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K I E L D I S C U S S I O N P A P E R S

163

# **The Transformation of Eastern Europe**

**by Horst Siebert**

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## I. The Gap between Western and Eastern Europe

1. Since 1985, the economic landscape of Europe has changed considerably, both in the West and in the East. In Western Europe, the Delors initiative for Europe '92, which started in 1985 with the White Book covering 300 single steps, has given new momentum to the EC. The liberalization of capital flows and services, replacing the unanimity rule in the Council of Ministers by majority voting in a weighted form for the larger part of the 300 directives, and the Cassis-de-Dijon ruling, which was handed down by the European Court of Justice, will reduce market segmentation and will lead to a more intense economic and political integration.

According to the Cassis-de-Dijon ruling, a product legally brought to market in one of the EC countries can automatically enter the markets in the other countries. The principle of mutual recognition of national rules will also be applied to the service industries. This principle constitutes institutional competition among national regulations. Arbitrage by consumers and firms will take advantage of differences in national regulations and these regulations will have to adjust. Institutional competition is a vehicle by which national market segmentation will be broken up. Together with the four freedoms of movement - for people, goods, services and factors of production - institutional competition represents an institutional innovation for Western Europe.

Institutional competition in Western Europe and the Delors-initiative have stimulated the imagination in Europe, and they have already contributed to an increase in investment activity, including the reorganization of firms and the relocation of some of their plants. This positive development in Western Europe has had a strong attraction for Eastern European Countries. The Eastern European development might not have taken place if Latin America had been Eastern Europe's neighbor.

2. While Western Europe has gained new economic momentum, Eastern Europe has experienced the Orwellian crisis of central planning and socialism. The planning system has proven to be completely inefficient and unable to provide enough goods

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<sup>1</sup> Opening lecture of a series on "The New Economic Landscape of Europe" at the Rijksuniversiteit Gent, November 21, 1990, in the context of the "Vereniging voor Economie"-Chair sponsored by the four Flemish Universities Antwerpen, Brussels, Gent and Leuven in winter semester 1990/91.

for people. Except for the privileged nomenklatura, the target of equality seemed to be realized - albeit on a very low level. As Churchill once remarked, "The inherent vice of capitalism is the unequal sharing of blessings, the inherent virtue of socialism is the equal sharing of miseries."

The political demand for individual freedom and open societies, for a social market economy and democracy, and for a new orientation of economic, social and political life is sweeping away old and rigid structures and changing the institutional setting of the Eastern European scenery. Starting in Poland and Hungary, the new political demand has extended to the Baltic States, East Germany and Czechoslovakia. Last but not least, the necessity of an institutional reform is apparent for the USSR.

3. 1985 - the year of the White Book in Western Europe - is also the year of Gorbachev. He must have recognized that the status of the USSR as a developing country - as Helmut Schmidt once remarked, an Upper Volta with atomic weapons - had to be changed. 1985 was thus an important caesura both in the West and in the East, and it will be an important year in the history books.

The feature common to the development in all Eastern European countries is the failure of the central planning approach and the need for decentralization. The requirement of a new economic institutional arrangement goes hand in hand with the political demand for individual rights and democratic forms of government. The communist parties have lost their political power in Poland, Hungary, East Germany and Czechoslovakia. We are witnesses of a major historical change.

## **II. The Starting Conditions**

4. Statistical information on the economic conditions in Eastern Europe is incomplete and distorted. If one were to believe the international statistics prior to the revolutions in 1989, some of the Eastern European countries fared pretty well. For instance according to CIA data [1989], income per head in East Germany (\$12,634) was estimated to be the same as the average of the EC countries in 1988, and it was supposed to be not too different from West Germany (\$14,192). UN sources [1989] also show a similarly high income per head in the ex-GDR. And the widely

quoted Summers and Heston [1988] data put East Germany on a par with Sweden (for all figures, see Table A1 in the Appendix).

5. In the meantime, we have become aware that these data were false. World Bank [1990] data (see Table 1), probably the most reliable in the field, indicate that income per capita in Hungary (\$2,460) and Yugoslavia (\$2,320) in 1988 reached half the level of Greece (\$4,800). Poland's income per capita (\$1,860) only matches half of the level of Portugal (\$3,650). It is not true that living conditions in the rich former socialist countries like the GDR and Czechoslovakia were on a par with less advanced nations in Western Europe. Moreover, environmental damages were ignored, medical facilities were inappropriate, housing was poor and social security insufficient.

Table 1 - Population and GNP per Capita in Some East European Countries, 1988

	Population mill.	GNP/Capita US\$
Hungary	10.6	2,460
Poland	37.9	1,860
Yugoslavia	23.6	2,320
OECD average		17,400

Source: World Bank [1990].

6. The economic conditions in the region of the former GDR and in Eastern Europe vary between the countries, but some features are common; namely,

- the inefficiency of production and a partially obsolete capital stock,
- a distorted trade structure oriented at the COMECON and not at the international market,
- product qualities that do not satisfy international demand, so that firms are not competitive,
- a "marked deterioration in the efficiency of capital investment and slower growth in productivity" in the 80's [Institute for International Finance, 1990]. The ICOR, the incremental capital output ratio, rose, indicating that more investment was necessary to produce an additional unit of output,
- a fall in productivity growth rates from 5 percent in the 70's to 2 percent in the 80's [Institute for International Finance, 1990],

- the poor environmental record, Czechoslovakia and the GDR having, for instance, the highest per capita sulfur dioxide emissions in the world.

Even the policy domain, where centrally planned economies are expected by some to outperform market economies, namely, income distribution, did not yield the intended results. "Post-tax income distribution in the Soviet Union, for example," - in contrast to Churchill's dictum - "does not appear to be more egalitarian than in many Western European countries" [International Monetary Fund, 1990, p. 68].

The *Economist* has pinpointed the situation: "McDonalds, an American fast-food company, opened its first Russian establishment, in Moscow's Pushkin Square. A hamburger plus accessories costs six roubles, which is roughly \$10 at the official exchange rate; more to the point, it is half a day's wages for most workers. A queue trails back and forth across the square; a wait of four hours is typical. An afternoon queueing in the cold to spend a morning's pay on a hamburger. That is as good a measure of economic failure as any."

### III. Three Major Areas of Reforms

7. Many books have been written on the issue of how one can transform a capitalist economy into a communist one and - ironically - since Karl Marx even more books have been written on reasons why one should do so. But we have no cookbook for the transition from a socialist economy to a market economy. The basic question is: How do you transform a socialist centrally planned economy into a market economy, where individual preferences count and where firms react to prices?

Obviously, central planning has to be given up and the economic system has to be completely revised. The basic mechanism of allocation must be the market and prices must be oriented at scarcities, especially at scarcities in the world markets. It is only in this way that the opportunity cost of production can be clearly evaluated.

Steering the economy by means of prices already has quite a few implications. It implies that government trading monopolies, both on the import and the export sides, have to go. At the same time, with national markets open to the world econ-



omy, there will be arbitrage between the commodity markets in different countries if the prices of tradeable commodities differ too much. Consequently, subsidies for tradeables have to be given up.

8. Prices also require decentralization and the autonomy of organizational subunits of the economy, i.e., of households and firms. That is that they must be free to react to supply and demand and to the forces of the market. At the same time, they must be fully responsible for their economic decisions, so that they will no longer need to be bailed out by the government. This means that economic losses have to be internalized to the firm and that the "soft-budget" constraint for firms [Kornai, 1980] has to be turned into a hard-budget constraint. Firms must be liable for their economic decisions. One aspect of this is that they can go bankrupt if they are not viable.

9. Not only commodity markets but also factor markets must be steered by prices. This holds for land, labor, natural resources and capital. Especially the capital market is crucial for a market economy. In the capital market it is determined whether it is worthwhile to put financial funds into a firm. If a firm is viable, it can attract capital and it can expand. If it does not succeed in attracting additional funds and if profits are negative, it will eventually have to disappear from the market. The capital market provides evaluation of firms and in this way controls management. It is an important steering mechanism for a capitalistic economy.

10. There are three major areas of reform which are all interlinked but which nevertheless can be distinguished: the institutional infrastructure, monetary stabilization and real adjustment on the microlevel, that is, in the firms.

The institutional infrastructure relates to the rules to be followed, to what the Freiburg school calls the "Wirtschaftsordnung," to the legal system, to contract law, to company law (including the rules holding for jointstock companies), to the two-tier banking system, to the independence of the Central Bank, to property rights and to the delineation of government and the private sector. In short, this is the economic constitution of a country.

One of the most important elements of the institutional infrastructure is property rights. Property rights define the rules for using scarce goods and resources. They provide the crucial institutional device by which decisions can be de-

centralized. The economic unit that enjoys the benefits of a decision should also bear the opportunity costs. Property rights are a device for satisfying this condition. They privatize the benefits and the costs of economic decisions. It should be noted that the equality of marginal benefit and marginal costs only holds for the marginal transaction in a market. In a market with many buyers and many sellers, there will always be buyers with a higher willingness to pay than the market price, thus receiving a consumer's surplus. Similarly, there are suppliers on the supply side who are prepared to sell at a lower price, thus receiving a producer's surplus. The producer's and consumer's surpluses indicate the advantage of a transaction to the parties concerned.

It need not be stressed that private property is an important motivational force for exploiting the best use of a resource, and, together with the market mechanism, it is the driving force in the search for new information, including new technology. Property rights and competition are thus an exploratory device in the sense of Hayek [1968]. Property rights are also an incentive to have a long-run outlook with respect to using resources. Transferability of a property right gives a capital value to the property, and the capital value can be cashed in by the next generation. Thus, property rights represent an intertemporal link between generations even without bequest. Of course, this intertemporal role of property rights clearly depends on the certainty of the property rights.

11. Macroeconomic or monetary reform is the second area of reform in the Eastern European countries. A stable and convertible currency is a mandatory precondition for the functioning of the price mechanism and for efficient allocation. If price level stability is violated, it is difficult to introduce or stick to the convertibility of the home currency as a precondition for capital inflows and the exploitation of comparative advantages. Moreover, there is a risk that eventually a run-away inflation must be controlled with a price stop; then the market mechanism will not function properly any more, and the whole reform attempt may have been in vain. Political obstacles to a new reform will have increased.

From the institutional side, monetary stability requires establishing a two-tier banking system with private banks and an autonomous central bank. Moreover, it implies that government expenditures can no longer be financed by printing money. With respect to governments, a new tax system has to be developed and a new social security system including unemployment insurance has to be designed.

Monetary stabilization is not only linked with the financing of the government, but it is also influenced by wage policy, because the changes in wages define the maneuvering space of the monetary authorities. Thus, the arrangement for the labor market and the definition of the role of trade unions are intertwined with monetary stabilization.

12. Countries starting from a monetary overhang, like Poland, with a hyperinflation rate of 650 percent in 1989, and the USSR, presently with a monetary overhang and a de facto price rise, face the problem that structural and institutional reform must be combined with a reduction of nominal absorption in order to get a stable price level. Reducing absorption means squeezing consumption and government spending. Tradeables must become more expensive so that production of tradeables increases and internal demand is reduced (expenditure switching) and so that there is an excess supply of tradeables for exports.

13. The third area of reforms relates to the microlevel. Markets imply competition, which means that government monopolies have to go and a new organizational structure has to be found for firms that were monopolies. As a rule, a whole industry was organized as one firm with a clearly segmented market. For instance, shipbuilding was organized as an industry. A publisher of children's books was not allowed to publish an economics text. Each industry had a neatly protected market for itself. This was made sure by delineating the industry's market from other sectors. Moreover, the Eastern European philosophy of international specialization from above implied that national industries were also protected from international competitors.

#### **IV. The Restructuring and Privatization of Firms**

14. The restructuring of existing firms consists of three aspects that are all interlinked. First, how can new, smaller organizational units be delineated? Second, how can existing firms be made efficient and economically viable? Third, in which way can firms be privatized?

The dismantling of the state-owned enterprises implies the splitting-up of firms into smaller units. Organizational subunits of state monopolies should have the option of declaring themselves as legally independent units. Moreover, an explicit

government policy should force existing monopolies to dismantle themselves into smaller organizational units or dissolve them by law. This approach was followed in the German case, where 316 "Kombinats" were turned into 8,000 legally independent firms. Breaking up government monopolies into smaller legally independent units does not yet solve the problem of making these new units efficient. But a smaller unit is easier to handle and more flexible.

15. Making existing firms efficient requires a spectrum of measures ranging over a wide area. First, a firm has to establish the product or product set it can sell in the market. The firm may have to establish a new product. Second, firms have tended to be as self-sufficient as possible, producing their own inputs in order not to depend on delivery from other suppliers. Thus, the production of intermediate inputs may have to be given up. This may also apply to the repair department, to the transportation division and other functions. Third, new production technology will be necessary in most cases requiring investment. Fourth, marketing is required and a distribution system (and service system) has to be set up. Moreover, there are many other aspects of firm's adjustment, including organizational changes, introducing new management techniques and, in most cases, reducing the work force.

16. Shaping new organizational units is intermingled with the issue of ownership of firms and control of managers. Firms should be privatized. The organizational structure of industry and the ownership of firms are the core problems for structural adjustment and for a dynamic change of the socialist economies in a Schumpeterian sense. The big issue is by which institutional arrangement privatization can be achieved. In Poland and Hungary, 90 percent of industry are in state hands. In Czechoslovakia, expropriated small firms will be given back to the previous owners in a "small privatization" plan. In a "large privatization" plan, the existing larger firms will be privatized.

17. Privatization has to provide a mechanism by which private owners are established. It must make sure that

- decisions in the firms are dominated by economic considerations,
- a dynamic process of structural change is possible,
- capital will be allocated to the best use, and
- managers are controlled by the capital market.

Additionally, privatization can be used to establish a new middle class of property owners and raise people's interest in their stake in firms.

Apparently, solutions to the privatization issue will differ depending on the weight put on the different targets. Moreover, solutions may vary with respect to the time they require.

18. The most comprehensive goal of privatization is to privatize firms and to establish a new ownership class. In this case, the old firms must either be given, or sold, to the population. A specific aspect would be using privatization to reduce the monetary overhang. In any case, ownership titles must be transferable in order to establish a capital market. Moreover, foreigners must be allowed to buy these transferable titles so that new (foreign) capital can be invested in the existing firms. In the initial allocation or sale of property titles, part of the ownership titles may have to be open to foreign investors.

19. Giving company shares exclusively to the workers of a firm has the disadvantage that

- the risk of employment and the risk of capital loss is centered on one group, implying rent seeking of that group in the political arena,
- workers will dominate the economic decisions of the firm and will impede structural change,
- workers tend to be interested in quick payouts and do not have an interest in providing capital,
- the total wealth is not equally distributed to the whole of the population.

The Yugoslav experience supports these concerns. In any case, if company shares are given to the workers, the shares should be transferable so that a capital market can quickly be established. This is equivalent to giving an option to workers to acquire shares and make the option transferable. In order to attract foreign capital, it is recommended to allow a portion of shares to be purchased by foreigners.

20. Governments are tempted to combine privatization with structural policy. Such an approach will fail because structural policy will attempt to smoothen the transition for individual firms, protecting employment by subsidizing old lines of

production and by intervening in the market mechanism that has to be created. People should be protected by social policy and not by structural policy. Clearly, privatization should not be mixed with structural policy.

Care must be taken that institutional arrangements for privatization do not perpetuate government ownership (e.g., giving property titles to communities), that big financial trusts with political interests (and rent seeking) are not established and that the managers are not controlled by workers' councils, but by the capital market.

21. In terms of organizational problems, a privatization agency can be set up, such as the German Treuhand charged with privatizing the firms (and in the case of Treuhand, the additional highly questionable role of making firms efficient). In a way this approach of establishing a privatization agency has the potential advantage of separating the policy arena from privatization; however, there will be strong political pressures on Treuhand. Thus, the organization charged with privatization should be independent.

22. A possible procedure would be to establish several holding companies for the whole country's government property in order to have competition among the holding companies [Kostrzewa, 1989; Siebert and Schmieding, 1990]. The allocation of existing firms to the holding companies must be done on a random basis. The holding companies should be forced to be dissolved within a specific time.

23. The holding company would have the right to define new units, but existing parts of firms with some organizational autonomy would have the right to initiate the process of privatization, for instance, by finding a buyer or using a management buyout for a specific organizational subsystem. In order to prevent a sellout, the sale should be announced publicly; if within a time span of 2 months, no other bidder would show up, the privatization deal would go through. Possibly, outsider investors could be granted the right to initiate a bid that would then be tested in an auction.

24. A voucher system may be a way to reduce the power of the privatization agency. The voucher is an ownership title to all government-owned firms. In this approach a voucher is given to each citizen. The voucher must be transferable. Once new firms have been formed, their shares are exchanged for vouchers. In

this case, privatization is obtained by distributing vouchers, and there is pressure on the privatization process from below, because voucher owners eventually want to have shares. The role of the privatization agency can be reduced if markets can be established in which the price of shares in units of vouchers is established.

25. The voucher system attempts to distribute the assets equally among the population. An alternative approach is to privatize firms by selling shares right away. Then the firm receives an injection of capital, new owners come into existence and, eventually, new management will be introduced by the new owners. This procedure cannot be followed if the selling of shares is intended to reduce the money overhang and if new management has to be introduced quickly in order to turn around the firm.

26. The conditions for privatization vary among countries. In the German case, it is important to privatize quickly and to use privatization as a vehicle to attract private capital quickly. Contrary to the transition in Eastern Europe, East Germany has a common currency with West Germany, it has the same institutional setting and therefore a large potential for massive capital inflows which must be tapped.

Methods of privatizing firms can be ordered on a continuum. Access of firms to the stock market establishes a reliable evaluation of the capital value of a firm by many buyers, including a market judgement on economic viability. In the German case, this would, in principle, represent a possibility for some viable East German firms, but access to the stock market requires many preconditions that are not fulfilled. Moreover, it is a time-consuming process. On the other extreme of the continuum, there is "informal selling" as a way to privatize, with one party, or only a few parties, on the buyer's side. Here the advantage is that informal selling does not require much time, but the buyer's side of the market is too "thin," giving rise to the possibility of a too low selling price. These two ways of privatizing firms - the stock market and informal selling - are two extremes on a continuum. In between is a formal bidding process like the one used in mergers and acquisitions in the US. This seems to be the appropriate approach for Treuhand.

27. In the German case, establishing a semi-stock market for East German firms by means of a less formal stock exchange admission regulation (Börsenzulassungs-Ver-

ordnung) is an interesting possibility. This would mean that firms have easier access to the capital market, and they can privatize themselves without needing the help of Treuhand. Apparently, this way is only possible when firms are somewhat viable. An issue may be that this procedure makes it easier for the old management to stay in power.

28. An important aspect of restructuring industry is the creation of new firms. As a matter of fact, it is more important to have new firms than to restructure the old ones. New firms will soak up workers from the inefficient old firms and will help to solve the unemployment problem. Thus, conditions must be established that allow new firms to come into existence. Market entry barriers should be abolished, location space must be supplied and finance must be available especially for the new and the small firms. Thus, the semi-stock market should be open for the new firms in Eastern Germany as well. It is worthwhile to recall that the majority of employment occurs in small firms, 78 percent of employment in manufacturing industries in Germany is in firms with less than 500 employees.

## **V. The J-Curve of Output and Employment**

29. In the adjustment of output and employment, the inefficiencies of the old planning system will be clearly revealed. From the German and the Polish experience, we know that the transition from a planned to a market economy is associated with a specific development in output and employment - a J-curve in output and employment with a dip, a valley or a deep gorge - where output and employment will fall first and then start to rise. The shape of this curve is not exactly known, but it is relevant for the political economy of transition. Clearly, the shape of the J-curve depends on the inefficiency of the existing firms, on the speed and methods of privatization, on the speed with which new firms come into existence and on the conditions of the process of restructuring.

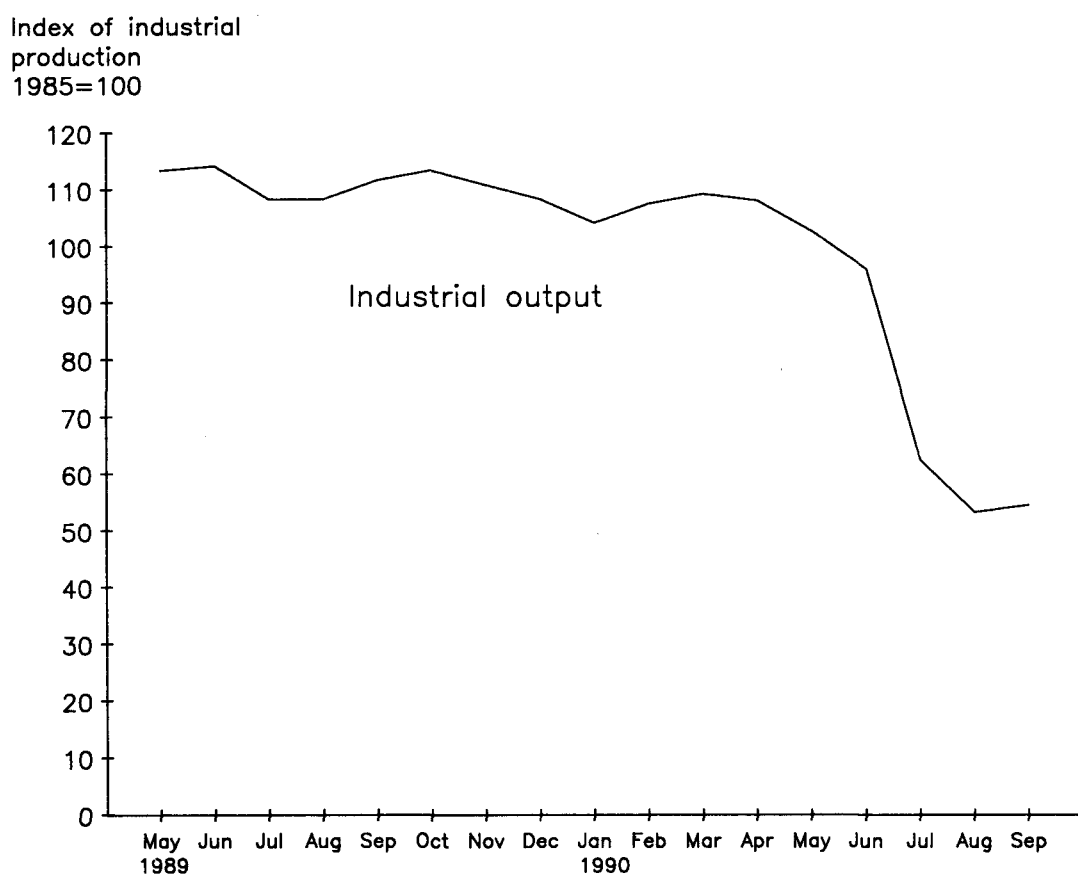
30. The statistical measurement of the J-curve is loaded with difficulties. The transition implies a sizable change in the price system, and indices of production use the obsolete quantity weights of the pre-reform period. For instance, for data on East Germany's industrial output, the quantity weights for 1985 are applied. Moreover, statistics on the planning period may be deliberately distorted, and



gross and net values of production may be falsely specified. Consequently, indices of production may not be meaningfully compared.

31. So far, we only can observe the falling branch of the J-curve. In the East German case, industrial output fell by 50.9 percent from August 1989 to August 1990 (Figure 1) despite subsidies of an unprecedented magnitude. The data suggest that the fall in industrial output has come to a stop.

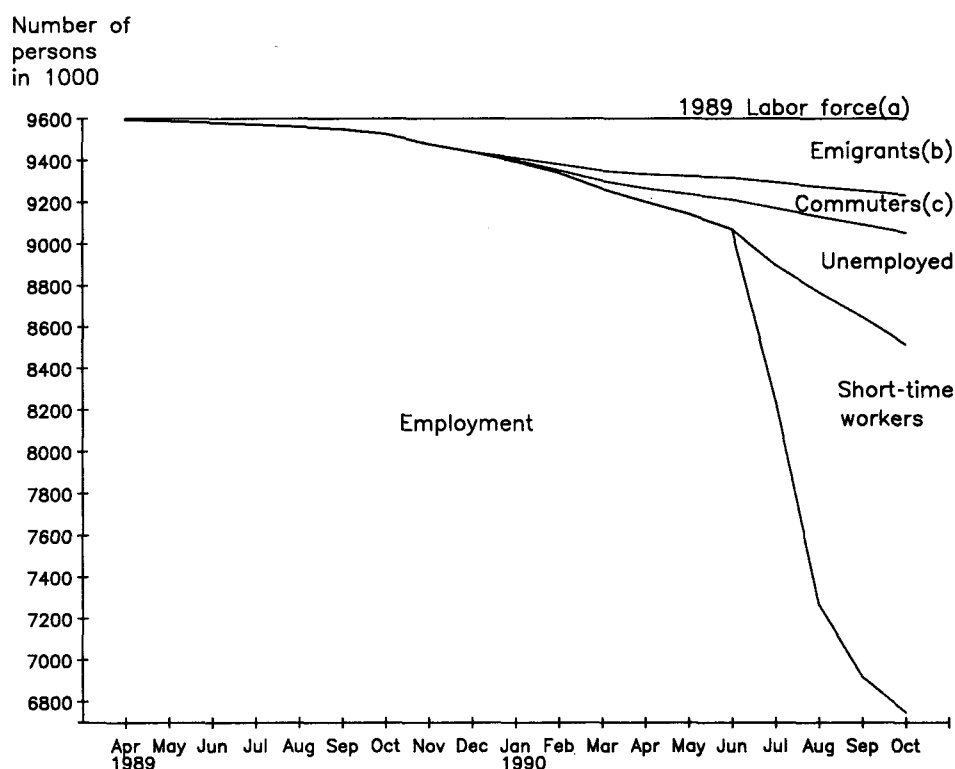
Figure 1 - The J-Curve of Output in East Germany



Source: Gemeinsames Statistisches Amt [1990].

Unemployment rose from 140,000 in June 1990 to 361,000 in August and 589,000 in November 1990. The number of people on short-time work amounted to 656,000 in June and 1.8 million in October and November (Figure 2). Moreover, net emigration rose from 12,000 per month in May and June to 28,000-31,000 in July, August and September.

Figure 2 - The J-Curve of Employment in East Germany



(a) 1989 labor force, including public sector employment, accounts for 9.6 mill. persons. - (b) Share of labor force that accounts for 70 p.c. of total emigrants. - (c) Data on commuters are based on rough estimations.

Source: Gemeinsames Statistisches Amt [1990].

## VI. Sequencing

32. The sequencing of the reform steps is a major issue. It is heavily debated whether the transition can be done in a gradual process or in a big leap forward where the crucial reforms take place as a shock to the system, either simultaneously or in relatively short intervals.

33. As a rough rule, the institutional infrastructure has to be established first (contract and company law, property rights, two-tier banking system, etc.). As a second step, the basic microreforms must follow. The microreforms may be split up into two different aspects: the start of the microreforms and their implementation. The first process includes decentralizing the economy (autonomous decision

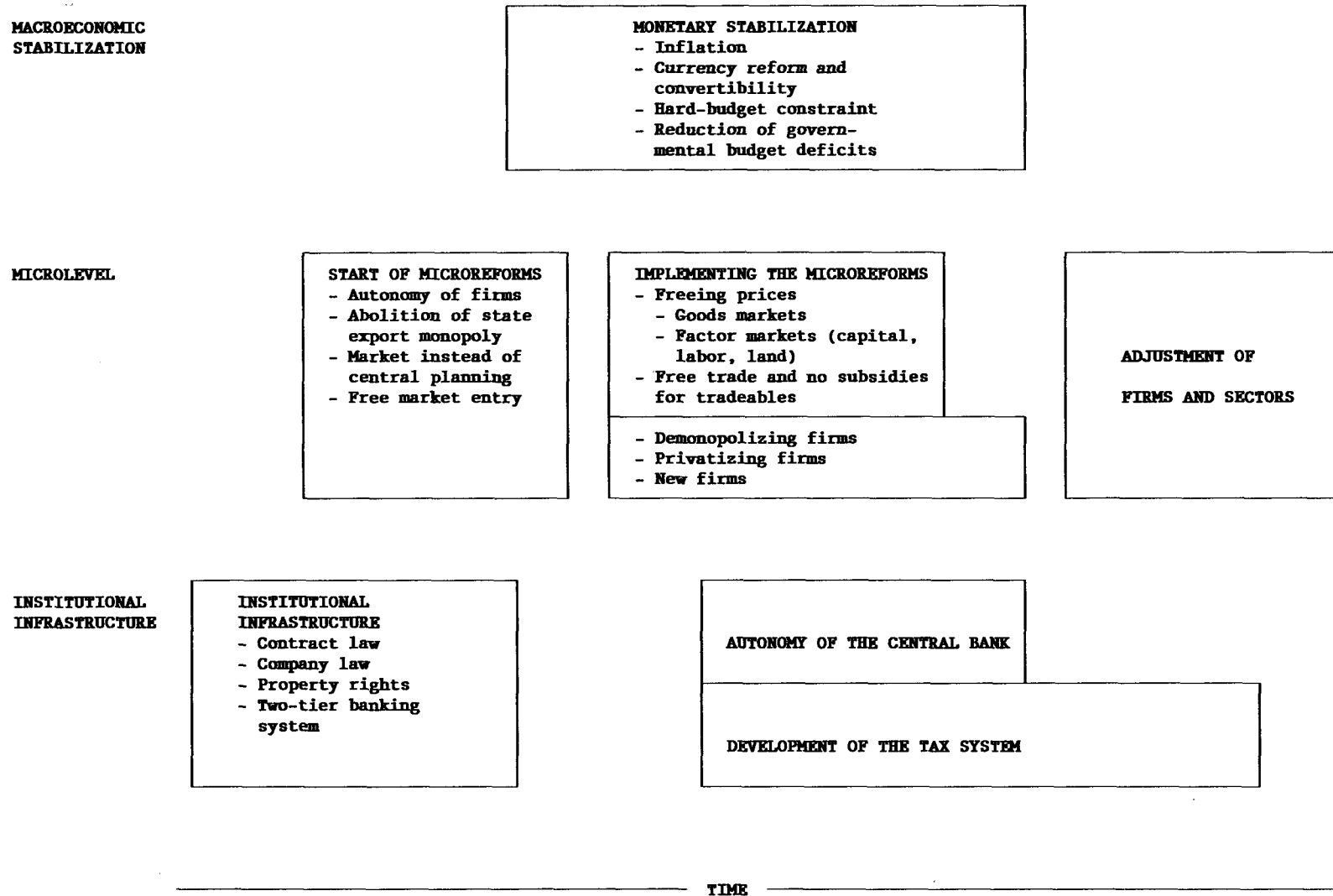
making by the firms that in this stage are not yet in private hands), introducing markets instead of central planning, and allowing free market entry for new firms. The first process must be connected with, or closely followed by, the most easily realizable component of the second process, namely, the freeing of prices in the most important goods markets. At the same time, the country must be opened to the world economy and subsidies for tradeables must be abolished. The other components of the microreform implementation process, such as introducing the capital market, demonopolizing the firms (e.g., dismantling the "Kombinats"), privatizing the firms and having new firms enter the market, will require more time (Figure 3).

Monetary stabilization cannot be too distant from the microreforms. There are two different approaches, one approach is to reduce the monetary overhang before (or simultaneously with) the microreforms. Then monetary stabilization precedes the microreforms. The other approach is to consider inflation as a temporary option for reducing the monetary overhang before stabilization bites. In this case, prices are freed when a monetary overhang still exists. But inflation involves the risk of giving reason to wage increases, of distorting the allocation mechanism, eventually requiring a price stop and consequently leading to a failure of the transition process itself. If that is a real danger, monetary stabilization cannot be separated too much from the microreform.

As already stated, monetary stabilization is linked to the institutional aspect of the independence of the central bank and to the rules of government finance, including the design of the tax system. Finally, the real adjustment on the microlevel of firms, such as demonopolization, privatization and creating new firms, will take very much time.

34. In Figure 3, an attempt is made to show the analytical structure of the basic reforms in the transition process. Except for the restructuring of firms which must be thought of in terms of years (and depending on the country, may involve one or two decades), all the reforms must be close to each other in time, and here we should think in terms of months (and not years). The relative position of specific measures in terms of time depends on the options chosen, as was explained with respect to monetary stabilization. Some measures such as the involvement of the specifics of contract laws can take time, too, but the basic rules of contract law must be established at the beginning.

Figure 3 - Sequencing in the Transition Period



35. This picture of transition can be made more specific by studying the sequencing possibilities in some detail. There is the question of whether a sequencing possibility with respect to some sectors exists [Edwards, 1989]. Thus, some non-tradeables (housing, some transportation) can still be subsidized. However, the option used by China [Lal, 1990] of first only introducing the market economy for agriculture, then for crafts and small industry and eventually for the whole economy is no longer viable for a country like the USSR, because such an option would be too time consuming. People are no longer willing to wait.

36. A sequencing in regional terms may be discussed in the case of the USSR, with individual republics such as the Baltic States undertaking a more intensive reform in a big jump. Politically, this regional approach may be considered as an aspect of the inevitable unravelling of the Soviet empire, and historical analogies to the British and French Empires may come to mind. Such an approach, though possibly promising in purely economic terms, bears the risk of political conflict and instability, with de Gaulle's memento that the USSR has twelve Algerias ahead.

37. Another specific aspect of sequencing relates to opening up the economy to the international division of labor. One question is to what extent the transition to a market economy may be coupled with import duties and other import restraints. However, the political economy of protection shows that import restraints tend to stay. Industries that are inefficient due to the planning system will have a chance to organize themselves in pressure groups when tariffs and other forms of protection are introduced. The Latin American experience of import substitution and the protection of potential export sectors suggests that it is not advisable to use "temporary" protection in the transition to an open economy. With respect to the convertibility of the home currency, full "internal convertibility" is instrumental in giving credibility to a monetary stabilization program. A strict monetary stabilization program aiming at price level stability and the hard-budget constraint for firms requires convertibility.

38. Four arguments can be put forward in favor of a big jump and of the Polish approach: "You cannot cross a chasm in two jumps."

- Some of the reforms are strongly interlinked and must be done more or less simultaneously.

- For investment to be undertaken, the reforms must be credible. This means they must be irreversible. Gradual reforms do not prevent the expectation that the planning system and the nomenklatura will come back. Consequently, reforms must be realized in a discrete way.
- The population, having been exposed to many empty promises in the past, is no longer willing to wait.
- The reforms must catch the attention of people, change their expectation and behavior. This cannot be done easily with a gradual approach.

## **VII. Integrating the New Market Economies Into the European Economic Space**

39. Of the three major areas of reform - institutional infrastructure, monetary stabilization and real adjustment on the microlevel - two are already solved in the German case, at least in principle. These are the institutional infrastructure, which was taken over from West Germany, and the monetary stability, which has been supplied by the monetary union. So East Germany is a special case of transition of socialist economies into a market economy with only the third problem left: real economic adjustment including privatization. Moreover, East Germany was instantaneously integrated into the EC.

40. Eastern European countries do not have as favorable conditions as East Germany:

- They have to develop their own institutional infrastructure, whereas East Germany has adopted the West German constitution and the basic economic laws.
- They have to solve the problem of foreign debt (Poland \$46 bill., Hungary \$19.7 bill.), whereas in the East German case, foreign debt has been taken over by the federal government of Germany.
- They have to create their own hard and convertible currency through a hard stabilization program.
- They will not have the advantage of sizable transfers.

Institutional change and structural adjustment therefore will be much more difficult in the Eastern European countries than in the ex-GDR.

41. The state of reform differs between the countries. Poland, so far, has followed a big-leap strategy, including a strict stabilization program to fight an inflation rate that reached 650 percent in 1989. Meanwhile the inflation rate is down to 4 percent per month in 1990; the zloty is stable relative to the dollar, and shelves are full. But industrial output in the first six months of 1990 fell below the level of the previous year, namely, by 30 percent. Unemployment has increased. The privatization of firms and the restructuring of industry seems to be dragging due to a strong influence of the worker's councils. Moreover, Poland has a convertible currency debt of \$46 bill. For the future prospects, the extent to which the new Polish government sticks to the transition strategy will be crucial.

42. In Hungary, slow reforms have been going on for 22 years. Tentative reforms in the past and the traditional openness towards the West have put Hungary into a privileged position in the East. In contrast to the USSR, the liberalization in the agricultural sector has guaranteed a sufficient supply of food. A fully democratic government is another important asset. However, industrial reorganization has hardly started yet. Presently, 80 percent of all prices are free and a lack of competitiveness in the state sector is obvious. State-owned companies rely heavily on subsidies. The government will have to make great efforts to enforce privatization and cut industry subsidies. Also, the debt burden of about \$20 bill. has to be coped with. The small trade surplus in 1990 could be increased if the country had access to the European agricultural market. The high internal debt has fueled inflation and driven interest rates to a figure of 33 percent, and the budget deficit has to be reduced. Nevertheless, one can count on a high level of entrepreneurship due to a well preserved private enterprise tradition. Today, 20 percent of the economy is in private hands and almost 2,000 joint ventures have been arranged.

43. Czechoslovakia seems to be attempting to establish the institutional infrastructure first. Czechoslovakia was one of the countries with the most advanced industry in the COMECON. The industrial sector accounted for 60 percent of the country's GDP. But fading intra-COMECON trading relations must soon be replaced by taking part in the international division of labor. For example, two-fifths of all exports used to go to the USSR in exchange for oil imports. This kind of trade has broken down almost completely.

The "small privatization" has already started; retail stores, restaurants and smaller business units have been put up for auction. The government will have to withdraw subsidies for noncompetitive sectors. Resulting unemployment during the period of transition could well be substantial. In the long run, the geographical advantage of being in the very center of Europe will play a dominant role. The neighboring markets of Austria and Germany will fuel export demand, thereby raising the level of employment.

44. In contrast to other European countries, there is a lack of reform in the USSR. Obviously, one fraction of the leading communist party still sticks to the idea of introducing market elements into the socialist system to arrive at a so-called "socialist market." But working out a concept for a third way will be in vain. Another group is in favor of the Shatalin plan, which regards private property as the fundament of a successful market economy. According to this "500 day plan," agricultural cooperatives must be decentralized and privatized immediately to avoid further food shortages or even famines. Shatalin advocates privatization and price deregulation at the same time. It will take a decade and more to reform the extremely distorted industrial structure. First steps have been taken to divert military spending and investment in heavy industries to consumer goods producing sectors.

45. There is a tremendous economic potential in Eastern Europe in terms of natural resources, land, labor and a market with a population of 136 mill. in Bulgaria, Czechoslovakia, Hungary, Poland, Romania and Yugoslavia and 290 mill. in the USSR. However, the output of the six Eastern European countries is less than 10 percent of the output of the European Community. "The combined convertible currency exports of the seven countries was only three-quarters of the exports of Hong-Kong" [Institute of International Finance, 1990, p.8]. The convertible currency trade of these countries accounted for less than 40 percent of their total trade.

So far, this economic potential has not been used. The region has had its own trade philosophy, which has attempted a specialization among the COMECON by political coordination. Tractors would be produced in country x, railroad cars in y, buses in country z. It was a specialization from above and along the traditional Ricardian lines of Portuguese wine for English cloth and Russian oil against Czech machinery. Government contracts were the vehicle of specialization. Contrast this



to the philosophy where international trade develops from below with a multitude of decentralized and individual contracts and where individual preferences play a role. Wine is exchanged for wine. A substantial part of trade is intra-industry trade. Also compare the Eastern European trade philosophy of self-sufficiency of the COMECON with export-orientation and the openness of the successful Asian countries.

46. In the American economic literature there is the concept of the new frontier:<sup>1</sup> the expansion of the economic space over the Mississippi and beyond the Rockies, a concept that derives from the American historical experience and that was extended to outer space by John F. Kennedy. The economic reforms in Eastern Europe can represent such a new frontier. The paradigm to be applied to this investment scenario cannot be attributed to Lord Keynes but to Joseph A. Schumpeter. The huge productivity gap between West and East Germany and between Western and Eastern Europe signals potential productivity gains. When the reforms succeed, there will be a positive supply shock for the world economy. The real rate of return will rise and capital will flow to Eastern Europe, where new production lines will open up. Eastern Europe can be the growth locomotive for the world economy in the 90's.

47. Economic reform in Eastern Europe must become a success. Just imagine the political implications of a failure: the market economy would then lose its credential, and we may be back to an undemocratic, populist, or authoritarian system. There is a risk of tremendous political instability. Finally, some people are vexed by the idea that an economic disappointment in Eastern Europe would see a new wave of migration from the East to the West - a *Völkerwanderung*, a mass migration. Relative to such a mass movement of European dimensions, the migration of East Germans to West Germany would appear minimal.

48. Even if there is no political instability in Eastern Europe, there will be a poverty border along the Oder in five years when East Germany has caught up. Moreover, there is a poverty border along the Danube. The difference in income per capita between Germany (\$18,480) and Poland (\$1,860) is 10:1 [World Bank, 1990]. With European borders no longer being equipped with machine guns, such income differences are not tenable. The situation is only sustainable if income per

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<sup>1</sup> Compare Alvin Hansen according to Higgins [1968].

head in Poland rises. Western Europe has a tremendous responsibility to help. It is of paramount importance that Eastern European countries receive financial support from Western Europe in order to ease their financial constraints.

49. If Western Europe closes its markets to Eastern Europe, as in agriculture, textiles and other protected areas, the economic opportunities in Eastern Europe will be dimmed; the incentive to emigrate will be increased. Thus, protecting Western European agriculture against the Australian or Brazilian farmer is different from protecting it against the Polish and Hungarian peasant. The Brazilian farmer cannot migrate to the EC. Thus, the protectionist politician will harvest the implication of his policy in terms of immigration problems. The events in Eastern Europe have completely changed the conditions for agricultural policy in Europe in the future. The opportunity costs of protection will become apparent in terms of migration.

50. The issue arises to what extent and in which forms the EC can open up to the Eastern European countries. It is an absolute necessity to open the EC to the countries in Eastern Europe, in some form or another. We can envision free trade agreements between the EC and individual countries for specific sectors similar to the 1973 free trade agreement with EFTA in manufacturing. Conceivably, some Eastern European countries may form another economic union that will be associated with the EC.

51. Western Europe seems to be developing a protectionist tendency. This relates to European agricultural policy but it also relates to sectors that so far were not protected, as for instance the automobile sector, where national import quotas will be elevated on a European level. There is a risk that the world economy will move away from multilateralism and that the paradigm of bilateralism and the concept of a triad, with strategic behavior as the dominant characteristic, will take over. It is somewhat ironic that the liberalization process in Eastern Europe is discovering the merits of the free market and is moving away from a philosophy of planned specialization among countries by international cooperation, whereas new theoretical, albeit naive, approaches of some international economists from the US [Brander and Spencer, 1985] seem to suggest a new era of managed trade and harmonization of strategic trade policy. Our aim must be to develop a multilateral institutional arrangement for the world economy in which economic decisions are decentralized.

52. Institutional and economic change both in Eastern and in Western Europe is a tremendous opportunity for a positive change in the world economy. There are benefits from free trade for the West and far more for the East. There is the chance of a larger economic space in Europe, and in addition there is a peace dividend for both the West and the East which will allow a reduction of military expenditures and a redirection of expenditures to other uses. But most of all there is a freedom dividend for the people in Eastern Europe which will allow them to enjoy individual liberty and political freedom, but also to introduce a new stimulus to economic activities and eventually to turn the change in Eastern Europe into a Schumpeterian event. As David Hume once said: "The increase of riches and commerce in any one nation, instead of hurting, commonly promotes the riches and commerce for all its neighbours."

## Appendix

Table A1 - Population, GNP, GDP and GNP(GDP)/Capita in Europe, 1988

	Population mill.	GNP bill. US\$	GNP/head US\$	GDP bill. US\$	GDP/head US\$(a)
Bulgaria	9.0	67.6	7,511	23.0	2,552
Czechoslovakia	15.6	158.2	6,000	66.3	4,246
ex-GDR	16.4	207.2	12,634	203.6	12,388
Hungary	10.6	91.8	8,660	28.1	2,660
Poland	37.9	267.3	7,053	n.a.	n.a.
Romania	23.0	126.3	5,491	n.a.	n.a.
USSR	283.7	2,535.3	8,937	1,062.0	3,555
Yugoslavia	23.6	154.1	6,530	61.4	3,605
EC countries	324.3	4,059.7	12,518		
FRG	78.0	870.0	14,192		
Spain	39.0	365.2	9,394		

(a) Converted from local currencies with end-of-year exchange rates. - n.a.= not available.

Source: Statistisches Bundesamt [1990] for population in Eastern Europe; World Bank [1990] for population in EC countries; CIA [1989] for GNP; UN [1989] for GDP.

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