The **Economist**

January 13, 1990

SECTION: World politics and current affairs; EASTERN EUROPE'S ECONOMIES; Pg. 21 (U.K. Edition Pg. 23)

LENGTH: 4376 words

HEADLINE: What is to be done?

HIGHLIGHT:
To clean up the shambles left by communist mismanagement, **Eastern Europe** must take a swift, dramatic leap to private ownership and a market system. West Europeans must help it do so, welcoming it as partner in a unified European market. So says Jeffrey Sachs, Harvard professor and economic adviser to the governments of **Poland** and Yugoslavia.

BODY:
THE first, basic steps to the transformation of **Eastern Europe's** centrally planned economies are two. One, the eastern countries must reject any lingering ideas about a "third way", such as a chimerical "market socialism" based on public ownership or worker self-management, and go straight for a western-style market economy. Two, Western Europe, for its part, must be ready and eager to work with them, providing debt relief and finances for restructuring, to bring their reformed economies in as part of a unified European market.

The main debate in economic reform should therefore be about the means of transition, not the ends. **Eastern Europe** will still argue over the ends: for example, whether to aim for Swedish-style social democracy or Thatcherite liberalism. But that can wait. Sweden and Britain alike have nearly complete private ownership, private financial markets and active labour markets. **Eastern Europe** today has none of these institutions; for it, the alternative models of Western Europe are almost identical.

The process of transformation will be difficult, and a shared vision in East and West of joining in a unified European market will be vital in keeping it on track. Such a market is the key for Eastern Europe's hopes of getting the new technologies, managerial talent, organisational methods and financial capital needed to overcome the dismal economic legacy of the past 40 years. For the West, the reintegration of Easter Europe into the market system will offer not only enormous investment and trade opportunities but also the best hope that the unleashed energies of the East will be channelled into peaceful and constructive purposes rather than into a renewal of ancient national rivalries.

The economic and political complexities of the transition to a market economy argue strongly for a decisive and comprehensive approach, such as the new Polish economic programme, introduced on January 1st. Poland's goal is to establish the economic, legal and institutional basis for a private-sector market economy in just one year. Other countries should pursue programmes of similarly rapid transformation, tailored to national circumstances: as one Polish economist has put it, "You don't try to cross a chasm in two jumps".

Reform and financial instability
Past attempts at reform in Eastern Europe have had a paradoxical result. The countries that have attempted the most market-oriented reforms -- Hungary, Poland and Yugoslavia -- are the very ones now suffering the greatest economic instability. Poland and Yugoslavia have hyperinflations; together with Hungary, they face the worst foreign-debt crises. Obviously, the reform efforts have gone seriously awry.

The basic reason is that, while the "market" reforms did indeed end central planning, they did not create real markets. State enterprises were freed from many central controls (though prices often remained controlled), but were still sheltered from competition. The private sector remained closely circumscribed, and crushed by high tax rates and bureaucracy. Private firms were allowed to fill some gaps left by the state sector -- in services, for instance -- but not to compete directly with it. International trade, another potential source of competition, was tightly controlled by quotas and foreign-exchange rationing.

This absence of real competition put central governments at the mercy of their own enterprises. The government could not realistically shut any firm down. For a start, a firm's financial position gave little indication of its true performance, since competition was weak and prices still heavily distorted. Secondly, the firm was most often a monopoly supplier. So firms were kept alive at any cost, including cheap credit, subsidies, tax breaks and the like; they operated under "soft budget constraints", in the phrase of Janos Kornai, the path-breaking Hungarian economist who predicted and explained this pathological condition.

Knowing the government would always bail them out, state enterprises acted accordingly. As decentralisation increased, workers and managers found new ways to appropriate the enterprise income for their own benefit. For example, workers pressed for ever-higher wages, which their managers routinely granted; both knew that the government would make up for the firm's higher wage costs one way or another.

Similarly, managers were eager to arrange whatever foreign loans they could, whether or not the money could be invested profitably. The loans were a one-way bet: if the project worked, the managers and workers would benefit; if it failed, the state would have to bail out the firm by taking the loans over. Indeed state enterprises were often allowed to borrow abroad with the explicit guarantee of the central government. The process was an invitation to irresponsibility. Much of Eastern Europe's $ 100 billion or so of western debt started out as loans for enterprise investments, and ended up in the hands of central governments.

The way ahead
So the reforms under communism were necessarily self-limiting, and thereby self-defeating. But after the democratic revolution of 1989, Eastern Europe can move beyond the failed "market socialism" and create a real market economy with a large private sector and free trade. Countries that have not yet given up central planning, such as Czechoslovakia, may require more time to set up market institutions; but they can also avoid some of their rivals' transition pains, by recognising the dual need to create real competition and to keep financial discipline over state enterprises.

There should be four simultaneous parts to a programme of rapid market transformation. First, let prices find market-clearing levels, in part based on free trade with the West. Second, set the private sector free by removing bureaucratic restrictions. Third, bring the state sector under control, by privatisation and by imposing tougher disciplines on such state firms as remain. Fourth, maintain overall macroeconomic stability through restrictive credit and balanced budgets. Thus:
* From the outset, governments should strive to create a set of market-clearing relative prices. Price controls should be ended, subsidies reduced or eliminated, and the economy opened wide to international trade. Sensible prices are vital for efficient resource allocation. And with market-clearing prices and competition from foreign trade, governments will have a strong and demonstrable basis for closing down enterprises that suffer chronic losses. That in turn will send ripples of discipline throughout the state sector.

In order to have free trade, the currency must be convertible; importers must be able to receive foreign exchange on demand. Convertibility has long seemed a distant dream to many economists in Eastern Europe, yet it can be accomplished rapidly through sharp devaluation combined with restrictive macroeconomic policies and financial control over state enterprises. It is one of the most vital steps toward market competition. Since the East European countries are small economies close to Western Europe, open trade will provide an immediate source of strong competition for the state enterprises.
* The second part of the programme is to eliminate restrictions on private economic activity. New commercial laws must be prepared, or old ones dusted off (Poland will start by updating commercial codes from the 1930s); company laws should allow for the easy establishment of

new enterprises; tax laws should remove the punitively high marginal tax rates that are now common; and various licensing restrictions now applied to international trade and domestic investment should be eliminated.
* The third and hardest part is to discipline state enterprises. Part of the solution is obvious: drastically reduce their number through privatisation. But that will take time. Meanwhile, they must be subjected to real market disciplines: by allowing private firms and importers to compete; by eliminating subsidies, cheap credits and tax concessions: by ending borrowing on the basis of central-government guarantees; by anti-trust policies to break up industrial giants; and by forcing loss-makers to close.
* The fourth need is to establish price stability (in the high-inflation countries), or to maintain it (in places like Czechoslovakia where inflation has been low). This can be done mainly through tight monetary and fiscal policies. In practice that will require balanced budgets; no more cheap credits for state enterprises; and direct controls on wage-setting, given that these enterprises have little incentive to restrain wages.

One part of the economy that will take time to put on a market basis is trade with the Soviet Union. Countertrade will continue, but Finland has shown that some countertrade can be incorporated into an otherwise well-functioning market economy. Still, as soon as possible, the East European countries should take up the Soviet Union's recent offer to trade on a more market-oriented basis, with accounts settled in hard currency. In the short run that may hurt them somewhat, as the Russians cut back on imports of low-quality machinery. But the increased rationality of resource use will easily justify the transition costs.

The need for speed
The transition programme (except for privatisation and Soviet trade) can be decisive and rapid. There are several reasons why it should be.

The first is that reform is a seamless web. Piecemeal changes cannot work, since each part of the overall reform has a role in strengthening the other parts. Financial control of the public sector requires active competition. That in turn depends on free trade and free access to foreign exchange. Currency convertibility at a stable rate in turn requires restrictive monetary and fiscal policies. So macro- and microeconomic reforms must go hand in hand.

A second reason is the state of the bureaucracy. Throughout Eastern Europe mammoth bureaucracies remain in place, ready to continue the mismanagement of the microeconomy. New governments of the microeconomy. New governments cannot change their course, nor replace them. The solution is to sidestep them, by letting market forces do their jobs. A sharp devaluation, for example, can eliminate bureaucratic allocation of foreign exchange.

A third reason is the sheer scale of the needed adjustments. Some sectors, notably in protected heavy industry, will have to shrink; others, particularly services and housing construction, must expand sharply. These changes will eventually produce great benefits, but they will be opposed by many in the shrinking sectors. Populist politicians will try to hook up with coalitions of workers, managers and bureaucrats in hard-hit sectors to slow or reverse the adjustment -- just as they have, successfully, in Argentina for more than a generation. So it is crucial to establish the principles of free trade, currency convertibility and free entry to business early in the reform process.

A fourth reason for dramatic action, at least in Poland and Yugoslavia, is that starting point is hyperinflation; which, if not decisively controlled, ravages societies by undermining tax systems, the budget process and, in time, the most elementary functions of the state. Argentina, Brazil and Peru provide stark illustrations of the failures of gradualism in ending it.

Poland as pioneer
Poland will bring in the first comprehensive market-oriented reforms in Eastern Europe. Yugoslavia will undertake a similar programme, especially as regards free trade and currency convertibility, but without Poland's timetable for dramatic privatisation.

Poland's shock programme emphasises monetary and fiscal discipline, aimed at: cutting 6% of

GNP from the budget deficit; free trade, with convertibility of the zloty for virtually all trade with the West; decontrol of almost all prices; and end to most consumer subsidies; various legal changes designed to strengthen the private sector; and the groundwork for widespread privatisation of state enterprises.

The programme, overseen by the deputy prime minister, Mr Leszek Balcerowicz, began on January 1st with several sharp policy changes. Coal prices were raised several-fold, as subsidies were sharply cut. The zloty was devalued to allow for convertibility. These steps will raise overall prices in January by 45-50%. At the same time wages are to be sharply controlled in the state sector, so that the devaluation and cuts in subsidies do not get dissipated in wage rises.

All this will reduce real wages sharply in 1990, by 20% or so relative to 1989. That is a brave step. But this decline will not mean an equivalent decline in actual living standards. These will in fact fall much less sharply, bolstered by the end of shortages and of the "inflation tax" now eating away at households' cash balances; genuine gains not reflected in the real-wage index.

Nonetheless, there will inevitably be pressures for wage increases, which the government must firmly resist. If it does so, inflation should subside rapidly. In Bolivia a similar programme required just nine days to stabilise the price index after a 24,000% inflation in the preceding 12 months. In Poland the return of price stability should be plainly evident by the spring.

The real test of the Polish government -- in addition to firmness on wage-setting -- will be whether the central bank sticks to its policy of tight credit; even as layoffs and plant closures begin to mount. It began to tighten credit last autumn, declaring itself ready to let loss-making firms go under, as part of the necessary restructuring. The early reactions are favourable: managers are scared about plant closes -- and therefore alert to profitability -- for the first time in memory.

Yet the government's declaration that "we will accept bankruptcies" has been the unfulfilled promise of many governments in Eastern Europe for a decade. If the Polish government weakens, so that deadbeat firms are kept alive with new credits, not only will resources remain tied up in the wrong sectors, but the money supply will get out of control.

Western observers should not over-dramatise lay-offs and bankruptcies. Poland, like the rest of Eastern Europe, now has too little unemployment, not too much. Jacek Rostowski, of London University, has been right in emphasising that much of the wage-push pressure is the result of economies running at unsustainably low rates of unemployment. Unemployment rates even above the natural rate (which might be 5% or so) should be expected -- and -- tolerated -- for a few years, as workers move from industry into services and construction. Now should the Polish government be so fearful of layoffs as its predecessors were. A growing private sector will absorb workers; the profitability of firms will provide an accurate gauge as to which ones should be closed; and a social safety net, including unemployment insurance and job retraining, will be established in Poland in 1990.

Note that the Poles will not take special measures to absorb a "monetary overhang", as might be necessary in some other East European countries and the Soviet Union. There, money balances have accumulated because of large budget deficits combined with repressed prices; in Poland the excess money growth was dissipated by high inflation. Real money balances were low, not high, at the start of the programme.

The puzzles of privatisation

Mrs Margaret Thatcher, the worlds leading privatiser, has overseen the transfer of a handful of state enterprises in a decade. Poland has more than 2,500 enterprises that should be candidates for privatisation. The great conundrum is how to privatise such an array, in a manner that is equitable, swift, political viable and likely to create an effective structure of corporate control.

The complications begin with the fact that the ownership of state enterprises in Eastern Europe is already politically contested. Workers often wonder what the fuss is about, since, of course, they own the firms. Many managers have simply assumed the right to trade, lease, merge or even sell their firm's assets, often for their own enrichment and to the fury of the public.

Privatisation should begin by establishing that central government owns the enterprises and alone has the power to privatise them. Workers' claims to ownership should be rejected on grounds of social equity: the industrial workforce represents only 30% of the labour force and 15% of the population. The workers' claims can, however, be partially recognised by giving them preferential access to some shares in their firms, and a seat on the corporate board, as provided by company law in parts of Western Europe. The government must also stop managers walking away with state property. Conflict-of-interest laws should be used to prevent them laundering state assets through dummy private-sector corporations.

The overriding aim should be to transform state enterprises into private corporations, with transferable ownership shares, rather than, say, into co-operatives or firms self-managed by their workers. Worker-management (except for small-scale, labour-intensive operations) puts workers at excessive risk and cuts the firm off from the capital markets, since outside investors know the workers can vote themselves higher wages out of profits. Governments must devise mechanisms that are rapid, but also transparent, for selling the firms.

In general, shares can be auctioned to the public, with a portion sold at a discount to the firm's workers. But many other arrangements, such as joint ventures or mergers with private firms, will also be needed. Governments will almost certainly regulate the participation of foreigners in these auctions. The firms should be sold for cash, not through swaps for foreign debt: the governments need the cash, and should seek more direct ways to debt relief.

The treasury in each country should oversee the process. But it is vital to establish institutional mechanisms to insulate treasuries from undue political interference, and to make use of expert financial advice. To this end, each country might establish a standing commission of international legal and financial experts, with fiduciary responsibilities, to advise on proposed privatisation deals. The commission could verify that proposed deals, above a certain size, meet legal standards; that competitive bidding procedures are being followed; and that the financial arrangements for the treasury are acceptable. Such a panel will be especially important in reviewing transactions that involve foreign investors.

The role of the West

Western governments are only now beginning to recognise how much they must do to support the changes in the East. They must provide more leadership and vision, and far more generous financial support.

The most fundamental support needed is a commitment to incorporate the East European countries into a common European market. As Eastern Europe ends trade restrictions and makes currencies convertible, Western Europe must be prepared to accept new imports from it. That means in agriculture as well as manufacturing: pig-farmers in the EC will just have to accept that free trade in Polish hams is a price to be paid for living in a united and democratic Europe.

At the same time the Cocom restrictions on exports of most high-technology civilian goods to Eastern Europe can, after a prompt review, be lifted. These restrictions have bizarre and unintended effects. Poland's central bank cannot get the communications equipment necessary for rapid cheque-clearing, nor its telecoms authority the switching equipment needed to upgrade the notorious Polish telephone system. The Solidarity newspaper cannot buy the Apple computer it needs for efficient typesetting.

As East European economies become more integrated with the West, they will tend to become more integrated with each other, as part of an expanding common market. But efforts to promote East European integration make sense only if they accelerate, rather than try to replace, what will occur naturally in a united European market. The East European common market that some suggest as a precursor to integration with the West would simply be a poor man's club. The answers to Eastern Europe's needs lie mainly in integration with Western Europe, whose market is perhaps 15 times as large.

As well as trade liberalisation, Eastern Europe will need financial support. The most urgent kind will be grants or loans directed mainly to building up its foreign-exchange reserves -- rather than increasing imports -- to help stabilise exchange rates and establish convertible currencies. IMF loans help to do this, but they are too small. From western governments Poland has received just $ 1 billion for this purpose, after much haggling among the lenders.

The second kind of support needed will be money to help finance a social safety net for the region. The West moved rapidly to provide food aid for Poland. But when the Poles asked the World Bank for cash to support workers dislocated at the start of 1990, the Bank reacted in slow motion, suggesting that a fraction of the sum requested might be available by next summer.

The third kind of support is cancellation of most of the debt owed to western governments and banks. Poland owes some $ 40 billion, Yugoslavia, Hungary and East Germany around $ 20 billion apiece -- all these figures are pretty uncertain. Any attempt to collect more than a small share of these or the lesser sums owed by other countries would subject Eastern Europe to financial serfdom for the next generation; a plight that would be particularly bitter since the debt is a legacy of communist mismanagement, over which the public had no control.

The debts should be reduced cleanly, not in a long-drawn out battle. If commercial banks are not pressed by western governments to accept a straightforward package of debt reduction, they will fight to collect fully, and, failing that, will press for debt-equity swaps and other inadequate approaches to debt relief. That would gravely threaten the overall effort of reform.

West Germany, of all nations, should champion the cause of debt relief. After each world war the Germans had to grapple with a crushing debt burden. Relief came too late the first time, only after Hitler's rise to power had confirmed Keynes's prophetic warnings to the victors against trying to collect reparations. In 1953 West Germany's creditors showed far more vision, cancelling much of its debt and thereby buttressing the financial basis for its spectacular economic recovery.

The fourth kind of support needed is long-term finance for development. The Marshall Plan provided grants, no loans, for Europe. Grant aid is again needed, for spending on infrastructure and on environmental control. But most proposal from Western Europe are for loans. And the form of these loans could well set back the market reforms. Take a standard official export credit from, say, West Germany to Poland. A German supplier contacts a Polish state enterprise, promising finance for a project. Though the loan is guaranteed by the German government, nearly always it must also be cross-guaranteed by the National Bank of Poland -- just the sort of soft option for enterprises that Eastern Europe must avoid.

Surely the West can do better than this in the 1990s. If western governments provide loans, these should be the sole responsibility of the recipient firms, not of their national government. The loans should be directed specially to the new private sector, in particular to small and medium-sized firms. And western governments should provide finance for an industrial project only when the private market also puts in some risk capital, with the governmental share being a minority of the total.

The French initiative for an East European development bank must be assessed in this light. Debt cancellation must precede new large-scale lending by any development bank. For infrastructure spending the bank should provide grants or concessional finance, rather than loans on market terms. For other projects it should aim its loans mainly at the private sector, and only when private money too is at stake.

Towards growth

Many recent visitors to Eastern Europe have expressed pessimism over its future, citing outmoded factories, the absence of sensible accounting systems, the shortage of managers and so forth. The reform process could indeed go off track with political paralysis or worse in the East and miserliness in the West. But surely we must find ground for hope in the great talents of the East Europeans, exemplified by the dignity with which they have assumed the mantle of political democracy. When we look beyond the region's shattered economic systems at more fundamental features, there are reasons for optimism.

Compared with any region of the world at comparable living standards (around $ 2,500, per head), the population is highly skilled; the resource base is strong; income inequality -- responsible for so much social strife in Latin America -- is modest; transport costs for exports are low; and the industrial base is diversified, though outmoded. We can be confident that a highly skilled Polish worker will earn many times his current wage of $ 100 a month once Poland's market economy is established and closely integrated with Western Europe.

Businessmen, not economist, will determine the new technologies, organisational systems and management techniques that will be the source of Eastern Europe's reinvigoration. It is they who will develop the new exports crucial for its growth. But the energies of business must be unleashed, through the combination of market reforms in the East and financial assistance and open markets in the West. It is up to politicians to act with vision and daring to create the conditions for Eastern Europe's economic transformation.

GRAPHIC: Picture 1, no caption; Graph, The legacy of Lenin, Source: The WEFA Group, Business International; Picture 2, What are these Bulgarians queuing for? Bread; Picture 3, Brave Balcerowicz; Picture 4, Any Trabant you want so long as it's off-white; Picture 5, Scrap him