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Paul J.J. Welfens*

Economic Reforms in Eastern Europe: Basic Problems, Options and Opportunities

The events in August in the Soviet Union demonstrated drastically the difficulties faced by the countries of Eastern Europe in the transition to a market-based system. The following article analyzes the specific distortions in their economies which this process involves. The author argues in favour of radical reforms at an early stage, but also emphasizes the importance of sustained and gradual reform steps in the longer term to deal with the accumulated distortions.

Based on a strategy of economic growth which relied on an increasing participation rate of the female population, massive exploitation of natural resources, the use of mass production and the promotion of heavy industries, the Eastern European countries increased output and productivity in the 1950s and 1960s. As long as there was an elastic labour supply – stemming from agricultural labour surplus or from rising participation ratios – economic growth could be maintained, especially since labour surplus was coupled in Eastern Europe with high investment-output ratios of 30-38 percent. Even with a declining marginal product of capital, rising real incomes could be achieved.

In the 1960s the CMEA countries also embarked upon a more specialized – actually monopolistic – intra-CMEA division of labour. Barter trade and multi-tier exchange rates were barriers to trade that were never really overcome – the transferable rouble (TR) introduced in 1963 did not represent a convertible currency and thus did not overcome the problem of trade-reducing quotas implicitly derived from the need and incentive to balance bilateral trade flows. Intra-industry trade with competition-enhancing effects was an exception and generally the degree of economic openness remained low. World market impulses only played a role in those countries where the share of trade in manufacturing products with

Western market economies was relatively high: Hungary and Poland were the countries most exposed to world market forces (cf. Table 1). Import substitution strategies were emphasized in the other countries of the CMEA where monopolistic state trade organizations institutionally separated the world market from the socialist production sphere. The high intra-CMEA trade shares of Bulgaria, the CSSR and Romania – with considerable “socialist trade” with China – therefore indicate the importance of politically determined and managed trade as opposed to Western trade on the basis of comparative advantages. The Soviet Union suffers from the special problem of large countries, whose trade opportunities are typically less than in smaller countries. However, in contrast to the USA, where the export-GNP ratio is only four percentage points higher than in the USSR, Soviet industry has no world market links via a network of foreign subsidiaries and foreign direct investment flows accruing from Japan, the UK and other countries. All CMEA countries face slow economic growth and rising open (CPI) inflation, as is obvious from Table 2. Negative growth rates were recorded in all socialist economies in 1990, which indicates the cost of reforming the system in Poland, Hungary, Yugoslavia and the CSSR, but also points to the costs of non-reform in the more slowly reforming countries USSR, Bulgaria and Romania.

While new services industries and world market forces – such as the rise of the newly industrializing countries (NICs), the oil price shocks of the 1970s and innovation dynamics – drove structural adjustment and growth in

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Western market economies, the socialist economies maintained heavy industry as the dominating core. The services industry, which accounted in OECD countries for a share of 47-65 percent, recorded shares of 33-49 percent in most CMEA countries (Table 3). The services industry and the liberal professions in particular were therefore under-represented in Eastern Europe, and this partly explains why the income share of the lowest quintile in socialist economies is typically higher and that of the highest quintile typically lower than in market economies (extremely high tax rates for those working in the craft industry play a role, too).

Monopolistic Structures

Opening up the economies within the CMEA group brought no additional competition in Eastern Europe, but reinforced – under the heading of international socialist specialization – the fragile system-specific network of monopolistic firms which constitute the official socialist economy. As access to Western imports was tightly restricted, each firm faced high delivery risks with respect to the existing small range of specialized suppliers; even if input quantities were supplied in accordance with plans, there was the risk of quality problems, whose occurrence shows a considerable variance. Consequently, all kinds of strategic behaviour by socialist firms were observed. The firms used their information advantage vis-à-vis the planning authorities to obtain generous input allocations that allowed them to cope with delivery risk and helped

them to easily fulfil the quantitative targets of the state plans (problem of tautness of plans). Naturally, socialist managers were eager to overfulfil the plan, so that wage premiums could be paid and career promotion be expected. If wage increases exceeded productivity gains, the rise in unit costs translated into higher prices, or, more often, into higher required subsidies that would cover the difference between costs incurred and prices obtained.

The socialist bias towards supplying the bulk of goods for basic needs at low or artificially lowered prices created a sustained excess demand in the goods markets, insufficient incentives to increase output, and a continued need to allocate subsidies to firms producing mass consumer goods. Implicit excise taxes on certain goods were used by state planners who wanted to generate enough corresponding extra profits to cover the rising amount of subsidies for non-profitable firms. However, this mechanism for balancing the state budget did not work in the late 1970s and the 1980s, when increasing world market prices called for adjustments in the assortment of products produced, in the energy-intensity of the technologies employed and in the location of industries. The USSR passed on these oil price hikes with a lag to its major CMEA trading partners and enjoyed some windfall profits from the OPEC price surges; however, the rising aspirations of the Soviet people could not be reduced when world market prices for primary products and energy started to fall after 1981. The tremendous international relative price changes that occurred in the world markets in the 1970s and 1980s hardly led to major structural

Table 1
Openness and Trade Orientation of CMEA Countries

(in %)

	Share of Exports in GNP ¹	Regional Shares									
		Eastern Europe ²		USSR		Industrial Market Economies		Developing Countries		Others ³	
		Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
USSR	8	54.1	48.9	–	–	25.1	21.9	8.2	14.2	12.6	15.0
CSSR	25	32.3	29.9	40.3	43.1	18.6	16.3	3.5	4.7	5.3	6.0
Romania	25	24.6	16.8	24.0	24.0	13.5	33.7	18.8	19.0	19.1	6.5
Bulgaria	22	20.1	18.1	53.7	62.8	15.5	6.4	7.8	9.1	2.9	3.6
Poland	17	17.2	16.2	23.4	24.5	45.7	43.3	7.1	10.2	6.6	5.8
Hungary	39	18.7	17.0	25.0	27.6	43.3	39.5	7.7	9.9	5.3	6.0
GDR	24	25.3	26.1	53.7	34.8	15.5	29.9	7.8	3.6	2.9	5.6

¹ Figures for Hungary, the CSSR and Poland are based on IMF: International Financial Statistics; Soviet figures according to IMF et. al.: PLANECON, 1990; figures for Bulgaria and the CSSR are estimates; figures for the GDR refer only to industry and are from DIW Wochenbericht 12/91.

² CMEA-6 (incl. GDR).

³ Includes PR China.

Sources: Martin Schrenk: The CMEA System of Trade and Payments: Today and Tomorrow, SPR Discussion Paper No. 5, January 1990; UN estimates and official national statistics of the CMEA countries; IMF: Direction of Trade Statistics, Yearbook 1990; IMF: IFS; IMF et al.: PLANECON, 1990; own calculations.

changes in the inward-oriented CMEA countries, where intra-bloc trade relied much on bilateralism and a myriad of exchange rates applied to different product groups. In the 1970s and 1980s the CMEA countries were facing increasing competition from the flexibly reacting NICs, which relied on an outward-oriented development strategy, relative world market prices, a strategy of nurturing firms and markets, an efficiency-promoting trajectory of progressively reduced protectionism and a successful adoption-cum-dissipation of modern technologies.

“Cost-based” Prices

In market economies higher energy prices were perceived as an incentive for resource/energy-saving technological progress, the closure of obsolete firms and the shift of many firms towards novel products and new industrial locations. These reactions were quite uncommon in socialist countries, where bankruptcy and explicit unemployment would not be accepted and where the demarcations of industries were defended by powerful branch ministries and well-organized monopolistic firms with their traditional reluctance to introduce technical progress. Increasing subsidies ultimately lead to higher government deficits and, if financed by resorting to the printing press, to repressed or open inflation. In the “cost-based” price system lies a central irrationality of the traditional socialist economy model. This is easily understood by looking at the counter-example of a market economy. The equation “market price = marginal costs” holds both in socialist and in market economies. However, in market economies the equation is read not from right to left, but from left to right: the market price (being the result of the ratio of aggregate supply to aggregate demand – of scarcity – in a given market) informs any potential supplier whether it is worthwhile to stay in, or enter into, a market. As long as the marginal costs faced by the firm are lower than the market price, expected profits encourage production: at the level of the individual firm, higher costs

do not entail higher market prices, whereas the socialist firms used cost increases to obtain higher state-administered prices (more or less automatically, if the standard formulas for price calculations were employed).¹ In the socialist countries, cost-based price determination, reinforced by the monopolistic industrial structure, prevented efficient production and favoured the excessive use of all input materials, which ultimately resulted in a permanent excess demand for most inputs.

The CMEA countries achieved neither static efficiency (equalizing marginal rates of substitution across industries) nor dynamic efficiency, which would have required optimal innovation – including the systematic use of dynamic economies of scale, which imply reducing marginal production costs as a consequence of learning effects and accumulated knowledge in quality control (e.g. in the chip industry).² Lack of foreign direct investment, which is a major route for technology transfer in market economies, was another weakness that also restricted the amount of intra-company trade within a network of multinational companies.

Stagnation

After the 1970s, economic stagnation and the negative repercussion effects of the intensive-growth strategy became increasingly apparent in Eastern Europe, where Hungary and Poland had embarked upon a modernization strategy financed by Western capital inflows. With high inflation rates in OECD countries, the associated low real interest rates greatly encouraged foreign indebtedness. This tendency was reinforced by political pressure or “encouragement” to extend loans to Eastern Europe. In

¹ An increase in costs at the level of the individual firm would thus in a market economy induce attempts to boost productivity and hence reduce unit costs, or a search for new fields of profitable activity.

² For Poland Kemme estimates the loss of output due to static inefficiency at 8-10 percent in 1971-83. See D.M. Kemme: Losses in Polish Industry Due to Resource Misallocation, in: Yearbook of East-European Economics, Vol. 14 (1990), No. 2, pp. 139-158.

Table 2
Developments in Real Output and Inflation
(% changes, annual averages)

	Bulgaria		CSSR		GDR		Hungary		Poland		Romania		USSR		Yugoslavia	
	Growth of Output	Increase in Prices														
1960-70	7.7	-	4.2	-	4.1	-	5.5	-	6.1	-	8.6	-	7.2	-	6.7	-
1970-80	7.1	2.0	4.7	1.2	4.8	0.0	5.4	4.6	5.4	4.6	9.4	1.0	5.1	0.3	5.8	17.5
1980-85	3.7	1.0	1.8	2.0	4.5	0.0	1.8	6.7	-0.8	32.5	3.0	5.0	3.2	1.0	0.7	47.5
1989	-0.5	6.2	1.3	1.5	2.0	8.2	-0.2	19.0	-0.2	260.0	-7.9	0.9	2.5	1.9	0.6	1240.0
1990	-13.5	19.3	-3.1	10.0	-19.5	-4.0	-4.5	29.0	-12.0	585.0	-10.0	5.7	-4.0	5.3	-7.5	585.0

Source: BIS: 61st Annual Report, Basle 1991.

1980 investment-output ratios were high in the CMEA: investment ratios reached 30.6% in the USSR, 38.1 in Hungary, 32.1 in Poland, 36.2 in the CSSR, 33.9 in the GDR, 33.9 in Bulgaria and 43.8 in Romania. Ten years later these ratios had declined by 5-15 percentage points – except for the USSR and Bulgaria.

With human and material production factor reserves increasingly exhausted, the switch to a more technology-based expansion strategy became necessary – a challenge that was not met in Eastern Europe at all with the exception of a few technically successful ventures with insignificant economic pay-off, e.g. in the military industry. In addition there was no significant growth of the services industry, which had traditionally been discriminated against in socialist countries; however, without a growing services industry that supplies customer-tailored services to both business and the household sector, there can be no modern manufacturing sector and thus no prospering economy.

In industrialized market economies economic growth is roughly attributed equally to labour, capital and technological progress. With increasing factor inputs an industrial country might have a sustainable economic growth of 3 percent p.a. which implies a ninefold increase of real output in one generation (75 years), whereas an economy with no growth of labour and know-how might have a growth rate of only 1 percent (doubling output in 75 years) or even stagnate. The traditional command economy, which relies upon a monopolistic network of state-owned firms and priority allocation of government funds for high investment, can generate economic growth as long as economies of scale from standard technologies or dynamic learning effects can be mobilized and as long

as political legitimacy and hence working morale in the state-owned socialist production system is preserved. However, in the late 1970s and in the 1980s the changing direction of international technological progress confronted the socialist economies with three major challenges that were basically not met for reasons inherent in the system:³

□ Resource-saving miniaturization (dubbed here “bonsai products”, paying due attention to Japanese achievements) required sophisticated quality control and the full mobilization of individual know-how and skills at the shopfloor level: neither the intra-firm communication structures in the socialist sector and its incentive system nor the detail-neglecting command approach in R&D and in investment were up to this challenge.

□ Flexible production techniques were not available which would have allowed the East European countries to meet the increasing demand for product variety that is typical for the stage after basic needs have been satisfied and which is a cornerstone for success in world markets; moreover the demand for services was not met by the slowly reacting planning system, where the vested interests of heavy industry favoured high investment in traditional industries. About 30 percent of national output was typically devoted to investment, but the CMEA countries never reached economic growth similar to Japan, where investment-output ratios also hovered around the 30 percent margin in the 1960s and 1970s. Low interest rates and the “soft budget constraint”⁴ – meaning easy access to subsidies – encouraged permanent overinvestment, very often in inefficient projects.

□ Ambitious to meet Western technological and economic advances, the political claim of communist party monopoly implied tremendous opportunity costs, as modern flexible communication, information and production technologies could not be applied on a wide base. With multi-use copy machines, modems, fax-machines and printers being considered as a threat to political control, millions of people were denied valuable experience with advanced technologies and know-how, where COCOM-restrictions added problems on the hardware-side. Software as well as hardware that could

Table 3

Income Disparities and Share of the Services Industry in Selected Countries

		Lowest Quintile	Second Quintile	Upper Two Quintiles	Upper Quintile	Share of Services in GNP, 1988 (%)
Poland	1987	9.7	14.2	58.1	35.2	35
Hungary	1983	10.9	15.3	55.2	32.4	49
CSSR						33 ^a
USSR						35 ^a
Italy	1986	6.8	12.0	64.5	41.0	56
Germany (W)	1984	6.8	12.7	62.8	38.7	47
France	1979	6.3	12.1	64.3	40.8	60 ^b
USA	1985	4.7	11.0	65.9	41.9	65

^a 1987; ^b share of employment in total employment (1987).

Sources: World Bank: World Development Report 1990; OECD: Services in Central and Eastern European Countries 1991; own calculations.

³ Cf. P.J.J. Welfens: Growth, Innovation Dynamics and Welfare: A Comparative Economic Systems Approach, paper presented at the second European Economic Association meeting, Copenhagen, August 22-24, 1987; P.J.J. Welfens: Innovationstheorie, -politik und -dynamik im Systemvergleich, in: P.J.J. Welfens, L. Balcerowicz (eds.): Innovationsdynamik im Systemvergleich, Heidelberg 1988, pp. 1-24.

⁴ J. Kornai: Economics of Shortage, Amsterdam 1980. For a comprehensive discussion of financial and real problems in Eastern Europe see K. Bolz (ed.): Die Wirtschaft der osteuropäischen Länder an der Wende zu den 90er Jahren, Hamburg 1990.

have been used to build more decentralized flexible production structures were hardly used, and – apart from the shadow economy – political control over the population with modern technologies was the only growth field left.

Shadow Economy and Monetary Overhang

Growing consumer dissatisfaction was the consequence of a system that offered neither the amount, nor the variety, nor the quality of goods and services desired. Shortages in the official system and overall production reserves thus generated a rapidly growing shadow economy, which draws on overmanning and reserves of factor inputs in the socialist system as well as on leisure. Contrary to certain groups of the population which had privileged access to goods at low state-administered prices, many people had to buy goods and services in the price-flexible shadow economy with its high market-clearing prices; the result was a new economic inequality among people with their very different assets

and skills which could be applied in the shadow economy.⁵ The shadow economy absorbed part of the excess money supply that was created as a consequence of the government budget deficits covered by printing money at a pace exceeding output growth. The illegal nature of most shadow-economy activities – necessary and useful as they were – nurtured a growing system of bribery and profit-sharing schemes that undermined the material incentive system applied in the official economy.⁶ Furthermore, as the governments in all CMEA countries set up “foreign exchange shops”, where goods in short supply could be bought by foreign and domestic residents, the population’s demand for Western currencies gradually increased,

⁵ Cf. M. Welfens: Das Phänomen der Schattenwirtschaft im Sozialismus, in: Osteuropa-Wirtschaft, Vol. 33 (1988), pp. 1-15.

⁶ Cf. M. Welfens: Bedingungen der Entstehung und Entwicklung der inoffiziellen Erwerbswirtschaft, in: D. Cassel et al. (eds.): Inflation und Schattenwirtschaft im Sozialismus, Hamburg 1989, pp. 375-404.

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SOCIAL MARKET ECONOMY

Experiences in the Federal Republic of Germany and Considerations on its Transferability to Developing Countries

In many centrally planned developing countries the mechanisms of central control as applied in state run economies have reached their limits: factors of production can no longer be allocated efficiently, growth is inadequate and there is diminishing scope for the redistribution of income. In the search for models solving their economic problems, increased interest is being shown in the Federal Republic of Germany, the “social market economy”. Its achievements in rebuilding its economy, its economic success and social stability enjoy considerable international prestige. Therefore the Federal Ministry for Economic Cooperation (BMZ) and the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) commissioned the Hamburg Institute for Economic Research (HWWA) to compile a study on the theoretical principles of the “social market economy”, the problems associated with its introduction and the experience gained with this economic system in the Federal Republic of Germany, and to examine aspects related to its transfer to developing countries.

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especially after inflationary expectations spread in the 1980s. The effective money supply was raised by devaluations in the foreign exchange market since total money supply = $M + eM^*$ (M = stock of domestic money, e = exchange rate, M^* = amount of unofficial foreign exchange).

In the 1980s, the stock of foreign currency (evaluated at black market exchange rates) in Poland was almost as high as the stock of domestic money.⁷ The Deutsche Mark and the US dollar were the preferred currencies in the long-observed process of currency substitution in Eastern Europe, which implies reduced seigniorage gains for domestic central banks and ultimately a resource transfer to Germany and the USA respectively. The real devaluation of CMEA currencies in the 1980s increased the incentive to work for (foreign) cash in the shadow economy, to work abroad (mostly illegally in some EC countries) and to sell assets, goods and services to businessmen and tourists from abroad. Increasing absenteeism at the official workplace and the declining work morale reduced economic growth in the official economy, aggravated shortages and distribution conflicts in the official economic system, and furthermore eroded the political legitimacy of the socialist system.⁸

Parallel to the reduction of economic growth of the official net material product, the socialist shadow economy has expanded. Increasing shortages in the official economic systems, the gap between the structure of output as provided by the socialist system and the preferences of people, and – in some countries (Hungary, Poland and Yugoslavia, the latter of which was not a CMEA member) – double-digit inflation have stimulated activities in the shadow economy. Goods are produced or privately imported, and durable consumer goods are exchanged as well as assets. Hence, part of shadow economic activities is value-adding and affects the allocation of factors in the overall system; other activities reflect mostly redistribution effects, where there is a clear tendency to generate considerable income inequalities that are difficult to accept for a society where equality of income and wealth has been emphasized officially.

The shadow economy is by no means a negligible quantity. Kornai argued that value-added in the unofficial economy amounts to roughly 20 percent of Hungary's GDP.⁹ Dallago estimates that – expressed at full-time job equivalents – the socialist shadow economy represents 44 percent of official registered employment in Hungary, where output reaches 15 percent of official production.¹⁰ Wisniewski's empirical investigation for Poland shows an acceleration of the shadow economy's share, too: from 3.8 percent in 1970 to 13.2 percent in 1982.¹¹ This problem is less evident for the USSR, Romania, the GDR and the

CSSR, but there is some casual evidence that the second economy is growing in these countries, as well.¹² So far, analysis of the second economies in both socialist systems and in market economies has shown that the shadow economy contributes to the structural flexibility of the overall system and, to the extent that it momentarily reduces the political pressure for reforms, it has a considerable social-mollifier function; the labour market plays a core role for shadow economic growth.¹³ In the transition phase to a market economy the shadow economy – this time of the capitalist type – might again become a welcome kind of social shock absorber.

Politico-economic reforms had to be undertaken in several CMEA countries, most notably in Hungary, Poland, the CSSR and the USSR. Mikhail Gorbachev marked with glasnost and perestroika a new era of public discussion about constitutional and economic reforms. In August 1989 under Prime Minister Mazowiecki and Minister of Finance Leszek Balcerowicz Poland embarked upon a market-oriented drastic reform programme. In late 1989, Hungary's decision to open the border to Austria for citizens from the German Democratic Republic made visible the huge potential for "voting with one's feet" in the divided Germany; with the Berlin wall's coming down, the peaceful revolution in East Germany (and later in the CSSR), and the "two-plus-four arrangement" for talks on

⁷ Cf. M. Both, P.J.J. Welfens: Internationale Determinanten des Geldangebots, in: D. Cassel et al. (eds.), op. cit., pp. 151-168.

⁸ Cf. D. Cassel et al. (eds.), op. cit.

⁹ J. Kornai: The Hungarian Reform Process, in: *Journal of Economic Literature*, Vol. 24 (1986), pp. 1687-1737; cf. also H. Brezinsky, C. Ros: The Development of the Second Economy in Hungary, in: *Korean Journal of East-West European Studies*, Vol. 1 (1985), pp. 95-127.

¹⁰ Cf. B. Dallago: The Non-Socialized Sector in Hungary: An Attempt at Estimation of its Importance, in: *Jahrbuch der Wirtschaft Osteuropas*, Vol. 13, No. 2, pp. 67-92.

¹¹ M. Wisniewski: Zrodla i rozmiary drugiego obiegu gospodarczego w Polsce, in: *Ekonomista*, 1985, No. 6, pp. 913-936. On Poland's shadow economy see also Z. Landau: Selected Problems of the Unofficial Economy in Poland, in: S. Allesandrini, B. Dallago (eds.): *The Unofficial Economy*, Aldershot 1987. An interesting case study in the system of Poland's parallel markets is W. Charemza, M. Gronicki, R.E. Quandt: Modelling Parallel Markets in Centrally Planned Economies: The Case of the Automobile Market in Poland, in: *European Economic Review*, Vol. 22 (1988), pp. 861-884. For a theoretical equilibrium model of the second economy cf. The "Second Economy" and Resource Allocation under Central Planning, in: *Journal of Comparative Economics*, Vol. 8 (1984), pp. 1-24.

¹² Cf. e.g. H. Brezinski, P. Petrescu: The Second Economy in Romania – Dynamic Sector, Discussion Paper, FB 5, University of Paderborn, 1986; A. Aslund: Private Enterprise in Soviet-Type Economies: A Comparison between Poland and the GDR, in: *Osteuropa-Wirtschaft*, Vol. 28 (1983), pp. 176-193.

¹³ D. Cassel: Funktionen der Schattenwirtschaft im Koordinationsmechanismus von Markt- und Planwirtschaften, in: *Ordo*, Vol. 37 (1986), pp. 73-104; D. Cassel, E.U. Cichy: Explaining the Growing Shadow Economy in East and West: A Comparative Systems Approach, in: *Comparative Economic Studies/ACES Bulletin*, Vol. 28 (1986), pp. 415-428.

German unification, the situation in Europe has changed dramatically.

Reform Programmes

All CMEA countries have launched politico-economic reform programmes. In some countries this is not the first time that serious attempts have been made. However, in the past most reforms failed – for various reasons. At the beginning of the 1990s, some external factors in Europe might be helpful; others could be disturbing. Internal adjustment programmes in major West European countries and the EC 1992 programme aimed at the creation of a single EC market have already created sufficient growth momentum to reduce unemployment rates in Western Europe considerably, although the EC average of 8 percent clearly is still above figures compatible with full employment. However, with positive expectations in the business community, the political pressures for protectionism in the EC are dwindling, and political stability in EC member countries might be expected for quite some time. A potentially destabilizing factor is the German unification process, although if handled properly it could generate a positive momentum for the reform process in Eastern Europe; if German unification is not handled properly in the international political arena, there is a serious risk that the achieved degree of political consensus and cooperation in the EC may give way to old-style rivalries among major European countries. In this case the EC could not act as a stabilizing force in promoting successful economic reforms in Eastern Europe. High real interest rates – associated with German unity¹⁴ – pose a particular problem for economic growth and could impair stability and policy coordination in the whole of Europe.

Strategic Problems

The general decisions to be made by all reform-minded CMEA countries are the speed at which the marketization process can be introduced, and the sequence and combination of internal and external measures to be used in creating an efficient, socially acceptable market economy under democratic political government. Should capital imports, mainly foreign direct investment, be allowed first – along with a liberalization of trade – and only then privatization programmes be enacted? Foreign direct investment by US or EC companies/subsidiaries in Eastern Europe typically helps to raise labour productivity and might boost exports of goods in the medium term, while the short-term impact is probably a deterioration of the trade balance – accompanied by an export-stimulating devaluation – due to growing imports of capital goods and

intermediate products from the parent company, subsidiaries in third countries or other foreign suppliers.

Existing state monopolies are then confronted with foreign newcomers whose extreme competitive pressure makes restructuring very difficult. This presence of foreign firms could be used as an argument to preserve large state enterprises because of alleged economies of scale, thus foregoing at the same time the more valuable long-term benefits of intensified domestic competition. The monopolistic legacy of large state firms means that established, well-organized interest groups from existing firms will exert extreme pressure on the political system not to dismantle large state firms. However, with the network of monopolistic firms more or less surviving, increasing domestic or foreign competition in the industries supplying intermediate goods will translate into higher profits for monopolistic firms at the end of the production line. This type of profit augmentation, which actually reflects static rents or market power, can easily be confused with improving economic efficiency. If these large firms are then privatized, the resulting private industry structure is obviously not in line with economic efficiency criteria. A complementary measure to increase competitive pressure is to encourage the foundation of new firms, which are so important for Schumpeterian innovation processes.

Any serious reform would face difficult transition phases in which the costs of reforms are already visible while the fruits still seem uncertain. Moreover, the move to a market economy will certainly benefit entrepreneurial personalities and create fortunes which might fuel envy and social unrest. An income tax system that favours reinvestment and thus postpones high consumption by the early birds in the markets until the imitative reactions of many individuals spread wealth and incomes more evenly would be advisable. The possibility of forming a political consensus is extremely important, and this implies a prime role for constitutional reforms. Transition to pluralistic democracy means for most countries a transitional phase with potential instability, because a multi-party system with many small parties and the lack of stable coalition patterns is the natural point of departure. This is true at least under proportional representation rules.

Shock Therapy vs. Gradualism

Even if there is a broad majority in favour of a transition to a market economy, the speed of adjustment must be determined. The unavoidable transition period, coupled with uncertainty and stress upon consensus-generating political mechanisms, suggests that one should opt for a hard and short reform trajectory rather than a prolonged

¹⁴ Cf. P.J.J. Welfens (ed.): *Economic Aspects of German Unification*, Boulder 1991.

period of ambiguous reform policies in which every setback could endanger the whole reform project. With established anti-reform (old boys") networks, the historically accumulated legacy of weak credibility of governments, and the overall amount of problems faced, a radical programme is obviously more adequate than gradualist concepts. In countries with (fragile) coalition governments a decisive (radical) move towards a market economy might, however, be impossible.

All long-run private and government planning requires a stable, but adjustable framework of action. A stable monetary and financial framework is of particular importance if the benefits of a market economy are to be realized. Its efficiency is based upon the interaction of competitive forces and relative price incentives as well as creative long-term entrepreneurial activities. It is well known that high inflation rates distort the relative price signals severely and tend to favour shorter maturities in bond markets. This in turn means that investment projects which require long-term financing and which offer high yields in terms of productivity growth cannot be realized. Therefore, institutional reforms in the field of monetary control (a relatively autonomous central bank) and prudential supervision as well as the nurturing of functional capital markets are of extreme importance. Only then can stable exchange rates and moderate shifts in the equilibrium exchange rates be expected, which in turn means that currency convertibility is closely connected with successful reforms of the financial and monetary system in socialist economies. High ratios of money to income, which are typical for socialist economies with their frequent rationing of consumers and firms, imply that there is a certain monetary overhang as compared with an economy where quantity rationing plays no role.

Hence, shifting to a market economy – i.e. getting rid of quantity rationing – means an inflationary boost. This is, however, only a transitory phenomenon which corresponds to a once-and-for-all adjustment of the price level. Naturally, for the ordinary citizen a once-and-for-all price level adjustment cannot be distinguished at first from permanent inflationary pressures. Here, indeed, lies a major problem, as trade unions might call for a full compensation in salary increases, which would actually set in motion a wage-price-wage spiral if monetary policy were accommodating; if monetary policy were not accommodating, increased unemployment would result. Finally, there is another once-and-for-all adjustment in the price level of the official economy. As was argued above, the socialist system of distributing goods emphasized low state-administered prices that were supposed to allow everyone to purchase these goods (but in reality with lower

prices each individual demands a higher amount of that good, and an overall excess demand results from fixing prices below market-clearing levels). The effective allocation of goods that results in this rationing context does not guarantee that people with the highest willingness to pay receive that good in the official economy at all. With the switch to a market economy, the principle of "serving the demand from above" (people with highest willingness to pay will obtain the desired goods) would entail higher average prices in all markets. This would *per se* increase the aggregate price level, unless the incentive and production effects associated with economic reforms did not lead to an offsetting increase in the supply of goods. A once-and-for-all increase in the price level could also result from the removal of state price subsidies, although a competition-augmenting supply-side policy might be able to dampen this effect by reducing static economic rents and promoting dynamic efficiency (a higher innovation rate).

Privatization and Structural Change

Privatization of socialist industry is the key to the transition to a market economy. Privatization concerns the question of creating a competitive private banking sector which itself would be a core element of a functional capital market. Privatization of socialist industry aims at assuring economic efficiency by creating a new strata of Schumpeterian capital-owners that put resources to their best use and contribute to profitable structural adjustment by innovation and investment. With private firms the supply side can be expected to react more strongly to price signals such that the elasticity of supply would increase. This would also be highly important for exchange-rate policies because a real depreciation that typically stands at the beginning of liberalizing and reforming the socialist economy will yield an increase in real income only if the supply elasticities and the demand elasticities exceed certain critical values. Moreover, only with private ownership can competition in the non-tradables sector be established (while import competition will spur efficiency in the tradables sector), and this in turn is necessary to ensure that factors are rewarded in accordance with their marginal product. Privatization also comprises the task of launching new businesses and thereby creating a host of small and medium-sized enterprises, which in market economies typically account for at least half of employment and a third of production, and at the same time are the basis for contesting the leading firms, which therefore are induced to maintain static and dynamic efficiency.

Privatization can take the form of public offering, leasing, liquidation or management/employee buy-out

(including voucher allocation for part of the capital), but whatever forms are chosen it is clear that it will take several years to reduce the share of state firms in industrial output from the present levels of 80-90 percent. To achieve momentum in the privatization process it could be useful to start with the host of smaller state-owned companies, where resistance to competition and market-based allocation is much weaker than in the well-organized and oversized big firms. In manufacturing industry the average firm size in the USSR for instance is five times that in the USA and this clearly shows the problem of regional concentration of labour and the need to achieve optimum plant size by way of dismemberment.¹⁵ In manufacturing industry alone the number of establishments reached 355,000 in the USA in 1986, and the number of business starts was 20,000 while the number of business failures was 4,800. This is in marked contrast to the USSR's 45,000 firms and a complete lack of new business starts and business failures in the mid-1980s.¹⁶ In the USA net growth of firms – defined as “birth rate” (number of new firms relative to the number of existing ones) minus “death rate” – reached 2.5 percent in the services industry in 1980-85. In the USSR and in the other CMEA countries the services industry has traditionally been neglected both for ideological reasons and because of the weak organization of consumer interests in socialist economies. Foreign direct investment could play a limited role in improving the supply side, both by greenfield investment that creates new competitors and by joint ventures and acquisitions.¹⁷

Macroeconomic Stabilization

Macroeconomic stabilization in turn is a prerequisite for making a price-based allocation system such as the market economy work at all. The existing monetary overhang in CMEA countries must be eliminated either in a currency reform or by a transitory “adjustment inflation”.

¹⁵ See EC Commission: *Stabilization, Liberalization and Devolution. Assessment of the Economic Situation and Reform Process in the Soviet Union*, in: *European Economy*, No. 45, Brussels 1990; O.Ivanova: *Die Konzentration in der sowjetischen Industrie*, *Berichte des Bundesinstituts für ostwissenschaftliche und internationale Studien*, No. 23, 1991, Cologne. In the USA firms with less than 250 employees accounted in the late 1980s for 96.2 percent of the number of all firms in manufacturing industry, for 38.2 percent of sales and 46.9 percent of employment. In the USSR firms with less than 300 employees accounted for 60.9 percent of all firms, 10.2 percent of output, 10.6 percent of employment and 6.4 percent of the capital stock; cf. O. Ivanova op.cit.

¹⁶ Figures for the USA are taken from US Department of Commerce (1990), 109th edition, Washington D.C.

¹⁷ The role of foreign direct investment for supply-side reforms in Eastern Europe is emphasized by A. Inotai: *Foreign Direct Investment in Reforming CMEA Countries: Facts, Lessons and Perspectives*, in: M. Klein, P.J.J. Wellens (eds.): *Multinationals in the New Europe and Global Trade*, Heidelberg and New York 1991, pp. 129-138; A. Inotai: *Liberalization and Foreign Direct Investment*, in: A. Köves, P. Marer (eds.): *Foreign Economic Liberalization*, Boulder 1991, pp. 99-111.

This would require the liberalization of prices such that they can reach their market-clearing levels. Phasing out price subsidies is necessary, too. At the same time the shadow economy should be both eliminated and legalized. However, the transitory adjustment inflation could result in permanent inflation if the adjustment process takes too long and if price and wage expectations are not geared toward moderate inflation anticipations. To check inflationary expectations one might use – as in the Polish case – a fixed nominal exchange rate and weak wage indexation as a nominal anchor for the price system. Given the problem of high repressed inflation dynamics and a large positive divergence between the official and the unofficial exchange rate, a fixed exchange-rate strategy requires the establishment of a unified exchange rate following a huge devaluation which in turn raises the prices of imported goods and tradables in general. This may lead to a devaluation-inflation spiral that could seriously disturb the monetary stabilization process. Another risk stems from the attempt to establish positive real interest rates in the presence of currency substitution. With foreign balances reaching up to 100 percent of the domestic money stock, a fixed exchange rate implies that high nominal interest rates on domestic deposits would translate into extremely high (ex post) real interest rates on foreign exchange: those who have foreign currency can exchange it for domestic deposits – yielding 64 percent in Poland in 1990 – and then convert it into dollars at the end of the period; only with a high currency depreciation or negative nominal interest rates on domestic deposits would this problem be avoided.

Encouraging Transition

Support for marketization and democracy in Eastern Europe and the USSR is certainly in the interest of Western countries. Political support for the ongoing and difficult reform process will therefore be required for quite some time. Opening up domestic markets for exports from these countries (most favoured nation treatment) and a gradual relaxation of export controls to these countries (COCOM) will be useful. As all these countries are more or less heavily indebted and will rely on external credit for thorough reform, due attention should be paid to preserving “orderly market conditions” in international financial markets. Both the G-7 countries and the international organizations (IMF, World Bank, Bank for International Settlements) will face long-term challenges here. New opportunities for investment and trade are urgently needed in the former CMEA countries. Adjustments in the EC and EFTA, and possibly also the creation of a Baltic Free Trade Association (BAFTA), could help here.