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Martin Raiser*

Old Habits Die Hard

A Note on the Nature of the Crisis in Central Eastern Europe

In the economic literature the reasons for recession during the transformation of a planned into a market economy are still debated. The following article sets the arguments in this debate against an interpretation of the stylised facts of the transformation process in Central Eastern Europe that is centred around the legacy of soft budget constraints for state owned enterprises. It is shown that deficient bankruptcy enforcement and a perverse incentive structure at the firm level can account for adjustment inertia in emerging market economies.

After more than two years of economic transformation in Central Eastern Europe the lack of strong recovery tendencies is testing the patience of politicians and populations alike. The adjustment inertia in the emerging market economies (EMEs) is particularly serious when seen in the light of official national income statistics that report GDP falls not experienced in Europe since the Great Depression of the 1930s. In this respect it is all the more unsalutary that the causes of the "transformation blues" are still debated among economists. This paper seeks to clarify the arguments in this debate by contrasting structuralist, demand-led, and credit-supply led interpretations of some stylised facts of economic transformation in Central Eastern Europe. Where appropriate we shall draw on structural adjustment experiences elsewhere for reference. In contrast to macroeconomic analyses of the stabilisation-recession sequence, we offer an institutional framework that can account for the particularities of the process of transition from socialism to capitalism. Our conclusion that the maintenance of soft budget constraints for enterprises delays structural adjustment and increases the costs of economic reform contains important lessons for other instances of system transformation and economic reform processes in general.

Some Stylised Facts of Transformation

In a recent evaluation of stabilisation and reform in Eastern Europe Michael Bruno claims that price level and exchange rate stabilisation has largely been successful

and rapid.¹ However, structural change and positive output response to the new incentive structure proceed more slowly. This divergence in the pace of adjustment has led to the emergence of the following policy concerns in the second phase of transition to a market economy:

(1) Inflationary tendencies have not completely subsided (cf. Table 1). In all former CMEA countries (with the exception of Hungary, which followed a gradual price liberalisation strategy) the initial price shock was much larger than expected. Moreover, apart from Czechoslovakia,² inflation has persisted; monthly inflation was around the 3-5 per cent range in Poland, 2 per cent in Hungary, and inflation is currently running at several hundred per cent annually in Bulgaria and Romania.

The resilience of medium inflation (20-50 per cent p.a.) is a characteristic that Central Eastern Europe shares with other stabilisation experiences. In the words of Pedro Aspe, Mexican Finance Minister, "It is much easier to reduce inflation from 200 per cent p.a. to 20 per cent, than it is to cut it from 20 per cent to 2 per cent."³ However, this should not give rise to complacency. As Latin American experiences have shown, inflation rarely stays on a medium plateau.⁴

(2) Fiscal deficits in Central Eastern Europe have re-emerged since the beginning of economic reforms (cf.

* Institute of World Economics, Kiel, Germany. This article is a shortened and revised version of Kiel Working Paper No. 549 entitled "Soft Budget Constraints: An Institutional Interpretation of Stylised Facts in Economic Transformation in Central Eastern Europe". Financial support from the Volkswagen Foundation is gratefully acknowledged. The author has also benefited greatly from comments by Claudia Buch, Norbert Funke, Ralf Heinrich, Peter Nunnenkamp, and Holger Schmieding.

¹ Cf. Michael Bruno: Stabilisation and Reform in Eastern Europe – a Preliminary Evaluation, IMF Working Paper No. 30, Washington 1992.

² We refer to Czechoslovakia as a whole in this article, as our data do not capture developments after the split.

³ Cf. Pedro Aspe: Economic Transformation the Mexican Way, Lionel Robbins Memorial Lecture, London School of Economics, 1992, unpublished.

⁴ Cf. Rudiger Dornbusch: Experiences with Extreme Monetary Instability, in: Simon Commander (ed.): Managing Inflation in Socialist Economies in Transition, World Bank Symposium, Laxenburg 1991, pp. 175-196.

Table 2). The Latin American experiences with macroeconomic stabilisation suggest that restoring fiscal balance within two years of the start of the programme was essential to prevent inflation resurgence.⁵ By this criterion the initial fiscal swing in Poland was impressive. The cut in subsidies from a level of 15 per cent of GDP in 1989 to 6 per cent in 1990, and large "paper profits" in the state owned sector, due to the revaluation of inventories, were transmitted into an overall fiscal surplus of 8 per cent of GDP in the first half of 1990. In Bulgaria the reduction of subsidies brought the cash fiscal balance down to -3.7 per cent in 1991. However, in both countries fiscal deficits have risen again lately. In Poland, government revenue slumped with the fall in enterprise profitability, and for 1992 the deficit was estimated at around 8 per cent of GDP.⁶ In Bulgaria the real extent of the budget deficit was probably concealed in 1991 and the rise in public expenditures towards year-end suggests a much higher figure for 1992.⁷

The trend of rising fiscal imbalances is evident in Hungary, too, which despite an early tax reform recorded a deficit of over 4 per cent of GDP in 1991. Due to much tighter bankruptcy enforcement in 1992 fiscal problems have worsened considerably since. The deficit is expected to reach HUF 250-300 billion (8-10 per cent of GDP) in 1993. In Romania the available figures are surprisingly low in view of galloping inflation and suggest that much of the public sector imbalances is transferred to the monetary authorities or to extra-budgetary funds. The only exception to the experience of rising fiscal deficits is Czechoslovakia, which has maintained its traditionally conservative macroeconomic stance.

(3) Possibly the most salient and debated feature of economic transformation is the dramatic fall in national output. In this area statistical problems are particularly large. Underreporting of private activities and the omission of services in the computation of net material product under the socialist accounting system may overstate the fall in GDP by several percentage points. However, since the largest share of the drop in output is accounted for by the demise of state owned enterprises, explaining the reason for and the extent of their problems gives an approximate upper bound scenario for economic decline. Table 3 summarises the official estimates for the fall in GDP and industrial output in Central Eastern Europe. The recession was most pronounced in Bulgaria and Romania. Hungary probably fared best, although its

⁵ Cf. Rudiger Dornbusch, op.cit.; Pedro Aspe, op.cit.

⁶ Cf. Stanislaw Gomulka: Economic, Social, and Political Problems in Economic Transformation: The Case of Poland 1989-1992, London 1992, mimeo.

⁷ Cf. Economist Intelligence Unit (EIU): Country Report No. 1, London 1993.

Table 1
Monthly Consumer Price Inflation for Selected Countries
(in %)

	Bulgaria	Czechoslovakia	Hungary	Poland	Romania
1990					
January	...	...	7.7	79.6	...
February	...	...	5.3	23.8	...
March	...	...	2.7	4.3	...
April	...	...	2.5	7.5	...
May	...	...	0.8	4.6	...
June	3.5	...	0.4	3.4	...
July	3.6	10.0	2.6	3.6	...
August	16.3	...	2.9	1.8	...
September	4.5	...	1.5	5.7	...
October	4.2	3.4	1.5	5.7	...
November	5.3	0.8	2.1	5.0	23.4
December	10.2	0.8	1.7	5.9	11.6
1991					
January	13.6	25.8	7.5	12.7	14.8
February	105.2	7.0	4.9	6.7	7.0
March	32.7	4.7	3.7	5.6	6.6
April	1.8	2.0	2.4	2.7	26.5
May	1.6	1.9	2.2	2.7	5.1
June	5.0	1.8	2.1	4.9	2.0
July	7.9	-0.1	0.9	0.1	9.4
August	5.1	...	0.2	0.6	11.2
September	4.7	0.3	1.5	4.3	7.3
October	3.1	-0.1	1.3	3.2	10.4
November	3.5	1.6	1.4	3.2	10.4
December	3.1	1.2	1.7	3.1	13.7
1992					
January	...	1.0	3.2	3.2	...
February	...	0.5	2.7	2.7	...
March	...	0.4	1.9	1.9	...
April	...	0.5	1.3	1.3	...
May	...	0.4	1.5	1.5	...
June	...	0.3	0.6	0.6	...
July	...	0.8	0.3	0.3	...
August	...	0.6	0.8	0.8	...
September	...	1.8	2.4	2.4	205 ^b
October	...	2.0	2.5	2.5	...
November	...	1.8	...	...	...
December	110 ^a	...	...	...	...

^a January-December figures. ^b January-September figures.

Sources: Michael Bruno: Stabilisation and Reform in Eastern Europe - a Preliminary Evaluation, IMF Working Paper No. 30, Washington 1992; Economist Intelligence Unit.

Table 2
Fiscal Balances for Selected Countries, 1989-1992
(in % of GDP)

	1989	1990	1991	1992
Poland	-7.4	3.5	-3.5	-8
Hungary	-3.1	-0.1	-4.1	-7
Czechoslovakia	-2.4	0.1	-2.0	-1
Romania	8.4	-0.1	-1.7	-3.6
Bulgaria	-1.4	-8.5	-3.7	>-5

Sources: PlanEcon, Monthly Economic Monitor, Washington, various issues; Economist Intelligence Unit Country Report No. 1, Romania, Bulgaria, and Albania, London 1993.

more gradual reform did not prevent a sharp drop in GDP in 1991. Poland's output curve displays a two step fall at the beginning of 1990 and 1991 respectively, while Czechoslovakia takes the two steps in one go to land at a level slightly above Poland at the end of 1991. Except for Poland, which has recorded a rising trend in aggregate output figures, due to the buoyancy of a large private sector, prospects remain bleak in all Central Eastern European countries.

(4) The recession in Central Eastern Europe is accompanied by the new and politically unsettling experience of large unemployment. Officially reported unemployment currently stands at 14 per cent in Poland, 12 per cent in Hungary, and an average of 7 per cent in Czechoslovakia.⁸ In the latter case the Czech lands suffer far less with only 3 per cent unemployment, while Slovakia faces problems similar to Poland with 12 per cent unemployment. In Bulgaria unemployment reached 16 per cent in January 1993, while the pace of labour shedding in Romania has been slower, with 8.3 per cent of the labour force out of employment by November of last year.⁹ Although unemployment by now has reached worrying proportions in Poland, Hungary and Bulgaria, it still lags considerably behind the fall in output. Particularly in the first years of transition, when the supply of private sector jobs is still low, the gradual rise in unemployment figures suggests that labour hoarding had not yet disappeared.

These four concerns overshadow the more positive developments in the area of trade reorientation and small scale private sector growth. As the evidence from Hungary suggests, more problems lie ahead once the restructuring of the large scale state owned enterprises (SOEs) is seriously tackled. Let us therefore now turn to the various interpretations of the transformation crisis in Central Eastern Europe found in the literature.

Creative Destruction?

Some observers have likened the recession in Central Eastern Europe to the structural shock administered to the industrial sector in the West following the second oil price hikes in 1979.¹⁰ Schumpeter's notion of creative destruction is borrowed to explain why initially the output response to price liberalisation is negative.¹¹ The sudden

⁸ Cf. PlanEcon: PlanEcon Report No. 7-8, Washington February 1993; Monthly Economic Monitor, various issues, Washington; Kopint Datorg: Economic Trends in Eastern Europe, No. 2, Budapest 1992.

⁹ Cf. Economist Intelligence Unit (EIU): Country Report No. 1, op. cit.

¹⁰ Cf. David Lipton, Jeffrey D. Sachs: Creating a Market Economy in Eastern Europe: the Case of Poland, Brookings Papers on Economic Activity, No. 1, 1990, pp. 75-147.

¹¹ Cf. Stanislaw Gomulka: The Causes of Recession Following Stabilisation, Comparative Economic Studies, Vol. 2, 1991, pp. 71-89.

Table 3
Growth of Gross Domestic Product and Industrial Production for Selected Countries, 1989-1992
(in %)

	1989	1990	1991	1992
<i>Gross Domestic Product</i>				
Poland	±0	-11.6	-7.5	+1
Hungary	-	-4	-8	-5
Czechoslovakia	1.4	-0.4	-15	-7.2
Romania	-5.8	-8.1	-15	-16
Bulgaria	-0.4	-11.8	-16.7	-14.0
<i>Industrial Production</i>				
Poland	-1.7	-22	-17	-10
Hungary	-1	-9.6	-20.8	-10
Czechoslovakia	0.8	-3.5	-24.7	-16
Romania	-1.0	-18.2	-22.0	-21.8
Bulgaria	-0.3	-13	-21.7	-20

Sources: Cf. Table 2.

exposure to world market prices eliminates forced substitution and renders a large share of the traditional capital stock obsolete. At the same time rigidities in factor markets prevent the rapid emergence of new industries.

The above argument is attractive. The general J-curve pattern it describes suggests that the initial recession is inevitable in any transition path.¹² It thus seems to fit the data presented for Central Eastern Europe. However, if structural reasons dominate in recession, then output falls should be branch specific. They are not. As Hare and Hughes¹³ show for Czechoslovakia, Hungary and Poland, in spite of wide initial differences in industrial competitiveness across sectors, the liberalisation of prices does not seem to have led to a significant reallocation of factors to the most efficient industries. The rather uniform pattern in labour productivity and enterprise profitability remains to be explained. The evidence for the low price elasticity of supply warrants a closer look at factor market imperfections and possible institutional reasons for the lack of recovery.¹⁴ Moreover, the particular

¹² Cf. Horst Siebert: The Transformation of Eastern Europe, Institute of World Economics, Kiel, Kiel Discussion Paper No. 163, 1991.

¹³ Cf. Paul Hare, Gordon Hughes: Industrial Policy and Restructuring in Eastern Europe, in: Oxford Review of Economic Policy, Vol. 8, No. 1, 1992, pp. 82-104.

¹⁴ Schmieding points to the theoretical inconsistency of neo-structural and neo-classical interpretations of GDP falls in EMEs. Thus a shift in relative prices even with factor immobilities does not reduce domestic value added at constant world prices. On the contrary, the lower use of inputs by former value subtractors should raise national wealth. The remaining explanation of factor price rigidities is at variance with the substantial decline in real wages in all EMEs. Schmieding proposes a transaction costs based interpretation of the transformation crisis that can easily be related to our analysis. Cf. Holger Schmieding: From Plan to Market: On the Nature of the Transformation Crisis, Kiel Institute of World Economics, mimeo, 1993, forthcoming in Weltwirtschaftliches Archiv; also: Douglas North: Privatisation, Incentives and Economic Performance, in: Privatisation, Symposium in Honor of Herbert Giersch, Tübingen 1992, pp. 3-16.

development of state finances is not contained in the structuralist view. Rather a fiscal J-curve would have been expected. In sum, as long as output developments in Central Eastern Europe take the shape of an L, the J-curve proponents are challenged to provide additional arguments to account for the evidence.

From a different perspective, the structuralist view has been attacked for the justification it provides for overly tight macroeconomic management. It is argued that this may lead to policy "overshooting" and the perpetuation of recession. There are essentially two different views that are both expressing such criticism, the Keynesian and the credit crunch hypothesis.

The Keynesian View

Keynesians see output determined from the aggregate demand side. While they would agree that a small transitional inward shift of aggregate supply may be possible, there is no *a priori* reason why output should fall during the process of reallocating resources. According to Keynesians, total factor productivity should increase in the economy, and since labour resources are unchanged, even the scrapping of some of the old capital stock would not justify the contention of much reduced total capacity. On the contrary, exogenous and policy induced demand shifts are held largely responsible for output decline.¹⁵ Most important amongst the exogenous factors is the deterioration of Central Eastern European trade relations. Undeniably, German unification in 1990 and the dollarisation of CMEA trade in January 1991 applied severe demand shocks to all reforming economies. What room does this leave for policy overshooting?

The Polish case is interesting since reforms there began before 1992. The loss of the East German market was offset in 1990 by a rise in convertible currency exports of 51 per cent from US\$ 8,046 million to US\$ 12,183 million.¹⁶ Brada and King conclude that the major factor accounting for the Polish fall in GDP is a reduction in autonomous consumer demand. They see this as partly related to consumer goods hoarding before price liberalisation but mainly attributable to a large fall in the

statistical real wage (40 per cent in January 1990 alone), which resulted from overly tight fiscal and monetary policies. Blanchard and Layard¹⁷ similarly attribute the fall in aggregate demand to the redistribution of revenue from wages to profits during price liberalisation cum stabilisation, while Frydman and Wellisz¹⁸ stress the wealth effects of a fall in real household money balances.¹⁹

The Keynesian view explains very differently than the structuralists why output initially contracts. The large fall in statistical real wages changes factor price ratios and justifies a decline in labour productivity across sectors. Low wages imply high profitability, which helps initial fiscal surpluses to emerge at the expense of household incomes. However, Keynesians offer no explanation for persistent inflationary tendencies under conditions of depressed demand. In fact one would expect falling prices and low profits (hence emerging budget deficits) in a deflationary scenario. Hence the Keynesian view needs to be supplemented by an institutional interpretation of price inertia. As Schaffer²⁰ shows, the hypothesis of monopoly pricing is not borne out by the evidence of constant mark-ups in Polish industry. Rather the development of wages in the latter part of 1990 may explain why inflation picked up again after a temporary low point in August (Table 1). The wage-price spiral in Poland in 1990/91 coincided with a relaxation of macroeconomic policies in the summer of 1990.²¹ We may hence conclude that the Keynesian advocacy of demand expansion is flawed at best and dangerously misleading at worst.

The Credit Crunch Hypothesis

In contrast to Keynesians, Calvo and Coricelli²² have argued that credit supply constraints rather than deficient investment demand lie at the heart of prolonged recession in Central Eastern Europe. In their model the domestic credit system fulfils its role as an intermediate institution between household savings and enterprise investment only imperfectly. Under such conditions lending rates are

¹⁵ Cf. Joseph Brada, Arthur King: Is There a J-curve for the Economic Transition from Socialism to Capitalism, in: *Economics of Planning*, Vol. 25, 1992, pp. 37-53.

¹⁶ Cf. Alan Berg, Jeffrey D. Sachs: Structural Adjustment and International Trade in Eastern Europe: the Case of Poland, in: *Economic Policy*, Vol. 14, 1992, pp. 117-175.

¹⁷ Cf. Olivier Blanchard, Richard Layard: Post Stabilisation Inflation in Poland, in: Fabrizio Coricelli, Ana Revenga (eds.): *Wage Policy during the Transition to a Market Economy: Poland 1990-1991*, World Bank Discussion Paper No. 158, Washington 1992.

¹⁸ Cf. Roman Frydman, Stanislaw Wellisz: The Ownership Control Structure and the Behaviour of Polish Enterprises, Columbia University Discussion Paper 432, New York 1991.

¹⁹ Note that under conditions of high dollarisation in the economy, a price liberalisation combined with inland convertibility and exchange rate devaluation does not necessarily reduce real money balances. The Polish evidence does not confirm this particular contention of a reduction in monetary wealth. Cf. Stanislaw Gomulka, 1992, *op. cit.*

²⁰ Cf. Mark Schaffer: Note on the Polish State Owned Enterprise Sector in 1990, Center for Economic Performance Working Paper 106, London 1991.

²¹ Cf. Martin Raiser: Soft Budget Constraints: An Institutional Interpretation of Stylised Facts in Economic Transformation, Institute of World Economics, Kiel, Working Paper No. 549, 1992.

²² Cf. Guillermo Calvo: Are High Interest Rates Successful in Reducing Inflation in Transition Economies?, in: Simon Commander (ed.): *Managing Inflation in Economies in Transition*, World Bank Symposium, Laxenburg 1991, pp. 247-260; Guillermo Calvo, Fabrizio Coricelli: Stagflationary Effects of Stabilisation Programs in Reforming Socialist Economies, Enterprise-Side vs Household-Side Factors, in: *World Bank Review*, Vol. 1, 1992, pp. 71-90.

de facto set by the central bank's refinancing rate. As a legacy from the old system, firms hold few liquid assets and are thus reliant on short term bank credit to maintain operations. A high interest rate policy or the imposition of credit ceilings by the central bank, in order to control the growth of money supply, effectively administer a credit crunch to the entire industrial sector. The unavailability of credit or its prohibitive cost forces firms to sell off inventories at the start of a reform program and to discontinue major production lines. At the same time they reduce costs by paying excessively low wages, which in fact represents borrowing from employees. Consequently high profitability and low real wages are not the result of relative price changes per se, but follow from restrictive monetary policy. One important consequence in such a scenario is that firms will seek liquidity at the expense of their suppliers by increasing involuntary trade credits. The deferment of payment obligations can lead to a bankruptcy spiral if one weak element in the chain of bad loans and inter-enterprise credits is forced to close down.²³

The credit crunch hypothesis poses a serious challenge to the structural interpretation of initial output decline. All firms are equally affected by the lack of liquidity. This would explain their uniform reaction in lowering wages and cutting back inventories. If liquidity remains tight, supply continues to be credit constrained and production may not recover. This implies that inflation persistence is due to a second round redistribution of liquidity towards wage earners and hence developing excess demand as transition proceeds.²⁴ The upshot of the

analysis is that unlike in the structuralist case efficient and inefficient firms are involved in the scramble for liquidity, so that restructuring is impeded by tight monetary policy. Hence, the focus of suggested solutions is on improving credit markets.²⁵

Still, the fundamental behavioural base for Calvo and Coricelli's model is not spelled out. For instance, it is not clear why firms initially lower wages rather than increasing redundancies. Moreover, defaulting on outstanding debt usually involves bankruptcy in a well functioning market economy. The fact that firms could rely on involuntary trade credit and defer payment obligations to banks suggests that their creditors expected to be bailed out at some future stage. Calvo and Coricelli in fact admit that firms may have adopted a wait-and-see attitude when monetary policy was first tightened.²⁶ If credit is subsequently relaxed this would confirm such expectations. Hence, the fact that tight monetary policy does not ensure efficient restructuring cannot be reversed into the opposite causality. Looser credit policies would simply fuel renewed wage increases and the build-up of inventories of unsold products. The fundamental issue concerns the nature of a firm's budget constraint. The contention of this paper is that institutional legacies in the public sector can maintain soft budget constraints for state owned firms. This phenomenon prevents restructuring and works against stability.

Soft Budget Constraints

Janos Kornai²⁷ has introduced the concept of soft budget constraints to derive three hypotheses concerning economic performance in a shortage economy. First, the

²³ Cf. David Begg, Richard Portes: Enterprise Debt and Economic Transformation: Financial Restructuring of the State Sector in Central and Eastern Europe, CEPR Discussion Paper 695, London 1992.

²⁴ In Calvo's model stagflation could arise via the cost push effect of high interest rates. To combine this with an excess demand view of inflation, Calvo and Coricelli draw on earlier structuralist development economics, where high capital costs cause an inward shift of aggregate supply. By contrast, we will stress the reasons for the subsequent unsustainable increase in wages rather than the supply constraint. This element is lacking in Calvo and Coricelli's model.

²⁵ Cf. Claudia Buch, Holger Schmieding: Better Banks for Eastern Europe, Institute of World Economics, Kiel 1992, Discussion Paper No. 197.

²⁶ Cf. Jan Winiecki: The Polish Transition Programme at mid 1991 – Stabilisation under Threat, Institute of World Economics, Kiel 1992, Discussion Paper No. 174.

Daniel Friedmann/Ernst-Joachim Mestmäcker (Eds.)

Rules for Free International Trade in Services

Symposium in Tel Aviv

The purpose of the study is to look at the worldwide movement toward freer trade in services from the perspective of Israel, the EC and the United States. Israel is the only country party to a free trade agreement with both the European Economic Community and the United States of America. The free trade agreement with the United States was the first international treaty that contained a declaration on free trade in services. As representative of the issues involved in the development of rules for free trade in services, we selected the areas of telecommunications, banking and insurance. The Conference brought together policy makers, government officials and scholars from Israel, West Germany and the United States.

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reaction of economic actors to price incentives is reduced, in other words the elasticity of supply in economic activities affected by budget softness is small. Second, price liberalisation will not eliminate shortages and, importantly for our purposes, the passivity of monetary policy in an economy with soft budget constraints makes the emergence of high inflation a likely outcome of partial economic reform. Third, the incentives for firm managers to increase productive efficiency are diminished and the long run growth performance of an economy with soft budget constraints is lower than that of a market system.

The relevance of Kornai's hypotheses for the transformation process in Central Eastern Europe should be obvious. Low supply elasticities, the slow pace of efficiency-improving restructuring in state owned industry, and macroeconomic instability are in stark congruence with the stylised facts identified above.

According to Kornai²⁸ the budget constraint of an economic actor is hard only if its projected expenditure cannot exceed its available wealth in each period. This means that budget constraints may be softened in four distinct ways.

First, when prices are controlled and quantities given by a central plan, a firm may improve its position by bargaining either for higher output and lower input prices, or restricting its output. This is seen as the underlying reason for the development of shortages under central planning.

Second, when prices and quantities are market determined, imperfect competition offers the prospect for pricing margins and prevents the exit of inefficient enterprises. Particularly, protection from foreign competition maintains structural problems in spite of domestic liberalisation.

Third, firms may be granted access to credit to finance current expenditures. In the absence of private ownership rights, a firm has no assets to pledge against loans, and the enforcement of obligations becomes difficult.²⁹ Moreover, with domestic financial repression interest rates do not reflect the real cost of capital. Hence loans are taken up that would not stand the test of profitability criteria.

Fourth, the state may subsidize loss-makers directly out of the state budget. Subsidies may take the form of

additional funds, preferential and discretionary taxes, or tax deferrals.

In the transition from plan to market the degree of budget softness due to politically flexible planning targets should greatly diminish. Indeed, Gomulka³⁰ had predicted that shortages would disappear with price liberalisation in spite of soft budget constraints. The price elasticity of demand is a function of the flexibility of income endowments relative to the speed of price adjustment. In all Central Eastern European economies the adaptive price shock has been extremely large and excess liquidity in the form of a monetary overhang has vanished. This has in consequence eliminated shortages. Moreover, implicit subsidies for SOEs have been reduced substantially with price liberalisation. Unfortunately the disappearance of shortages does not indicate that the problem of soft budget constraints has gone away, too. The remaining three areas of soft budget constraints still present ample opportunities for enterprises to avoid the restructuring necessitated under the new relative prices.

The degree of protection from foreign competition is hard to evaluate during the process of transition. All Central Eastern European EMEs (with the exception of Hungary) have administered large nominal exchange rate devaluations together with the liberalisation of prices.³¹ The effect on the real exchange rate remains unclear. The empirical evidence points towards an initial collapse of imports, followed by rising import penetration. In Czechoslovakia, Hungary, and Poland the recent boost of exports will allow a steady rise in import levels, as trade is fully reoriented towards Western markets. Protection levels in all five countries have remained comparatively low, although there is no data on effective protection rates. We may safely conclude that domestic inflation has by now wiped out any upfront undervaluation of exchange rates in the EMEs, and that tariff and non-tariff barriers are not used to effectively shelter domestic producers from foreign imports. This impression does however conflict with the evidence of restructuring and industrial competitiveness presented by Hare and Hughes.³² Using domestic resource cost calculations to establish the competitiveness of industrial sectors in Central Eastern Europe they find that output falls have not shown a close correlation with value added produced at world prices. Thus, the question is raised, how firms that are net value subtractors can survive both foreign competition and the gradual emergence of private domestic firms. An answer

²⁷ Cf. Janos Kornai: *The Economics of Shortage*, North Holland, Amsterdam, London, New York 1980.

²⁸ Cf. Janos Kornai: *The Soft Budget Constraint*, in: *Kyklos*, Vol. 39, 1986, pp. 3-30.

²⁹ Cf. Joseph Brada: *The Demise of Loss Making Firms in Capitalist, Socialist, and Transitional Economies*, Berichte des Bundesinstituts für Ostwissenschaftliche und Internationale Studien, Munich 1992.

³⁰ Cf. Stanislaw Gomulka: *Kornai's Soft Budget Constraint and the Shortage Phenomenon: A Criticism and Restatement*, in: *Economics of Planning*, Vol. 1, 1985, pp. 1-11.

³¹ Cf. Michael Bruno, *op. cit.*

³² Cf. Paul Hare, Gordon Hughes, *op. cit.*

to this question is central to our interpretation of the transformation process.

Budget Softness and Hard Habits

Our argument is centred around an evaluation of expectations of economic actors in EMEs, particularly managers and workers in public enterprises and government administrators. As the literature in institutional economics has established,³³ credible contract enforcement is a central aspect of reducing transaction costs in an economy with a complex division of labour. Information processing problems, risk and uncertainty necessitate the provision of adequate incentives for entrepreneurs to invest and require that economic actors are made fully responsible for the consequences of their decisions. The establishment of individual property rights and working capital markets are essential elements of the first, a credible bankruptcy threat central to the second requirement. Both are part of an institutional framework that underlies the prosperity of capitalist economies, both are missing in the EMEs. Because there is no reward for managers in SOEs for adopting efficiency-improving measures, that may in fact entail costly opposition from workers, and because misbehaviour is not sanctioned, a perverse incentive structure results in which economic actors play end games, merely looking at maximising the chances of immediate survival.³⁴ We argue that the crucial cause of incentive distortion is budget softness. How does it manifest itself?

First, inter-enterprise credits have been used extensively as a substitute for money during the initial phase of economic reform, when tight monetary policies reduced the volume of official bank credit available to SOEs (cf. Table 4). Second, the share of non-performing loans in bank portfolios has reached levels of around 30-40 per cent of total money supply. Calvo and Coricelli attribute the rise in inter-enterprise arrears to the "credit crunch" resulting from excessively high interest rates. They argue that it was an involuntary development that subsided as soon as official bank credit started to increase again. However, the notion of forced trade credits suggests that there is an opportunity cost involved in drawing on this source of liquidity. For the debtor the cost and not the source of liquidity is important, while creditors could simply have refused to supply goods without cash payments. The fact that inter-firm credits rose substantially

Table 4
Ratio of Inter-enterprise Credits to Official Bank Credit
in Czechoslovakia, Hungary and Poland, 1991-1992
(in %)

		Czechoslovakia	Hungary	Poland
1991	I	13.6	—	139
	II	20.1	19.46 (May)	137
	III	22.9	—	134
	IV	23.0	—	146
1992	I	25.8	—	130
	II		21.14 (May)	

Sources: Claudia Buch and Holger Schmieding: *Better Banks for Eastern Europe*, Kiel Discussion Papers No. 197, 1992; Martin Raiser: *Soft Budget Constraints: An Institutional Interpretation of Stylised Facts in Economic Transformation in Central Eastern Europe*, Kiel Working Papers No. 549, 1992.

reflects the expectations of creditors that their debtors, particularly within the public sector, would be bailed out as was usual under the previous system. This is precisely what happened in Poland during the summer of 1990, when credits to SOEs rose above the level of inflation, and in Bulgaria and Romania in early 1991, when a large monetary correction was used simultaneously to price liberalisation to allow firms to pay back arrears. Inter-firm credits are hence more accurately interpreted as part of "credit largesse" in EMEs.³⁵

The concern with inter-enterprise credits is complemented by the substantial share of non-performing assets in bank portfolios. In Hungary the overhang of bad debts from the period of central credit allocation threatens the stability of the financial system.³⁶ In Poland the high inflation of 1989 all but wiped out financial legacies. Nonetheless, bad debts have again risen to over a third of money supply.³⁷ In a sample of 65 Polish enterprises studied by Pinto et al.,³⁸ the level of debt was significantly negatively correlated with profitability. In the absence of administrative skills, human capital and, maybe most importantly, accurate information about the expected long-run returns on investments, any appraisal of creditworthiness becomes an impossible task. Hence, administrators in the still largely state owned banks opt for the safest strategy: they continue to cultivate previous relationships with SOE managers, and grant fresh money to troubled customers wishing to roll over their debt. At the same time banks attempt to recapitalise themselves by increasing interest spreads between deposits and loans.

³⁵ Cf. Holger Schmieding: *From Plan to Market: On the Nature of the Transformation Crisis*, op. cit.

³⁶ Cf. Saul Estrin, Paul Hare, Marta Suranyi: *Banking in Transition: Development and Current Problems in Hungary*, in: *Soviet Studies*, Vol. 44, No. 5, 1992, pp. 785-808.

³⁷ Cf. Martin Raiser, op. cit.

³⁸ Cf. Brian Pinto, Marek Belka, Stefan Krajewski: *Microeconomics of Transformation in Poland: A Survey of State Enterprise Responses*, World Bank, mimeo, Washington 1992.

³³ For a summary see Thrainn Eggertson: *Economic Behaviour and Institutions*, Cambridge Surveys of Economic Literature, Cambridge 1990.

³⁴ Cf. Holger Schmieding: *From Socialism to an Institutional Void. Notes on the Nature of the Transformation Crisis*, Kiel Working Paper No. 480, Institute of World Economics, Kiel 1991.

As a result, the high real cost of credit deters private entrepreneurs from profitable investments, while SOEs that face the likely prospect of liquidation claim the major share of the loan market. As with inter-enterprise credits both creditors and debtors rely on a future bail-out by the government and thereby mortgage financial stability.

Governments in the Central Eastern European EMEs have so far been unable or unwilling to monitor economic decisions in SOEs. The incentive problem for the government arises from the fact that the social costs of bankruptcy enforcement and liquidation are likely to be substantially higher than any revenues derived from the sale of public assets. The problems of SOEs and the banking sectors in EMEs are in fact concealed fiscal deficits. Any solution would involve a substantial rise in the national debt, unless governments are willing to confiscate consumer deposits.³⁹ Moreover, the severance payments for workers of liquidated firms may consume all of the value of a firm's capital stock or even more. The social costs of unemployment are additionally mentioned by Hardy,⁴⁰ who proposes a comprehensive safety net in order to counteract government incentives to avoid unemployment. These considerations show what short-run costs are involved in an effective hardening of budget constraints.

A government will choose to bear short-run costs if its discount rate is low enough. This requires a fairly high degree of political stability and credibility.⁴¹ By contrast the political economy in EMEs is characterised by shifting coalitions and insecurity of public officials, which may explain why reform in the institutional realm, including the privatisation of SOEs and banks, has been so slow.⁴² It is from the nature of the polity in EMEs that the importance of institutional legacies derives. The mechanisms of decentralised democratic control are as yet underdeveloped. In such a situation all conflicts are concentrated between powerful enterprise managers and the central government. Many public administrators have maintained "old boy" networks with SOE managers. Both groups know that their long-run hold on power is highly insecure. The discretion of individual administrators

increases, because political sanctions are deficient. In the end, old habits persist and budget constraints remain soft.

Survival of Inefficient Habits

Soft budget constraints for SOEs are one important reason why reform programmes in Central Eastern Europe still suffer from continuing price instability, and have so far failed to bring rapid recovery to the economies of the region.

With the central government unable to control the distribution of credit in the financial sector, inflationary expectations remain high in EMEs. The consequence is that SOEs use available funds to satisfy their workers' demands for higher wages. The rise in prices is checked to a certain extent by competing consumer goods imports, but in attempting to avoid a collapse of the financial system the monetary base expands too quickly and inflation fails to disappear.

When banks attempt to recapitalise themselves with high interest spreads, the access to investable funds that is crucial for the emergence of a dynamic private sector is impeded. The failure of capital markets to allocate resources according to criteria of profitability chiefly accounts for the slow pace of restructuring in industry. At the level of SOEs, the lack of incentives for managers to maximise the value of their assets increases the power of workers. Initially, while uncertainty about future competitiveness prevails, SOEs cut production and lower real wages. But once it has become clear that budget constraints have remained soft, the costs of market transactions further rise relative to the costs of access to public resources and the returns from asset depletion. The pace of labour shedding thus lags considerably behind the fall in production.

Finally, the lack of restructuring in SOEs creates a particular fiscal problem in economic transformation. The former tax base dwindles once the inefficiency of many public enterprises is exposed, while a new tax base fails to develop quickly enough. These fiscal problems are exacerbated by the discretion of public officials who maintain close political relationships to SOE managers and further aggravate the misallocation of resources rather than accepting the short-run costs of public finance restructuring.

Overall, the behaviour of economic agents in the still dominant public sectors of Central Eastern Europe changes only slowly. The continuing existence of soft budget constraints for SOEs means that inefficient old habits survive. The perverse incentive structure they create lies at the heart of the transformation blues.

³⁹ Begg and Portes estimate the additional budgetary costs of national debt service to be around 2-3 per cent of GDP for Poland. Cf. David Begg, Richard Portes, *op. cit.*

⁴⁰ Cf. Daniel C. Hardy: *Soft Budget Constraints, Firm Commitments, and the Social Safety Net*, IMF Staff Papers, Vol. 39, No. 2, Washington 1992, pp. 310-329.

⁴¹ Cf. Norbert Funke: *Die Glaubwürdigkeit von Wirtschaftsreformen: Bedeutung, Ursachen und Ansatzpunkte zur Lösung von Glaubwürdigkeitsproblemen*, in: *Die Weltwirtschaft*, No. 2, 1991, pp. 175-196.

⁴² Cf. Jan Winiecki: *The Political Economy of Privatisation*, in: Horst Siebert (ed.): *Privatisation, a Symposium in Honor of Herbert Giersch*, Tübingen 1992, pp. 27-54.