economic Area	Number employed in Trade (mn) 1985	Number employed in Trade (mn) 1988	% of Working Population employed in Trade (%) 1985	% of Working Population employed in Trade (%) 1988
EC	19.01	-	15.4	-
USA	24.19	-	21.1 [1]	-
Japan	10.89	-	17.7	-
USSR	8.12	8.43	6.9 [2]	7.2 [2]
East Germany	0.87	0.88	10.2 [3]	10.3 [3]

Source: Kamp, Klaus: Major gaps in Trading Network published in Dynamik im Handel, 34th Year, 1990, No. 10, pages 9-14, page 10.

Notes:

1) Wirtschaftswoche, No. 33/1989, pages 56/57
2) Economy of the USSR in 1988, officially authorised statistics, pages 34/35
3) 1989 East German Statistical Yearbook, page 19

ii. The Structure of Retail Trade

In Eastern Europe the retail sector is split into three main groups:

1. food retailers;
2. retailers of industrial goods;
3. general retailers.

and these in turn are divided into:

1. retailers with their own sales space;
2. retailers without their own sales space; e.g. kiosks, petrol stations, outlets selling fuels and cars

In contrast to Western Europe the number of sales outlets in Eastern Europe continues to increase, partly because numbers were previously very low and partly - as in Hungary - because privatisation has resulted in a sharp increase in the number of stalls.

Table 6. Retail Outlets in East European Countries, 1988

Country	1980 ('000)	Outlets 1988 ('000)	Outlets 1988 with sales space ('000)	Outlets 1988 without sales space ('000)	Population 1988 (mn)	Outlets per 1,000 inhab. with sales space	Outlets per 1,000 inhab. without sales space
E. Germany	103.5	94.8	73.3	21.5	16,675	4.4	1.3
Bulgaria	40.0	44.0	34.4	9.5	8,987	3.8	1.1
Czechosl.	64.8	62.8	55.9	6.9	15,624	3.6	0.4
Poland	203.7	227.0	160.7	66.4	37,775	4.3	1.8
Rumania	58.1	58.8	52.1	6.7	23,112	2.3	0.3
Hungary	46.9	63.7	53.2	10.5	10,590	5.0	1.0
USSR	695.2	736.0	565.3	170.7	286,717	2.0	0.6

Source: 1989 COMECON Statistical Yearbook, Moscow 1990 based on internal statistics.

Major importance of state ownership and co-operatives

The ownership of retail outlets in Eastern Europe is split between:

1. state ownership;
2. co-operative ownership;
3. private ownership.

The relative importance of each of these ownership forms is illustrated on a country by country basis in the table below. As can be seen, in Eastern Europe distribution has predominantly been in the hands of the State and of co-operatives.

Table 7. Changes in Ownership of Retail Outlets in Eastern Europe, 1980-1988 (%)[1]

Country	State Ownership 1980	State Ownership 1988	Co-operative Ownership 1980	Co-operative Ownership 1988	Private Ownership 1980	Private Ownership 1988
Bulgaria	42.5	52.0	42.5	43.0	15.0	5.0
Czech.	57.5	60.0	42.5	40.0	-	-
E.Germany	47.5	37.5	30.0	31.3	22.5	31.2
Poland	15.0	17.5	75.0	65.0	10.0	17.5
Rumania	55.0	52.5 [2]	45.0	47.5 [2]	-	- [2]
Hungary	35.0	27.5	42.5	32.5	22.5	40.0
USSR	47.5	45.0	52.5	55.0	-	-

Notes:
1) rounded up
2) 1987

Source: 1989 COMECON Statistical Yearbook quoted by Seitz, Helmut: The new order in the Soviet Union - Trading Options, lecture given at the 1st European Trade Forum "New opportunities in East Germany and Eastern Europe" 28/29th June 1990 in Berlin.

In some countries, even in the 1980s, private ownership, which in some cases had been allowed to supply certain very local needs, was seriously restricted and curtailed. Bulgaria and East Germany are examples of this.

Furthermore, state-owned outlets are even more important in terms of the proportion of total retail sales that they handle than they are in terms of actual proportion of outlets.

Table 8. The Importance of State and Co-operative Retail Outlets in selected East European countries, 1986
(%)

Country	Retail Trade State % of outlets	Retail Trade State % of turnover	Retail Trade Co-operatives % of outlets	Retail Trade Co-operatives % of turnover
Bulgaria	52.0	71.4	45.2	28.5
Czechoslovakia	59.2	74.7	40.7	25.3
E. Germany	35.1	54.3	29.8	31.7
Rumania	28.9	69.1	33.8	36.2
USSR	46.8	71.0	53.2	26.4

Source: Handelshochschule (Commercial University) Leipzig quoted by Seitz, Helmut: The new order in the Soviet Union -Trading Options, lecture given at the 1st European Trading Forum "New opportunities in East Germany and Eastern Europe" 28th/29th June 1990 in Berlin.

Small shops and few large outlets

In Eastern Europe retail sales space per head of population is only 20-30 per cent of that for Western Europe. In Western Europe the sales space per 1,000 head of population is about 1,000 sq m; in West Germany it is even higher at 1,200 sq m.

Table 9. Size of Retail Outlets in Eastern Europe

Country	Sales space ('000 sq m)		Population in 1988 (mn)	Sales space per 1000 population	Department Stores absolute	
Bulgaria	2,012	(1985)	8,987	224	348	(1984)
Czech.	,769	(1986)	15,624	306	172	(1983)
Poland	13,610	(1986)	37,775	362	367	(1984)
Rumania	-		23,112	-	-	
Hungary	2,413	(1986)	10,590	226	1,342	(1986)
USSR	52,292	(1985)	280,717	189	800	(1984)

Source: Handelshochschule Leipzig, 1989 COMECON Statistical Yearbook, Moscow 1990.

In the 1980s the average shop size in the majority of East European countries changed very little. This is true of both food and non-food outlets. In 1986 retail outlets varied in size between 50 sq m (Hungary) and 95 sq m (USSR).

Table 10. Changes in the Average Size of a Retail Outlet
In Selected East European countries, 1980-1986
(sq m)

Country	1980	1986
Bulgaria	56	60
Czechoslovakia	71	85
E. Germany	64	66
Poland	66	70
Hungary	52	50
USSR	87	95

Source: Handelshochschule Leipzig quoted by Seitz, Helmut: The new order in the Soviet Union -Trading Opportunities, lecture given at the 1st European Trading Forum "New opportunities in East Germany and Eastern Europe" 28/29th June 1990 in Berlin

Food outlets dominate the retail scene in Eastern Europe. Leading the field in Eastern Europe is Hungary where 70 per cent of the turnover in the retail sector comes from food and drinks (excluding the restaurant trade): Rumania has the lowest percentage with food accounting for 55 per cent of retail turnover.

Table 11. Structure of Retail Sales in selected East European Countries, 1988
(%)

Country	Specialist retailer [1]	Restaurant Trade [1]	Food Total [2]	Non-Food
Bulgaria	81.1	18.9	68.75	31.25
Czechoslovakia	87.3	12.7	60.00	40.00
E. Germany	89.9	10.1	60.00	40.00
Poland	94.1	5.9	62.50	37.50
Rumania[1]	-	-	55.00	45.00
Hungary	90.3	9.7	70.00	30.00
USSR	91.5	8.5	57.50	42.50

Notes:
1) 1987
2) Turnover from food and drinks retailers excluding restaurant sales.

Source: 1989 Comecon Statistical Yearbook, Moscow quoted by Seitz, Helmut: The new order in the Soviet Union - Trading Options, lecture given to the 1st European Trading Forum "New Opportunities in East Germany and Eastern Europe" 28th/29th June 1990 in Berlin: Comecon Statistical Yearbook, quoted by Stutzer, Dietmar: Unlimited demand but limited capacity published in Lebensmittel journal, 42th Year, No. 41, 12th October 1990, page 82.

Poor infra-structure

Poor transport infra-structure and the small number of private households with access to a vehicle has meant that most people have to walk to the shops. This has favoured retail outlets in town centre locations or near residential areas and made it difficult to establish retail outlets on greenfield sites.

Profit margins

Profit margins in Eastern Europe are much lower than in Western Europe. For example, gross profit margins in Czechoslovakia in 1990 for the combined wholesale and retail sector (as a percentage of retail turnover) were as follows:[6]

basic foodstuffs	20%	glass and china	20%
confectionery	14%	sports equipment & toys	17%
outer clothing	21%		
shoes	15%		

In 1991 alone margins in the retail sector were increased from a rate of 15 - 20 per cent to a rate of 35 - 40 per cent. This was meant to alleviate the effects of the doubling of interest rates and the increase in personnel costs.

High losses in turnover in recent years

In recent years the actual turnover of the Eastern European retail trade has been tumbling. Between 1980 and 1990 it fell by 50 per cent in Yugoslavia. In the first seven months of 1991 alone the turnover in retail trade reduced by 44 per cent while the inflation rate in the same period of time amounted to 60 per cent in Czechoslovakia. In Bulgaria, Romania, Poland and the USSR it is known that consumption levels have decreased considerably. An upswing cannot be expected before 1994 at the earliest.

Rents in Eastern Europe

Considerable interest has been shown by investors wishing to invest in East European towns, particularly in their capital cities. This has been generated by the increasing demand for office space. For example, monthly rents in Budapest and Prague have increased by an equivalent of DM 50 per sq m and in Warsaw the increase has been even higher. Experts reckon that the return on office space in these cities is between 12-15 per cent.[7]

Retail trade in the USSR

According to Soviet statistics the 1988 turnover in the retail sector in the USSR was 366.4 billion Rubles, which represents 1,200 Rubles per head of population. Yet the annual per capita income was only 2,500 rubles. It is unlikely that the figures for 1990 will be as high.

The reforms in the USSR introduced in 1985 have not solved any supply problems but have favoured the black market.

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6 Statistics from the Internal Trade Research Institute, Prague.

7 See also non-attributed article: Continuing increase in rents in East European cities, published in Blick durch die Wirtschaft, 33rd Year, No. 222, 15th November 1990, page 1.

Since 1988 companies may offer those products on the free market which they produce beyond the level prescribed by the central government. This has led to extremely high prices, fuelled even further by speculation.

In 1990 about 23,000 retail shops were privatised and offered on lease in the USSR. In addition to these small outlets the department store GUM in Moscow with a turnover of 2.5 million Rubles, making it the biggest department store in the USSR, was also leased. The total turnover of the retail trade in 1989-90 has been estimated to be some 340 thousand million rubles. In 1990 the turnover of the privatised sector accounted for 8 per cent of this total volume. In the meantime a number of wholesale establishments and restaurants have been founded.

In late 1990 a further privatisation programme for the retail sector was presented stating that about 75,000 food stores with less than 100 square metres and 80,000 non-food stores with less than 160 square metres of sales area were to be privatised.

It is also proposed that at some time in the future larger stores are to be turned into public limited companies. The monopolies in the Soviet wholesale trade sector are to be broken up in various ways:

1. National inspectors will be dismissed.
2. Warehousing businesses will be let on lease.
3. Existing companies will be turned into public limited companies.
4. A co-operative wholesale trade will be founded.

Privatisation in Czechoslovakia

Tumbling turnovers have had a negative impact on privatisation. The expected privatisation of 13 per cent of all shops was reduced to 8 per cent by the Ministry of Trade. Most privatised shops have a sales area of less than 100, or even less than 60, square metres.

Privatisation also includes real estate. Food shops have to be run for a minimum of 2 years after privatisation. Such limitation does not apply to the non-food sector.

Privatisation is achieved through auctions. In the first round only Czech citizens may make offers. Only those shops that are offered a second time may be purchased by foreigners.

Black and grey markets

In order to guarantee better supplies and to fulfil the economic targets set by the central government, black and grey markets developed in all Eastern European countries. In some, especially in the USSR, this has led to a strong shadow economy.

Since all producing companies are obliged to make contributions to the supply of consumer goods and to take care of their staff, a supply cycle outside of the classical retail trade was created. At present some goods do not even reach the open market.

Experience has shown that black market systems fall apart as soon as goods are no longer scarce and currencies function properly; hence black and grey markets tend to be of a transitional nature.

7. A GENERAL BUSINESS STRATEGY FOR WESTERN COMPANIES TRADING IN EASTERN EUROPE

i. <u>The Philosophy in Eastern Europe</u>

Any consideration of the strategic options resulting from the opening up of the Eastern countries must start with the philosophy prevalent in Eastern Europe. The problems of infrastructure and distribution which exist in Eastern Europe mean that a somewhat more comprehensive view of trade is required.

An important criterion for successful involvement in Eastern Europe is 'increasing convergence'; i.e. the creation of production facilities and trading outlets which can offer services capable of being marketed throughout Europe. A fundamental requirement for any trading venture in Eastern Europe is, therefore, the immediate creation of a well-rounded policy which avoids fundamental differences between East and West, as travel and cross-border shopping forays will bring about a rapid increase in the awareness of Western products and practices.

<u>Languages</u>

Some knowledge of the national language is almost an absolute essential. Russian has to be spoken by people interested in the USSR, since the older generation tends to speak German, while the younger people are more familiar with English.

In all other Eastern European countries German is the first and English the second foreign language. In Poland, French is rather more important than English.

<u>The axiom of complete commitment</u>

The central principle fundamental to success is the commitment of top management to Eastern Europe. Unless the level of identification is extremely high, the risks of an involvement in the East will be under-estimated and its opportunities over-estimated. As a rule the time span required in Eastern Europe tends to be under-estimated.

<u>Aspects of authority - the dominance principle</u>

The dominance principle is essential and unavoidable in Eastern Europe, because for decades a belief in the strength and importance of institutions was nurtured; in the early stages capitalism in East Europe will have to orientate itself accordingly. The most realistic market structure will be a narrow oligopoly with the concept of decentralisation only gradually gaining acceptance.

II. Individual Strands of an East European Strategy for Commercial Companies

A strategy involving entry into Eastern Europe must be based upon:

1. analysis of the market;
2. analysis of potential locations;
3. analysis of potential partners;
4. selection of partners;
5. agreements with partners;
6. training and transfer of expertise.

Factors that will promote the development of trade are:

- the existence of the right contacts with administrative authorities;
- the ability to find the right partners;
- the training of local management in the country of the Western partner;
- the willingness to be involved in offset trading;
- the ability to adopt a long-term approach;
- the ability to develop production in Eastern Europe with components supplied from Western Europe;
- the ability to develop local production or production through joint ventures;
- the ability to develop language skills;
- the willingness to employ former East European residents who have completed an appropriate business training.

The development of trade will be impeded by:

1. a lack of foreign exchange;
2. the fact that few of the consumer goods produced in Eastern Europe at present will survive in the long term;
3. the need for good staying power;
4. the lack of language skills.

Product restrictions in Eastern Europe

If equipment and products are developed abroad, they must fit in with the servicing potential within individual countries. There are several service constraints at both the local and the regional/national level that must not be overlooked.

Product quality must adjust to servicing capabilities. The greater the division of labour and sophistication of skills within the service infrastructure of any country, the fewer the constraints imposed by servicing factors. The opposite will also apply: if division of labour and trade skills are less well developed, the constraints imposed by servicing requirements will increase accordingly.

Eastern Europe is weak in this respect and this will impose considerable constraints on product complexity for some considerable time; this is certainly true of such products as electrical equipment and electronic components in motor vehicles. Product complexity will gradually increase in line with infrastructure developments, but in the initial stages this will mean, for example, less electronics in products ranging from household equipment to cars.

The lesson to be learnt is that if the servicing infrastructure is weak, the complexity of products must not exceed:

1. local technical skills;
2. logistical structures.

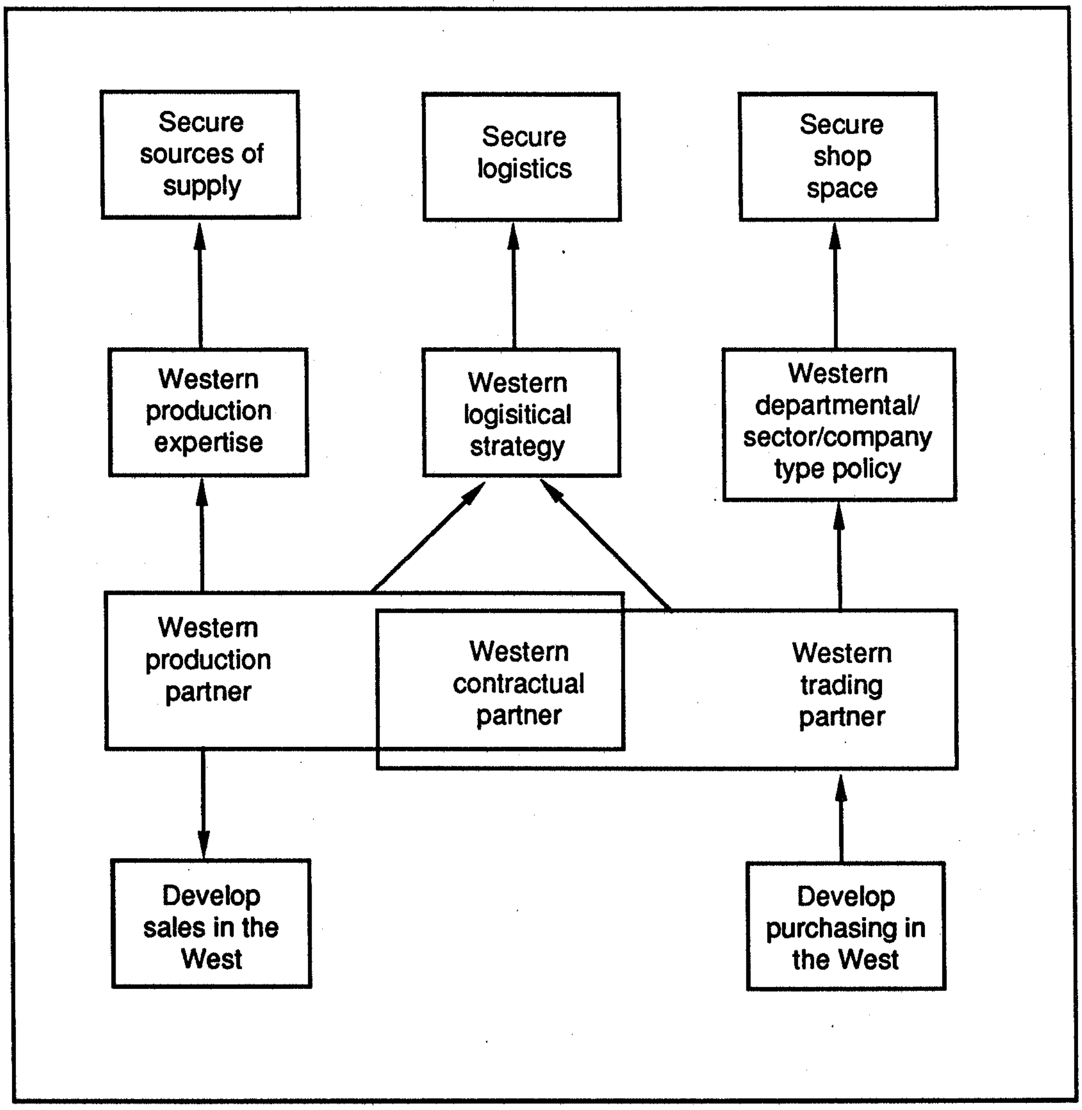
The constraints of complementary products should also be borne in mind. For example, tractors with powerful engines cannot be coupled to agricultural machinery designed for tractors with a low engine capacity.

Integrated strategies

From the outset any company wishing to trade in Eastern Europe must develop an integrated strategy which takes account of all purchase and sales conditions.

Summary 3

The Development of a Trading Organisation in Eastern Europe



iii. Management Strategies for Western Companies in Eastern Europe

In terms of management structures there are differences between developments in Eastern and Western Europe:

1. in Western Europe, there is increasing centralisation of market-oriented decision-taking, with divisional structures having control over regional structures;

2. in Eastern Europe, orientation is primarily on a country basis, with regional structures having supremacy over divisionalisation.

This variation is explained by the fact that the markets are worked differently and with different intensity.

One word of caution, however: unless there are mass markets or niche dominance, the principles of divisionalisation should not be followed slavishly. Excessive divisionalisation can represent self-inflicted wounds.

Project management for Eastern Europe

Standardisation in Western Europe has resulted in a logical shift from a country-based philosophy to one based on country groups or on Western Europe as a whole. However, in Eastern Europe there will be differences in the way individual countries develop and in the way they cast off their former COMECON links and develop their own national structures. This means that any strategy should be country-based, at least for the next decade.

Admittedly the products to be sold in all East European markets can be very similar. However, the way the market is approached and the marketing strategy adopted should vary from country to country. In all cases it will make sense to assign separate project/working groups to each of the countries in Eastern Europe where a company is already present or intends to be present in the future.

Because of the speed with which change occurs, changes in direction cannot be assessed from abroad. A qualified management team must be developed in each country. Every company must employ East European specialists who have permanent contacts in the country in question.

The role of any management team is as follows:

Summary 4

Role of Management Teams in Eastern Europe

1. Contacts

   i. Foster contacts with national, regional and local authorities and administrations;

   ii. Foster contacts with trading organisations with potential for co-operation or integration;

   iii. Foster contacts with the increasing number of specialist released by state institutions as a result of deregulation;

   iv. Rigorous development of contacts with all scientific institutions in Eastern Europe with a bearing on trade.

2. Structural activities

   i. Prepare development programmes with the relevant companies and enterprises concerned with:

      a) trading;
      b) production, to support the trading activities;

   ii. Prepare contracts for such development programmes.

3. Operational activities: Prepare operational activities in line with agreed policies

   - own projects;
   - joint projects.

4. Financial activities: Secure required finance.

5. Budgeting: Rolling budgets extending over several years to cover the activities in any given country.

8. RETAIL STRATEGIES FOR WESTERN COMPANIES IN EASTERN EUORPE

The most sensible policy for retailers will probably be to start with city and urban outlets and gradually extend to rural areas. There is much to be said for coming to an arrangement with existing state trading organisations and co-operatives, so that existing capacity can be utilised for both food and non-food retailing.

Because of limited product ranges and the existing level of supply it is unlikely that the establishment of large food outlets will be an overriding priority.

Even during the initial phase the development of specialist markets can be successful, particularly in locations where a specialist market can be linked to a non-food self service department store acting as an anchor store. Discount stores will be particularly welcome.

Most active Western Countries in Eastern Europe

Precise information on which West European retailers have moved into Eastern Europe is hard to find and, moreover, becomes out of date quickly. The Corporate Intelligence Group in London, however, published in September 1991 a report on 'Cross-Border Retailing in Europe', in which it identified 77 Western retail operations that had moved into Eastern Europe. German retailers had been by far the most active, accounting for 25 of the 77 operations, followed in order of importance by Italy (14 operations) and Austria (13 operations). No other Western country came near to this level of activity.

Table 12. Foreign Retailers in Eastern Europe by Country of Origin, 1991

Country of Operation	Host country Bulgaria	Czechoslovakia	Hungary	Poland	Romania	USSR	Yugoslavia	Total
Austria	-	3	5	1	-	1	3	13
Belgium	-	-	2	-	-	1	-	3
Denmark	-	-	-	1	-	-	-	1
Finland	-	-	-	-	-	1	-	1
France	-	-	-	3	-	3	-	6
Germany	3	2	8	4	-	6	2	25
Italy	1	2	2	2	2	3	2	14
Netherlands	-	2	-	-	-	-	-	2
Spain	-	-	-	-	-	-	1	1
Sweden	-	1	1	1	-	1	1	5
Switzerland	-	-	1	-	-	-	-	1
UK	-	-	1	1	-	1	1	4
USA	-	1	-	-	-	-	-	1
Total	4	11	20	13	2	17	10	77

Source: Cross-Border Retailing in Europe, The Corporate Intelligence Group

Most attractive retail sectors

The retail sector that has attracted the most attention from Western retailers is clothing. The report from The Corporate Intelligence Group showed that the fashion/clothing sector in fact accounted for one-third of all the moves into Eastern Europe (23 of the 77 moves identified to date). Next in order of importance came mail order or catalogue selling (11 moves), food and groceries (9 moves) plus supermarkets and discount groups (6 moves) and department stores (8 moves). The full analysis is as follows:

Table 13. Foreign Retailers in Eastern Europe, analysed by Retail Sector, 1991

Retail Sector	Country Bulgaria	Czechoslovakia	Hungary	Poland	Romania	USSR	Yugoslavia	Total
Clothing/fashion	1	4	6	3	1	6	2	23
Grocery	-	1	4	-	-	3	1	9
Supermarkets/ Discount stores	-	2	-	2	-	-	2	6
Total food	-	3	4	2	-	3	3	15
Mail Order/ Catalogues	1	2	2	1	-	3	2	11
Department Stores	2	1	2	1	-	2	-	8
Furniture/Household	-	1	1	2	-	1	1	6
Footwear	-	-	2	2	1	1	-	6
Health & Beauty	-	-	-	1	-	1	-	2
DIY	-	-	-	1	-	-	-	1
Miscellaneous	-	-	3	-	-	-	2	5
Total	4	11	20	13	2	17	10	77

Source: Cross-Border Retailing in Europe, The Corporate Intelligence Group

A full list of the retailers concerned is contained in The Corporate Intelligence Group's report.

Franchising

One suitable approach for Eastern Europe may well be to invest in efficient franchise systems. This could offer rapid expansion prospects, even within the framework of existing state trading organisations and co-operatives.

The concept of franchising includes many features which are not unknown in a centrally-planned economy. The concept will, therefore, be more easily understood. The customary commission element included in franchising schemes will, for example, be acceptable.

As an example of such a development, Leclerc has started to train Polish entrepreneurs to open their own shops in Poland. In addition, the Italian clothing group Stefanel has signed an agreement with Universal, a Romanian retail group company, to establish a chain of franchised clothing stores. Stefanel already has one shop in Bucharest. The plans are to have seven franchised units at the end of this year and a chain of 60 shops within three years.

Direct selling by West European manufacturers

Manufacturers from Western Europe are already active in Eastern Europe, either on their own or through joint-ventures.

As examples of this, BSHG, the Munich based Bosch/Siemens household equipment company, has opened shops in Belgrade, Split and Zagreb in Yugoslavia in a joint venture with Genex; Scholler-Movenpick is seeking to pull the rug from under the feet of competitors like Langnese (Unilever) by selling direct from stalls in East Germany and Eastern Europe.

Another example would be Yves Rocher, which has for ten years had eight employees working in a central department responsible for trade relations with the state-trading countries. This department has been taking care of the entire "Eastern market" from the People's Republic of China to Cuba, from the USSR to Yugoslavia. Business was quite monotonous until the Berlin Wall collapsed. The goods went to trade centres which dominated the distributive channels, had foreign currencies at their disposal and sold Rocher cosmetics in exchange for foreign currencies to customers. Yves Rocher, however, also used barter deals in order to stimulate sales in the socialist countries.

Whenever possible, Rocher also made use of any domestic production capacity that was available. This was based on co-operation or joint ventures. With national currencies a broader circle of female customers was able to buy products at reasonable prices. The range of products was deliberately extended to essential goods, such as soaps and shampoos, in order to avoid the image of a luxury goods supplier.

In Czechoslovakia the goods were sold via a national organisation and paid mostly with the domestic currency. Much of the Polish market has been conquered by Rocher. Most payments are made in foreign currencies. In Yugoslavia the majority of Rocher products go to the duty free shops in the tourist areas. Turnover amounted to 15 million French Francs. In Bulgaria Rocher is extending its popularity by sponsoring sporting events. The USSR is at present controlling 80 per cent of the companies' activities in the East primarily on the basis of barter and clearing contracts.

In Romania first steps have been taken since the "revolution". Rocher admits, however, that the Hungarian market has been neglected because of all the activites elsewhere.

Organic growth by retailers

Retailers can of course opt for a policy of organic growth. In Poland, for example:

Spar	has started a test market operation in the Krakau area.
Otto	is supplying non-food products to 12 Sezam department stores.
Hertie	is opening a small department store in Posen in co-operation with Bovis.
Quelle	is setting up a joint venture to sell a range of products in Southern Poland.

Acquiring Eastern firms

The Austrian group Julius Meinl has acquired a 51 per cent share of the Hungarian food chain, Csemege Trading Company of Budapest, a consequence of the privatisation policy of the Hungarian government.

Csemege is the largest food retailer in Hungary with 119 shops, sales of 15 billion forint (2.3 billion Austrian schillings or $ 190 mn) and 4,300 persons employed. In addition the company has 95 Intourist shops offering Hungarian specialities aimed mainly at tourists.

Julius Meinl was prominent in Hungary before the second World War. Market research has shown that the name Julius Meinl is recognised by 53 per cent of the Budapest population as being synonymous with coffee and quality foodstuffs.

Servicing Policy

For technical equipment it may well be appropriate to develop service networks which are largely independent of the supplying company. The former repair stations are available as a starting point. This offers the possibility of extending the concept of franchising to technical skills.

Consignment depots and shop-in-a-shop units

The large multiple retailers in Eastern Europe have now established wholesale departments linking with supply depots; for example, the Centrum department stores in Hungary have linked with Moulinex in France and Media Markt in Germany. In addition franchised departments and shops-in-shops have been introduced in some stores, e.g. Ardek EG, Germany, selling clothes for children and teenagers.

Through its subsidiary Eduscho Osterreich GmbH, Vienna, the Bremen based company Eduscho has set up a joint venture company in Budapest - Eduscho Budapest GmbH. Alfa Mozaik AFESZ, the Hungarian food production and distribution company, has a 50 per cent stake in the joint venture. Initially three sorts of coffee, "Gala", "Wiener Gold" and "Mokka

Grande", are to be sold through food and restaurant outlets. In addition a separate distribution network consisting of Eduscho branches and Eduscho depots will be developed using the West Germany structure as a model. Eduscho reckons that coffee consumption, currently running at 4 kg per head, could double in Hungary in just a few years.[8]

Tchibo decided to go east by producing coffee jointly with government-owned enterprises. Thus Tchibo Praha is producing the brand "Le Cafe" in Czechoslovakia. Similar methods are being applied in Hungary, Poland and Yugoslavia.

Direct marketing in Eastern Europe

Mail order and direct marketing operations should be able to achieve a good market share within a very short time, either with or without facilities locally, particularly if customers are also offered instalment terms.

Avon, the cosmetics company, which is already represented in over one hundred countries and which employs some 1.5 million consultants, entered the Hungarian market in 1990. Its policy is similar to that adopted in other countries i.e. products can be obtained exclusively from an Avon consultant who sells direct. About 220 products are offered at reasonable prices with payment in Hungarian Forints. The Avon catalogue has been reprinted with 32 pages in Hungarian. Orders are processed and dispatched from the Head Office and Production Plant of Avon Cosmetics GmbH Deutschland at Neufahrn near Munich. In addition a separate sales organisation has been set up in Budapest. Market research has estimated that personal spending on cosmetics in Hungary is about DM 200 billion. Avon is reckoning on a market share of between 5 and 10 per cent.[9]

Suppliers with a fixed base are also involved, at least in the catalogue/campaign business; an example of this would be the campaign launched by Konsum/Interbuy in co-operation with the Association of Consumer Co-operatives (VdK) in East Germany to sell TV sets.

Financial services

The "unleashing of consumer credit in Eastern Europe" correctly predicted by Helmut Wagner of ASKO, (i.e. the widespread willingness of the individual to incur personal debts), also creates a need for suitable financial services and banking products in Eastern Europe, offered in co-operation with Eastern and Western banks.

Mail order

Neckermann Versand AG has been active in Hungary since 1987 where it co-operates with the trading organisation Skala Coop/Skala World Trade. In 1990 it launched a 16 page, four-colour brochure in Hungarian for the Hungarian market. 500,000 copies have been distributed. It contains a range of 80 hardware products. The customer can order the goods in writing or by telephone from the Neckermann sales office in Budapest. The goods are delivered direct to customers irrespective of where they live.

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8 See non-attributed article: Eduscho goes to Hungary in the Lebensmittel journal, 42nd Year, 6th July 1990, No. 27, page 18.

9 See non-attributed article Avon - now in Hungary also published in the Direct Selling Bulletin 1990, No. 3, page 14.

As well as from the traditional sales outlets - shops, collective purchasing and gift services - customers have since 1989 been able to order products direct from the Neckermann AG, Frankfurt, head office using a screen. Via a link to the Neckermann Accounting Centre customers can obtain immediate information on delivery dates enabling them to place an order and receive an immediate confirmation of delivery.[10]

CONCLUSIONS: THE DEVELOPMENT OF BUSINESS IN EASTERN EUROPE

Currencies are not stable and are not convertible. These factors, combined with the chronic shortage of foreign exchange associated with indebtedness, make it difficult to assess the economic potential of any involvement in Eastern Europe. However, the attractiveness of markets in Eastern Europe is determined less by the current economic structure and more by the speed and intensity of the liberalisation process.

There is overwhelming evidence that the first major upturn in Eastern Europe will be in the wholesale trade, which may well exert a dominant influence over both the supply industry and retailing in the initial phase. At the same it should be possible to develop the retail trade by using existing companies or by developing land already in use. The opening up of Eastern Europe by trading organisations will be characterised by a twin dynamism:

1. the wholesale trade as joint developers with industry and promoters of domestic and foreign markets;

2. the retail trade, ensuring that the consumer is supplied with products commensurate with market demand.

Important developments in this respect are:

1. The considerable head start enjoyed by companies already active internationally in Western Europe;

2. The trend towards reciprocity between partners in the West and East, through the medium of joint ventures;

3. Close strategic alliances between West European banks, insurers and other service providers and production and trading companies in Eastern Europe.

Several countries, in particular the Soviet Union, previously neglected the import of consumer goods despite the weaknesses of its own consumer goods industry. It is, therefore, important to use trade to encourage the development of an independent, viable consumer goods industry in Eastern Europe.

The implication is that West European trading companies must seek to overcome the one-sidedness and over-specialisation associated with both industry and the distributive trades.

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10 See non-attributed article: Neckermann launches mail order catalogue in Hungary published in Horizont, 1990, No. 44, page 21.

Every company must concentrate on achieving a maximum level of self-sufficiency fairly quickly. This means that trading organisations from Western Europe must also establish contact with industrial companies from Western Europe and encourage them to grant licences in Eastern Europe or to pass on expertise to East European partners. This will ensure that goods acceptable and exportable to the West can be offered as quickly as possible on the domestic market and then made available for export as well.

Such considerations as these show that successful involvement in Eastern Europe will require major networking; i.e. there will be companies who will manufacture westernised goods in one production shift or within the production department of an existing company. These goods will be sold partly at home and partly abroad. As the materials for such goods, for example in the textile and shoe industry, cannot be produced in Eastern Europe, they will have to be imported from Western Europe into Eastern Europe during the initial phase.

The involvement of western companies in solving logistical problems will be far greater than one would have assumed at the outset, because poor logistics are a root cause of bottlenecks in Eastern Europe.

A major emphasis must be placed on the training of local managers. Several West European companies have started training programmes running for several months in which managers from the East are trained in the West.

West European companies must be wary of under-estimating the cost of an involvement in Eastern Europe. Any company that decides to trade in one or more countries should set up a firm budget covering a period of several years. It must assume that the return on both market investment and the investment in the trading infra-structure will take several years to materialise.

Despite these enormous problems entrepreneurial initiative is the only way to make a contribution towards increasing the pace of economic development in Eastern Europe, the only way to secure peace in the Northern hemisphere and to create a framework in which the problems of developing countries and the threatening North/South conflict can be solved.