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by Holger Schmieding

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1. Introduction

In many respects, the peaceful revolution which swept East-Central Europe in 1989 has been a surprising and instant success. Politically, democracy seems to be taking hold; economically, a courageous transformation from socialism to a market economy has been initiated in most parts of post-communist Europe. Nonetheless, some of the great hopes and expectations which initially accompanied the downfall of political and economic totalitarianism have been dashed for the time being. While some adjustment difficulties were widely expected, the depth of the economic crisis into which the emerging market economies (EMEs) have plunged has taken many observers by surprise.

This paper discusses the possible nature of a transformation crisis. The major point is that the institutional void which the collapse of socialism has left behind is a major cause of the slump. The wealth of developed economies, be they socialist or capitalist, springs from a complicated pattern of an extended division of labour. Any beneficial specialisation in production in turn depends on an appropriate institutional framework for the reliable coordination of the various activities. The essence of systemic transformation is an institutional revolution: the old high-cost institutional setting (socialism) is abolished to make way for an ultimately far superior low-cost one (capitalism). However, the emergence, establishment and consolidation of the new institutional arrangements takes time. Furthermore, the new social devices lack two essential features: they have no well-established reputation (credibility) and economic agents are not yet familiar with them (information costs). The present institutional deficiencies include the lack of a reliable means of deferred payments, i.e. a sound money. Before these institutional aspects are elaborated, this paper addresses some

other possible causes of the transformation crisis, notably the issue of inherited inefficiencies, the role of an insufficient responsiveness of supply and the consequences of real factor price rigidity.

2. Separating Exogenous from Endogenous Causes

The transformation crisis is defined here as a decline in real GDP that is attributable to the systemic transformation from a Soviet-type economy to a market economy. By focussing on GDP levels, this paper largely abstracts from mere distributional issues. Naturally, the transformation is likely to go along with substantial changes in the distribution of incomes - which, incidentally, may be of more interest to the people concerned than the development of GDP levels. Distributional aspects of the transformation are considered only to the extent that resistance to such changes, notably downward rigidity of real factor incomes, may affect the level of GDP. By emphasising the transformation aspect, the analysis deliberately abstracts from exogenous shocks, most of all from the actual development of the external terms of trade of the post-communist countries. Note that, in doing so, I also neglect one important feature of economic relations between the Central and East European countries, namely the inter-country distributional impact of the transition to world market prices and the settlement in convertible currency for intra-CMEA economic exchanges at the beginning of 1991. This step had put an end to the implicit transfers which under the old regime allegedly flowed from the oil-exporting Soviet Union to her oil-importing CMEA partners.

In order to focus on the transformation crisis, I also exclude those economic problems in East-Central Europe which simply arise from the continuation of a downward trend, notably the consequences of the long-term run down of buildings, the infrastructure and the capital stock and the pollution of the environment. These are shortcomings inherited from the old system, not genuine problems of systemic transformation. Sure enough, it is logically conceivable that these factors cause a

GDP shortfall relative to an already established trend. This may happen if the impact of, say, infrastructural decay does not develop steadily in time, for instance if still-usuable bridges or pipelines that have not been repaired or modernized for a long time suddenly break down altogether. If such collapses coincide with the systemic transformation, it may falsely appear as if the ensuing problems were caused by the regime switch[1)].

The abstractions are not meant to belittle the role of adverse - or positive - external shocks or of the simple continuation of an existing unfavourable trend in East-Central Europe at present. They are needed for the somewhat theoretical discussion of the transformation-specific elements of the crisis, i.e. for the purpose of this paper.

3. The Irrelevance of Inherited Inefficiencies

A standard explanation for the transformation crisis is that the systemic changes have revealed the extent to which the command economy and the socialist firm were inefficient. This argument confuses a sorry state of affairs with a further deterioration or, more abstractly, a level with a change in levels. A distorted structure of production, an outdated capital stock, a sub-standard infrastructure, an undisciplined workforce and grossly inefficient firms constitute an unpleasant legacy. Because of these factors the actual levels of GDP and labour productivity (gross value added at world market prices per physical unit of labour input) were and still are much below their potential

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1) If environmental standards are raised as part of the regime switch, as they well might, the costs of these higher quality standards have to be borne by other factors of production - who may wrongly perceived the reduced remunerations which they receive out of a given physical volume of production as an economic recession. In fact, the local factors of production simply get rewarded differently, less in money terms and more in terms of better environmental quality. Unfortunately, the latter will show up only with a delay, i.e. once investments in a cleaner environment bear fruit.

levels. This does not imply that the unsatisfactory levels get worse simply because they are disclosed by the transformation of the economic system.

Admittedly, the transformation to a market economy and the exposure to the world market will make it plain that a considerable part of investible funds had previously been channeled into sub-optimal uses. Nonetheless, it would be wrong to conclude that the systemic changes have reduced the genuine value of the capital stock. The adjustment of the book values of firms merely puts an end to the false pretension that the capital had been invested productively: After the adjustment, the books finally reflect the low value which the misinvested capital had had ever since it had been locked irreversibly into sub-optimal uses.

Picture a small (ex-)communist economy which cannot influence world market prices by its decision to participate or not to participate in the international division of labour. Whatever the defects of the old system, the command economy had provided its population with goods and services. If sold on the world market, i.e. if valued at world market prices, the output of the command economy - net of its world market imports - would have had a positive value equivalent to the country's true value added[2)]. The systemic transformation does not affect the physical quantity and quality of the EME's factor endowment. With its given factors of production, it could still produce the same goods and services as before and hence attain the same level of value added and GDP. The simple exposure to the world market - at unchanged world market prices - cannot be a cause of a genuine economic decline.

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2) For the sake of the argument I assume that a world market price for non-tradables could have been established in a comparable fashion. To separate the issue of the transformation crisis from that of terms-of-trade changes, remember that the peculiarities of intra-CMEA trade are neglected. Imports from other socialist countries are implicitly treated as if they had been produced locally.

Note however, that the inter-sectoral distribution of value-added may be quite skewed. Locally produced inputs for manufacturing, notably energy and raw materials, used to be substantially underpriced in socialist times. If energy and raw materials are imputed their much higher world market prices, the calculation of genuine value added may well reveal that major parts of the manufacturing sector of a socialist economy never produced any positive value added.[3)] In the extreme case, it is logically possible to imagine a small socialist economy in which most or even all economic activities employing underpriced local inputs destroyed rather than created value added. This however does not mean that the economy as a whole created no significant positive value added. It merely implies that the genuine value added of primary production was much higher than the distorted internal price would have suggested while the opposite holds for the sector which processes primary goods (i.e. manufacturing). Once again, the previous overall value added could still be attained by simply carrying on as before. Sure enough, as the entire manufacturing sector is actually a value substractor and hence a mere burden on the primary sector (and perhaps also on the tertiary sector), the economy as a whole would in this extreme case be much better off if it stopped the wasteful processing of its own raw materials and simply sold them on the world market.

4. Insufficient Responsiveness of Supply

The above argument concerning the irrelevance of inherited inefficiencies may appear to be superficial because it rests more on the physical factor endowment and on physical output than on values. It may be argued that changes in the incentives faced by firms - including the relative prices - warrant a structural

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3) For an excellent calculation of the share of value-subtracting activities in manufacturing in Hungary, Poland and Czechoslovakia see Hare and Hughes (1991). According to these authors, 24 per cent of Hungarian and Polish and 19 per cent of Czechoslovak manufacturing output was produced with negative value added.

change; and such a price-driven structural adjustment may cause at least a short-run decline in GDP. Suppose that relative prices for a variety of goods on the world market change in a way which - in the case of instant and costless restructuring of production - would enable the economy to attain the same value added as it had before.[4] Such a change raises the price of the output and hence the value productivity of the factors presently employed in one line of production and reduces the value productivity in another activity. If factors cannot move instantly from the lower-value to the higher-value activities (until marginal value productivities are once gain equalised) the loss in value added in one sector may exceed the gain in the other sector so that total value added is less than it used to be.

This argument holds for changes in the external relative prices; it helps to explain the nature of the short-term costs of structural change that may have to be incurred even in the case of an adjustment to an ultimately more favourable pattern of the international division of labour. As the value added produced in one sector has declined, the factors of production employed in this sector cannot keep their previous incomes simply by continuing to produce the same quantity of the same physical good.

Once again however, the argument does not apply to a structural adjustment at unchanged world market prices. In the Soviet-type economy (to borrow a phrase from Winiecki 1988), prices were little else than mere bookkeeping entries, they had played hardly any role but for the distribution of some consumer goods to the population. Production decisions and the allocation of resources were not steered by the notional prices but by central commands and a complicated pattern of vertical and horizontal negotiations, i.e. of negotiations between different layers of

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4) Remember that, for the sake of isolating the transformation-specific causes of a decline in GDP, I do not consider the case of a negative terms-of-trade shock.

the economic administrations and between units on the same hierarchical level. Because of the distorted pattern of incentives, factors of production were not allocated to the activities in which their marginal value productivity as measured at world market prices would have been highest. Hence, GDP was much below the level that could have been attained with the same factor endowment in the absence of the allocative distortions.

The process of systemic transformation implies that price signals become more relevant for the economic agents and that the world market prices can now largely feed through into internal prices in the small ex-socialist economy. This poses an incentive for a reallocation of resources. If economic agents can respond vigorously to the new signals which are closer to the relative prices on the world market than the old signals, value added will rise. But even in the extreme case that all factors are immobile between sectors, i.e. are specific to their original activity, the change in internal relative prices need not cause a decline in GDP. Whatever the internal upheavals, total value added as measured at world market prices would remain unchanged if all factors of production remained in their present activities and continued to produce the same physical output. At unchanged world market prices this output is worth exactly the same as before. Even a total lack of responsiveness to price signals does not suffice to explain the occurrence of a transformation crisis as defined in this paper.

To sum up: while a change in world market prices may trigger a temporary crisis in an economy, a systemic transformation which helps to bring the pattern of internal incentives more into line with the given relative prices on the world market need not cause any decline in GDP. This holds even in the extreme case that all factors of production are completely immobile.

5. Factor Price Rigidity

Unfortunately, this is not the end of the story. While external prices for outputs remain unchanged, the internal prices not only

for outputs but also for factors of production are likely to be severely affected by the removal of the distortions of the planned economy. The analysis presented in the paragraphs above implies that all factors actually accept as remuneration for their services whatever their genuine marginal value productivity happens to be. For the factors locked into the sectors in which the old internal output price had been above the world market price, this transition to world market prices can obviously amount to a substantial reduction in their real factor incomes. To a lesser extent, the same problem arises also in those sectors in which the old internal shadow prices[5)] for the respective outputs were equal to or even below the world market prices. The previous remuneration of all factors had reflected the old distorted incentive structure, not their genuine world-market marginal value productivity. Even in the sectors which seem to be favourably affected from the transition to world market prices, some of the old factor prices may have been well above the genuine marginal productivity of these factors - at the expense i.a. of other factors employed in this activity. If some real factor incomes, notably real wages in important subsegments of the labour market, are inflexible downwards or if there is a floor (a reservation wage) below which the real wage cannot fall (for instance because of social security provisions), the outcome is different from the non-crisis case derived above[6)]: To the extent that the value productivity and hence the incomes of some factors of production in some sectors would otherwise be below this floor, these sectors will lay off factors and reduce output

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5) For expository convenience, this shadow price of the output is taken to include all subsidies, perks and fringe benefits which were distributed to the factors employed in the production of a good - as well as the respective burdens which were placed upon these factors. The shadow price hence sums up what society really had to pay for the output, an amount that was hardly related to the bookkeping entry called the "price" of the product under socialist conditions.

6) With regard to the question whether free trade can cause unemployment, a parallel point has been made by Brecher (1974).

until the marginal value productivity of each factor meets the relevant norm. Many firms may even cease to produce at all.

Even if factors of production were perfectly mobile, this problem does not vanish. For some factors the relevant floor, which may for instance equal the real remuneration under the old distorted system, may exceed the marginal value productivity of this factor even in the case of an instant and optimal factor reallocation. Hence, this factor would not be fully employed after the transition to a market economy. If the new factor prices to some extent still reflect the old distortions, notably in the sense that some factor prices have not declined (sufficiently) to reflect their marginal value productivity while the prices of other factors have risen, output will be below its potential level and perhaps even below the pre-transformation level.

For expository convenience, one may divide the economy of the small country in transformation into three kinds of sectors which are classified according to their value added at world market prices:

- value subtractors
- low value adders (the true marginal value productivity of at least one factor is below the relevant floor)
- high value adders (the true marginal value productivity of all factors is above the relevant floor)[7)]

Ideally, the systemic transformation, i.e. the move towards an incentive structure in line with world market prices, implies

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7) The importance of value-subtractors has been stressed by McKinnon (1991). Note that the classification in this paper differs from the one presented by McKinnon and others. Conventionally, the line between low and high value adders is drawn where genuine value added equals the sum of all factor rewards. In this paper, all activities in which the genuine marginal value productivity of at least one factor is below the relevant floor are included in the low-value-adding category. Even if overall value added exceeds total factor rewards, these sectors may have to reduce the input of at least one factor after the transition to a market economy.

that factors of production will move out of the value subtracting and the low-value-adding activities until the marginal value productivity of all factors still employed is at least as high as the relevant floor. This has the following consequences for total value added:

(1) The termination of value subtracting activities constitutes a genuine gain;

(2) the complete or partial termination of activities with positive but insufficient value added amounts to a loss;

(3) if factors of production are completely immobile in the sense of being activity-specific and, hence, cannot move into high-value-adding activities, value added in the latter sector will remain constant; if factors are largely but not completely specific, the high-value-added sector will expand somewhat, though not sufficiently to mop up the entire factors set free by the other two sectors.

The net effect of these changes on total value added may be negative, depending on the relative importance of the three kinds of activities and the degree of factor immobility. Factor price rigidity may hence constitute a genuine cause of a transformation crisis. The depth and length of this crisis depend on the degree and the temporal evolution of factor mobility.

Note that, in a certain sense, this is a point which refers to a distributional rather than an allocational issue. In the old system, actual factor rewards differed substantially from the corresponding genuine marginal value productivities (as measured at world market conditions). With the systemic transformation, the old arrangements for inter-sectoral redistribution come to an end. These arrangements had kept the insufficient value adders in business. While the collapse of the low value adders is ultimately warranted, it can nevertheless cause a short-term decline in overall value added.

6. Temporal Inconsistencies: Decentralisation Precedes Privatisation

The transformation from socialism to capitalism cannot be achieved at one stroke. Some institutional changes such as the privatisation of state firms consume at least some time. As the transformation is hence a process, the temporal profile of the various steps becomes relevant. Inconsistencies in this profile, be they avoidable or not, may be a source of a transformation crisis.

Inefficient and distorted as it was, the old command economy did have its own kind of internal logic. This logic becomes apparent by contrasting it with that of a market economy. An ideal market economy is characterized by the spontaneous, continuous and horizontal coordination of individual plans, with private property rights being the major device to ensure that individuals take the major positive and negative consequences of their actions into account. Private property rights establish the coincidence of individual self-interest with the common weal; in the absence of externalities, the optimal policy is to give economic agents an unrestricted scope for pursuing their own individual ends.

A centrally-planned economy does not have such an automatic mechanism which reconciles the supposed common weal with individual interests; the central administrators cannot rely on the voluntary compliance of the agents affected. As the execution of the supposedly optimal plan thus necessitates central commands (cumpolsory targets) to firms, the scope which the managers of firms and other economic agents have for pursuing their individual self-interests has to be limited. State ownership of the means of production is one of the ways to foster effective central control over the economy.

With systemic transformation, the old rationale for state ownership no longer exists. The more the strict command system gradually degenerates into a chaotic negotiation system or the more it is abolished by a deliberately implemented transformation

programme, the more autonomy will individuals have to pursue their own interests, subject to the much less binding constraints under which they now have to operate. Hence, the more important it will be whether the incentives for individual action are economically efficient or not.[8)]

Consider the case of managers of state firms. If they react to market signals in a textbook manner and care about the long-run profitability of their firm almost as if they were controlled by private owners, there would be no need to worry about a combination of decentralised decision making with still-centralised property rights (state ownership). If managers do not react in this way, other steps of systemic transformation, notably the abolition of the central planning mechanism, may simply enable managers to step up socially harmful activities.

Having gained a higher degree of autonomy than they used to have, rational self-interested managers of not-yet-privatised firms have a choice of three strategies (the first two of which are not always mutually exclusive):

(1) Wait and see. Their major interest may be to try to keep their present job and to act very cautiously, especially as long as they may have some doubts whether the new policy regime will last. They will be particularly inclined to avoid painful choices, to cut production rather than costs, to pin their hopes on subsidies and to use their time to clamour for such subsidies from the state - or from banks or even other firms. In case those banks or other firms are still unlikely to go bankrupt, a pattern of cross-subsidization within the state sector may well emerge. The spread of inter-firm credits in the EMEs seems to be part of such a process.

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8) The following paragraphs draw heavily on Schmieding (1991a), p. 104.

(2) End games. If managers are afraid that they will lose their job in the near future anyhow, they have a particularly strong incentive to use their remaining time to enrich themselves at the expense of the firm, be it via ordinary theft or via some more sophisticated variants of "spontaneous privatisations".

(3) Reputation-building. If managers consider it likely that they may make a future career in the management of a private firm, they may do their best to establish their credentials and hence to lead their firm as if it were privately owned already, at least within the confines in which they have to operate.

Only the third strategy implies an economically efficient behaviour. Nonetheless, some variants of "spontaneous privatisation" - disregarding the unpleasant distributional implications - may lead to the emergence of efficiently-run private firms rather than a mere plundering of state property as well. In all three cases, the managers, often discredited by their nomenclatura past and lacking political backing in the transition period (Hinds 1990), are likely to be in a particularly weak position vis-a-vis excessive demands from workers. In the first two cases in which managers have little or no incentive to safeguard the capital value of their firm, managers and workers may even jointly try to increase their current incomes by deliberately living off the capital of their firm.

The negative consequences of such behaviour go beyond the state firms whose managers have adopted a socially sub-optimal stategy. Consider private economic agents who ponder the possibilities of engaging in potentially beneficial exchanges with state firms. These private agents do not know about the strategy which the managers of the state firms concerned have adopted. They are hence in doubt about the incentive which these managers have to honour contracts in the future. Consequently, private agents - or other state firms - will be more reluctant than they would be otherwise to do business with these firms at all - and/or insist

on comparatively inefficient simultaneous exchanges (a related point is taken up below).

To sum up: The factor endowment is not changed by the transition to a market economy. Nonetheless, an inconsistency in the temporal profile of the various transformation steps, namely a decentralisation of decision-making without a corresponding decentralisation of responsibilities may provide economic agents with individual incentives to use at least one factor of production, namely capital, even less efficiently than before. In the extreme case, the run-down of assets which are owned but no longer effectively controled by the state may continue until the entire capital stock of state firms has been consumed by the other factors of production. Ceteris paribus, this implies a decline in value added.

This point can be put in more general terms: as long as proper markets for some important factors of production, notably capital, entrepreneurship and corporate control, are still missing or are not yet sufficiently developed,[9] the liberalisation of other markets and the relaxation of central controls may cause a decline in GDP. Note that this is not an argument against liberalisation. Rather, these considerations point to the need for keeping the perhaps inevitable time span between the liberalisation - or evolution - of different markets as short as possible.

6. The Institutional Void

Although private property is one of the major institutional devices of a market economy, the introduction of individual incentives for using all factors of production including capital efficiently does not suffice to guarantee that GDP does not drop below its pre-transformation level in the short run. The wealth

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9) Hinds (1990) has forcefully stressed the importance of factor markets for the transformation process.

of developed economies, be they socialist or capitalist, relies on a complicated pattern of an extended division of labour. A specialisation in production in turn depends on an appropriate institutional framework for the reliable coordination of the various activities. The institutional arrangements concerned encompass not only bureaucracies and administrations but also - and much more importantly - all transaction-cost reducing social devices such as the entire body of laws, rules, regulations and patterns of behaviour which constitute the non-budget constraints under which economic agents can pursue their own individual ends. Sure enough, the institutions of the old command economy were grossly inefficient by the standards of a market economy. Nevertheless, the design of these institutions was not arbitrary. They were consciously (although imperfectly) geared towards the needs of the old system. They provided for a - mostly hierarchical - coordination of individual activities and hence for a far-reaching specialisation of production. Inefficient as it was, the system worked to some extent, albeit in its own peculiar way.[10)]

The essence of systemic transformation is an institutional revolution: the old high-cost organizational setting is abolished to make way for an ultimately far superior low-cost cost one. The way the new institutions succeed in shaping the behaviour of individuals depends on what economic agents know about the new contents of the new arrangements, about the way these arrangements work or the way they are applied, about how stable and reliable they are, about the preferences of the major decision makers (and their eventual successors) and about how the

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10) Previous attempts at reforming the socialist system, i.e. the mere tinkering with the existing institutions, have in most cases initiated a crisis (Winiecki 1991, p. 12 ff.). When the old institutional arrangements were weakened, economic performance became worse. This observation strengthens the point that institutional matters are at the heart of the transformation crisis. Value added may decline until the new and ultimately far superior institutional arrangements are firmly in place.

judicial system will settle eventual disputes. One may identify various separate problems:

(i) Time profile of institutional transformation

In theory, some of the new institutional arrangements may be created by the stroke of a pen, for instance new administrations and new laws and regulations. In practice, the present experience in the ex-communist countries shows that it takes considerable time to establish new institutional arrangements, for example to elaborate and pass the relevant laws and regulations.

(ii) Destruction of embodied human capital (institutional capital)

The mere creation of new administrative bodies and the passing of new laws is only one step towards a new and better functioning institutional infrastructure. The more economic agents are familiar with the institutional setting under which they operate and the more credible and reliable this setting is, the more can it serve its purpose of reducing the transaction costs of an extended division of labour. For instance, if economic agents are unsure whether and how the judiciary will enforce private contracts, they will be reluctant to engage in non-simultaneous exchanges - or resort to comparatively costly private enforcement devices. Institutions as defined in this paper encompass the knowledge which the individuals who administer these arrangements and the economic agents who are subject to them have accumulated over the course of time. The human capital embodied in the old institutions is rendered worthless by the systemic transformation, i.e. by the abolition or breakdown of the old institutions. The accumulation of knowledge about the new system and the evolution of behavioural patterns geared towards the new circumstances take time; and learning under uncertainty may involve a costly process of trial and error rather than a smooth adaptation.

(iii) Reliability and credibility of the new institutions

Even if public administrators and private economic agents were familiar with the workings of the new institutional arrangements,

they may be unsure about the stability of these institutions. For instance, they may believe that the regime switch from socialism to a market economy is not yet completely irreversibly. Furthermore, government may not know from the outset whether the new institutions are really best suited to serve the purposes which the government wants them to serve. Anticipating the possibility of future institutional changes, rational economic agents will hedge their bets and not adjust completely to the new arrangements - which will hence be less effective.

If economic agents perceive the new institutional arrangements as being insufficiently stable and credible, this has three major negative consequences to be elaborated below: (1) the level of investment will be suboptimal, (2) the arrangements will not shape the behaviour of economic agents in the way in which credible institutions would, and (3) until administrators and private economic agents have gathered sufficient experience with the new institutions, the coordination of individual activities will cause higher transaction costs than before. With higher transaction costs and hence a less extended division of labour, overall value added may fall even if the new laws and adminstrative arrangements are ultimately far better than the old ones.

(1) Any remaining uncertainty, say about the future regulatory systems for the various sectors of the economy, affects the calculations of investment profitability. Investors whose capital would be locked in once it had been invested in a specific sector have an incentive to wait until the institutional uncertainty abates over the course of time.

(2) If economic agents knew for certain about the nature of an institutional arrangement and the preferences and the resolve of the relevant decision makers, they would neither need to devote resources to find out nor would they have an incentive to put the institutions to the test. Consider macroeconomic policy. If workers do not know whether an announced commitment to monetary and fiscal discipline and to a policy of cuts in subsidies is

credible or not, they have an incentive to find out about government and the new central bank by pressing for higher wages - weighing the probability of success against the risk of not obtaining subsidies or even losing their job. Hence, uncertainty and/or a lack of credibility causes macroeconomic instability - which in turn adds to the overall uncertainties on the macro and micro level. This may even initiate an institutional vicious circle.

(3) Due to the weakness of the legal system (the lack of appropriate contract and company laws, the unfamiliarity with such laws and the apprehension that these laws may be subject to changes or to re-interpretations), the legal enforcement of contracts is unreliable; rational economic agents will thus either conduct only simultaneous exchanges or resort to comparatively costly private enforcement mechanisms - or they will conclude contracts only with those few partners with whom the probability of future contacts is sufficiently high as to make the agreements self-enforcing. In times of general economic and social upheaval, i.e. in the transformation process, the number of such partners is likely to be much smaller than in well-established market economies with a comparatively stable pattern of recurrent economic contacts. To some extent, simultaneous exchanges are a convenient solution (Kronman 1985). Sales or purchases with a widely accepted money constitute a simultaneous exchange as long as no element of a credit between the two parties is involved. Naturally, an economy with money-only exchanges is much less efficient than an economy in which intermediation via credits or other means of deferral is possible as well. And such a tendency for a cash-only economy makes the need for a reliable money even more urgent than in a well-established market economy.

8. Lack of a Reliable Money

In the same vein as prices were bookkeeping entries rather than genuine informations about relative scarcities, the medium through which price signals are transmitted in a market economy,

i.e. money, played only a minor role in the centralised command economy. Admittedly, transactions between shops and consumers were indeed conducted in money and influenced by money prices, although provisions for differential access for the various strata of society (market segmentation) and outright quantity rationing may have been of even greater importance for the acual allocation of consumer goods. However, economic transactions between retail outlets and producers, between firms and the various levels of the central administration and among firms themselves were guided by quantitative allocations and to some extent by bilateral barter trade. Although accounts were kept in money terms and although a monetary equivalent of the (official) transactions was recorded in the books, money was next to irrelevant. The central administration had farreaching control over the monetary balances of firms through the system of state banks; it could change the financial position of firms almost at will. Hence, changes in the recorded monetary balances of firms were mere reflections of outright commands or of economic transactions that depended on the central plan and on the bargaining skill of managers. The monetary side of the transactions hardly influenced the behaviour of firms. In short: major parts of the economy were not monetized in a meaningful sense.

The virtual irrelevance of money for inter-firm transactions and for the coordination of production activities had one interesting consequence: The quantity of money mattered only for the distribution of final goods to consumers. An excessive accumulation of money (cash or savings deposits) in the hands of consumers relative to the supply of goods would show up in lengthening queues and a spreading of quantitative rationing. But as long as the central plan was more or less strictly observed and as long as the autonomy of firms was limited, even serious monetary imbalances would not disrupt the coordination of inter-firm transactions. Apart from the negative effects of absenteeism - which may get worse in line with the time workers have to spend queuing for consumer goods - output was not affected.

The transformation from central planning to a market economy with prices determined by supply and demand necessitates a comprehensive monetization of the economy. If money continued to play only the minor role which it had under the old system, the abolition or breakdown of the hierarchical non-monetary coordination would give rise to bilateral barter - which may even be a more inefficient method of coordinating an extended division of labour than a central plan, at least until an appropriate money substitute has emerged.

Whether and at which speed the monetization and hence the reduction of transaction costs will actually happen depends on the readiness of economic agents to accept the money as a means of deferred payments. This in turn reflects the trust which individuals place in the future stability of the money.[11] The stability is jeopardised in five different ways:

(1) Under the old system of central planning and fixed prices, the inherent value which a nominal quantity of money had for consumers was impaired by the spread of non-monetary allocation mechanisms and only to a lesser extent by open inflation. When prices are no longer fixed, the unleashing of pent-up demand shows up in a one-shot increase in prices which may ignite further inflation. Such monetary instability may reduce the propensity of consumers to hold money much more than the need to queue for goods with fixed prices had done before.

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11) The question whether money is neutral or not used to be one of the most contentious points in the discussion between adherents of different schools of economic thought. The introduction of a reliable means of deferred payments into a pure barter economy reduces transaction costs. While the nominal quantity of money may usually be neutral, the existence of sound money - and the soundness of the existing money - is not. Hence, at least to the extent that changes in the money supply affect the perceived soundness of money (and succeed to surprise economic agents), monetary policy is not neutral.

(2) The monetary overhang which is behind the increase of the price level in the transformation period consists not only of excess balances of consumers. Once firms have gained sufficient autonomy to control their own financial affairs, the previously almost irrelevant monetary balances of firms add to the overall monetary overhang to the extent that firms ceteris paribus also intend to reduce their money holdings.

(3) Inconsistencies in the transformation concept can lead to an acceleration of the growth of monetary balances. For instance, if wages controls are removed for firms which enjoy an explicit or implicit guarantee that they cannot go bankrupt, wages are likely to rise well ahead of the development of productivity. To honour its non-bankruptcy promise and to avoid unrest, the state has to make up for the losses. The budget deficit and the money incomes of the population increase without a corresponding expansion of aggregate supply. This seems to have been the major effect of the ill-fated Law on State Enterprises which went into effect in the Soviet Union at the beginning of 1988.

(4) In a similar vein, firms can evade and counteract a restrictive monetary policy by resorting to inter-firm credits to purchase supplies. The underdeveloped system of financial intermediation through banks - and the weak legal framework for the enforcement of credit obligations (World Bank 1991) - make this option attractive. It is rational for firms to extend such credits to each other more or less regardless of the ultimate creditworthiness of the borrower if firms believe in an implicit state guarantee, i.e. if they expect that the state will extend subsidies in case of imminent default in order to prevent cascading bankruptcies. Furthermore, if managers of firms have a short time horizon, perhaps because they expect to lose their job anyhow in the near future, they have little reason to worry about a future repayment of these credits.

(5) With the transformation of the economic system, the quasi-automatic financing of state activities via the state banks and the central control of all major monetary flows comes to an

end. As the grip of the state on the economy lessens, the state has to resort to the budgetary instruments of a market economy, namely taxes and credits, to finance its expenditures. Both sources of funds are likely to yield less revenues in a economy in transformation than in a well-established market economy with a comparable GDP. The tax system needs to revamped, income and consumption taxes have to be introduced or at least modified. Appropriate institutions for the collection of taxes need to be established. And due to an underdeveloped system of financial intermediation, the state cannot raise as much domestic credit as he could in an established market economy (at least not without coercion). Hence, the government will have a comparatively strong incentive to finance budget deficits via credits from the flegdling central bank. This in turn fuels inflationary expectations and makes it even more difficult to raise funds in the nascent domestic financial market.

The ensuing monetary instability can cause a decline in GDP in the transformation period for five reasons:

(i) With the abolition of central planning of production, monetary disturbances which used to be restricted to the consumption sphere can spread to economic transactions between firms. While the old signals (compulsory targets) are no longer there, the new signals (prices) are highly unreliable in an environment of monetary instability. An insufficient monetization or even a progressive de-monetization of the economy raises the costs of coordinating a complex division of labour among firms.

(ii) Inflationary distortions channel resources into sub-optimal uses; saving is discouraged and savings are diverted excessively into non-productive uses like the purchase of real estate.

(iii) Because of a premium for macroeconomic risk, real interest rates are higher than they would be otherwise.

(iv) In emerging market economies, the customary problems of distinguishing between temporary and permanent changes in prices

and between changes in price levels and in relative prices are exacerbated by the fact that economic agents are unfamiliar with price signals in the first place.

(v) Inflation gives rise to inflationary expectations which become embedded in nominal contracts like wage contracts that are adjusted only periodically. Because of such rigidities, a macroeconomic stabilisation policy to stop inflation can result in a stabilisation crisis, i.e. a decline in GDP on top of the genuine transformation problems. While the adverse side-effects of macroeconomic stabilisation are not specific to the transformation process, the collapse of the old system has contributed to inflation - and hence to the need to for such stabilisation.

Sure enough, some apparently optimal institutional arrangements might be established almost overnight by a simple law, namely an independent central bank compelled by law to safeguard the internal value of the currency. However, the extent to which such a central bank succeeds in shaping private and public behaviour depends on its credibility. Being new, the central banks lack the anti-inflationary reputation which arises from a history of resisting short-term incentives for loosening the monetary reigns.[12)]

9. What Crisis?

This paper has discussed the nature of a transformation crisis without referring very much to the actual economic development in East-Central Europe. According to standard statistics, Europe's emerging market economies are indeed going through a deep slump (World Bank 1991). Both the countries or regions where rather radical transformation programmes were enacted (like Poland and East Germany) or where the old economic order simply collapsed by

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12) Possible solutions will be discussed in a subsequent paper (Schmieding 1991b).

default (Soviet Union) record substantial declines in their gross domestic product (GDP). In a recent survey, the World Bank (1991, p. 9) states that "output per capita is not projected to attain its 1989 level until late in the decade", with even Hungary, Poland and the CSFR, i.e. the three countries in the vanguard of the transformation process, merely "regaining their 1989 levels in 1996".

Given the difficulties in compiling accurate data however, it is quite natural that the reliability of the standard statistics is dubious. Especially with regard to Poland, these statistics are said to paint a picture that is far too bleak (Lipton and Sachs, 1991). For instance, the decline in the volume of industrial production which is behind some of the bad news on GDP reflects at least to some extent the breakdown of value-subtracting activities which had been concentrated in the investment goods sector. Although the end of this waste is recorded as a decline in production, it in fact constitutes a GDP gain.[13] Such a development may well be of considerable importance although the decline in output in the Polish consumer goods sector was even more pronounced than in its investment goods sector.

Furthermore, the standard statistics may be marred by a systematic underreporting of booming private activities. This point seems to be rather valid. Note, however, that the private sector started from a very low base. Initially, even three-digit rates of growth of this subsector of the economy add only a few percentage points to overall GDP. It is implausible to assume

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13) This observation does not suffice to dismiss the standard GDP statistics outright: Before the value-subtracting activities were stopped, they had been supported by other sectors of the economy. Relieving those viable sectors from the burden which they had previously been forced to shoulder might show up directly or indirectly in the statistics on these sectors, for instance in the form of higher incomes for the factors employed in these sectors. Hence, the point made by Lipton and Sachs would be valid only if the standard statistics systematically neglect the positive impact on real factor incomes in the value-adding sectors.

that the expansion of those private sector activities which elude the statistics could already have been so vigorous as to fully compensate for the decline in recorded GDP.

Given the impossibility to compile fully accurate data on unofficial private activities however, the argument that the emerging market economies are not in a severe crisis cannot be refuted with absolute certainty. Hence, the starting point of this paper and of most of the discussion on the transformation process, namely the statement that there actually is a recession in East-Central Europe, must to some extent remain an assumption rather than a completely verified fact.

Fortunately, the arguments of this paper would remain valid even if the apparently crisis-stricken countries of East-Central Europe were not in a recession in the sense of an actual decline in real GDP as measured at world market prices. If the more fortunate interpretation were true, the arguments would not refer to causes of a crisis but to reasons why opportunities for even faster growth have not yet been exploited.

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