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Introduction

Olivier Jean Blanchard, Kenneth A. Froot,
and Jeffrey D. Sachs

When communism fell in Eastern Europe in 1989, the issue in most countries was not whether to go to a market economy but how to get there. Arguments ranged from the timing of stabilization, to the speed of price liberalization, to the design of privatization.

The debate was extraordinarily compressed in time, for several reasons. First, and most important, the new governments came into power with little preparation and had to formulate programs quickly in the face of worsening economic conditions. During the late 1980s, the anti-Communist reformers certainly had little premonition that they would be in office (some of the new leaders came almost directly from jail), and the oppressive political milieu of the Communist period had prevented a full and open debate over economic options. As a result, the policy debate had typically been about long-term and philosophical issues rather than short-term and programmatic issues. Also, microeconomic issues, such as privatization and demonopolization, rather than macroeconomic issues, tended to dominate the debate, and many basic macroeconomic issues had hardly been discussed. The prevailing view among reformers at the end of the Communist period was that macroeconomic reforms, such as price liberalization and convertibility of the currency, would be gradual.

Much of this changed with the emergence of the Solidarity-led government in Poland in September 1989. In view of the rapidly deteriorating macroeconomic conditions in Poland at the end of 1989, the debate shifted quickly to macroeconomic stabilization and exchange rate management. And, with widespread public support for fundamental change, the policy debate shifted in favor of radical reforms. This shift of focus and emphasis culminated in the Balcerowicz Plan, introduced on 1 January 1990, which called for rapid price liberalization, sharp cutbacks in the budgetary deficit, tight monetary policy, and a quick opening of the economy, all this without waiting for privatization.

Czechoslovakia, Bulgaria, and Romania subsequently followed Poland's lead, while East Germany had a "shock" program of its own resulting from the economic and monetary union with West Germany in the summer of 1990. The situation was different in Hungary, where both the political and the economic transformations were less abrupt than elsewhere. Market reforms in Hungary had been under way gradually since 1968, and the macroeconomic situation was adverse but not collapsing. Under these circumstances, the new government opted for a more gradual course, although also one that was based on stabilization and liberalization first, to be followed only later by privatization.

Most of those countries have now taken the key steps of substantial price liberalization and macroeconomic stabilization, or at least enough stabilization to arrest the slide to hyperinflation. The process has been controversial from the start and has raised many questions. Can orthodox stabilization measures work in an economy dominated by state ownership? Can the lessons of stabilization in other parts of the world be transferred to the socialist economies? Can successful stabilization precede privatization and demonopolization of industry? These questions remain controversial. But they largely concern the past. East European governments are now turning their attention to the problems of privatization and restructuring. Here, the very scope of systemic transformation is such that there are few historical experiences on which to rely. Some apparent guideposts, such as privatization in Western countries, can be more misleading than helpful. Other historical cases, such as postwar reconstruction in Western Europe, provide at best fuzzy guides. The problem in Eastern Europe is not just to rebuild but to transform. Resources locked up in heavy industry must be reoriented toward light industry, housing construction, and services. Enterprises organized for a planned economy must be restructured in order to be responsive to market signals. Governments must also create the right incentives for economic actors during the transition period. This is proving difficult.

The purpose of this NBER conference, held in Cambridge, Massachusetts, in the spring of 1992, was to take stock, to identify common progress, common difficulties, and tentative solutions. The conference was divided into two parts, which correspond to volumes 1 and 2, respectively: (1) looking at the experience of specific countries (Poland, Czechoslovakia, Hungary, Germany, Slovenia, and the former Soviet Union), with an emphasis on macroeconomic policies and performance, and (2) looking at the problems of restructuring, from fiscal reform, to labor market structure, to the design of privatization and of bankruptcy mechanisms, to the role of foreign direct investment.

One of the aims of the conference was to draw on both the experience of those who have shaped or closely followed events in Eastern Europe and the expertise of those who, while not having been involved in the process of transition, were familiar with the particular issues at hand. This mix is reflected in the set of papers presented here.

A theme clearly emerges from the two volumes. The private sector is grow-

ing fast and filling many of the holes left by the previous Soviet-type economies. By contrast, the transformation of the large state firms is proving slow and difficult. This is not so much because they were in worse shape than expected as because privatization has been slower than expected, leaving those firms with neither the incentives nor the tools to restructure. The future of reform depends on the success of the delicate balancing act between growth of the private sector and rationalization of the state sector that governments have to perform. The newly emerging private sector is not yet large enough or wide enough to bring success alone. The state sector must be cut down to size, made more efficient through privatization and restructuring, before its inertia bankrupts the process of transition.

Volume 1: Country Studies

The countries of Eastern Europe can, for our purposes, be roughly divided into three groups. The first includes the major countries of Central Europe, in which there has been generally strong support for reform and, until recently, few redefinitions of borders. Those countries have already gone through stabilization and price liberalization and are now proceeding with privatization and restructuring. The second group includes just one country, the former East Germany, where the resources and the role of West Germany are so overwhelming as to lead to a radically different adjustment process. The third group includes those countries that have to struggle with both less support for reform and the redefinition of borders. This includes the states born out of both the former Yugoslavia and the former Soviet Union. The conference focused on both the experience of Slovenia, a new state born out of Yugoslavia, and the start of the reform process in the former Soviet Union.

Reform in Central Europe

Reform in Central Europe is the topic of the first four papers. The first is by Michael Bruno, who identifies both similarities and differences in the reform experience of Hungary, Poland, Czechoslovakia, Bulgaria, and Romania. Except for Hungary, which has pursued a stop-and-go limited reform process for most of the past twenty years, reform in those countries is a recent process. The first one to implement a full-fledged stabilization and liberalization plan was Poland, in January 1990. The others followed in early 1991. The experience of Poland is then reviewed in detail by Andrew Berg and Olivier Blanchard, that of Czechoslovakia by Karel Dyba and Jan Svejnar, and that of Hungary by Kemal Derviş and Timothy Condon. From these four papers, one can draw the following lessons:

1. In all countries, stabilization has been associated with a sharp initial decrease in measured output. While there are serious problems of measurement, the sign of the movement is unambiguous, although the scale is not. An important issue is how to allocate the causes of the measured output decline

among possible causes, including mismeasurement (especially underreporting of the new private sector), the decline of previously subsidized and protected sectors, the cyclical effects of monetary stabilization, and the collapse of trade arrangements within the CMEA (Council for Mutual Economic Assistance), especially between the East European countries and the Soviet Union. For Czechoslovakia, Bulgaria, and Romania, stabilization and the collapse of the CMEA coincide, making it difficult to allocate blame. But the decline of output in Poland in 1990, before the major collapse of the CMEA, suggests an important role of stabilization and also mismeasurement. Contrary to some expectations and fears, the decline in output appears to be due not to supply disruptions but rather to a demand contraction.

2. In all countries, stabilization and price liberalization have led to a large price adjustment. In Poland and Czechoslovakia, there was a large jump in the price level at the point of price liberalization. In some countries, inflation has since tapered off; in others, it is still running at 2–5 percent a month. The initial price adjustment was higher than initially forecast, but it is not clear that much more has been at work than the passthrough of cost increases that were also larger than expected. Berg and Blanchard argue that, in the case of Poland, the price increase can be more than fully attributed to cost increases, counter to the idea that price liberalization allowed monopolistic enterprises to raise their markups over costs. Bruno raises the possibility that, in some countries, the large initial devaluation may have contributed to the initial inflation.

3. In all countries, there has been some shift of export markets from the East to the West. One of the most controversial elements of the "big bang" in Poland and elsewhere has been the rapid opening of the economy. This trade liberalization typically embodied several steps, including a steep devaluation, followed by convertibility of the currency on current account; an elimination of most quantitative trade restrictions; and the imposition of relatively low tariff rates. One of the goals of the rapid liberalization was to end the "anti-export" bias of the old regime, in which exporters were subject to a hugely overvalued exchange rate as well as many other restrictions. The second goal was to introduce international competition into domestic markets that were typically oligopolistic in market structure. One wide fear in Eastern Europe was that quality of production was so low that "there would be nothing to sell in the West." These fears have not materialized. In fact, exports to the West have grown rapidly and have helped compensate for the very sharp decline in trade with the Soviet Union.

4. Implementing privatization has proved harder than expected. In most countries, substantial progress has been made in privatizing small- and medium-scale firms. But privatization of large firms is still largely in the future, for many reasons. Parliaments have insisted on extensive involvement, making the process more democratic but also cumbersome. Various stakeholders have had strong incentives to oppose or sabotage particular schemes. Initial schemes, often modeled on Western ones, have proved unworkable, or work-

able only at very low speeds. Countries are now experimenting with a variety of more radical schemes. Poland is preparing for mass privatization, through the creation of investment funds as financial intermediaries. Hungary has shifted to a system with more reliance on individual initiative and only ex post control by the state. Czechoslovakia has embarked on the most ambitious plan, a voucher system with auctions, for about one-fourth of all large state firms. Dyba and Svejnar give an insightful discussion of the benefits and dangers of the voucher plan.

5. Largely as a result of slow privatization, there has been less restructuring than was expected and than is needed. In many countries, and particularly in Poland, workers have gained substantial rights of governance within the enterprise and in many cases have operated with shorter and shorter horizons. Firms have decreased employment by less than output, leading to declines in labor productivity. Despite the presence of government incomes policies in all countries, wages have increasingly appropriated revenues, and profits have declined. In the presence of constraints on credit to state firms, firms in difficulty have often relied on forced interenterprise credit. Bankruptcy laws have been little used for several reasons: many creditors are now hostages to borrowers; banks are state owned, with few incentives to press bankruptcy proceedings; the bankruptcy laws are difficult to apply; and creditors, debtors, and the courts have little experience. The credibility of the hard budget constraint is and will be tested for some time to come. Reading the papers in these two volumes, one senses different degrees of pessimism among the authors, with somewhat more pessimism regarding Poland than Hungary. Nonetheless, given the sketchy information available, it is difficult to judge whether the different nuances add up to real variations among countries. Data comparisons between Hungary and Poland, for example, do not suggest any notable differences in macroeconomic performance.

6. In all countries, the private sector has done very well. In the nonagricultural economy, Poland's private sector now represents around 30 percent of total employment, up from 13 percent at the start of reform. Including agriculture, almost half of Polish GNP is already produced in the private sector. Most of the growth has been in services and trade, two sectors repressed under the previous system. Some of it has been in industry, and some signs are very encouraging. At the end of 1991, private exports accounted for 20 percent of total exports in Poland; in Hungary, 50 percent of exports was accounted for by firms with fewer than fifty workers. Nevertheless, because of lack of know-how, of entrepreneurs, and of a competent banking system, new private firms remain for the most part very small businesses; it is clear that the new private sector cannot by itself be counted on to replace the state sector. The papers point to interesting differences in private-sector growth. In Czechoslovakia, private-sector growth appears to have been much faster in the Czech lands than in Slovakia, leading to much higher unemployment in Slovakia. Variations are also evident in Poland, with low unemployment rates in the largest cities (ex-

cept for high-unemployment Lodz) and higher unemployment in the rural areas.

7. Two years into reform, most governments face similar short-run issues. Reform fatigue tends to set in, making it harder to pass legislation with large redistributive implications. Most governments are faced with chronic deficit problems, coming primarily from the declining revenues from the profit tax on state enterprises. In the short run, they must deal with the fiscal crisis, until revenues from the new taxes come on line. But, more fundamentally, they must change the behavior of state firms. Even if the current privatization schemes proceed on schedule, it is not clear that the decentralized ownership that they may generate will be sufficient to bring about restructuring. Clarification of bankruptcy rules is essential. So is the reform of the banking system, an issue discussed at some length by Bruno. And so is maintaining the credibility of the hard budget constraint: even profit-maximizing owners have an incentive not to pay taxes or not to repay loans if they think that there are no risks in doing so.

The Absorption of the Former East Germany

The experience of the former East Germany, which is reviewed by Rudiger Dornbusch and Holger Wolf, differs in two major ways from that of other Central European countries. First, firms in the former East Germany have been pressed to pay wages close to those current in West Germany. Second, the former East Germany is benefiting from an infusion of West German know-how, finance, and transfers on a scale unavailable to other countries.

The first issue taken up by Dornbusch and Wolf is that of conversion of the ostmark into the deutsche mark, at a one-to-one exchange rate. Even though most observers concur that the conversion took place at a hugely overvalued exchange rate for the ostmark, Dornbusch and Wolf argue that the rate of conversion probably made little difference to the macroeconomic outcome. In particular, given the implicit commitment of the German government and the privatization agency, the Treuhand, to absorb losses of firms for some time to come, the drive for wage parity was probably unavoidable and not very much affected by the official rate of conversion. In fact, East Germany wages rose sharply in nominal terms after the conversion of ostmark wage rates into deutsche mark wage rates, suggesting that the conversion itself was not the source of the wage pressures in East Germany.

Dornbusch and Wolf then document the extent of the drop in production in East Germany. Industrial production was down by 54 percent in 1990 and by another 20 percent in 1991. In effect, very few products are competitive at the existing wages. At the same time, transfers from the West to the East amounted to 73 percent of East Germany GDP in 1991. The high transfer payments therefore are supporting the high wages and consumption levels, despite the lack of competitiveness at those wage rates.

Dornbusch and Wolf then turn to the actions of the Treuhand, which at the

beginning assumed 95 percent of the enterprise sector and was given the task of privatization. Its strategy has been to look for single buyers, preferably with expertise in the given sector, and to put weight not only on price but also on employment and investment commitments. This has led the Treuhand to dismantle some of the larger *Kombinate,* in order to make the pieces more attractive, and to be more discretionary in its choice of buyer than auction systems would have been. Progress has been fast, but, as is documented in the paper, tax breaks and debt relief have made some of these sales very costly for German taxpayers. Earlier studies have suggested that East Germany could address its lack of competitiveness by putting in place wage subsidies that would phase out automatically over time. Alternatively, Dornbusch and Wolf suggest announcing an end to subsidies for jobs and the enforcement of bankruptcy rules thereafter, saying that what is important is to "protect people, not jobs." It is, however, an open question whether the German government can actually commit to a fixed timetable for removing subsidies, especially in cases of large firms in regions with high unemployment.

Dornbusch and Wolf conclude that the reform is likely to prove a success, albeit a very costly one. In view of the size of the transfers from West to East Germany, they wonder whether Central European countries will be able to succeed, whether the much more depreciated exchange rate (and lower wages) will be sufficient to offset the lack of transfers.

Creating New States: Slovenia and the Former Soviet Union

According to the paper by Boris Pleskovic and Jeffrey Sachs, Slovenia's recent experience in achieving political and economic independence offers lessons for the nineteen other new countries that have emerged out of the former Yugoslavia and the former Soviet Union. Slovene independence from Yugoslavia was achieved in steps during the period January 1991–October 1991. By the end of this process, on 8 October 1991, Slovenia introduced its own currency, the Slovene tolar, thereby becoming the first of the new states to achieve monetary independence. Subsequently, it stabilized the economy and carried out fundamental economic and institutional reforms. This progress was accomplished despite difficult circumstances, including the Yugoslav civil war and the nearly complete loss of the former Yugoslav market.

The basic idea of the monetary reform was straightforward. All bank accounts and domestic wages, prices, and other contracts were to be converted automatically from dinars to the new currency, the tolar, on a one-to-one basis. The currency in circulation was to be physically converted during a short period of time. The new currency was to be the sole legal tender after conversion and was to trade freely with international currencies on a convertible basis and also to float freely against the Yugoslav dinar. The implementation of the monetary reform was carried out during 7–10 October 1991, according to plan, although some vestiges of the old multiple exchange rate system remained for a few months.

The most urgent motivation for the monetary reform was to protect the Slovene economy from hyperinflation, a fate expected for the Yugoslav dinar. As it turned out, these expectations were correct. Yugoslav inflation has grown very rapidly since October 1991, reaching 100 percent per month in June 1992. In contrast, in Slovenia, monthly inflation peaked at 21.5 percent in the month of conversion and since then has fallen gradually, to 5.1 percent in April 1992 and to 1.2 percent in August 1992.

Slovenia has also been successful in other areas of macroeconomic stabilization and trade liberalization. It carried out a tax reform and achieved a slight budget surplus in 1991. Exports to the West increased, and the economy experienced a trade and balance-of-payments surplus both in 1991 and in the first half of 1992. The decline in industrial output continued in 1992, but at a slower rate than in the last quarter of 1991. The unemployment rate reached around 11 percent in early 1992. As elsewhere, progress on privatization and financial restructuring has been very slow.

According to Pleskovic and Sachs, there are several lessons to be gained from Slovenia's experience. First, the experience shows that it is possible to move quickly on macroeconomic stabilization with the help of a well-conceived monetary reform. Second, convertibility (at least trade transactions) can and should be introduced from the beginning of the monetary reform. Third, technical work on the conversion can be done quickly. Fourth, trade will reorient itself to new markets, as soon as sufficient opening of the economy occurs. Fifth, as in Central Europe and the former Soviet Union, Slovenia's experience also shows the risk of becoming bogged down in a protracted privatization debate.

At the time of the conference, reform had barely started in the former Soviet Union (FSU) and was taking place within the context of a collapse not only of the relations between republics but also of the central structure within each republic. After reviewing the past, in particular the New Economic Policy (NEP), Stanley Fischer focuses on the two issues that are making reform in the FSU harder than elsewhere.

Macroeconomic stabilization requires a firm grip on the budget and on money creation, but that firm grip is present in neither case. Taxes collected at the local level are often not being transferred to the center. The central bank, sometimes under pressure from the Parliament or the government, is willing to let credit to state firms increase rather rapidly, making stabilization more difficult. Thus, as of the time of this writing, the budget deficit is large and inflation high.

Privatization is nevertheless proceeding. The collapse of the center has left managers de facto in charge of firms (unlike in Poland, workers in the FSU have little authority within the enterprises). Fischer argues that Russia has learned from the problems of privatization in other East European countries. Current privatization plans recognize the de facto stakeholders, so as to enroll

their support. He suggests a two-track privatization plan, one for small firms and one for larger firms, the latter encouraging self-privatization with approval by the privatization agency.

Fischer then turns to the relations between republics. He argues that, to understand current developments, one must understand the role of Russia as the leader and the sheer difficulty the other republics have taking steps on their own, such as creating their own currencies. He discusses the pros and cons and the ways of introducing different currencies. He argues for the creation of a payments union, whether or not republics move to the adoption of convertibility and their own currency.

Volume 2: Restructuring

With the country papers in volume 1 having provided the context, the papers in volume 2 then turn to the particular issues. These include labor market institutions, public finance, privatization, bankruptcy reform, and foreign trade. We discuss them in turn.

Organizing Labor Market Relations

Should East European countries move toward a system of centralized or decentralized bargaining? Should institutions be different during the process of transition? These are the questions taken up by Richard Freeman. Given that we do not have the answers to those questions even for Western countries, Freeman emphatically refuses to make specific recommendations. But his paper nevertheless provides a useful framework within which to think about the issues.

Freeman first looks at existing institutions and points out that the old Communist unions are doing well. In Czechoslovakia, the old unions have been taken over by new leaders. In Poland, Bulgaria, and Albania, old and new unions coexist; in Hungary and Romania, new unions coexist with breakaways from the old ones. Old unions are doing well because of the advantages of incumbency, the large resources that they have been able to keep, the organizational weakness of the new unions, and the benign neglect of the government. Thus, the initial situation in labor relations as well as in most other places is not one of a tabula rasa.

Freeman then looks at changes in the labor market. Wage dispersion is increasing, usually in a way related to differences in profitability across enterprises. Unemployment is increasing but is not yet felt to be a major hardship by the population as a whole. The private sector is growing and the state sector contracting. Freeman argues, both informally and with the help of a simple model, that the main risk to reform from the labor market is that an increasingly large group of workers will feel that they will lose from reform and at the same time be sufficiently powerful to stop it. Thus, he argues, structures of

negotiation and organization that reduce this risk, for example, unions that cover both the contracting and the expanding sectors, will increase the chances of success of reform.

Achieving Fiscal Reform

Three papers deal with fiscal reform. Roger Gordon looks at fiscal policy in the transition and the design of a new fiscal structure. Peter Diamond looks at the setting up of pension funds. Alain de Combrugghe and David Lipton look at the concrete problems faced by Polish fiscal policymakers today, as a case study of the budget in transition economies.

Roger Gordon emphasizes two aspects of prereform fiscal policy. The first is that the structure of taxes differs considerably from that of Western counterparts, in particular, with the large role played by profit taxes. The second is that, as soon as the transition process starts and prices start playing a role, all the distortions implicit in the tax system are activated. If not changed, the heavy emphasis on enterprise profits, together with the steady decline in the profits of state firms in the trańsition, is a recipe for fiscal crisis, as has indeed occurred in a number of countries. This problem, together with the many distortions of the tax system, implies that fiscal reform should be high on the reform agenda; distortions can derail the reform process.

After looking at the institutional constraints, including the lack of a reliable accounting system, the difficulty of taxing much of the private sector, and the difficulties in enforcing tax collection, Gordon recommends the replacement of both turnover and profit taxes by a value-added tax. Given the relatively small dispersion of most incomes, he even suggests that a value-added tax may for a while be an acceptable substitute for an income tax. Gordon suggests first changing from the turnover tax to a value-added tax on state firms, a change that can be achieved rapidly, and then introducing a value-added tax on private firms, a move that will take longer.

The transition economies of Eastern Europe are surely not first-best economies. Thus, many proposals have suggested offsetting the various externalities and distortions by taxes and subsidies. In the last part of his paper, Gordon discusses a number of such proposals, from tax holidays to the design of unemployment benefit systems. There is no simple punchline here, but an informed and useful discussion.

One of the largest components of the fiscal reform is the pension and disability system. Peter Diamond's paper examines pension reform proposals in Poland, the country that has gone the furthest toward developing a new system. As with the overall fiscal situation, the status of the pension system as the Communist regime collapsed was highly problematic. The Polish system was a defined-benefit system, with benefits based on years of service and earnings in the last twelve months of work. As Diamond argues, this structure presents a number of incentive and compliance problems and is likely to be inappropriate for a capitalist economy with voluntary (and variable) employment. (To

complicate transitional matters, no records are currently being kept for earnings prior to each employee's last year of work.) Furthermore, the current structure provides for only a very low level of income for many current and prospective retirees, and there is little operating room in the overall fiscal position.

It is in this environment that the Poles are considering revamping their pension system. Diamond explores various implications of the current proposal, which has three critical features: first, it would provide for a *social* pension system with initial benefits of up to 120 percent of the national average wage; second, it would mandate a ceiling on *total* (social plus private) benefits of 250 percent of the national average wage; and, third, it would create a privately funded system for benefits in between 120 percent and 250 percent of the national average wage.

As both the United States and Chile provide models for advanced, privately funded, defined-contribution pension systems, Diamond draws lessons from these cases. He considers in detail some of the key differences between privately run, defined-contribution plans and publicly run plans. The most important of these include the effects that changes in pension expenditures have on nonpension parts of the government budget, the pros and cons of having a competitive group of privately managed pension funds (as opposed to a centralized fund), and the transition difficulties involved in establishing fully funded plans.

Diamond also discusses the particular difficulties of finding channels for pension savings in a country with poorly developed capital markets. In some respects, forced pension saving mandated by the government may be considerably less efficient than private savings, which may not need the same degree of financial intermediation. Diamond explores many other considerations, such as implications for corporate governance and management oversight and the feasibility of regulating privately sponsored retirement plans.

De Crombrugghe and Lipton look at the difficulties of managing the fiscal budget before, during, and after the transition to a decentralized economy. Their specific focus is on Poland, but it is striking how widely relevant the discussion is for any country in transition. The paper begins with a description of the pressures on Poland's budget as the Communist regime collapsed. Despite sharp decreases in revenues, the budget still averaged a 3 percent surplus in 1990. De Crombrugghe and Lipton argue that this was the result of four factors: a one-time paper profit windfall, leading to temporarily high measured profit; the sharp cut in subsidies associated with the price liberalization facet of the reform program; the reduction in external debt service; and a reduced level of government investment spending.

However, new budgetary pressures emerged. Over time, the immediate improvement in enterprise tax revenues vanished, as some of the capital stock became useless at market prices and with the collapse of the CMEA, as further wage increases in the state-owned sector reduced profits, and as many new private-sector businesses were able to escape taxes on profits. A new tax sys-

tem is being put together, but it will take time to eliminate loopholes and improve compliance. On the expenditure side, spending on unemployment insurance and social security benefits has begun to rise rapidly.

De Crombrugghe and Lipton emphasize that these budgetary pressures will continue in the years ahead. Public investment is badly needed to clean up severe environmental degradation and to shore up an infrastructure that is inadequate for a growing economy. Recapitalization of the banks (whose assets include a sizable proportion of bad loans) will also create demands on the budget. Deficit financing for these needs may be desirable if bond finance (domestic or foreign) rather than monetary finance can be tapped.

The authors emphasize the magnitude of the short-run dangers. Demands on the budget will grow much more rapidly than either financing or tax-revenue-raising programs. There will be a strong near-term temptation to monetize deficits, which must be resisted if inflation targets are to be achieved. Existing taxes, such as "dividends" (a tax on enterprise assets), should be used actively until more flexibility is developed. The task of reinventing fiscal expenditure and revenue programs is immense and is one that every East European economy currently faces.

Accelerating Privatization

Three papers in volume 2 address what is probably the single most formidable obstacle facing Eastern Europe in its transition to capitalism—privatization. As the privatization process unfolds across Eastern Europe, it is clear that the experience across countries will be highly varied. In general, privatization will take place amid prolonged confusion about the identity of owners (including past owners), the rights of managers and workers, and the role of the government. While, in Germany, the Treuhand rapidly sells thousands of East German enterprises to West German firms, the other countries will necessarily confront a period of conflicting claims among various stakeholders in state property. Large state-owned firms will certainly pose the greatest challenges, as they present a complex web of overlapping claims for residual control rights and no easy answers.

This diversity of claims is well illustrated by Russia, where existing control rights are among the most poorly defined in Eastern Europe. Andrei Shleifer and Robert Vishny argue that the first hurdle in accomplishing Russian privatization will be to resolve ambiguous and conflicting ownership claims among various enterprise stakeholders. The state and (what is left of) the central ministries, local governments and bureaucrats, managers, and workers all have some powers of residual control and therefore some bargaining strength. Each of these groups must somehow be either accommodated or disenfranchised if privatization is to go forward. The paper gives a sense of the power positions of these groups by tracing the evolution of de facto ownership claims since the collapse of central planning. Until the 1988 reforms, central bureaucrats had a good deal of bargaining power, and the workers had none (in spite of ideologi-

cal assertions to the contrary). Since that time, the situation has been nearly completely reversed.

Shleifer and Vishny point out that the presence of such imprecisely defined control rights leads to the failure of the Coase theorem. That is, under current circumstances, there is no reason to think that negotiations among interested parties will produce an efficient allocation and end use of enterprise assets. Interest groups may have an incentive to undertake destructive actions, block moves away from the status quo, or roll their own brand of "spontaneous" privatization, in which management and workers "buy" enterprises by bribing local officials and ignoring control claims of the center. Such spontaneous privatizations are technically illegal but can often be accomplished quickly because they respect the claims of most stakeholder groups. The resulting concentrated management buyout (MBO)–type ownership structure may produce relatively efficient, if inequitable, economic outcomes (although Shleifer and Vishny question whether such structures give too much control to workers). However, the main disadvantage of spontaneous privatization is the political dangers that it brings. Spontaneous transactions are likely to be perceived as unfair because they occur at very low prices and primarily benefit the old-guard incumbent managers and *nomenklatura.*

Shleifer and Vishny suggest that a Russian program of rapid, broad-scale commercialization could help shut down spontaneous privatizations and set the stage for a smoother privatization process. Commercialization entails the conversion of a state enterprise into a state-owned joint-stock company, subject to the normal commercial law for joint-stock companies and governed by a normal supervisory board (or board of directors) rather than by a ministry or a workers' council. The charter of the new joint-stock companies would spell out the rights and responsibilities of management and the supervisory board and would put legal constraints on self-dealing and conflicts of interest of the managers.

A program of comprehensive commercialization could also reduce corruption by stripping local governments and bureaucrats of their ability to dictate privatization outcomes. However, commercialization may be difficult to accomplish as it is likely to be opposed by managers to the extent that it reduces their bargaining power. A successful commercialization program is therefore likely to require the immediate transfer of some of the enterprises' shares to management and workers. It remains to be seen whether the center has sufficient power to mandate and execute a large-scale commercialization program, although it will try to do so. Of course, for large, capital intensive firms, spontaneous privatization is not really an option; for these enterprises some form of top-down process that begins with commercialization will be necessary.

As Andrew Berg's paper points out, a policy of mandatory commercialization from above was briefly attempted by the first post-Communist government in Poland in early 1990 but soon abandoned. Workers' councils, which gained de facto and de jure prominence in Poland during the 1980s, strongly resisted

the approach. As a consequence, Poland's post-Communist governments have so far treated commercialization as a voluntary measure, to be carried out on an enterprise-by-enterprise basis, as each firm is prepared for privatization. Subsequent to commercializing, some firms have been sold to investors through IPOs (initial public offerings) and through trade sales to other businesses, both domestic and foreign. Some firms have been corporatized in preparation for Poland's Mass Privatization Program, described below.

An alternative privatization track, known in Poland as "liquidation," has been far more extensively used, having already been selected by firms representing about 10 percent of the work force. Under the liquidation approach, the firm ends its existence as a state enterprise, and the assets of the enterprise are then made available to the workers and management in a lease-buyback arrangement. Liquidation has been particularly popular for small- and medium-sized firms with relatively low capital intensity. There is as yet no established privatization track that has been widely used by the large Polish enterprises.

Liquidation, which is a bottom-up process that respects most enterprise stakeholders, has similarities with the spontaneous privatizations in Russia and Poland, in that assets end up with the "insiders" (workers and management). The difference is that liquidation is a legal process that is monitored and regulated, with the result that a wide cross section of workers and management, rather than a few *nomenklatura* managers, ends up with ownership rights. In this way, the liquidation track also seems to have solved the potential political problems posed by spontaneous privatizations. Significantly, it appears that firms that undertake these liquidation privatizations often engage in significant and beneficial restructuring.

This is not to say, however, that privatization through liquidation is moving quickly enough. Berg's paper explores many of the reasons why privatization generally has been difficult and delayed in Poland. For liquidations in particular, the approvals process (which includes the Ministry of Privatization and the responsible branch ministry) can be painstakingly slow. Individual bureaucrats, concerned with the criminal liabilities that arise if there is impropriety or the appearance of impropriety anywhere in a transaction, have little incentive to push privatization forward. This is, of course, an inevitable cost of the extra transparency compared with spontaneous privatizations.

The progress on mass privatization schemes for large firms has also moved slowly in Poland. Although Poland was the first country to begin grappling with the problems of mass privatization of large industry, it has been hampered by political disputes as well as the complexities of coordinating wide-scale distribution and management of ownership claims on large enterprises. Czechoslovakia, by comparison, experienced less internal dispute within the federal government in the formulation of a mass privatization program and as a consequence has already succeeded in promulgating a mass privatization program and in issuing vouchers. Delays in initiating mass privatization in Po-

land almost surely have given vested interests time to dig in further and to oppose a wide distribution of enterprise shares.

The privatization of business and the growth of the private sector have occurred most rapidly in East Germany. The Treuhandanstalt (the agency charged with accomplishing the privatization and restructuring of East German enterprises) has aggressively sold Eastern firms to West German companies. Wendy Carlin and Colin Mayer examine the activities and goals of the Treuhand. They articulate five functions that the Treuhand actually performs: valuation of enterprises; liquidation and closure of uneconomic activities; creation of supervisory boards for ongoing concerns; selection and evaluation of prospective buyers; and negotiation of purchase terms. In many cases, the price a buyer is willing to pay for a firm is less important to the Treuhand than are other nonprice terms. Acquiring firms will often guarantee minimum levels of employment and investment spending over time. In doing this, the Treuhand attempts to create freestanding enterprises that can obtain external financing without giving up control to foreigners.

Carlin and Mayer also discuss what other East European countries might learn from the German experience. East Germany's rapid privatization is of course made possible by its close links with the West German commercial and financial infrastructure and made so pressing by the high level of East German wages established during unification. Carlin and Mayer argue that the Treuhand's interventionist approach to privatization, which includes investment and corporate control, has some advantages over standard arm's-length auctions of enterprises. Even before the enterprise is sold, the board of directors becomes active in establishing policies that keep the value of the enterprise from needlessly declining.

In the conference discussion of the Carlin and Mayer paper, several participants stressed the important differences between East Germany and the rest of Eastern Europe, which limit the direct relevance to other countries of the Treuhand's experience. Most important, the Treuhand has relied on sales at low prices to West German enterprises. This is both politically and economically possible because, in such sales, the enterprise stays "within the family," that is, in Germany. In the rest of Eastern Europe, there is no corresponding network of private firms willing and able to buy up the state industrial enterprises. Moreover, as Carlin and Mayer make clear, the Treuhand approach has been enormously costly in many cases, with large subsidies promised to prospective buyers. Once again, such largesse would be crippling in the financially strapped countries elsewhere in Eastern Europe.

Designing Bankruptcy Rules

One strength of the Treuhand's interventionism is that it involves restructuring *both* sides of an enterprise's balance sheet so that all financial claims are rationalized in the privatization process. Outside Germany, it will be common for enterprises to enter into commercialization and privatization with large

debt burdens. It is likely that there will be a lot of financial restructuring to do in the aftermath of privatization. And, as in the West, this will need to be accomplished through some form of bankruptcy proceeding.

Philippe Aghion, Oliver Hart, and John Moore examine the options that East European countries face in choosing bankruptcy rules. They argue that there are important flaws in currently used bankruptcy procedures such as Chapters 7 and 11 in the United States or the receivership system in the United Kingdom. They propose a new bankruptcy procedure that avoids some of the main pitfalls of the existing procedures. In it, a bankruptcy judge allocates shares (and perhaps options to purchase shares) to enterprise claimants according to absolute priority. Next, shares are traded in an open market among claimants. The judge then solicits bids to purchase the enterprise, which the final shareholders vote on. Once the shareholders' decision is made (they may choose not to sell the firm at all), the firm exits from bankruptcy.

This kind of procedure has several advantages over standard bankruptcy proceedings. First, unlike existing procedures in the West, implementing it would not require a large number of experienced and specialized bankruptcy judges and lawyers. Judges and lawyers do not need to get involved with how the firm is run during bankruptcy as long as creditors and shareholders follow the procedure. Second, the bids to purchase the firm can be evaluated by outside or inside consultants engaged by the ultimate shareholders. Third, there is some leeway in how the equity-allocation rules are designed. One *dis*advantage of this approach is that creditors would need to understand the enterprise's business well enough to act intelligently. This may be a problem in Eastern Europe, where the largest creditor is often a national bank with little or no expertise in industrial oversight or in making valuations of enterprises (and, perhaps, without the proper incentives to carry out these tasks). Nevertheless, the lack of financial and bankruptcy expertise in Eastern Europe will hinder *any* bankruptcy policy.

Nurturing the Growth of the Private Sector

Of crucial importance to the success of reform is the emergence of a new private sector. Simon Johnson's paper looks at the growth of private-sector activity in Poland, Czechoslovakia, and Hungary. The growth of private-sector activities is probably the most rapid in Poland, and in some sectors privately owned activities are already the dominant ownership form. Even though there are relatively few remaining barriers (e.g., tax, export-import, foreign exchange) to private activity, private businesses remain small in size. One problem may be a lack of bank-borrowing opportunities, on which small Western firms are highly dependent for growth. East European firms can often grow only as fast as they can retain earnings.

Johnson also points to some country-specific differences in the growth of private business. Poland's private sector has developed more quickly than Hungary's, which has developed more rapidly than Czechoslovakia's. While private

activity has been growing steadily in Hungary over the past decade, in Poland the liberalization of 1990 generated a surge of activity so large that Poland has surpassed Hungary in total small-firm private activity. This suggests that a poorly developed private sector does not constitute a valid argument against rapid transition.

Fostering Foreign Investment and Foreign Trade

With the radical transformation of these economies has come a wave of interest by both countries and companies in inward foreign direct investment (FDI). But relatively few large deals have been finalized, and today it looks unlikely that foreign direct investment will provide substantial net capital inflows. The major problem confronting countries is to find a way to lower the costs of involving foreigners in the privatization process.

Kenneth Froot's paper looks at the costs of getting foreigners involved in the privatization process and in how countries have attempted to lower these costs. In many cases, complex rules and changing tax laws and property rights make it extremely time consuming and costly for foreign firms to consider investment seriously. Froot traces out developments in Poland's treatment of FDI that are the result of the authorities' attempts to cut down on these costs of exploration and establishment.

The paper also looks more theoretically at how entry costs to FDI can seriously impair the ability of countries to obtain competitive prices for enterprises being privatized. Froot then explores a number of ways that countries can improve their bargaining power. He finds that it is probably much better for countries to invoke a kind of two-step process, in which assets are first privatized to dispersed groups of domestic investors and then sold to foreigners later.

The reforms in Eastern Europe brought with them two major changes for trade. First, the macroeconomic stabilization and liberalization programs in the East led to radically different price structures, to large exchange rate devaluations, and to an opening of borders. Second, trade among Eastern bloc countries institutionalized in the CMEA collapsed. Both these shocks had major effects on both East European terms of trade and the level of trade.

Dani Rodrik's paper investigates the effects of the transition on Eastern Europe's foreign trade. He looks at Czechoslovakia, Hungary, and Poland and finds that all three have achieved a substantial degree of openness to foreign trade. In all three countries, trade is now demonopolized, and licensing and quotas play a very small role. Exchange controls have virtually disappeared for current account transactions. Judging by partner statistics, export performance has been impressive in all three countries, and import booms are under way in at least Hungary and Poland as well. Rodrik finds that the export growth in the West is not simply a shift from the Soviet market to the West European market. On the whole, it seems that, in the first stages of adjustment, former exporters to the Soviet market have not had much success in finding new sales in the West. Rather, the increased exports seem to come from firms that were already

exporting in the West or that are shifting from domestic markets to Western markets.

The collapse of the CMEA represents a significant shock, amounting to a loss of real income of 3–4 percent of GDP in Poland and 7–8 percent of GDP in both Hungary and Czechoslovakia. Export performance can be attributed to exchange rate policy in part, but the collapse of domestic demand has possibly played an even more important role. Finally, Rodrik suggests that trade liberalization in the first year or two after the start of reforms appears to have had little effect on internal price discipline, in large part because of the substantial devaluations that have accompanied it. This will likely change, however, as currencies appreciate in real terms following the initial large devaluations.