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1 Introduction

There is a widespread movement of economic reform in former Soviet type economies towards market economies but economics does not yet provide adequate assistance. Transition economies are a complex and new chapter of economic theory.

The economic theory of developing countries has become relatively well established since its first basis was formulated in the forties and fifties. There is an abundance of older literature on the Soviet economic system. The economic theory of market equilibrium has been elaborated in many different forms since Adam Smith's Inquiry into the Nature and Causes of the Wealth of Nations of 1776. The elements of these theories can help to build the economics of transition. Its task is to grasp the essence of changing economic relations in the transformation of former centrally planned command economies into free market economies with entrepreneurial capitalism.

2 Characteristics of Command Economies

Soviet type economies or centrally planned command economies are very different from free market economies (see the many studies by Jan Winiecki). Important characteristics of centrally-planned command economies are the following:

- **Central planning** means central allocation of production factors. However this allocation is based upon unreliable statistical information. Thus adjustments are almost certainly necessary.

- **Continuous wage drift** takes place within the framework of rigid income structures. Highly subsidised prices are administratively fixed.

- **Public ownership** of land and other productive assets are mostly organised in large state enterprises even in the agricultural sector. Uncertainty in the production processes leads to excess equipment and excess stocks.

- **Over-emphasised heavy industries** are managed in a technocratic way. Lack of market incentives causes absence of any inducement of product innovation in all sectors except military production.

Command economies in Central and Eastern Europe and the Soviet Union, have become economies in which the gap between the real economy (production, consumption, capital expenditure, employment) and the monetary (money supply, interest rates, deficit financing etc) became larger by the day. This gap has to be bridged.

3 Towards Open Market Oriented Economies

In his recent book on transition Janos Kornai defines some of the characteristics of the free market economy.

It is characterised by
. competition;
. unhampered entry to, and exit from the market;
. private ownership;
. stimulation of individual initiative.
The free market economy is surrounded by an environment of institutional structures, protected by enforceable laws and embedded in a democratic political order.

This definition reveals at least two important elements: First, the unavoidable link in the economics of transition between economics and politics. Second, the need for an infrastructure for market processes with its own checks and balances.

3.1 Political Economy

The definition shows that a free market cannot be developed without basic democratic features such as individual freedom of speech and initiative and private ownership protected by enforceable law.

As is stressed in Window of Opportunity, the so called Yavlinsky-Allison plan of June 1991, economic reform cannot be sustainable without political reform and without political reform the economic reform cannot be effective.

The existing situation in Central and Eastern European countries proves this without any doubt. The economies in those countries have been dominated by a command structure that encompassed the political as well as the administrative and legislative branches of government. This command structure was not only all embracing, but was also for many decades in the exclusive hands of one party: the Communist Party.

The command economy was based on a concept of top down orders. Very detailed plans were drawn up on physical input and output in state enterprises and the allocation of resources was planned accordingly. Most of the production was organised in large units. Input and output were allocated centrally. Prices did not matter at all.

This administrative machine has been in charge of economic planning for many decades. At every stage of the economic process the strong grip of the administration, i.e. the Communist Party, was felt.

Against this background reforming the political and administrative system is a prerequisite for change of any element in the economic system. Trying to implement a market economy whilst maintaining the pre-existing power structure in the Central and Eastern European countries is impossible and unthinkable, as recent experience in the Soviet Union has shown.

The Agreement establishing the European Bank for Reconstruction and Development presents the Bank's vocation in fostering open market economies and the principles of multiparty democracy and pluralism in Central and Eastern Europe. This combined mandate is certainly new in the world of existing International Institutions, where political consideration in operational policies is generally explicitly forbidden. In the view of all the Signatories: 39 countries including all Central and Eastern European countries and 2 International Institutions, the successful transition to market economies is closely linked to parallel progress towards democracy. The resources of the European Bank can only be used in countries applying these combined principles.

3.2 Market Economy, a Complex System

Another aspect of the presented definition of a free market economy deals with the complexity of the free market economic system. The reference to institutional structures, protection by the rule of law, etc. indicate that there is more than a simple market process where supply and demand meet and fix equilibrium prices. Too little attention is paid to this aspect in many discussions and many well meant pieces of advice.

In a way the economics of transition have again revealed the complexity of the system of a free market economy. Market economies of today encompass a great number of restrictive elements preventing them from functioning according to the law of the jungle.

Market economic systems are surrounded by at least three overlapping circles:

- the circle of legislation and regulation on national and sometimes supranational level;
- the circle of self regulation in sectors and branches;
- the circle of business ethics.

These circles of control mechanisms are important for the functioning of existing market economies. They are the result of a long historic process of experiencing errors and sometimes excesses.

Some of the evident examples of market environment legislation are:

- fair competition legislation and anti trust laws;
- laws on consumer protection and product liability;
- labour laws on the protection of the basic rights of workers (hiring and firing) and their working conditions;

- social security legislation organising a substantial redistribution of income and limiting some of the potential adverse consequences of enterprise failure;
- bankruptcy laws, including protection of creditors' rights;
- financial sector legislation such as banking laws and supervision of the insurance sector.

Apart from those laws, additional systems of self-regulation, in particular in the financial sector have been developed over the last decades. For instance, Stock Exchanges regulate the conduct of the business of their membership and use strict compliance rules.

Strong associations and trade unions have acted as platforms for discussion on business ethics. Trust and honesty are vehicles for recurrent transactions in competitive markets. Corruption and competition do not go very well together.

Reform programmes for the transition of command economies to market economies have strong commitments to liberalise markets. However, the embedding of these programmes in a framework of checks and balances must be part of the reform plan.

4 Elements of Transition

In its recent study on the transformation of economics in Central and Eastern Europe, the World Bank staff presents an interesting table of economic elements of transition.

The main items are:

- macroeconomic stabilisation;
- price and market reform;
- private sector development, privatisation and enterprise restructuring;
- redefinition of the role of the state.

These issues will be briefly commented on below.

4.1 Stabilisation Policies

Macro economic stabilisation policies encompass programmes that are aimed at reducing the excesses of the command economies, in particular in the areas of fiscal policy and monetary policy. The fiscal situation in most Central and Eastern European countries has been distorted by the impact of their political and economic system: Budget expenditure for defense purposes was enormous, especially in the Soviet Union where it exceeded 25% of GDP. The system of administrative prices was supported by huge price subsidies for almost all basic consumer goods. The revenue of the government budget was inevitably most of the time unpredictable and weakly based.

Apart from a levy on hard currency exports outside the communist region, the main elements of government revenue were turnover tax and taxes on the net income of state enterprises (including sales of natural resources and energy exports). The vulnerability of these revenue sources for the effects of the economic cycles and wage pressures is self evident.

Resulting budget deficits have been growing over the recent period. These deficits were largely financed by monetary means.

The monetary situation has been largely characterised by lack of effective control. Liquidity in the economies has been growing substantially faster than the availability of marketable goods with their fixed prices. This resulted in a situation of a huge so-called monetary overhang; a situation in which the theoretical purchasing power of available money in the economy exceeds the value of the supply of goods and services for sale.

The administratively fixed price system with its built-in subsidies kept this situation of monetary overhang very much alive. Such a monetary situation is incompatible with flexible market prices and freely convertible currencies. The monetary overhang destroys domestic convertibility: The money has no real exchange value for domestic trade as it does not reflect real purchasing power. Thus convertibility based on an exchange rate of one currency for another, is even further off the course of economic reality.

The economic situation in most of the countries led to the need for substantial western imports financed by credits. The external debt of almost all Central and Eastern European countries, with the exception of Rumania and to a lesser extent the CSFR is therefore towering.

The monetary situation can also be characterised by a lack of control over domestic credits. The banking system was in government hands. Credits to enterprises were most of the time not based on sound banking principles but were a result of the planning process and governed by the administrative bureaucracy. Interest rates charged for credits were unrealistic; repayment of loans was rather the exception than the rule. The impact on the monetary situation was disastrous, especially if on top of this the monetary financing of budget deficits is taken into account.

A tough policy to tackle this and gain control over the monetary and fiscal situation is a clear priority. Some of the countries, for instance Poland, have put together stabilisation programmes as integral parts of their reform programmes. This is a harsh way, especially within an overall recessionary world economy. Demand reduction and enterprise restructuring cause high unemployment.

For some of the other countries, the timing of the stabilisation programme: before, parallel to or after the reform plans, has been a topic of discussion. There are pleas to organise large-scale stabilisation programmes with international aid preceding the actual reform of the economy to buy social peace and popular support.

Economic factors argue for reform before or at least parallel to an economic stabilisation programme. Stabilisation within the old economic system tend to delay the necessary reform at somebody else's expense.

The conclusion must therefore be that macro economic stabilisation must be part of a reform plan; it is an integral part of the economics of transition.

4.2 Price and Market Reforms

Price and market reform form a second category of essential measures in the transition programme. Key elements are:
- price liberalisation;
- liberalisation of labour and capital markets;
- financial sector reform.

Under the price system, prices, particularly those of consumer goods and of raw materials (natural gas, oil, metal, etc.), were set administratively. In some countries of Central and Eastern Europe the prices of basic food products are still governed by this system. Administrative prices require an elaborate system of state subsidies for the production of goods.

Of course the introduction of a market economy requires the dismantling of the system of state orders and the removal of administrative prices and subsidies. The resulting steep increase of prices will help in a harsh way to reduce the monetary overhang. One of the prerequisites for competitive markets of goods and services is the undisturbed supply of goods. Market reform to reduce the impact of monopoly state industries must facilitate market access and encourage the supply of goods and services. The effect will be that sometimes irrationally kept excess stocks, based on the uncertainty of continuous supply, will disappear.

Some of the elements of price and market reform relate directly to the rigid labour market and wage control system in a complex interdependence. Only if the factor markets, markets for labour and capital, are restructured and liberalised, can the prices of some services be freed as well. For example, the price for housing, the rent, is set in the context of a rigid wage policy, narrow wage ranges and the employment of both men and women. The same applies to the level of interest rates on the capital market. This system of phantom prices for factors certainly does not promote efficient allocation of production factors.

The necessary reform of the financial sector is another priority within the market reform programme. The role of the Central Bank must be redefined and focused on monetary policy and bank supervision. Commercial banks must be established, applying sound banking principles. Other financial institutions, such as stock and commodity exchanges, insurance companies, etc. would create a system with supportive and distinct channels for financial transactions in a market economy.

In many of the Central and Eastern European countries new banking laws based on a two-tier banking system have been established: a central bank or central banking system setting monetary policy and exercising bank supervision on the one hand and independent commercial banks providing credits to market agencies on the other.

4.3 Private Sector Development

Private sector development, privatisation and enterprise restructuring are presented as a third cluster of measures to be taken in the transition process with:

- establishment of efficient property rights;
- demonopolisation and promotion of competition;
- privatisation and
- restructuring of state enterprises including conversion of defence industries.

In most countries in Central and Eastern Europe property rights were defined on the basis of "socialist" ownership, such as state ownership of land and state enterprises. Private ownership was mainly restricted to personal and household goods.

In the reform plans in most countries the introduction of full range private ownership of all sorts of assets, including private ownership of land, is an essential element.

Demonopolisation of the existing enterprise structure must be undertaken as soon as possible to build markets. This implies the breaking up of existing monopolies and the promotion of competition between enterprises. Competition requires free access of new enterprises to markets. Commercialisation and transformation of existing state enterprises are supporting actions.

Privatisation is at the core of the reform. It must be noted that privatisation does not restrict itself to only a change in ownership. It requires a change in management followed by competitive marketing of goods.

Conversion of defence industries is an important and complex issue. Large defence industries exist in almost all Central and Eastern European countries, especially in the Soviet Union.

Conversion will be a very difficult and long-lasting process. This is the case not only on the basis of an assessment of the enterprises involved, but also because defense industries are most of the time complexes of industries, military facilities, related infrastructure and urban settlements. These complexes are sometimes very difficult to transform for civil application.

4.4 Redefinition of the Role of the State

The redefinition of the role of the State is a conditio sine qua non. It involves legal reforms on the constitutional level, reform of legal institutions and information and control mechanisms (accounting, audit). Social security legislation is a complementary element in the total reform package.

Legal reform in constitutional terms is a vital element of transition from the command economy to a free market economy. The economic planning in command systems required a very strong centralised apparatus. So the transition process cannot take place without an enormous shift in power. This power shift reduces the role of the centre and enhances the responsibilities of other authorities and agencies. Without this a market economy is not feasible.

Reform of legal institutions is encouraged by the substantive power shift from central government to other authorities. For example, the banking legislation, formerly based on full state control and therefore on integration of monetary and credit policy, must be changed. A new system requires separate responsibilities for earlier combined functions, such as monetary policy, banking supervision, credit policy and solvency requirements, lending and borrowing, etc.

The reformulation of rules and regulation for economic activities is an essential part of the reorientation of the role of the state in the economy. Stability in the legislative environment is a precondition for favourable economic and entrepreneurial developments.

Accounting rules and regulations for audit of financial reports are vital elements in market economies. Where they do not yet exist, a well balanced system with clear responsibilities for company management and supervisors, including external auditors must be formulated.

Social security is an essential element in a well-developed market system. In command economies, social security functions were seen as part of the responsibilities of state enterprises. Officially, unemployment was non existent. These responsibilities must now be transferred to publicly administered agencies for social insurance, such as unemployment insurance, health insurance, old age pensions, etc.

5 The Path of Transition

The path of transition is designed by its starting point and its destination: i.e. where the countries are and where they want to go to. First, the study of the starting point and awareness of the current economic situation in micro terms is important, e.g. the existing industrial structure. Second, a rough sketch of the ultimate goal and the desired structure of a new system of free market economy and multiparty democracy can help successful reform.

5.1 From Obsolete "Assembly" Economies...

The sectoral composition of most Central and Eastern European economies is obsolete in comparison to developed market economies. The agricultural sector is disproportionally large; the industrial products are not up to present standards. First, the enormous amount of money spent on Defence has lead to huge military non market production. The
Defence industries form the privileged core of industrial production. Second, the other heavy industries are over-emphasized. Statistics available on industrial

production and exports show that steel, rolled metal, spare parts, machines and tractors form the main part of the industrial output.

The service sector is relatively underdeveloped. The command economies generated only limited demand for important parts of the service sector: commercial banks were not needed; financing was organised by State owned banks on the basis of the planned allocation of investment and capital expenditure. Furthermore, central planning by-passed the need for all sorts of intermediary functions (brokerage functions, distribution and transport, communication services etc.). Consultancy was evidently not in demand.

On top of this unfavourably micro economic picture the existing industrial structure was very much characterised by another "blessing" of the planning system: the Council for Mutual Economic Agreement (CMEA), the supranational cap of the communist command economics. The system that lasted for more than four decades started on the basis of a political set of goals such as:

- relative autarky within the socialist region;
- commanded preferential treatment of the communist brother countries and
- division of labour and skills between these CMEA members.

On the basis of this overall planning conception, production processes were split up. Separate units for primary production, for further improvement of semi-manufactured articles and assembling units for end products were created on different sites within the former CMEA trade bloc.

All these separated production units were controlled from the centre. Central allocation of resources for production was complemented by centrally managed input and output flows from unit to unit. The whole process was supported by exclusive trade contracts on the basis of currencies that had no real value, e.g. currencies that were non-convertible outside the trade zone.

Therefore the economies in the countries of Central and Eastern Europe and the Soviet Union are strongly interlinked; they depend on each others trade and supplies. This interdependence is not based on efficiency or effectiveness; it is a result of planning conceptions: a "phantom" trade. Moreover the system of commanded supplies has evidently not stimulated innovation.

Thus the starting point for a transition to market economy is not favourable: the economic structure requires major adaptation.

5.2 ....Towards a System That Is Not Uniform or Standard.

The political and administrative system and the economic management in all countries of Central and Eastern Europe looked very much alike. The one party system combining politics, administration and legislation and its central economic planning was standard throughout the whole region.

The ways in which developed democracies and free market economies have structured themselves differ substantially. All existing patterns nowadays are certainly the product of long histories and cultural changes.

Although the separation of the executive and legislative branches of government is essential in western style democracies, the way the democratic system is designed looks different in individual countries. For example, in constitutional terms, the Head of State in France (the directly elected President) has a very dominant executive role and presides over the Council of Ministers, where in the United Kingdom (hereditary monarchy) and in Germany (indirectly elected President) the Head of State has a very limited non-executive role.

In most countries there are two chambers of representation, always one on the basis of direct general elections. However most of the time the election system is not comparable and therefore the way in which the multiparty aspect of democracy has been formed is different. The United Kingdom has basically a two party system. In Germany three (or rather, four?) political parties dominate the scene. In France, as in many other Western European countries, the number of political parties sometimes grouped in political blocks, is substantially greater.

In economic terms the landscape of developed market economies looks very different as well. All Western European countries can certainly be characterised as free market economies. However economic policy and macro management, income redistribution, for instance through social security, the industrial structure and nationalised industries, etc., differ from one free market economy to another. These phenomena function in their own right in the different environments (see Joseph Stiglitz).

If the importance of the public sector in an economy can be measured by the percentages of the public expenditure, the differences are quite substantive. Public expenditure in France and in Germany was close to 50% of GDP in 1989; a comparable figure for the Netherlands was 60%. In the United Kingdom public expenditure was only 40% of the GDP in 1989. In the area of income redistribution through the social security systems, similar differences can be observed: France paid 22% of GNP on social transfers, Germany only 16% and the United Kingdom even less at 14% of GNP in 1989.

The different role of the State in these economies can also be illustrated by the extent of state ownership of industries and enterprises. In France a substantial part of industry is nationalised not only in the public utility sector. In the banking sector all the major banks were nationalised in 1981. Some basic industries such as the chemical and automobile industry have larger state enterprises. In contrast to this, recent developments in the area of privatisation in the United Kingdom have shown a completely different picture. There even the public utilities have been denationalised or privatised in recent years.

Macroeconomic management differs substantially as well. In France economic planning is a prominent part of government policy. In the United Kingdom, interference in the economy by the State is regarded as ineffective.

Starting from a relatively uniform command system the need for formulation of the ultimate target is important. The path of transition has be to indicated in order to make the process of reform transparent for everyone, both abroad and at home.

6 Transition Economics, Challenging Complexities

Transition economics require mind boggling exercises in political economy. It is a very complex subject of economic policy and economic theory. Transition economics call for substantive input from all chapters of economic theory: from macroeconomic and monetary theory, from microeconomic theory, from theories of public finance, comparative economic systems, industrial relations, public choice, from human capital theories and welfare economics and many other chapters of economic theory. It cannot be emphasised more: Transition economics require a profound study of the market economic system.

All the elements for transition economics require independent and further study. However, the following three aspects seem to be prominent:
This short survey does not do justice to the profound problems and the complexity of the process. However, it hopes to illustrate its complexity and the interdependencies between issues.

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