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ECONOMIC CRISIS IN EASTERN EUROPE : PROSPECTS AND REPERCUSSIONS

by

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Summary

Since the mid-seventies a crisis has developed in Eastern Europe and the Soviet Union. This paper reviews the symptoms of the crisis, grouped under i) deterioration of growth performance, ii) external imbalance, iii) internal imbalance, and outlines an explanatory model of the functioning of Soviet-type economies, which embodies their specific systemic features (in particular the centralisation of political power and economic decision-making, and the systemic commitment to economic growth, full employment and price stability) and is capable of generating economic and political cycles of the kind experienced by Eastern countries. The implications for East-West relations are also considered; the combined effect of economic crisis in both systems is claimed to be exercising a positive influence on those relations, especially in Europe.

ECONOMIC CRISIS IN EASTERN EUROPE : PROSPECTS AND REPERCUSSIONS*

Domenico Mario NUTI

1. Introduction

There is an old Polish saying that the main advantage of socialist planning is that it solves successfully all those problems which without socialist planning would not arise. This may appear as an instance of Polish cynicism but in reality is both an understatement and an overstatement. It is an understatement because it neglects the contribution of socialist planning to the industrialisation, urbanisation, price stability, full employment and social progress of one third of the globe; since the last War there has been no period in which the growth of income and industrial output in the socialist countries (or "centrally planned economies" in United Nations parlance) as a group has been exceeded by the groups of advanced capitalist economies or developing countries. It is also, however, an overstatement because the development process of socialist countries has generated new problems, conflicts and contradictions which the system has not yet been able to solve. Since the mid-seventies a crisis has developed in Eastern Europe and the Soviet Union, not only in the broad sense of deterioration of economic performance, stagnation or even decline, but in the stricter sense of a phase of a cycle, due to the relative weight of demands and resources, and deeply rooted in the specific systemic features of these economies, namely the centralisation of political power and economic decision-making, and the systemic commitment to economic growth, full employment and price stability.

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* A lecture given at the European University Institute, Florence, on 20 April 1982.

In my lecture I review the symptoms of this crisis, outline an explanatory model of the functioning of these economies and how they generate crises; I then consider the implications of current trends for the West in general and Western Europe in particular.

2. Symptoms of economic crisis

In its most spectacular form economic crisis has manifested itself in Poland: accelerating decline of income, down by 15 per cent in 1981 and still falling, 40 per cent unutilised capacity and rising redundancy of labour, mounting external indebtedness of the order of $ 30 billion with over 100 per cent debt-service ratio and de facto default in international financial commitments, open and repressed inflation at accelerating rates, endemic and growing shortages, rationing and queues, the collapse of the central management of the economy. The economic crisis gave rise to massive political unrest, the conquest of political rights unprecedented in Eastern Europe, and then military rule. Let me say now that Poland is a unique phenomenon deeply rooted in a thousand years of national history and not to be repeated in the foreseeable future in the rest of the socialist commonwealth. But the same kind of symptoms, to a lesser and varied extent, have manifested themselves throughout the area, and can be grouped under the headings of: i) deteriorating growth performance, ii) external imbalance and iii) internal imbalance; with equally important political implications, though less drastic than in Poland.

i) The deteriorating growth performance is clear from yearly plans in 1976-81 envisaging income growth rates lower than originally postulated in the five year plans, and at a decreasing rate over the period; and from actual growth rates being systematically lower than planned and also recording a decreasing trend over the period. The only exception is 1977 in Hungary and the German Democratic Republic, where plans slightly more ambitious than in the previous year were realised. It is true that Bulgaria and the GDR maintained their growth, in spite of plan underfulfilment, around the appreciable rates of 6 and 4 per cent a year; but the slowdown was much steeper in other countries (in 1981 growth rates were 3.1 per cent in the Soviet Union, 2.1 per cent in Romania, 1.8 per cent in Hungary, 0.2 per cent in Czechoslovakia) and negative growth was recorded not only in Poland in 1979-81 but also in Hungary in 1980 (-0.8 per cent), far from the earlier record, five year plans and scaled down yearly targets. Identical trends can be found in industrial production; while agricultural output, which in the ten years up to 1983 had increased at an average 5 per cent per year, in the following five years slowed down to 3 per cent, declined in 1979, to recover slightly in 1980-81. Current plans confirm these trends.

This deteriorating growth performance is particularly disappointing in view of the massive accumulation of capital undertaken throughout the area, with the share of gross capital formation in national income rising until the mid-1970s up to levels of 30-40 per cent, with peaks of 45 per cent (Poland 1975), and the policy of technology transfer from the West pursued by means of massive imports of machinery by the Soviet Union and other countries (especially Poland and Hungary, though much less so by the more advanced GDR and Czechoslovakia).

The mirror image of this performance is the generalised increase in capital/output ratios, the slowdown and occasional fall in labour productivity, the increasing inefficiency in the allocation of resources. Microeconomic inefficiency has always been a widely recognised feature of the socialist economy, thought to be compensated for by macroeconomic rationality, but the suggestion of increasing overall inefficiency is substantiated by the observation of increasing overcapacity, i.e. unemployment of capital, the dispersion of investment means over a widening front of unfinished projects, and unused or even uninstalled machinery (subject to obsolescence and physical deterioration) often imported at great expense (Poland, Czechoslovakia). There are other concrete indications of increasing inefficiency, such as the continued growth in energy consumption per capita, at 3.2 per cent per year in 1974-78 (with respect to 3.6 per cent in 1971-73), whereas in the same period it fell by 0.2 per cent in developed market economies (with respect to 3.1 per cent yearly increase in 1971-73); leading to a consumption of energy per unit of output in CMEA countries roughly double that of OECD countries by the end of the decade; clearly the failure to respond to increasing energy scarcity can only be interpreted as increasing inefficiency.

ii) The second symptom of economic crisis is the widening external imbalance, in the form of recurring trade deficits and mounting cumulative foreign indebtedness. In 1976-81 the trade balance of the six Eastern European countries with non-CMEA countries has been negative every year (with the exception of Bulgaria in 1977-80 and Czechoslovakia in 1980). In 1970-79 the Soviet Union has run trade surpluses with developing countries and slightly smaller trade deficits with the developed West, but since only about a third of its surplus was in convertible currencies it has needed hard currency finance. In 1980 the Soviet Union registered over $ 200 million surplus with the developed West (and $ 2.7 billion with less developed countries) but in 1981 the situation has changed drastically, leading to a $ 3 billion deficit with the West and $ 0.4 billion deficit with less developed countries. Between 1976 and 1981 the total hard currency debt of the six Eastern European currencies more than trebled, to $ 65 billion (about ten times their total debt in 1970s; the prudent limit of 40 per cent debt-service ratio recommended by the IMF was overstepped in 1980 by Poland, Hungary, GDR and Bulgaria, while Poland in 1981-82 and Romania in 1982 have effectively defaulted, though have not been declared officially to have done so. Together with the Soviet Union, also facing a severe cash shortage, total debt exceeds $ 75 billion, while access to fresh credits and even rolling-over facilities is limited by bankers' reluctance to raise their exposure, due to political pressure and loss of confidence in the so-called "umbrella theory", whereby the USSR would ultimately guarantee loans to the entire area. The burden of debt is exacerbated by its time-structure dominated by short-term maturities which have to be renewed at rising interest rates and subject these countries to the continuous scrutiny of their affairs by bankers; and by the combination of inflation and high interest rates which involves "front-loading" or the "bunching" of the service burden in the early years of indebtedness, with respect to the burden which the same real interest rate would have for a lower rate of inflation.

While it is inappropriate to single out individual trade flows in order to explain the rising indebtedness, it is interesting to note the gradually falling energy net export (mostly Soviet), the mounting food deficit (from 1976 onwards in the six East European countries, from 1972 onwards in the area including the Soviet Union), the large scale machinery imports by CMEA countries (quintupled over the 1970s for a cumulative amount of almost $ 100 billion, though slightly declining since 1978), the increasing East European dependence on the West for raw materials and semi-finished products (as well as massive hidden subsidies by the Soviet Union to East European countries through the underpricing of Soviet oil exports to them caused by CMEA pricing rules for infrabloc trade).

iii) Internal imbalance has taken several alternative or simultaneous forms: open inflation; hidden inflation due to forced substitution of cheap products, rationed or simply unavailable, by more expensive substitutes, whether provided by the official or the "unofficial" or "black" markets; repressed inflation, in the form of large and increasing excess liquid balances in the hands of the population, as well as a progressive squeeze on the share of gross profits on turnover. Since the post-war monetary reforms, in 1955-75 open inflation had become an almost forgotten phenomenon in Eastern Europe and the Soviet Union, but in the second half of the 1970s (more recently in the Soviet Union and the GDR) it has returned at slow but increasing pace (especially if hidden price rises are included); though hyperinflationary rates have only been seen in Poland after the military attempted the restoration of monetary equilibrium. The question "Will there be money under communism?" has two alternative answers in Russian folklore: "There will only be money" and "There will be money for some but not for others"; in the last few years socialist countries have come perilously close to both answers, with endemic shortages of essential goods as well as luxuries, and unequal access to scarce goods through either official privilete or unofficial exchange.

In each period the current imbalance between intended expenditure and the mass of goods and services provided for the population, valued at official prices - the "inflationary gap" - is added to the "inflationary overhang" that is the sum of past inflationary gaps cumulated over time. While the precise calculation of intended expenditure (and therefore of inflationary gaps) raises controversial methodological problems, and the mere presence of excess demand (queues, rationing) should not necessarily be identified with repressed inflation (which is an <u>increase</u> in the rate of excess demand) we can nevertheless, from the observed rise in monetary balances held by the population with respect to current income, infer a progressively widening gap between actual and desired monetary balances of the population. Even for a falling inflationary gap the inflationary overhang increases over time, and this cumulative problem exercises a destabilising influence on the orderly distribution of consumption goods and services; shortages have a strong demoralising effect and adversely affect productivity through time-wasting search and queueing and through the weakening of monetary incentives; moreover, they lead to the population hoarding more consumption goods and distort consumption patterns. Sooner or later, through derived demand for competing inputs or through international trade, inflationary pressure spills over from the consumption goods sector to production goods, leading to shortages of supplies to production enterprises. Shortages have a multiplier effect, in that one rouble of missing component may lead to a chain reaction of disruptions in other supplies to production enterprises down the line; this "supply multiplier" effect is growing all the time with the growing complexity of internal and international division of labour, and is only alleviated by a tendency towards vertical integration within the industrial system (which is most advanced in the GDR model but is an observable trend throughout the area). Shortages also promote the growth of the non-socialist sector, composed of a private sector, a straight criminal economic sector, as well as a "second" or "informal" sector in different shades of grey, intermediate between the official private and the criminal sphere, where unplanned (or rather a-planned) transactions take place. This "second" economy, however, is an integral part of the system, which is why it is tolerated and occasionally encouraged. There are innumerable examples of the "privatisation" of state power on the part of people invested with that power, for their own benefit and that of their protegés. The problem is not the excessive power of the state, as claimed by critics of Soviet-type alleged "state capitalism" or "state socialism", but a quasi-feudal fragmentation and devolution of state power, with interlocking small and large fiefs rigidly set in an ossified structure, at odds with social justice and economic efficiency.

The economic crisis and its visible side-effects generate, at the same time, pressure for economic and political change. For a quarter of a century there have been numerous attempts, in the Eastern European countries and the Soviet Union, at relaxing central planning and introducing greater enterprise autonomy; market rather than planned discipline; profit-linked investment and material incentives. The extraordinary thing is that these attempts have not succeeded and reform projects either remained dead letter or failed and were reversed. (The only exception seems to be Hungary, where the so-called New Economic Mechanism was introduced in 1968 and has done relatively well, though the system, even there, has a tendency to revert to the original Soviet-type model under economic pressure). The same thing is true of political reform: economic failure undermines the legitimacy of the system, breeds dissent and leads to pressure for political democratisation and liberalisation; historically moves in this direction accompany, with leads or lags, trends towards economic reform, and also revert towards the authoritarian model sooner or later. Poland, again, is the most spectacular instance of such a reversal.

We now have a number of important questions: Why is there an economic crisis in Eastern Europe? Why is there no stable progress towards economic and political reform? Can the system generate alternative solutions? Or is it doomed?

3. A model of socialist development

Soviet and East-European literature talks of "disproportions" and "imbalances" instead of crisis, and relies primarily on three explanations: i) exogenous factors, such as natural disasters and the world crisis; ii) the wickedness or incompetence of individuals, to be found and punished; iii) the switch from intensive to intensive growth in East-European development. There is no doubt that "crisis" is what these dubious euphemisms stand for, and that the factors suggested while have substantial weight do not add up to a total explanation.

Natural disasters like droughts and floods, ice and heat waves beyond reasonable expectations have taken place and have had an adverse effect (especially in Poland and the USSR) on harvests, building and transport, but they were not so impredictable; moreover their effects have been amplified by persistent underinvestment in these sectors and by systemic problems, especially in agriculture. The energy crisis has affected the export prospects of East European countries but they have shown no flexibility in adapting to new conditions; besides, the Soviet Union is a net oil exporter and directly benefited through its terms of trade, Poland was a net energy exporter and through coal sustained its terms of trade (actually improving them in 1974), and East European countries had at least three years notice before being exposed to dearer oil. The incompetence of decision makers must be regarded as a systemic feature in view of the numbers involved, and a selection system based on party nomination to crucial posts (nomenklatura) instead of professional merit. As for the switch to intensive development, the exhaustion of labour reserves and natural resources has certainly raised the cost of growth and possibly acted as triggering factor for economic problems: however, if this were all it would be difficult to understand why economic reforms have failed to produce a system more suitable to the "intensive" stage of socialist development.

I suggest a more complex model of socialist development which embodies these factors, and others, in a pattern of behavioural regularities, conflicts and contradictions, which are capable of generating a crisis of the type just reviewed, as well as a more attractive potential course. It is a model of the possible "laws of motion" of a socialist system, which applies, among other things, Marxian methods to a Marxian-inspired system, with a vengeance.

The construction of the model procedes from the following empirical observations, or "stylised facts" of socialist development:

i) there is a connection between political centralisation and economic centralisation; to start with the establishment of one-party rule and "democratic centralism" leads to the centralised Soviet-type model; subsequently forms of political democratisation are "associated with" (i.e. without asserting a one-directional causal link) economic decentralisation;

ii) economic centralisation is associated with microeconomic inefficiency in the allocation of resources, for the choice of production methods, their technical application, and the choice of consumption structure;

iii) economic and political centralisation leads to a bias towards capital accumulation. First, at all levels the same urge to accumulate typical of the capitalist system is present, but without the checks and constraints of that system (such as stock market valuation of enterprise assets, takeover bids, bankruptcy discipline). Second, overoptimistic expectations about the system's ability to promote labour productivity raise investment requirements for the creation of new jobs over actual requirements. Third, in the course of communications and interactions between the various agents (Party, Gosplan, Ministries, firms associations and firms) strategies are developed that result in ambitious investment policies.

iv) As long as there are labour and material reserves, the capital accumulation bias of the system generates fast economic growth, outweighing the disadvantages of microeconomic inefficiency and ultimately leading to "full employment", in the strict sense of exhaustion of labour and material reserves (thus, for instance, not only full employment of those willing and able to work, but high industrialisation and urbanisation).

v) at "full employment", so defined, capital accumulation comes up against increasing costs of economic growth; also when the full employment is hit there are echo repercussions throughout the economy which make for fluctuations and some instability. The microeconomic inefficiency of the system becomes more serious, in that at full employment wasting the same amount of labour and materials becomes "more" inefficient than before full employment. Thus full employment adds to pressure for economic reform. In principle, an economic reform could take place, encouraging political democratisation which in turn would encourage further decentralisation and so on until market socialism and socialist democracy are established, in the best of all possible worlds. Why does this not happen? Because the accumulation bias and full employment also have adverse effects:

vi) in the absence of automatic checks, the persistence of accumulation bias at full employment causes overaccumulation. Accumulation can be excessive not, or not only, with respect to the time preferences of the population, or other plausible but intangible benchmarks; accumulation can be said to have been excessive in Eastern Europe and the Soviet Union with respect to the interests of maintainable consumption (investment leading to higher income streams but not higher consumption streams in the future); with respect to the absorption capacity of the system (investment being "frozen" in work-in-progress for longer gestation periods than necessary, or machines uninstalled or unused); with respect to the ability of the system of financing both internally and externally the capital expenditure and the recurring costs of operation; with respect to the preferences expressed by the leadership in their own plans, since often the sum of investment plans adds up to more than the centrally planned level of investment, and those plans are systematically overfulfilled.

Even when investment is slowed down (as in the second half of the 1970s) unless the slowdown is planned long in advance (which it was not) investment continues to be excessive and contributes to excess demand.

vii) Full employment of labour, in spite of wage norms and an incomes policy directed at maintaining broad macroeconomic balance in consumption markets, leads to wage drift (through informal bargaining at the factory level) and adds to excess demand;

viii) the built-in tendencies towards excess demand in both production and consumption markets are aggravated, or alleviated, by the net effects of exogenous factors and their change over time: the volume of world trade, terms of trade, the volume and terms of international loans, defence expenditure, agricultural harvests, the pace of technical advance, the exhaustion or discovery of natural resources. It would require a permanently favourable balance of these factors to offset the underlying excess demand, which is utterly unrealistic;

ix) in view of the systemic commitment to price stability, enshrined in the theory and practice of socialist countries where prices are raised only under the most formidable demand and cost pressure, normally excess demand generates shortages, which cumulate over time and through spillover effects disrupt the system of management and planning of the national economy; shortages and disruption generate pressure towards greater and not lesser centralisation, and the application of war-type methods of rationing, priorities and direct control;

x) the coexistence of pressure to reform (due to inefficiency and instability), shortages and pressure to centralise leads to an impasse: either the pressure to centralise is stronger than the reform drive, and there is no reform, or the reform drive is stronger and a reform takes place in conditions of shortages and excess demand which doom it to fail. The system is locked into a vicious circle of stagnation and waste.

This is not, however, the end of the story. Shortages, inefficiency and instability lead to mounting discontent and political unrest. This eventually affects the level of political centralisation, but the impact can go either way: sustained political pressure may induce democratisation, but if pressure goes beyond a critical point it is perceived as a challenge to the system and it may well induce an authoritarian involution. The lesson of the recent Polish experience is not that political change is impossible, but that it is touch and go whether sustained political pressure leads to democratisation or military rule.

The system can, or at any rate it would be rash and unwarranted to claim that it cannot, break out of its vicious circle by the weakening of any of the perverse links: autonomous political democratisation as in the Soviet Union in 1956 or Czechoslovakia in 1967-68; economic reforms timed to coincide with favourable exogenous factors, as in Hungary in 1968; a relaxation of the system's commitment to full employment, as advocated by Dr Popov of the Moscow Academy of Sciences Institute of Management; a relaxation of the system's commitment to price stability, which seems to be taking place throughout the area, and which would prepare a better environment for economic reform; last but not least the possibility of political pressure being directed not at opposing the system but at negotiating political democratisation in exchange for the acceptance of austerity, as might have happened in Poland if both trade unionists and government had had more sense. It may be overoptimistic to expect rapid and drastic changes along these lines in the near future in Eastern Europe and the Soviet Union, but it is plainly wrong to expect that the system is incapable of changing, or to expect its collapse.

4. Implications for the West

The same kind of symptoms of economic crisis and prospects are also shared by and large by capitalist countries: deterioration of growth performance, external and internal imbalance; it is also a cyclical phenomenon rooted in the systemic features of capitalism. Some of the causes are common to both groups: the world energy crisis and concomitant inflation and recession in world trade; poor labour relations and the failure to reach a social pact between government and workers. But other causes, the actual mechanisms, depth and specific features of the crisis, however, are profoundly different. In particular, capitalist countries face macroeconomic constraints internally and internationally instead of structural capacity constraints; they have unemployment of labour as well as unemployment of capital, and instead of several queues for commodities they have one single and long queue for jobs, people being unable to buy money with their labour (which is even worse than being unable to buy goods with money because unspent labour cannot be saved for later expenditure).

These specific differences suggest that there is a certain degree of complementarity between the crises affecting different systems. This complementarity generates opportunities for foreign trade and capital movements of a kind which has nothing to do with conventional Heckscher-Ohlin type international trade theory, i.e. with relative factor endowments and even relative market prices, but is nevertheless a tangible form of comparative advantages. The sale by the West of advanced technology, grain, foodstuffs, steel, semifinished goods, contributes to solving East European structural problems of mismatching of demand and supply, while the sale of anything can relieve the overall pressure of excess demand discussed earlier, at a lower social than private cost to the West in view of large scale unemployment and spare capacity. These sales can activate capacity utilisation in the East, with supply-multiplier positive effects, and generate additional goods which would enable the East to recover and pay, sooner or later, for what they have received. The problem is that short of mounting a gigantic multilateral intertemporal barter operation, which is impracticable, the benefits of this complementarity between economic systems can only be reaped by the provision of large scale credit, which is not impossible but requires a degree of international co-operation, goodwill, and development of financial institutions which is simply not there. Economic factors, however, would amply reward East and West for any effort aimed at trade promotion and credit expansion.

Any move in the opposite direction, in the form of trade embargoes, credit restrictions, refusal to reschedule debt and demands for formal declarations of default for the worst affected countries like Poland and Romania, has an economic cost for both the West and the East and has a destabilising effect on the economic/ /political cycle of socialist countries, through the aggravation of shortages, inefficiencies and economic disorganisation. President Reagan believes that the economic cost to the West of trade denial and credit denial in economic relations with the East is worth paying in order to expose and enhance the economic difficulties of the socialist bloc, to force political democratisation in socialist countries, especially the USSR and Poland. On this, three final observations are offered:

First, the cause of democratisation in Eastern Europe is better served by trade and credit expansion than restriction; the economic difficulties of these countries are already sufficient to generate political pressure. By aggravating these difficulties through arms races and economic warfare the diffusion of authoritarian solutions throughout the bloc is more likely than democratisation. If, for instance, Western assistence had been made available to Poland in 1981, instead of Western banks cutting almost their entire short term credits in the spring of that year, the Polish economy would not have collapsed and the state of emergency would have been appreciably less likely.

Second, while both East and West stand to gain considerably from economic cooperation in trade and loans, Western economic warfare could cost the West a great deal and would not hurt socialist economies much. For instance, embargo on the Soviet gas pipeline construction would cost the West at least $ 10 billion machinery exports but would only temporarily delay the project, actually improving Soviet cash flow in the short run. High technology sales to the Soviet Union no longer contribute as much as they used to to Soviet productivity growth. The formal declaration of Polish default would seriously affect Western banking circles (especially if the possibility of deposit withdrawals from the most affected banks are considered) and lead to the write-off of Polish debt and the loss of current interest payments, but Poland could continue to trade on a balanced basis for cash, through friendly intermediaries and alternative transport routes, the higher cost of intermediation being offset by the relief from interest payments. In spite of appearances, the socialist countries are not so vulnerable to Western warfare.

Finally, the considerable cost to the West of trade and credit denial would fall much more heavily on Western Europe than on the United States. For instance, out of the

$ 25 bn of Polish debt to the West, less than 4 bn represent the maximum US exposure both direct and through government guarantees. The bulk of machinery sales for the Soviet gas pipeline would be commissioned to Europe, while Soviet gas would reduce European dependence from OPEC countries and broaden European energy options. US exports of high technology to the USSR are of the order of $ 150 mn a year, i.e. half those of Italy and France, and a fifth of West German sales. The disparity between the US and Western Europe is just as bad in the general field of manufacturing products. There is a significant unfairness in the distribution of costs of Reaganite policies between the US and its European allies, which justifies the visible European reluctance to follow the US lead.

In conclusion, the combined effect of economic crisis East and West is exercising a sobering and positive influence on East-West relations, especially in Europe.

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