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THE EASTERN TRANSITION TO A MARKET ECONOMY: A GLOBAL PERSPECTIVE

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INTRODUCTION

This paper contains the text of a series of public lectures given by Professor Williamson at the London School of Economics on 24th and 25th February 1992. Professor Williamson is the first holder of the British Petroleum Professorship, awarded annually to a visiting academic of the highest standing. The School is extremely grateful to British Petroleum for making possible both his visit and the series of lectures.

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LECTURE 1

When British Petroleum consented that I be invited to give the first set of BP lectures at London School of Economics, they were surely unaware that one of my duties in the course of the period I spent in the Treasury was to sit in judgment on their corporate ambition to become a force in the Western Hemisphere. The date was 1970, and BP wished to raise a large sum of money in the Euro-dollar market which would be spent on developing the Alaska oil-field that they had discovered and acquiring a US oil company in order to provide an outlet for their anticipated production. I do not recall whether Treasury consent was required because we were then the principal shareholder, or because such operations required exchange control permission, or both; but the Treasury did have to approve the project, and they put their only international economist on the committee that had to decide whether to give the go-ahead. It was not a difficult decision, but at least it was a sensible one, as I am sure the sponsors of these lectures will agree.

Were BP to hatch an equally bold plan today, my successor in the Treasury would have no say in whether or not it came to fruition. The public sector holding

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account would the Treasury be involved. These are but two minor developments in in BP has been sold off, and exchange control has been abolished, so on neithera global trend - a trend whose most dramatic manifestation is the attempt to make

the transition to a market economy in Central and Eastern Europe and the former Soviet Union (henceforth "Eastern Europe" for the sake of brevity) that I shall be discussing in these two lectures.

This attempt at transition is one of the two great economic issues of the day, the only question of comparable importance being that of averting a global environmental disaster. It is an issue that economic historians a century hence, or a millenium hence if economic history has still not ended, will surely pore over with the sort of attention that has long been lavished on the origins of the industrial revolution. I am one of those economists who has been fortunate enough to be at least marginally involved in the Great Trek to the east, despite the absence of any background specialist knowledge of the region or any ability to understand its languages. I hope that those here who have such knowledge will both forgive my lapses and seek to remedy them. But when I was invited to give these lectures, I knew that I wanted to take advantage of the opportunity to try and think through the significance of what is happening in Eastern Europe. I am grateful to both BP and LSE for having provided me with this opportunity.

Having been unable to resist the temptation to stray beyond my usual terrain of international economics, I looked for some way to link it to my area of expertise. It occurred to me that it might be of interest to trace the way in which world developments in the past couple of decades have influenced the emergence of the quite unusual degree of professional consensus that seems to exist at the moment on how the transition should be sought. Hence I added the phrase "A Global Perspective" to the title of these lectures. In the second of them I shall go on to ask whether results so far suggest that the consensus is merited.

The Failure of Socialism

The need to seek transition to a market economy arose because socialism failed to provide an effective alternative way of organizing an economy. This failure was not always obvious, certainly not when I came to LSE as a student back in the 1950s. Growth was in fact faster in Eastern Europe at that time,[1] a fact that led Khrushchev to threaten to bury us a few years later. Moreover, income was distributed more equally (something that remained true right to the end, despite the privileges of the nomenklatura). The reasons for opposing communism related to Stalin's abuses of human rights, not economic failure.

Yet by the 1970s it was becoming clear that the communist countries were falling behind economically. By the 1980s it was glaringly apparent: the comparisons of Austria versus Hungary, East versus West Germany, North versus South Korea, mainland China versus Taiwan, bore no reasonable interpretation other than that one system worked and the other did not.

[1] Although I have seen no definitive study, I have little doubt that will remain true even after appropriate allowances are made for the statistical practices that systematically exaggerated growth rates in the communist countries.

Why did central planning not work? When its feasibility was first discussed by economists back in the 1920s, two potential obstacles were identified. One, which was already an old issue at the time, was the problem of inadequate motivation of economic actors. The other was novel: it related to what von Mises (1920) argued would be the prohibitive information requirements needed to permit efficient central planning when one dispensed with a price system.

If the second, more technocratic, problem were the only one, surely Oskar Lange's market socialism (Lange 1937) - which aimed to simulate markets and the information they provide - would have provided an answer. In fact, however, the attempts of reform economists to move in that direction never seemed to achieve much. Principal emphasis on inadequate information also faces the problem of explaining why for a time the communist economies did work tolerably well - although one can argue that a system without the information mediated via market-clearing prices became progressively less adequate as the economy became more complex.

Thus, while I think the information difficulty was a real one, it seems to me less fundamental than the old ideological issue of motivation. This relates to one of the two basic emotional appeals of socialism (the other being the appeal to a sense of class injustice). Socialism promised to replace the base appeal to pecuniary self-interest as the principal motivation for economic action by something more noble, like altruism. I am not an uncritical adherent of public choice theory, with its demeaning assumption that everyone in public life is there only for what they can get out of it and totally uninterested in promoting the public good. But that extreme assumption is surely less far-fetched than the opposite assumption that everyone will always work altruistically to promote the public good, or what they are told is the public good, with no prospect of personal reward. Few of us are prepared to act month after month like socialist heroes were supposed to, especially after word gets out that the elite is engaged in rent-seeking.[2]

[2] Most of us seem to be prepared to make minor modifications in our actions (e.g. by recycling) to further a social cause of which we approve even though we could free-ride; or to act professionally, meaning to follow practices aimed at benefiting a client even if rewards are not tied closely to the outcome; or even to risk our personal safety if the cause is sufficiently urgent and unambiguous (e.g. in emergency situations). But that is not enough.

And so one got the attempts to work as little as possible and the resultant fights over norms. Perhaps even more devastating was the lack of motivation to care for - to economize on the use of - capital and natural resources (capital had no "guardian", as George Soros, 1990, put it). Another area that clearly suffered was the incentive to innovate. Even the neglect of the environment - the most paradoxical failure of socialism to those of us who were brought up on Baumol's vision of the state as the guardian of externalities (Baumol 1952) - seems to have been a result of a breakdown of the professional ethic bred by stretching beyond breaking point the divorce of personal reward from achievement. The record suggests that greed can be contained by competition to work in socially benign ways far more easily than it can be displaced.

The diagnosis of inadequate motivation is consistent with the historical record of progressive decay from the early period of heroic accomplishments when many surely were motivated by idealism, through the black period when fear provided an all-too-common motivation, to the pervasive cynicism that led to stagnation by the 1970s. The outlook was for worse to come: the extraction of energy and materials was encountering diminishing returns, while the input of energy and materials per unit of GDP was actually rising rather than declining. Sooner or later someone had to come to power who was conscious of the yawning and widening gulf between life under socialism and that in the market economies, and who would try and do something about it. The accession of such individuals led to limited reforms in Hungary and Poland. But the major event was the coming to power of Mikhail Gorbachev in the Soviet Union, with no big brother breathing down his neck.

Gorbachev's program of perestroika was intended to address the problem of missing motivation. The principal instrument to that end was the Law on State Enterprises of 1987, which devolved power down to the enterprise level. Enterprises were no longer required to transfer all their profits to the state at the end of the year, effected by the expedient of cancelling bank balances. A profits tax was created instead, and enterprises were allowed to pay a part of their after-tax profits to the workers, as well as to use another part to make investments determined by the enterprise management. Many enterprises were also given the right to export directly, rather than having to go through a foreign trade organization, and were allowed to keep a portion of their hard currency earnings, with the intention of providing an incentive to develop exports.

However, the attempt to build some incentives into the economy turned out to do more harm than good. A first problem was that the loss of tax revenue through the effective lowering of corporate tax rates was not compensated by increased tax revenue from some other source or a reduction in expenditure: on the contrary, it reinforced the loss of tax revenue that had already resulted from Gorbachev's anti-alcohol campaign. Within two years the Soviet Union was transformed from a paragon of fiscal virtue into a country with a chronic budget deficit of close to 10% of GDP. The ubiquitous price controls ensured that the resulting inflation was repressed and a monetary overhang built up instead, but that made the inflation more rather than less damaging, as goods progressively disappeared from the shelves. This simple failure of macroeconomic prudence is the major explanation for the breakdown of the old Soviet economy.

But there was also a microeconomic factor that underlay the Soviet collapse. One of the major papers that emerged from the School during my period as an undergraduate here was Lipsey and Lancaster's general theory of the second best (Lipsey and Lancaster 1956). When we came across it in our final year, I recall considerable puzzlement as to whether second-best theory dealt with pathological cases of no practical relevance, whether it destroyed the scientific basis for all reform proposals (given that in practice it is inconceivable that all but one of the conditions for Pareto optimality will be satisfied simultaneously), or whether it contained important implications for economic policy from which reformers can benefit rather than be paralyzed. Perhaps the rest of the profession decided years ago that the third view is right, but there is surely no longer any room to doubt that conclusion after contemplating experience in Eastern Europe: partial reform repeatedly worsened rather than improved the situation, for second-best reasons. Reformers need to take care to design programs that are immune to sabotage by the second-best.

Many anecdotes could be cited to illustrate how partial reforms led to worse outcomes, as second-best theory asserts can happen. I will restrict myself to what is still my favourite: Jeffrey Sachs's story of how Poland had emerged as an exporter of semi-tropical flowers prior to the big bang at the beginning of 1990. No central planner would ever have dreamt of doing anything so idiotic as subtracting value by having a country with Poland's climatic endowment export semi-tropical flowers, but decentralized enterprises pursuing their self-interest in the face of energy prices that were under 10% of the world level were entirely capable of doing so.

I suspect there is an opportunity for a wonderful thesis in compiling a list of these anecdotes and examining them analytically with a view to seeking some measure of just how important second-best considerations really were. However, to the best of my knowledge nothing like that has yet been done, and so I have to restrict myself to asserting that Polish exports of semi-tropical flowers were not an isolated case. To tell agents to pursue their self-interest without a set of prices that reflect relative scarcities so as to guide decisions in a socially beneficial way is to invite economic decline. And socialist prices were never intended to guide allocative decisions, which were made by the central planners rather than by decentralized enterprises: prices were chosen to further distributional rather than allocative ends.

The Design of a Reform Programme

Thus central planning failed primarily because it lacked a mechanism to motivate agents to make routine decisions in socially beneficial ways, and especially to make innovation and economy in the use of capital a part of the routine way of doing things. In some cases attempts to provide the missing motivation made things worse rather than better, most conspicuously where they were allowed to undermine macroeconomic discipline but also more insidiously by giving rise to pervasive second-best problems. What would these conclusions suggest for someone who wanted to give the citizens of those countries a chance to catch up with living standards in the West - in other words, for an East European reform economist or one of their Western advisers?

A first implication concerns the content of the needed reform programme. The economy must be transformed to a market economy: half-measures will not do. That is not to pre-judge the choice between the laissez-faire version of a market economy that Anglo-Saxons in principle tend to subscribe to, the German social market economy sketched by Hans Tietmeyer here last week, or the Japanese variant where the corporation regards itself as responsible to a series of stakeholders. What it does rule out is the sort of massive public sector sought by socialist parties in Western Europe in the early postwar years or the state-directed economies built up by many third-world countries in the 1960s and

1970s. Leszek Balcerowicz of Poland, Vaclav Klaus of Czechoslovakia, and ultimately the Russian reform economists rejected the search for a third way between communism and capitalism. Klaus as usual expressed it particularly forcefully when (as mentioned by Hans Tietmeyer) he quipped that "the third way is the quickest way to the third world".

As it happens, the third world had also been coming to that conclusion in the second half of the 1980s. I first realized this in 1989, which prompted us at the Institute for International Economics to organise a conference designed to explore the nature and extent of the change in attitudes that was occurring in Latin America. This conference was based on a paper of mine called "What Washington Means by Policy Reform" which presented a taxonomy of the policy reforms that were being commended to Latin America by mainstream opinion in Washington (basically the US government and the international financial institutions).[3] I labelled this, rather unwisely, the "Washington consensus". It did not occur to me that to use this term to describe a list of the policy reforms that were being urged on Latin America might be interpreted by my Latin friends as implying that Washington had figured out what needed to be done and was engaged in imposing economic correctness on them. In fact my view is that Washington had come to those views[4] as part of a worldwide intellectual trend to which Latin America had itself contributed, primarily through the work of Hernando de Soto (1989), and which has been most dramatically manifested in Eastern Europe. But since this explanation does not seem to have assuaged my critics, let me endorse in substance their latest barb, which is that the term is a misnomer because the Washington consensus is now being implemented in every capital of the hemisphere bar Washington![5] One fears that the results of the

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[3] The ten headings were: fiscal discipline; reorientation of public expenditure priorities toward (e.g.) health and education at the expense of defence, administration, indiscriminate subsidies, and white elephants; tax reform; financial liberalization; a single competitive exchange rate for current account transactions; trade liberalization; liberalization of foreign direct investment; privatization; deregulation; and the establishment of secure property rights in the informal sector. These can be summarized as macroeconomic discipline, microeconomic liberalization, and outward orientation. See Williamson (1990).

[4] The list was drawn up as a positive description of what was being urged rather than a normative one of what I thought was needed. In fact I largely sympathize with its content, although the agenda is distinctly circumscribed on the equity side for my taste.

[5] Carlos Prima Braga, who is responsible for this gibe, seems to have overlooked Havanna.

early primary elections may push Washington further along the populist path that it still condemns when practiced elsewhere.

The substance of the reforms being sought in Eastern Europe obviously overlaps those that have been taken up in one Latin country after another for the past seven years. Nor are these the only parts of the world where macroeconomic discipline, microeconomic liberalism and outward orientation have acquired a new respectability. Here in Britain Mrs Thatcher was associated with at least the first two causes, which have now been endorsed across the political spectrum. In Southern Europe, East Asia, Australia and New Zealand, now India, and even spottily in sub-Saharan Africa, the same revolution in economic attitudes has occurred. The mainstream economics that was taught to students here at LSE in the 1950s, but that we did not quite trust in our political hearts, has triumphed.

In my view that triumph results once again from a set of stylized facts that are too apparent to ignore. The crucial fact is that the most successful cases of development have occurred in resource-poor economies which chose capitalism, macroeconomic prudence and outward orientation rather than resource-rich economies that used the rents from resource exploitation plus deficit spending and foreign borrowing to build up large state sectors and invest in import-substituting industries. The professional literature (I think particularly of the painstaking accumulation of evidence by economists such as Balassa) has tended to support the obvious inference that in a broad sense the policies produced the results, although there remains debate about exactly what those policies were (one can hardly invoke Korea to justify the minimalist state and laissez-faire).

Let me add two points. One is that macro discipline, micro liberalization and outward orientation are supposed to supplement rather than displace the emphasis on savings and investment, and especially of investment in human capital, to be found in the development literature. The other is that the new orthodoxy crystallized in the "Washington consensus" has received further confirmation in the eyes of many of us by the recovery that is now clearly gathering force in Latin America. It took up to five years for these policies to begin to pay off, but they are now doing so. Adjustment is an investment and not an exercise in self-flagellation.

While the reform programmes in the economies in transition of Eastern Europe are clearly pursuing those same three objectives, however, the task is altogether more demanding than anything confronted elsewhere in the world. The reason is the need to create the institutions of a market economy from the ground up. When the Berlin wall fell few of us had ever given any thought as to how one would go about organizing a transition to a market economy, since it had not occurred to us that this would be a question that would arise in our lifetime. The exciting thing about being a part of the Great Trek to the east is that one is repeatedly challenged to think about the logic of the institutions that underlie the market economy, which we had always taken for granted. What legal infrastructure is needed to support the development of markets? What arrangements for corporate governance result in enterprises acting in the social interest? Can commercial banks fulfill their principal social function if they lack employees trained in the art of loan appraisal? If the subject of economics gains a new dimension out of the events in Eastern Europe, it will surely be by a new understanding of the institutional bases of a market economy. Perhaps we shall even get some insights into the debate that never quite seems to happen about the relative merits of alternative forms of market economy (the Anglo-Saxon emphasis on profit maximization alone, versus the German social market economy, versus the Japanese tradition of corporations responsible to a series of stakeholders).

Of course, the challenge facing Eastern Europe is broader than simply that of making the transition to a market economy, massive as the latter is. Every one of those countries is also attempting to replace the authoritarian regime of the past by a democratic system. There seems to be a general assumption these days that democracy and a market economy are natural complements. I hope that this turns out to be right, but I cannot help recalling that only 15 years ago the opposite was generally assumed to be true in Latin America: a market economy was something that only the military regimes in the Southern Cone would either have wished to establish or conceivably have been capable of establishing. For the moment we should treat the natural complementarity of democracy and the market as a hypothesis and (for some of us) a hope; but it is not an established fact.

So far as the former Soviet Union is concerned, there is a third historical transformation being attempted simultaneously with democratization and economic transition: the dismantling of the last of the world's great multinational empires. All sorts of long-suppressed nationalist tensions have suddenly been released, leading to a whole range of extra economic problems stemming from the likelihood of monetary disintegration and the possibility of a breakdown of trade relations. In association with a Ukrainian-born economist, Oleh Havrylyshyn, I have already attempted to address some of those problems (Havrylyshyn and Williamson 1991). In these lectures I simply note that this extra dimension makes the challenge facing the new nations of the CIS even more extraordinary than that faced by their neighbours to their immediate west, who in turn confront more dimensions than do reforming developing countries, let alone anything that we in the West have attempted in living memory.

The Case for a Bang

Let us return and focus on the economic aspects of the transition. There has never been much difficulty in identifying the long list of reforms that need to be made in order to convert a planned economy to a market economy:

-establish property rights;

-abolish the planning mechanism and state orders, and make enterprises autonomous units;

-privatize;

-harden budget constraints;

-legalize the firing of workers;

-liberalize prices;

-break up monopolistic enterprises and introduce anti-monopoly legislation;

-establish a competitive commercial banking system and recapitalize the banks;

-make the central bank responsible for controlling inflation;

-create a social safety net;

-eliminate the monetary overhang;

-reform the tax system;

-secure fiscal discipline;

-permit inward foreign direct investment;

-establish convertibility for current account transactions at a single, competitive exchange rate;

-liberalize trade.

The focus of the debate has been on how those reforms should be ordered, or, in the jargon, sequenced. In particular, there has been passionate debate on the merits or otherwise of a "big bang".

The widespread adoption of big bangs in Eastern Europe is a remarkable break from the postwar pattern. Until the Polish program at the beginning of 1990, there had been only one programme that deserved to be called a big bang[6] since the Erhard programme of 1948 (alluded to by Hans Tietmeyer during last week's Erhard memorial lecture). Even when Indonesia had to stabilize a near-hyperinflation following the ouster of Sukarno in 1967, the approach was gradualist. Similar recommendations for trying to ease hyperinflation down over several years were being given to Bolivia in 1985. Credit for the rejection of that advice in favour of an attempt to stop inflation in its tracks should go at least in part to Jeffrey Sachs, who was advising the candidate who did not win the 1985 Bolivian election, but who bequeathed some calculations of the extent of the fiscal contraction that would be required to the incoming team.

Sachs was not, however, responsible for the Bolivian decision to go for a big bang that would combine stabilization, liberalization and opening up of the economy to the outside world. That was a decision of the Bolivian team taken during the period immediately after the election of Paz Estenssoro when Sachs was not advising the Bolivian government nor present in Bolivia. He did, however, approve strongly of their courageous approach, and he became the transmission mechanism that brought the idea to Eastern Europe, for he played a key role in mustering support for a big bang in Poland in the second half of 1989. Doubtless big bangs might have been adopted anyway, without the Bolivian precedent or the intermediation of Sachs, but it is nonetheless an interesting reflection on our times that half a dozen policy-makers in a poverty-stricken country high in the Andes should

[6] Perhaps the Argentine Austral Plan and the Brazilian Cruzado Plan were also intended to be big bangs, but they forgot to include the fiscal discipline that is an indispensable element of any programme that deserves to be called a big bang.

have provided the model for the programmes that are attempting to terminate the biggest failed social experiment in history.

Rather to my surprise, I not only endorsed the Bolivian decision to go for a big bang, but I have also found myself arguing the need for rather large bangs in Eastern Europe. I find this surprising because I had long been an instinctive gradualist. I took it for granted that the gradual liberalization of the British and European economies in the postwar years was the natural way to go about it, and laid the basis for the boom of the 1960s. I have argued for trade liberalization to be done gradually, on the ground that there is a limit to the rate at which resources can be redeployed into new export industries, and that until such redeployment is possible it is better that resources be used to produce something, even if it be of low value-added, than that they be thrown into disuse and add zero value. I also criticized liberalization in the Southern Cone of South America a decade ago as precipitate. In particular, I was persuaded that it was a mistake to liberalize the capital account of the balance of payments so soon - a position that has now become conventional wisdom, since liberalized trade (to avoid the danger of immiserizing growth), a well-established non-traditional export sector (to ensure that the trade balance is not jeopardized by real appreciation from a capital inflow), and a liberalized domestic financial system (to distribute a capital inflow to activities with high rates of return), are all recognized as desirable preconditions.[7]

My preference for gradualism led me a year ago to ask: suppose you want to do as little as possible simultaneously, in the interest of minimizing administrative overload and economic disruption, what things must be done at the same time? What is the content of a "minimum bang"?

Let us specifically ask: what else has to be done at the time that prices are liberalized? To begin with, do all prices have to be liberalized simultaneously? I have failed to identify any appealing principle that could guide the order in which prices are gradually liberalized. One possible principle, which was applied in Russia last month to retain controls on "socially necessary goods" (like bread and milk and vodka), is to free luxuries first and necessities last. But, if producers have any opportunity to vary the output mix in response to price incentives, that leads to perverse results: producers have

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[7] See, for example, Edwards (1984) and McKinnon (1991).

an incentive to divert output toward luxuries, and the shortages of necessities become even more chronic than before. In principle that could be countered by subsidizing the production of necessities, if the budget can stand the strain, but we generally teach that it would be more efficient to free prices and subsidize needy consumers. In any event, such subsidies do not always seem to work: Russia continues to subsidize the socially necessary goods on which price controls were retained, but reports indicate that milk has nonetheless become even scarcer since the beginning of January because of the diversion of supplies into the production of butter and cheese, the prices of both of which have been liberated. If one cannot find any plan for gradual price decontrol that begins to look sensible, one is driven to the conclusion that prices should be liberalized simultaneously. That in itself is enough to guarantee a pretty big bang, even if a few prices - typically of utilities, rents and energy - are exempted from decontrol.

Could macroeconomic stabilization precede price liberalization? Sometimes: where consumer subsidies are not enormous, it may be possible to establish fiscal discipline before prices are liberalized. But in a number of the East European economies subsidies had become such a large source of spending that it had become almost inconceivable that budget balance could be restored without the price liberalization needed to dispense with the subsidies; in those cases it was impractical to stabilize before freeing prices.

Can stabilization be postponed to a later stage, until after prices have been liberalized? It is difficult enough for an established market economy to function tolerably under conditions of high inflation: enterprises cannot be expected to learn to make allocative decisions with reference to prices that are far from equilibrium (as relative prices always are at any particular point in time during a rapid inflation). The Bhagwati-Krueger study on trade liberalization (Krueger 1978), the first of the large cross-country comparative studies to be undertaken, established back in the 1970s that attempts to open up an economy to the outside world were time and again thwarted by the absence of macroeconomic discipline. Since then the World Bank has studied the success of structural adjustment lending, and affirms emphatically that stabilization should not be delayed until after liberalization. It is true that one can cite odd instances of countries that started to liberalize before stabilizing (Mexico) or that undertook a major liberalization following a half-baked stabilization

(Turkey), but the professional consensus is nonetheless that stabilization needs to come at the beginning of a reform programme.

Stabilization requires not only the establishment of fiscal discipline so as to be able to limit future monetary emission, but also that any monetary overhang that may have built up during the period of repressed inflation should be eliminated. If this is not done deliberately either by a monetary reform or by the sale of public-sector assets, it will occur automatically at the time of price liberalization by a corrective inflation. Finally, stabilization requires that monetary emission be stringently controlled, which implies not just fiscal discipline but also the hardening of enterprise budget constraints.

That provides one of the several reasons why enterprise autonomy should also be part of the minimum bang. We have already discussed the second-best problems that arise if enterprises are allowed to act autonomously prior to prices being freed to reflect relative scarcities. Conversely, prices cannot be freed until enterprises are autonomous, because it is the enterprises that have to set decontrolled prices. Hence enterprises should be made autonomous, and planning abolished, at the same time that prices are freed.

Enterprise autonomy is but a first step on the road to privatization. It may be possible to make a start with small privatization prior to price liberalization, and one can agree with the critics of the Russian programme that it would have been desirable to have privatized much of the supply and distribution network prior to price liberalization. Nevertheless, it would be wrong to privatize very much prior to price liberalization, for the fundamental reason that one would not want to risk driving potentially viable enterprises into bankruptcy, as could happen if hard budget contraints were enforced when sub-equilibrium output prices were being enforced and resulted in a firm trading at a loss. In practice there is not much danger of privatization being carried too far prior to price liberalization, for privatization is inherently a slow process if it is to be done well, meaning that property rights will be well-defined, that an effective structure of corporate governance is put in place, and that the state gets a reasonable price for the assets that are sold.

An implication of enterprise autonomy is that the enterprise should be free to fire workers who contribute less to the value of output than they cost the firm to employ: indeed, one could hardly contemplate enforcing a hard budget constraint until enterprises have that right. But it is politically impossible - or, if it isn't, it ought to be - to contemplate allowing workers to be fired without providing some form of social safety net for them independent of the enterprise, which used to be the main provider of social security. Hence the provision of a social safety net is something that has to be done no later than enterprises are made autonomous.

Allowing autonomous enterprises to charge whatever prices they see fit runs the danger of inviting massive price increases in an economy where the planners had deliberately built up monopoly sources of supply (on the theory that economies of scale are unlimited and that competition is wasteful, and abetted by the systematic underpricing of transport). In the long run it may be possible to break up some of these monopolistic enterprises into competing firms, but this takes time. One should at least be able to eliminate entry restrictions immediately, but it would be unwise to rely on a rapid buildup of competition from new entrants. But there is one other source from which it should be possible to elicit at least some competitive pressures to discipline price increases quickly, and that is the rest of the world. This provides the case for moving quickly to eliminate quantitative trade restrictions and to make the currency convertible on current account.[8] Note that there is a persuasive reason why one should advise these countries to move to current account convertibility far quicker than Western Europe did in the postwar years - Western Europe had a functioning market economy and prices that more or less reflected scarcity, so that convertibility merely allowed best advantage to be taken of relations with the rest of the world. In contrast, Eastern Europe needs to import a price system and competitive discipline if it is to get a working market economy any time soon.

Hence I concluded that a minimum bang needed to include widespread price liberalization, accompanied by the establishment of enterprise autonomy and current account convertibility and,

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[8] Convertibility means a right to buy foreign currency with domestic currency. Current account convertibility means that that right is available only where it is needed to pay for imports of goods and services: it is in practice usually circumscribed by excluding or restricting payment for foreign travel, on the ground that it is not administratively possible to preclude illicit use of unlimited travel facilities to export capital. East European discourse is customarily couched in terms of internal convertibility, which means the right of residents to buy foreign currency when needed to buy imported goods and services (other than tourism). The main difference from current account convertibility is that it excludes the right of foreign investors to remit profits; since all countries grant that right as well, in the interest of attracting foreign investment, I am unclear why they stick to the term internal convertibility.

unless they had already been accomplished, by macroeconomic stabilization and the creation of a social safety net. Such a package cannot be introduced overnight: it needs a certain amount of time to be designed and legislated. That time has varied from under two months in Russia to almost exactly a year in Czechoslovakia. But, once preparations have been made, the argument is that one should make a decisive, broad-based move from one set of rules to another.

Thus, despite being a temperamental gradualist, I came to the conclusion that in the specific circumstances of the economies in transition a "minimum bang" is in practice not much different to the sort of "big bang" advocated by Jeffrey Sachs, who is a temperamental advocate of shock treatment. A rather similar prescription has in fact found remarkably broad acceptance among mainstream economists. Obviously the details of presentation varied, but I am not aware of any essential differences between the advice in the IMF/World Bank/OECD/EBRD (1990) study on the Soviet economy, the EC Commission's report on the Soviet Union (European Commission 1990), the IIASA report (Peck 1991), the WIDER study (Blanchard et al 1990), the advice dispensed by Aslund, Dornbusch, Fischer, Layard, Sachs and Summers, or my minimum bang. The profession for once seemed to have reached timely agreement on some novel and pretty fundamental issues of momentous import.

However, we now have over two years of experience with reform programmes that more or less follow those recommendations, and the outcome so far is not obviously reasssuring. Perhaps it was inevitable that the initial euphoria would give way to gloom, but one can hardly reproach the citizens of Eastern Europe for a certain gloom at this stage. I shall talk in the next lecture about the reasons for the current pessimism, enquire into the causes of the disappointments, ask whether there is reason to revise the advice that we have been offering, and discuss whether the West should do more to try and ensure that the transition is successfully completed.

LECTURE 2

In my first lecture I reviewed the reasons for the failure of the scoialist experiment and outlined the main components of the reform package that we economists, who seem to be remarkably united on this issue, have concluded are needed to allow the transition to a market economy. I pointed out the basic similarity in the content of the reforms that have been increasingly implemented around the world for a little over a decade now, and those that are being introduced at breakneck speed in Eastern Europe, which are perforce more extensive because of the prior absence of the infrastructure of a market economy but are directed at the same three objectives of stabilization, liberalization and opening up. I described the logic underlying the mainstream position on the main controversy that has arisen during the debate on the transition, namely the merits of a "big bang" (an idea whose roots I suggested could be traced to Bolivia).

I shall start this second lecture by examining the facts about what has happened so far in the transition. I shall proceed to examine alternative explanations for the massive declines in output that have occurred, and will then ask what lessons need to be drawn from this experience, including lessons for what the West ought to be doing.

Experience of the Transition

The breadth of the reforms that have been introduced in Eastern Europe in the two and a half years since the fall of the Berlin wall is truly awesome. First Poland, then Eastern Germany, then Czechoslovakia, then Bulgaria, then Romania, and most recently Russia have adopted in substance the package of price liberalization, fiscal (and in most cases monetary) discipline, enterprise autonomy, provision of a social safety net, devaluation and current account convertibility, as recommended by the mainstream view outlined in my last lecture. Eastern Germany has gone much further, notably with massive privatization already accomplished by the Treuhandanstalt. Hungary has got about as far as any of the others, though through a piecemeal ("gradualist") program that eschewed a big bang. The CIS states other than Russia, and Albania, have still to take the plunge.

The expectation was that these programs would produce a sharp initial increase in prices, a "corrective inflation", as prices were liberalized, the monetary overhang was inflated away, and devaluation pulled prices up. But it was hoped that, after the initial step price increase, inflation would quickly die away, since there would no longer be a monetary overhang, fiscal and monetary discipline would eliminate excess demand, and (in the Central European countries, at least) the fixed exchange rate would act as a nominal anchor. All countries (except Eastern Germany, which experienced an effective revaluation when monetary unification occurred) did indeed have large initial price increases - in every case substantially larger than anticipated. In one case, Czechoslovakia, this was a one-shot increase as expected, and price stability was achieved within months of the big bang. In other cases inflation did fall back from the months of (and in some cases immediately before) the big bang, but nevertheless showed a worrying degree of persistence that has had to be accommodated through a flexible exchange rate policy (a frequently adjusted peg in Hungary, a crawling peg in Poland, floating rates in Bulgaria and Russia). Inflation remains a problem.

But the worst news relates to output. Table 1 shows rounded versions of recent Morgan-Stanley estimates of how far output has fallen since 1988, before the communist system started to unravel. To provide some historical perspective I also provide figures of the output decline in the United States, Britain and Germany during the Great Depression, and in Germany and Japan at the conclusion of World War Two. Clearly ouput has fallen at least as far in Eastern Europe as it did during the historic disaster of the 1930s Depression, although its decline is still somewhat less than that in Germany and Japan at the end of the war. It is of a different order of magnitude to the little local difficulties confronting Messrs Major and Bush as a consequence of the current Western recession.

It is true that the extent of the fall in output is almost certainly exaggerated by the official figures. The reason is that the collection of statistical data is largely, or in some cases wholly, confined to the state enterprises and largely or wholly ignores the private sector. Since the public sector is declining while the private sector is growing, in most cases at dramatically high rates (although from a small base), the actual situation is somewhat less bleak than portrayed. But the needed correction is probably worth only a percentage point or two of GDP, so the stylized fact of imploding output remains.

Critics of the big bang strategy claim that these output falls provide strong support for their position. Before assessing that contention, I want to discuss how far we understand the causes of the collapse in output.

A Taxonomy of the Sources of Output Decline

Let us start by reviewing the sort of conventional taxonomy that we would use in discussing the sources of an output decline in developing countries (Table 2). Output might fall either because of demand or supply. Demand factors would be broken down into those stemming from external demand and internal demand respectively. External demand might fall exogenously, because (for example) of a world recession, or it might fall because the country had allowed its currency to become overvalued on the foreign exchanges (typically as a result of holding the exchange rate fixed in nominal terms despite an internal inflation much above the world rate). A fall in internal demand would result in a Keynesian demand deficiency. A special case of the latter arises where the government is forced to deflate domestic demand because of a balance of payments constraint (as analyzed in the two-gap model). The supply factors that cause output declines are typically exogenous shocks like bad weather or natural disasters.

The first few entries in our taxonomy can remain unchanged when we turn to Eastern Europe. It is certainly still true that a reduction in demand from abroad may cause output to decline. If the production facilities were specifically geared to supplying the market that vanishes, output cannot be restored through macroeconomic policy. This is generally believed to be true of the empirically important case of this phenomenon - the 50%-odd decline in Soviet demand in 1991, which was important in all the other economies in transition. Most of the goods for which demand dried up were "shoddy goods" that were unsaleable in the West at any price.

Dani Rodrik (1992, Table 5.2) has recently made estimates of the extent of the output loss occasioned in the three Central European countries in 1991 by the collapse in Soviet orders. Excluding the terms of trade cost of the change in the CMEA trade regime, which enters at a later stage of the taxonomy, that cost amounted to 1.6% of GDP in Poland, 2.2% in Czechoslovakia, and 4.5% in Hungary. Eastern Germany and Romania also suffered, though perhaps to a more modest extent, while the impact on Bulgaria was presumably massive in view of Bulgaria's former dependence on the Soviet market (over 60% of its exports were shipped there). The order in which the countries are listed in Table 3 gives my guess of the relative magnitude of the impact of this factor on the various countries.

The final column of Table 3 presents a first assessment of the welfare significance of each source of output decline. An exogenous decline in foreign demand confronts a country with an unavoidable welfare loss, which is greater the more difficult it is to transfer the resources formerly used to produce exports into alternative uses. The losses stemming from the disappearance of the Soviet market were undoubtedly severe.

The second heading is currency overvaluation. An overvalued currency can destroy the tradable-goods industries and thus damage output, as anyone who recalls British experience in the early 1980s will be well aware. So far this seems to have been important only in Eastern Germany, where the 1:1 exchange rate chosen at the time of German monetary union made East German costs hopelessly uncompetitive. I am not claiming that matters could have been materially alleviated by choosing a different nominal exchange rate at the time of unification: on the contrary, the fact that East German wages rose sharply after unification suggests that the competitive benefits would have been inflated away very quickly. Exchange rate policy was impotent because of the high degree of labour mobility combined with the willingness of West Germany to pay almost unlimited sums to curtail the migration of workers to the west. It nonetheless remains true that the uncompetitive exchange rate led to the collapse of output in East Germany.[9] It looked last year as though the Polish zloty was in danger of becoming overvalued, but Poland began to crawl last October, perhaps just in time. Thus the only country that I enter under this head in Table 3 is Eastern Germany.

In general I would classify currency overvaluation as a social loss due to policy error (an "avoidable loss"), although a modest and temporary overvaluation might be a rational part of a programme of combating inflation and therefore be classified as an investment in stability. (The phrase "avoidable loss when excessive" in Table 3 is intended to convey the notion that some output

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[9] Akerlof et al (1991) argued that the output costs could have been diminished by a well-designed labour subsidy.

loss from this cause may be a rational investment, but that when carried to excess it involves social waste.) But in the particular case of Eastern Germany I think it is fair to classify the overvaluation as exogenous, because of Western Germany's willingness to pay subsidies of over 50% of Eastern German GDP to curtail migration.

The third heading is Keynesian demand deficiency. Fiscal and monetary policy may be tightened with a view to controlling inflation or correcting the balance of payments, and the consequent reduction in nominal demand may cause a fall in output for Keynesian reasons. We know that in principle a totally credible stabilization programme might not have any output cost at all in the presence of rational expectations, but we also know that stabilization typically does have a temporary cost in terms of lost output, perhaps because of the need to build credibility, perhaps because not all expectations are rational, and perhaps because of the structure of contracts. Such output losses are in the nature of an investment if they are no larger than is necessary to achieve stabilization, and a social waste if demand deflation overshoots.

There was a vigorous debate in Poland as to whether demand deflation was responsible for the depth of the Polish recession. For a time I subscribed to the view that an excessive devaluation of the zloty at the beginning of 1990 had replaced monetary overhang by monetary stringency (by reducing real balances) and in that way led to excessive deflation. The fiscal surplus of the first half of 1990 reinforced the charge of overkill. But in an interesting paper Stanislaw Gomulka (1992 forthcoming) points out that the bulk of the Polish money supply at the end of 1989 was in the form of dollars rather than zlotys, and therefore its internal purchasing power tended to be increased rather than decreased by devaluation. Meanwhile the budget deficit has reappeared while inflation has not vanished. It thus seems difficult to classify Poland as a case of deflationary overkill.

The one country that does seem to me to have erred in that direction is Czechoslovakia. This is a shame because the microeconomics of the transition were handled better there than anywhere else: the government took a year to prepare its plans and then moved with a broad-ranging package of measures, very much in line with the recommendations summarized in my first lecture. Until the end of 1990 the economy remained in macro balance: output fell only marginally, inflation was low, there was no appreciable monetary overhang or external deficit, the budget was balanced, and the foreign debt remained modest. These figures provided no convincing rationale for allowing fiscal policy to produce a surplus of 8% of GDP, devaluing to close to the black market rate,[10] or raising the interest rate to a real rate of 20% a year, let alone doing all three together. That looks like deflationary overkill to me.

The fourth reason for output loss can be considered a special case of the preceding one,[11] when a demand deficiency is dictated by a shortage of foreign exchange. When I was a student we took it as axiomatic that inadequate foreign exchange could force a country into deflationary policies, but since this seems to be doubted nowadays by those whose training is too narrowly neoclassical it may be worth spelling out why a freely floating exchange rate does not make this a non-problem. Consider a country whose exports are less than its full-employment imports at a competitive exchange rate, defined as an exchange rate such as to induce balanced trade[12] at full employment in the medium term. But suppose that exports have not yet built up to their steady-state level, so that there is a trade deficit at full employment. Does it follow that devaluation could necessarily reconcile internal and external balance in the short run? No. The short-run effect of devaluation in switching expenditure toward domestic goods is small, and the capital inflow predicted by Dornbusch's overshooting model requires national creditworthiness that is currently lacking in Eastern Europe. Thus the mechanism that will achieve external balance with a floating exchange rate is a downward float until domestic inflation has deflated real money balances to a sufficiently depressed level to achieve trade balance, at the cost of the level of output. Internal balance is sacrificed.

It may be possible to limit that output loss by restricting imports, which is what Western Europe did during the years of postwar reconstruction. This can be efficient if protection that is

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[10] Even without the mistake of announcing that intention months ahead of time in a public lecture at LSE! Incidentally, the objection to going to near the black market rate is that, since black markets are marginal markets driven by attempted capital flight prior to stabilization, there is a strong presumption that the exchange rate established there will be too weak to sustain a desirable macroeconomic equilibrium after stabilization. Note also that the devaluation caused the fiscal surplus: the price of inventories rose, which created paper capital gains on which enterprises had to pay profit taxes.

[11] Special cases are indicated in Table 3 by a dash preceding them in the first column.

[12] Strictly speaking one should refer to a trade deficit that can be safely financed on a sustainable basis rather than implying that only trade balance is acceptable in the medium term.

confined to imports that compete with domestic production can buy more expenditure-switching per unit of inflationary pressure than can be achieved by devaluation, which seems likely although not quite tautological. Where this alternative exists, to tolerate a loss of output because of the foreign exchange constraint is another case of social waste. Where it does not exist, a foreign exchange shortage has to be classified as imposing an unavoidable loss. Of course, output losses imposed by the foreign exchange constraint provide a classic case for international aid.

Several East European countries have undoubtedly been foreign-exchange constrained in the past couple of years; perhaps most critically Bulgaria, but also Romania and in 1991 the Soviet Union. All the successor states of the Soviet Union face a foreign exchange constraint in the future, although Russia has by far the best prospect of overcoming that constraint relatively rapidly (because of its supplies of energy and raw materials). These constraints are more severe than can plausibly be dealt with by transitional tariffs. Other countries may also have suffered from a foreign exchange shortage: if the worsened Central European terms of trade consequent on the demise of CMEA[13] can be partially blamed for their output declines, this is the channel through which it would have worked. But since it is not clear that they have in fact been foreign-exchange constrained, I have not included them in this row of Table 3.

At this point it is necessary to extend the taxonomy that we hijacked from the developing countries, because there are at least two other demand-side effects that have been blamed for reducing output in Eastern Europe. The first of these is <u>demand-shift</u>. When demand shifts from one type of good to another, resources have to be redeployed from the former to the latter. There is typically a delay between their release and their reabsorption in a different activity, and in the meantime they produce nothing and in consequence output declines. For example, in Czechoslovakia last year government spending fell by an estimated 12% of GDP (OECD 1991): most of that was offset by tax cuts so that in due course the main effect will be on the composition rather than the level of output, but because this redeployment takes time the short-run effect is to decrease output.

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[13] These were estimated by Dani Rodrik as amounting to 2.9% of GDP in Poland, 3.7% of GDP in Hungary and 5.4% of GDP in Czechoslovakia (Rodrik 1992, Table 5.2).

An important cause of demand shift in an economy integrating itself into the world economy is from the production of import substitutes to that of exports. This shift is in the nature of an investment - an immediate cost that will bear fruit in the future as redeployment into higher-productivity activities occurs. But it is nevertheless inefficient to have large pools of resources that are made idle years before they can be reabsorbed elsewhere. This provides the justification for transitional "senile industry" protection: it is better that, until they can be reabsorbed elsewhere, resources should produce goods of low value-added than that they should not add any value at all. Hence I have to divide my entry in column 3 into a "slow demand-shift" that is an investment and an "excessive demand-shift" that goes into the category of avoidable social loss.

A special form of demand shift occurs when goods that were formerly produced are no longer wanted. The unwanted goods are not only military supplies but also inventories that were accumulated as a store of value in the absence of financial assets capable of fulfilling that role and investment goods whose only purpose was to produce unwanted goods, including more investment goods with no end-use (steel to build steelworks to build more steelworks...). Production of fewer unwanted goods is a benefit and not a cost.

This is a particularly potent factor in the former Soviet Union, especially Russia, where the military-industrial complex was vast, perhaps as much as 25% of GDP. The surplus inventories and pointless investment activities were also extensive. It is remarkable that there are no serious estimates of just how large the benefits of stopping producing unwanted goods have been, but they were probably significant in all the countries, except perhaps Hungary.

Let us now turn to the supply side of the equation. We can again start with the sort of exogenous shocks that figured in the previous taxonomy, though there is not much reason to attribute the decline in East European production to that source, except possibly for part of the fall in output of petroleum in the former Soviet Union.

Of vastly more importance is the fact that price changes make some part of former output uneconomic. The extreme case is where the production of a good requires inputs with a higher value (at world prices) than the value of the output - the case of negative value-added (NVA). (Polish production of semi-tropical flowers is a case in point.) Hughes and Hare (1991) calculated that between 19% and 24% of industrial production in the three Central European countries resulted in negative value-added. That may be an over-estimate inasmuch as it assumes zero ability to substitute inputs, but on the other hand it makes no allowance for the costs of pollution. (Some observers also question the plausibility of their finding that the food processing industries of Central Europe all seem to have negative value-added.)

In general an end to the production of goods with negative value-added is another benefit almost as great as ending the production of bads. It is true that Ronald McKinnon (1991) has argued that industries producing negative value-added should be given time to adjust to the new vector of input prices confronting them, on infant-industry grounds. Clearly it is conceivable that some enterprises that presently produce negative value-added might be driven out of business by a precipitate move to world prices despite having the potential to adjust and become viable, but I must say that I would want to see evidence that the present value of saving an activity was likely to be positive before I went out of my way to defend value subtraction. In the absence of evidence we should cheer the demise of such activities.

Activities may also be forced to close down where value-added is positive but too low to support conventional levels of payments to the factors of production involved. Modest output losses as such activities are closed gradually and the resources are absorbed in other, more profitable, activities are an investment. But in excess we come again to the case for senile industry protection - a far more promising cause in Eastern Europe than infant industry protection *à la* McKinnon.

Another supply-side reason for output declines has been the dislocation of input supplies. As enterprises stop supplying goods through the traditional channels formerly dictated by the planners, their customers may have difficulty in arranging alternative sources of supply. Similarly, there are fears in the former Soviet Union that the new international boundaries between the sovereign states may result in disruption of input supplies. The output lost through such dislocation of input supplies is pure social loss.

What is not clear is whether this is a cost that can legitimately be attributed to liberalization, rather than to the collapse of the old regime. Consider the Soviet case, which is where the disruption of input supplies has certainly been a major factor. As Soviet central planning broke down, more and more enterprises began to neglect their duty to fulfill their state orders before selling some of their output at free-market prices through the commercial exchanges. These exchanges are still less than two years old, but there are already over 400 of them dealing in everything from primary commodities to used steel rails to consumer goods. Their rapid emergence is a standing refutation of the charge that Russians lack entrepreneurial instincts. At first blush one would assume that a market that provided a mechanism for enterprises to relieve their bottlenecks by buying critical missing inputs could hardly fail to be welfare-enhancing; but diversion of supplies to the exchanges has also been responsible for creating bottlenecks. In an environment where there is no mechanism that enables managers to know which state orders are supplying critical needs and which are dispensable (even if there were an incentive for them to respect such priorities, which was in fact also lacking), it is at least possible that a part of the reason for the collapse in output is that input supplies have been arbitrarily disrupted in order to earn the much higher prices available from sales on the commercial exchanges. Presumably one benefit of liberalization will be to make the more conservative enterprises willing to trade on the exchanges (or bid the market price), thus diminishing the danger that supplies will be diverted from high-priority to low-priority uses. That gives ground to hope that, after the current initial period of chaos as supply relationships are changed, liberalization should decrease rather than increase output losses from this source.

The final supply-side effect comes from a credit squeeze. This is a factor that has been emphasized by Calvo and Coricelli (1992). Withdrawal of subsidies coupled with massive devaluation and severe limits on credit expansion meant that enterprises no longer commanded the credit to buy the inputs needed to continue producing the former level of output. Enterprises resorted to increased levels of inter-enterprise credit to try and circumvent the shortage of bank credit - a circumvention that the authorities have also tried to limit. Calvo and Coricelli argue that this can explain a number of the apparent paradoxes of the Polish stabilization programme: the coexistence in labour-controlled enterprises of high profitability and wages less than the ceiling allowed by the incomes policy, and the coexistence of continuing inflationary pressures with the fall in output and rise in unemployment. This seems to me convincing, though perhaps I should confess that my approval may be encouraged by the confirmation the theory seems to provide for one of my longest-standing convictions, which is that any government that allows its exchange rate to become seriously misaligned is asking for big trouble.

Specifically, I can still blame some of Poland's troubles on the excessive Polish devaluation even though Gomulka tells me there was no real balance effect. Conditions in Czechoslovakia seem to be similar, and possibly the expansion of inter-enterprise credits in Hungary also suggests that credit stringency may have been involved there. A credit squeeze beyond what is necessary to control demand and to impose hard budget constraints on enterprises seems counterproductive, and accordingly I describe it as imposing an avoidable loss.

Assessing the Conventional Wisdom

Does the above assessment of the factors that have led to the collapse in output in the economies in transition suggest that the sort of advice we economists have been giving is seriously flawed?

Note first that Table 3 suggests there are a lot of reasons why output might have been expected to decline. Unfortunately, apart from Rodrik's estimates of the impact of the Soviet demand shock and the Hare and Hughes attempt to measure the prevalence of negative value-added, we have no quantitative estimates that would help decompose output declines among the various possible causes. I am not sure that my taxonomy is perfect, *i.e.* mutually exclusive and collectively exhaustive, but I hope that it may be good enough to stimulate some effort into decomposing the sources of the collapse. Until we have a reasonably convincing decomposition of the causes of output decline we cannot do much to develop policy recommendations.

Second, some output losses were positively desirable, others were unavoidable, and others were in the nature of an investment. I do not doubt that avoidable losses remain, but their magnitude is less, perhaps substantially less, than that of the decline in output.

Third, a general accusation of excessive demand deflation appears unwarranted. That complaint can legitimately be made against policy in Czechoslovakia, but elsewhere I see little justification.

Apart from excessive demand deflation in Czechoslovakia, the table suggests two other areas where policy may have erred. One is in not providing substantial transitional protection to buffer the adjustment process: in early 1991 I heard a high Polish official boast that Poland's trade regime was as liberal as that of Hong Kong. He may have exaggerated slightly, but one cannot doubt that several countries did make a dash for world prices. It is one thing to argue in favour of starting off adjustment quickly on a broad front, it is another to demand that the system go straight to free trade prices. The problems of adjustment in response to demand shift, a foreign-exchange shortage and low value-added as a result of price changes all seem to call for transitional protection. This is one of the issues that remains controversial among economists advising Eastern Europe, and perhaps this is where I should have distinguished my minimum bang from the big bang.

The other possible policy error was to squeeze credit excessively. One decision that was made in every stabilization programme so far was to inflate away the monetary overhang (even where there wasn't one, in Czechoslovakia) rather than to undertake a monetary reform, as happened in most European countries other than Britain after World War Two. It is increasingly argued that this has been a mistake (Dornbusch 1991, Newbery 1991, Sturzenegger 1991, Williamson 1991). The monetary overhang was inflated away by a policy of severe devaluation, to an exchange rate close to the prior black (or parallel) market rate, accompanied by price liberalization. The fact that the exchange rate was fixed subsequent to its devaluation was described as "providing a nominal anchor"; since the exchange rate was so devalued as to pull prices up, however, it would have been more accurate to describe it as providing a nominal balloon. This large devaluation gave enterprises head room to raise prices and wages without the hard budget constraint biting, and presumably a degree of inflationary momentum built up from what was supposed to be a one-shot price increase. The monetary overhang was quickly not only inflated away but replaced by a credit shortage, which depressed supply and thus output while not necessarily being effective at controlling inflation.

The alternative policy would have involved a monetary reform designed to absorb the monetary overhang without large price increases, on the model of what was widely done in Western Europe after World War II, accompanied by an initial wage freeze and an exchange rate that was fixed so as to validate the existing wage level. The idea of monetary reform was rejected out of hand in the Soviet

Union, following the bitter public reaction to Pavlov's "monetary reform" of January 1991. That was surely a mistake. Inflating away the overhang results in its confiscation just as much as any monetary reform does. Moreover, confiscating money balances in excess of some threshold is not the only possible form of monetary reform. Indeed, it seems a very silly form in countries that have a vast stock of assets needing to be privatized and virtually no non-monetary savings that the public can call on in order to buy those assets. It is not practicable to mop up the overhang directly by selling assets because privatization takes time if it is to be done properly. But it would have been possible to issue some form of "privatization certificates", that could have been used to purchase assets in due course, for money holdings in excess of whatever threshold was allowed to be converted into the new money.

A different type of complaint is that the reform programmes have once again committed the mistake of concentrating overwhelmingly on the demand side, when in fact the real problems of the ex-socialist economies lie on the supply side. This complaint comes in two main variants. One is the complaint that privatization has been too delayed. I think that most of us would have liked to see privatization move faster, especially of the supply and distribution network in Russia. Actually I am sure the same is true of Gaidar and his team, but small privatization is a local responsibility in Russia, not something whose pace can be decreed by the economic team. On the other hand, I would resist the idea that rapid large-scale privatization of large enterprises could have helped, since it takes time to privatize well and it is most inadvisable to privatize before price reform for fear of driving viable enterprises into bankruptcy.

The other complaint, voiced in a recent paper of Tad Rybczynski (1991), is that banking reform (including recapitalization) needed to precede or accompany price liberalization, so that the financial system would have been in a position to carry out its function of intermediating funds to those enterprises able to make a supply-side response. Once again, this is something that one would surely have liked to see happen sooner, although there is a question as to how much a reconstruction of balance sheets could do before the banks acquire personnel trained in the art of loan appraisal. Despite this caveat, I think that there is a case for wiping the slate clean of debt inherited from the past so as to permit a real hardening of budget constraints - a sort of equivalent to monetary reform so far as the enterprise and banking sectors are concerned.

What emerges from this review is that there may have been too little transitional protection, that one might have wished for more rapid privatization (especially of the supply and distribution networks in Russia), and that a widespread mistake has been made in not opting for monetary reform and an analogous sanitization of the balance sheets of enterprises and banks. But note that those latter operations would have been accomplished most naturally as another component of a bang, thus tending to make bangs bigger rather than smaller. Is transitional protection the only difference between a minimum bang and a big bang - the only crumb we should concede to the criticisms of the gradualists?

The gradualist case is based on the superior performance of countries that have opted for a more gradual strategy of adjustment, notably China and Hungary. China has certainly shown impressive growth ever since it started liberalizing something over a decade ago. However, the existence of a large, relatively self-contained agrarian sector just itching to get back to non-collectivist production practices created an opportunity for gradual reform in China of a sort that was absent in Eastern Europe.

Hungary is perhaps a more relevant comparator. It is true that Hungary has also experienced an output decline, but it is somewhat less severe than elsewhere in Eastern Europe. Moreover, there is wide agreement that it is the best-placed of the East European countries (excluding Eastern Germany) to resume growth in the near future.

These two cases do demonstrate that gradualist strategies exist: it is evidently not true that a committment to gradualism guarantees that a country will never make the transition. The analogy of a chasm that has to be crossed in a single leap is unpersuasive - so let us resolve that in future we will analyze these questions and not resort to analogies, which are often misleading.

But existence is not the same as optimality. It is at least possible that Hungary would be better off by now if it had invested in bolder reforms in the past, even if that strategy had brought with it a larger initial output decline. Where a country has a choice between a decisive package and gradualism, as Czechoslovakia did, it still seems to me sensible to make the choice that was made in Czechoslovakia. I limit this endorsement strictly to the set of microeconomic reforms that marked the move to the market and not to the macroeconomic policy that followed the bang, which I have already argued was poorly conceived. Vaclav Klaus reminds one of Mrs Thatcher: doing a rather good job of pushing through a number of badly needed microeconomic reforms, but then spoiling the results for a rather long short run by refusing to think seriously about the design of macro policy.

It is also relevant to note that what is probably the biggest output collapse of all (though admittedly it is not shown as such in the figures in Table 1) cannot be attributed to a big bang, because it occurred in a country - Albania - where no reform programme has yet started.

However, for most of the economies in transition the really decisive argument in favour of a big bang, or at least of a minimum bang, is quite different to that discussed in my first lecture. Most of those economies - the exceptions being Czechoslovakia, Hungary and Eastern Germany - were in a state of collapse when the reformers took office. Prices were rising, despite the maintenance of price controls; many goods had disappeared from the shelves; there were large budget deficits that had cumulated over time into monetary overhangs; the balance of payments was in crisis; the currency had become absurdly undervalued on the black market, indicating a pervasive lack of confidence; corruption was rampant; output had started to decline. Under those conditions the option of gradualism - of allowing a private sector to grow in parallel to the public sector, and making modest changes one at a time calculated to repair the most glaring defect evident at that moment in the public sector - simply does not exist. Drastic problems call for drastic remedies. The architects of reform in Poland, Bulgaria, Romania, and Russia have simply bowed to force majeure in opting for big bangs.

What is at Stake?

Let me devote a few minutes to discussing what is at stake in securing a successful transition. Let us start by considering what is at stake for the peoples of the countries directly involved.

Success will presumably lead to absorption in the Western mainstream: the construction of pluralist civil societies practicing democracy and enjoying increasing prosperity. It will take a long time - close to a half century under the best of circumstances[14] - before living standards will approach those in North America, Northern Europe and Japan, but communism bequeathed these countries

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[14] Eastern Germany may make it much sooner, but no other country can expect external assistance on a comparable scale.

populations that were sufficiently educated to give one reasonable confidence that they will succeed in starting to converge on the leading countries once sensible institutions and policies are in place. The big doubt must be whether they will have the patience to start the process. Once recovery is under way, the fact that they are still a lot less affluent than the other peoples of the temperate zone is unlikely to seem unbearably irksome.

I doubt whether the alternative to this comfortable (though to some doubtless unexciting) future is a reversion to anything approaching Stalinism or fascism. Something resembling Argentina in the decades between Peron and Menem is more likely: a succession of coups and democratic restorations, of populist experiments that bring temporary upturns at the cost of further undermining the fundamentals and programs that promise to restore the fundamentals but are never sustained to the point of giving recovery a chance. Or perhaps (particularly in Russia) it will involve the collapse of the authority of the central state and the emergence of warring subjurisdictions, as we have seen this past year in Yugoslavia. Whatever the form this alternative takes, the dangers of mass misery, of endless calls on the Western purse, of large-scale migration, of environmental disasters with a global impact, and of violent conflict that could even have a nuclear dimension, are vastly greater than they will be with a successful transition. I cannot understand those who claim that some collectivist abstraction called the "national interest of the United States" is uninvolved.

What is at stake for the developing countries? One encounters (or, in the case of Latin America, used to encounter, for Latin self-confidence has flooded back recently) widespread concern that trade, aid, investment, and technical expertise will be diverted from them to the economies in transition. Obviously no one can guarantee that no such diversion will occur, and indeed the most serious study I know of that tried to look at the diversion of trade and investment (Collins and Rodrik 1991) concluded that it could be significant, especially through the higher interest rates that are likely to result from increased investment demand. In one sense I would like to believe that the diversion of economic expertise away from the developing countries will be a blow to them - although I must confess that I have not quite convinced myself that they will miss us that much! It also looks to me as though the aid going to the East is largely additional rather than at the expense of the (almost invariably much poorer) previous aid recipients.[15] I see little danger that FDI will be diverted away from existing recipients: direct investment expands to fill the investment opportunities available, so new opportunities in the East will mean primarily more direct investment worldwide rather than diversion of a fixed fund from one area to another. I would even argue that the same may happen with trade: more production of clothing in East Europe may encourage West Europe to import more clothing and divert the resources into producing goods that can be exported to the East, rather than cutting imports from the third world. I am not saying this is inevitable: but I do believe that those interested in influencing policy should focus on the need to try and make it happen, rather than belly-ache about a threat from the East.

Another group of questions concerns the relations between East and West. If things go right, I would expect the East to be absorbed in the West. This is their desire, and I can see no legitimate Western interest in preventing it happening. The process has indeed already started, and it will continue this year with the entry of most or all of the 15 former Soviet republics into the IMF and World Bank. If the transition makes good progress, it will continue with the entry of the Central European countries into the OECD and subsequently into the European Community, and with Russian entry making the G7 into the G8. But the EC will have to think about much more enlargement than just absorbing the three countries of Central Europe: the real long-run question is whether Europe is interpreted to include or exclude the two countries that straddle both Europe and Asia, namely Russia and Turkey. All these new entrants will seem much less strange as the trade patterns of the countries of the East adjust westward, as research suggests they will.[16]

Concluding Remarks

I would conclude that we can now identify several respects in which, with the benefit of hindsight, we can see that the transition could have been handled better. We could have benefited from more transitional protection and early small privatization, Czechoslovakia adopted an

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[15] In one area the threat of diversion is real, because the need for aid will be long-term. I refer to the outlook for the Central Asian republics.

[16] Collins and Rodrik 1991, Vavilov and Vjugin 1992.

unnecessarily tough macro stance, and above all it was a mistake not to follow the path of monetary reform and sanitization of the balance sheets of enterprises and banks to let them start off with a clean slate. Perhaps some of these things could still help, though it would have been much better if they had been done sooner, at the time of the bang.

Nevertheless, the primary advice that we should address to Eastern Europe at the present stage must be to hang tough where a bang has already happened and to grit their teeth and take the plunge in those places where it has still not occurred. There are no demons whose ouster will take the pain out of the transition, and no panaceas whose implementation will guarantee a rapid turnround. To say this is not to claim that policy has been perfect or that we should stop searching for improvements, such as summarized in the preceding paragraph. But it is to recognize that there is a far greater danger of the transition being aborted because of a surrender to populist pressures than because some desirable policy modification remains unmade.

Such advice is hypocritical without a willingness to help. But once again we encounter here one of the profound changes in policy attitudes that has crystallized during the past decade: we no longer take it as axiomatic that more aid is better. Aid has sometimes been used to perpetuate that which needs to be ended to give recovery any chance. To avoid this danger, aid must be geared to supporting programs of real reform. Where such reform programmes are in place, we should be prepared to spend real money. That criterion suggests to me that we have been spending too little in Bulgaria and perhaps Romania and have been much too hesitant in offering serious aid - a stabilization fund and balance of payments support - to Russia once they take the next step of demonstrating that the budget is indeed under control and that the central bank will enforce a stringent monetary policy. The present economic team needs Western endorsement in a form that the Russian people can understand will be of benefit to them, in order to strengthen its political hand in the infighting that is likely to continue in Moscow for a long time yet.

It is a pity to end a discussion of such momentous issues by policy advice almost as boring as that which one dispenses when one testifies to the US Congress ("fix the budget deficit"). But the duty of economists is to give good advice rather than to entertain, so I do my duty.

TABLE 1

Output Changes in Eastern Europe 1988-91 (%)

	GDP	Industrial Production
Albania	-30	-40
Bulgaria	-30	-40
Czechoslovakia	-20	-30
Eastern Germany	-45	-65
Hungary	-15	-30
Poland	-25	-45
Romania	-30	-40
Soviet Union	-25	-30
Memoranda		
US 1933/29	-30	
UK 1930/28	-6	
Germany 1932/28	-11	-72
1946/39	-55	
Japan 1945/39	-50	na

Sources: Morgan Stanley, "Greater Europe 1982 - The Year of Living Dangerously", EuroStrategy No. 14, January 1982.

Angus Maddison, The World Economy in the Twentieth Century, OECD, Paris, 1989.

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TABLE 2

A Taxonomy of the Possible Causes of Output Decline in Developing Countries

External Demand:	Exogenous decline (world recession)
	Overvalued currency (inflation and fixed exchange-rate)
Internal Demand:	Keynesian demand deficiency - induced by FX-shortage (2-gap model)
Supply:	Exogenous shocks (weather)

TABLE 3

Possible Causes of Output Collapse in the Economies in Transition

Cause		Countries involved	Welfare implications
External demand:	Exogenous decline	Bulgaria, Hungary, Czechoslovakia Poland, Romania, East Germany	Unavoidable loss
	Overvalued currency	East Germany	Avoidable loss when excessive (unavoidable in East Germany)
Internal demand:	Keynesian	Czechoslovakia; Poland?	Avoidable loss when excessive
	-FX shortage	Bulgaria, Romania, SU, successor states	Avoidable/unavoidable loss[1]
	Demand-shift	Czechoslovakia, Poland	Slow: investment Excessive: avoidable social loss
	-Unwanted goods	Russia, all	Benefit
Supply:	Exogenous shocks	Russian oil	Unavoidable loss
	Uneconomic output	Widespread	NVA: benefit LVA: avoidable loss when excessive
	Input dislocation	Russia, CIS	Avoidable loss
	Credit squeeze	Poland? Czechoslovakia? Hungary?	Avoidable loss

Note: 1. Depending on whether transitional protection can buy more expenditure-switching per unit of inflationary pressure than devaluation.

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