

Schmieding, Holger

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**External Protection for the
Emerging Market Economies ?**

**The Case for Financial Liberalisation instead
of Import Barriers in Eastern Europe**

by Holger Schmieding

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Contents

- I. Introduction

- II. On the Logic of Transitional Protection in the EMEs
 1. Underdeveloped Capital Market
 2. Predominance of State Ownership
 3. Unwarranted Collapse of Low Value-Adders

- III. Schemes for Transitional Protection
 1. Preferential Arrangements among the EMEs
 - a. Preferential Trade Area
 - b. Payments Union
 2. Uniform Protection
 - a. Devaluation
 - b. Uniform Import Tariff and Export Subsidy
 - c. Uniform Nominal Import Tariff
 3. Differentiated Nominal Tariff
 4. Asymmetric Liberalisation
 5. Evaluation
 - a. Information Problems
 - b. Incentives for Rent-seeking
 - c. Inter-sectoral Distortions

- IV. The Paradox of Protection: Financial Liberalisation Renders Trade Protection Obsolete

References

**External Protection for the
Emerging Market Economies ?**

The Case for Financial Liberalisation instead
of Import Barriers in Eastern Europe¹⁾

I. Introduction

After the transition to a market economy with flexible prices and a free choice of suppliers, relative prices and other elements of the incentive structure bear little resemblance to previous conditions in Eastern Europe's emerging market economies (EMEs for short). Some firms immediately benefit from the new structure of relative prices, others find that their revenues no longer cover costs even if the firms had shown sizeable surpluses under the old structure of relative incentives. Firms are forced to adjust their input requirements, their technology as well as the quality and product mix of their output. Unfortunately, the adjustment is hampered by a variety of special factors in the EMEs. Hence, the question arises whether these deficiencies warrant some corrective state interventions to give those firms, which may otherwise go under, the opportunity and time to adjust.

The main points of this paper are that the case for transitional import barriers for the EMEs is very weak; neither a discriminatory regional payments union nor a uniform import tariff nor a differentiated tariff schedule designed in accordance with the presumed adjustment difficulties are warranted. A radical

1) This paper has benefited from financial support from the EC's Action for Cooperation in the Field of Economics (ACE) in the framework of a joint research project on "Reintegration of Poland into the West European Economy by Internal and External Liberalisation" undertaken by the Warsaw World Economy Research Institute, the Milan SDA Bocconi Institute and the Kiel Institute of World Economics (Grant No. 90100081 P).

liberalisation of the financial system in the EMEs is much better suited to promote and smooth the adjustment to market conditions than any scheme for transitional protection. The paper is organised as follows: at first, the major arguments for transitional protection are addressed; thereafter, various schemes for the protection of the tradable goods sector are analysed; ultimately, a proposal for radical financial liberalisation as a superior substitute for trade protection is presented.

II. On the Logic of Transitional Protection in the EMEs

1. Underdeveloped Capital Market

As the substantial adjustment cannot happen overnight and as some residual distortions in the EMEs will persist for some time, the financial situation (liquidity) of firms after the regime switch is a grossly misleading indicator of their future viability (solvency),²⁾ even far more so than in established market economies with less distortions and less need to adjust at any point in time. Firms whose revenues exceed outlays may simply be running down their assets and accumulated stocks without any prospect of becoming genuinely profitable in the future whereas other firms which have splendid opportunities to restructure and to become viable may need substantial external funds to cover temporary losses. In a developed market economy, profit-seeking banks would step in and provide the needed funds as credits. However, banks and other financial institutions are underdeveloped in the EMEs.

The problem does not lie in a clearly insufficient level of credits for firms. As a matter of fact, credits to firms in the emerging market economies have blossomed in 1990 and early 1991 to such an extent that for instance the Hungarian government even had to impose severe restrictions on the volume of credits. Instead, the problem is that access to credit and the credit

2) See i.a. Hughes and Hare (1991).

conditions depend less on clear criteria of viability but rather on the ability of managers to extract credits from suppliers, customers or banks and on the sheer luck of having the right personal contacts. Large and less solvent firms are among the prime receivers of funds (see Dabrowski et al. 1991).

A haphazard pattern of credit disbursement entails substantial losses in efficiency for the economy as a whole: scarce investible funds are wasted; viable ventures which by pure chance suffer from a lack of credit go bankrupt while their less promising competitors have sufficient funds to stay afloat. The extent of these latter costs depends on the alternative uses for the factors which become redundant upon the dissolution of a firm. The firm-specific part of human capital and - if no alternative use in the same kind of activity can be found - also the activity-specific human and physical capital is rendered obsolete. Furthermore, the inefficient enterprises which stay afloat crowd out more efficient ones on the market for factors and intermediate inputs (Hinds 1990, p. 150). These costs could in principle be avoided by state interventions to counteract the underlying market failure.

Capital market deficiencies are a well-known argument for transitional protection. Indeed, as Giersch (1977) has emphasised, a peculiar kind of capital market failure, namely that workers cannot finance a learning-on-the-job by credits, is the core of the standard infant-industry argument (see also Corden 1974, Chapter 9). The first best solution would be the rapid development of the capital market (see chapter three). If the deficiencies of the capital market in the EMEs could not be righted immediately, compensatory state interventions could be warranted until the capital market has developed sufficiently. The second-best solution would be a finely balanced pattern of special subsidies for credit-starved firms and special taxes on those firms who enjoy too easy access to credit. However, this second-best approach would presuppose that government were a benevolent superbank which had all those informations on credit and the creditworthiness of firms which the normal banks do not have. As

this is clearly unrealistic, some scheme of external protection for local producers appears to be the third-best alternative.

2. Predominance of State Ownership

A second peculiarity of the emerging market economies may be taken to strengthen the case for government action: the vast majority of firms in the tradable-goods sector is still state-owned. In general, these firms do not adjust as smoothly and quickly as private firms to new conditions (see i.a. Hinds 1990). Hence, an argument could be constructed along the following lines: As long as government has not yet succeeded in privatising the firms and hence in making them more responsive to market signals, firms need to be shielded to some extent from competition. Otherwise, many of them may not be able to survive the interim period until privatisation spurred them to put their specific factors of production to better use. In other words: the failure of government to immediately privatise the firms necessitates a government intervention to mitigate the negative consequences of slow ownership change. Naturally, the obvious solution is not to protect these firms but to speed up their privatisation. A discussion of methods for doing so is beyond the scope of this paper though.

In terms of static economic theory, the above argument for corrective protection is valid if the negative repercussions on other sectors of the economy are not worse than the perceived benefits for the protected sector. As a preferential treatment of the state-owned enterprises discriminates against the nascent private sector in an economy in which the development of the private sector is one of the top priorities, the economic rationale for such discrimination looks very shaky if dynamic considerations are taken into account. More importantly, such protection entails a grave politico-economic hazard: it gives managers and employees of the state-owned firms an additional strong incentive to lobby against privatisation. If this lobbying were successful, it would seriously delay the adjustment of firms and perhaps even jeopardise the entire transition to a market economy. Hence, this

argument for transitional protection ought to be discarded completely; it is not taken up in the following discussion.

3. Unwarranted Collapse of Low Value-Adders

Under socialism, many firms had generated little value added. The collapse of the old mechanisms for inter-branch redistribution which had kept the low value-adders in business is one potential cause for the transition crisis. Williamson (1991) argues that it may be rational to grant temporary protection to those loss-making firms which generate at least some value added. Williamson's argumentation is not fully consistent, though. According to Williamson, the labor which the future export industries will eventually need should in the meantime stay in low value-adding activities rather than be laid off. However, the future jobs prospects in new export industries are a separate criterion which is not obviously related to the question whether the workers are presently employed in low value adders or value subtractors. If future employment prospects were the relevant criterion - and if anybody could guess these prospects - then it would be logical to support those branches which provide for the best requalification and learning on the job, independent of the current financial situation of these ventures and regardless of the kind of output which these firms produce (importables, exportables or non-tradables).

Nonetheless, a theoretical case can be made for transitional state support for low value adders which is logically distinct from the credit-market rationale for protection outlined at the beginning of this chapter. Suppose that the credit market were perfect and that the refusal of banks to extend credit to low value adders was fully warranted because it was known that these firms would never become profitable. Assistance to these firms could no longer be justified by the argument of capital-market failure. But suppose that these firms employ factors of production which cannot move rapidly and easily into alternative uses. These factors thus generate either little value added or none at

all for the time being. In this case, aid for low value adders would indeed cushion the short-term decline in GDP.

However, the above argument disregards the question whether such protection would cause severe long-term losses in terms of delaying a necessary adjustment. In fact, if the plausible assumption holds that the speed of adjustment is a positive function of the pressure on the suppliers of factor services to search for alternative uses, policy makers are faced with a classic trade-off between the depth of the adjustment crisis and future growth. From a purely economic point of view, the temporary protection of low value adders is rational if the present benefits outweigh the future costs. Whether this is the case depends on the answers to two questions: (i) will the factors of production which are presently employed in the jeopardized firms generate more value added over their lifetime (more precisely: present value of the stream of present and discounted future value added) if they are induced to stay in a low-value adding activity for the time being or if they are laid off now; (ii) which repercussions and incentive effects would a temporary protection of low value adding activities have on the suppliers of factor services in other branches? Even if convincing theoretical models were constructed, the precise pattern of future factor remunerations in the EMEs is highly uncertain. All attempts to answer these questions are pure guesswork. A meaningful economic evaluation of the costs and benefits of cushioning the short-run crisis at the expense of future growth is next to impossible.

The argument presented above is anyhow more convincing if it is interpreted in political rather than economic terms: If the successful transition to a market economy is jeopardized by the depth of the adjustment crisis, it makes sense politically to take short-term measures which dampen the crisis and serve to keep the transition process roughly on track. The counterargument that the economic costs of these emergency measures may exceed the gains in the long run becomes obsolete if the alternative was not the first-best outcome of maximum adjustment but a major

political setback which would considerably delay or even partly reverse the transition to a market economy. However, if the core of the argument is political and not economic, note that it makes little difference whether low value adding branches or even value subtractors are affected. If a meta-economic rationale made political emergency measures inevitable, these steps should be designed to the best political effect in terms of fostering political support for the basics of the programme of transition to a market economy, even if these measures made little economic sense.

To sum up: Neither a slow speed of privatisation nor the theoretical benefits of keeping low value adders in business for the time being provide a convincing rationale for transitional protection. Hence, the following sections focus entirely on the capital-market rationale for corrective state interventions. In the following chapter, the merits and drawbacks of various protectionist schemes are analysed.

III. Schemes for Transitional Protection

Various schemes for the protection of existing producers in the emerging market economies have been proposed or at least hinted at in the literature. These schemes can be categorized under three major headings, namely schemes for a regional discrimination in favour of suppliers from other emerging market economies (van Brabant 1990), schemes for a uniform protection of the importables (Dornbusch 1991) or the entire tradables sector and schemes aiming at a differentiated protection of the various branches in the importables sector (McKinnon 1991). These three schemes for the design of external barriers to trade and the further option of using selective subsidies instead of external tariffs are considered in turn.

1. Preferential Arrangements among the EMES

In the days of Soviet-type economies, the Central and Eastern European countries (including the still-existing Soviet Union)

conducted most of their external economic exchanges among each other. The bulk of this trade was not subject to world market prices and hard-currency settlement but to the special trade and payments arrangements of the Council of Mutual Economic Assistance. The core of these arrangements was a network of bilateral five year agreements and more specific annual protocols determining prices and quantities (for details see i.a. Wolf 1988). In order to mitigate the shock of a sudden transition to world market conditions (which largely happened at the begin of 1991), temporary special arrangements for the ex-Comecon members have been advocated as a half-way house. During the overall switch to a market economy, such transitory arrangements between the EMEs may take two forms, first that of a preferential trade area (for instance a free trade area between Hungary, Poland and Czechoslovakia) and/or second that of a payments union.

a. Preferential Trade Area

The case for a free trade area or a less ambitious preferential trade arrangement between the ex-socialist countries is intuitively convincing: The transition to world market conditions has dealt a severe blow to the economic exchanges between the emerging market economies; why should this trade be further impeded by tariffs or other protectionist tools which mostly did not even exist before? The issue is more complicated though. Under the old regime, intra-Comecon exchanges enjoyed a special status. The new trade regimes which the EMEs are erecting do not discriminate between exchanges with other ex-Comecon members and the world market. A preferential trade area would re-introduce special treatment.

Like any other kind of regional preferentialism, the selective abolition of the newly introduced trade barriers between the EMEs would constitute both a genuine liberalisation and an additional distortion. Consider the standard arguments for liberalisation: Apart from a few special cases, the welfare gains of a removal of trade barriers clearly exceed the costs. A liberalisation induces a more efficient allocation of resources (including the

exploitation of economies of scale), diminishes the scope for X-inefficiencies and increases the competitive pressure on all producers so that the rate of productivity increase might even be permanently higher than otherwise. Even in a simple and static partial analysis, the replacement of a domestic producer by a cheaper foreign supplier is beneficial because the additional consumers surplus is greater than the losses in tariff revenue and producers surplus.

However, the establishment of a preferential trade area has two main effects: it removes the discrimination between suppliers from within the area; at the same time, it introduces a discrimination between suppliers from partner countries and from outside which would not have existed otherwise. Therefore, additional imports from partner countries may replace either less efficient domestic production ("trade creation") or, if the tariff wedge exceeds the cost differential, imports from more efficient extra-area producers ("trade diversion"). In the latter case, the increase in the surplus of domestic consumers would still exceed the reduction in the surplus of domestic producers. Nonetheless, this net gain may be smaller than the foregone revenue on the displaced extra-area imports so that the overall welfare effect of trade diversion may be negative for a member of a preferential trade area.

There is one reason why trade diversion may be particularly relevant in the case of a preferential trade arrangement between the emerging market economies: Because of the inherited pattern of specialisation under the Comecon-regime, the production structures of the EMEs are highly complementary to each other (Kenen 1991); hence, there is little competition between suppliers from EMEs. Consequently, additional imports from other EME would for the time being not tend to replace less efficient domestic production (trade creation) but imports from the world market (which may result in trade diversion).

Nonetheless, the standard argument of static trade diversion against a preferential trade arrangement does not carry much

weight in the case of the EMEs, notably the small ones. Firstly, levying tariffs on imports from other EMEs appears to be particularly unwise: As the EMEs have inherited a complementary pattern of production, in many instances there simply would be no local producers which such tariffs on imports from other EMEs could protect. However, exports to the traditional markets in other EMEs would be harmed by the tariffs. Hence, protectionist arguments against free trade among the EMEs are rather pointless. Second, for small countries like the Central and East European EMEs, any widening of the area within which they can trade freely matters much more than for large countries. The creation of a preferential trade area is hence comparatively beneficial for the small EMEs - as long as this does not delay or impede the removal of trade barriers against third countries. Note that, if the trade-diversion objection against a regionally restricted liberalisation among small countries were valid, this would constitute an argument for erecting trade barriers within large economic units (such as Russia - or the US and the EC for that matter).

The debate on a preferential trade area begs the major question, namely that of the logic of protecting domestic producers against competition of the world market. It merely raises the issue of external protection from the national level to the level of a small regional grouping. The members of the group would still have to consider individually - or collectively in a tightly-knit club - the merits of external protection via tariffs or other means.

Hence, the central question to be asked about preferential trade arrangements among the EMEs is not whether such a device makes sense as such but the role which it is supposed to play in the design of the overall trade policy of the EMEs: Is it a complement or a temporary alternative to further liberalisation progress between the EMEs and those countries whose markets matter more in the medium-run, i.e. the industrialised West? If the arrangement has no negative ramifications whatsoever on the mutual liberalisation of trade between the EMEs and the West and if investors are aware of this, an immediate preferential trade

area between the EMEs constitutes - on balance - an additional liberalisation step which slightly mitigates the disruptions of the transition to trade at world market prices and in hard currency and which promotes the adjustment to a division of labour according to comparative advantages; if the preferential trade area is a time-consuming detour on the way towards a proper liberalisation of exchanges with the world market, it delays necessary adjustments and distorts investment decisions.

b. Payments Union

Proponents of a Central and Eastern European Payments Union usually cite the perceived success of the European Payments Union (EPU) as one of their main arguments (van Brabant 1990, Buchheim 1990). The EPU lasted from mid-1950 to the end of 1958. At first glance, the European Payments Union was highly successful: On December 27, 1958, the currencies of member countries became freely convertible into dollar for current account purposes; and - perhaps most astonishingly - the organisation named EPU was actually dissolved at that time (unlike the OEEC which turned into the OECD in (1961). Although the transition to full convertibility on current account took considerably longer than anticipated in 1950, the fact that it actually happened can be counted as a noteworthy achievement. In terms of the objectives laid down in the Preamble of the EPU Agreement in 1950 (EPU 1950, 1959), i.e. (i) the removal of quantitative restrictions on the basis of non-discrimination within Europe, (ii) further moves towards full convertibility, (iii) increases in foreign exchange reserves, and (iv) the attainment of independence from US aid, the EPU members made remarkable progress during the years in which the EPU operated.³⁾

The apparent success of the EPU may deceive though. A look at the special circumstances of the time is warranted. The need for an EPU arose from a specific pattern of exchange rate misalignments:

3) The discussion of the EPU draws on Schmieding (1987).

In the early 1950s, all major West European currencies were grossly overvalued against the dollar while the intra-European exchange rates were far less out of line. The transatlantic exchange rate imbalance showed up in a lack of liquidity in convertible currency in Europe and most other countries outside the dollar area. Because of this shortage of liquidity, intra-European trade was conducted almost exclusively in the form of bilateral barter, with detailed trade agreements specifying in advance the kinds and values of the goods to be exchanged. In mid-1948, the recipients of Marshall Plan aid formed the Organisation for European Economic Co-operation. This club was a means through which the US applied pressure on West European countries to liberalise intra-European trade. As a supplement to the OEEC, the EPU was designed to advance European economic integration in two ways: (i) under the EPU regime, all intra-EPU payments were to be settled monthly on a strictly multilateral basis, thus reducing the overall need for transaction balances in transferable currencies (i.e. the dollar); (ii) the EPU was to provide for the automatic extension of limited balance of payments credits from countries with net surpluses in intra-EPU exchanges to net debtors.⁴⁾

The clearing mechanism enabled the countries to run offsetting bilateral imbalances; only the payments position with the union as a whole mattered at any point in time. The credit mechanism created the scope to run payments imbalances with the union over time as long as the cumulative imbalance did not surpass certain limits. Within these EPU quotas, 60 per cent of net deficits or surpluses with the EPU were to be settled by the extension of credit and the remaining 40 per cent in gold or dollars (abstracting from a few technical details). The US supplied the EPU with an initial working capital via an infusion of 350 million dollar of Marshall Plan aid and used further bilateral

4) Bofinger (1990) has pointed to a third function of the EPU, namely that of coordinating the transition to full current account convertibility.

payments to induce countries like Belgium who expected to end up as structural creditors to the EPU to participate in the scheme.

The working capital of the EPU and the automatic credits which members granted each other enabled them to relax restrictions on the convertibility of their currencies among each other sooner than vis-a-vis the dollar.⁵⁾ This progress went along with a liberalisation of trade between the participants under the auspices of the OEEC that outpaced the removal of import barriers against the world market (at that time: the dollar area). Hence, the EPU helped Europe to mitigate the negative effects of the dollar gap on intra-European exchanges.⁶⁾ Nonetheless, the EPU was not a genuine policy achievement; it was merely an - albeit successful - means to limit the damage of a misguided exchange rate policy.

Whether the EPU recipe may be advisable for the Central and Eastern countries depends first of all on the yardstick applied; the answer may be different if the thoroughly liberalised trade and payments regime of 1991 or the Comecon regime which lasted largely until 1990 is taken as the system of reference. Consider the present situation first. By now, the currencies of the EMEs are not collectively overvalued; the substantial decline in trade between the former Comecon members is not the side effect of any currency misalignment vis-a-vis Western currencies; the EMEs are not in a position in which a lack of liquidity forces them to

5) For details see Kaplan and Schleiminger (1989).

6) All in all, the US and Western Europe made the overvaluation of West European currencies sustainable for quite some time by (i) US aid to Western Europe, (ii) an intra-European trade regime which discriminated against imports from the US, and (iii) the equally discriminatory payments regime of the EPU. Over the course of European reconstruction in the 1950s, the real overvaluation of West European currencies gradually corrected itself as (West) Germany re-emerged as a major supplier, as the special post-war needs to import food and machinery from the US abated and as high-inflation countries in Europe, notably France, finally devalued their currencies substantially.

maintain a system of bilateral barter and to balance their bilateral trade at any point in time. Instead, the currencies of Poland, Hungary and Czechoslovakia are largely convertible for current account purposes. In other words: the settlement of current account transactions between the EMEs is already multilateralized almost as much as possible; bilateral imbalances do not show up in separate accounts but in the overall level of freely fungible foreign exchange reserves. Hence, there is no need for a second-best option of the EPU kind. More precisely: Only if the EMEs really wanted to revalue their currencies, to reimpose severe restrictions on current account convertibility and to back up these steps by a return to managed trade might an EPU-type clearing arrangement make sense to limit the damage of such policies.

Nonetheless, assume that the old Comecon regime would still apply and that some internal or external constraints made current account convertibility and a realistic valuation of the EME currencies impossible. Even in this case, there are two reasons why a clearing mechanism for Central and Eastern European countries would make much less sense as a half-way house than the EPU did in the 1950s:

(1) The harm which preferentialism could do to Western Europe in the 1950s was limited. The member countries of the EPU were - and were expected to remain - by far the most important trading partners for each other. Together, the EPU participants were a major part of the world economy. As a matter of fact, the EPU area accounted for 57.4 per cent of world exports and for 61.7 per cent of world imports in 1950. For Central and Eastern Europe however, a redirection of trade flows towards the world market is a major and hardly dispensable element of overcoming the adjustment crisis. In 1989, the goods which Central and Eastern European countries (including the Soviet Union) exported to each other amounted to no more than 3.13 per cent of world exports (United Nations, May 1991, p. 260).

(2) In a similar vein, a combination of new restrictions on current account convertibility vis-a-vis third countries and preferential clearing arrangements to promote intra-group exchanges of goods with sub-standard quality is unlikely to contribute to a process of East European catching up to the technological leader. After World War II, Western Europe and Japan needed to repair the damages which the war had done to an otherwise rather modern infrastructure and an up-to-date stock of physical capital. In terms of human capital and technology, the gap to the US was not as pronounced as it is today in the EMEs after 40 years of communism. Furthermore, a major part of Europe's post-war shortage of high-quality and high-tech capital goods could easily be overcome once (West) Germany, the dominant pre-war supplier, was readmitted to the West European trade circuits.

The arguments above focus on the clearing aspect of a payments union. The verdict is negative. Still, the question remains whether a special credit mechanism may still be warranted. The answer is, on balance, negative as well. First, remember that not only internal but also external trade is now conducted between individuals in the various EMEs, not between state authorities. The state becomes relevant in this respect only if the demand for foreign exchange exceeds the supply at a fixed exchange rate, i.e. if economic agents cannot acquire on the market the foreign exchange which they need for cross-border transactions. In this case, the central bank has to step in and defend the insufficiently flexible parity by selling foreign exchange from its reserves. If the central bank has too little reserves and does not want to adjust the exchange rate, it would have to impose a rationing system for foreign exchange that restricts cross-border transactions like trade. Suppose that the payments imbalances would be offsetting over time and that short-term fluctuations in the exchange rate are to be ruled out. If the central bank could draw on a credit line to smoothen such short-term imbalances on the foreign exchange market, there would be no need for restricting trade in this case. This is the rationale for a liquidity buffer.

Naturally, special credit lines among the central banks of the EMEs would not augment the sum of foreign exchange reserves in the EMEs: instead the credit lines serve to pool the reserves of the participants. If the fluctuations in the participants' demand for foreign exchange offset each other at least to some extent, any kind of pool reduces the overall amount of foreign exchange which the EMEs need to hold: A common buffer can be smaller than the sum of individual buffers.

However, even the logic of pooling reserves does not imply that the central banks of the EMEs should grant each other special credit lines in ECU, DM or dollars. The world capital market is a far greater and superior pool than an artificially created market segment between the central banks of EMEs. According to the arguments made above in favour of a pooling of reserves, the EMEs which would temporarily draw on such credit lines would put the foreign exchange to the good use of avoiding the re-imposition of trade and payments restrictions. The EMEs should usually be able to obtain credit lines in foreign exchange for this beneficial purpose on the private world capital market. Hence, proponents of a special credit arrangement among the EMEs would have to go one step further: They would need to prove that the international capital market is deficient in the sense that credits are refused to good borrowers or that the EMEs are charged interest rates which contain a clearly excessive risk premium. The mere existence of a risk premium in interest rates does not suffice. If the premium reflects the best available information on the credit risk, the premium is instrumental for an efficient allocation of scarce credits on the world capital market.

There are two theoretically conceivable reasons why the mutual granting of special credit lines may be more advantageous for the EMEs than borrowing from the world capital market. If the capital market was severely affected by informational asymmetries, the risk premium may be excessive. More precisely: if the EMEs had better information on the creditworthiness of fellow EMEs than other participants in the world capital market (including specialised international organisations such as the International

Monetary Fund or the World Bank), it would pay for the EMEs to utilise their information by granting each other credit lines at conditions which differ from those demanded on the market. Given the fact that financial expertise is in very short supply in the EMEs, this is highly unlikely though. Still, a somewhat unconvincing case could be made that the central banks of the EMEs have an informational advantage over potential lenders from countries which are not themselves undergoing the transition from plan to market. If the central banks of the EMEs thought that this were the case, there is no reason why they should not go ahead and extend credit lines to each other. Note that such a system of mutual credit lines would need no formal institution nor any outside support.

In a similar vein, a situation may arise in which the EMEs were systematically excluded from the world capital market, for instance because some or all of them had failed to serve their foreign debt. In this case, they would need to convince potential lenders that a new credit for the purpose of smoothing short-term fluctuations in the balance of payments would be fully repaid and would not be included in any deal to settle old indebtedness. Once again, this is a problem of information. The EMEs will rationally enter a new credit-line arrangement with those potential lenders whom they could most easily convince of their intention to honour such a balance-of-payments credit regardless of the fate of the old debt. Assume that the authorities of the EMEs are trusted by their counterparts in other EMEs more than by other potential lenders. In this case, a special arrangement between the central banks of the EMEs would be the easiest option for the EMEs to obtain such credit lines in foreign exchange.

To sum up, the EPU experience provides no sound argument for a special payments regime among the former Comecon members. In terms of currency convertibility, the EMEs are already in a far more favourable position today than Western Europe was in 1950. Only a partial retreat to previous malpractices - with damaging repercussions on the credibility of the transition strategy as a

whole - would re-create the conditions under which a discriminatory clearing arrangement along the EPU-lines could make some sense. And although it is possible to construct scenarios in which a special system of credit lines among the central banks of the EMEs could indeed be the best option for a de facto pooling of foreign exchange reserves, the underlying assumptions of an artificially restricted access to the world capital market and of peculiar informational asymmetries seem to be far fetched.

The discussion above has abstracted from one a further argument which actually plays a major role in the debate on the merits of a payments union among the EMEs: In intra-Comecon exchanges, Soviet deliveries of oil and other raw materials were severely underpriced. Hence, the transition to world market prices entails a substantial worsening of the terms of trade for the erstwhile partners of the Soviet Union. Many proponents of a payments union see such a transitional arrangement as a device which could serve to delay this change in the terms of trade or at least to financial compensation to the losers of the switch to world market prices (see i.a. Bucheim 1990). The proposal of a such payments union is either a nicer sounding way of saying that the Soviet Union should grant her erstwhile satellites in Central and Eastern Europe a generous credit at soft conditions to ease the financing of the dearer oil bill - or it amounts to a call for Western donors to channel further assistance to the EMEs. Hoping for financial aid from the Soviet Union - or rather the successor states of the ex-Soviet Union - seems to be mere wishful thinking. And if balance of payments assistance from Western institutions were warranted, there is no reason why this aid should be channeled through a discriminatory payments arrangement among the EMEs rather than be disbursed directly - and be subject to the usual macroeconomic strings which Western institutions attach to such assistance.⁷⁾

7) Kenen (1991) stresses the need for balance of payments support to help the small Central and Eastern European countries adjust to dearer oil and settlement in hard currency.

Although the case for a payments union is unconvincing, the drastic decline in trade between the former Comecon members that commenced in 1990 and accelerated after the transition to world market prices and settlement in hard currencies at the beginning of 1991 nonetheless points to a genuine problem. Sure enough, a major part of the decline is attributable to two special factors, namely (i) the collapse of East German supply and the redirection of East German demand after the introduction of the DM in East Germany at an unrealistic exchange rate and (ii) the implosion of the Soviet Union. However, even the trade between the other ex-Comecon members in Europe declined by more than the production of tradable goods in these countries. Soft evidence (newspaper reports, private discussions with firm managers) conveys the impression that firms in the emerging market economies indeed forego at least some opportunities for mutually beneficial exchanges because of liquidity problems.

As the currencies of the EMEs are largely convertible for current account purposes, the lack of liquidity is not a deficiency of the foreign exchange regime which might be cured by any payments union. Rather, the soft evidence quoted above indicates that facilities for trade credits are insufficient. Firms that were engaged primarily in intra-Comecon trade were even less accustomed to standard market-based trade practices than those firms who had already dealt with the world market in communist times, albeit mostly indirectly via state agencies. Hence, the degree of disorientation after the regime switch and the difficulties of learning the new ways to conduct trade may well be more pronounced in the firms which had specialised on intra-Comecon trade than in those which could build on established links with the world market. The remedy for this kind of problem is not an intervention into the foreign exchange regime (a payments union) but enhanced access to trade-related credit, perhaps in the form of an export-credit insurance system along the lines of Germany's state-sponsored Hermes system. In the last analysis, the trade credit problems highlight the importance of a modern banking system and a capital market, not the desirability

of schemes to discriminate between intra-EME and extra-EME transactions.

2. Uniform Protection

a. Devaluation

A non-discriminatory option of giving local producers of tradable goods a head start into the world market could be to fix the exchange rate at a lower level than would otherwise have been chosen (undervaluation). For simplicity's sake, consider the consequences in the terminology of a devaluation relative to a previous (and sustainable) level of the exchange rate for a small economy (i.e. at given world market prices). Immediately after the devaluation all goods are still traded at their previous prices in local currency while they are cheaper in terms of foreign currency. Local producers of exportable and importable goods can then expand their production and raise their prices by the rate of devaluation.

The protection effect of the nominal revaluation solely depends on the rise of the output price of tradables relative to the price of their non-tradable inputs.⁸⁾ However, the devaluation diverts domestic output demand from dearer tradables to still-cheaper non-tradables; at the same time the expansion of tradables production increases the demand for non-tradable inputs. Both effects result in a rise in the prices of non-tradables. On the monetary side, the price adjustment will be supported by an inflow of reserves (once an eventual J-curve effect is over). If all prices for non-tradables rise by the rate of the nominal

8) Note that the extent to which the various branches of the exportables and importables sector benefit is not uniform. While tradable inputs have become dearer, non-tradables have not (at least not in the first round, i.e. before the repercussions of the devaluation on non tradables are taken into account). Hence, the effective protection of value added is a positive function of the share of non-tradable inputs in all inputs of the individual branches.

devaluation, the initial situation will be replicated and the original real exchange rate will be restored; in this case, the devaluation will not have had lasting real economic effects - just like any other kind of mild and temporary inflation.

Whether the devaluation has no permanent effects at all depends on the nature of distortions in the economy. If the induced process of price adjustments entails an opportunity to rectify distorted relative factor prices (and relative output prices in the non-tradables sector) in a manner which would have been more difficult without the change in the price level (say because of the downward stickiness of some nominal factor remunerations), the process will enhance the efficiency of factor allocation. In this case, it may even serve - along the lines of a Keynesian-type macro-argument - to draw in previously unemployed factors of production.

Sure enough, these lasting benefits of a devaluation could have been obtained by any domestically engineered inflation (with a subsequent devaluation to prevent an outflow of foreign exchange reserves). Unlike a simple monetary expansion, the option of a devaluation-induced price level adjustment will lead to a build-up of foreign exchange reserves during the process until the real undervaluation has been corrected. Note, however, that this benefit depends on the assumption that a reverse overshooting will not occur: the factors of production which were temporarily undervalued will be content once they have regained their previous real income and will not try to recoup their temporary loss.

Although the major effects of a devaluation may be transitory, this does not suffice as a counterargument. The very switch to a market economy is a transitory problem; hence, even a relief that would be merely temporary might be warranted. However, even a mild inflation may undermine the confidence of investors in the macro-stability of the economy and give rise to inflationary expectations. This hazard is particularly grave for those emerging market economies which had to cope with serious

macroeconomic problems to begin with. Hence, a slight and unsustainable undervaluation may have been more advisable for Czechoslovakia in early 1991 than for inflation-ridden Poland in early 1990.

The historical experience of West Germany in the second half of the 1950s indicates that a currency undervaluation may indeed be quite useful, albeit not as a means of protecting local producers of tradables. Originally, the DM had been grossly overvalued vis-a-vis the dollar. The process of rapid reconstruction, the favorable development in West Germany's external terms of trade and a comparatively tight monetary policy at fixed nominal exchange rates turned this initial misalignment into an undervaluation first relative to other European currencies and eventually even to the dollar in the second half of the 1950s. West Germany tried to fend off the ensuing imported inflation via a unilateral reduction of trade barriers. If skilfully used - and if inflation is genuinely unpopular - an undervaluation may hence be the opposite of a protectionist device: it may be used as a temporary means to facilitate politically the permanent removal of barriers to imports.

With respect to the exchange rate of a country that wants to catch up to more advanced countries, Giersch (1986) has recommended a peculiar mix of over- and undervaluation - and raised an intriguing definitional problem. Giersch distinguishes between two major yardsticks to assess whether a currency is over- or undervalued: (i) Does the current account exhibit a deficit (overvaluation) or a surplus (undervaluation); (ii) are the costs of producing standardized goods - Heckscher-Ohlin goods in the terminology of Giersch - below or above those in the more advanced countries? Giersch recommends an exchange rate that looks overvalued from the current-account perspective; with the current account deficit reflecting a net inflow of investible resources from abroad. At the same time, the currency should be undervalued in terms of the costs to produce Heckscher-Ohlin goods so that the catch-up country can increase its share of the world market in these goods.

In the terminology of this paper which focusses on the relative price between tradables and non-tradables, the Giersch recommendation can be rephrased as such: With given world market prices for tradables, the prices for non-tradable inputs in the catch-up country ought to be so low in terms of foreign currency as to make the country an attractive location for the production of exportables and importables. If this is the case, investible resources will flow into the country to benefit from the comparatively cheap supply of non-tradable inputs. The current account deficit reflects the capital inflow. A situation of this kind is not sustainable though; both the inflow of mobile factors of production from abroad and the expansion from the production of exportables will tend to raise the prices for non-tradable inputs, notably land and immobile labour. Giersch's recommendation is hence identical with the proposal of a temporary real undervaluation discussed above.

b. Uniform Import Tariff and Export Subsidy

The option of combining a uniform nominal import tariff with a uniform nominal export subsidy of the same magnitude is similar to a nominal devaluation. Sure enough, the immediate impact is slightly different: A devaluation reduces the domestic prices in terms of foreign currency, the tariff-cum-subsidy raises the prices for imported goods at home and reduces the prices for exported goods abroad. Like a devaluation however, the combination of import tariff and export subsidy creates a scope for the local producers of importables and exportables to expand production and raise their prices to match the world market prices. Hence, the further effects are largely identical with those of a nominal devaluation. Once again, the decisive questions are how the prices for non-tradables are affected, whether the adjustment of the real exchange rate serves to correct distortions in factor prices or in the prices for non tradables, and whether the temporary undervaluation induces an inflow of resources from outside which stay in the country even after the return to a sustainable real exchange rate.

Nonetheless, there are some differences which set this option apart from a corresponding devaluation. (i) By definition, tariffs and subsidies affect the state budget. Unless the import value and hence the tariff receipts equals the export value (and hence the investment outlays) at any point in time, the net revenues of the government will change. As the development of trade cannot be forecast with any semblance of certainty, these changes in the net revenue position of the state will be unpredictable. In the case of a devaluation, only indirect budgetary effects occur via the induced changes in the level of economic activity and hence the tax base and via the impact on the central bank's seigniorage. (ii) Because of the need to collect tariffs and disburse subsidies, this option is more difficult to implement and more prone to fraud. Hence, a nominal devaluation is the superior method to give the tradables sector a head-start into the market economy.

c. Uniform Nominal Import Tariff

A uniform nominal tariff has been repeatedly advocated as a warranted kind of transitional protection for the importable goods sector in post-socialist countries.⁹⁾ The standard arguments for a uniform tariff are straightforward: In cases in which some degree of protection for the import-competing sectors of the economy is supposed to be desirable, a uniform nominal tariff

- necessitates less administrative effort than a differentiated nominal tariff,
- is more transparent and less prone to lobbying, and
- implies comparatively minor distortions between the various import-competing activities.

The first two arguments are obviously valid. The requirement that the nominal tariffs on all imports ought to be uniform

9) See for instance Dornbusch 1991, Blanchard et al. 1991, Peck and Richardson 1991.

constitutes a rule which leaves decision-makers no discretion as to the tariff-treatment of individual sectors. Hence, as long as it is credible that the rule will not be broken, special-interest groups have no reason to devote resources to lobbying for sector-specific tariff increases. Sure enough, some lobbying for a higher uniform tariff rate may still occur though. For two reasons, these lobbying activities would be much weaker than those for sector-specific treatment: (1) as the benefits of a uniform tariff accrue to a great variety of sectors, each sectoral interest group would have an incentive to be a free rider, i.e. to let others devote resources toward securing the tariff hike (Panagariya and Rodrik 1991); (2) as a uniform tariff affects the prices of importable inputs as well as that of the output, an increase in this uniform rate yields a smaller change in the effective rate of protection of a given sector than a corresponding increase in the specific tariff of this sector.

The last of the three arguments mentioned above is less obvious and merits more attention. The following sections focus on the pattern of effective rates of discrimination which a uniform import tariff yields; the implicit system of reference and hence yardstick is free trade and not any existing trade regime.

(i) No repercussions

To assess the effects of a uniform tariff, first consider a single small branch within the importables sector of a small economy and abstract from all inter-sectoral repercussions. Like all other branches, this branch employs various inputs which can be subsumed under four headings:

- importable inputs (IM)
- exportable inputs (EX)¹⁰⁾

10) Strictly speaking, the importable inputs also include the import content of the exportable and non-tradable inputs; in the same vein, the exportable inputs include the exportable content of the other inputs.

- non tradable inputs (NT)
- value-added generating inputs (VA).

By definition, the value of output equals the sum of the input values (which include residuals such as profits). The last three comprise the local content of the output, of which VA is a primary (not-preproduced) input, exportables and non tradables are the local intermediate inputs.

A uniform tariff increases the prices of both the output and the importable input by the tariff rate. By definition, the value of the local content (per unit of output) rises by the same rate. As the prices of local intermediate inputs (EX and NT) remain unchanged in the absence of inter-sectoral repercussions, the entire increase in the value of the local content accrues to VA. The smaller the share of VA in local content, the higher will be the rate of effective protection, i.e. the rate at which value added in the branch rises as a consequence of the tariff. More precisely: the rate of effective protection of this branch equals the nominal rate of protection divided by the share of value added (i.e. of primary inputs valued at their non-protection remunerations) in local content. If the share of value added in local content differs between branches, the effective protection of value added differs correspondingly between branches.

(ii) Repercussions on non-tradable inputs

Protection not only creates scope for the specific primary inputs (VA) to appropriate a rent at a given level of output; it also makes the expansion of production profitable. If the protected branch is sufficiently large or if a sufficient number of branches is protected, the corresponding increase in demand for at least some factors of production will raise the prices of these inputs. Assume that the price of exportable inputs is given by the world market (at an unchanged nominal exchange rate). Non-tradable intermediate inputs (NT) and the primary inputs (VA) thus constitute the variable-price components of local content which together benefit from the tariff rent. The higher the share of fixed-price exportables in local content, the more will the

percentage rise in the sum of NT and VA factor rewards exceed the rate at which the value of the local content per unit of output has risen (the tariff rate). The effective protection of the VA is reduced relative to the no-repercussions case discussed above; the dearer the NT become and the higher their share in overall local content, the less scope remains for the VA to raise their remunerations, in other words: the less will the effective rate of protection of the primary inputs (VA) exceed the nominal rate of protection. Depending on the relative elasticities of supply and demand, the prices for some NTs may even rise by more than the remunerations for some components of VA. As these elasticities and the relative importance of the three components of local content (EX, NT, VA) vary across branches, the pattern of effective protection of VA in various branches is correspondingly differentiated despite a uniform nominal tariff.

(iii) Exchange rate repercussions

The uniform nominal tariff creates a uniform wedge between the internal and the external prices of importables and a corresponding wedge between the output price ratios (exportables to importables) on the local and the world market. The world market prices for all importable and exportable outputs and inputs are given; the local price of exportables equals the world market price, adjusted for the exchange rate. The reduction in import demand induces a nominal appreciation of the exchange rate;¹¹⁾ the more pronounced this appreciation turns out to be, the less will the local prices for importables rise and the more will the local prices for exportables decline.

The revaluation directly diminishes the tariff rent accruing to the local-content factors of production (EX, NT, VA); the overall effect of the uniform tariff on the local prices of the

11) Or - in the case of fixed exchange rates - the corresponding shifts in the ratios between the monetary bases and ultimately nominal demand and price levels at home and abroad.

importable output and the importable inputs hence equals the nominal tariff rate minus the rate of devaluation. Although the revaluation is by definition a uniform adjustment of local prices relative to world market prices, the effect of the revaluation on the inter-branch profile of effective rates of protection is not uniform. The uniform reduction in the price of exportable inputs benefits NT and VA, not EX. The higher the share of exportables in local content, the less does the revaluation diminish the effective protection of VA and the scope for rises in the prices of NT (see Corden 1974).

(iv) Demand repercussions

Apart from the exchange rate effect explained above, a uniform import tariff has further repercussions on other sectors of the economy and hence on the remunerations which factors of production can reap there. The repercussions are transmitted via changes in the demand for outputs and inputs. Consider the output-demand effects first. Final demand is diverted away from the dearer importable output whereas the cheaper exportables will become more attractive. How the overall demand for non-tradables changes is unclear; the smaller the elasticity of substitution between non-tradables and dearer importables is relative to elasticity of substitution between non-tradables and cheaper exportables, the more likely is it that the overall demand for non-tradable outputs will decrease. Furthermore, to the extent that the import protection reduces the overall welfare (allocational efficiency) and the growth dynamics of the economy, there will be downward pressure on the relative price of non-tradables; typically, recessions show up in a decline in the price of non-tradables relative to tradables (real devaluation).

Now turn to the input-demand effects. The growing importables sector draws in factors of production from elsewhere whereas the shrinking exportables sector sheds factors. Broadly speaking, the factor price ratios move closer to their autarchy levels. The prices of those factors which are relatively intensively employed in the production of importables will rise while those that are

used relatively intensively in the exportables production will decline. These factor price changes directly affect the effective rates of protection of the primary factors of production in the importables sector. Lower prices for the inputs that were used intensively in the exportables production imply a higher rate of effective protection, higher prices for the inputs which the producers of importables need most to expand production reduces the rate of effective protection in the importables sector. As the factor input requirements of the individual branches of the importables sector differ, the changes in relative factor prices will affect the effective rates of protection in these branches in a non-uniform way.

(v) Repercussions on exportables and non-tradables

The repercussions of a uniform import tariff on the exportables sector are obvious: the revaluation implies lower prices for the exportable output; the tariff raises the price of importable inputs; the pull of factors of production into importables and also into some branches of non-tradables feeds through into higher prices for some local intermediate inputs. The effects of the uniform import tariff on the exportables sector are a mirror image of those described above for the importables sector. Whereas the revaluation harms the exportables sector as a whole, the inter-branch pattern of effective rates of discrimination will be highly differentiated.

The impact on non-tradables is less clear. On the one hand, this sector may benefit from the diversion of demand away from importables and the shedding of factors in the exportables sector; on the other hand, the diversion of output demand towards exportables and the higher prices for inputs which are used comparatively intensively in the importables sector impair the profitability of non-tradables production. Regardless of the balance of these overall effects, the effective rates of distortion (effective protection in case the uniform import tariff benefits VA in an individual branch of non-tradables, effective discrimination if the opposite holds) will - for the reasons explained above for

importables - vary across the various branches of the non-tradables sector.

To sum up, a uniform nominal tariff on all importables yields a highly differentiated pattern of effective rates of protection of the value added in the various import-competing branches¹²⁾ and equally differentiated rates of effective discrimination in the various branches in the exportables and non-tradables sectors. Few generalisations and hence ex-ante predictions of the inter-branch profile of effective discrimination are possible. Consider the limited systematic implications of a uniform nominal tariff: Ceteris paribus, the degree of effective protection of an individual import-competing branch is a positive function of

- the share of exportable intermediate inputs in local content and
- the degree of similiarity in input requirements between this branch of importables production and those branches of exportables which contract most.

For all import-competing branches, the level of effective protection is a negative function of the tariff-induced revaluation.

12) Consider a simple numerical example: a uniform nominal tariff of 20 per cent is levied on all imports. In one protected branch, local content is composed of 50 per cent EX, 30 per cent NT and 20 percent VA; in another protected branch, the respective figures are 20, 30 and 50 per cent respectively. Without any repercussions, VA in the first branch is effectively protected by a rate of 100 per cent (i.e. five times the nominal rate) and in the second branch by 40 per cent (case 1). In a further step assume that - due to the repercussions on input prices - the prices of NT rise by 3.3 per cent in the first branch and by 20 per cent in the second. The rate of effective protection of value added which the uniform nominal tariff yields now amount to 95 per cent in the first and merely 28 per cent in the second branch (case 2). Ultimately, consider the effects of a 10 per cent revaluation (which for simplicity's sake is also taken to reduce the prices for non-tradable inputs by 10 per cent relative to their levels in case 2). The rates of effective protection in the two branches decline to 85 per cent and 18 per cent respectively. In the second branch, the effective rate of protection is hence even below the nominal rate.

The effect of the revaluation on different branches of exportables and hence on the structure of factor prices can hardly be ascertained beforehand. Unlike internal factor prices, the structure of prices for exportable inputs is given by the world market. The major systematic element of variation in the effective rates of protection which may lend itself to an ex-ante evaluation is hence the share of exportable inputs in all inputs. A systematic discrimination in favour of branches employing a comparatively large share of exportable inputs may be warranted if these branches suffer more than others from the credit market deficiencies. This would be the case if the firms in these branches had to cope with larger transitional losses although they had on average the same probability of becoming viable in the future and faced the same or even more severe credit constraints as firms in other branches.

Such a situation is conceivable in the transition to a market economy: suppose that, with the liberalisation of prices and the removal of subsidies, the internal prices of exportable inputs rise relative to the prices of other inputs. In this case, the severity of the adjustment problems would be a positive function of the share of exportable inputs in all inputs. The most clear-cut and dramatic impact of the regime switch in Central and eastern Europe on internal factor prices is the hike in energy costs. For all ex-socialist countries, dearer energy reflects the reduction or abolition of subsidies; for the oil-importing countries among them, it is also the result of having to pay world market prices for Soviet oil. In countries with exportable energy, the revaluation induced by a uniform nominal tariff would reduce the price of energy in local currency and hence benefit the energy-intensive branches. If the energy-importing countries wanted to introduce a comparable discrimination in favour of energy-users, they would have to exempt energy imports from the otherwise uniform nominal import tariff. This would be a step towards a purposefully differentiated pattern of nominal protection. In order to avoid a duplication of arguments, the logic of a systematic discrimination in favour of energy consumers is discussed not under the heading of a uniform nominal tariff

(which has this implication for energy exporting countries only) but in the following sections which deal with a consciously designed pattern of differentiated protection.

3. Differentiated Nominal Tariff

The most famous plea for a differentiated pattern of nominal protection for importables in the emerging market economies has been made by McKinnon (1991). When the prices for raw material and energy inputs in Central and Eastern Europe suddenly rose to the world market level, many enterprises discovered that their value-added at the new set of relative prices is low or even negative. Lacking credits to cover temporary losses in the period of adjustment, even ultimately viable firms would have to close in the absence of some corrective government action. A devaluation is no suitable remedy because it would increase the local-currency cost of energy and raw material inputs by as much as the local price of the output. Hence, McKinnon argues for a temporary tariff protection to industries which had been most subsidised by the low prices of these inputs in the past. More precisely, McKinnon advocates a cascading nominal tariff schedule which is scaled downwards according to the distance from the consumer and to the degree of manufacturing complexity (ibid. p. 182). For example, a low tariff of, say, ten per cent should be levied on inputs, a somewhat higher rate should be applied to capital goods, an even higher one on consumer non-durables while consumer durables should be subject to the top rate of, say, 100 per cent. This protection ought to be phased out gradually over the course of roughly ten years.

Note that this design for the pattern of protection does not necessarily follow from the analysis of the underlying problem. Energy and raw material intensity are not identical with the degree of manufacturing complexity or the distance from the consumer. If it were true that the hike in energy and raw material prices created the problem, then the rate of protection should reflect the energy and raw material intensity and not some

characteristic of the output (capital or consumer good, durable or non-durable).

If these issues are considered more closely, three different rules for the design of a rational pattern of nominal protection can be derived:

- input-price rule: the rate of protection should be a positive function of the extent to which the various sectors suffer from the hike in energy and raw material prices;
- output-quality rule: the rate of protection should reflect the quality differential between locally produced goods and world market imports;
- value-added rule: the pattern of protection should serve to keep firms with low value added or even negative value added in business.

McKinnon's analysis of the problem points towards an input-price rule, his actual proposal seems to mimic an output-quality rule, his discussion of the effects of devaluation hints at a value-added rule. All three conceivable rules for the rational design of a tariff schedule are fraught with problems. Most fundamentally, all three rules are of a second-best nature. They are neither linked to the future viability of firms in the various branches nor to their ability or inability to cover temporary losses by credits. The input-price and the output-quality rule focus on the adjustment pressure, the value-added rule should serve to keep workers employed for the time being who make at least some positive contribution to GDP and who would otherwise be laid off and not generate any value added at all.¹³⁾ Neither rule is geared towards the opportunities to adjust.

For example, the closeness to the consumer and the degree of manufacturing complexity may well be a rough indicator of the quality gap. Nonetheless, the opportunities to close the gap are

13) The rationale for specifically protecting low value adders has been dealt with above.

not necessarily related to the extent of the gap. After the economic unification of Germany, East German consumers largely switched from local to Western processed food; the substantial quality gap reflected a variety of factors ranging from the more appealing packaging of Western products to the health hazard posed by some polluted East German products. Still, the East German food processing industry shrank much less than other branches of importables (DIW and IfW 1991, p. 9). The quality gap in this branch of non-durable consumer goods could be closed rather easily by the adoption of Western-looking labels, the replacement of polluted inputs and a tightening (or introduction) of quality controls. McKinnon's scheme would have granted the producers of these goods the second-highest rate of nominal protection.

In a similar vein, the degree of manufacturing complexity is no clear indicator of the adjustment difficulties and hence of the supposed need for transitional protection. Even if the quality gap to Western products is huge with regard to the output, the firms may have brand names and the workers employed may have acquired skills which make them particularly attractive for investors. The liaison between Volkswagen and Skoda automobiles dwarfs all other foreign direct investments in the emerging market economies by comparison. With their easy access to the world capital market, foreign investors do not need to care about any deficiencies of the local capital market. Under McKinnon's scheme, consumer durables such as cars would have enjoyed the highest degree of protection.¹⁴⁾

These counterarguments and counterexamples are directed against McKinnon's actual proposal, not against the underlying energy-

14) At first glance, the Volkswagen example could be taken as a justification for a tariff discrimination in favour of those sectors which are least attractive to foreign investors. However, such a tariff schedule would be most absurd: it would be a recipe for protecting not the ultimately viable but the clearly unviable branches which foreigners rationally shun.

shock rationale. Consider the pros and cons of a tariff schedule which reflects the energy-input rule. Such a pattern of protection would entail three specific disadvantages:

(i) the emerging market economies have so far wasted energy on a grand scale, any further discrimination in favour of energy users would tend to delay the improvement in energy efficiency;

(ii) the EMEs need to drastically reduce energy consumption for ecological reasons; an internalization of the external effects of energy consumption would necessitate special taxes on the use of energy rather than a tariff schedule that rewards energy-guzzlers;

(iii) in the case of energy-rich countries, such a tariff schedule would constitute a clear case of discrimination against a particularly promising branch and a potent foreign exchange earner; as energy is readily exportable (or rather the raw materials to generate energy), the oil-rich republics of the erstwhile Soviet Union (Azerbaijan, Kasachstan and Russia) and Eastern Europe's major coal producers (Poland, Russia and the Ukraine) should rather steer resources into the production and the export of energy and not create distortions which slow down the improvement in energy-efficiency.

The first argument is clearly valid; an in-depth evaluation of the second argument. i.e. the ecological aspect, is beyond the scope of the paper. The ecological case for dear energy or even a hefty eco-tax on energy use in the emerging market economies is less clear than appears at first glance though. Whereas major ecological damage has already been done in the past, the capability of the EMEs to clean up the mess depends on their economic progress. If a temporary brake on the rise in energy costs would substantially smooth the transition to a market economy, the benefits in terms of having more resources to invest into environmental protection may outweigh the costs of the additional pollution which had been generated on the way towards prosperity.

The third argument, convincing as it may appear at first glance, actually strengthens the case for transitory discrimination

against energy producers. Oil, natural gas, and coal have no inherent quality differentials to Western products, they are readily exportable and can be extracted and transported with a technology that Western investors are familiar with. Hence, it is comparatively easy to calculate the future viability of these activities and to get Western investors interested in the promising oil and gas fields and coal pits. Because of their established access to the world capital market, foreign investors are not subject to the credit constraints and capital market distortions which retard the restructuring and growth of viable firms within the EMEs during the process of transition to a market economy. If the discrimination against the energy producers were clearly temporary, it would neither have a major impact on the decisions for long-term investment into energy production nor seriously delay the pull of further resources into these activities. For the same reason, the incentive to invest into energy conservation (the first argument made above) would not be seriously impaired. Instead, the temporary brake on the rise in energy costs would constitute a partial relief for those other branches which cannot adjust abruptly to the hike in energy costs and whose factors of production cannot move readily into alternative uses. Note that this argument refers only to the energy exporting countries. They could attain the desired wedge between internal and external energy prices via an export tax on energy.

To sum up, whereas the arguments for protecting firms in the EMEs are unconvincing, a temporary tax on energy exports can be warranted. However, remember that this holds only if two crucial conditions are met:

- (i) The commitment to phase out the discrimination must be credible, otherwise investment decisions would be distorted (see Schmieding 1991a);
- (ii) Western investors must be permitted to engage in the extraction, transport and marketing of the energy-generating raw materials, otherwise the systematic advantage of easy access to the world capital market would not be realised.

4. Asymmetric Liberalisation

Demands for an asymmetric liberalisation are frequently raised in the debate on a suitable liberalisation strategy for the emerging market economies and particularly in discussions on their integration into the West European market. The large, rich and well developed EC should open its markets for the EMEs immediately while the small, crisis-stricken and less advanced EMEs should be granted a considerable time until they have to reciprocate. Indeed, the drafts for the association agreements which the EC intends to conclude with Poland, Hungary and Czechoslovakia provide for such an asymmetry.

An agreement on an asymmetric liberalisation has various interesting features:

- barriers to trade are removed only gradually in successive steps of unilateral liberalisations;
- at the beginning trade is liberalised only partially, i.e. by one participant;
- the delayed reciprocal liberalisation is merely announced;
- the EC and the EMEs differ considerably in size.

Whether a liberalisation should be complete or partial is not the subject of this section (it relates to the overall logic of transitional protection which has been dealt with above); the credibility aspect of an announced (reciprocal) liberalisation has been discussed in Schmieding (1991a). Instead, the following section discusses the peculiar claim that it makes a difference whether the large EC or the small EMEs liberalised first and that the EMEs have something to gain from being the second mover.

First, consider the implications of trade liberalisation between a large and a small country in a Heckscher-Ohlin-type setting. For simplicity's sake, assume that the trade account is always balanced (which it is in non-monetary models of the Heckscher-Ohlin type). Both countries gain from a move from autarchy to free trade; by definition, both experience the same expansion of their mutual trade in absolute terms. However, the importance of these gains and of all other trade-induced changes relative to the autarchy situation differs: the resumption of trade with a

small country has comparatively little impact on the large country; in the extreme case, the internal relative prices in the big country remain unchanged;¹⁵⁾ they become the world market prices and hence the new relative prices in the small country, adjusted for the impact of trade barriers.

The structure of production will adjust in both countries. Because of the difference in size, the effect will be hardly noticeable in the large country and quite substantial in the small one. In the extreme case, the small country will completely specialise in the production of one good while the large country will slightly expand its production of all other goods and perhaps even continue to produce the good in which the partner has specialised.

Suppose that - contrary to standard Heckscher-Ohlin models - the adjustment is not smooth. In this case, the relative size of the countries matters. In the large country, only a minor part of the entire stock of activity specific human and fixed capital is rendered obsolete, in the small country, this share is substantial. Furthermore, if factors of production are immobile internationally, those factors which have to leave their original activity have relatively more alternative employment opportunities in the large country and a greater probability of finding a new employment where they can still utilize at least a part of their specific features.

Second, assume that the two countries do not move to free trade but that one country continues to levy an import tariff (asymmetry). Does it matter who has liberalised unilaterally and who still maintains a tariff? The internal relative price in the small country differs from the unaltered relative price in the

15) According to a time-honoured rule of thumb, the relative importance of the gains from free trade for a country in a Heckscher-Ohlin model is a positive function of the trade-induced change in its relative prices.

large country by the rate of the tariff. If the small country imposes the import tariff, importables become dearer relative to exportables on the local market by the amount of the tariff; if the large country levies an import tariff, the price of the small country's exportables is depressed in the small country by the amount of the tariff. The impact on the internal relative price in the small country and hence on the level and structure of mutual trade does not depend on who did the liberalisation. For the same reason, the opportunities and the need to adjust are identical in both scenarios for both countries. Hence, the major argument for asymmetric liberalisation is invalid in such a setting: in terms of the pains of adjusting to freer trade, it does not make a difference whether the EMEs or the EC reduce barriers to their mutual trade, as long as it is done by a comparable magnitude.

This point can be made in more general terms: The expansion of mutual trade and the trade-induced structural adjustment go hand in hand. Country A cannot enjoy the benefits of freer trade without having to incur the pains of adjustment even if only country B did the liberalisation and A kept its import barriers. Naturally, the asymmetry matters for the distribution of the revenue from the levy on mutual transactions: the country which imposes the tariff collects the revenue.

Third, because of their low labour costs and their geographic and cultural proximity to Western Europe, the emerging market economies are considered potentially attractive locations for producers who want to serve the West European market. The more and the earlier Western Europe opens its markets for products from the EMEs, the more interesting will the EMEs be for foreign capital. In the context of the discussion whether an asymmetric liberalisation could serve to reduce the pressure for real economic adjustment, this has an interesting implication. Assume that mutual trade need not be balanced at any point in time so that intertemporal trade and hence capital flows enter the picture. As access to the larger country's market counts for potential foreign investors while the external trade regime of the small

country is comparatively unimportant for investment decisions, it now matters whether the small or the large country liberalises first. If the EC did so, capital would flow into the small country. Abstracting from short-term problems of the Dutch disease-type, this is beneficial for the small country as a whole and for the local immobile factors of production in particular. Nonetheless, the import surge and real revaluation which correspond to the capital inflow put further adjustment pressure on the tradable goods sector of the EME.

To sum up: the principal purpose of the asymmetry in liberalisation is to mitigate the competitive pressure on the importables sector in the small EMEs. In a simple setting with balanced trade, the effect is nil; and if capital flows are taken into account, the result is the very opposite from the intended one.

However, the analysis presented above rests on one major implicit assumption, namely that there are only two tradable goods or, rather, that all importables are always affected in exactly the same way by changes in tariff rates. The results are different if a non-uniform pattern of effective rates of protection is considered. Whereas an increase in mutual trade between the two countries naturally leads to adjustments in the structure of production in both countries, the precise inter-branch pattern of these changes depends on who abolished his barriers to trade. Those branches which enjoyed above-average rates of effective protection in the liberalising country are hit harder than the other branches in this country and the importables producing branches in the second country. Although the overall level of adjustment pressure is identical for both countries, the country which does not liberalise maintains its inter-branch structure of effective protection. Hence, being the second mover in asymmetric liberalisation means to be able to continue with the specific protection of some branches although the average pressure to adjust is not reduced. The discussion on asymmetry begs the major question, namely whether such specific protection makes economic sense (see the evaluation below).

Note that, after the collapse of the old Comecon trade regime which did not rely on standard protectionist devices, the EMEs, and notably Poland, do not yet have a highly differentiated structure of protection in place whereas the EC does. Hence, the above argument is of little relevance to the EMEs immediately after the regime switch. These countries simply do not yet have much to gain from the asymmetry in terms of delaying the pains of adjustment in specific branches. Sure enough, they might introduce a more differentiated pattern of protection over time, either via raising import barriers for some products or via exempting these products from general tariff reductions. As to the EC, whether the asymmetry seriously changes the inter-branch profile of effective protection of local producers against competitors from the EMEs depends on the extent to which the highly protected branches, i.e. agriculture, steel, coal and textiles, are liberalised. According to the first drafts of the association agreements, these branches will be at least partly exempted.

5. Evaluation

The underdeveloped state of the capital market seems to provide a theoretical rationale for temporary protection. However, serious objections remain.

(a) Information Problems

On the basis of the capital-market argument, the effective protection of the various branches of the economy should be a positive function of the probability that the firms in these branches will be viable in the future and a negative function of the ease of access to credits and of the opportunities for the employed factors of production to move into alternative uses. Attempts to design a rational pattern of protection along these lines are marred by serious informational problems: First, government has to calculate the optimal rate of effective protection or discrimination for all branches of the economy. Second, it has to establish the nominal tariff schedule which generates

the desired result. As has been described above, even a uniform nominal tariff yields a highly differentiated and hardly predictable pattern of effective rates of protection. These problems get even worse if the nominal tariff schedule is to be differentiated as to generate a supposedly rational pattern of effective protection. To calculate the effective protection of the various branches, an input-output matrix and the prices for primary factors of production and for non-tradable intermediate inputs need to be known.

Consider the price problem first: Whereas the pre-tariff prices of factors and non-tradables may be known, the post-tariff ones are not. Even a rough evaluation of the likely structural changes which the tariff will induce does not suffice to guess the new prices for factors of production and for intermediate non-tradable inputs. First of all, the change in the structure of output demand and hence of the prices for factors and for non-tradables depends on how the state spends the tariff revenues. Furthermore, some factors are internationally mobile. The changes in relative factor prices caused by the tariff induce a different pattern of cross-border flows of factors; these flows will under normal circumstances mitigate factor price differentials and undercut the effect of the additional trade impediment; to the extent however that for instance flows of financial and human capital react not to present factor prices but also to the perceived growth potential, the impact on these flows may be quite different from the ones predicted by static theories of international transactions. The less is known about factor prices, the more difficult does it get to design a rational tariff schedule.

Now turn to the input-output matrix. The analysis of the effects of a uniform and a differentiated nominal tariff has been based on the assumption that the quantity structure of the input-output matrix would remain constant (implicit assumption of linear-limitational production functions). In other words: the input-output ratios and the relative input intensities are neither affected by

relative input prices nor by changes over time.¹⁶⁾ Even if the production technology made major changes in relative input intensities difficult, these ratios are still unlikely to remain constant. The transition to a market economy gives rise to drastic changes in relative input prices, the reliability of supplies is greatly enhanced so that inputs which were suitable but not available can be used, there are far more opportunities to look for alternative inputs. All in all, massive and somewhat unpredictable changes in input ratios are to be expected within a relatively short period of time.

These arguments render all calculations based on the old input-output matrices and hence the attempts to deduce a rational pattern of effective protection almost meaningless. Sure enough, standard calculations of effective rates of protection usually rely on constant input-output ratios and constant relative input intensities; they show by how much the present remunerations for primary factors exceed the level which they could attain without protection at unchanged input ratios; they are not identical with the true opportunity costs which would have to take the effects of all quantity adjustments of liberalisation into account. Whereas such calculations are useful for comparatively stable settings (established Western market economies), it makes little sense to apply this method to post-socialist countries where substantial changes in the input ratios would happen even without any change in external protection.

Should input-output matrices of advanced Western countries be taken instead as a basis for the design of the tariff schedule which yields the desired inter-branch profile of effective protection? This would not be sensible: (i) By the time the EMEs

16) In their technically excellent calculations of the competitiveness of industry in Czechoslovakia, Hungary and Poland, Hughes and Hare (1991) had to utilise input-output tables for 1986 (Hungary), 1987 (Czechoslovakia) and 1988 (Poland). In all three countries, the major changes in the economic regime happened thereafter.

had adjusted relative factor intensities to the pattern in the developed Western economies (or to that in, say, the South-East Asian NICs), no further transitional protection would be needed; (ii) Western input-output ratios are also no indication of long-run viability of these activities in the EMEs and hence the appropriateness of temporary protection.

Ultimately, consider that the theoretical optimum would be a finely differentiated pattern of nominal tariffs and subsidies to attain a desired pattern of effective protection and discrimination. Such calculations, which would have to take the repercussions of these subsidies and the way in which these subsidies are financed into account, are simply infeasible.

(b) Incentives for Rent-seeking

Even if a supposedly rational tariff schedule could be designed, the inter-branch pattern of protection is likely to be largely shaped by considerations of political economy. The more differentiated the pattern of protection is supposed to be anyhow, the greater will be the incentive for sectoral lobbies to strive for a tailor-made protection of their specific sector. In the same vein, a complex tariff schedule facilitates rent-seeking activities by making the process of changing the structure of protection less transparent. Any consciously designed and complex pattern of protection (and subsidisation) is likely to be particularly unstable and to widen the scope for negative-sum games. Most importantly, the greater the scope for rent-seeking activities, the less likely is it that the supposedly temporary protection will actually be phased out.

(c) Inter-sectoral Distortions

The arguments of political economy point towards introducing a uniform nominal tariff in cases in which some import protection is supposed to be warranted. By its very nature however, import protection introduces a discrimination between the sectors of the economy. Producers of importables are favoured at the expense of producers of exportables. Furthermore, non-protected importables

(services, tourism) are discriminated against and squeezed by the revaluation in exactly the way in which exportables are; on the other hand, those sectors which use these services as major inputs benefit. Incidentally, this also complicates the calculations of effective rates of protection even further.

Reconsider the credit-market rationale for transitional protection discussed at the beginning of this paper. It does not refer to a specific characteristic of the importables sector.¹⁷⁾ The deficiency of the capital market affects all branches of the economy, albeit to a different extent. Import protection which discriminates against exportables and - usually to a lesser extent - also against non-tradables is hence not an appropriate second- or third-best solution. Even if a uniform nominal tariff did in fact yield a somewhat rational pattern of effective protection within the importables sector, the distortionary repercussions on exportables and non-tradables would remain.

Remember that the case for temporary protection was based on an analogy to the infant-industry-argument. However, the infant-industry-argument is in essence a branch-specific argument; it refers to some selected branches and not to all sectors of the economy. According to the argument, transitional protection can be warranted as a second-best means to counteract a market failure which affects only the pioneers in some specific

17) The same holds for the two other rationales for transitional protection discussed in chapter two: (i) The slow progress of privatisation affects all sectors of the economy. True, the small privatisation (shops, crafts, restaurants and small businesses) proceeds comparatively smoothly. As most of these activities are in the non-tradables sector, some discrimination in favour of tradables might appear to be justified. However, it does not warrant the blatant discrimination between the two kinds of tradables, namely exportables and importables, which is the major effect of import protection. (ii) The low value adder argument refers to low value adders in all sectors of the economy, not just to the import-competing ones; if this argument was taken seriously, a protection based on this rationale should equally benefit those low value adders which are not in the importables sector and which have nothing to gain by an import tariff.

activities (the nascent modern branches in which firms invest heavily into teaching their workers new skills and cannot themselves attract skilled workers from other activities). In this setting, the negative repercussions on other activities may be small enough to be bearable for a while. As soon as a sufficient number of workers has completed the learning on the job so that an interchange of workers with comparable skills can occur among firms, this specific transitional protection is no longer warranted (see Giersch 1977, pp. 314-315). The infant-industry-argument provides no valid rationale for the wholesale protection of all import-competing activities. As the capital-market failure affects all sectors of the economy, it cannot be corrected in a second-best or third-best manner by a uniform import tariff.

On the macroeconomic level, one argument may be taken to provide a case for a general import protection in the EMEs. The external liberalisation causes an import surge; hence, the producers of importables face specific adjustment problems. Because they hence have specific liquidity needs, they suffer more from the general capital market deficiencies than other sectors. However, this is an exchange rate issue, not an issue of protecting importables; Poland (1990) and the CSFR (1991) have demonstrated that the exchange rate can be set as to generate a trade surplus with the West. In other words: any protection warranted by this argument could be delivered via a temporary undervaluation of the exchange rate.

To sum up: The rationale for import protection in Eastern Europe's emerging market economies is very weak. Only a temporary undervaluation of the exchange rate and some temporary measures to mitigate the sudden hike in energy costs (in the form of an export tax on energy, not an import tariff on other goods) can be justified economically under certain conditions. Wholesale protectionism cannot serve as a second-best remedy for the specific capital-market deficiency in the EMEs. Instead, free trade is the best commercial policy for these countries as well.

IV. The Paradox of Protection: Financial Liberalisation Renders Trade Protection Obsolete

The negative verdict on import barriers as a second-best or third-best compensation for the capital market deficiencies underlines the need for overcoming the present distortions in the allocation of capital. The EMEs need to ponder rapid ways of creating a sophisticated system of financial intermediation. Fortunately, such systems exist in the West. As the EMEs are striving to become members of the EC, their future financial system need to be compatible with the EC laws and regulations anyhow. The EMEs could save time and evade a future need for adjusting their nascent financial system to EC requirements if they opted for an institutional transfer in the first place: they could copy the basic elements of the financial system of an EC member (or the system of an EC non-member which is compatible with the EC requirements).

The wholesale institutional transfer necessitates the following steps:¹⁸⁾ The EMEs

- clean the balance sheets of existing state banks of old loans to state firms which were incurred before the switch to a market economy,
- adopt a regulatory system from a Western country which provides for universal banking and is compatible with the EC regulations,
- invite the regulatory body of that Western country to establish a branch office and to regulate the nascent domestic banking system,
- privatise the existing banks, preferably to foreigners, and
- invite all foreign banks to become active in the EMEs subject to the just-adopted regulations.

18) See Schmieding (1991b); Begg (1991, p. 57) has also noted that the first-best solution would be to remedy the credit-market failures.

The wholesale institutional transfer removes the legal uncertainties for Western banks. In conjunction with the cleaning of the balance sheets of the existing banks, it constitutes the most radical way of turning the presently underbanked EMEs into a promising field of activity of foreign banks. Sure enough, a fully sophisticated capital market will not spring up overnight even under these circumstances. Under the given (and mostly adverse) circumstances, this institutional transfer makes it as easy as possible for Western banks to become active in the EMEs and to transfer and fully utilise their expertise.

Unlike import barriers, radical financial liberalisation is targeted towards the root of the peculiar credit-market failure in the EMEs which aggravates the adjustment of production to the new and much more rational set of relative incentives. The sooner the capital market matures, the earlier does the case for transitional protection - which is economically unconvincing anyhow - become completely obsolete. It is a paradox of protection in the emerging market economies that a radical liberalisation, namely that of the financial system, is a far better means to attain the very end which import protection is supposed to serve: a smoother transition to capitalism.

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