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THE CHANCES OF ECONOMIC REVIVAL

T. ERDŐS

The author tries to show that, even after the lowest trough of the present economic crisis—not likely to be reached in 1992—there cannot be a revival of significant strength. The reasons are: the product structure is still outdated; a deflationary policy has to be implemented simultaneously with a reduction in the budget deficit; and, owing to the accumulation of foreign debts, there is no possibility for seeking further loans. With regard to the anticipations of the companies and profitability of the whole enterprise sector, the same conclusion can be drawn. The Hungarian economy is in a crisis of a special nature, and a marked increase of production will not come of itself.[1]

Today, despite certain declarations of the government, it is obvious to everybody that the Hungarian economy is in a deep crisis. After the long-lasting, virtual stagnant situation which existed before 1989, there came a rapid fall in economic performance. GDP is expected to decline by the end of 1991 by 11 percent in relation to that of 1989; the decrease of industrial production is approximately 20 percent. Within two years, consumption of the population has declined by 10, and the investments by 16 percent. At the end of 1991 unemployment reached a level of 9 percent, worsened by the fact that the number of vacant jobs has been negligible and the average period of unemployment has promised to be long. Since the end of World War II, in the advanced capitalist countries nowhere has an economic crisis even approached the depth and duration of the present crisis in Hungary. On the basis of annual data, at times of crisis their GDP decreased by 1–2 percent only, and they never experienced a decline of production which lasted more than two years. There is no guarantee that the decline in industrial production will not continue in 1992—what is more, a significant reduction of agricultural production is almost certain. If the latter really does occur, the regression of production would extend into a third year, which would indeed be a rare exception in the history of crises. (Of course, this does not include economic shocks that are determined by political factors.) There is no sense in denying the crisis, and it is a poor consolation that in the majority of the other countries of the former CMEA group the situation is much worse.

[1] The paper is based on a lecture given at the 29th Itinerary Congress of Economists (Siófok, September 25–26, 1991).

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MAGYAR
TUDOMÁNYOS AKADÉMIA
KÖNYVTÁRA

The nature of the economic crisis

The recession which has come about in the last two years is a special and rather serious type of economic crisis, and it will be very difficult to get out of it. It is not a cyclical crisis connected with the natural fluctuation of the economy. Despite the large extent of decline in production, the current balance of payments is negative and, because of the serious foreign debt, an increase in the deficit is out of the question. In contrast to this, in a cyclical crisis the balance of payments usually becomes active and after the crisis it may become worse. In Hungary, the reduction of the approximately 40 percent rate of inflation is a vital problem; yet in a cyclical crisis inflation tends to be low and there may even be a deflation. Hence, in the latter case, after the crisis, a growth of the rate of inflation is permissible—ie. it is unnecessary to put a brake on inflation, because it does not hinder recovery. The deficit of the Hungarian state budget is of considerable concern, for it is higher than that allowed by the agreement with the IMF. Also, the increasing deficit threatens to cause an acceleration of the inflation, and consequently a further undermining of internal and external equilibrium. On the other hand, with a cyclical crisis, deficit spending and increasing the deficit stimulate aggregate demand in a fiscal way, and these are important factors in helping recovery from such a crisis. It should also be noticed that the crisis in Hungary is, at the same time, a structural crisis, ie. it is linked to the outdated structure of production. However, with a bad internal and external balance position, and with the dominance of state ownership, restructuring is an extremely difficult task.

Consideration of the nature of the crisis is important if we want to see what is not self-evident. A cyclical crisis is necessarily followed by a revival and the dynamics of this revival may be rapid. However, in Hungary another type of crisis exists and because of its nature a significant revival, or indeed any revival, cannot automatically follow.

Something that is already causing worries is whether the bottom of the crisis will be reached in 1992. In contrast to the government's opinion, nothing can really be said for sure about this: something could always intervene in the meantime. It is especially difficult to foresee events, especially when dealing with a crisis that has a mechanism which is different from the usual type of crisis, ie. different from a cyclical crisis. For instance, in the USA, the Americans—who are really excellent in economics—at the beginning of the second half of 1974 were still not sure whether the oil price explosion would cause a crisis. And, in November 1974, they were bewildered as for the duration and depth of the recession. In our case, the 1992 performance of agriculture is uncertain, but it seems likely that it will significantly worsen. In addition, the results of the collapse of the CMEA are, to a great extent, still before us, and the expectations of the enterprises (the majority of which are not optimistic) will also play a significant role. Of course, we must consider how we can participate in the food-relief programme designed to help the Soviet Union,

and organized by the West. (If we think about the excess food stocks accumulated in the western countries and the natural endeavours to get rid of them, Hungary should not anticipate a great role in the process.) It is also important to give attention to the development of the conditions necessary for joining the Common Market. All things considered, anything may happen, even if the crisis may reach its lowest point in 1992—although the probability of this is not too high.

Still, the real problem is whether the trough can be followed by a revival and how powerful it will be. In this respect the government is optimistic, but in my opinion there is little basis for such optimism. A strong revival will only occur if demand grows dynamically and if there is enough useful capacity to meet it. Furthermore, it would only be possible if investments could grow rapidly and companies could finance the investments from credit and their own resources; also, another condition is that the revival should not be impeded by a commitment to improve the balance of payments, nor by a pledge to keep foreign debt at a constant level. Such a revival should be stimulated by budgetary means too and the deficit of the state budget should not be reduced. Even the rate of price rises ought to be allowed to accelerate to some extent in relation to the preceding period. In practice, however, everything we have to do contradicts the process of revival: we have to implement a deflationary policy for a number of years, and we have to improve the balance of the state budget—in other words, domestic demand cannot grow dynamically. The balance of payments deficit has to be reduced and foreign debt must not grow (the latter only being possible if, year by year, we are able to scrape together 1.7 billion dollar interest payments). This will reduce the resources that can be accumulated, worsen the position of the state budget and, through an indirect process, cut profitability in the enterprise sphere. All this will have to take place at a time when, in order to increase activity, we ought to be forging ahead and stabilizing our position in the world market. At the same time everything is impeded by a product structure which is wholly inappropriate for the above purposes. In other words: a revival, for the time being, cannot even rely on those reserve capacities which ought to be able to turn out competitive products.

The thesis that the trough of a recession is not always followed by a revival is also emphasized in economic literature. Every notable western study of economic policy refers to the Mundell-model, which demonstrates that revival comes of itself only if the current balance of payments is positive during the course of the recession. In an opposite case, revival of the economy—which usually worsens the current balance—further enhances the external disequilibrium; this may occur to be inadmissible. In such cases it is a complicated task to get out of the economic crisis: in order to revive the economy such means is necessary which stimulates the growth of production to a higher degree than it elicits the deterioration of the balance of payments. At the same time—in the spirit of *Tinbergen*'s idea that we have to use as many policy tools as many goals we want to achieve—other means will have to be used to shape the balance of payments which improves the latter

more than it worsens the revival of production. (Namely, improving the balance of payments usually worsens the internal recovery process.) In this way the internal and the external equilibrium can gradually be approached, the production step by step increased and also the position of the balance of payments improved. What is extremely important for us is that the improvement in eqilibrium, together with the growth of production, can only be very slow. R. A. *Mundell* (1962) also applies some assumptions which clearly show that he did not reckon with such severe constraints that exist in Hungary today and that will be prevalent in the coming years. He, for instance, allows increasing budget deficit as a factor promoting the revival, and takes into account the inflow of money capital from abroad which can be stimulated by raising the interest rate. Neither increasing the deficit, nor raising the interest rate can be used with us if we want to get out of our troublesome situation. Also, according to the Mundell-model, improvement is slow despite the fact that his model is obviously based on the relations of the developed market economies. This means that the dominance of private ownership is not a cure-all, either. It must be added: a successful economic policy aimed at stopping the recession and restoring the external equilibrium postulates the approximate knowledge of quantitative interdependencies, otherwise it cannot be known that a given means worsens the internal recovery process to a lesser degree than it improves the balance of payments. However, with regard to the knowledge of interdependencies we are in a very poor position nowadays owing to the collapsed statistical information system. The lesson is that in a difficult situation the solution can be found only in a much more complicated way, and the interactions between economic revival and the position of the balance of payments have to be considered very seriously.

From certain declarations and government programmes it seems that the difficulty caused by the interaction between the balance of payments and economic revival can be surmounted by a skilful step: by implementing an export-oriented policy which makes both the trade balance and the balance of payments positive. And because the expansion of exports quickens the internal economy, the balance of payments can simultaneously be improved with starting the period of economic revival. Now, however, the question arises: can we be sure that there will be a dynamic and lasting growth of exports which can exceed even the liberalized imports? This obviously necessitates a rapid restructuring in the area of production which, in turn, requires investment activities that are large in their dimensions and adjusted to the criteria of efficiency. It is not enough to refer to the undoubtedly rapid expansion of the small-scale enterprise sector, nor is it satisfactory to show that at present the balance of payments is almost in an equilibrium. It is certainly relevant whether the eqilibrium of the balance of payments comes about in a state of crisis or in the recovery period. During the recession the balance of payments always shows a better position than in the period in which a revival has already begun, since production is always less import intensive during the recession than during the time of recovery. In addition, at present the relatively favourable position

of the current balance is, to a great extent, the result of non-recurrent effects: those who were able to change over to western exports have already done so; the receipts in foreign currencies stemming from remittances—which are undoubtedly of a significant quantity, amounting to almost 800 million dollars—are partially a result of the legalization of the convertible currencies that have, up to now, been hidden; it would be a mistake to extrapolate this dynamism. The conception that the restructuring of production is a question of life and death has been hacked to death. Now, when the revival following the lowest point of the recession has become the subject matter, the need to reshuffle the product structure is often forgotten. The question is mostly about rearranging the trade structure by regions. However, without changing the product structure a sound revival can not be realized.

The preconditions of restructuring

To renew the structure of production takes time, and certain preconditions are of key importance. If we take these into account only a little bit more thoroughly, it turns out that the same troubles that occurred when studying the Mundell model are once again in evidence.

First of all, the rate of inflation has to be markedly reduced. It is not true that the the speed of inflation is of secondary importance in getting the conomy afloat. Rapid inflation leads to high nominal interest rates, and this hinders the investment activities; yet without the latter no significant restructuring can be carried out. However, keeping down inflation is always a time-consuming task and it is especially so in the Hungarian situation.

The firms' expectations have already adjusted to a rapid and accelerating inflation: price rises have come to be an everyday feature. The companies are also trying to solve the difficulties resulting from the crisis situation by raising the prices, and paying not much attention to the price elasticity of demand. This endeavour is supported by the monopoly or quasi-monopoly positions of many companies, especially in the case of the larger companies. Because of the fall of real wages, wage pressure is very strong; resistance to it is insufficient because of the dominance of state ownership. A serious inflationary danger is represented by the deficit of the state budget, which comes nearly to 100 billion forints. This may enhance inflation, not only through the crowding-out effect but also directly. The situation is made more difficult by the unsophisticated tool system of fiscal policy, by the inferior role of open market operations and by the fact that, due to the effect of various factors, the monetary base (which affects the amount and the expansion of the money supply) has rapidly increased. The latter constitutes a reserve for the excessive increase of money supply. In addition to all this, several reasons make it probable that agricultural production will fall in 1992. The gap between

industrial and agricultural prices has been growing for a long time. This has caused an accumulation of tensions, and therefore the declining agricultural production is likely to result in the rapid growth of prices in the food industry, the products of which represent a significant weight in the consumers' baskets. Furthermore, if we consider also the incidental burdens on the state budget entailed by the compensation, to be given to the former owners who were deprived of their wealth and take into account its disturbing effects too, we can surmise: the fall in the rate of inflation can be expected to be modest, even if the price rises stemming from the reduction of subsidies will be less than they have been so far. The conclusion from all this is that the reduction of nominal interest rates will only be moderate and gradual. Consequently, the expansion of investments will be slow, even after the lowest point of the recession has been reached. It is also important to note that a policy which urges the reduction of the rate of inflation is usually first accompanied by a sudden halt, rather than by a revival.

The success of the restructuring process depends to a large extent on how favourable the ownership relations are for investments aimed at effectiveness. This is how privatization, as one of the vitally important conditions of a fast revival, comes to the fore. However, privatization is also time consuming, even in the advanced countries where the conditions for a rapid privatization are much more favourable. In addition, in Hungary the purpose and strategy of privatization have not been properly worked out, which has a harmful influence on the privatization supply. Certainly, the process of privatization will not be as fast as was expected at the beginning. This is also a factor that contradicts a sound recovery process.

The recovery process may be underpinned by stimulating the company initiatives and on this basis by the investments promoting the structural changes. However, the current dimensions and proportions of the investments by no means assure a restructuring process of sufficient dynamism. A decade earlier, and especially before 1979, excessive investment activities were a characteristic of the Hungarian economy. However, since 1979, when the economic management was compelled to restrain growth in the framework of an economic policy that aimed at the "preservation of the achieved living standards", efforts have been directed to restrict investments which manifested itself in an absolute cut in the volume of investments. Though GDP has increased moderately, capital investments have shown a sinking trend: over the 10 years to 1989 the rate of investments fell by 10 percentage points. From 1989 on, the situation has changed merely so that beside investments the GDP has also fallen strongly, but the fall of investments exceeded even that of the GDP. Today it is difficult to form a picture about the level of the investment rate but it is almost certain that it lags behind 20 percent; the Institute of Economic Research estimates it to be 19 percent. This ratio will surely have decreased further by the end of 1991 and by 1992 this decline will continue because of the rapid fall of the investments. By the end of 1992 the rate of investments will probably achieve not more than 17–18 percent.

This proportion is much lower than the average in Western Europe, though it is still higher than the level customary in the USA: here the "domestic private investments" (which means the vast majority of investments) stood at around 16 percent in the period following World War II. Even in Hungary there are opinions which believe many things can be done with the given amounts of investments. This is, of course, true, if successful allocations are made; however, due to the unsettled ownership relations, this cannot be guaranteed for the time being. It is also a serious problem that, in relation to realistic demand, the expected level of investments is rather low. A superficial comparison of the rate of investments with the western level is an unfortunate operation. Apart from the problem of efficiency the same calculated investment ratio is much less in real terms with us than in the West, especially in relation to the US. It is enough to refer to the price ratios and to the role and valuation of services. In Hungary, the investment goods in relation to the consumption goods are much more expensive than they are in the USA. Since GDP is composed of consumption goods and services, because of the high prices of investment goods in Hungary an investment of equal intensity shows up in a much higher rate than, for example, it appears in the US. In turn, an investment rate calculated as being equal covers a much weaker investment activity with US. The same result is reached if we think of the consumer services (such as public health, education, cultural services etc.). In this sphere, valuation of the activity depends practically on real wages. Therefore, the same activity appears in a much higher value in a rich country, than it does in a poor country. Hence, the GDP in a rich country is "overvalued" in relation to a poor one, among other things for the reason that the weight of consumer services in the structure of consumption is much greater in a rich country. Hence, an investment of the same proportion seems to be higher in relation to the GDP in an underdeveloped country than it is in an advanced economy.

If, in addition to all this, we take into account that, in Hungary, the streamlining of worn down, neglected infrastructure and product structure would transitiorily require a much higher investment rate (calculated on a real basis) than it does in the advanced countries. (not to mention that the success of the struggle against unemployment also mainly depends on how the investments are developing) It is obvious: competitiveness, and, together with it, a sound recovery require not only the proper utilization of the existing investment resources, but also a definitely increasing investment rate. This, however is not guaranteed for the time being, with regard to both the external sources of the companies and their internal resources for investments. The external resources are restricted partly by the underdeveloped capital market, and partly by the high nominal interest rates that are due to high inflation. Making investments under such conditions is too risky. The internal resources are meagre mostly because of the low profitability of companies. The latter

is due to several factors and is greatly related to the country's heavy internal and external balance position.[2]

Hence, if we consider the transformation of the product structure to be serious and urgent, until the time when the restriction of the aggregate demand becomes unavoidable—e.g. for reasons of the balance of payments—the investments ought to be stimulated, e.g. by reducing the investment costs. This could be done, for instance, by allowing favourable interests to be paid on the investment credits (in fact, this has been applied up to now). Furthermore, it could also be achieved by introducing the "investment tax credit", in the framework of which a certain percentage of the investment expenses could be deducted from the taxes. In western textbooks it reads: "If a government wants to follow a strict monetary policy in order to reduce inflation, but it is also interested in stimulating investments, it can implement an investment promoting policy by granting investment tax credit." In other words, the structure of aggregate demand can be changed in favour of investments. In Hungary there is a real need for it, since the strata of society growing rich spend their money on luxurious consumption rather than on investments: this

[2] The improvement of the internal and external balance positions necessitates a restrictive economic policy; this involves delimiting the aggregate demand which, among other things, requires a high real interest rate in business life. A rapid inflation reflects the lack of internal equilibrium and causes high nominal interest rates. This circumstance and the high real interest rate have an unfavourable influence on investments. Since, as a result of macroeconomic interactions, the realized profit of the enterprise sector as a whole is closely connected with the extent of the investments on average, the profitability of the companies can only be on a low level. Thus, one trouble gives birth to another. If investments are moderate, the profit level can only be low; consequently, the investments can again only be moderate.

External indebtedness imposes a heavy burden of interest payments on the country. Hence, the profit of the National Bank of Hungary (i.e. the central bank) is not paid into the state budget, or at least increases the revenues of the state budget to only a limited extent which causes the profitability of enterprises to weaken. The money is credit money created by the National Bank. The Bank has interest income from it which, in the end, reduces the profit of enterprises and increases that of the National Bank. The National Bank is, however, obliged to pay the whole of its profit—except for a minimum part of it—into the state budget. For this reason, the tax revenue may be by the same amount less this minimum amount which through various transmissions, improves the profitability of the enterprise sector. Therefore the final outcome is that, in its totality, the companies' profitability still does not decline. If, however, the National Bank, because of foreign debts, is committed to pay interest to abroad, the profit of the enterprise sector will be less by an amount that equals the value of the interest paid to abroad. This means that, if the interest to be paid amounts to 1.7 billion dollars, and it is fully paid, it reduces the profitability of the enterprise sector by 130 billion forints at the present exchange rate.

To be sure, there may be some other factors acting in the opposite direction. If the state budget shows a deficit, the amount of it increases the profit of the enterprise sector and may, at least partially, counterbalance the effect of the interest payments to abroad. Yet this is only true if household savings do not compensate for the effects of the budgetary deficit. Owing to the high level of uncertainties the savings of the population are now significant, which, together with the interest payments and the relatively moderate investment activities, means that the profitability level of the enterprise sphere is rather low.

causes antipathy and does nothing to promote the revival of the economy.[3] It is true that in this case the state budget loses some revenue, ie. it may worsen the internal balance position.

An even more significant measure would be either to put an end to the unfavourable situation or, at least, remedying the problem that, owing to the lasting and rapid inflation, the depreciation fund, in relation to the need for replacement has lost much of its value. It causes the real tax burden imposed on on the firms to be greater than that is shown by the profit tax rate. The corrections included in the bill on taxation passed at the end of the previous year are insufficient. According to these, as a result of increasing amortization, the tax liability of firms would decrease by at least 4 billion Ft or at the very most by 10 billion Ft. This, in relation to the 120 billion Ft expected profit tax for 1992 is a very small amount. It will not increase the investment sources to a significant extent. To be sure, a substantial correction, at least at the beginning, would considerably increase the deficit of the state budget. Yet, we either allow—using also external sources—a greater realized net profit and/or cheaper investment opportunities for the firms (in this case we enable an accelerated restructuring process considering it from the income side); or, we are averse to doing so "because" the requirements of equilibrium must not be violated and external sources must not be used up. However, in this case we would have to be aware of the fact that, in order to realize the fine goals, no financial basis is available in the foreseeable future.

Now, here we have arrived at the statement that in order to prepare a recovery and to boost the economy, some capital injection from abroad would also be necessary. As a matter of fact we are facing the repeatedly asserted thesis that getting out of the mess depends to the extent of 9/10 on our own efforts and only to the extent of 1/10 on the support of foreign countries. Support coming from abroad, however, seems to be indispensable. At present the concrete matter in question is that if, for instance, acceleration of the structural changes needs a more flexible amortization policy, it has to be implemented and its effect on the budget has to be borne by involving other, perhaps external resources—e.g. credits, too. We say it in vain, that restructuring has to be implemented exclusively from internal resources, if they are insufficient for it. As for a rapid revival relying purely on internal resources, this has even less likelihood especially in the coming years.

An external capital injection may come even in the form of direct capital import, for which recently there have been strong expectations. However, the advantages that would result from the direct capital import also have to be realistically valued. Thus the amount of such capital import (owing mainly to the backward infrastructure, the uncertain economic relations, and the intricate ownership relations over the next few years), will in all probability remain below 1 billion dollars—ie. its value will be much less than that of the interest burden to be paid

[3] On "investment tax credit" see, for example, *Fischer and Dornbush* (1983).

annually after the foreign debts. Foreign capital is, for the time being, reserved. Some part of the direct capital import takes the form of a non-cash contribution which, by its effect on production may, after a certain time, increase the incomes in hard currencies, the magnitude of which is, however, uncertain. The other part of the direct capital import which implies at the same time revenue in convertible currencies affects the money supply and, together with it, the rate of inflation and the level of the interest rates. This necessitates a prudent financial policy, if we want to avoid awkward surprises. Beyond all this, the effect of direct capital import on the balance of payments is not merely positive. It takes time until it turns out how large the degree of repatriation may be and how it affects the current balance. It is also an important question how the direct capital imported influences the domestic performance. So far foreign direct capital has primarily flown into the tertiary sector, and the investments destined for production and technological modernizations implemented by foreign capital are rather moderate. The lack of large-volume investments is also conspicuous. Although the effect of direct capital import is unambiguously positive, its extent falls behind earlier hopes. Hence, the expectation that in the near future a turn in economic development can be achieved by relying on the direct capital import is without foundation.

"Investment tax credit", a flexible policy concerning the practice of depreciation and leaving much more movement to the firms as well as the direct capital import, can directly influence the extent of the investments. The direction in which the investment resources are allocated—ie. where the investments are made and what they are used for—has special significance. This is why privatization is important, although it is time consuming, and this is why import liberalization is important which bears hard on the current balance of payments. We must add: the investments have to be oriented so as to utilize the comparative advantages. It requires a careful exchange-rate policy.

The exchange-rate policy is closely connected to the requirement that the allocation of investments and, together with it, restructuring take place under the pressure of external competition. Import liberalization itself cannot be independent of exchange-rate policy. Still, there are many who stress that imports have to be liberalized and the forint devalued so that, along with it an appreciation of the real exchange rate must not occur.[4] In this case, however, import liberalization would be inconsistent.

Here we are facing the dilemma that improving the balance of payments calls for a devaluation of the forint—what is more, its real devaluation. At the same time, the requirement of restructuring aimed at enhancing efficiency would be a real revaluation of the forint. The concepts have to be understood relatively, since real

[4] "As for export incentives, our aim is that the exchange-rate policy should not allow a real revaluation of the Hungarian currency, ie. such domestic regrouping of incomes which would afflict the exporters." *SZDSZ* (1991)

revaluation does not mean that the forint be overvalued compared to its purchasing power parity. Today the forint is in a strongly devalued state, primarily considering the domestic and foreign consumer prices, and the situation is approximately the same with regard to the producer prices. Hence, real revaluation may only imply reducing the extent of the devalued state of the domestic currency.

Restructuring giving preference to efficiency in part means that the production structure has to be adjusted to the comparative advantages. However, under the conditions of liberalization and with market automatisms based on company decisions, the devalued currency makes it favourable to produce goods being in comparative disadvantage as well, because thus the export of the latter can also be highly profitable. The greater the degree of devaluation, the more this is so. In the case of a very strong devaluation even the most inefficient product can be profitably exported. In the long run, however, this may lead to serious disturbances because it dissipates resources. For the Hungarian economy being short of resources it is of vital importance to concentrate resources to efficient activities. One of the means to do this is a gradual revaluation of the forint; yet, if in Hungary inflation is faster than it is with our commercial partners, a recurrent nominal devaluation of the forint may take place and, in all probability, this will indeed occur.

The real revaluation is additionally justified by the following: a) In Hungary the basic obstacles to increasing exports are not the relatively high costs and prices of the goods, but the composition and quality of production. For this devaluation is no help. b) Real revaluation puts a brake on inflation, partly because it strengthens external competition and slows down the rise of import prices. And, forcing down inflation is a key step towards getting out of the crisis. Real revaluation can only be allowed step-by-step; it follows from the position of the balance of payments, and also from the circumstance that the burden of external competition can only be gradually imposed on the internal economy. Of course, even in this context, the consideration arises that restructuring makes it desirable to make use of external resources, too.

With regard to the exchange-rate policy the case of South Korea is instructive. In this country structural updating the industry was a central objective of economic policy in the 1960s. It is conspicuous that this was not started and implemented along with a real devaluation of the domestic currency. On the contrary, they carried it out with a somewhat revalued state of the won. The disadvantage to exports stemming from the exchange rate of the currency was even overcompensated by several export-promoting measures, e.g. by granting cheap loans to the exporters, by applying the investment tax credit, by permitting accelerated depreciation and by allowances associated with customs duties. Hereby it has become evident—by comparing external and internal prices—what is profitable. At the same time, the import of raw materials and machinery—made cheaper by the exchange-rate policy—also helped the modernization of industry and enhanced the export capacity. Paradoxically, the slight revaluation of the won was halted when

Korean industry began to be competitive in the world market. (*Kyoung-Hwie Mihn* 1988) True, it is not sure that what was applied in Korea could also be employed in Hungary. There, private property was already dominant and foreign indebtedness could be rapidly increased. The lesson is, however, that sometimes it is precisely the unusual solutions that bring success.

All in all: restructuring is a time-consuming, resource-intensive and complicated task. One of its preconditions is to reduce the rate of inflation, which may also take several years. Privatization must continue to gain ground and also the narrowed-down state-owned sector has to be made more cost-sensitive. Modernization of the production structure is time-consuming even if it takes place on the basis of the changing ownership relations, or even if it is well-founded by economic policy. In addition, it will again become evident: revival of the economy and improving the equilibrium of the balance of payments may often contradict one another. In such cases, economic policy has to be restrictive. Because of these facts, we cannot reckon with an export offensive that relies on sound foundations within a short time. Hence, any revival following the crisis can also only be a protracted one. We reach the same conclusion we did above, when discussing the Mundell model. In contrast to the government, I would treat the forecasts for 1993 and 1994 with much more prudence.

Recently certain voices, calling for starting up and immediately accelerating the economic growth, have been strengthening. These opinions disregard the fact that in a deep crisis the approximate equilibrium of the balance of payments is no reason for self-confidence. As if 1984 repeated itself. I hope this paper shows that forcing growth immediately would bring about much more serious consequences than it did in the late 1980s. Let us at least learn from our own mistakes.

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SHOCK-THERAPY VERSUS GRADUAL CHANGE: ECONOMIC PROBLEMS AND POLICIES IN CENTRAL AND EASTERN EUROPE (1989–1991)

A. KÖVES

The author considers the wide range of experiences that central and East European countries have had during their first two years after political change. He pinpoints key differences within the region as well as identifying common themes—including economic decline, mounting social tension, etc. He offers a comparative analysis of the various approaches to economic stabilization and liberalization.

Despite significant ideological and political differences, the political elites of the new regimes among most of the Five came to power in 1989–1990 with the firm belief that they should establish a Western-type market economy with a significant or predominant role for the private sector to replace the Soviet type planned economy with overwhelming state ownership.[2] Indeed, proposals concerning the need for some "third way" of economic and social development in Central Europe, or for at least some Central European countries, i.e. a development pattern essentially different from both Western "capitalism" and Eastern "socialism," are coming to light time and again. The supporters of the "third way" theories, however, proved unable to translate their ideas concerning the economic system they would prefer into practical terms. Consequently, their existence could not challenge the general consensus over the transition to a market economy.[3]

The first question relating to systemic transition is what kind of market economy Central and East European countries wish to establish. Theoretically, they can

[1] Reprinted from *Central and East European Economies in Transition: The international Dimension*, by András Köves (Westview Press, 1992) by permission of the publisher.

[2] This statement certainly holds true from the very beginning of the new system for Poland, Czecho-Slovakia and Hungary. Notwithstanding political difficulties and a chaotic economic situation, transformation to a market economy seems to have become the dominant strategy in Romania and Bulgaria as well. In what was the Soviet Union it was only quite recently that establishing a Western type market economy became the officially declared strategic aim of the ruling elites. At least until the defeat of the conservative coup in August 1991, the Soviet Federal government continued to proclaim its adherence to socialism.

[3] The existence of the "third way" ideology and of populist groups *within* the new elites, however, leave their mark on many political actions and legal acts of the new governments and parliaments. It would be difficult to suppose, after more than 40 years of planned economies in Central and Eastern Europe, that all followers of the Soviet type system have disappeared forever. They remain however, very small in number (in many countries they *have been* for many years or decades), and outside the political and professional elites.

opt for liberalism of the American experience, or some version of a more socially oriented West European market economy, and even patriarchal market economy that exists in Japan and some newly industrializing countries. Different combinations of economic systems existing elsewhere are also feasible. Jeffrey *Sachs* of Harvard University maintains that arguments about the ends of transformation ("whether to aim for Swedish-style social democracy or Thatcherite liberalism") 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." (Sachs 1991, p. 235) Clearly, problems of the ways and means of the transition are much more urgent than those of the ends. Yet in many instances, the two cannot be separated from each other. For example, political decisions are to be taken and legal acts introduced concerning the development of a social safety net in the early stages of the economic transition. Conceptual problems of privatization are also to be settled as soon as possible. Present dilemmas encompass privatization versus reprivatization (returning property to pre-nationalization and pre-collectivization owners) or restitution (total or partial compensation to former owners for lost property) as well as those concerning different approaches supporting the emerging private sector. The methods and the scope of privatization of state-owned firms will have a direct and long-term impact on the future economic (as well as the political and social) system in the countries of Central and Eastern Europe as the outcome of the transition process. It is exactly those long-term implications which are especially important, and make present decisions about the actual strategy of the transition problematic. It would be naive to expect economic rationality to be the only guiding force of the transition. This points to the most serious problem of all: economic policies are being endangered by implications of policy actions outside the scope of economic policy proper. There are some illuminating examples to demonstrate this.

However, quite apart from the political and other difficulties, the tasks of the economic policy are immense and "no single detailed road map can guide the way to the new systems" (*Fischer and Gelb* 1991). In the words of the Polish economist Dariusz *Rosati*, "reading backwards existing Marxist-flavoured textbooks on the transition from capitalism to socialism" (Rosati 1990, p. 2) is not enough as a correct answer concerning the policies of the transition. Unfortunately, sweeping generalizations of that kind are not unfamiliar to many institutions and authors both in the East and the West. They imply, in one form or another, that the *speed of the transition is what really counts*, and speed is the single most important indicator of success of governmental policies of the economies in transition.[4] The

[4] Cf. "The winners of the day are those who promise to shorten the transition to a prosperous market economy, even at the price of a significant drop in economic activities, in the standard of living and in employment levels during the period of transition. Those who advocate a more

really provocative agenda put forward by Rudiger *Dornbusch* (1991) suggests that systemic transformation should be carried out in seven days.[5] Although there are some incontestably strong arguments in favour of a rapid transition to a market economy, this way of thinking and the omnipotence attached to the pace of the transition ignores both the actual state of affairs in Central and Eastern Europe and the complexity of issues that should be addressed. What is more, those who think along these lines "seem to forget that market reforms of these economies are not an end in themselves ... economic growth is the goal of transformation process" (*Brainard* 1991, p. 95).

All economies in the transition are facing a large number of different tasks. Their most important and immediate task is *macroeconomic stabilization* (both external and internal). *Economic liberalization*—ie. reducing the role of government in microeconomic decisions—should also be initiated or allowed to continue. This involves both liberalization of foreign economic relations (trade, investment, and finances) and domestic policy. As illustrated by the experiences of 1991, revamping what used to be intra-CMEA type relations is a most difficult part of liberalization of foreign economic relations. Finally, *privatization* is an essential feature of establishing a market economy. Privatization means both promoting the establishment and development of new private firms, and privatizing state-owned companies.[6] As stated by *Lipton and Sachs* (1990a), "comprehensive action" is necessary on all those fronts. Obviously, the different tasks of economic policy listed above are closely interrelated. For example, requirements of economic stabilization, as far as some aspects of it are concerned, may contradict the liberalization policies. More importantly, a long-term stabilization program should be supported by systemic transformation from the centrally managed economy to one which is market ori-

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reasoned gradual approach to the manifold steps of transformation are immediately labelled as conservative, as unwilling to hand over the old bureaucratic controls and on the whole as hindering the transition to a market economy." (*Levcik* 1991)

[5] As Dornbusch argues, gradualism "is largely illusion ... The administrative capacity for successful gradual reform simply does not exist. After all, communism—even with the advantage of repression—could not handle the task of allocating resources reasonably efficiently ... In the grey area between a control-economy that no longer functions and a market economy that is not fully accepted, economic collapse is inevitable." (Dornbusch 1991) This is a very sad predicament for both those countries that chose gradualism instead of a jump and for those which could *not* jump long enough to reach the heavens of the full-fledged market economy "in seven days." Actually, until now the Soviet Union has been the only country for which the hard verdict surely applies. Even in the Soviet case, political collapse is to a large part responsible for the economic one.

[6] There are alternative ways of listing the fields of necessary policy action in transitional economies. Some authors insist that the creation of other institutions of a market economy such as the system of financial intermediation capable of managing the whole process of privatization and liberalization is as important as other measures of systemic transformation and should precede the latter (Brainard 1991).

ented. If not, dangers of destabilization will persist. Structural reforms, in turn, can only work in a stable macroeconomic environment.[7]

Macroeconomic stabilization as number one priority was placed on the agenda in many countries as a consequence of the most serious economic imbalances which accumulated over the course of the past decade. Certainly this was the case with the two principal countries mainly concerned here—Poland and Hungary. External debt accumulated rapidly since the mid-1970s in both countries. As early as 1980, Polish hard currency debt amounted to 24 billion dollars, or 39 percent of the country's GDP and its debt service ratio was 96 percent. In Hungary gross debt amounted to 11 billion dollars in 1983 or 57 percent of the GDP and debt service was 47 percent of hard currency exports.[8] Protracted debt management difficulties made austerity measures inevitable both in Poland and Hungary throughout the 1980s (austerity in Poland started even earlier). However, Hungary has managed to fully service its debt while Poland had to declare insolvency as early as 1981 and repeatedly rescheduled its debt during the 1980s. As a result, the drop in the production and living standards was much more severe in Poland than in Hungary. Other differences related to the degree of internal disequilibrium also had a significant impact on economic decline and deteriorating living standards. Stubborn inflation accelerated in the 1980s in both countries. The inflation rate in Hungary remained a one-digit figure until as late as 1987 and the consumer price index did not exceed the 30 percent level in the difficult year of 1990. Polish inflation, however, was becoming very dangerous in the late 1980s and turned into hyperinflation during the last months of 1989 (the *first* months of the Solidarity-led government of Prime Minister Mazowiecki).[9] Furthermore, due to earlier reform efforts and growth of the private sector, domestic markets in Hungary have been more or less

[7] Those reformist tasks for economies in transition are associated with the political change in Central and Eastern Europe. That is correct. It should not be forgotten, however, that action on *all those fronts* started earlier, even if it was weak, inconclusive, contradictory, and consequently to a large extent unsuccessful, and did not involve all of the Five. The clearest case is macroeconomic stabilization that had been a priority policy task in Romania, Poland and Hungary during the whole decade of the 1980s. Economic reforms in socialist countries aimed at moving away from traditional central planning and towards developing market relations were steps however inconsistently to economic liberalization. True, the overwhelming state ownership of the means of production was not being questioned anywhere until the very end of the old regime. Yet, for good or bad, important changes concerning property rights have taken place in some countries. For example, in Poland and Hungary enterprise councils were established and received a part of property rights concerning their own enterprises. In Hungary, commercialization of the state enterprises started *prior* to political change. More importantly, development of the small-scale private sector, legal and semi-legal, commenced in Hungary more than a decade ago. In the Polish agriculture, private sector, though very week, has survived the four decades of central planning.

[8] Data on Poland are from *Szabó-Szuba* (1991); those on Hungary computed and based on OECD sources (1991b).

[9] For an analysis of the causes of the Polish hyperinflation cf. *Kolodko* (1991) and Rosati (1990).

balanced (at least, by East European standards), and shortages of individual commodities were more an exception than the rule. As a result, although discrepancies between the official and black market rates of the forint repeatedly reached 50 percent, the domestic currency has kept its confidence with the consumers and the enterprises whereas in Poland domestic markets were in total disarray in late 1989. Moreover in Poland shortages of consumer goods were universal. The zloty did not function as *the* Polish currency; in many fields it was being squeezed out by the dollar; in other fields, consumers had to queue up for many hours a day to obtain prime necessities. This kind of an all-out shortage situation was and to a great extent remains to be characteristic in other countries such as Bulgaria and Romania and of course, what previously was the Soviet Union. It is important to note, however, that though the shortage phenomenon is to be explained by systemic factors,[10] the very high intensity of excess demand and repressed inflation in Poland and in some other countries during the period of political change in 1989–1990 should be attributed to the extraordinary depth of economic decline, as well as to the weakness and incompetence of economic policies prior to those changes. Furthermore, not only the economic situation of the Five was strikingly different, the same can be said about their domestic political situation. For example in Poland, "the new government came into power with broad public support, giving it an implicit mandate to introduce even a deeply unpopular program" (*Köves and Marer* 1991a), whereas public support for the Antall government in Hungary was much weaker. In Bulgaria and Romania the political situation was even more complicated.

In sum, this implies that no sweeping prescription or scenario for how the economic transition should take place can be applied. Every country in the transition to a market economy should have its own specific mix of actions aiming at macroeconomic stabilization, liberalization and privatization. This is not to say that they should not take into account the positive and negative lessons from each others' policies. For example, the Polish experience in 1990 and 1991 is of great significance for all economies in transition.

Shock-therapy in Poland: some lessons and implications

Poland was the first country in Central and Eastern Europe to announce a comprehensive and radical program of *economic stabilization and liberalization.* The program linked to Deputy Prime Minister Leszek Balcerowicz started on January 1, 1990. The philosophy of the program and its content are as well-known as the controversies surrounding its application.

[10] For the classical explanation, cf. *Kornai* (1980), for an account of the pre-1990 Polish shortage economy cf. Lipton and Sachs (1990).

The Balcerowicz program was devised in cooperation with the IMF and other international experts. It is regarded by the international community as the *par-excellence* stabilization scheme in Central and Eastern Europe; subsequent programs for economic transition in other countries are being implicitly or explicitly judged to a large extent, depending on whether or not they are as radical as the Polish program was. The Balcerowicz program represented a genuine shock-therapy. Its authors were convinced that the conditions for long-term stabilization and systemic transformation *must, and can* be established at the cost of a serious *short-term* recession and decline in living standards. They were also certain that gradualism would not be successful. According to their way of thinking, as explained by Rosati (1990, pp. 6–7): "...the tactics of extending the reform process over longer time leads invariantly to mounting resistance from conservatives and an erosion of support from the populace".[11] Further, they also thought that "piecemeal approach in implementing necessary changes" was "very likely to aggravate the overall economic situation and contribute to a decline of welfare level." Finally, "radical political changes" were needed ... "to allow for overcoming ideological constraints in the process of establishing new institutions and new power structure in the economy".

The Polish stabilization program aimed at eliminating excess demand in the Polish economy in one go and reducing the inflation rate to nearly 1 percent a month by the second half of 1990. However, its most important and distinguishable feature as a stabilization scheme was that rapid action on stabilization was being intertwined with a likewise radical liberalization. The instantaneous introduction of the "internal" convertibility of the zloty as a result of its sharp devaluation was being regarded the cornerstone of the whole stabilization package.

The official zloty per dollar rate increased from 1339 in September 1989 to 5400 on December 22 and 9500 on January 1, 1990.[12] At such a rate internal convertibility was conceivable. Polish residents (firms and individuals alike) were allowed to officially exchange zlotys for convertible currencies practically without any restrictions. The zloty–dollar rate was fixed to serve as a *nominal anchor* in the ensuing process of economic stabilization and liberalization. In fact, the sharp devaluation has allowed for the balance of supply and demand for foreign exchange and an all-out liberalization of imports (the removal of administrative restrictions in the allocation of foreign exchange). The package also included deep cuts in government expenditures, essentially subsidies; and a tight monetary policy. Further, to prevent the re-emergence of a wage-price spiral, a restrictive income policy was introduced with prohibitive taxes on any increases in wage bills that exceeded pre-

[11] When arguing for the rapid transition David Lipton and Jeffrey Sachs refer to Machiavelli's famous advice that a government should bring all of the bad news forward. (Lipton and Sachs 1990).

[12] This paragraph draws heavily on Rosati (1990 and 1991).

determined indexation coefficients pegged to the inflation rate. Finally, dramatic price liberalization was introduced. By the end of January 1990, only 10 percent of prices were subject to any kind of administrative controls as compared to 50 percent in 1989.

The Balcerowicz program was backed by external financial assistance including, among others, a one billion dollar stabilization fund provided by the OECD countries to support internal convertibility of the zloty. No drawings from this fund have so far been necessary.

To assess the Polish stabilization program in an unbiased way, one has to distinguish between the ideology of the "big bang" and Polish realities from which the Balcerowicz program was born. As indicated, the quest for a radical shock-therapy was advocated because what Polish and international experts judged as unfavourable experiences of Poland and other socialist countries with gradual reforms. To be sure, reform failures should be attributed to different—mostly systemic—factors and political constraints, and not simply to the inconsistencies of a gradual approach. The concept of gradualism is for all practical purposes a very difficult one. Above all, as it will be shown later, gradualism could mean very different policies depending on the circumstances in which those policies are carried out. What is crucial concerning discussions surrounding gradualism versus shock-therapy is the need for a clear distinction between stabilization and liberalization (or structural reform, in general). Whereas a strong case can be made that in largely destabilized economies there are no alternatives to brave surgical operation involving serious costs and painful cures, there is no theoretical and empirical evidence to suggest why liberalization should be as instantaneous as stabilization. Generally, attempts at economic liberalization in the international economy seem to provide more evidence for the advisability of the gradual approach. As Jeffrey Sachs, one of the best experts of stabilization programs in developing countries (later playing a prominent role in preparing Central and East European reforms) put it: " ... structural reform (especially a shift towards greater outward orientation and trade liberalization) is a very difficult process that takes many years to bring to fruition. The process is so difficult economically and politically that it is likely to fail under the best of macroeconomic circumstances, and is in general greatly jeopardized by a concurrent macroeconomic crisis. The historical record suggests that stabilization should be given temporal priority in the design of adjustment programs, with structural reforms proceeding gradually and mostly *after* (italics in the original—A.K.) macroeconomic balance has been restored." (Sachs 1989, p. 202) Those points must have been overlooked during the preparations of the Polish stabilization *cum* liberalization program. It may well be that this happened given the existence of weighty arguments in favour of a one-time surgery *addressing specific Polish economic problems* of late 1989: grave domestic market disequilibria, a dual currency system, hyperinflation, and unmanageable foreign debt. Shock-therapy was applied

as a remedy for those ills. In this respect, and especially as a means of overcoming hyperinflation, the justifiability of the shock-therapy is beyond reproach.[13]

How efficient was the therapy? According to Rosati: "It seems unlikely ... that the Polish experience may be successfully emulated in other countries where political environment is not so favourable. What is, however, much more important is that final results of the program are still to be seen, and the shock therapy has still to prove its long term viability" (Rosati 1990, p. 11). Some Polish analysts assess the outcomes of the stabilization program in outrightly negative terms (Kolodko 1991), whereas international assessments vary. Actually some of the most important short-term targets of the program were being totally fulfilled, other aims have been partially achieved only and, perhaps, temporarily. However, most importantly, the price to be paid for those achievements proved to be very high (much higher than perceived while in the planning stage). Consequently, Polish economic prospects continue to be uncertain.

The most important lasting change in the Polish economy was doing away with excess demand. As a result of the stabilization operation of January 1, 1990, Poland turned practically overnight from a shortage economy into a demand constrained one. For the first time in many years or decades, Polish shops are full of commodities and queueing up as a way of life has disappeared.

Hyperinflation did come to an end. Yet, inflation rate targets have not been met. Not only the anticipated "corrective" inflation of early 1990 related to price liberalization and the realignment of energy prices proved to be higher than planned; the 1990 inflation was well three digit and its monthly rate in the second half of the year 1990 was about 4 percent and accelerated in early 1991. According to preliminary data, in 1991 consumer prices have apparently increased by 65–70 percent. (See *Table 1* for the recent inflation data in Poland and other countries of Central and Eastern Europe.)

Internal convertibility has also worked. The zloty was devalued so sharply that given its new level, no difficulties arose in balancing foreign exchange demand and supply. It was not before May 1991 that, because of the rapid inflation and worsening external balances a new devaluation of the zloty was announced. The 1990 hard currency trade surplus of approximately 4 billion dollars and the resultant current account surplus is occasionally also considered an important achievement. That is, however, "a questionable advantage for an impoverished country in the time of transformation" according to apposite remark of the Austrian economist Friedrich Levcik (1991). To be sure, the surplus was due to the country's deep

[13] It is an other question that, according to Kolodko (1991, pp. 14–15), the hyperinflation in late 1989 was to a large extent induced; it was a political choice "of using inflation to curb inflation" that was partially "encouraged by the practical situation especially the coincidence of a change of government and outbreak of rampant inflationary processes happening at the same time."

Table 1

Inflation rates in Central and Eastern Europe (percentage change in consumer price indices)

	1989	1990	1991[a]
Bulgaria	9.8	64.0	400–475
Czechoslovakia	1.4	10.1	55–58
Hungary	17.0	28.9	35
Poland	251.0	553.4	65–70
Romania	n.a.	n.a.	290[b]
Yugoslavia	1250.0	588.0	235

[a]Preliminary estimates based on OECD and national data
[b]October 1990–December 1991
Source: OECD Economic Outlook Nr 50. December 1991.

recession. *Table 2* presents Polish output decline in a Central and East European perspective.

Table 2

Output in Central and Eastern Europe (percentage change)

	Net material product			Industrial production		
	1989	1990	1991[c]	1989	1990	1991[c]
Bulgaria	-0.4	-13.6	-(20–26)	2.2	-14.1	-24
Checho-Slovakia	1.0	-3.1	-(12–14)[a]	0.8	-3.7	-(22–23)
Hungary	-0.2[a]	-5.9[a]	-(7–9)[a]	-2.5	-4.5	-15
Poland	-0.2	-13.0	-(8–10)[a]	-0.5	-23.3	-(12–14)
Romania	-7.9	-10.5	-(10–15)	-2.1	-19.8	
Eastern Germany	2.1	-19.5	-20	2.3	-28.1	-50
Yugoslavia	0.6[b]	-7.6[b]	-15[a]	019	-10.3	-21

[a]GDP
[b]Gross material product (value added of the material sphere including depreciation)
[c]Preliminary
Source: OECD Economic Outlook, Nr 49. July 1991, Nr 50. December 1991, Economic Survey of Europe in 1990–1991. New York. United Nations 1991, KOPINT-DATORG estimates and projections based on national data.

Prior to discussing the issues of recession, one more important achievement of the program of stabilization should be identified. In the wake of long negotiations, Poland's creditors (especially Western governments to whom Poland owes most of its debt) have proved willing to forgive a large part of the country's debt. Given that Polish debt has been by and large non-performing for a decade or so, the

agreement should not be considered as an unilateral favour granted to Poland by the creditors. Indeed, it was a mutually advantageous act. As far as Poland was concerned, the agreement for the first time since 1982 made the country's future debt management feasible (though not easy). This is an important precondition for long-term stabilization in Poland.

The consensus view by Polish economists is that "the stabilization program actually overshot, producing excessive financial results obtained at excessive real costs" (Rosati 1990. p. 23). As indicated, to achieve convertibility of the zloty, the Polish currency was very radically devalued. Convertibility had to be sustainable. Consequently, given the previous years of external isolation and serious disequilibrium of the economy, devaluation had to be much more excessive than "required by standard considerations related to stabilization policies" (*Oblath* 1991b). Therefore, austerity introduced as a means to restrain inflationary tendencies inherent in devaluation also had to be more rigorous.[14] The result was an unexpectedly severe decline of domestic demand that could not have been balanced by an increase in exports. Output fell sharply. For 1990 there was a planned 5 percent drop in industrial output, 3 percent decline in GDP and 1 percent decline in consumption. Actually, GDP has declined by 12 percent and its 1990 level equals that of 1984. What is more, as 1984 was a year of consolidation after the crisis of the early 1980s, the 1990 Polish GDP was not higher than during the years 1973–1974. In a single year of 1990, domestic uses of the GDP have declined by 17 percent (consumption—by 24 percent and investments—by 9 percent). Living standards sharply deteriorated, and industrial output of the socialized sector decreased by 23 percent. To be sure, this decline shows the weakness of adjustment process in the state sector. This weakness is very pronounced when compared to the dynamically growing private sector. Growth of value added of the latter was 17 percent (in sectors other than agriculture—26 percent) in 1990. Despite the dynamism of the private economy, by the end of 1990 there were more than 1.1 million unemployed in Poland comprising 6 percent of the labour force (KOPINT-DATORG 1991). Understandably enough, the strong domestic support for the Solidarity-led government when it had come to power gave way to strikes, political disillusionment and social unrest. The high support for the outsider candidate Stanislaw Tyminski at the presidential elections of late 1990 was indicative of the deep change in the political atmosphere.

Contrary to expectations, unfavourable trends continued in 1991. For instance, output and real wages further declined. Preliminary data show 8–10 percent drop in GDP and 14 percent drop in industrial production as compared to the previous year. 1991 was the third consecutive year of severely declining investment volumes (10 percent as compared to 1990), real wages dropped by another 2–3 percent and the trade surplus vanished. As indicated, inflation is soaring and

[14] Sharp devaluation may also have contributed to the government's inability to contain inflation (Oblath 1991).

unemployment growing. At the end of 1991 the number of unemployed was above 2.1 million. As shown in *Table 3*, Polish unemployment rates are the highest in Central and Eastern Europe. If the previous year's decline in economic activities and incomes were, at least partially, counter-balanced by favourable effects of end to the shortage economy and establishing internal convertibility of the zloty as it is often claimed, in 1991 there was nothing to compensate the population for growing hardship and an almost intolerable deterioration of living conditions for a large number of people.

Table 3

Unemployment rates in Central and Eastern Europe (percent of labour force)

	December 1989	December 1990	April 1991	June 1991	December[d] 1991
Bulgaria	0.0	1.4	2.7[a]	6.0	10.0
Czechoslovakia	0.0	1.0	2.8	3.8	6.8
Hungary	0.5	1.6	2.9	3.9	8.3
Poland	0.3	6.1	7.3	8.7	11.1
Romania	n.a.	n.a	0.6[b]	2–3	5–6
Eastern Germany	...	10[c]	...	25[c]	40[c]
Yugoslavia			...	20	19

[a]March

[b]According to Economic Survey of Europe, the rate was 1.8 as early as January 1991.

[c]Figures include an estimate for effective short-time work.

[d]Preliminary

Source: OECD Economic Outlook. Nr. 49, July 1991; Nr 50 December 1991; official reports and national press; KOPINT-DATORG estimates.

Largely as a consequence of social discontent related to the economic decline, the government of Prime Minister Mazowiecki resigned, and in the aftermath of the parliamentary elections in late 1991 this was followed by the dismissal of Leszek Balcerowicz and his team of economic reformers. The new Polish government came to power amidst the most serious attacks on austerity and promises of reflation. Should it stubbornly insist on fulfilling the policy changes promised during the election campaign, the economy could soon easily return to hyperinflation and shock-therapy as its only solution. Most observers do not think this version is likely to occur. More probably, the government will not depart materially from previous policies, even if it will not be able (or willing) to counter-act the pressures for an easing of the austerity. Indeed, the loosening was started much earlier—by Balcerowicz himself. The important point is that two years after the shock-therapy was launched and monetary austerity introduced, severe recession and high inflation continued to persist, unemployment is on the rise and the entire future of the

economy is clearly uncertain. Thus continuation of the policies of the last two years would also not be a promising alternative.

Other experiences with shock-treatment

As to the other Central and East European countries, it was their economic and political situation which was different from Poland which led them to chose other approaches to transitional policies. Nevertheless, pressures coming from different directions and a high priority attached to the speed of the transformation process, as well as the tremendous difficulties experienced with the gradual approach, have compelled many policy-makers towards what is usually being called a shock-therapy. This is particularly applicable in the case of Bulgaria and Romania because of the near-collapse of their economies coupled with grave political uncertainties and a dramatic turnabout. Bulgaria has already engaged in its own version of shock-therapy. Budget subsidies were largely reduced, prices liberalized and monetary austerity introduced. Imports in the first half of 1991 were one third their level a year ago. The government argues that there are no other options available and the Bulgarian population is able to endure a 50 percent cut in living standards (which according to official sources, *did* happen in the first quarter of 1991) and other hardships.

Specifically, a radical move to introduce convertibility of their national currencies is frequently suggested to all Central and East European countries. Therefore, it is important to note that previous attempts at a rapid transition to convertibility in former socialist countries did not have a lasting positive effect on the economy. Either the price to be paid for its introduction has proved very high (Poland), or has failed outrightly (Yugoslavia), or the mere abolishment of the all-pervasive system of administrative import licensing has been now called convertibility (viz. Czecho-Slovakia). (However, for the most part of 1991, Czech and Slovak firms wishing to import commodities valued above 6 million crowns had to consult the National Bank. Restrictions on purchasing foreign currency by the population for tourist purposes apply.) In the most recent (Rumanian) case, introducing internal convertibility in November 1991 did not even entail an effective abolishment of import licensing (it is the Rumanian National Bank that disposes of the applications for imports).

Yugoslavia also faced hyperinflation in 1989.[15] Consumer price index increased by 1256 percent. This situation justified the Yugoslav version of shock-therapy: the Markovic Program (after the Prime Minister of the federal government). In all other facets the Yugoslav situation was dissimilar to that of Poland.

[15] This paragraph follows the narrative of KOPINT-DATORG (1991).

An outstanding difference was that there were no shortages in the domestic market. Inflation too was being fed from different sources. Although internal convertibility of the dinar was introduced and it was tied to the D-Mark, approximately 15–20 percent of imports remained under administrative control. Other measures included a partial price and wage freeze for half a year (instead of the wage indexing scheme that had existed in 1989).

By late 1990, the Markovic Program collapsed. After the wage freeze ended in June and according to the schedule of the program, inflation accelerated and the deficit on the current account soared. In view of the deteriorating economic situation (output was down by 8 percent in 1990) political developments were already threatening the very survival of the country. The population withdrew its confidence from dinar and a large-scale conversion of dinars into D-Mark started. To prevent the worst, free exchange of dinar into convertible currencies was stopped in the autumn. Subsequently in December 1990, the government limited access to the deposits on foreign exchange accounts. As far as imports were concerned, the dinar officially preserved its convertibility but actual access to foreign exchange accounts depended on the liquidity of the bank in which the accounts were held. The conditions of civil war and payments arrears led to the withdrawal of trust by the IMF and the international financial community from Yugoslavia. Even before the declaration of Slovenian and Croatian independence in June 1991 and the armed conflicts obscuring the future of what was previously Yugoslavia, the chances for re-introduction of convertibility were extremely slight.

However specific the reasons for the failed attempt at convertibility in Yugoslavia and the grave difficulties experienced with the Polish case analyzed above, some relevant conclusions for the Five can be drawn.[16] Introducing convertibility is regarded by many experts and institutions, especially in the West, as the most important step in external liberalization of Central and East European economies; in short, a sign of how serious are the reform programs of the governments of the countries concerned. To some extent, all governments of the Five, whether opting for shock-therapy or gradual liberalization, are being influenced by this approach. Surely convertibility should be introduced during the transition process but the high priority attached to introducing it on the outset is mistaken.[17] *Firstly*, this approach ignores both the gradual establishment of convertibility in post-war Western Europe and the experiences of developing countries. *Secondly*, it concentrates on the technical side of the opening up of Central and East European economies instead of more important economic processes making such an opening possible, for example, reorientation of foreign economic relations, structural adjustment and development of international competitiveness. In this way, the real problems of external liberalization are being left out of consideration. *Lastly*, the recent expe-

[16] This paragraph draws heavily on Oblath (1991a).

[17] For an account of the different concepts of convertibility cf. Köves and Marer (1991a).

riences of introducing convertibility in former socialist countries are also neglected. Those experiences suggest that it is relatively easy to simply *announce* establishing some version of convertibility and *introducing* internal convertibility is also possible. Further, if exchange rate devaluation is deep enough, the chances for a *sustained* convertibility for some period of time will be strong. However, the price to be paid in terms of production and income losses is very high and makes the whole exercise quite dubious.

It should be clear that the deep recession and the resultant severe deterioration in the living standards is not simply an uncomfortable by-product of the therapy applied. Much more is at stake. In socio-political terms, those developments can lead to an Argentine type trap instead of West European or North-American way of development. As to the short or medium-term economic policies, such a severe economic decline would make the adjustment process unable to succeed even in normally functioning market economies. In the weak transitional economies, the continuous large fall in domestic demand may cause inextricable adjustment difficulties not only for the state-owned sector, given its traditional rigidities, but also for the newly-developing private sector. This is due to a lack of necessary capital in acceptable terms to finance business start-ups and for difficulties in finding enough customers that can pay reasonable prices for the undertaking to be rewarding. Governments also would face unresolvable tasks. Growing unemployment should be financed largely from the budget notwithstanding those incomes having been sharply reduced. More importantly, the austerity policy would inevitably lead to the withdrawal of established measures of liberalization. Other structural reforms would also cease. Given the strong inflationary pressures and the impending (renewed) hyperinflation that are concomitant of the present economic situation in some of the Five, policy-makers would have no alternative but to attempt once more shock-therapy.

A detour: German reunification as shock-therapy

Beside Poland and Yugoslavia, there is a third well-known example of a shock-therapy in what was a socialist country, the former German Democratic Republic. It is naturally a specific case of shock-therapy as systemic transformation was taking shape as a consequence of German reunification. Therefore, what was called the GDR has joined Western Germany and became the five new *"Länder"* of the Federal Republic of Germany. It adopted overnight the economic and legal system as well as the currency of the latter. The economy of the GDR as a single, national, economy in its own right ceased to exist. Accordingly, the problem of macroeconomic stabilization as one of the most difficult parts of the systemic change is henceforth simply pointless. The considerable external indebtedness of the former

GDR was assumed by the FRG as was the responsibility for monetary, fiscal and social policies. Western Germany as one of the richest and biggest economies of the world was able to shoulder the burden of swallowing a much smaller and weaker economy (although the long-term macroeconomic impact of the reunification on Germany is open to question).

Nevertheless, the short-term economic consequences of this particular way of systemic transformation for the former GDR proved to be more shocking than when the therapy was applied in Poland or other countries. According to preliminary estimates (*Tables 2* and *3*), industrial production in 1991 was 50 percent below the level of the previous year and may not have exceeded 36 percent of the 1989 level, and unemployment (including part-time work) might have surpassed 3.5 million which amounts to more than 40 percent of total labour force. Part of the explanation is consistent with the crisis in Central and Eastern Europe (for example, the collapse of the Soviet market) yet the depth of the shock is due to the specifics of economic reunification. Most importantly, not only the transition to a market economy and an opening to the West German and international economy took place overnight, quite in the spirit of the big bang theories, but also a special *revaluation shock* hit the East German economy. Convertibility was achieved in East Germany by introducing the D-Mark instead of the Mark of the GDR. A 1:1 ratio was used for converting wages, other incomes, and smaller savings into D-Mark, while 2:1 ratio applied for converting larger money holdings and savings balances as well as enterprise assets and *debt*. For all practical purposes, the operation was tantamount to a significant revaluation of the East German currency.[18] It is not surprising that weak and internationally uncompetitive East German industries could not survive the shock.

Given the issues addressed in this study two important questions should be asked. The first is whether or not the terrible short-term shock to the East German economy and population was unavoidable. Obviously, the manner in which economic reunification was achieved can only be explained in terms of political considerations that made German unification *pressing*. Political reunification was to proceed quite quickly, and the commonly held view in West Germany was that economic reunification should take place parallel to achieving political unity. (As a matter of fact, economic, monetary and social union in July 1990 did *precede* political reunification.) Given the sad state of the East German economy the shock could have been avoided (or lessened) by finding some method for a more gradual integration into the West German economy. However, political circumstances did not allow for serious discussions concerning such an alternative. Conversely, the

[18] Since a unified exchange rate of the domestic currency had not existed in the GDR, it is difficult to quantify the measure of the revaluation. However, the East German enterprises had been exporting to the West at an exchange rate of 4:1, at average (in electronics, the rate was 4.8:1) which gives an idea of the order of its magnitude.

conversion rate of the GDR Mark into the FRG Mark was open to discussion before the Union was established, for example, between the *Bundesbank* and the Federal Government, and still is a topic of contention. The shocking consequences of the established rate are apparent. What should be underlined, is that given the tremendous difference between the economies of the *Bundesrepublik* and the GDR and the perceived need for their immediate union (including the overwhelming weight of non-economic factors shaping the unification) *no appropriate or "satisfying" conversion rate could have been established.* To put it simply: smaller (than agreed on) revaluation of the GDR Mark would have meant not only a *relatively* better competitive position as well as a smaller indebtedness *vis-á-vis* the state for East German enterprises but concomitantly a much stronger cut in assets, starting wages, and other incomes of the former GDR population. The Federal Government at the time was right assuming that a considerably different, more competitive conversion rate could have been politically unacceptable for the East German population. According to analysts, whatever advantages a more competitive rate would have ensued they would have been reduced to nought because of the inevitable strong wage increases.[19] In turn, a neglect of the specifics of the East German economic situation and a lack of fine-tuning the currency change added much to the unavoidable difficulties.

The other question is what will be the potential and the actual benefits of the big bang for the eastern part of Germany. The unique feature of the East German situation is that because of the tremendous West German financial transfers amounting to almost 100 billion D-Marks in 1991 alone, Germany could "afford" the terrible decline in Eastern production and income. Also the longer-term prospects of external financing of the East German economy are brighter than in the Five. It remains to be seen whether those significantly more favourable conditions as officially expected will bring about a swifter recovery, a stronger restructuring and a raising up to European (or West German) industrial levels and living conditions than in the case of the other former CMEA member countries. Namely, there are some very weighty factors on the negative side. *Firstly*, the GDR was one of the few socialist countries with almost no steps taken towards creating conditions for a market economy until the very end of its separate existence. That could represent a serious obstacle to improving efficiency in the aftermath of rapid marketization in some fields (i.e. large-scale heavy industries that have been oriented almost exclusively to the Soviet market) despite the introduction of West German legal and economic system. *Secondly*, the longer-term impacts of the present very serious decline in production are not yet clear. The effects may be varied. For example, it can clear the way (by discontinuing uncompetitive and obsolete activities) for starting

[19] As John *Williamson* (1991, p. 65) puts it: " ... wages in eastern Germany rose briskly after unification, so it seems rather doubtful that a more competitive initial exchange rate would have done anything much except reduce the stock of assets held by East Germans after union."

a healthy development, but, at the same time, large-scale labour migration to West Germany may continue. Wages will continue to close up to match West German levels more rapidly than productivity does, and thus, the position of East Germany as an investment location may remain questionable. *Thirdly* and most importantly, it is not only the East German national economy that has discontinued to exist as a consequence of unification but there is complete lack of involvement of the East German population in political and economic decision-making concerning their own fate. A kind of West German tutelage is prevailing concerning the important questions of life in Eastern Germany including economic restructuring.[20] Even if there are some plausible explanations for this policy, it is doubtful whether or not a real general upswing can be achieved without an active and creative involvement of the population.

Even if it is due to West German financial support that shock-therapy in Eastern Germany can remain manageable, the availability of West German assistance in itself is not an argument in favour of the big bang. In principle, availability of assistance has not been restricted to the shock-therapy approach. Would political considerations have allowed for gradualism in economic reunification, financial assistance could have come in similar ways and amounts as in the case of the shock-therapy.

The case for gradualism

The foregoing analysis suggests that if conditions make it possible, governments of the countries in transition should choose a gradual approach to reforming their economies instead of the arrogant messianism of shock-therapy.

Before turning to the experiences of the gradual approach to stabilization and liberalization in Central and Eastern Europe, two remarks are apposite. *First*: by any conventional economic standards, the pace of systemic changes is very dynamic in the countries declaring preference for a gradual approach. The single most notorious example of a more rapid systemic transition is the discontinuation of the market economy in the aftermath of the October Revolution in Soviet Russia, and in Central and Eastern Europe after the communist take-over in the late 1940s. In

[20] To quote an American sociologist explaining the situation: " ... together with an abiding trust in the market, this political leadership (i.e. the German government—A. K.) has a *profound trust in the state.* This trust, moreover, is accompanied by a deep, and almost indiscriminate, *distrust of East German society* (both italics in the original—A. K.). Forty years of communism, according to German leadership, have produced a terrible human tragedy—the personality structures, habits, dispositions, expectations, and mentalities of the citizens of the new lands make them unfit and incapable of managing their affairs. It is not their fault, but they are no longer trustworthy. They must be remolded and re-educated not simply in industrial skills but with new mentalities." (*Stark* 1991, p. 42)

addition, the gradual theory is being applied for countries that have already been shocked by decade-long economic decline topped recently by a severe recession. *Second*: as already indicated, gradualism is a philosophy proposing step-by-step changes as opposed to a big operation that would solve the most difficult problems of transition in one sweep. In case of very serious disequilibria, gradualism implies a clear-cut distinction between the tasks of stabilization and structural reform, timing and sequencing of liberalization accordingly. Gradualism may in practice be the name for very different economic policies. They range from consistent reform policies to evading reforms. Therefore, the author's preference for gradualism does not imply any judgement about particular policies in countries in which gradualism prevails.

In this context, it also becomes obvious why it is difficult to draw a clear line between shock-therapy and gradualism for systemic transformation in Central and Eastern Europe. Therefore some governments may have difficulties in labelling their economic policies as a shock-therapy or a gradualistic approach.

A case in point is Czecho-Slovakia. As frequently being pointed out both by Czecho-slovakian economists and foreign observers (*Hrncir* 1991, *Williamson* 1991), initial macroeconomic conditions for systemic transformation appeared at least in some respect more favourable than those of other countries in the region. This was "due to the traditionally prudent monetary, credit, fiscal and income policies." Domestic macroeconomic stability and the level of foreign indebtedness were relatively satisfactory at the time of political change. Contrarily, despite macroeconomic prudence and a long tradition of industrial development, in terms of its technological level, industrial patterns (the predominance of smokestack heavy industries), the environment, and finally, growth and export performance, Czechoslovakia was mediocre to bad even by Central European standards. Looking beyond the predominant political conditions a large reason for this situation lies with the traditional mandatory planning and resource allocation system that remained practically fully intact in Czechoslovakia until the very end of the *ancien regime*. Furthermore, the discussions concerning the ways and means, as well as the desirable speed, of the transition process in this country were protracted. This may explain why the old economic system essentially survived well into 1990.

As Hrncir (1991, p. 23) explains, after long discussions between the proponents of "fast" and "slow" transition, the Czechoslovak government opted for a *radical systems change and a transition path as quick as feasible* (italics in the original—A. K.). At the same time, the measures adopted take into account the differentiated time scales of the various elements making up the transition process." In accordance with this approach, policy makers in Czecho-Slovakia seem to have a very critical view of gradualism.

As noted above, the introduction of an internal convertibility of the Czech crown, on 1 January 1991, (together with its strong devaluation, monetary austerity and other measures) was much less drastic than the Polish shock-therapy.

Williamson (1991, p. 70) seems to be right when having stated that the Czecho-Slovakian program is close to a "minimum bang." Nevertheless, grave shocks have hit the economy of the country. In 1991 industrial production declined by 22 percent and GDP by 12–14 percent when compared to one year earlier. As mentioned, real wages declined by more than 20 percent. Unemployment is on the rise—in Slovakia it is already more than 10 percent. Critically-minded economists also emphasise that the decline in production and incomes involves "a structural downward trend, a rise in the share of primary heavy industries, in export, in production and in profits ... the already excessive, energetic and material consumption of our economy continues to rise by about 3% per annum (although it was approximately about one half higher compared with the developed world)" (*Pick* 1991). Although a large part of the 1991 difficulties should be attributed to the collapse of CMEA trade, it is true, however, that even managing the "minimum bang" can be a very cumbersome process in case of Czechoslovakia. The general assumption is that 1992 will be a year of further significant economic decline (at least 5 percent in terms of GDP) and further growth in unemployment. At the same time, both government and experts forecast an inflation rate between 10–15 percent—that could be a unique achievement in present-day Central and Eastern Europe.

Distinguishing the Czecho-Slovakian case as a "minimum bang" from the "shock-therapy" applied in Poland and other countries can be challenged. Considering for instance, the Czecho-Slovakian government proudly declares that its policy is a shock-therapy and its critics also focus on the mistakes of the Czecho-Slovakian policy as those of a shock-therapy (*Komarek* 1992). To be sure (and this may justify calling it a "minimum bang"), the Czecho-Slovak adjustment program is *relatively* less painful than the therapies applied elsewhere in Central and Eastern Europe. At the same time, what also makes the Czecho-Slovak case different is that the bang was launched against an initial state of relative macroeconomic equilibrium (no significant inflation, no shortages, no unmanageable external debt)—i.e. without an apparent need of big *stabilization* surgery. Whereas in Poland and other countries some kind of surgical operation was unavoidable to launch meaningful structural reforms, in Czecho-Slovakia surgery (involving rapid price liberalization, import liberalization called internal convertibility; as well as budgetary and monetary austerity that have led to big declines in domestic demand) was a deliberate policy *choice* presumably based largely on theoretical and political considerations. But, as this *was* a surgery (even if not as big as the Polish operation), the program's definition as a "shock-therapy" is also plausible.

Hungary is the only country of the Five where generally the view is that for this country a gradualistic approach to systemic transformation is appropriate. This consensus does not exclude deep divisions concerning other issues of economic policies or different interpretations of the suggested content of a Hungarian gradualistic approach. It simply expresses a disbelief in any "great leaps forward" or single, well-constructed policy-packages that would enable the econ-

omy rid itself once and for all of the inherited economic burdens and handicaps as well as structural illnesses. It means an apprehension in simplified notions like establishing convertibility of the domestic currency, price stabilization and a strong export initiatives as being *sufficient* conditions for recovery and lasting economic growth (Köves and Oblath 1991). Gradualistic policies may of course end with shock-therapy under certain circumstance but gradualistic approaches take it for granted that, *first*, the preferable solution is to avoid those circumstances and that is precisely the aim of economic policy. *Second*, shock-therapy, even if it proves inevitable, will *not* solve the problems of establishing a market economy.

The differences between Hungary and Poland as regards pre-transformation economic systems, macroeconomic and political conditions which made shock-therapy inevitable in one case, and gradualism possible and desirable in the other, have already been mentioned. To briefly revert to one important point of argument about gradualism versus shock-therapy, as Williamson mentions (1991, p. 71), it is often argued that the lessons of the Hungarian economic reform "show the perils of gradualism: 23 years after a major reform was started, Hungary has still not achieved a market economy." A reply possibly to those arguments is: "until 1987 the Hungarian political leadership had made no real commitment to reform and its policies amounted to a series of pragmatic changes undertaken in response to particular problems as they arose".[21] Whether or not Hungarian reforms in the period 1968–1989 were successful depend on the success criteria one formulates and uses which each come to very different conclusions about what has been achieved and what has not been achieved during those years. To say however that the failure to achieve a market economy before 1989 is proof of the reform fiasco is not supported empirically. It was in the first instance undoubtedly that international political constraints and not the perils of gradualism prevented the creation of a market economy in Hungary. However, reform and the corresponding important changes in priorities of economic and in general domestic policies, and their emphasis on political opening, consumer satisfaction and work incentives (to a large part, outside the traditional framework of the state owned enterprises) made this country in a way different. Hungary with its developing commodity markets and embryonic labour markets was certainly a non market economy in quite a different sense than the traditional Soviet-type economies were up to the very end. To be sure, the Hungarian reform was not fully implemented and had uncertain prospects,

[21] To this Williamson (1991, pp. 71, 73) notes: "Interestingly, these piecemeal reforms do not seem to have led to the type of second-best difficulties experienced by other countries introducing partial reforms. This provides perhaps the best evidence that a feasible sequence of partial reforms does exist." He concludes: "The main lesson of the Hungarian experience seems to be that gradualism does not deserve the contemptuous dismissal that it has tended to receive in much recent discussion. Under certain circumstances it does provide a feasible road to reform. But this is surely true only where the economy has never been allowed to get out of hand, which excludes a gradualist strategy for most of the countries of the region."

ideological as well as political limitations, and many of its originally declared aims proved to be illusory in the given circumstances (Kornai 1986). Indeed, few of the big innovations for changing the way a socialist economy functions that were introduced in Hungary produced the expected amount of positive effects. Perhaps the most notorious example is that as government and business could not be separated, abolishing mandatory planning and resource allocation resulted in a kind of non-traditional, indirect central planning and management in its stead.

The relevant question concerning the pre-1989 Hungarian reform remains as to whether or not it has eased the burden of economic transformation in Hungary after the political change. Is the Hungarian economy now in better shape, is it better suited for the transition to a market economy, as a consequence of 20 years of reforms rather than without those reforms? All available evidence (including comparisons with other transitional economies) suggests that the answer is yes. More importantly, economic agents (the bureaucracy, managers, employees, consumers—the entire population) have had a decades-long experience with a non-traditionally Soviet type, more open and business-oriented system. It means that the inevitably long learning process concerning the organizational and legal system, operation modes, business thinking, sociology and psychology, as well as international relations complementary to a market-type economic development has started in Hungary at an early date. True, in some very important respects, such as property rights, the Rubicon could be passed after the political change only. However, the majority of liberalizing reforms that were to start in most other former socialist countries after 1989 from the very beginning, had been progressing well in Hungary since the introduction of the "New Economic Mechanism" in 1968.

In spite of the relative advantages related to the long-standing economic reform it would be premature to assert that Hungarian gradualism is doomed to success. Even if decline in economic growth and incomes, or in employment, in Hungary is more modest, social conflicts less intense, imbalances less acute then in most of Central and Eastern Europe, economic crisis is protracted and significant by international standards and it is far from assured that it may soon be over. The reasons for difficulties are multiple. For example, imprudent macroeconomic policies of the past bear a large share of responsibility for the huge foreign debt. The need to manage the debt and to overcome the recent external shocks (collapse of Eastern trade) restrain the scope for macroeconomic policy action and make austerity inevitable.

Inflation clearly remains public enemy number one. Yet anti-inflationary policies must not disregard the balance-of-payments targets as well as the deep recession (GDP declined by about 4–6 percent in 1990, and 7–9 percent in 1991). The grave (15 percent) 1991 decline in industrial production is also interpreted as warning signal. Unemployment continues to grow much more dynamically than expected. There is a severe decline in personal consumption (7–8 percent in 1991). Timing, sequencing and fine-tuning of macroeconomic policy and liberalization measures

require the largest amount of professional and political skill from policy-makers. In this situation, it is a most difficult policy task to strike a balance between the needed prudent macroeconomic policies, on one part, and avoiding deepening of the social strains and political conflicts on the other. The balancing act is especially complicated by inflationary pressures and growing social conflicts involved in the politically charged issue of state property redistribution in favour of pre-nationalization and pre-collectivization owners (traditional churches included) mostly at the expense of the lower strata of the population already being endangered by inflation, unemployment and cuts in social services. The role of the state (the scope as well as the form of government interventions) in the economy in general and in managing the processes of systemic transformation (privatization included) is subject to not yet decided professional discussions and party politicking.

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ENGINEERS OF THE TRANSITION (INTERVENTIONIST TEMPTATIONS IN EASTERN EUROPEAN ECONOMIC THOUGHT)

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The paper focuses on current developments in the history of economic thought in Eastern Europe. In contrast to the conventional interpretation positing a neoliberal breakthrough in postcommunist economics, the author emphasizes the old-new interventionist (constructivist) elements of Eastern European economic thinking. In the first part of the paper, he draws parallels between the scholarly and sociological positions of the former reformers and the present "transformers". In the second part, he provides samples of the transformers' arguments for the "engineering" of the transformation processes by the new governments.

It is again time to bid farewell to a metaphor. I am saying goodbye to the imaginary pendulum which—according to Western experts—would swing Eastern Europe from the one extreme of a command economy to the other extreme of *laissez-faire*. "Tit for tat" is how I would irreverently rephrase the logic of this thesis, if I did not suspect its inherent vision of the future—namely, that collectivism would shift to liberalism. To put this in the language of the daily newspapers: the more Stalinist the economy/economics used to be, the more Thatcherite they should become. Or to adopt Habermas' somewhat loftier style: a *nachholende Revolution*, that is, a revolution staged with the purpose of catching up with the West, is taking place in this part of Europe.

In any event, the really good news was announced by Fukuyama: the "end of history" is almost upon us. There is no reason to deny that these prognoses are dramatic, since they envisage a major turnaround—at least in theory. They forecast a neo-liberal (libertarian, conservative) breakthrough in, among other things, postcommunist economic thought.[2]

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[1] An earlier version of this paper was presented in Budapest at a session of the Hungarian Social Science Association on December 18, 1991. It was published later by the *2000* (cf. „A jövő mérnökei", *2000* January 1992). Thanks are due to János Gács, Mihály Laki and the editors of the *2000* for their comments.

[2] Cf. Jerzy Szacki: A Revival of Liberalism in Poland?, Social Research 1990/2; Elemér Hankiss: Eastern European Alternatives—Are There Any?, Oxford 1990; Jacques Rupnik: The Other Europe, London 1988; John K. Galbraith: The Rush to Capitalism, the New York Review of Books 1990/10/15; Amitai Etzioni: Eastern Europe: The Wealth of Lessons, Challenge July–Aug 1991; Samuel Bowles: What Market Can—and Cannot—Do?, Challenge July–Aug 1991; Robin Blackburn: Fin de Siècle: Socialism after the Crash, New-Left Review 1991/185; Peter Wiles: Die kapitalistische Siegessicherheit in Osteuropa, Europäische Rundschau 1991/3.

Over the past few months Western newspapers have carried headlines like "Maggie Thatcher Goes East," "Chicago Boys in Warsaw," "Champions of the Wild East in Prague" and "Young Liberals in Moscow." These headlines refer both to the economies in transition and the leading economists. Indeed, the individuals in question have been reluctant to issue a disclaimer. Leszek Balcerowicz still speaks proudly of the Polish shock therapy (whose Big Bang philosophy seems to justify the pendulum metaphor); Václav Klaus rarely misses a chance to quote from *Free to Choose* by Milton and Rose Friedman. (An associate of his, Czech Privatisation Minister Tomás Jezek, professes to be an ardent follower of von Hayek.) Yeltsin's economic advisers wish to cross the Rubicon dividing the really existing socialism of yesterday from the capitalism of tomorrow in a matter of a few hundred days. Let us not forget Hungary, our own country: Márton Tardos, who is the head of the parliamentary group of a liberal party, now uses the seemingly ultra-liberal expression of "privatizing privatisation"; and János Kornai has recently published a pamphlet in the United States under the title *The Road to A Free Economy*, a reference to Hayek's *Road to Serfdom*. Every now and then, Harvard's "diabolical" Jeffrey Sachs shows up in their company. This "Grand Stabilizer" is touted by the national populists throughout the region as an advocate of unfettered liberalism.[3]

Nevertheless, it is not only the Hungarian government in Eastern Europe that boldly refuses to obey the law of the pendulum. Most of the new administrations seem to be doing their best to reject the allegation that no statist (i.e., interventionist, dirigist, recentralizing) programmes—and no economists who keep inventing such programmes—can thrive on the ruins of communism.

Those who attached their expectations to the magic force of the pendulum a year or two ago are so horrified by the recent symptoms of a new authoritarianism under post-communism that their first reaction is to hasten to readjust the short-term *political* forecasts about the triumph of democracy and the rule of law in the region. Instead of keeping track of the actual movement of the pendulum in the economy or the dominant economic discourse, they adhere to the earlier practice of describing most of the Eastern European scenarios of economic transition as ultra-liberal. At the same time, they are busy developing elaborate prognoses based on the model of "authoritarian rule-cum-free market." As has happened several times

[3] Leszek Balcerowicz: Die "Unreife" der freien Marktwirtschaft in Polen, Neue Zürcher Zeitung, 1991/1/13,14; Václav Klaus: A Road to Market Economy, Prague 1991; Václav Klaus & Tomás Jezek: Social Criticism, False Liberalism and Recent Changes in Czechoslovakia, Eastern European Politics and Societies, Winter 1991; Kornai János: The Road to a Free Economy, New York 1990; Jeffrey Sachs: What Is To Be Done, Economist 1990/1/13; D. Lipton and J. Sachs: Privatization in Eastern Europe. The Case of Poland, Brookings Papers on Economic Activity 1990/2; J. Sachs: Crossing the Valley of Tears in East European Reform, Challenge, Sept–Oct 1991; Im Niemandsland zwischen Plan und Markt, Die Zeit 1991/11/1.

in the past, the analysts now start out from Latin American and Southeast Asian examples.[4]

Let us confess that, to a certain extent, we "domestic observers" tend to accept this attitude. True, Hungarian economists who have experienced the various reform cycles of market socialism cannot be impressed by any optimistic prophesy about a rapid shift from extreme collectivism to liberalism. This is because, over a period of several decades, their chief concern was to reconcile pragmatically the moderate elements of these two world of ideas. In the end, they did not succeed in working out an original and logically coherent paradigm for the reform of real socialism—even though that was widely hoped for. Nevertheless, as the years went by, the concept of a command economy disintegrated in Hungarian economic thought. At the same time, while few experts predicted a neo-liberal breakthrough, hardly anybody expected the present proliferation of illiberal political aspirations. Consequently, it is now very difficult for former reform economists who have become disillusioned with the utopia of a "*socialist* market economy" to find even moderately liberal versions of the "*social* market economy" politically unfeasible.

Sensing signs of a new authoritarianism in Eastern Europe, we economists rapidly brace ourselves and attempt a diagnosis. Endowed with historical experience, it has not taken us long to discover the early symptoms of the emergence of a new, postcommunist party-state: we unmask the old-new bureaucratic elite and their growing clientele; we lay bare the new interventionist political ideologies—sometimes I have the impression that the patterns are all too familiar. As a rule, we avoid flirtation with any new enlightened absolutist rulers; we feel antipathy to the notion of a corporative state and are far from being enthusiastic about the idea of replacing the parliamentary system with a presidential one. However, apart from these *political* reservations, we rarely think about the illiberal *economic* temptations which Eastern European scholars also ought to resist while examining what comes after communism.

We should be especially aware of these dangers because it may well be that our "Great Transformation" is incompatible even with the "Chilean Road." From an economic point of view, the puzzle called "transition" may have *no* liberal solution, let alone a radically liberal one. The new dictatorships which appear to be emerging in our region would probably be unwilling to give a free hand to the economy (at least not to the degree that Pinochet did).[5] Even more importantly,

[4] Oleg Rumiantsev: Authoritarian Modernization and the Social-Democratic Alternative, Social Research 1990/2; L. A. Gordon: Soviet Prospects: Not Absolutely Hopeless, Challenge May–June 1991; Ellen Comisso: Political Coalitions, Economic Choices, manuscript, 1991; Adam Przeworski: Spiel mit Einsatz. Demokratisierungsprozesse in Lateinamerika, Osteuropa und anderswo, Transit 1990/1.

[5] Alfred Stepan: State Power and the Strength of Civil Society in the Southern Cone of Latin America, in: P. Evans, D. Rueschmeyer, T. Skocpol (eds): Bringing the State Back In, Cambridge 1985; M. A. Garreton: The Political Evolution of the Chilean Military Regime and Problems in

the crisis-ridden state economies in Eastern Europe would, almost instinctively, appeal on a daily basis for resolute intervention by the governments in power. Even firmly established political democracies would find it difficult to resist such aggressive claims. Hence it follows that, in contrast to the ideal of democracy-cum-market and the second-best option of dictatorship-cum-market, the countries of the region might easily find themselves waking up to the depressing reality of dictatorship-cum-controlled economy.

Whence the temptation? Why am I invoking the spectre of interventionism (which Hayek refers to as "constructivist rationalism") at a time when the economic thought of Eastern Europe is witnessing an unprecedented upsurge in liberal fervour? Let me state my answer somewhat harshly: I think the rhetoric, language and programmatic trappings of this fervour—as well as some of the practical measures taken in the spirit of liberalism—make many economists of transformation believe that what they are doing is merely assisting spontaneous evolution. Consequently, whenever they do advocate something "non-spontaneous", they justify it to themselves by claiming that they are acting under the compulsion of conditions, in the service of a sublime objective, against the dictates of their own consciences and, above all, with the sole purpose of finding a provisional solution.

I wonder why we are still so impressed by spectacular symbolic contrasts, such as the setting up of the Polish stock exchange in Warsaw in a building that used to house the Central Committee of the Communist Party, or the auction of Soviet tanks in the satellite countries, or the substitution of party membership cards with chequebooks? Why do we only notice the policy of interventionism when it is coupled with shallow populist-nationalist ideologies or when, in the worst case, it introduces the machinery of political *Gleichschaltung* in the economy as well?

Reformers and "transformers"

To avoid any misunderstanding, let me state in advance some of the assumptions inherent in my train of thought:[6]

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the Transition to Democracy, in: G. O'Donnell, P. C. Schmitter, L. Whitehead (eds): Transitions from Authoritarian Rule. Latin America, Baltimore 1986; E. A. Cardoso: Privatization Fever in Latin America, Challenge Sept–Oct 1991.

[6] For more detail, see János Mátyás Kovács: Reform Economics: The Classification Gap, Daedalus, Winter 1990; Übergang: das grosse Experiment, Transit 1990/1; Szocialista vagy szociális piacgazdaság? (Socialist or Social Market Economy?) Világosság 1990/1; From Reformation to Transformation. Limits to Liberalism in Hungarian Economic Thought, in: Rediscovery of Liberalism in Eastern Europe, Eastern European Politics and Societies, Winter 1991.; Compassionate Doubts about Reform Economics, in: Kovács J. M. & Tardos Márton (eds): Reform and Transformation in Eastern Europe. Soviet-Type Economics on the Threshold of Change, London 1992.

(1) Below I shall use the term "transformer" (in contrast to "reformer") to refer to those theoretical economists in Eastern Europe who—working as researchers or, more often, having been hired on a semi-permanent basis by some party or government department—write comprehensive scenarios on key aspects of the radical transformation of the Soviet-type economy. I intend to observe their scholarly and political activities from the perspective of a *historian of economic thought*. At this point, I am concerned with what they recommend, the form in which their recommendations are presented and the purpose of such recommendations. Here I do not deal with the feasibility of their proposals.

(2) I begin with the assumption that during the 1980s the dominant majority of transformers excelled as reformers (often radical ones). For a longer or a shorter period, they experimented with market simulation. In other words, they avoided challenging, simultaneously and decisively, the two main taboos of real socialism: state ownership and one-party rule. I include in this group the members of the older generation (Aleksander Bajt, János Kornai, Karel Kouba, Gavriil Popov, Stanislav Shatalin, etc.) as well as numerous younger representatives of the middle-aged generation (Leszek Balcerowicz, Tamás Bauer, Vladimir Dlouhy, Yegor Gaidar, Joze Mencinger, Jerzy Osiatynski, Attila Károly Soós, etc.). I am not going to mention those few "unspoiled" young scholars who have no reformist record of any kind.

(3) Even if some of them regret it now, most of the reformers did not start out as "closet capitalists" who had to disguise their authentic liberal conviction. Liberal thought was not an asset a reform economist inherited from precommunist times; instead, it was one that he attained. He usually acquired it in addition to (and rarely instead of) his socialist commitment during the course of political bargaining over economic reform. The typical reformer took up liberal ideas almost reluctantly, deriving them from his own trial and error experiences rather than from scholarly works about, say, the renaissance of Austrian economics, the economic theory of the property rights or constitutional economics. For a long time, he had already been instinctively aware of most of the government failures, while doctrines of welfare economics about market failures still dominated his thinking.

(4) As a consequence, the reformer should not be seen as a herald of a radical liberal dream when he becomes a transformer. Even though, at times, he may act with a neophyte's haughtiness, one can, without a German schoolmaster's exactitude, consider his liberalism unsophisticated, somewhat distorted and eclectic. Reformers have always had a predilection for "introducing", "building up" and organizing the market. They have always had a constructive reform programme, an expert solution, or an expedient for emergency on hand. They justified, with some truth, their constructivist and holistic attitude, as well as their Grand Designs with the explanation that in such a naturally non-spontaneous system as the Soviet-type economy the policy of "live and let live" must prove ineffective. In fact, that policy would let live those who would not let others live.

The image of the future could not be defined within the framework of reform economics; in other words, the question "where does the Third Way between capitalism and socialism lead to?" could not be answered for either political or logical reasons within the Soviet-type system. Thus, reformist liberalism found its source, pragmatically, not in an abstract but definable ideal (natural) state of the past or the future, but in the ups and downs of the reform process itself. The reform proposals, radical as they were, rarely ever used ethical considerations to praise the intrinsic "beauty" of the market, the value of individual initiative or the virtues of private property. For a long time, the reform economist had a purely technical and pragmatic attitude to the market (competition, entrepreneurship). He considered it a tool to be used to repair the malfunctioning machine of the Soviet-type economy whenever necessary.

In an ideal situation, that machine was the market itself (see the controversial reformist concept of "economic mechanism"), and it was the government's duty to control it from above. This meant switching the market on and off, and coupling its cogwheels with those of the plan almost at will. The market seemed to be suitable for planners to simulate because it was defined as a sterile institution free of the property rights. Furthermore, state ownership seemed to be politically neutral: according to widespread assumptions, it could be decentralized and rearranged into smaller-scale collectivist forms (managerial socialism, workers' self-management). Because they were dismissed as obsolete and technically not viable, concepts like free enterprise, invisible hand and nightwatch state were omitted from the reformist plan-and-market discourse. As a consequence, the principle of methodological individualism was also ignored. The state, in the reform economist's vision, remained vigilant during the day just as by night. Similarly, to use Mario Nuti's *bon mot*, the invisible hand was from time to time disciplined by "visible fists".

I am exaggerating, of course. It is well known that Eastern European reform thinking has always had some liberal mavericks (Tibor Liska, Nikolai Shmeliev, Jan Winiecki, Václav Klaus and others of their ilk), radical periods of development and pioneering country cases. Also, who would dispute the fact that the theory of reform underwent a long process of secularisation/radicalisation starting from the cautious adjustment of planning targets in the 1950s to the nearly profane demand of "reforming the reform" in the late 1980s? Nevertheless, reform ideas shed their mechanical, collectivist and interventionist features very slowly—and always within the limits of "political decency".

(5) As for reform countries in Central Europe, after the early 1970s, it was not simply the anticapitalist attitude inherited from Marxism that prevented the reform economists from giving up the attempt to reconcile "plan" and "market" to concentrate, instead, on the desirable proportions of public and private ownership. To a certain degree, the delay was due to the very nature of reformist theory: limited liberalisation by trial and error is a slow process; the market in the shadow economy was only partly justified, and workers' self-managment was only partly

falsified under the old regime, etc. There were, however, significant external causes as well, which, in the long run, may have proved even more significant than the internal ones.

Here I am referring to the reformers' well-known intermediary position between scientific research and politics, opposition and government, East and West, and the numerous compromises concomitant with their role as mediators. Let me concentrate on just one of the multitude of non-scholarly roles which Eastern European reform economists have played in recent decades—that of the adviser and expert, i.e, the *social engineer*. I shall focus primarily on the way they offered their expertise in social engineering: how they identified themselves with this programmatic activity and the related search for compromises, whereby the task of answering the question "what is?" was overshadowed by active participation in planning what "ought to be." This participation went well beyond the limits of independent advisory work (see, for example, the reform economists' shuttling between the scientific community and the government apparatus or, God forbid, the Communist Party headquarters). The foundation of this relationship was an attitude of cooperation and constructivism. Of course, the economist working as an adviser could always console himself with the paradoxical explanation that, even if he were cooperating with the party-state, he was nevertheless instrumental in dismantling the state economy. As he explained to himself, his mission was to regulate deregulation and plan the "domestication" of planning. (As opposed to the genuine dissidents, then, one could characterize the reformers as assenting dissenters.)

Before the reader accuses me of administering justice retroactively, I hasten to add that the comments above should not be taken either as criticism or a condescending pat on the shoulder. At a time fraught with the threat of witch-hunts, the chronicler should at the very least emphasize the reformers' crucial contribution to "disenchanting" the planned economy and "softening" the communist economic elite.[7] What you have read so far is nothing more than a brief status report that serves a practical goal—namely, the demonstration of the similitude I am inclined to observe between the former reformers and today's transformers. Yet there is more here than the simple fact that for the most part we see the same faces as before. I have arrived at the real subject of my paper...

Liberalism delayed?

What does a radical reformer think when political and ideological restraints that once controlled his imagination are one by one taken off? In principle, this

[7] J. M. Kovács: Planning the Transformation? Notes about the Legacy of the Reform Economists, forthcoming in: J. M. Kovács (ed): The Ambiguous Legacy of Communism, Transaction Publishers 1993.

may act as a catalyst: his creative powers may begin to soar, taking him to ever more liberal heights. Yet, as optimistic as that may sound, that option is rather unlikely. An economist who has learnt by doing (I would say, for want of a better solution) that beyond a certain stage marketization is logically inconceivable without privatisation, will be apt to paraphrase Churchill's aphorism on democracy even after 1989: private property is the worst form of ownership except for all the others . As a result, private property may join the reformist interpretation of the market within the category of "necessary evils."

In a free world, an economist may become a freethinker. Now that the political and ideological barriers of the Soviet-type system have been lifted, there is in principle an unhindered passage to the domain of the "free" market, or at least to that of "social" market economy. Apparently, the only thing yet to be done is to conclude the train of thought that started in Eastern Europe a few decades ago; in other words, the programme of simulated marketization needs to be made both real and complete by introducing the essential components of private property and political democracy. One wonders how far the transformer will proceed in these areas. Or, thinking back on the opening metaphor, where will the pendulum stop, once it has passed the imaginary point of suspension?

In our search for an answer let us not interview ex-reformers. They would probably respond: "We may have indeed been slow in realizing that the 'emperor' whom we once served 'had no clothes on.' Nevertheless, from a strictly intellectual point of view, 1989 found us in a fairly mature state. Once (self-) censorship was abolished, only technical obstacles prevented us from asserting our liberal ideas. Consequently, there is no need to revise the original theoretical tenets of reformist thought; one needs merely to streamline them by simply removing the former taboos. Some of the economic solutions thus put forward may still be 'second-best', but they will be second-best on their own merits, not as a result of the sociological and methodological compromises deeply rooted in reform thinking."[8]

Eastern European economists have arrived at this state of relative calm without catharsis. The present mood of the transformers may be briefly characterized, with some malice, as follows: "the new democracies in our region may continue to produce half-heartedly liberal political elites (who would slow down the economic transition); yet, thank God, we are no longer obliged to invent comprehensive theories to prove that half-hearted liberalisation is the best of all possible economic programmes". In other words, there is no more need to incorporate external hindrances into the theory.

[8] Cf. the responses of Leszek Balcerowicz, Aleksander Bajt, Wlodzimierz Brus, Karel Dyba, András Hegedüs, Branko Horvat, Gennadii Lisichkin, László Szamuely and Márton Tardos given to the questionnaire of Acta Oeconomica (1989/3–4) on socialist market economy. See also, Wlodzimierz Brus and Kazimierz Laski: From Marx to the Market, Oxford 1989.

Spoilsports are always booed off the stage. Unfortunately, however, one cannot overlook another reason for the lack of catharsis. What if the "brave new world" the transformer confronts beyond the barriers of the Soviet-type economy is greatly reminiscent of the old one? It may well be that neither his new sociological status, nor the actual economic processes of the transition will prompt the former reformer to readjust his ambiguous liberalism.

Advisers then and now

Strange as it may sound, in 1989 the reformers did not leave the stage of Eastern European economics as losers. Except for those who had not been able to differentiate between cooperation and collaboration with the old regime , the reform economists were not forced to leave at all. They were not compelled to withdraw to the seclusion of libraries or to start up businesses as entrepreneurs. Even before they had the chance to escape the public eye and ponder "where did we go wrong?", a considerable number of them, if not the majority, became incorporated into the new political elite.[9] Reform economists were thereby able to bounce from the position of potential loser to that of a winner.

Some of the ex-reformers have vaulted into higher places in the political hierarchy than they had previously occupied. They accomplished this due to the following circumstances: they had a rather good relationship with the dissidents; the new parties and governments had an urgent need for experts; and, most importantly, these institutions needed precisely those who could become "*engineers of the transition*"; that is, those who could elaborate party manifestos, draw up plans for national salvation or, simply, develop proposals for day-to-day crisis prevention. Thanks to the vacuum in political management in the first months of the transition, the first generation of transformers (Bajt, Balcerowicz, Klaus, Shatalin, etc.) could propose their mammoth programmes of stabilization, deregulation and privatisation in an environment almost free of institutional opposition. They did not have to confront in earnest either the *nomenklatura*—which was collapsing—or the parliament, which had not really found its feet yet. Since then, transformers have been extremely deft in what had been called under market socialism "reform mongering". Just as they did in the past, they are buying and selling Grand Designs, experimenting with alternative models, and constructing new schemes, though it

[9]Here I have in mind scholar-politicians such as Dyba, Dlouhy, Klaus, Komarek, Kouba in Czechoslovakia; Bauer, Bod, Kádár, Matolcsy, Soós, Surányi, Tardos in Hungary; Balcerowicz, Jozefiak, Lewandowski, Osiatynski, Mujzel in Poland; Aven, Gaidar, Jasin, Petrakov, Popov, Shatalin in the former Soviet Union; or Bajt and Mencinger in the former Yugoslavia. See also, Pekka Sutela: The Economic Views of Gorbachev's Advisers, Communist Economies and Economic Transformation 1991/1

is true that market and private property feature higher in their economic policy packages than ever before.

Why the fuss over their old-new role—one could ask with justification—as long as the intervention devised by the transformer does not serve the preservation of the command economy, but rather the dismantling of it and the creation of a genuine (not simulated) market economy? Could this be done in any other way? Could the state economy be deregulated without the help of new state regulations?

"Sound interventionism"

Below I will do everything in my power to avoid answering these questions. My sole pursuit in this paper is to find out in what manner interventionist arguments—some of which are indeed tenable—encourage transformers who began with a liberal creed to revert to their constructivist attitude. As years go by without the liberal order being firmly established, such arguments seem to crowd out all other ones in the economic literature on postcommunist transition. I have started collecting them and stopped counting at ten.[10] (They are not listed in order of importance.)

[10] Cf. Janusz Beksiak & Tomasz Gruszecki & Alekszander Jedraszczyk & Jan Winiecki: The Polish Transformation, CRCE London 1990; H. Bloomestein & M. Marrese (eds): Transformation of Planned Economies: Property Rights Reform and Macroeconomic Stability, Paris 1991; Csaba László: Közép-Európai rendszerváltás és stabilizáció (Systemic Change and Stabilization in Central Europe), Külgazdaság 1991/9; Marek Dabrowski: A lengyel stabilizációs program (The Polish Stabilization Programme), Külgazdaság 1991/3; R. Dietz: Transformation: From Command to Exchange Communication, manuscript 1991; R. Dornbush & J. Edwards: The Economic Populism Paradigm, NBER Working Papers, May 1990; John Farrell: Monitoring the Great Transition, Comparative Economic Studies Summer 1991; Roman Frydman & Andrzej Rapaczynski: Evolution and Design in the East European Transition, 1991, Manuscript; Gábor R. István: Második gazdaság, modernitás, dualitás (Second Economy, Modernity and Dualism), Közgazdasági Szemle 1991/11; Stanislav Gomulka: The Causes of Recession Following Stabilization, Comparative Economic Studies, Summer 1991; Irena Grosfeld: Privatization of State Enterprises in Eastern Europe. The Search for a Market Environment, Eastern European Politics and Societies Winter 1991; Tomasz Gruszecki: Privatization in Poland, Communist Economies 1991/2; Historical Precedents for Economic Change in Central Europe and the USSR, Oxford Analytica 1990; G. W. Kolodko: A lengyel hiperinfláció és stabilizáció (Hyperinflation and Stabilization in Poland), Külgazdaság 1991/2; Kornai János: The Road to a Free Economy...; A privatizáció elvei Kelet-Európában (The Principles of Privatisation in Eastern Europe), Közgazdasági Szemle 1991/11; Jiri Kosta: Ökonomische Aspekte des Systemwandelns in der Tschechoslowakei, in: R. Deppe, H. Dubiel, U. Rödel (eds): Demokratischer Umbruch in Osteuropa, Frankfurt 1991; Robert Kuttner: The Dustbin of Economics, The New Republic 1991/2/25; K. Laski: Transition from Command to Market Economy in Central and Eastern Europe, manuscript 1991; Helmut Leipold: Die Politik der Privatisierung und Deregulierung. Lehren für die Wirtschaftsreformen im Sozialismus, in: Zur Transformation der Wirtschaftssystemen, Marburg 1990; Paul McCracken: Thoughts on Marketizing State-Managed Economies, Economic Impact 1990/2; John M. Montias: The Sequencing

1. *Beware of survivors!* Strict government supervision is indispensable both to the assembly of parts for the new economic system and the dismantling of the components of the old one, unless our objective is to make it easier for the old elite to capitalize—literally—on their political privileges. Spontaneous evolution favours the strong—however, it was mainly under the *ancien régime* that one could accumulate strength. If privatisation is spontaneous, the result will be capitalism for the *nomenklatura* only. To assure equal chances for all, it is necessary, at least in the beginning, to discriminate against the old ruling elite. Anyway, nobody expects a transsexual man to increase the country's birth rate.

2. *Checking the lobbies.* The supervision of the transition will be ineffective unless it is coupled with the systematic dismantling of the economic institutions of the Soviet-type system and their accompanying lobbies, the breaking up of monopolies, and the disruption of the informal networks. If we deduct the state-party from the party-state, the result, unfortunately, will not be zero. Until the state economy has been fully demonopolized, a strong hand is necessary to keep the lobbies under control. The old monopolies must not be allowed to strangle, under the banner of *laissez faire*, the "young markets." A strong government must discipline the state sector before, during and after privatisation, keeping all possible budget constraints hard. Otherwise, inflation will spiral upwards, capital will leak away before it can be privatized, and stabilization will be obstructed by producers' strikes and financial chaos.

3. *Old-new socialism.* Because the state economy might come not only under liberal but also collectivistic criticism, socialist hopes, egalitarian endeavours, self-managment programmes and populist illusions may reemerge in the course of the old order's demise, especially in the case of a profound economic crisis causing rapid social polarisation. To protect the liberal path of social progress, it is necessary to restrain socialist leanings that are reborn along with capitalism. Third Way type programmes can, unfortunately, be built not only on the basis of the first

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(state) economy but also on the more market-friendly second (shadow) economy. The reviving trade unions should be counter-balanced by the government until the employers' organisations grow strong.

4. *Horror vacui.* The death of the old is not tantamount to the birth of the new: unless we are careful in sequencing the economic measures of the transition, illiberal wizards with their self-styled recipes can easily find their way into the "no more communism—not yet capitalism" void. We must be armed with detailed plans for pulling down the old house as well as for building the new one, or both might collapse on top of us. It is in this "transitional" stage of the transition that fatal mistakes can be committed. Until the rule of law (legal state) is asserted, it is the state that represents the law. While the market is not fully in place, the state has no alternative but to assist in privatisation. Until the private property becomes widespread, who else could launch marketization if not the state? As long as the market is incapable of stabilization, and so on...

5. *Cleaning up the mess.* Transformation does not start with a *tabula rasa*: the first priority is to clear away the physical, spiritual and moral heritage of communism as quickly as possible. The real work ("unmaking the omelette", "remaking the aquarium from the fish soup") can only begin afterwards. Over the past decades, things have fallen apart, and one needs detailed instructions to put them all together again, if that is even possible. Reconstruction will probably be facilitated by innovative experimentation. It is a unique historical trick of communism that even the measures designed to eliminate it bear its distinctive characteristics.

6. *The missing agent.* In the absence of a strong middle class (entrepreneurs, civil society, etc.), the state must act as its temporary substitute. At the same time, it has to produce and train the natural agents of capitalist development. This is not the first time this will happen in this region—as demonstrated by Gerschenkron and Polányi. Once again, a bourgeois revolution has to be launched with the subsequent approval of the emerging bourgeoisie. Indeed, the first thing we are building in our new house is the loft. To use the language of systems theory: the new economic order comes into being in an *autopoietic* way; that is, it creates the preconditions of its own genesis. We are not born to be entrepreneurs...

7. *Transition laboratory.* Postcommunist transition is an unprecedented venture in the history of mankind. Similar transformations are either removed from us by centuries (early capitalism), are anything but liberal (Southeast-Asia), or tend to be unsuccessful (Latin America). Undoubtedly, there have been more recent, more successful and more liberal examples which may be instructive for Eastern European transformers (the reconversion of modern war economies, the German social market economy, privatisation in the United Kingdom, etc.). However, their success has rested on institutional conditions mostly lacking in Eastern Europe. One thing is for sure: the means we employ today should be at least as statist as those of the late 1940s and early 1950s, when the German economy was stabilized

and freed from the legacy of Nazi rule. Until the appropriate techniques of transformation are found, there is a genuine need for macro-experimentation. At the same time, market simulation no longer works: there can be no more "Monopoly game" for adults played on a "plastic Wall Street." Instead, we have to choose between feasible capitalist arrangements, possibly even combining several of these, enriching them with new ideas. The only certain element in the transition is that every now and then the transformer will be confronted with uncertain developments.

8. *Time pressure.* The liberal expedition sets out at a time of an acute economic crisis. The distance between the point of departure and even a moderately liberal stage of the transformation is so long, and the expectations of the population are so high (and their limit of tolerance so low) that the transition may easily lose its original momentum. Step-by-step modification may be neutralized, whereas across-the-board changes are technically unworkable and politically risky. Given the interdependence and inertia of—and frictions between—the tasks related to transformation, if we want to prevent the process from collapsing, we must strive for an effective breakthrough right at the beginning. Therefore, we have to guarantee the critical mass of measures at the outset, and we must be adroit in selecting and ranking the subsequent steps in order to accelerate or at least sustain the pace of change. We are witnessing a new era of Sturm und Drang and we should not be ashamed of that.

9. *Technical, logical and political dilemmas.* There are numerous tasks that need to be performed simultaneously. (In the economy: marketization, privatisation, stabilization, modernization, opening up to the West, etc; in politics: democratisation, establishing the rule of law, reforming the public administration, institutionalizing social partnership, etc; in society: embourgeoisment, distributing the social costs of the transition, creating the "Capitalist Type of Man", etc.) By contrast, the working capacity of the decision-makers/transformers is limited. Moreover, the required tasks often support and, at the same time, counteract one another (some logically, some politically), and it is extremely difficult to compare the short- and long-term advantages and disadvantages of the qualitatively different processes. Thus, without a constant and occasionally daring rearrangement of priorities, the liberal transition will become too costly and painful. Similar to the truism that "once a leg has to be amputated, it should be done at once rather than bit by bit," shock therapy should only be applied only to certain stages and spheres of the transition.

10. *Transition is intervention.* A number of transformative measures require, almost automatically, goverment intervention in the economy. Resolute central guidance is part and parcel of processes such as macroeconomic stabilization, sectoral restructuring, comprehensive welfare reform, and liberalisation of foreign trade. A " stabilization surgery" cannot be executed by an "invisible hand." After all, there must be someone present to regulate wages, consolidate the currency, distribute subsidies, and adjust exchange rates, taxes and rates of interest. Let us not

forget, it was the party-state and not the state as such that became discredited this past half a century in Eastern Europe. There is a widespread desire for a strong but democratic government, administered by a highly qualified bureaucracy, which is capable of making limited and mostly temporary intervention in the economy. Such types of intervention create an appropriate environment for the market, without either replacing or distorting it. The history of capitalism cannot be started afresh: the free market tends to eliminate itself; it is better to have some minor intervention today than to have a major one tomorrow; the market should be protected from itself; the mixed economy was not born by accident. Besides, what has become of the conservative revolution of the 1970s and 1980s in the West?

After the first push

The arguments above have incorporated some of the stock expressions of leading Eastern European transformers. Without evaluating the arguments, it is clear that they portray the state as a "*chief architect*" of the transition. Furthermore, the state must be prepared to act as a construction manager, dispatcher, programmer, designer, laboratory assistant, tutor and arbitrator. *Horribile dictu*, it may even serve as a security guard (but not a night watchman!) and garbage collector. As far as the transformer is concerned, he supplies the government with pieces of (literally) constructive advice, and joins this crucial construction project primarily as a building engineer.

He speaks of tasks to be executed, programmes to be drawn up and deadlines to be met, and allows little time for observation and explanation. He is active, normative and programmatic. Yet, paradoxically, the uncertainties and theoretical dilemmas of the transition, as well as the general shortage of reliable information about the real processes of change, could just as reasonably argue not for but *against* state intervention.

Evidently, most of the roles listed above could be fulfilled modestly, with wise self-restraint and on a temporary basis. They could be performed in such a way that, wherever selection is possible, the less illiberal option is chosen. At this stage, let me voice some doubt. I think I have seen this cast of characters before. True, as a result of privatisation, the scope of government intervention is bound to decrease over the long run. In the short run, however, until the public sector starts shrinking, there may even be a considerable increase in state tutelage. Hence, it follows that the familiar dilemmas of reformism concerning the political base, timing, structuring, etc., of reform moves are unlikely to disappear for good from Eastern European economic thought. On the contrary, new dilemmas will probably appear. It is sufficient to think of the mixed results of shock therapy as applied to the issue of simultaneous liberalisation (stabilization) and democratisation.

There was a time when reform economists were justified in thinking that their stabilization and liberalisation proposals fell on deaf ears because the party-state allowed too little democracy in the economy. Now as transformers, they are about to learn, to their dismay, that crisis management, marketization and privatisation can be blocked in a parliamentary system as well, even though the new Social Contracts are more permissive than the old ones. The search for compromises through experimentation will therefore continue. True, from now on, the reconciliation of private property, market and parliamentary democracy (i.e, of historically more compatible concepts than "plan" and "market" in reformist thought) will be the aim of the trials and errors. Furthermore, even the compromise solutions are likely to come closer to the liberal ideals.

Let us return to the Hayekian dilemma of "how to arrive at a spontaneous order from an extremely non-spontaneous one, through evolution." After having absorbed the above ten arguments in favour of "sound (defensive) interventionism", one should be astonished if the metaphoric pendulum were to swing to the extremes of neoclassical liberalism. One would be equally surprised, if the economists firmly opposed to social engineering represented more than a negligible minority in Eastern Europe.

It is very telling that even the most devoted advocates of spontaneity (who are also the least limited in their political influence) such as the team of transformers working with the former Czecho-Slovak finance minister, Václav Klaus, act with a kind of "*delayed liberalism*" when cautiously defining the stages of "laying the foundations of capitalism". They assert that (a) spontaneous market selection is unsuitable for the rapid deregulation of an overregulated state economy; (b) resolute, so-called, "negative" reform measures should be taken by the government to accelerate deconstruction; (c) from among the components of monetarism, during the first stage of the transition, stress should be laid on restrictive rigour; (d) the initial steps of marketization and privatisation have to be taken under strict government control; (e) to serve the right goal—"market economy without adjectives"—one should not even shrink from collectivist solutions (see *kupon* privatisation); (f) the state should only withdraw, gradually, after the "*first push*" has been made and when the appropriate economic and legal infrastructure for market self-regulation has already been established.[11]

All in all, then, Friedman before Hayek. Confronted with the above arguments, innocent Western observers ask: what should we consider the appropriate infrastructure? That of the mixed economy of Sweden, Germany, the United States or Japan? Or that of South Korea or Mexico? Eastern observers, who are usually less innocent, may raise, full of anxiety, the following questions: who will decide

[11] Václav Klaus: A Road to Market Economy...; Das kann man nicht mehr kontrollieren, Weltwoche 1991/9/; V. Klaus & T. Jezek, Social Criticism, False Liberalism...; The Evolutionary Approach, Financial Times 1989/12/13.

when the appropriate stage of liberalisation has been reached? Why should the state quit, and why should the government bureaucracy commit collective suicide after having been so successful during the heroic years of the transition? What if sooner or later the state abandons Friedman and falls in love with Keynes again? Finally, those with no innocence, who were reared on Lenin's teaching about the withering away of the state, would simply feel at home when they hear the familiar explanation about the need to substitute temporarily the state for the middle class. (This time it is not the proletariat that has to be replaced by its vanguard, the Communist party-state.)

Many observers suppose that what we are witnessing in the Eastern European economies after 1989 is a kind of "transformation dictatorship" wrapped in neo-liberal arguments. As a consequence, they vehemently demand from the economists of the transformation a commitment to democracy, sensitivity to welfare issues and devotion to civil society. When will somebody notice the absence of serious neo-liberal arguments as well?

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ON THE EVE OF THE SECOND BANK REFORM

Z. SPÉDER–É. VÁRHEGYI

Analysing the present state, activity and institutional structure, as well as the efficiency of the Hungarian banking system, in the process of modernization beginning with the mid-eighties, the study attempts to point out the deficiencies which the system can only get rid of through a new reform. The major commercial banks depending on state ownership and on the enterprises, are struggling with internal structural and management problems, whose solution is indispensable of raising the efficiency of capital allocation. Although in the cleaning of bad bank portfolios the state has to undertake a role, the authors believe that the demolition of state ownership must be a basic feature of the second banking reform.

The 1987 modernization of the Hungarian banking system was one of the most important elements in the reform wave of the eighties; it was a contribution to prising apart the institutional frameworks of centralized capital allocation. However, it also showed the limits of the then reforms. It did not touch upon the substance of the earlier system—namely, the centralized type of economic management and the dominance of state ownership. The collapse of these taboos was necessary for further modernization of the banking system to become topical in the framework of a "second" bank reform.

The intent to continue the reform may, however, still become prey to short-sighted power interests. On the other hand, further development of the banking sector has become now more difficult because of the procrastination of many years. This is because the distorted roles and relative positions which were created by the 1987 "first" bank reform have become fixed in the past four or five years.

Our paper attempts to reveal, on the one hand, the deficiencies of the earlier bank reform and, on the other hand, the desirable elements of the "second" bank reform. In order to do this we present the conditions of the banking system—primarily of the commercial bank sector—today.

The current state of the commercial bank sector

We are going to review the operations of the commercial banking sector, the structure of its most important passive and active business branches, and of the circle of its clients, on the basis of the situation which had developed by the end of 1990. With the *exception* of the savings banks and cooperatives which engage in the deposit and credit transactions of the population, we have divided the banking institutions into three characteristic groups:

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"*large banks*": Magyar Hitel Bank (Hungarian Credit Bank) (MHB), Országos Kereskedelmi és Hitel Bank (Commercial and Credit Bank) (OKHB), Budapest Bank (BB), Magyar Külkereskedelmi Bank (Hungarian Foreign Trade Bank) (MKB);

"*medium-size banks*": Agrobank, Általános Értékforgalmi Bank (General Banking and Trust Co.), Általános Vállalkozási Bank (General Bank of Venture Financing), CIB II, Citibank, Creditanstalt, Dunabank, Iparbank (Industrial Bank), Inter-Európa Bank, Konzumbank, Mezőbank, Magyar Takarékszövetkezeti Bank (Bank of Hungarian Savings Cooperatives), Postabank (Postbank Corp.), Unicbank, Ybl Bank;

specialized banking institutions: Ingatlanbank (Estates Bank), Innofinance, Ipari Fejlesztési Bank (Industrial Development Bank), Merkantil Bank, Reálbank, Portfolióbank.[1]

With regard to the relationship between the large banks and the smaller banks, the first and most important question is whether it has been possible to break the large banks' monopoly position in the capital market. Looking at the grand totals of the balance sheets, *a slow shift between the market shares of the various types has already started but as yet, and for a long time to come, no breakthrough can be expected.* The share of the large commercial banks over the whole of the first four years decreased from 92 to 73 percent, while the market share of the more dynamically growing small banks accordingly increased. Within the group of small banks, the position of the commercial banks became stronger in relation to the specialized banking institutions.

Table 1

The distribution of balance sheet totals (in percent)

Description	1989	1990
Large banks	82	73
Medium banks	15	23
Specialized banking institutions	3	4
Total	100	100

Source: Annual bank reports

The balance sheet total for all the commercial banks at the end of 1990 was 1248 billion Ft, and it exceeded that of the preceding year by 33 percent. The corresponding figure for the large banks shows an increase of 22 percent, while for the medium-size ones the increase was 98 percent; the specialized banking institutions

[1] When classifying the banks, we have not taken into account those which had no data available for one of the two analyzed years suitable for evaluation.

also showed an increase that was much higher than the average. Nevertheless, the medium-size banks, despite the conspicuous increase, could not become real rivals of the large banks, while the specialized institutions are still *quasi* "captives" of their specialized situation.

Funds owned by commercial banks

The funds owned by the commercial banking sector are determined by totalling the subscribed capital, the accumulated capital, the reserve capital and the pre-tax risk reserves. This total relates to the period before tax grew within one year from 88 to 96 billion Ft, i.e. altogether by 9 percent. In nominal value the founding capital grew by only 5 percent, whereas the accumulated capital grew by 16.5 percent. The reserve for risks before tax, decreased by almost 3 billion Ft. Namely, since May 1989 there has been no possibility of developing such reserves. Therefore the changes may "only" result from consuming the reserves or from writing off the credit losses. It has been replaced by reserve capital, which amounts to approximatively 6 billion forints. (Though cancelling the possibility of developing a pre-tax reserve for risks was disputable already at the time of the original government decision, the government decided not to revise it, and this has remained the case up to the present day. A change will only be brought about if a new law on banking institutions comes into force.)

Table 2

The extent of resources owned by the different types of banks (billion HUF)

	Subscribed capital		Accumulated capital		Reserve capital		Pre-tax risk reserves		Total of own resources	
	1989	1990	1989	1990	1989	1990	1989	1990	1989	1990
Large banks	39.6	41.3	8.6	8.1	–	5.2	8.6	6.2	56.8	60.8
Medium banks	20.8	22.6	1.1	2.7	–	0.3	0.8	0.6	22.7	26.2
Specialized banking institutions	8.0	8.0	0.2	0.7	–	0.3	0.1	0.1	8.3	9.1
Total	68.4	71.9	9.9	11.5	–	5.8	9.5	6.9	87.8	96.1

Source: Annual bank reports

Table 2 indicates that the growth rates of not only the particular resource elements owned by the banks were different, but they varied also within the bank groups. The founding capital in the specialized banking institutions remained unchanged, whereas in the large and medium banks it somewhat increased. Growth in

the first group resulted from issuing shares to private individuals (employees) and from the paying-in of earlier capital increases that have become due. In the second group, growth came from the rise of the capital of Postabank, which amounted to almost 1.5 billion Ft.

While the *accumulated* capital slightly decreased in the large banks in nominal value, it doubled in the other groups. The decrease of the accumulated capital in the sector of the large banks can be attributed to a limited use of this resource element. For instance, it cannot be used for covering the credit losses, despite the fact that the accounting rules of banking systems working on a market basis know no such distinctions.

Almost 90 percent of the *reserve capital* can be found in the four large commercial banks, although this can no longer be attributed to the distribution of doubtful debts among the bank groups. Hence, the stock of doubtful debts in the medium banks and specialized banking institutions has grown without there being an adequate growth of the related reserves.

With regard to the own resources, attention has to be drawn to three sources of tensions. The size and slow growth of own capital does not provide for

— preserving the real value of bank capital,
— filling up the reserves needed for covering the credit losses,
— compliance with the capital adequacy requirement of the European Community.

External resources

In our analysis we review only the deposits and refinancing credits, these being the most important elements of the external resources.

The development of the stock of deposits by bank groups, in a distribution according to maturity is shown in *Table 3.*

The stock of deposits still amounts to about one third of the bank resources—summarized without including those of the National Savings Bank; however, increasing their share has failed, despite the significant efforts of the banks. An increment which amounted to 104 billion Ft (32.9 percent) was only sufficient to keep pace with the average growth rate of the resources (33.5 percent).

In the distribution of the deposit stock among the individual bank groups a significant concentration can be observed. Though their share somewhat declined, 78 percent of the deposits of the commercial bank sector is still placed with the four large commercial banks. At the same time, it is important to mention that a significant forging ahead by the medium banks is clearly evident, because their stock of deposits has more than doubled within one year.

The *maturity structure* of the deposits has continued to worsen, though this may be considered to be natural, owing to the rising inflation rate and to economic

Table 3

Development and distribution of the stock of deposits

Groups and maturity	1989 billion[a] HUF	1989 per-cent	1990 billion HUF	1990 per-cent	1990/1989 per-cent
Large banks					
within a year	190.5	71.2	255.5	78.4	134.1
over a year	77.4	28.8	70.4	21.6	91.0
Total	267.9	85.0	325.9	77.8	121.6
Medium banks					
within a year	34.0	88.5	81.8	93.7	240.6
over a year	4.4	11.5	5.5	6.3	125.0
Total	38.4	12.2	87.3	20.8	227.3
Specialized banking institutions					
within a year	6.5	72.2	3.5	60.3	53.8
over a year	2.5	27.8	2.3	39.7	92.0
Total	9.0	2.8	5.8	1.4	64.4
Total of the commercial bank sector					
within a year	231.0	73.3	340.8	81.3	147.5
over a year	84.3	26.7	78.2	18.7	92.8
Total	315.3	100.0	419.0	100.0	132.9
Total of bank resources	935.0		1248.6		133.5

[a]billion = 1000 million

Source: Annual bank reports

uncertainty. The share of deposits that mature within a year amounted to 81 percent of the total. A year earlier this ratio was somewhat more favourable, the figure being 73 percent. Though the proportion of time-deposits (for over a year) decreased in all the bank groups, from this point of view the position of the medium banks is the worst, because only 6 percent of the deposits have a maturity of over a year.

From the aspect of company saving intentions, it is important to note that hardly 15 percent of the end of year stock (the end of the year being December 31 1990) was tied up by some contract—i.e. that part of the deposits which reflects a real intent to save. Within this, the amount of deposits with a maturity over a year represents a mere 2 percent. A major part of the entrepreneurs' deposits—52 percent—consists of deposits for the settling of accounts, the expression of inflation

(41 percent), and the foreign trade deposits for special purposes; the latter appear as forced savings (11 percent).

The most important element of resources, following the deposits, is constituted by the refinancing credits of the bank of issue; their share within the total of bank resources is—despite their continuous contraction—still around 20 percent. Similarly to many other resource elements, the distribution of the refinancing credits is also uneven among the bank groups, as is reflected by *Table 4*.

The market of the refinancing credits is also characterized by the dominance of the large banks. With regard to the refinancing credits that mature within a year we can also point to a significant reduction of the market share—to 50 percent—while in the case of credits that have a maturity of more than one year, the hegemony of the large banks continues.

In the medium banks refinancing by the Central Bank has significantly increased (to more than double its earlier figure). However, this does not mean a turn in the policy of the Central Bank; the growth can merely be attributed to the increasing number of group members.

The specialized banking institutions are apparently on the margin of the market of bank of issue resources, though in the auction market they also have an opportunity to extend their resources.

Parallel with the changes in the distribution and structure of the refinancing credits, some modification in their allocation mechanism has also taken place. One such change is that the *extent of normative refinancing* linked to their own capital has fallen within a year from the level varying between 15–90 percent uniformly to 15 percent. It is a favourable feature that the stock of *current account credits*, disregarding the creditworthiness of the banks, has been halved over the last year. At the same time, this positive change has also had its drawback—namely, all those banks and groups who were given no other bank-of-issue resources beyond the normative refinancing credits, were more strongly driven out of this market than their favoured rivals. Simultaneously, the channels for increasing the short-term refinancing credits were provided by the export-financing constructions, the foreign exchange deposits and the rediscounting of bills of exchange. The amount of the stock of credits extended against foreign exchange deposits approached 50 billion forints at the end of the year, while the credits granted in the framework of export pre-financing amounted, at the same time, to more than 20 billion Ft.

Although the bank of issue resources have, even if slowly, been restrained from financing the commercial banks, the outlines of the new bank of issue regulations—which would even be able to deal with the foreign exchange deconcentration—have still not been developed.

Table 4

Development of the refinancing credit stocks and their distribution among the bank groups

Groups and maturity	1989 billion HUF	1989 per-cent	1990 billion HUF	1990 per-cent	1990/1989 per-cent
Large banks					
within a year	44.6	23.5	53.1	25.6	119.1
over a year	145.6	76.5	154.2	74.4	105.9
Total	190.2	81.4	207.3	81.4	109.0
Medium banks					
within a year	9.5	79.8	22.3	79.6	234.7
over a year	2.4	20.2	4.7	20.4	195.8
Total	11.9	5.1	27.0	10.8	226.9
Specialized banking institutions					
within a year	0.0	0.0	2.4	96.0	-
over a year	0.3	100.0	0.1	4.0	33.3
Total	0.3	0.1	2.5	0.6	833.3
Rediscounted bills of exchange	31.4	13.4	21.2	8.2	67.5
Total of commercial bank sector					
within a year	85.5	36.6	99.0	38.4	115.8
over a year	148.3	63.4	159.0	61.6	107.2
Total	233.8	100.0	258.0	100.0	110.4

Source: Annual bank reports

Active business branches

In the last year considered in the analysis the total of bank assets showed a 28 percent increase in nominal value, which is significant but lags behind the rate of inflation. Within it, the placings with a duration of more than a year hardly increased by 19 percent, while those maturing within a year grew by 46 percent. This difference reflects the inflationary adaptation of the banking sector.

With the placings for *over one-year* the large banks and the specialized banking institutions achieved above average figures (28 and 45 percent, respectively), and the medium banks a somewhat lower than average (14 percent) growth.

The decisive factors of increased growth in all the sectors included the following business branches: *credits to small venturers* (by 124 percent), *foreign exchange transactions* with foreign partners, *placings banks and banking institutions among each other* (by 163 percent), furthermore, *capital investments and property inter-*

ests (by 47 percent). Parallel with this, the *company credits*, which are still decisive because of the weight of their share, increased merely by a few percentage points, even in nominal terms.

Hence, the shift—which was positive from the aspects of the expansion of the business pattern of banking and the strengthening of the requirements of banking safety—was not sufficient to change the customary structure of bank assets, which continued to disregard the risks of interests and returns.

The development of *placings maturing within a year* was also different in the particular groups of banks: while the large banks attained a growth rate strongly below the average (13 percent), the medium banks reached 98 percent growth, and the specialized banking institutions 36 percent growth—the latter two figures being around or much higher than the average.

The factors determining growth were the following business branches: current account credits (44 percent), occasional short-term credits (40 percent), discounting of bills of exchange (99 percent), foreign exchange credits (146 percent) and placings of banks and banking institutions among each other. However, the individual factors were variously asserted in the different bank groups. It has to be stressed that in the group of large banks the current account credits, bill of exchange discounting and inter-bank placings were decreasing in the last year. Behind the reduction of the current account credits in the large banks the strategy (to be implemented in the medium range) was aimed at increased financing of transactions instead of clients. In the rest of the groups the increase of this element was linked to the extension of the sphere of business partners. Behind the reduction of the discounting of bills of exchange, an unequivocal "harmonization" of the large banks can also be observed: the short-term occasional credits and the bills of exchange show contrary movements. It is an additional motive of the large banks that by delimiting the discounting of bills of exchange the financial mediators can be driven out of the market. On the other hand, the figures developed in connection with the inter-bank placings show that the group of large banks remains a net debtor of the market.

Traditional financing of the entrepreneurial sector

Amongst the active business branches of the banking system the greatest weight is characteristically represented, even today, by *credit placings*. Within this, the most significant item is the stock of credits extended to entrepreneurs; the credits maturing within and over a year extended to this group approach 36 percent of the total of the bank assets. Though the bank credits granted to the entrepreneurs are typical in any of the bank groups, their significance varies. While

in the portfolios of the large or medium banks their share is 50–55 percent, this ratio is 37 percent in the specialized banking institutions.

Precisely because of this, it is not surprising that the share of the particular bank types in the entrepreneurial credit market is rather unequal. The major units financing the enterprise sector are the *large banks*. 62 percent of the credits maturing within one year and 80 percent of the credits maturing later than one year stem from the sector of large banks and, even within this, from the three large banks which were separated from the National Bank of Hungary in 1987.

The medium banks—despite the significant share of entrepreneurial credits in their balance sheet totals—are only secondary participants in the enterprise credit market. Their share in the loans with terms of one year or less is 29 percent, while in those with maturity over one year it is 6.5 percent. Larger amounts of investment loans were granted in this sector by only a few banks (e.g. Agrobank, Mezőbank, Postabank), while in the last year most of them did not grant any such credits. The increase on group level was also caused by the increasing number of the medium banks.

The specialized banking institutions take a peripheral place on the entrepreneurial credit market. Altogether 3.6 percent of the enterprise credits for terms within one year, and even less, 1.3 percent of those for over one year come from "specialized banking institutions". At the same time, owing to the continuous increase of short-term placings, one can say the specialized banking institutions, established for financing technological development, innovation and new ventures, assure their profitability to a decreasing extent by successfully pursuing the special activities emphasized in their articles of operation and in their business policy. The customary commercial banking activities and short-term business credits are increasingly gaining ground.

Within the sphere of credits granted to the enterprise sector, the business branch of credits to small ventures is worth emphasizing. In this segment a powerful concentration can be observed. Approximately two thirds of this market are in the hands of OTP (National Savings Bank). This fact—taking into account OTP's traditions, its professional specialization in this particular area and the wide network of its branch offices—can be considered as natural. Though the bank's dominance—especially in the market of the credits with terms of one year or less—somewhat declined during the last year of the analysis, the share of such credits granted to small ventures is still 38 percent, and in the credits with terms of over a year it is 77 percent.

With regard to their market share, the *large banks* are in the second place, despite the fact that these institutions are still very bureaucratic and their business policy has been concentrating—up until the present time—on the sphere of the big enterprises. With their 46 percent share in the credits with terms of a year or less to small ventures they have already jumped to first place and even the 16.7 percent market share in the credits with terms of over a year may be said to be significant.

However, it is too early to speak about a change in the business policy of the large banks, since within the total of their assets the small ventures still have a share of only 3.6 percent.

Though in the small-venture credits that mature within one year the share of the two other bank groups has increased somewhat, in financing this sphere of the clients the *medium banks and specialized banking institutions* still play a peripheral role. In the small venture credits with terms of over a year their common share did not exceed 7 percent even in 1990, while in the credits that mature within a year the same ratio was around 15 percent.

Table 5

Distribution of credits by bank groups (in percent)

	Entrepreneurs		Small ventures	
	1989	1990	1989	1990
Large banks	78	70	12	24
Medium banks	14	21	5	8
Specialized banking institutions	2	3	1	1
OTP	6	6	82	67
Total	100	100	100	100

Source: Annual bank reports

Though, owing to their size and business philosophy, the medium banks and specialized banking institutions are much closer to the sector of small ventures, their relatively small market share is not surprising. It is the large banks and OTP to whom a nationwide network of branches is available, and which are able to grant many-sided services, even to the small ventures, such services being accessible on the spot. This is important also because in this sphere—owing to the above-average risk—a credit relationship between the bank and the entrepreneur is unimaginable without prior experience being linked to the keeping of accounts.

The credit constructions for privatization

It is in connection with the financing of entrepreneurs that the banking sector has adjusted to the actual system of economic political requirements. It has done this by applying various combinations, supporting the process of privatization, and helping in the creation and the strengthening of the stratum of private owners. Such are, among others, the loans financed by the "Magyarországi Vállalkozásfejlesztési Alapítvány" (Foundation for the development of enterprise in Hungary), the "E-

credit", the refinancing credit framework of the National Bank of Hungary serving for privatization, the long drawn-out Start-credit.

Undeniably, the extension of the financing facilities—by increasing the demand for property—may contribute to the start of an entrepreneurial boom. However, something which seems to be a positive achievement for entrepreneurs, *may entail disproportionate risk burdens* to the banks. Though the possibility of credit appraisal exists in the cases of all the listed credit constructions, it can be asked how much use this can have in the cases of ventures with no antecedents—see, for instance, the loans for re-starting. Most of the novice ventures are unprepared and unable to properly assess the market, and the capital requirements needed to start a venture, or the risks entailed. The situation is even worse if such ventures are started on the ruins of earlier inoperable state property. Since the risks that appear here cannot be handled in the framework of credit constructions, such demands for financing ought to be ranked according to *venture capital financing* rather than *credit constructions*. Despite this circumstance, regulation is rather parsimonious: the interest margin of 4 percent provided to the bank undertaking to grant the credit is in no way proportional to the work to be accomplished and to the size of risk to be taken, especially if the venturer's own share can also be paid in compensation-notes (coupons).

Bank guarantee

Specific forms of extending "bank resources" and of "placings" involve guarantees undertaken by the banks. This item—which is shown "below the balance sheet"—increased in the course of the last year by 95 percent. The increment was significant in all the bank groups: it amounted to 93 percent in the large banks, to 62 percent in the medium banks and to 125 percent in the specialized banking institutions. Larger amounts of credit are granted by the medium banks and by specialized banking institutions—especially to partners of the large banks—only under the condition of a bank guarantee. Thus the risk of credit appraisal and placing is shifted. The amount of bank guarantees increased within the course of one year from 67 to 130 billion Ft.

In addition to the quantitative increase of the bank guarantees that were undertaken, their extremely *concentrated distribution* provides another problem. 94 percent of the bank guarantees were given by the large banks, thereby compensating for the credit demands unfulfilled because of the shortage of resources and/or due to lack of creditworthiness. Since to a certain extent the guarantees are often encashed by the banks, they then become actual items of the balance sheet.

The weight of the problem can be demonstrated by the fact that the proportion of undertaken bank guarantees to the total of the assets has increased: in the

banking sector as a whole this ratio increased within a year from 5 to 8 percent, and in the large banks from 10 to 16 percent. Though accurate data about the bank guarantees encashed are not available, on the basis of the deteriorating company positions it is probable that their ratio has also been increasing.

Capital investments, property interests

Since the establishment of the two-tier bank system in 1987, investment activity is the only one which has made unbroken progress. The expansion of this business branch was a typical feature of 1990: a 47 percent increase was recorded, and this resulted in the growth of the stock of investments and property interests from 22 billion to 32.5 billion Ft. A decisive part of the growth produced by investments is in the real sphere: the amount of these bank assets increased in the last year by 74 percent—in absolute terms by more than 8 billion Ft. The stock of bank investments in the sphere of financial institutions was stagnant—even nominally—throughout the last year.

Table 6

Capital investments and property interests (million HUF)

	Investments				Total investments	
	in financial institutions		in the real sphere			
	1989	1990	1989	1990	1989	1990
Large banks	7,297	6,314	9,517	17,089	16,814	23,403
Medium banks	647	1,655	1,903	2,938	2,550	4,593
Specialized banking institutions	130	174	1,192	2,283	1,322	2,457
Total	8,074	8,143	12,612	22,310	20,686	30,453
Increase (in percent)		100.9		176.9		147.2

Source: Annual bank reports

Though the expansion of this business branch in the last year was characteristic in all the bank groups, the decisive role is still played by the four greatest commercial banks: their capital investments and property interests grew by 6.5 billion Ft in the last year. This represents more than 75 percent of the increment experienced in the whole of the banking system.

The positions of the individual groups as related to one another and the structures, developing within the groups, reflect the contradictory role the business branch of investment played in the Hungarian banking system. Though investment is an immanent element in the activities of the universal types of large banks created

in the wake of the two-tier bank system, an autonomous investment policy and practice cannot be spoken of, despite the continuously increasing share of this activity. Namely, the major part of bank investments has come into being in a forced situation: the bank strives to change into shares the credits outstanding in the sphere of those enterprises that are unable to cope with the requirements of changing markets and products. This also happens to those enterprises which are incapable of restructuring their organization and whose financial management is parsimonious. It is precisely for this reason that it is not by chance that those banks which play the leading roles in the investments are ones where the decisive part of the company credits is concentrated, where the sectoral and company-level concentration is extremely strong, and where the major part of the doubtful and irrecoverable debts have settled down.

Among the roles played by the banks in the sphere of investments, the differing investment philosophies of the individual banks have also played a part. For instance, MHB (the Hungarian Credit Bank) was much more ready to convert debts into shares than OKHB (the National Commercial Credit Bank) or BB (the Budapest Bank). It has to be mentioned that, owing to the stock of doubtful and irrecoverable debts, there was an appropriate occasion for doing so in all three banks. The latter ones often preferred a "silent" withdrawal by strengthening the credit guarantees, even if the company had been in a crisis for some time and the bank in an emergency situation. Though the changing of debts into shares is increasingly being used as a way of coping with the doubtful and irrecoverable outstanding debts of the banks, any rational consideration of this policy will show that it contains significant risk factors. If the indebted company has not become finally insolvent and there is no sure intent of investment aimed at taking over the ownership share of the bank, the risk inherent in the conversion of debts into shares consequently increases. Those of the bank's claims which are covered by pledges and which enjoy priority (e.g. mortgages or mortgages for the security of bank credits) will be replaced by "proprietary claims" that are ranked in the last place. The risk will also be increased by the fact that transformation and/or reorganization of the companies needs not only special professional expertise but also takes time. It is precisely for this reason that even the claims converted at full parity, and the liquidation of property parts entail above-average risks. There is also the possibility that a share in the property will mean "forced financing" for the bank. This usual practice, which is acknowledged normal as a problem in company takeovers, appears when the additional capital injection keeps companies alive with unchanged frameworks of organization and operation.

Doubtful outstanding debts

The credit rating system of the banks and the formal criteria of granting loans have become more severe in the last year, the favourable effects of the system—such as the reduction of the number of the doubtful debts—were not apparent. It seems that the depression in the Hungarian economy and the deteriorating position of the big company sphere came to pass so rapidly and radically that the practice of bank crediting was unable to respond.

Table 7

Distribution of the doubtful debts by bank groups

	1989		1990	
	mill. HUF	percent	mill. HUF	percent
Large banks	21,227	88.7	38,838	84.3
Medium banks	2,352	9.8	6,377	13.8
Specialized banking institutions	349	1.5	854	1.9
Total	23,928	100.0	46,069	100.0

Source: Annual bank reports

With knowledge of the large banks' portfolios, the inherited doubtful debts and the concentrated stock of credits, it comes as no surprise that in the "market" of doubtful debts the large banks continue to play a decisive part, with a share of 84.3 percent. Within the group, the ratio of doubtful debts compared to the balance sheet totals increased and thus reached 5 percent. At the same time, it is significant that the medium banks—with virtually no doubtful outstanding debts—increased their share from 9.8 to 13.8 percent. Within the group there was even a bank where the proportion of doubtful debts related to the balance sheet totals reached 15 percent, while the average indicator of the group at the end of 1990 was only 2.7 percent.

The extent of development and the growth rate of the doubtful debts in itself raises questions about the implementation of a banking business policy aimed at protecting the depositors. The problem becomes even more obvious if we compare the doubtful portfolio with the reserves that serve the writing-off of credit losses. The three banks—MHB, OKHB and BB—which still carry with them the earlier heritage of the NBH, would need an extra reserve of approximately 30 billion Ft, if all their doubtful outstanding debts became irrecoverable.

Income, costs and profitability

A significant part of the banks' revenues (approximately two-thirds of it) is provided by interests received. However, there still are significant differences between the structures of revenues of the particular bank types. While the major part of the large banks' revenues consist of the interest from traditional commercial banking transactions, the specialized banking institutions obtain the majority of their receipts from non-typical commercial banking activities (e.g. by leasing, granting funds and other operations).

Table 8

Distribution of the revenues in 1990 (percent)

	Large banks	Medium banks	Specialized banking institutions
Interest received	71.4	68.0	41.6
of which:interest received from the central bank	1.3	6.4	0.3
Commission fees	9.0	9.3	1.0
Cost-refunds	7.5	1.6	1.4
Other	12.1	21.1	56.0
Total	100.0	100.0	100.0

Source: Annual bank reports

The *profit in relation to the revenues* was in almost all groups less than had been produced in earlier years; in 1990 it fluctuated between 12 and 21 percent, in contrast to the 25–30 percent around which they moved in earlier years. The rising cost level was, on the one hand, linked to the expansive widening of the branch network of the banks, to the modernization of banking technology, and to increasing labour costs; on the other hand, it was also related to the increasing costs of resources.

The profit produced in the commercial banking sector was approximately 46 billion Ft, which exceeded that of the preceding year by 13 billion Ft. Behind the average increase, different individual positions have developed. While in the large banks the growth was 18 percent, in the medium banks and the specialized banking institutions this indicator came to be higher than 70 percent.

With regard to the banking system as a whole, the *profit related to property* increased within a year from 44 to 55 percent. The higher profitability has evolved due to the proportionate contribution of the individual types of banks. The difference in profitability between the particular bank groups, owing to the ratio of own/external capital, continues to exist. Among the resources of the specialized

Table 9

Cost levels in the banking sector (percent)

	1989	1990
Large banks	75.2	81.1
Medium banks	73.4	78.5
Specialized banking institutions	72.0	81.7

Source: Annual bank reports

Table 10

Development of profitability by bank groups (percent)

	Profit as percentage of capital		Profit as percentage of assets	
	(1989)	(1990)	(1989)	(1990)
Large banks	45.4	55.2	4.0	3.9
Medium banks	32.1	40.2	5.1	4.6
Specialized banking institutions	16.2	20.2	3.4	4.7

Source: Annual bank reports

banking institutions the weight of own capital is relatively still great; this can be seen in their profitability, which is significantly below the average.

The outlines of a second bank reform

The present structure and operation of the Hungarian banking system bear the deficiencies of the 1987 bank reform. The structure, which was developed artificially by passing on the particularities of the former monobank system (and which has since been decentralized) has been unable to break through the walls of the segmented money and capital market. The banking system has been unable to free itself from the captivity of the credit market which is "governed" by the money demand of the big state enterprises.

The mutual dependence which has developed between the sectors of the big companies and the large banks through credit relations, has also been strengthened by the *ownership structure of the banks*. Beside the direct state share of 40 percent, the owners of the large banks are, to a great extent, precisely those enterprises which are at the same time the main credit debtors. Although supervisory regulations

have gradually reduced the sphere of transactions allowed between the banks and their owners, a really significant decrease in their number has not come about because of their mutual intertwining and the quality of the credits.

The direct and indirect ownership dominance of the state influences the behaviour of the banks through several channels. The state, as a direct owner, is interested in the operations of the banks in four types of the roles played by them and these roles raise requirements which are contradictory to one another. In its role as an owner, the state is in principle interested in the banks' stable profitability, their long-term capital increase and their ability to pay dividends. In this capacity, the state can be considered a "good" owner (what is more, better than others), because up to now it has not been characterized by a hunger for dividends that is resulting in "living up" the profit. This moderate behaviour, however, is not independent of another type of role, which is oriented towards the increase of the revenues of the state budget. In this respect the state is definitely interested in the generation of "fictitious" bank profit—namely, in this it has a significant share. This comes about through taxation, and its amount is a multiple of the dividends.

The third role is connected with the implementation of the government's economic policy. In this capacity, up to now the state has urged the maintenance of the big companies' *status quo*, rather than weakening them by withdrawing the bad credits. Hence, it has contributed significantly to the development of the above-mentioned problems of the banks.

Finally, in its surveillance of the banks the state has proved to be fairly weak. Though it has gradually "hardened" the requirements regarding bank operations, it has not really been interested in implementing them. Also, it has been unable to assure, against fiscal interests, a principled system of requirements that provides safe operation of the banks.

Beside direct state ownership, the effect on the banks exerted by the ownership role of the state companies must also be considered. Companies that pursue economic activities in a socialist way not only fail to strengthen safe and efficient bank operations, but actively contribute to the development of bad credit portfolios. Their relationship to their bank is not really one of an owner, but it is formed primarily in accordance with their position as a credit debtor. Their basic interests—if for no other reason than their individually small ownership shares—are embodied in a struggle for the fulfilment of their momentary credit needs.

In addition to the legacy of earlier credit allocation and the survival of mutual dependencies and the direct and indirect proprietary role of the state, we must also mention the surviving *politically motivated influences* on the commercial banks. These actually survive despite the new circumstances which came about after the free parliamentary elections. The demand and promise to "bring order"—both before and after the parliamentary elections—was precipitated by emphasizing existing and imaginary anomalies of the banking system. Some party ideologists attempted to win the society—which had been educated in a framework of anti-

market ideologies—for their own political purposes. They did this by arousing a public feeling that was hostile to trade and banks. Populist declarations that were opposed to banks and bankers (e.g. those that blamed the banks for the applied credit interest rates or accused them of denying certain concrete commercial credits) were signals which rightfully caused hesitation in the (Hungarian and foreign) participants in the banking world.

Beyond the ideological overtones, in their search for a new power basis the government parties have also made the situation of the banks, primarily of the large ones, uncertain. In a semi-market economy with an eighty-percent state economy, the methods of governing that may easily gain acceptance are those which try to carry through their economic policy by direct management of the strongest participants in the economy. The initiative to re-elect the company councils and to change the management of the companies still under the supervision of state administration also show a tendency in this direction. It has been (and is still) feared that the process may be accomplished by the more or less open "subordination" of the most significant banks, either by changing their management, or by a decision to appoint persons to represent state ownership on a political basis.

Such an atmosphere endangers first of all the managements of large banks in which the state has a high share of ownership. The banks that carry heavy burdens from the past and which are therefore unable to develop an independent strategy for getting out of the situation, have to manoeuvre more skilfully than earlier. In the given political atmosphere this means they have to be aware of the different parties, the government and the various bodies representing professional interests.

In our opinion a second reform has to change those inherited relations which could not be changed in the course of the 1987 reform (e.g. ownership), or which seemed to be impossible (e.g. arranging the inherited credits), or which looked undesirable (e.g. asserting European norms). In the course of this reform the banking sector has to be freed from the dependency on the state and its preferred companies. The power relations, economic constraints and artificially built-up walls which push the interests related to implementing the monetary targets and effective capital allocation into the background, have to be broken down. Carrying out such a reform means a self-limitation of power, postulates self-restraint by those forces standing behind the government, and furthermore the reinforcement of the authorities who will regulate and supervise the operations of the banking sector on the basis of professional viewpoints.

The codifying and problem-solving work going on in expert workshops of the state administration mostly reflect this recognition. The draft bills on the bank of issue[2] and the banking institutions, that have been approved by the government, anticipate the possibility of forming a central bank with greater autonomy than before, and developing a banking system which operates in conformity with modern

[2] This has been enacted in the meantime—Ed note.

European norms. The government's proposal to write off the inherited doubtful outstanding debts (problem loans) through taking over some of the related burdens by the state budget, may also assist the banks in freeing themselves from the captivity of forced credits. Also, the government's concept of privatization no longer raises principal hindrances that prevent the commercial banking sector from being placed even in private majority ownership. It requires only that the majority of the greatest commercial banks are maintained in national ownership.

However, the problems are, as usual, hidden in the details. The principled intents of the reform measures that have been emphasized may easily get lost in the labyrinths of improperly delimited and/or incidentally oversized governmental licences, or in rebuilt power positions.

In the course of elaborating the draft bill on the financial institutions, emphasis was laid not only—and even not primarily—on the conceptional debate about the desirable development trend of the banking system, but on the authorised sphere of intervention by the supervising body and by the government.

The conceptional discussions on the *type* of banking system to be developed have finally led to a compromise. The latter, though formally different from the European development trend (in that it raises restrictions against the universal type of banks), practically allows the commercial banks to pursue the activities of trading in securities. It also allows them to be trustees of investment funds, acting through the subsidiary institutions owned by them. No doubt that in the process of integration in the European Community the legislation will be forced to abandon the restriction and to comply with the European regulation that allow universal banking.

In the course of the lengthy elaboration of the bill, another important point dealt with the *licences of the supervisory organizations of the banking system.* The view that the establishment of banking institutions must not be left merely to the market, was one that was strongly held. Accordingly, bank surveillance and the government are qualified to judge whether a new bank coming onto the market "strengthens the economically necessary competition". Such licences given to the organs that permit the foundation of a bank would greatly expose both the existing and the potential members of the banking sector. The final bill submitted to the parliament authorizes the licensing government to judge the extent of the "economically necessary" competition only in those cases in which the founding of such banking institutions or the acquisition of ownership in them, involves a foreign ownership share that exceeds ten percent. The foundation of all other banking institutions is bound to objective and normative conditions serving a safe banking operation.

The *exceptional position of the state* would also play a market-restricting role in relation to the owners of the banking institutions. In Hungary the distorted operation of the mostly (directly or indirectly) state-owned banks still stems from the lack of proper proprietary motivations and/or other interests that cross the

effective capital allocation. Hence, even today it is not reasonable and thus makes no sense to except the state from a limitation of its property share in any single bank to 25 percent, as is applied by the law in general to an individual owner. It should be clear that it is impossible to reduce overnight the state's 35–50 percent property share in the existing large banks. Yet it would be desirable that, within a transitory period to be generally specified by the law, the state should also be obliged to reduce its determining proprietary influence in the banking sector. Beside the general provisions, the state or self-governments would have the right, reserved for some important reason, to have a greater than the specified property share in certain banking institutions, provided that they are established for special purposes of public interest. In addition to financing government development projects, such a purpose may be a banking-type treatment of regional problems.[3]

The limited efficiency of the 1987 bank reform, and the insignificant improvement of the effectiveness of capital allocation in the years since that time, can be explained to a large extent by the virtually unchanged strong influence of the state. The state has exercised this influence in its role as an owner, and in other ways as well.

The illusion that the structural problems of large banks can best be solved by appointed representatives of a state working for good causes, has been disproved precisely by the system we wish to transcend. On the basis of historical facts and international experience, we have some hope that private ownership may bring about positive changes in the operation of the banking sector, too.

The state is able to influence the ownership structure of the banks primarily by regulating competition, and it can force safe operation of the banking sector with good laws and effective surveillance. Besides the monetary authority, the bank of issue also has some tools which it can use for influencing, on the one hand, the adequate bank liquidities and, on the other hand, capital allocation.

In addition to all these, the Hungarian state, as a determinant owner and mainly as possessor of the tax revenues, has the power to make the "problematic" large banks more attractive than they are today. The process of "cleaning" the bad bank portfolios and of cutting down the inherited doubtful debts with government assistance have started—albeit with a considerable delay. Based on the balance sheets of 1990, a decision was made that the state undertakes to guarantee to cover half the then recorded irrecoverable credits that have emerged on the basis of decisions made before 1987 (this refers to approximately 10 billion Ft); the condition for the three banks concerned is that they write off the other half at their own cost. This solution will unquestionably help the banks to offer their shares to the investors under conditions more attractive than today. This is necessary not only because of the overbearing dominance of state (or state-company) ownership, but

[3] Finally the legislators have accepted this proposal, giving the state a five-year transition period to reduce its share in the banks to 25 percent.—Ed. note.

also because it will help them to adjust, by the raising of capital, to the requirements of capital congruence—on West-European model, as formulated in the new bill. Such requirements are destined to protect the safety of depositors.

Despite all these points, a serious question remains open, and this is linked to the so far still unclarified government intentions regarding the ownership reform of the banks. This is, whether the reduction of the property share of the state will act as a catalyst to the privatization of the bank sector (which would be desirable in our opinion); or, whether the state will withdraw from the large banks when, and to such an extent that they can acquire new owners by increasing their capital. Since at present the latter alternative has some reality, it is worth drawing attention to its dangers, too.

The dominance of the state in the ownership (for which an ownership rate of 25–30 percent is enough, since the other owners can only have 25 percent), may deter otherwise interested investors (mainly the foreign banks). This is because it may obstruct the achievement of their business policy targets to a more than usual and, indeed, necessary extent. Consequently, not only will the privatization process be slowed down, but also an additional danger could emerge. Namely, owing to the continuation of dominant state ownership, the bad outstanding debts of the bank will be reproduced. (For it is practically the same state—which is not primarily business-oriented and which has already assisted in the creation of the earlier bad debts—that intervenes in the management of the banks.)

Another cause for concern is that if the large banks which are in a critical situation fail to find new owners within a short time, they will not be able to cope with the crisis of payments of the Eastern markets. These new owners need to be well-provided with capital, such that they have adequate money and business interests to eliminate the losses; also, in given cases, they should strive for a majority share. First of all foreign investors who see long-range possibilities in the Hungarian economy may come into question. It should be clear that, by writing off the bad debts inherited from before 1987, and by using state and bank means, there is absolutely no guarantee that the problems of the large banks can be solved. In the past four years an increasing proportion of credits placed by the commercial banks either voluntarily or because of government or company pressure—have, day by day, become irrecoverable, owing to the collapse of the big company markets. Though the draft bills on accounting and on financial institutions submitted to Parliament will, together, force the writing off of the bad or dead debts, it is doubtful whether the banks will have sufficient coverage (i.e. reserves for risks, reserve capital). Since reducing the degree of capital supply (which is anyway low both in international relations as well as compared to the volume of placements) is not desirable, it can be expected that the question of the doubtful debt settlement will again be put on the agenda next year. In the course of this less, or less direct state participation may be expected (owing to the fact that these debts had already been produced by the "new" banking system).

Coming back to the problem of the *reform of bank ownership*, the following questions require an answer: who could relieve the state of the proprietary management of the large commercial banks, and what should the ownership structure of the banks be like in the future?

While the range of the potential owners is fairly wide, in reality the possibility of choosing is narrow. Apart from the state companies, the domestic banks, private investors, foreign investors and the albeit almost non-existent institutional investors may come into question. However, this sphere is actually significantly narrower, this being due to the fact that already in the short term real owners and naturally developed ownership structures are needed. The new owners of the banks need to be applicants who emerge in the wake of economic decisions that take into account the conditions of competition in the capital market; the new owners should not be the result of forced mechanisms. The potential owners should be able to assert clearly their viewpoint as genuine proprietors. As is indicated by these requirements, at the moment a fairly narrow scope of movement is available for the development of new ownership structures.

We have already spoken about the contradictions of *state ownership* and about the necessity of pushing back the role of the state. The *companies*, when exercising their licences of bank ownership, carry the burden of even greater contradictions. The most important element of their proprietary motivation is to obtain a more favourable position for themselves in the distribution of credits; they can do this because of the control they have due to this ownership. In addition—similar to the state—they are also interested in withdrawing the short-term incomes. Hence, crediting on a business basis, as well as the property interests of companies as owners of the banks, have real inherent dangers in the short run. Despite this, we cannot give up company ownership. This is not only because independent economic units cannot be forced not to develop their investment policy on the basis of their own interests, but also because in the short run there is no other participant who would be able to take over the ownership interests of the company sphere. However, in the medium range, parallel with privatizing the company sphere, as an indirect result the banks will also be privatized, and the simultaneous decentralization of the companies will moderate the dependence of the banks. The remaining distortions of crediting can be eliminated by rationalizing the procedures and delimiting the credits to be extended to owners.

The proprietary activities of the *domestic banks* within the sector have, up to now, been indifferent. In many cases their role has been limited to providing for capital requirements, while in several other cases—for example, when the satellite banks were established—their aim has been to accomplish special tasks. Through bank ownership of the financial institutions some organizational formations seem to be taking shape, which show the way towards the European processes of implementing the development of a holding-like organization of banks. Therefore it is

necessary to delimit the banks' proprietary operations only as far as it would mean a significant restriction on competition.

While real privatization could result from involving the *private sector*, on the basis of its participation up until now it can only be considered as a symbolic actor. The poor demand of the population for bank shares is a decisive result of the fact that, owing to lack of insight into financial relation and the significant stock of doubtful debts, the investor stratum of the population does not trust the big commercial banks, and those who are thinking in short terms, are deterred by the low values of dividends. From the viewpoints of private investors there are such disadvantages as: the 20 percent resource tax, the lack of a liquid security market, which makes it impossible to realize (potential) gains from changes in quotations. Though significant changes can be achieved in these conditions even in the short run, it would be an illusion to count on a soaring increase in the direct purchase of bank shares by the population, even in a medium range. In the advanced market economies, too, the small investors do not aim to guide banks directly. Such functions are delegated to the institutional owners—who are as yet non-existent in Hungary.

Though we think that an increasing share of *institutional* ownership would be desirable under any conditions, in the short term and assuming organic development, we cannot count on it. Although the institutional and legal conditions for the emergence and operation of the institutional investors have partly been developed (see the Stock Exchange, the law on associations and securities), and are partly under development (see the law on investment funds), the economic conditions for bringing about masses of mediating institutions and their operation according to their real functions, are still missing. The Stock Exchange is in an embryonic state; neither the supply of securities, nor the liquidity of the market make it possible for even a single institutional investor to be able to optimize its portfolio on a profit basis. In fact, the confidence of likely investors has not strengthened—rather it has continued to weaken; this is partly due to the manipulating effect of insider trading and fictive buying and selling transactions. Inflation has reached such a level that it has brought about a general decline of demand for securities; this is particularly true for a market which is still in a state of evolution. The hectic movement of frequently sinking *prices* discourages even those investors prepared to undertake above-average risks. This is due to the strong inflationary expectations. In addition, the prices on the Stock Exchange do not reflect the real position of the debtor company, and capital market control is inoperative due to the artificial development of prices.

Based on the foregoing, there can be no doubt that if the government is earnest about privatizing the banks, significant roles have to be granted to *foreign* (primarily professional) investors. This is not only because the *capital necessary for the ownership reform* of the banks is not available within the country, but also because the restructuring of the banks requires *special expertise and foreign*

investors' contacts are needed (e.g. in order to sell the doubtful debts in capitalist markets).

However, it is not being suggested that foreigners should be allowed into the large banks' sector with no special conditions. Such entry should be tied to the fulfilment of *three conditions.* These are: the settlement of doubtful debts, the cessation of favours granted to joint ventures with regard to the banks, and full decentralization of foreign exchange management.

In the sphere of *portfolio settlement*—as we have mentioned—advancement can be expected within a short time.

Since the banking sector is a branch that fulfils special role and is customarily rather profitable, the maintenance of favours granted to joint ventures is by no means justified. Experience gained so far proves that the demands of foreigners for participation in joint ventures have not been affected by the fact that the government—in its licensing role—has treated the renouncement of special favours with particular concern. Hence, making such renouncement general would merely mean the legalisation by the legal system of a licensing practice that had shifted in a positive direction. Thereby, of course, only the "unjustified" outflow of foreign exchange could be restricted, but not the repatriation of capital and profit. Exporting the profit produced in joint ventures can only be prevented by a proper economic environment, in which there is confidence in the Hungarian economy.

The condition which is most difficult to realize is *decentralization of foreign exchange management.* Since in the case of the large banks that are subject to mixed ownership the involvement of foreign resources cannot be prevented, this may render ineffective a monetary policy aiming at equilibrium; this being due to the creation of money through accounts. However, this in itself is not a problem, because if the surplus quantity of money stands behind the appropriate financing targets, and through it a marketable commodity supply comes into being, the monetary equilibrium will not be upset, and the confidence in the domestic currency will also be strengthened.

The surplus quantity of money flowing in and generated through the banks in mixed ownership might be a source of danger, if the given bank strives to realize an extra profit in its business operations by activities containing above-average risks. However, this can only be imagined if owners behave irrationally and if there is a monetary regulation that assists their activities. If we suppose that the investors who wish to be involved in the banks strive to implement a long-term strategy, and even as proprietors do not want to risk their money by financing a "company sphere that undertakes any conditions of interests"—and cannot obtain guarantee for such transactions—the source of danger can be minimized.

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NOT EVEN THE CONTRARY IS TRUE: THE TRANSFIGURATIONS OF CENTRALIZATION AND DECENTRALIZATION

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One of the basic dilemmas of the Central European transformations is whether the process should be controlled from above or it should rely on spontaneous economic forces. This dilemma appeared on the surface in the process of Hungarian privatization between 1988 and 1992 as a continuous shift from a decentralized (enterprise governed) decision-making on selling the state assets to the centralized methods and than back again. The paper analyses the real process behind the official declarations, namely the intention of the government to the expansion of centralization and the reasons of its limited results.

The year 1991 brought about various shifts of emphasis in the rearrangement of the ownership structure. One of the most conspicuous of these shifts is the division of the decision-making right linked to transformation and privatization, i.e. of the role of the state in these processes. In principle, the distinctive feature of 1991 was—on the level of legislation—centralization. In summer 1990 the question as who should be the seller of state property became seemingly settled. In all matters of transformation, of selling property and privatization the State Property Agency (SPA), subordinated to the government, was vested with the right of decision-making. However, the actual assertion of this trend came up against certain obstacles. From mid-1991 on, voices calling out for decentralization grew gradually louder and demanded the reduction of the SPA's overpower towards enterprises and other government apparatuses. The draft bills, which first appeared in the autumn, reflected the effects of this pressure. However, the end of the year brought with it yet another new turn: although it seemed on the surface that there was to be a decentralizing of decisions, the forces of centralization forged ahead. What is more, this centralization not only affects the seller's role, but also concerns the totality of proprietary rights.

Decentralization in the shade of centralization

After the parliamentary elections, the SPA was given wide powers of decision-making with regard to transforming state-owned enterprises into economic associations and then selling them. However, these rights, even in principle, did not bear on all enterprise actions and in practice even the valid authorizations could not always be asserted. The limits of centralization can be studied from three an-

gles. First, what was (either formally or informally) affected by the influence of the SPA? Second, how far was the SPA able to control the contents of external initiatives? The third point, what were the results achieved by the centrally initiated programmes?

The sphere of authority and influence of the State Property Agency

The first important limit, laid down even in law, to the decisions made by the SPA in 1991 was that its control and powers of approval involved nothing more than the transformations and privatization. With enterprises which were not subject to such transactions, the proprietary rights remained in the hands of the enterprises' self-governing bodies and the branch ministries. Decisions made by the SPA affected 448 firms, and if pre-privatization is included, the total came to 819 firms (*Table 1*).

Table 1

*The number of decisions made by the State Property Agency**

	1990	I	II	III	IV	1991	1991/1990
		quarters of 1991				total	percent
Accepted transformation	27	12	55	10	112	189	700.0
Accepted establishment of companies	46	34	21	10	15	80	173.9
Other matters of property protection	38	18	43	29	80	170	447.4
Rejected propositions	19	3	1	1	4	9	47.4
Total decisions	130	67	120	50	221	448	344.6

Source: SPA data base (un-published)
*Without pre-privatization.

The second limitation is the value limit of transactions. According to the law, enterprises are allowed to implement transactions in values less than 20 or 30 million Ft within their own sphere of authority. According to the published data and our own estimates, only a small number of company-foundation went through the decision-making mechanism of the SPA. We assume that in 1991 about four thousand joint stock companies and limited liability companies were established with the participation of state property. The data of the SPA show that, until the end of September,[1] 237 transformations and 703 self-privatization sales were carried out. This indicates that the Agency was involved in one-quarter of the total number

[1] At the time this paper was completed the Central Statistical Office had not published the

of companies established. The data concerning the companies founded with foreign participation are more accurate. Based on the information summarized in *Table 2*, we can say that slightly over five percent of the joint ventures were established with the intervention of the SPA, though it is true that seventy percent of the invested foreign capital was concentrated in these deals. This proportion indicates that the firms not included in this number were probably small ones. However, there is the possibility that even greater transactions were able to evade central control. /For example, a well known tactic is to establish a small limited liability company and afterwards carry out a great increase of the initial capital.)

Table 2

Foreign capital investments registered by the Central Statistical Office (CSO) and the SPA

	1990			1991		
	CSO	SPA	SPA/CSO	CSO	SPA	SPA/CSO
Number of undertakings involving foreign interest	4343.0	93*	2.1	4098.0	220.0	5.4
Domestic capital invested (billion Ft)	63.2	20.4	32.3	39.4	77.6	70.1

Source: Calculated on the basis of KSH Statisztikai havi közlemények (Central Statistical Office Monthly Bulletin of Statistics) and SPA data base.

*The total number of transformations and matters of property protection added to the accurately given number of foundations of associations (estimated value).

To what extent was the SPA able to influence the transactions submitted to it? In fact the respective numbers do not show the decisive role of the SPA. First of all—with the exception of the short period covered by the third quarter of 1991—most of the initiatives (according to the evidence of *Table 3*) 95–100 percent of them came from the companies. Secondly, the number, or rather the proportion of rejected propositions decreased. In 1990, 19 propositions were not approved, and this represented 15 percent of all decisions; however, in 1991 this occurred nine times, and represented two percent of the decisions. Hence, complete rejection became exceptional. More could be said of the process if more were known about the weight of the issues that were approved in an unchanged form. On this point, only earlier information is available. According to the report of the State Audit Office on the first year of the SPA's operation (State Audit Office 1991), the vast majority of the transactions—disregarding pre-privatization—were initiated by the enterprises. Out of 229 such issues, 140 were not complete transformations

data for the fourth quarter. Thus the basis of comparison can only refer to the period lasting till the end of September.

but so-called property-transfer initiatives. These fell within the law on property protection and in 85 percent of the cases the property value amounted to less than 100 million Ft. In addition, 85 percent of the total of this type were approved by the SPA without any changes. These numbers show that a major part of the SPA's activities were connected with smaller business transactions and firms, and in practice the formally prescribed permission was granted without any detailed examination or interference. A conversation conducted with one of the leaders of the Agency confirmed this observation: the leader implied that the Agency is unable and does not even want to deal with petty matters, yet the majority of cases belong to this category.

Table 3

State and company initiatives in the decisions of the State Property Agency (in billion Ft)

	Dec. 31 1990	I	II	III	IV	1991 total
			quarters of 1991			
Total company initiatives						
–No.	111.0	160.0	540.0	49.0	193	948
–Value	65.0	170.1	266.5	36.5	124.8	264.2
Total state initiatives						
–No.	0.0	799.0	333.0	386.0	2050.0	3593.0
–Value	0.0	n.a.	n.a.	min. 252.2	min. 86.2	338.4
Company initiatives as a percentage of all transformations						
–by number	100.0	16.7	62.1	11.3	9.4	20.9
–by value	0.0	n.a.	n.a.	12.6	144.8	43.8
State initiatives as a percentage of all transformations						
–by number	100.0	100.0	100.0	23.9	95.1	88.4
–by value	100.0	100.0	100.0	12.6	59.2	43.8

Source: Calculated on the basis of SPA data.
n.a. = not available

When evaluating these numbers, it is, of course, necessary to take into account the point that the potential power of the SPA—even if it rarely resorts to it—may drive the enterprise plans in a definite direction. Their orientation would only be really clear and strong if central decisions were to be governed by an unequivocal, definite system of criteria. Instead of this, however, the viewpoints are multifarious and often contradict one another. For instance, the extent of sales returns may

come into conflict with strengthening competition, with the viability of the firm to be founded, with the speed of action, the viewpoints of the pace and costs with those of inviting tenders, the quickness of sales with taking measures against the monopolies and so on. All these aspects are represented in the "Guidelines of ownership policy," yet they have weighting and give free scope for individual deliberation. Also the importance of the particular criteria has changed over time—partly as the result of external pressure. In the spring of 1991 privatization incomes were lagging far behind the planned level. Owing to rebuke from the government (the Ministry of Finance), price became the most important factor. Later on—according to those participating in the decision-making—from the end of summer and beginning autumn it was mainly viability that was taken into consideration. As the abrupt decrease of the cases in progress indicates, the end of the year was the period of "tidying up the loft": decisions were rapidly made in all issues where it was possible, in order that the numbers would appear as favourable as possible. In addition, actions allowed for the SPA were prohibited for the enterprises (at least for some of them). One of the most serious charges against the leaders of the firms was that in 1990,—"living up" they "consumed" the state property[2]—this often led to their dismissal. At the same time and without more ado, the SPA allowed other firms to sale immovables. (Such were the 43. sz. Állami Építőipari Vállalat (State Construction Company No. 43), or the central building of CAOLA).

Under such conditions it was natural that the companies—often arm in arm with the potential buyer and the consulting firm—deployed all the tools available for exploring the actual goals, for bargaining and for exercising pressure—in other words, they adjusted to the rules of the game of official decision-making. (Csillag 1991) Thus, the existence and formal directory power of the SPA influenced the other participants; yet this was mostly evident in their forms of behaviour and not the substantial criteria of their propositions. In the latter sphere just a few rules of thumb developed—for instance: price should not go below the official property valuation, and it would be preferable for it to be one-and-a half or double the book-value. Also, it would be easier to accept a proposition if there had been some public competition of the buyers, or if earlier attempts at selling had been unsuccessful.

Looking at things in this way the chances of privatizing several companies ought to grow better. Beside the long series of approvals we know of several cases when the plans prepared for the sale of a firm were blocked by the SPA; yet it has done nothing to settle the future of the particular enterprise (for instance, the case of Hungarhotels has been protracted since 1989, that of the Nagykanizsai Sörgyár (Brewery of Nagykanizsa) since September 1990, of the Óbudai Hajógyár (Shipyard of Óbuda) since April 1990, and of Caola since the beginning of 1991. In not one of these cases has substantial progress been made.)

[2] That is, in order to obtain revenues and thus preserve solvency, they sold parts of the firm's immovables—Ed. note.

The "active" privatization programmes

The central programmes initiated by the SPA concerned 100 firms, which is barely one-tenth of the number of Agency decisions and cases in progress. The First Privatization Programme (FPP), destined to be of exemplary value in selecting the stable firms with regard to its procedure and its results, "turned out to be not as successful as we hoped" (Magyar Hírlap 1991) as it was evaluated by the top manager of the SPA. We might say: it ended in a spectacular failure, and became the show-animal of veterinary pathology, exhibiting all the diseases of the Hungarian privatization process, rather than a model of success.

The action proclaimed in September 1990, according to the original plans, should have been essentially accomplished by the end of 1991. However, with the exception of 3–4 smaller transactions, the handing over of property into private hands had (at least for the time being) failed. The actual result of 1991 was, instead of privatization, re-nationalization. The twenty enterprises affected were mostly transformed into joint stock companies with majority ownership being in the hands of the agency. In some cases (such as IBUSZ, Tritex, Kner Printing Office, Pannonplast, Richter Gedeon Rt.) also employee ownership was introduced, but only to a negligable extent.

Obviously, in this way the aim of increasing state revenues could not be achieved. Even the widening of the sphere of small investors was only carried out by selling (with favourable conditions) shares to the employees. The other method, via the stock exchange, did not work, even where attempts were made at implementing it (IBUSZ, Pannonplast, Danubius Hotel Company). True, this may be due to foreign political and world economic reasons, but the situation of the companies and the weakness of domestic demand must have played a part, too. Whatever the case, the FPP contributed neither to the widening the capital market, nor to the improvement of the viability and efficiency of the companies.

From this point of view even the selection of the firms did not follow the announced guidelines. One fifth of the so-called "good" companies (Volán Tefu, Erdőgép, Gamma, Salgótarjáni Síküveggyár) were loss-making or on a razor's edge, right at the outset. Others (like Richter Gedeon Rt.) fell into a difficult situation during the implementation of the programme. The reason of these failures was external—i.e. the collapse of the Soviet market; yet privatization was unable to help it, either by managing the crisis, or by accelerating the sales. This is one of the most serious causes and it is spreading over an even wider sphere: The SPA, with its complacent, complicated proceedings, protracts the process of selling—in the worse cases it discourages the investors. At the same time, the value of the company rapidly decreases, owing to the narrowing external and domestic market, and to the uncertain and defenceless position of the management. Thus, (using the vividly descriptive expression of István Csillag 1992), what is won on the

roundabout—by the higher prices arising from public and controlled privatization—is many times lost on the swings, owing to the insertion of the SPA's "staple right".

Similar devaluation of property can be caused not only by loss of the market—which emerges as an "elemental disaster"—and not only by the SPA's protracted decisions, but by other state—e.g. budgetary—actions too. The privatization of the hotels was halted because three preferences were withdrawn from them at the same time: the interest rate on their earlier obtained loans was raised from 6 to 27 percent, they were left out of the sphere of those entitled to enjoy tax cuts given to joint ventures, and they also had to renounce the preferences due on development credits. Such cases again call attention to the contradictions in the decision-making criteria. One cannot expect the simultaneous occurrence of rapid selling, high incomes from privatization and additional income that improve the balance of the state budget. What seems to be even more dangerous, while the government loudly announces the priority of privatization, it is at the same time authorized to take financial measures preventing this at any time and then, with outstretched arms, to say: unfortunately, the handing over of state property into private hands has proved to be unsuccessful. Thus the property, although having declined in value, remains under state control.

The first privatization programme also largely failed to achieve the announced purpose of vitalizing competition. The selling-off of enterprises in parts occured in several cases, but it was used only once (in the case of Gamma). Apart from that case a few units were detached from the hotels, before transforming them into companies.

From the summer of 1991—partly under parliamentary pressure—life was successfully galvanized into the "dying small privatization" process. (Heti Világgazdaság 1991) According to the original law of September 1990, the sale of 10 thousand units of 370 firms was planned. It came soon to light however, that approximately half the shops were in hands of cooperatives or private persons, or they had been rented by contract for long-term periods, or the SPA itself had withdrawn them from the pre-privatization programme (for the sake of selling whole commercial chains). According to the data of the SPA, until the end of 1990, 3767 shops were advertised, 3211 were put up for auction and 2120 were actually sold. The total income (according to data of October 31) was 2.6 billion Ft. Hence, the annual plan target was, by and large, approached, though at the price of compromises which did not eliminate basic defects of the original method.

The action started by re-nationalization. The SPA obtained not only the right to sell the firms which were earlier in the ownership of local councils, but it could consider as its own the property of every commercial and catering firm which had been transformed into several companies. One of the difficulties emerged from the resistance of the enterprise centres concerned. The bargain was then ended either by a peremptory order (drawing the firm under direct state control) or by withdrawing them from the scope of the programme, which meant for the enterprise

concerned at least the chance of keeping it together and finding the foreign investor (Hungarhotels, Centrum Áruház, OFOTÉRT etc.). The other hindrance was the system in which many decisions are concentrated in the hands of the SPA: it has had to deal with hundreds of companies, and with the valuation and advertising of thousands of shops. Decentralization of the preparation (and, together with it, the substantial power to influence) came to be unavoidable. The valuation of property and auctions were transacted by external firms and institutions and by those concerned. Instead of asset valuation, simplified property estimates were introduced. Hence, more than half a year after passing the law, in April 1991, the process was successfully started. (By that time, however, owing to the continually declining turnover, the interest in the firms and, with it, the achievable prices had in most cases decreased.)

Some important problems are still unsolved. In three-quarters of the cases it is not the property but the right of rent that has been sold. Although it is forbidden to give one-sided notice to the renter for ten years, and the renter's right can be sold, the opportunity for the local governments to demand a one-time utilization fee, and to raise or even multiply the amount of the rent, in effect means the renters are defenceless. A benevolent warning from the SPA was that local governments can be brought to court for such measures. The small privatization was promoted by reducing the put-up prices by 20–25 percent in summer 1991. True, instead of the planned 50-percent price-increasing effect of bidding, a mere 32-percent additional income was reached, even in relation to the lowered level. Considering the average for the year, one-third of the auctions—despite evidence of an improving trend over a period of time—was unsuccessful. Nor did the financial difficulties essentially change in 1991 due to the uncertainty of the construction of preferential credit, the high mortgage claims, the lack of institutions for moderating the risks, and the over-cautious attitude of the banks. Up to the end of November the so-called existence-loans were resorted to in 716 cases, averaging one-and-a half million Ft in each case.

The destinies of the other three programmes of the State Property Agency, which started in October and December 1990 and in April 1991, are even less promising. In general, the result is, in the case of "emptied" centres of property, the enterprises of the construction industry and the companies belonging to the vertical line of wine processing, that the firms come under the control of state administration (similar to the first privatization programme). This, if it is implemented together with commercialization, means an expansion of the proprietary role of the SPA and the growth of the assets under direct state control. *Thus, the intention of centralizing the selling rights has in fact led to the centralization of the state's ownership rights.* Before this process really had a chance to unfold, however, attacks against the centralized system of decisions concerning selling rights had started.

Centralization with the slogan of decentralization

The ambivalent results of rope-pulling among the offices

The first sign was the "Kupa-programme"[3] in February 1991 which pronounced: "a detailed privatization strategy is forthwith needed, for increasing the efficiency of the SPA's work and for decentralizing the process of privatization". (A magyar... 1991) The first proposition of the Proprietary and Privatization Committee (PPC) was accomplished by the end of March. This marked the beginning of the debates which culminated in the summer, at the sessions of the Economic Cabinet. In addition to the Committee, the main participants included the Ministry of Finance, the branch ministries (primarily the Ministry of Industry and Trade), and the State Property Agency. Each participant presented its own suggestions, so that the Economic Cabinet discussed at least three or four versions, one after the other. The government tabled its approved strategy and the guidelines of its ownership policy in Parliament but it was swept away by the accelerated legislation process at the end of the year and by the surprising lack of interest shown by the majority of the members of Parliament. Up to the beginning of 1992 Parliament was not prepared to accept a decision of obligatory force. Nevertheless, preparation of the partial laws is going on with a conspicuous hurry, as if the results of the voting on the general principles had already been anticipated in advance.

This brief outline of events shows that the legal framework of the organizational and ownership changes will invariably be determined by the struggle for power fought by the state organizations against each other.[4] This process, however, will be informally influenced by other participants too—i.e. by the enterprises concerned, the potential buyers and the political parties. (In the appearance of the trend towards decentralization—beyond the evident failures and stuggles within the government—the pressure of the opposition (mainly of the Alliance of Free Democrats), and that of the enterprises and the consulting firms has also played some part.) The bargaining negotiations have, so far, excluded the wider public as well as expert and parliamentary discussions.

Accordingly, the rope-pulling has been going on mainly around the questions of "division of labour", i.e. division of power, and the right of disposition over enterprise property and incomes from privatization. The first programme of the PPC was still a relatively restricted one. The summer proposition of the Ministry of Finance contained an open attack against the "overpower", and the bureaucratic and slow proceedings of the SPA. It suggested splitting up the SPA—thus setting up three top organizations of ownership and privatization—and wished to draw the

[3] M. *Kupa* is Minister of Finance in Hungary. Ed. note.

[4] This phenomenon is analysed in detail by KOPINT-DATORG in its Report on business cycles, No. 3. 1991.

Agency essentially under the supervision of the Ministry. It wanted to prescribe self-privatization as the general rule and not as an exception. The plan—like the PPC—also designed significant rules for the observance of the branch ministries in restructuring the firms and in supervising the board of managers of the holding company i.e. the State Property Company—SPC).

The latter section also indicates that in the spring and summer of 1991 the Ministry of Finance—in contrary to the traditional line—formed an alliance with the ministries against the SPA. The ministries basically agreed with the proposition of the Ministry of Finance, but they wanted to acquire some part of the incomes for themselves and for the firms. Furthermore, they contested the list of the firms that were to remain in permanent majority state- (national) ownership. (The list had been circulated since March.) They wished to keep altogether 155 companies in this sphere (meaning fifty percent of the property involved in industry and trade), while the PPC and the Ministry of Finance suggested a figure that was one-third of state assets.

At that time, the State Property Agency started an offensive strategy. While it affirmed repeatedly that 99 percent of the decisions of the SPA were based on enterprise initiatives and 90 percent of the income was stemming from them, in the summer it increased significantly the number of state initiatives and decisions. Anticipating the recommendations of its rivals, in July the Agency proclaimed self-privatization—with no legal basis whatsoever. In the first period 300 small firms were put on the list with a total value of about 20 billion forints. (By December the number of firms had increased to 370; 161 firms concluded contracts with consulting companies, and 20 business transactions were completed—in a value of about one and a half billion forints. The number of self-privatization actions in progress was 353. More than half the transactions registered and started by the SPA—representing, however, only six percent of the property concerned—belonged to this category.)

The ownership and privatization strategy approved by the government shows that in the autumn of 1991 the Agency succeeded in protecting its most important positions. Its organization was not split up into two parts, and it preserved its function in asset management. Its hierarchic subordination remained unchanged, and the president of the board of its directors continued to be a minister without portfolio. The only obvious "loss" is the organization that was to be set up for managing the permanent state property and the sphere of companies assigned to it—the scope of which is still undefined. The government strategy and the Ownership Policy Guidelines linked to it are tending towards a decentralization of the decisions on privatization, i.e. towards a reduction of the power of the SPA. The Agency itself seemed to agree with this. What is even more important, the turn was by no means as sharp as the propaganda of the government declared it to be.

The key element of decentralization is self-privatization. The government strategy, however, does not consider this to be the main rule—as was suggested by

the Ministry of Finance—but the initiative by the enterprises. It says about the latter that "with the exception of the strategically important firms, every enterprise may choose this method". (A kormány... 1991) Within this, the "simplified process" can be applied.

First of all, self-privatization does not differ much from the methods of the earlier period, contrary to initial assumptions. We have seen that enterprise initiative and—especially in petty matters—approval without modification have up until now had a preponderant role. Hence, the formal modification does not mean more than legalization of the former situation. Second, in the government documents the essential conditions of the new process—i.e. the sphere of authority and the responsibility of the particular participants—are not elaborated. As could be expected the concrete conditions were developed by uncontrollable bargains. (The rope-pulling between the SPA and the consulting firms actually started in the autumn.) Third, the "Ownership Policy Guidelines" state: the Agency, "with the exception of the property of enterprises and companies remaining permanently in state ownership... is entitled to initiate the privatization of any company and/or enterprise property." (A kormány... 1991, point 1.2) This formulation, at least, does not exclude that a sale left to the enterprises can, at any time, be withdrawn. In other words, the self-privatization right of a particular firm may be suspended at discretion. Finally, while the sphere of authority of the SPA may be significant even in self-privatization, centralization in other spheres (such as taking enterprises under direct state control, or collecting the share of companies, or in small privatization), is preserved even according to the new strategy.

Hence, the losening of centralization is partial and ambivalent. In addition, it is temporary as well. If, according to the forecasts, the "obligatory transformation into companies" is introduced, all state enterprises will have to transform themselves by December 31 1992, or else they will be taken under direct state control. Then, together with the enterprise councils and delegates' assemblies, the legal basis of self-privatization will cease to exist.

Thus, the trend of decentralization, declared in autumn 1991, was not free from contradictions, even in its principles. The chances of its implementation bear the imprints of the decision—making mechanism and the system of legal conditions. According to the proprietary strategy and the draft of the "Ownership Policy Guidelines", the government will gain an almost fully free hand in controlling and selling state property. Owing to the lack of society's consent, and of a legal basis, forces either within or outside of the sphere of government may, at any time, question certain elements of the strategy. Thus, wide scope is given for re-negotiating decisions and for the uncontrollable assertion of various interests. The programme, in this case too, is not the conclusion of an agreement, but the overture to a novel bargaining process.

Direct party influence and affirmation of proprietary rights of the state

It could already be felt in the autumn of 1991, and by January 1992 it had become certain, that there are serious forces which were able to swing the pendulum towards the opposite, centralizing pole. No consensus was reached—not only amongst the apparatuses but not even within the coalition, and moreover, within its greatest party.

A few weeks after the completion of the government strategy, the Monopoly group of the parliamentary faction of the Hungarian Democratic Forum (MDF) presented a privatization concept that was at odds with actual existing guideline. The essence of their suggestion is the full restoration of the founding and ownership right of the state, with a special focus on the protection of property—even at the cost of slowing down privatization. Their plan, being contrary to the government strategy, was contested by the presidents of both the PPC and SPA, and also by several experts. The presidium of the MDF called for support, however, the Economic Committee of Parliament at first did not even put the issue up for discussion—and even some members of the MDF voted against such a discussion. Yet a few weeks later, this body, as well as some other committees, gave way to the discussion. For the time being, however,—together with the strategy and the "Ownership Policy Guidelines"—the concept was taken off the agenda.

The changing atmosphere was also reflected by the autumn and winter conduct of the State Property Agency. First of all, the number of cases involving the drawing of firms under state control, multiplied. While in 1990 twenty firms were concerned in 1991 the figure was at least forty. Secondly, parallel with the starting of self-privatization, in the fourth quarter, the transformation into companies—only to a certain extent initiated by the enterprises—increased at an unprecedented rate, representing one quarter of all decisions in the year and approximately half the property concerned (see *Tables 1* and *2*). In the majority of these types of transformation the share of the SPA's ownership is one hundred percent, or at least it holds the majority. The property that is owned by the Agency—together with the banks—exceeded the amount of 300 billion forints by the end of 1991, according to our estimates.[5]

Thirdly, significant efforts are being made to strengthen the direct political influence on the institutions of privatization. The SPA, which was taken under governmental supervision in the summer 1990, seems to be getting increasingly under the direct influence of the MDF. A member of the board of directors who belonged

[5] The data—including the amount of revenues—in the period between the annual parliamentary reports, are wrapped in mystery. According to the government report of June 1991, the property belonging to the SPA amounted to a value of 95 billion Ft. We added to this 65 percent of the approximately 340 billion Ft value of transformations between May and December, taking into account the average ownership ratio of the SPA (see *Tables 3* and *4*).

Table 4

*The value of the decisions made by the State Property Agency (in billion Ft)**

	1990 total	I	II	III	IV	1991 total	1991/1990 II. quart (percent)	1991/1990 total (percent)
		quarters of 1991						
Accepted transformation	41.5	19.7	175.0	30.9	192.9	418.5	961.0	1008.4
Accepted foundations of companies	19.5	3.3	3.8	9.0	1.6	17.7	73.8	90.8
Other matters of property protection	4.0	2.4	3.2	0.1	13.0	18.7	407.5	467.5
Rejected propositions	4.9	3.9	1.1	0.0	0.2	5.2	26.5	106.1
Small privatization		0.4	0.7	0.7	n.a.	1.8	n.a.	n.a.
Total decisions		29.7	181.8	40.7	207.7	461.9	618.9	660.8

Source: SPA Data base (unpublished)

*In the accepted cases the market value of property is given, and in those in progress the book-value is given.

to the Alliance of Free Democrats resigned, and was replaced by a secretary of state. The latter is an MDF member standing near to the Monopoly group. A new post of "managing director" was created for the former agent in charge of the economic political committee of the MDF. The new political secretary of state of the Ministry of Finance came from the same sphere; at the same time, he was appointed president of the SPA's board of directors. Hence, the relative independence of the State Property Agency seems to be vanishing. It is not only the influence of the coalition's leading party that has increased but—returning to the concept of summer 1991—also that of the Ministry of Finance (not formally, but through personal contacts).

After the affirmation of the power positions it is no longer so dangerous for the government and the MDF to further extend the authority sphere of the SPA. Considering the working pace of the apparatuses and the internal controversies, the Ministry of Justice, the Ministry of Industry and Trade, and the Ministry of Finance were able to prepare, at surprising speed (i.e. by December 1991) the draft bills regarding the enterprise property of the state. One of the laws concerns the temporary state property, i.e. it essentially deals with the activities of the SPA.

The backbone (more than one-third of the paragraphs) of the law, the role of which is to formulate the government's concepts on decentralization, is the obligatory transformation into companies. Up to September 30 1992, it will also be possible for a company to initiate this. The SPA, however, still has to decide about the methods and conditions. After the transformation, every proprietary right—including that of foundation, of handing over the property to the management, of selling the assets, and of appointing the leading executives—is vested in the State

Property Agency. At the same time, the strait-jacket of company—in opposition to the trend of decentralization—means re-nationalization, centralization of ownership rights, an unparalleled extension of the State Property Agency's power and, beside that, an enlargement of the power of the institution destined to manage the permanent state property.

The idea involving the liquidation of the self-governing bodies of enterprises had already emerged in the first version of the comprehensive government programme—namely, in the summer of 1990. Later on this plan was watered down so that it became a prescription for re-election of managers, but the political intention was still unequivocal: it would be necessary to take action against the enterprise leaders (nicknamed "power preservers") and replace them with new, "reliable cadres". The background logic of the new version is presumably the same, though in 1991 two arguments of economic type were stressed. One of these aims was to ward off the delaying force of the restitution law: i.e. the pre-emptory right of the original owner ceases to exist if the property has been sold as part of a company. The other one is that the company form facilitates privatization. In the opinion of those preparing the law, it is easier to involve external investors in joint stock companies or limited liability companies, and to sell stocks or business shares than it is to sell off complete enterprises. Yet the events of recent years have, in general, not justified this assumption. On the one hand, transformation into companies may bring about an intricate network of ownership, especially if a cross ownership system of state companies, or banks is built up. This makes actual privatization more difficult. One example of this is the state of affairs surrounding Videoton.[6] On the other hand, it is precisely in the cases of firms near to bankruptcy, that real estates and machinery can be more easily and rapidly sold separately, than the business shares.

Before being transformed into some kind of company, or, if the enterprise fails to take the necessary measures by the given deadline, the SPA's board of directors is entitled to take any firm under direct control—without being required to give any special reason. The ideology is similar to that concerning transformation into a company—namely, the promotion of privatization. "The farms were drawn under state control. The aim is faster privatization"—this was announced with regard to the action extended to more than 80 state farms. (Magyar Hírlap 1991) In practice, this represents, here and elsewhere too, re-nationalization. The plan, of course, may be privatization. On the basis of central programmes and decisions made so far, however, we can by no means be sure about the result. (This is also shown in the case of the state farms mentioned as an example. According to a report of March 1992, the government made a decision according to which all state farms have to pass into private hands during this year. However, the legal conditions are

[6] A firm producing Tv sets, other telecommunication equipment—formerly also for the army and export—Ed. note

missing, and the ministry concerned wants to slow down the process. Thus the SPA is between the upper and the nether millstone and does not know what to do with the 140 new organizations left on its shoulders. Up to now only one thing happened: the leaders of more than half the farms have been dismissed, without any particular explanation being given. (Magyar Hírlap 1992)

Re-nationalization is disquieting also because the Agency has been even less able to cope even with its own proprietary role than with its privatization tasks. The method suggested by many—i.e. handing the property over to be managed by someone else, was only sporadically applied, mostly with rather poor results.

Under the new conditions, the future of self-privatization is not clear either. Self-privatization, formerly called "simplified *privatization* construction" (and now, in a treacherous manner, "simplified *transformation* process") was given only five paragraphs in the draft bill. The sphere is, even here, marked out by the board of directors, without any closer commitment—or the guarantee of extending it. The body, whose originally wide sphere of authority was defined by the principle of paity between parties and ministries and protection against the exaggerated influence of the apparatus, by the early days of 1992 had become an organization expressing the will of the MDF.

Thus, while pretending to loosen centralization, an unprecedented power concentration has emerged. Within the SPA, the board of directors has a free hand, while the organization itself partly draws away rights (of foundation) from the branch ministries and partly terminates the proprietary role of the company councils. *With the centralization of privatization, every ownership right and the right of disposal over the whole of state property has been centralized in one hand.*

In effect, the power of the SPA has only a single limitation, not in content but with regard to its extent: this is the State Property Company, (SPC), which will be a joint stock company for managing and utilizing the property that will remain permanently in state ownership.

The list of the companies remaining permanently in state ownership has even now not been finalized, after a year of negotiations. The government seems to have the intention of maintaining uncertainty, even in the long run. The sphere has not been defined either in the draft bill, or in the ownership strategy—which at least has been discussed by Parliament. The government wishes to keep this decision in its own hands and the intention is the regrouping the firms (which are in temporary or permanent state ownership) between the SPA and SPC. According to preliminary information, at the outset one-third of state property would belong to the latter authority and this would decrease to one-quarter by selling minority (or even majority) packages of shares.

What we are talking about here is a large group of firms, powerful with regard both to their dimensions and their influence. This is all the more pertinent because in all probability the giant monopolies of energy production and the basic material industries will also belong to this sphere. Their influence, and, because

of it, the part the government will play in developing the price- and cost-relations of the whole economy, will obviously be rather strong. The common bargaining power of the companies will also be strong in relation to the government. It is to be feared that a conglomerate—which is not transparent and cannot be controlled from outside—will come into being. The debate on the general form, i.e. whether it should be a "budgetary organization, or a company", even if decided in favour of the latter, does not help—rather, it worsens the situation. Namely, if permanent state property is organized in the framework of a joint stock company, it is formally not part of the central budget—Parliament is not even entitled to inspect its incomes and expenditures. (Former propositions wanted to exclude the controlling right of even the State Audit Office, but these motions were finally rejected.)

The denomination of a joint stock company which has no detailed definition of its rules of operation, leaves it wrapped in a mystery. Two things are clear. One is the hierarchic organization, the stages of which are: the government, the supervisory minister appointed by it, the stock company's board of directors and, finally—at the bottom—the producing stock companies. Another certain thing is the right to appoint the managers and the boards by the government (and the parties standing behind it). The draft bill leaves all other controlling and regulating rules undefined. Is the board of directors of the stock company interested in the incomes or in increasing the value of the property? It is not clear, to whom the stock company will give its assets for property management. What will the relations be like among the asset and the companies? To what extent will this system of control be direct, and who will be responsible, and for what? Can such a joint stock company go bankrupt? Can it depend upon the regrouping of incomes within the SPC? If so, what criteria will there be for any redistribution?

These questions are well known from the era of the planned economy. Given the experiences gained through the reforms of several decades, it is also known that there are no really good solutions. Of course, one can in principle argue that circumstances have changed: state enterprises have to operate under the conditions of a market economy. This "market economy", however, has not yet evolved and, at the same time, the mass of property and economic-political power belonging to the State Property Company (and to the State Property Agency) is rather large. It cannot be discounted that the rules of the game will be developed by them, rather than by the slowly growing private ventures. The latter, under the given circumstances, will be ready to adjust to the state-owned sector.

What can be brought about by centralization

Centralization of the proprietary rights had already started in 1991. This was done by increasing the number of firms under direct state control, as well as by

an increase of companies established with the majority share of the State Property Agency. This process will be, in all probability, accelerated and accomplished when Parliament passes the new package concerning the SPC and the SPA. Hence, centralization impinges not only on the selling of state property but also on the whole sphere of the proprietary functions. Furthermore, the appointment system of the leaders of the two big property centres (and the measures taken so far) indicate that here again the aim is to strengthen the direct influence not simply of the government but also of the party(ies) in power.

Evidently, company managers will try to anticipate the central decisions: they will make efforts to elaborate and draw up plans for self-transformation before the end of 1992. In the first three-quarters of the year rapid changes into companies may be expected. In this way, however, it is precisely the declared aim of the government, that will be injured, i.e. the preparation of privatization. The race against the threats of the state and against time will hinder the realistic asset valuation, internal restructuring, the changing of the organizational form and the involvement of foreign investors. What will probably happen—as we have seen so far—is that fraction shares will be granted to the employees on preferential conditions. This may be in the interest of both company leaders and the government: it increases popularity without risks. However, the economic results of a "people's capitalism" in Central Europe—where the task is not so much the redistribution of wealth, but the development of an ownership structure suitable for creating the market—are rather doubtful.

A substantial centralization of proprietary rights is obviously impossible. The State Property Agency has so far been unable to cope with a much smaller mass of property. Therefore one of the most important tasks of the second half of 1992 will be to build up the system of institutions for asset management. In the struggle for these rights—i.e. in the bargains conducted with state offices—the actual management will start out with the best chances. In this way it can return to its original quasi-owner position—now sanctioned by the state—and perhaps go further towards becoming a legal proprietor.

Thus, simultaneously with declaring the centralization of ownership rights, it is very likely that decentralization will start. Based on experiences gained so far, we may assume that there is little chance of centralizing the decisions on privatization. To speed up privatization by centralized methods at most distribution can be applied (e.g. extension of restitution, increasing the property belonging to institutions, to local governments, and to pension funds). Therefore, due to the practical constraint and under the pressure of the economic units, (and not as a result of government intentions declared in 1991 and since pushed quietly into the background) the first wave of self-privatization involving small-scale enterprises, may be extended.

The most important method of self-privatization has been—at least so far—the employees and management buy out. Thus, the company leaders can, beside

their agreements on asset management, preserve, what is more, strengthen their proprietary role. What they could not realize in the years of "spontaneous privatization" and what they were unjustly charged with at that time, is now possible by restoring the ownership rights of the state.

Thus, centralization may have the effect of ensuring the asset managing position of the mangers, as well as legalizing their proprietary role. However, the orientation point of company managers will be (in the former case, permanently, in the latter one temporarily), the government and the party in power. If nothing else, the rights of dismissal and appointment can be centralized. This means, for those concerned, dependence and threat. For those having the right to appoint, it provides the possibility to develop their clientèle, and, in its totality, it implies a new wave of interdependence between politics and economy.

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CHARACTERISTICS AND CRISIS SYMPTOMS OF THE HUNGARIAN AGRICULTURAL SYSTEM

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Food production, once regarded as one of the most successful branches of the Hungarian national economy, is facing a serious crisis. The agricultural sector, along with other spheres of the economy is also ripe for a fundamental transformation. The main cause of the crisis focuses on structural problems: it is rooted in the deepest layers of the enterprise organization system, the inadequate efficiency of economic management, the financial system and so on.

In our paper[1] we wish to analyse the major characteristics, the nature and reasons for the continuing and increasing problems of the development of the food economy over the last few decades.

The system of Hungarian agriculture

The role of economic policy in agriculture

Hungarian economic policy—under the direction of the planned economy, and even after the reforms of 1968—worked hard to influence the development of agriculture. The aim was to have an agricultural policy which, after assuring domestic food supply, provided a surplus for export; from 1974–75, there were specific arrangements for the exchange of cereals and meat for hydrocarbons from the former Soviet Union, and for vegetable and fruit exports to the former GDR. By creating a system of pricing, taxation and subsidies which *took notice* of the structure, it was possible to develop the technology and purchasing prices of processing and marketing appropriate at that time. Hence, the method of regulation started out from the experience gained from these factors, and from the prices of supply for meeting the *quantitative* demand—the latter being formulated on the basis of plans. The aim of the participants in economic management was—by taking the price and cost system for granted—to compensate for changing conditions (above all, changing prices), so that at the very least the stability of the system would survive.

Money was left with the agricultural enterprises only to the extent that it rendered possible continuous operation. This was the way in which economic manage-

[1] The paper has been compiled on the basis of the authors' study „Az agrárrendszer válsága és a kibontakozás lehetőségei" (The crisis of the agricultural system and the possibilities of finding a way out) published in a series of Pénzügykutató Rt. entitled „Jelentések az alagútból" (Reports from the tunnel).

ment was able to ensure that the enterprises developed—even after the reform—in the direction determined by the plans of the national economy; it also ensured that the funds accumulated would only be available for large-scale farming enterprises.

Owing to the isolation of the various market sections, their prices were fixed so that they would not interfere with the income interests of the next phase. Therefore a part of the incentive functions of the supplying prices were taken over by subsidies. The principle of agricultural prices adjusting to the inputs of those pursuing their activities under average conditions—complemented with a land-tax system aimed at drawing away a major part of the differential ground-rent—made it necessary to subsidize not only those producing on land with unfavourable endowments but even those operating under better conditions.

In addition to the aforementioned practice of pricing, the subsidies granted to the inputs used by the investment projects and by agriculture also made it possible for the will of the state to be asserted on a maximum level. In other words this system impelled the large-scale agricultural enterprises to make capital investments which were *deemed to be proper by government administration*. Thus the enterprises could only obtain support and/or special favours if they joined into some central programme. Economic policy created an *artificial market* where the prices of inputs, outputs and of the recommended investments were defined by central management. The incentives created by an artificial environment were intended to stimulate the enterprises to do what the state wanted them to do. This was the logic of the system.

The enterprise system and agriculture[2]

The enterprise system of the food economy of today came into being on the basis of considerations alien to the terms of a market—i.e. under the circumstances of the economy of plan instructions. The enterprises were formed in accordance with the agricultural sectors, and they were unified on a territorial basis so as to conform with *the logic of the planned economy*. This meant that not only companies in a *monopoly position* were established in some agricultural sectors, but also certain particular enterprises obtained the right to pursue a concrete range of operations in a certain geographical region. The role of the particular partial market sections was *taken over by the trust* responsible for the surveillance and control of the market in question. However, in this situation—i.e. protected against competition—the participants in the market were also compelled to undertake "non-market" activities. The trusts operating in the food economy had to maintain the smooth operation of their sector. They were obliged to buy from the enterprises belonging to them.

[2] For more details about the evolvement and development of the enterprise system and the historical analogies, see *Juhász* (1982), *Gaál, Juhász and Magyar* (1988, pp. 1–11 and 89–116).

They were responsible for providing proper domestic supply from the products of their sector. The companies in the counties had to ensure the supply of their own county (this meant that "free-booting" in other areas was forbidden).

Among the factory units or plants subordinate to the trusts, a forced division of labour developed. They sold and purchased commodities to and from each other and distributed their products in the market only after such transactions. The member companies were not allowed to choose their business partners, so the majority of their business deals were transacted through the trust centre. On the other hand, within the trusts a financial redistribution—especially with regard to investments—and a physical redistribution of the products took place. *The redistribution*, however, did not follow the logic of the market: it allocated the capital not to the activities producing or promising the greatest profit, but on the basis of some principle of "impartiality". Hence, the centre's way of thinking did not follow the market system of verticality; rather, it was interested in the reproduction of its own activities and power position.

The large-scale farms were in a similar position. In a particular geographic area they were the exclusive trustees of agricultural activities. The large collective farms—in accordance with the law on cooperatives—were charged with the *obligation to provide employment*. Therefore, in time they came to behave as if they were the protectors of the interests of the village population. Another forced role of the big farms was *the integration of the household plots*. However, the history of the *forced symbiosis* of small-scale and large-scale farms (which was declared to be the basis of the Hungarian agricultural miracle) well reflected the ambiguous attitudes of the leading agricultural policy-makers towards small-scale production. Small-scale production, which for a long time was regarded an unavoidable evil, only had the opportunity to develop in those activities which the large-scale farms could not carry out. However, owing to the various market and legal restrictions, even in these areas small-scale production had to work within narrow and petty frameworks.

The effect of the enterprise system on economic behaviour

The roots of the problems in the company system of the Hungarian food economy—the structure of which was overmonopolized and aimed at fulfilling non-market tasks—were to be found in the character of the monopolies.[3] This also made it difficult to harmonize (integrate) the activities of the various production verticalities. The Hungarian organization of procurement, processing and distribution was not created such that it could integrate the verticality of a given activity (e.g. that

[3] Concerning the institutional problems of inter-company cooperation see Juhász (1987, pp. 250–253).

of cereals-fodder-meat-meat processing). Its purpose was to uphold controllability, of all the processes—all of the latter being based on central conceptions. The phases that were organically linked to one another were often characterized in practice by a mutual lack of interest. In contrast, the organizations operating in the market economies of the advanced countries ensure that the connection between productive units cooperating with one another cannot be unnecessarily broken by the market. This is done inserting so-called meta-enterprise forms (which might even enjoy a monopoly position in their own sphere). Thus the common interest can be asserted throughout the whole verticality. For instance, in the West the integrator (a trading, or food industrial unit), such as pig-breeding, commonly organized the supply of basic materials, fodder, and the technology of fattening. Furthermore, it is also responsible for meat processing and selling. The participants of the verticality share in the profitability of the complete line of cereals-fodder-meat, which provides the effective cooperation and market activities of the partners.

This latter procedure barely operated in Hungary. Adhering to the previous example, the producers of the fodder mix were neither interested in the utilization of the fodder, nor the development of the animals, nor the quality of meat. All this led to deteriorating efficiency, and to troubles in production and marketing. Yet the source of the conflicts was not merely the existence of monopolies in the Hungarian economy. It was rather due to the fact that these monopolies had arisen not because of the extension of the activity system (ie. by integrating the verticality) but on the basis of official consideration. In this system the companies were exposed to monopolies on both sides, ie. in their purchasing activities as well as in their selling operations. In recent years the companies of the food industry have obtained more liberty in their operations. However, a development based on the vertical integration of certain product groups (needed for effective appearance in the market) has not been able to unfold in this way. This is precisely because these groups are encircled by monopolies. A situation evolved in which nobody could really develop. It was futile for a company to organize a particular production phase, because it was often defenceless when facing suppliers and customers. A company which attempted this was unable to exert direct influence on either the quality or composition of the delivered products or on the demand for its own products. It was pointless for a company to make innovations, for it had a monopolized customer and it was impossible to separate itself from the customer's demand for the old product, or from the earlier technology related to it. To a certain extent this is the factor which explains the standardized supply of the food industry, the latter having been a feature for decades.

Still worse is the situation in the sphere of *investments*, since there is no power in the system able to harmonize the investments of a given production verticality or that could avoid the internal logic of the phases being asserted in the utilization of sources. For instance, when a certain amount of capital was available for slaughtering capacities, it was used for them, often irrespective of the processing capacities

and/or the quantity of animals offered by the producers. This is a system in which autonomy necessarily leads *to sectoral restrictions, sectoral paranoid thinking, and to a phase-oriented development system*. The competition for obtaining investment resources became a war of redistribution. If a company wished to break out of its position try to harmonize the verticality of some product, it had to turn to the authorities of state administration. There was no other possibility of getting the green light for investment and also, in parallel, for getting the investments needed in the connected phases—i.e. needed for changing production and carrying out the related restructuring.

At the same time, there was never enough money in the hands of the leaders of economic policy and they were never in a position to finance the complete modernization of a verticality (e.g. that of animal breeding, processing and marketing). These two factors meant that development could only take place in phases that were separate from each other. The leaders of economic management did not follow purely economic views because they had to do justice to the various interest groups (such as meat producers, canning factories and pig-breeders). In doing so they were led by some principles of equality, so that the requirements of every lobby, or at least those of the strongest ones, should be largely met. This type of conduct regularly *reproduced intervention*, for the negative effects of the particular modernization campaign had to be continuously corrected.

In such a situation the behaviour of the participants shifted from an economic to a moral basis, and all those involved in the economy expected the others to play an appropriate part. The state expected the companies to pursue, in parallel, their market and non-market tasks and to adjust properly to the regulators contrived by it.

The companies, at the same time, expect economic policy to show the way, to give directives regarding the trend to be followed and, when necessary, to lift them out of their troubles. (If a company started some activity because of some central initiative and failed, even if it was its own mistake, the company expected economic management to help it out of the difficult situation.) Since neither of the parties could meet the commitments demanded of them, a mutual distrust developed. At the same time, none of the parties dared or was able to resign from the role it was meant to fulfil.

The enterprises of the food economy were characterized not only by a forced division of labour within the sector and within the trust; there were also forced contacts and constrained common lots that contributed to the rigidity of relations. The plants were allowed to contact only each other, even if some other enterprise could carry out the same work at a lower price. In such a system the aim was the stability and continuous operation of the company and the reproduction of internal power relations: the aim was not to make the company as profitable as possible. Hence, the different plant units within the company—the activities of which should have been built upon one another—had no effect on the quality of the products,

nor on the scheduling of inputs and outputs: similar to the situation in the trust organization and on the level of the national economy. For instance, the processing units of a company designed for the slaughter of many hundreds of thousands of animals were tied to their own slaughterhouse. Yet such a gigantic slaughterhouse—swamped in its own problems of deliveries and scheduling and in the surplus costs stemming from these—was inappropriate for developing the various fattening and breeding forms suitable for the different types of utilization. *The prime concern of filling up the capacities suppressed all other problems.*

At that time, the plant and organization system of Hungarian agriculture was characterized by two extreme types.[4] The first group consisted of *large-scale plants* which, owing to their sphere of activities, were, from the outset, inappropriate for fulfilling the original function of agricultural cooperation—the latter aimed at integrating the producers and developing them into a market power. (They were unable to do so because of the constraint of their non-market roles, which put them permanently in conflict with profitability; also, the artificial market directs them toward non-market solutions.) The large-scale agricultural plants were *simultaneously too big and too small.* On the one hand, they were too big for the fields of a particular village, and this is why such activities were often united in a single enterprise (from viticulture to handicraft industry, from machine repairs to pig fattening). Such diverse activities could not be fitted into a consistent production chain, because they usually had nothing to do with each other. By combining the particular branches in a common company the branches were expressly inhibited and prevented from building up contacts with their suppliers and customers independently and at their own risk, and so could not create a chain of vertical integration. At the same time, the Hungarian collective farms were too small, for none of their particular business were capable of producing a mass of products such that the quantity would have been sufficient for achieving a significant market share. (For instance, 400–600 cows are not enough for a cooperative of the dairy industry to be a powerful one. It has to build up cooperation with several other dairy farms and many private producers if it wants to bring about integration forms on which the producers can have strong influence.) It follows from this structure—which is at the same time too small and too big—that even though *the large-scale farms were of a large dimension, they were only able to produce on a small-scale level.*

At the other pole of plant organization were the small-scale plants. The small-scale plants—due primarily to political and legal limitations—were, from the outset, pressed into considerably narrow frameworks. Thus the activities they could start with were defined for them. The most decisive limitation proved to be the one that inhibited the obtaining of land. Since, for a long time, the small-scale producers were allowed to have only a minimum amount (1 "hold") of land, they

[4] On the problems of the dual plant system of agriculture, for more details, see Juhász (1973, pp. 43–55) Juhász (1990, pp. 129–130) and Gaál, Juhász and Magyar (1988, pp. 89–105).

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were primarily engaged in labour-intensive activities that were not preferred by the large-scale plants. However, if they started highly land- and asset-intensive activities (e.g. cattle breeding), they had to depend on the services of the large-scale plant. A political slogan was created out of this dependent position, stating that the big plant integrated the household plot—whereas the situation was rather a case of forced adjustment to a monopoly.

Deficiencies in the operation of the system

The defects in the operation of the agricultural enterprise system can be ascribed to the following: the American agricultural technology introduced by the government in the early 1970s operated not in a farming system, but in a form of neo-Taylorian plant organization.[5] Namely, according to the enterprise philosophy that was dominant in the 1970s, industrialization of agriculture meant that the organization system of agricultural plants should be copied from that of the industrial large companies. The simplification of Taylorian organization ideas brought about a strongly specialized form of labour control, divided into phases and persons (by introducing a managing organization of four or five grades); this form became general in agriculture. The caste-like system type of administrative organization that emerged from all this was significantly outdated in agriculture.

The large-scale farm separated, with rigid organizational borders, some activities. The results of the latter would have been appreciated by the market (e.g. mass fodder production and animal breeding). The agricultural large plant was an enterprise that was too big and too complex to enable a close unity of technological development, breeding and fodder management to grow independent of the totality of the company. It could not follow the logic of some partial systems (e.g. those of the fodder-meat or the fodder-milk line) and thus could not approach an autonomous, self-interested organizational process. The closed, hierarchic order within the enterprise prevented the coordination of the phases of verticalities. (The western farmer, even when preparing hay-fodder, is interested in milk production and not in the yield of hay or in the appreciative opinion of his boss. Consequently, he pursues mowing at another time and fertilizes using a method different from that of a tractor driver attached to the interests of the leader of the plant-growing sector, and working in a task-wage system. The farmer is interested to see that the soil is tilled properly and sowing done in due time, and not in running the tractor to the maximum possible extent of normal hectares etc.) In Hungary, the investments were separated from the requirements of verticalities. In making deci-

[5] For more details about the deficiencies in the operation of the agricultural large-scale plants, see Juhász (1973, pp. 43–55), *Juhász and Prugberger* (1988, pp. 97–101), Gaál, Juhász and Magyar (1988, pp. 89–105) and *Kopátsy* (1987, pp. 26–32).

sions connected to such investment, the company managers were motivated not by profit, or by realistic needs; they calculated by considering which activities qualified for state subsidies, or for loans with favourable conditions attached. Hence, bottlenecks and unutilized capacities were simultaneously created by the system. Considerations of quality were also not asserted, for the individual phases within the enterprise were hardly able to influence the quality of the preceding phase that was most important for them. Scheduling of the output was also linked to the interests of certain phases and not to the requirements of the whole production process. In this way the capital-intensity of production grew and this led, on the one hand, to the deterioration of fixed-asset efficiency and, on the other hand, to problems of current-asset management. Owing to the forced contacts within the enterprise, the quality requirements of the market were not transmitted through the mediating chains of the production verticality. Since there were no services competing with each other, only those problems of the partners that were pointed out within the company came to be sensed.[6]

Economic management was compelled to take notice of the fact that the individual market sections (those of industrial origin, of large-scale producers, of buyers-up and manufacturers, of consumers' trade and of exports) were more or less isolated from one another—this was the form in which they had been created. Since the participants in the particular markets were living in accordance with different rules of the game, and the contacts among each other reached only a very minimum level, some part of the market functions had to be *simulated by economic policy*. It had done so when developing the supplying prices which, after all, could not be asserted, for their effects could not roll along the whole chain of production and circulation. (Or, if they were asserted, it was only with significant disturbances, for the participants of the particular phases may have expropriated and wasted the surplus income that happened to appear in their area. On the other hand, some participants collapsed because of the deficit produced by the given phase.)

This was the reason why economic management was compelled to fix the prices and subsidies by the particular markets and by groups of interests, so as to avoid violation of the income interests of the subsequent phases. In this system the constraint of bureaucratic coordination was thus constantly reproduced, since in the case of any serious trouble the participants' attention turned towards the state budget and not towards rearranging the chain of cooperations. The harmful side effects of this are well known. They involved the spreading of technological and organization panels, irrespective of the circumstances (i.e. standardization of economic management), investment projects that disregarded the regional endow-

[6] A paradoxical situation developed: the company organization system in question, which came into being irrespective of the market, was able—with some extra inputs—to unite only those activities into an automatically reproduced and, if necessary, rearranged form of collaboration, among which the market could have adequately mediated.

ments and were disconnected from one another; there was a lack of interest in the return of fixed capital, poor interest in improving the productivity of soil, a tendency for the enterprises to isolate themselves (i.e. weakness of integrational contacts), and wars of redistribution.

Beyond all these, the main defect of the *system of prices and subsidies* was that it *impeded the transformation* of the organization system in which it developed. This had sufficient reasons of its own, for after the reform the task of the regulation system was not to promote reproduction on an increasing scale (and, within it, the industrialization of agriculture), but to *stabilize* the given institutional system and, together with that, the hierarchic relations among the institutions.

The crisis of the agricultural system

Processes in the period up to 1990

The real processes and the observation of the crisis by the leaders of agricultural policy

In the early 1980s economic politicians became aware of the fact that the structure of the Hungarian economy, from the aspect of world economic competitiveness, was developing unfavourably.[7] Still, due to the unfolding crisis of indebtedness, the measures needed for transforming the structure were not taken. A few changes of regulation—deemed to be in conformity with a market economy—were destined to initiate some processes that were to be used as starting points for a future restructuring. However, these measures were pushed into the background by the forced import restrictions and by the constraint that—irrespective of the profitability or the structural effects of a particular activity—anything that could be sold for convertible currencies had to be produced.

Though the restrictive type of economic policy (accumulation was restricted) afflicted the enterprises of the food economy more seriously than the earlier policy, their organization system continued to remain unaffected—in fact, it *came to be in a protected position*. In other words, in a situation in which an indebted Hungary found it difficult to produce exportable products other than food in appropriate quantities, the position of agriculture was necessarily revalued. In addition, after having overcome the crisis of indebtedness, the sector could even congratulate itself on having played the role of the "saviour of the country" (which, however, cost the country quite a lot, because the constraint of having to export pushed into the background every other economic consideration: it was necessary to export,

[7] For more details of the economic and political dilemmas of the 1980s, see Juhász (1989, pp. 180–182).

regardless of the expenses). The political power of the agricultural system also increased due to the fact that—despite the low capital efficiency developed in the large-scale units of agriculture—in relation to other sectors of the national economy, it was more or less effective. These farms, compared to most of the industrial plants, appeared to be successful and really economically managed enterprises.

The respect paid agriculture was especially enhanced by the fact that, beyond a safe domestic supply, with regard to both production yields and exports, it came to be in line with the most highly advanced countries. This was at a time when the macro-economies of the other socialist countries were struggling with serious troubles.

Hence, during the preparation of the programme for "dynamizing the economy", urged by the Hungarian Socialist Workers' Party in 1985, agriculture was in a *strong bargaining position*. The agrarian lobby was successful in putting across the belief that by intensifying meat production, and relying on the safe demand of the Soviet market and corn production as its basis, new resources could be revealed and exploited in order to increase the performance of the economy. Thus, it was necessary to encourage producers to reconstruct the animal breeding plants and to increase the range of processing. However, to achieve this it was necessary to increase not only the production and export subsidies, but—owing to its depressed position—the subsidies for the food industry as well. However, in the middle and second half of the 1980s—when it became obvious that world market prices were going to remain permanently below the high level they had achieved in the late 1970—the inviolability of the agricultural institutions grew weaker. It was possible to attack the Hungarian agrarian system because the food industry, despite the price scissors in agriculture, fell into an even more difficult price gap. In vain did the prices of agricultural products grow to a lesser degree than those of industrial materials—it was still a price rise. So, owing to the falling world market food prices, the food industry was *able to survive only by rapidly increasing subsidies*. By 1986–87 the situation was such that the food industry was able to work only if it received more direct and indirect subsidies, and these came to a larger total than the new value produced by the industry itself. Nonetheless,—in addition to this—even the direct subsidies to agriculture increased.

Despite the factors mentioned above, one third of the enterprises involved in agriculture and the food industry were, by 1988, lacking in current assets to such a degree that *their continuous operation was jeopardized*. This was despite the fact that they received subsidies for making settlements in the large-scale plants, for the reconstruction of plants, and for continuing production and exports.

After the change of government in 1987 it became obvious that even agriculture could not avoid the changes. It became ever more clear that socialist agriculture, built upon the forced symbiosis of large-scale and small-scale plants, had used up its reserves. The *small-producer private farms*, pressed between economic and legal restrictions, had *achieved the limits of their growth*. Also, *in the area*

of the large-scale plants, the number of farms employing irregular organizational forms and operating internal ventures even in basic agricultural activities, increased. These *experiments* broke open the frameworks of the legally possible forms; therefore the large-scale farms were forced to apply illicit internal regulations or acquire individual licences. The number of large-scale farms that had no prospects in the traditionally developed form were also increasing. Possibilities had to be created for these enterprises to try to make their activities profitable by using some new forms.

In order to solve at least some of the accumulated problems, at the end of 1987 the laws on land and on the cooperatives were amended, and in 1988 so too was the law on the agricultural cooperatives. However, these *amendments of laws* were still imbued with the attitude of "let us continue our well-proven agricultural policy". The protection of common property was a dogma that was stronger than any other principle before the eyes of legislators. Consequently, the Law on Land (1987) confirmed continuation of the monopoly of the large-scale farms on landed property. The first amendments to the laws on land and on the cooperatives came into being the following next year. The aim of the amendments was to permit the existence of a land-market and personal property for the members. However, even in these bills the standpoint continued to be asserted that the changing ownership relations must in no way disturb the safety of the existing enterprises—what is more, it had to strengthen their autonomy.

In the wake of the political changes that started in 1988 and accelerated in 1989, criticism of the agricultural system also strengthened. The Hungarian agricultural miracle and *the propaganda of success crashed* publicly, in front of everybody. The fact of the crisis became undeniable, because the large-scale farms, as well as the small-scale producers, were experiencing ever more serious problems in the course of their everyday operations (such as the rapid decline of capital efficiency, the abject state of one-third of the collective farms, the starting of running through property, the conspicuous disorders in the circulation system, and the problems of selling).

Everybody knew: these were not transitory difficulties, but serious troubles which had to be faced. Of course, the leadership and supporters of the sector searched for the reasons of the troubles outside of agriculture.[8]

The new political parties, primarily the Smallholders' Party, criticized large-scale agriculture more strongly than ever before. The most effective and powerful slogan was that which identified the agricultural crisis as the consequence of forced collectivization, thus making it appear as the agony of a fossil of Stalinism. This

[8] By drawing up their complete arsenal of the input ideology (the example of the corn combine; agriculture is subsidized in the West too; since 1982 the agriculture sector has been a net payer-in etc.) they endeavoured to present their troubles as problems of redistribution, but they maintained silence with regard to the internal problems of agriculture.

argument placed the problem of ownership into the centre, bringing up vividly descriptive examples of the agricultural cooperatives' practice of lavish and wanton economic management, comparing it unfavourably with the peasant farms of the past, and the present small-scale farms and the western models. Hence, a "dialogue between the deaf" came into being: the land conception of the Smallholders' Party raised memories of 1947, and it was accompanied by a whispering campaign against the "green barons", contrasting the latter with the more professional argumentation of the agricultural élite.

The open crisis and its major constituents

The years 1989–1990 were ones in which the Hungarian economy was severely shaken, and this included agriculture; at that time no political changes had come to pass. The economic system which had developed in the sixties and seventies and had been preserved throughout the eighties, *fell into deeper crisis*. Although this crisis did not question the fact that Hungarian agriculture enjoyed a distinguished position in the national economy, it made it clear that its traditional internal proportions, the system of its plants and enterprises and, above all, its economic behaviour and the demands and attitudes which had consequently developed in its participants, had become totally irrelevant.[9]

The Hungarian national economy was built up so as to ensure that agricultural exports and products of the food industry (which produce one and a half times the quantity needed for domestic consumption) would pay for the majority of Soviet energy and raw-material deliveries. The latter were vital for the metallurgy and chemical industries. To a certain extent these two industries operated in such a way that the processing industry, which before 1989–90 required twice as many western imports as it could cover with exports, could sell its mass products and the agricultural surplus to the West. Therefore, *agricultural surplus production played a role in preserving a circular process involving the wasting of energy and capital*.

With the collapse of the former socialist system, this division of labour became impossible.

The crisis which became acutely manifest in 1990, was no longer a simple question of redistribution; it meant that Hungarian agriculture faced a situation in

[9] "Only the producers of the agricultural sector believe that if they produce a bushel less of cereal, even on the worst soil, or a kilogramme less of meat—regardless of costs—that the country will be immediately lost". The agricultural producers still took no notice of the point that "... they have to act not for the sake of some incomprehensible, abstract, total economic interest; rather they should see that it is worthwhile investing their material assets, using their skill and workforce in the place they are, in the most rational possible—ie. the most profitable—way." Report on economic cycles (KOPINT, 1990).

which the *markets* for which it produced were narrowed down or *shocked* to their foundations.[10] For nearly half a century such a state of affairs had seemed to be impossible.

The collapse of the CMEA accelerated and the East European market grew uncertain. The payment difficulties of the Soviet Union, its decreasing readiness to receive new deliveries, and the end of the former GDR, caused major problems with sales of wine, vegetables, canned products and fruits.

The western channels which had been built up since the early 1980s—despite the ever increasing export sales return—were, for the most part, saturated. The zest for producing for these markets had caused overproduction of raspberries and geese. Because of the changing trends in the processing industry, a part of the Hungarian wool production became superfluous. The sharpening competition and the faltering Arab market made it more difficult to sell cattle and poultry.

The narrowing of domestic demand—owing to the continuously rising food prices and the declining real income of the population—brought about an oversupply even in the domestic market. Thus in agriculture the symptoms of a real classical crisis of overproduction began to appear.

New regulatory solutions and their effects

From the early 1980s on, significant changes have taken place in the organization system of the food economy. The process of splitting up the trusts was started, and as a result of this they ceased to exist in every sector. The commitments of supply based on sectoral and regional principles were cancelled. The monopolies of the foreign trade companies that had been tailored for the trust system were considerably loosened. A partial liberalization of exports and imports was introduced and measures were taken to bring about an open management of quotas and exports connected with a competition system. In 1991 the corn-exchange commenced its operations and so did the meat-exchange (as a matter of fact, these were not the result of government measures). There was a gradual loosening of the rigidity of the price system which, as mentioned above, had been differentiated according to market sections and groups of participants. More and more product groups were left out of the sphere of official prices. In 1989, with a developed corn and livestock market and supply market, the government decided to introduce free prices (with the exception of bread-grain and milk). This measure was taken for two reasons: on the one hand it was destined to promote transformation of the relations and, on the other, to take the wind out of the sails of those producers who were complaining about the agricultural price scissors. The regulatory solutions—although they

[10] For more details about the problems that emerged in 1990, see Juhász (1991), *Juhász and Mohácsi* (1991), KOPINT (1990).

were significant steps towards building up a market economy—could not, by their very nature, bring about clear-cut results. In other words, regardless of whether market-type or non-market methods were adopted, it proved impossible to regulate an enterprise system that had been created on the basis of the logic of a planned economy. Thus the intentions of the decision-makers were only partly achieved.

The participants in the economy have not changed much in their attitudes despite the effect of the crisis in the agricultural system; this is so even though the weaknesses of the product structure and the financial institution system have become obvious.[11]

The large-scale agricultural plants are wage-worker organizations with mixed profiles. As a consequence of this, their adherence to a particular agricultural business sector or to agricultural activities as a whole is much less than that of the peasant-farms or farmers' economic units in rival countries. Hence, the elasticity in the supply of certain activities and, concomitantly, the inclination of production to cyclical tendencies is higher than it is in other sectors or in the advanced capitalist countries. Therefore the system often gets into a situation in which it over-reacts to the effects of regulators, to price fluctuations and to the difficulties of producing and selling. At the same time, owing to the high volume of capital tied up in agriculture and to its slow return, when difficulties appear, the companies do not look for new forms of purchasing and selling, but strive to get rid of the risky sectors and to withdraw into operation forms which still seem to be safe (this process is also evident in the food industry). These dangerous processes are strengthened by the fact that the companies are not really interested in property. Instead, they make efforts to keep their income at a definite level—even at the cost of selling their properties.

In certain areas large-scale farms have remained as monopolists in their respective agricultural activities. According to the amended law on land, many could have sold off some of their land, but only a few made use of this right. This was not primarily because of the fear of the new form or the former leaders (though these were also important motives) but because the crisis of sales had created a situation which meant there were many more risks for the private producers than for the small-scale plants. It was not worthwhile giving up the possibility of an assured income from the cooperative—however small it was—and of the additional small-scale production, simply for the sake of a risky, individual adventure. Another point is that the interests of the leaders require employees and entrepreneurs to hold on to the enterprise infrastructure (the leaders are monopolists from this point of view as well. This is so that the reproduction of power relations within the organization can be assured. Thus, large-scale plants invariably impede the starting

[11] For more details about the rigidities and basic institutional defects of the agricultural economy, see *Juhász and Gaál* (1989, pp. 13–17).

of technological development and the creation of new forms of cooperation which are indispensable for bringing about the missing system of medium-size plants.

The majority of small-scale producers continue their agricultural activities as a secondary occupation. Because they are needed their number increases and thus there is no danger that masses of them would give up production. The small-scale producers respond extremely sensitively to changes in their environment. However, if something is not right, they do not change their technology, or search for new contacts, or bring about a new form of organization—rather, they begin some other activity. Though their innovation and investment activities are quite significant, the innovations that have been applied in the system of small-scale producers have not developed as a result of a search for higher efficiency, but merely for the maintenance of the current operating capacity. Without some investments aimed at strengthening growth and competitiveness, there is no rival in the sphere of small-scale producers who might stimulate the large-scale plants to search for renewal. Thus, no cost competition can evolve, and the markets will be divided simply because of the division among them.

Although the erosion of the system widened the action sphere of the market, the market sections which developed were unlike those that come into being in the circumstances of a market economy, and they did not serve to help the emergence of vertical organization. Such a *halfway open* market has sections which tend to mislead, and thus petty crises and small deadlocks often occurred.

In a particular market segment (e.g. in the meat sector or the verticality of vegetables or fruit) the contact system among the enterprises was considerably liberalized, while the companies of the food industry continued to be bound to the large-scale farms. Since the "old/new" participants are invariably still connected with the redistribution system, the system's capacity to create new participants has continued to be rather limited. Though some new venturers have appeared (such as regional meat processing plants, larger and/or smaller trading organizations etc.), these, in general have not had sufficient capital to enable the production of items that would be marketable in demanding markets. The entrepreneurs that have filled gaps, have utilized the deficiencies in the operation of the existing enterprise system. Though they have greatly contributed to the weakening of the large companies, and to their operation (liquidity) troubles (see the various so-called "wars" of production and trade: the cases of the eggs, raspberries, rabbits and so on) they have been *unable to bring about alternative vertical chains* and to organize new networks. Although various forms of the old stall-keeper trade have revived, this in itself is not enough in a modern agricultural system.

In the Hungarian economy the classical agricultural cooperatives, the corn dealer firms, a normally operating produce-exchange, and the wholesale markets acting as exchanges are missing. Therefore, the agricultural system is lacking in information and the participants are unable to build up well-founded strategies. It is a resulting paradox that, due to a lack of integration, the producers are *simul-*

taneously dependent and autonomous. (In other words the contractual systems are inoperative.) It follows from this situation that—with the exception of a few products that move along simple trading paths (wheat, corn, sunflower and, to some part, milk)—production and trade cannot be regulated, either by tools that conform with the market, or otherwise. In addition, instead of open market competition—even in the case of products that move on simple pathways—a "competition" based on contacts and privileged information is now dominant.

Developments in the year 1991

In 1991 the system of agricultural economic conditions became even more severe. The budgetary subsidies to the sector were reduced from 55 billion Ft to 29 billion. The official price of edible wheat ceased to exist and for milk a form of maximum price was introduced. In accordance with agricultural rules, minimum prices were fixed for basic products (wheat, corn, pig and cattle). Due to earlier elements of regulation the export subsidies came within the sphere of authority of agricultural rules.

Owing to the collapse of the CMEA the year 1991 started with inauspicious prospects. Yet, later developments have shown that the returns of export deliveries exceeded those of the preceding year. Therefore we may say with good reason that *the crisis of the agricultural system did not come about simply because of the collapse of the eastern markets.* Thus the severity of the crisis is even more obvious. Furthermore, we may also state that the contradictions of agricultural organization would not be solved even if, owing to some miracle, the earlier proportions and dimensions of the East European turnover were to be restored. (Lányi 1991)

The processes of the domestic market increasingly reflect the image of a disorganized agricultural system. A harmony between the physical and financial processes can only be brought about with increasing difficulties and disagreement. (Mohácsi 1991; Fertő 1991) This is because the organizations which earlier pursued some state functions (successor organizations of trusts, and processing and stockpiling companies) are no longer able to—nor are they interested in—continuing these functions. On the one hand—owing to the growing strictness of financial policy—their financing capacity has strongly declined. On the other hand, along with the cessation of their responsibility as suppliers, the companies which have come about due to the splitting up of trusts are not interested in undertaking stockpiling tasks which would mean heavy burdens on them. At the same time, no new companies have been created for settling the troubles. In turn, the producers are unable to keep and finance large amounts of stocks. By changing the conventional paths of circulation and the disintegration of the old organization system, the earlier forms

of financing the stocks have been eroded—yet, up until now *the gap caused by the disappearance of the earlier structure has not been replaced by anything at all.*

The markets continue to suffer because of a serious *lack of information*. Experience gained so far about the grain- and meat-exchange, and the regulation linked to them, bears witness to the fact that even the most fundamental operating conditions of such institutions are missing.

More liberalization and the introduction of a few market institutions, without a production information system and without trading channels comprehensible to and influenced by the producers, has not ensured normal operation of the food market. Apart from this, the conduct of the market participants is often extreme, and this gives free scope to damaging speculations based on false preconceptions.

Some constituents needed for renewal of the sector

The development path of the Hungarian food economy which has been followed up to now, can no longer be continued. Neither the financial sources, nor the (mostly East European) markets which earlier exercized a pulling effect are available to the necessary extent and with the proper structure. The government has gradually recognized the crisis afflicting the sector. However, the measures taken for the sake of managing it are insufficient for relieving the tensions accumulated over the course of several decades. Nevertheless, they are in themselves progressive and important, involving such things as: freeing prices, liberalizing foreign and domestic trade, cancelling supplying commitments, facilitating entering and leaving the market, and commencing the elaboration of the elements of agricultural rules.

Of course, this is not an easy task. In other words, it is necessary to face the fact that an agricultural system (in particular several elements of it) that was developed in a false way, has to be gradually broken down, even though it possesses certain useful values. Parallel with this, an up-to-date food economy, suitable for the requirements of the various markets, has to be built up. Without analysing in detail the tasks accompanying the development of a modern agrarian system, we would like to call attention to some factors.

A key question of the transformation process already in progress due to the active intervention of the government, is the restructuring of the enterprise system of agriculture and the food industry (i.e. the disintegration of monopolies). The creation of organizations capable of independent moves is needed, so that they can respond to the ever changing and differentiating market requirements. To promote this, the transformation and privatization of the state farms and the food industry, as well as the law on the transformation of cooperatives are all necessary. It is also a basic requirement to urge the establishment of new organizations (e.g. product funds, exchanges, credit cooperatives etc.) which can serve as a basis for

organizing the most varied forms of market cooperation. Also, the frameworks for the action of the state and the economic units have to be determined, so that they can lay down the limits of intervention and the state can assume certain risks. The principles of the rules of the agricultural market, the basic elements of the crediting system, and the guiding principles of the produce exchange and produce funds have to be fixed as soon as possible. It is also necessary to promote the formation of credit cooperatives backed with a state guarantee. After having arranged the basic principles of landed property and the valuation of land, the practice of mortgage credits has to be introduced. Furthermore, it is vital to create organizations of interest representation which are indispensable for modern vertical cooperation.

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GERMAN UNIFICATION AND SYSTEMIC TRANSITION: TOWARDS A NEW GERMAN ECONOMIC MIRACLE?

P. J. J. WELFENS

In this study we analyze German economic unification and compare the West German economic miracle of the 1950s with the conditions in Eastern Germany. Evaluating the chances of an economic miracle it seems that the prospects are modest since there is a considerable risk that an East German economic miracle would reduce West German economic growth and thereby weaken the all-German economy. A comparison of Germany in 1949/50 and 1989/90 shows significant divergences. East German restructuring offers limited lessons for Eastern European countries, but the few clearcut conclusions are quite important for the systemic transformation for which a growth-oriented long run strategy promises most success.[1]

Introduction

When the unification of Germany took place in 1990, many observers were quick to point out the potential for another German economic miracle. Would the systemic transformation from a planned economy to a market system in East Germany not be similar to the West German switch from a war economy with state planning to a market economy in 1948? Moreover, if Eastern Germany could rapidly catch up with Western Germany would this not imply that the economy of a united Germany would become the economic locomotive for sustaining growth in the EC and the whole of Europe?

The notion of an economic miracle implies a very rapid economic catching-up process or a quick switch to prosperity—an economic development so rapid that even economists with their assortment of models, theoretical approaches and policy analyzes would consider it difficult to fully explain it, to predict its exact dimensions and to identify other historical cases showing similar dynamics. From a pragmatic point of view one may define an economic miracle as a process in which there is a sustained economic growth rate of at least 6–7 percent p.a. This means that per capita incomes are doubled within a decade. Such a rate would be exceptional by historical standards. However, one may emphasize that the history of economic development offers at least some case studies of super-rapid growth of per capita output, namely Korea and Taiwan in the period 1966–87, China in the period 1977–

[1]I have benefitted from the comments on an earlier draft presented at the AICGS/Johns Hopkins University seminar. In particular I am grateful for discussions with Gerry *Livingston* (AICGS), Wolfgang *Reinike* (Brookings Institution), Piotr *Jasinski* (Oxford University) and Randall *Henning* (Institute for International Economics). The responsibility for any weaknesses in this article is all mine.

87,[2] and West Germany in the period 1948–59. Is there the possibility of a miracle in Eastern Germany—one which may have lessons for Eastern Europe?

Historically, the ingredients for economic miracles have been similar:

(1) a high rate of capital formation in combination with a high savings rate of private households, business and government—all this in an environment of competitive markets which ensure that investment decisions follow efficiency criteria and systematically take into account technological progress.

(2) a rapid diffusion of technologies in combination with a well-trained and well-motivated labour force; also, the ability to pick up foreign technologies and to develop indigenous R&D capabilities is important for maintaining high marginal factor products.

(3) open access to leading economic or political positions, thus encouraging performance-orientation in the process of upward mobility and motivating people to engage in human capital formation, to look for higher-income opportunities and to generally concentrate more on incremental income than on conflicts over the distribution of a given income.

(4) a stable political framework, including monetary stability and/or exchange rate stability.

(5) high growth rates of trade—sometimes of foreign direct investment too, so that allocation of resources is embedded in a dynamic process of international competition. This holds for Western Germany or Japan as well as for Asian NICs: export growth supported income growth since it helped realize comparative advantages and, associated with this, reduced the incremental capital-output ratio strongly and made unnecessary the "stop and go policies" that impaired development in many developing countries.[3]

As Eastern Germany was an economically backward country in which productivity reached only 25 % of that of Western Germany, one may expect a rapid catching up process as soon as Eastern Germany emulates West German patterns of investment, innovation and trade.

The following analysis argues that there is some limited potential for an economic miracle in Eastern Germany in the 1990s, but that the nature of this miracle will differ from the West German experience of the 1950s. I will raise four basic questions which concern: (a) the possible nature of an economic miracle in the former GDR, (b) the difference between the late 1940s in Western Germany and the early 1990s in Eastern Germany, (c) the side-effects of economic miracles;

[2] See on the catching-up process in Korea and China *World Bank* (1991).

[3] On the Asian NICs see *Krueger* (1991); in the case of Korea real exchange rate stability in the sense of only modest appreciations was important for growth, and also for positive stable real interest rates—it averaged 2.5 percent in 1977–87, compared to high negative real rates in Argentina and Mexico; see *Collins* (1991).

and (d) the relevance of any East German success stories for other parts of Eastern Europe.

German economic miracles

The first German economic miracle

A striking example of systemic transformation and economic recovery after 1945 is the reconstruction of West Germany.

West Germany's market economy represents a successful example of a rapid economic catching-up process. Per capita real GNP increased from DM 6,839 in 1950 to 13,199 in 1960, while the unemployment rate rapidly fell from 11.0 % in 1950 to 1.3 % in 1960; moreover—mainly as a consequence of people migrating from former eastern territories and the GDR—the labour force in West Germany increased by 3.5 million in the period 1950–60, and more than 5 million new jobs were created. A growing savings rate of private households and high efficient investment contributed to full-employment and high economic growth. In this period the savings ratio increased from 4.2 % of disposable income to 9.4 % in 1959.

A relatively high share of output (18.9 % in 1950, 24.3 % in 1960) was devoted to investment. This yielded high marginal output effects, since World War II had inflicted dispersed patches of destroyed private and public capital—much in contrast to the almost general obsolescence of the GDR capital stock after German unification in 1990. The high speed of capital formation was mainly achieved by high profit rates and moderate wage pressure on the one hand, and, on the other hand, by tax incentives for reinvested earnings, and by anticipated capital gains. Capital income relative to GNP was between 38 and 42 percent in 1950–60, but it seems that even more important was the relatively improved wealth position of capital owners as measured by the change of the real value of capital (stock price index/cost of living index): in 1950 the stock price index stood at 10 (1980=100), and the price index at 39.2 (1980=100), but in 1960 the stock price index was at 111 and the price index at 47.2; the real value of capital increased by 822 % in the period 1950–60. By contrast, profit expectations in Eastern Germany today are moderate and the higher oligopolistic interdependency in industry nowadays will only partly compensate for this; investment by industrial leaders could induce parallel investments of rival firms willing to accept low returns on investment in exchange for a minimum market share in Eastern Germany.

Table 1 gives some key figures for Western Germany's economic development in the 1950s and 1960s. In the 1950s real GNP growth reached almost 8 percent; on a per capita basis it was almost 7 percent. Profits were healthy and hence investment high (mostly financed from retained earnings) since real GNP increased 2.3

percentage points faster than real gross wages. In the 1960s real wages increased slightly faster than output, which itself reached an annual growth rate of 4 percent on a per capita basis. Price stability characterized both the 1950s and the 1960s. This was in contrast to the 1970s when the oil price shocks changed the macroeconomic scenarios in Western Germany and many other OECD countries for the worse. Between 1950 and 1987 real GNP increased by a factor of 6.2 in Western Germany, while real wages increased by a factor of only 4.

Table 1

German economic key figures 1950–1987
(Average annual change in percent)

	real GNP* (GNP* in 1950= DM 323.5 bill.) (1)	real gross wages (2)	profits (1) % (2)	real GNP per capita (3)	industrial production (4)	cost of living (5)	labour force (6)	unemployment rate (7)	real wage index 1980=100 (8)
1950–59	7.8	5.5	2.3	6.7	10.8	1.1	1.5	6.7	24.7(1950)
1960–69	4.8	5.3	-0.5	3.9	5.8	2.4	0.1	1.0	42.8(1960)
1970–79	3.1	3.9	-0.8	2.9	2.4	4.9	0.1	2.8	74.9(1970)
1980–87	1.3	0.8	0.5	1.3	0.5	3.1	0.6	7.8	98.8(1985)
GNP* in 1987: 2020 b.									

*real GNP=GNP at 1980 prices
Sources: Deutsche Bundesbank (1988), Forty Years of the Deutsche Mark, Monthly Report of the Deutsche Bundesbank, May 1988; Statisches Bundesamt and Deutsche Bundesbank, own calculations.

Points of departure in Eastern Germany

Despite many favourable West and East German economic statistics for the East German economy of the 1970s and the 1980s, the GDR economy faced economic stagnation and never achieved a significant reduction of the German-German income gap. System specific traits caused economic stagnation; this was the result of an autarchic trade policy, an industry structure dominated by big firms, a gradually increasing gap between domestic costs and internal prices, and a politically repressive system that could not allow the popular use of modern telecom and office equipment because it would have destroyed the Communist party's power and information monopoly. Private entrepreneurship had been almost completely banned in the 1960s and the 1970s, when state economic planning became more comprehensive, but proved unable to cope with changing international energy prices, with

new technology trends in the development of microelectronics, the service industry and flexible production networks. Some 250 giant economic combines—which excluded any competition in industry—replaced the thousands of firms which had still existed in the 1950s and 1960s.

While Hungary had been experimenting with gradual economic reforms since 1968 and Poland openly discussed reforms in the 1980s, the GDR maintained that there was no need for major economic or political reforms. In the 1980s its last chance for reforms was not used (i.e. in the mid-'80s when Gorbatchev launched the perestroika and glasnost campaign in the USSR). When Hungary opened the border to Austria the accumulated frustration of so many East Germans, then on holiday in Hungary, became apparent. More and more holiday-makers simply left Hungary for Austria and Germany, and the GDR system, after some desperate and short-lived attempts at reforms in late 1989, collapsed politically and then economically. People had high expectations of the West German Deutsche Mark and the economic miracle they associated with West Germany and its hard currency. The divergences between the two Germanies are obvious from *Table 2*.

The first question which we will address is the following: what type of economic miracle could one expect with a sudden switch to a market economy in the GDR? If one suddenly destroys a gradually accumulated network of institutions and invalidates standard working and management attitudes, one must expect a collapse of production—especially if consumers are, for the first time, facing unrestricted access to superior Western goods. One has to expect a steep fall in output and employment, and thereafter—this would be the miracle—rapid and sustained economic growth in Eastern Germany. From a theoretical point of view one may argue that the sharper the short-term fall of economic output, the higher the expected long term growth rate. This holds within certain limits, namely to the extent that there is a trade-off between subsidies paid for obsolete firms or production sites and public or private expenditures devoted to increasing the capital stock. This trade-off, together with reorganization of production and management activities, will shift the production possibility frontier outwards.

Since a command economy represents a weak form of organizing the production and exchange of knowledge and know-how among producers and between consumers and producers, one can expect improved productivity from a market-based allocation of resources. Static and dynamic efficiency criteria were violated in command economies; subsidies and multiple exchange rates created irrational price structures and a lack of competition. Also, a narrowly defined frame of economic liberties reduced the potential for economic growth. Budgetary structures can be adjusted quickly if the political process is redefined, as is the case in Eastern Germany.

Eastern Germany has three big advantages in the transition to a market economy:

Table 2

Macroeconomic indicators for West Germany and East Germany in 1989 (currency units M for the GDR, DM for West Germany)

Population, income, standard of living indicators and wealth	West Germany	GDR (relative to W. Germany)	
GNP	2260 bill. DM	190 bill. M	(about 8 %)
population	61.7 mill.	16.4 mill.	(26.6 %)[a]
population density (per km^2)	248	152	(61.3 %)
average monthly income in industry (Jan. 1990)	3809 DM	1184 M	(31.1 %)
telephones per 100 households (1988)	98	9	(9.2 %)
dwelling space per capita (in m^2)	35.5	27.0	(76.1 %)
monetary wealth p.c.	40747 DM	11022 M	(27.0 %)
		7654 DM[b]	(18.8 %)
Employment and capital		*figures in percent*	
employment structure			
agriculture	3.9	10.8	
industry	39.6	47.1	
services	56.5	39.6	
employment in firms with > 500 employees	20.8	78.5	
unemployment rate[c]	6.4	3.1	
age structure of the capital stock	(Jan. 92: 6)	(Jan. 92: 17)	
0–10 years	69.9	49.5	
over 20 years	5.3	21.1	
Savings and trade			
private household's savings ratio	13.9	7.0	
exports to EC-12 ('90#)	54.5	5.9 (.6 % of W. Ger.)	
share of trade with Eur. CMEA countries (ex/im)	3.8/3.8	69.5/68.7	
exports to the USSR	1.7	36.9	
export-GNP ratio	34.4	19–25[d]	

#figures are for Jan.–July 1990;

[a]is equivalent to 21 % of the all-German population;

[b]checking and savings balances of GDR residents, held in M(ark) in the state banking system were converted at an average rate of 1.44:1 into DM on July 1, 1990;

[c]figures are for July 1990. On the conversion factors see Deutsche Bundesbank (1990a), Monatsberichte der Deutschen Bundesbank, July 1990. The conversion factor applied to income payments and pensions was 1:1. Assets and liabilities of industry were converted at a rate of 1:2.

[d]Author's estimate (multiple exchange rates imply uncertainty; DIW estimate for the export-GNP ratio in industry: 24 %.

Sources: Council of Economic Experts, Zur Unterstützung der Wirtschaftsreform in der DDR: Voraussetzungen und Möglichkeiten, Sondergutachten vom 20. Januar 1990, Wiesbaden; Statistisches Bundesamt, Statistisches Jahrbuch der Bundesrepublic Deutschland, Wiesbaden 1989; DDR 1990, Zahlen und Fakten, Wiesbaden 1990; Staatliche Zentralverwaltung für Statistik, Statistisches Jahrbuch der DDR 1989, Berlin 1989. Institut für angewandte Wirtschaftsforschung Berlin, Ursachen der Wirtschaftskrise in der DDR, Berlin 1990. Trade figures for Jan.–July 1990 were directly obtained from the Deutsche Bundesbank (DB); DB: Reiche 3, Zahlungsbilanzstatistik. Own calculations.

— the former GDR can expect massive transfers of public funds from Western Germany; public financial transfers to Eastern Germany reached DM 140 bill. in 1991 and are expected to reach DM 180 bill. in 1992 (6.5 % of West Germany's GNP).

— Eastern Germany has adopted West Germany's proven institutional framework. However, this is a very complex set of institutions, regulations and laws which together represent a web of rules and constraints that impose high learning and adjustment costs on Eastern Germany.

— with the accession to the FRG, Eastern Germany has recreated five Bundesländer that are now part of the federal structure of the united Germany. Federalism in Germany means both fiscal federalism, competing policy concepts at the regional policy level, and different approaches to public investment. Compared to the former centralist politico-economic decision-making process, the new federalist decision-making should on average improve the quality of the political process.

The four main disadvantages of Eastern Germany are:

— The privatization of industry is very time-consuming, and even bold attempts by the government's quasi-agency *Treuhandanstalt* to organize a feasible privatization process imply high adjustment costs and conflict-prone restructuring. After a slow start privatization is gaining momentum, especially now 15 newly created regional Treuhand subsidiaries are supporting the privatization attempts of the Berlin Treuhandanstalt, which concentrates on the big companies.[4] Net revenues from privatizing nearly 4,000 firms out of a total of some 11,000 were negative at the end of 1991, and the net proceeds could indeed be negative after the whole privatization process has been completed (BMF 1991, p. 26). However, the privatization process is well organized in the sense that the unbundling of assets and spinning-off of firms is undertaken so that the number of firms has increased from 8,000 initially to over 11,000 in early 1992. Privatization is organized for whole respective industries and this allows the development of competition, and thereby

[4] German unification was completed on October 3, 1990. By the end of 1991 the small privatization of retail trade, restaurants, pharmacies etc. was already completed. The big privatization of industry proceeds at a lower speed, but at least it is a sustained process; this is achieved by the considerable manpower and financial resources of the Treuhandanstalt with its more than 3,000 employees and a host of consulting firms working for the Treuhandanstalt.

encourages static and dynamic efficiency gains. Some 600 firms were closed and more than 5,000 firms had been privatized by early 1992.

The Treuhandanstalt has engaged in many restructuring attempts that are even more time-consuming than the privatization of more or less profitable firms; and liqiudation of firms also takes some time. From a fiscal point of view—this at least is my view—the privatization revenue is of minor relevance as long as the privatized firms contribute to profitable future production. With an average ratio of tax revenues to GNP of nearly 23 percent the implicit fiscal value of additional production by privatized firms in Eastern Germany has an infinite capitalization horizon and a 10 percent discount rate: 0.23/0.10=2.30 DM. If one includes other tax revenues the tax income ratio in Germany is almost 0.4 such that 0.4/0.01=4 DM is the social value of each output unit in a privatized firm. As long as the future tax revenue from privatized companies is not lower than the discount rate it is reasonable to proceed with privatization (we disregard here non-fiscal arguments which also support privatization).

— The former GDR has not been exposed much to international trade and foreign direct investment; thus international business is a weak side of Eastern Germany for the moment. This is a disadvantage in a world economy in which the internationalization of the world economy has accelerated since World War II. For most East Germans the acquisition of an international background, specific know-how and developing competitive advantages will take time. Hence it will take several years for the GDR to contribute decisively to Germany's export and international investment position. However, after a first spending spree in 1990/91 which partly reflected pent-up demand under the former socialist system, and partly indicated an increased aspiration level in consumption, one can expect the (West)German current account surplus (which melted away in 1990/91) to show up again.

— People in Eastern Germany are not used to addressing political and economic conflicts in an open and pluralistic arena, having been accustomed to solving conflicts by compromise and package-dealing. New social conflicts will emerge in the course of the systemic transformation and, due to the switch to an open society, they will also become more visible. Whether political stability and economic prosperity can be maintained under such changing conditions is an open question.

— Due to its geographical location, it is most exposed to the instabilities of Eastern Europe and the ex-USSR. Widespread anti-Polish and anti-Russian sentiments, as well as a lack of tradition in living together with a considerable population of foreigners imply an increased sensitivity of East Germany to the pressure of migration from Eastern Europe. If the introduction of West Germany's social market economy is experienced by East Germans as a process in which they become second class citizens they might express their frustration in a first class discrimination of foreigners.

1949 vs. 1991

The developments in Western Germany in the late 1940s are in marked contrast to the decline of East Germany's industrial production after currency unification in 1990: in the second half of 1990 it was almost 50 % lower than a year earlier. Setting the production in March 1990 at 100, we see that the index fell by another 17.3 percent in January 1991 and another 9 percent in February 1991 before a first increase of 4.1 percent was recorded in March 1991; the index at the end of 1992 stood at 64. Prices had to be reduced by East Germany's industry in order to maintain market shares in Germany: the index of producer prices of industrial products (domestic sales) fell from 100 in 1989 to 63.1 at the end of 1991. At the same time consumer prices rose as the price structure of Eastern Germany moved closer to that of Western Germany: at the same time price arbitrage shifted the prices of tradables up to West German levels. In the former GDR net output in manufacturing industry sharply declined, and in March 1992 1.3 million were unemployed. 500,000 were short-time workers, some 450,000 were undergoing special vocational training, 400,000 were in job creation schemes and 458,000 benefited from early retirement schemes. Active labour market policies were thus applied in Eastern Germany. Consequently, any economic miracle which will take place in Eastern Germany starts from a low economic basis.

The main differences between 1948/49 (Western Germany) and 1990/91 (Eastern Germany) are the following: property rights, bottlenecks, expectations, capital formation, labour force development, labour market, competitiveness, external resource transfer and external situation.

— **Property rights**: In Western Germany, private property rights were hollowed out during World War II, but after 1945 private industry started where it had left off in 1939; most industrialists successfully reclaimed their former property even in cases where collaboration with the Nazi government seemed to weaken their position. However, the Cold War and a host of practical problems helped part of the old elite to maintain power, property and political influence. In Eastern Germany more than 1.3 million claims for restitution of property were filed by end-1991. 45 years after World War II and decades after various nationalization waves, unclear property titles pose a very complex problem, and this reduces the number of industrial sites and premises that are attractive for investors in Eastern Germany. Legal uncertainty is costly since it reduces proceeds from privatization and raises subsidies required to keep unemployment rates below 20 percent. The principle of "restistution goes before compensation"—applied in accordance with the "Unity Treaty"—is a formidable impediment to investment growth. The Treuhandanstalt faces the problem of privatizating almost 11,000 firms—only a few hundred of them in the context of foreign investors: most notebly from France, Switzerland, Austria, Sweden, the U.K., the U.S. and the Netherlands. Of the 550,000 new enterprises established by the end of 1991 many are bound to suffer economic failure. In

West Germany only 50 percent of newly established firms survived the first 5 years and the considerable lack of well-trained managers, engineers, businessmen and the labour force in general lets one anticipate an even higher failure rate in Eastern Germany. Conflicts about property titles will impair East Germany's attractiveness for investors, entrepreneurs and business founders for many years until the complex legal problems have been sorted out.

— **Bottlenecks**: From the perspective of a market-oriented economic system there is no comprehensive role for government intervention. However, there is a role for government in rationalizing its own activities in providing services and increasing public investment, especially when this raises the marginal product of private investment and improves market coordination by either widening a market's radius (resulting in greater competition and allowing a *better exploitation* of economies of scale) or enhancing the communication/transportation network.[5] Given the many distortions that characterized the initial situation in Western Germany in 1948 and in Eastern Germany in 1990, there is an important role for government in three respects: removing economic distortions within the government sphere, providing the institutional framework for efficient competition (in Western Germany only in 1957 did Ludwig Erhard's "Magna Charta of competition", the *Gesetz gegen Wettbewerbsbeschränkungen* get passed in parliament) and helping to overcome bottlenecks in the physical infrastructure of the country. Both institutional and physical bottlenecks can severely reduce the productivity of private investment.

— **Expectations and attitudes**: Expectations at the time of currency union in July 1990 were running high in Eastern Germany. The rich Western Berlin—located within the GDR—inspired East Germans particularly those in the Berlin area) to have the freedom to travel. Also, the impact of the German media stimulated the desire to catch up with West German standards of living quickly. In 1991 the former GDR was given fully coverage not only by West German TV but by competing Western newspapers and magazines. For the population the time to anticipate German unification was measured in months rather than the three years in the case of West Germany's road to a currency reform in the period 1945–48. Very optimistic expectations for a quick recovery of East German industry had, of course, been fuelled by the politically popular analogy with the post-1945 West German economic miracle. In mid-1990 a majority of the East German population anticipated reaching West German standards of living within a few years (yet 10–15

[5] The Western allies undertook immediately after World War II successful attempts to overcome transportation bottlenecks which were preventing regional excess supplies from finding their ways to regions of excess demand. Given technical indivisibilities and considerable minimum (optimal) plant sizes, the economic viability of certain industries can—at the margin—critically depend on lowering transportation costs on the one hand, and, on the other hand, input costs of those factors whose price will fall relatively whenever factor mobility is increased by a better transportation and communication network.

years is a more realistic and representative view). The decision to move the government from Bonn to Berlin is so far the most important decision for maintaining optimistic expectations in Eastern Germany. When people decide where to live economic expectations are not less important than the momentary economic performance. The changing of attitudes is more difficult than adjusting expectations, especially if they were formed during more than four decades of a command economy as in the East German case—in contrast to the roughly 10 years of a military and war economy in the Third Reich. The changing of attitudes often requires a generational change at the decisive levels of government and business. Given the Pandora-legacy of Stasi-files (files of the GDR's former secret service), one may expect that the old elite will relatively quickly give up leading positions that can then be taken by younger managers, civil servants and politicians. The "import" of civil servants and business people from West Germany helps to destroy the old party networks which often represented unproductive redistributive coalitions in the command economy. Following *Olson* (1980), who argued that rigid distributive coalitions tend to reduce society's emphasis on output growth, innovation and structural change, one may expect that new opportunities for growth in Eastern Germany emerge as a consequence of newly created alliances and creative personal networks.

— **Capital formation and technological progress**: A high investment output ratio in combination with a high rate of innovation and diffusion would be needed for high economic growth. Stimulated by high profit expectations investment-output ratios in West Germany were high in the 1950s. West Germany also benefited in the 1960s from the transfer of management skills and the financing of capital formation by subsidiaries of foreign multinationals, mostly from the U.S. West Germany's dynamic small- and medium-size firms, which are among the most innovative in Europe, also helped to foster growth. The investment output ratio in Eastern Germany is expected to reach about 25 percent in 1991/92. This is 5 percentage points higher than in West Germany. While the investment output ratio does not look too impressive, the rate of technology transfer can be expected to be exceptionally high. This is true despite the fact that foreign direct investment in Eastern Germany has not played a significant role so far since almost 90 % of all firms privatized by the Treuhandanstalt were sold to West German firms (some of them subsidiaries of foreign multinationals).[6] However, as West German firms are

[6] By early 1992 the Treuhandanstalt (THA) had privatized about 50 % of state-owned firms, but more than 60 % of the jobs in the former state sector remained on the THA payroll (or became unemployed). The dominance of big firms would have required privatization of an overproportional number of big firms, but privatization was evenly spread among firm sizes, and indeed bigger firms require a longer lead time for restructuring and privatization. Major labour market problems are still to be solved, but as the privatized firms start growing and employment increases in the mid-1990s, the second half of the 1990s could become a preferred period for privatizing the bloc of

Europe's leading innovators—as measured by patent applications at the European patent office—and since technology trade is usually on an intra-company basis, the massive investment of West German firms in Eastern Germany implies a rapid diffusion of advanced West German know-how and technologies. The lack of small- and medium sized firms in Eastern Germany has at least been partly remedied by the integration into the single EC market. An open question is whether Eastern Germany can absorb the enormous amount of investment needed to catch up with West German productivity levels by the year 2000. One scenario of the IMF (1990, p. 77)—assuming a starting capital stock of DM 624 bill. and an East German productivity level of 30 percent of that in West Germany—shows that for output per worker to achieve 80 percent of West German productivity by 2001 required net investment is in the range of DM 1,000–1,300 billion. Of this about 20 percent would have to be public investment. The ratio of gross investment to GNP implied for the former GDR would be around 40 percent; this does not seem to be very realistic (in Western Germany the ratio of gross investment to net investment is 3:1).

— **Labour force developments**: The West German economic miracle was able to build upon a continuous influx of refugees and expellees from former German territories. Many of its most qualified people left the former GDR in 1989/90, and the intra-German gap in wages and social infrastructure implies that Eastern Germany will lose part of its most trained and mobile labour force in the coming years. This intra-German brain drain will not benefit economic growth in Western Germany very much, but could strongly impair the prospects for productivity growth in Eastern Germany.

— **Labour markets**: In West Germany the wage freeze was abolished in November 1948 and collective bargaining rules established on the basis of a special law six months later. Strong competition, the influx of refugees and expellees, and still weakly organized unions allowed real GNP to grow much faster than real wages, such that profits and incentives to invest were particularly high.[7] In Eastern Germany in 1990/91 real wages increased by almost 50 percent within the first year after unification and reached between 55 and 65 percent of West Germany's wage levels in mid-1991. However, labour productivity still is only 1/3 of that in West Germany, so that this time real wages are ahead of output growth. During the West German reconstruction unemployment reached its peak in the first quarter of 1950, when the unemployment rate was 12 percent. In the former GDR the second half of 1991 shows a similar figure as the peak of unemployment. However, it might take much longer to reduce the unemployment rate in Eastern Germany than it took in the West German case. Structural change in Eastern Germany is certainly also

remaining THA firms. On the role of foreign direct investment in the transformation process see *Inotai* (1992).

[7] In Western market economies the technology factor accounts for about 1/3 of economic growth.

reflected by labour market turnover phenomena—nearly 2 million East Germans changed their job within 15 months after currency union.

— **Competitiveness**: With the German monetary, economic and social union of July 1 1990, the East German industry became fully exposed to the competitive pressure of West Germany's industry and the whole world market. The conversion rate chosen for the GDR's currency, namely for wages and most savings 1:1 (average conversion ratio 1.8 Mark to 1 DM) certainly was very favourable compared to black market currency rates. However, the conversion rate implied a sharp appreciation of the East German currency such that East German goods became much more expensive in Western markets and in the former CMEA partner countries. While West Germany's economic miracle benefited from a 20 percent devaluation of the Deutsche Mark in 1949, the former GDR is suffering from the strong currency appreciation associated with (currency) unification. While minor investment might suffice to upgrade quality and increase product varieties to Western standards, it will take many years for indigenous East German entrepreneurs to learn how to be successful in dynamic international markets. Moreover, it will take at least a decade to thoroughly modernize the outdated GDR capital stock and to clean up the environmental damage that characterizes many industrial sites; it will also take many years to retrain the labour force in Eastern Germany. Although rapid productivity increases of up to 30 percent in the first year can be expected in the cases of some West German and foreign direct investment, average productivity growth is likely to reach not more than 10 percent p.a. in the 1990s. Rebuilding the capital stock and retraining the labour force is a time-consuming process that reduces the scope for an economic miracle.

— **External resource transfer**: Almost 60 % of the East German income represents a resource transfer from West Germany. In relative terms this is much more than West Germany received from the Marshall-Plan: Germany obtained about 10 percent of the Marshall-Plan funds, but it also benefited from the U.S. Government Aid and Relief in Occupied Areas (GARIOA). Thus Germany received between July 1946 and March 1950 goods financed by both programmes, each representing $ 1.6 billion[8] (at 1991 prices this amount would be about six times as high). Funds from the Marshall-Plan were used particularly for financing private investment: up to 10 percent of private investment was financed from the Marshall-Plan funds in Western Germany. Given a West German GNP of DM 98.6 billion in 1950 (378.1 billion in 1985 prices), the external resource transfer amounted to 3–3.5 percent of the German GNP. From a donor perspective, the whole Marshall-programme represented about 1 percent of US GNP. In 1991 West Germany will transfer an equivalent of about 6 percent of its GNP to Eastern Germany.

— **External situation**: Under the pressure of the Western Allies the (West) German territory adopted most-favoured nation treatment in 1948 for 13 countries,

[8] See Dokumentation zur Außenwirtschaft, 3/7/1990.

and for all other countries in 1949 when most quotas were also lifted. External liberalization progressed in 1950 and 1951 when a regime of low tariff rates for imports was adopted. In addition to gradually exposing the West German economy to world market competition, the Western Allies strengthened its supply side responsiveness and economic competition by the dismemberment of powerful German cartels, such as the IG Farben. The Korea boom (June 1950 saw the outbreak of the Korea War) stimulated the German economy considerably since the Federal Republic's industry had excess capacities and offered a wide range of products desired in the world markets. 60 percent of Germany's imports had already been liberalized by 1950 and imports increased so quickly that a balance of payments crisis occurred. However, due to the anticipated cancellation of German external debt/reparations in the Treaty of London and the capital inflows under the Marshall Plan/GERIOA Programme the scope of this crisis was limited; moreover, monetary and fiscal restraint reduced domestic absorption in order to improve the balance of payments. Together with rising external demand from the Korea boom, the growth of potential output due to the rebuilding and restructuring of the West German industry brought a shift to a positive trade balance and, indeed, convertibility for the current account was achieved in Western Germany in 1952. The Federal Republic benefited very much from renewed economic prosperity in Western Europe. While the currency reform of 1948 had been a key element of internal economic success in Western Germany, the formation of the EC ten years later was the key event in the external sphere.

Eastern Germany's external environment is much less favourable: almost 2/3 of its external trade had been with Eastern Europe (including the USSR). The switch to hard currency balance of payments settlements and the demise of the CMEA in 1991 invalidated the established international trade network of the former GDR. Trade in Eastern Europe dropped by 19 percent in 1990 and is expected to remain weak as long as economic growth cannot be restored and the problems of foreign indebtedness impair regional trade creation.[9] The *de facto* currency appreciation, the ongoing systemic transformation in Eastern Europe, economic stagnation in the former CMEA countries and the disintegration of the USSR all contribute to a negative external environment. Similar problems are faced in the West: the EC 1992 project of creating a single integrated market accentuates the locational competition for attracting investments. At the same time the EC imposes tough and costly environmental regulations and standards on the East German

[9] Trade creation in Western Europe was stimulated in the years following the end of World War II by the Marshall plan (the European Recovery Programme) from which Western Germany benefited not only directly, but also in the sense that the much higher funds allocated to Germany's trading partners the U.K., France, Italy and Austria generated impulses for regional economic growth and trade. Under the ERP the U.K. received $ 3,198.8, France 2,713.6, Italy 1,508.8, the FRG 1,390.6 and Austria 677.8 mill. in the period April 3, 1948–June 30, 1952. See for these figures *Sanford* (1982).

economy. This reinforces adjustment problems caused by the exchange rate shock and the wage hikes in 1990/91.

Prospects for an all-German economic miracle?

There is little doubt that East Germany will catch up with its own historical potential in the long run. However, it is likely that it will take more than a decade for the transition process to be completed in East Germany. Economic and political instability in West Germany could result from conflicts over how to finance the adjustment process. Deficit-GNP ratios of 5–6 % imply high interest rates, and increasing value-added tax rates/excise taxes, plus higher state-administered prices, imply the risk of higher anticipated and actual inflation rates; these could reach 4–5 % in 1992/93. Even an expected growth rate of 10 % in Eastern Germany in 1992 does little to offset the 30 percent fall of GNP in 1991. *Table 3* summarizes the spring 1992 projections of Germany's five leading research institutes, which expect the all-German growth rate to reach 1.5 % in 1992 (1991: 0.1 %):

Table 3

Key figures for Western Germany and Eastern Germany, 1991/1992 (annual real growth rates for GNP and its components)

	Western Germany		Eastern Germany	
	1991	1992	1991	1992
GNP growth	3.1	1.0	-30.3	10.5
private consumption	2.5	1.5	5.5	3.5
government consumption	0.8	2.5	1.0	-1.0
machinery and equipment	9.4	0.0	88.7	-31.0
construction investment	4.1	1.5	-14.0	22.0
exports	12.1	3.5	-5.2	21.0
imports	12.6	4.0	91.0	7.5
consumer prices	3.6	3.8	13.6	12.0
unemployed (millions)	1.7	1.8	2.5*	1.8*

*unemployed plus short-time workers

Source: Frühjahrsgutachten der fünf führenden Wirtschaftsforschungsinstitute, Berlin et al.

Subsidies and welfare benefits in Western Germany will have to be cut. Under the pressure to finance public investment in Eastern Germany and to subsidize private investment there, established public expenditure patterns in Western Germany have become unviable. Moreover, well-established distributive coalitions are becoming fragile and traditional arguments against changes unconvincing. If people in East Germany's brown coal fields are losing their jobs because lignite is not

competitive in energy generation and because its use damages the environment so much, why should people working in the uncompetitive West German hard coal fields enjoy undiminished state subsidies?

If private infrastructure projects or competitive power generation are feasible in Eastern Germany, at least in some cases why should state provision of many goods and services or regional energy monopolies be maintained in Western Germany? This debate will take several years to fully unfold, but attempts at reducing subsidies and deregulating part of the economy are already visible in the old FRG. If impulses for change lead to growth-augmenting liberalization and restructuring in West Germany as well, one may indeed hope for an economic boost for the whole German economy. Privatization of telecom, the railway system and utilities could be major projects in this area. The exploitation of hidden reserves for economic growth could be all the more necessary since major EC partner countries face slow economic growth—not least because of high German and EC-wide real interest rates. Moreover, the Maastricht criteria for entering stage III of the European Monetary Union in 1997 or 1999 require that deficit-GNP ratios should not exceed 3 percent and debt-GNP rates should be no more than 60 percent; without rapid growth Germany could fail to meet these (and the other) criteria and new conflicts over income could impair economic stability and prosperity.

Also required are changes in public spending patterns on the one hand, and, on the other hand, a generally higher public and private savings ratio. Government consumption in Japan was almost 10 percentage points lower in the 1970s and the 1980s than in Germany (8 percentage points lower than in the U.S.); the share of public gross investment as a percentage of GNP was 2 points higher than in West Germany (4.4) and more than 4 points higher than in the U.S. (1.6 %). Net national savings as a percentage of national income were about 8 points lower in the 1980s than in the 1960s in Western Germany, and reached 11.6 %, whereas Japan's ratio stood at 20.9 percent (against 25.2 in the 1960s) and the U.S. ratio at 4.0 (against 10.8 in the 1960s).[10]

Since 50 percent of Germany's trade is with the other EC countries, in order for Germany to prosper it will be vital that unification does not weaken or even destabilize the EC. High real interest rates and increased inflation rates—that are partly caused by high German public deficits—are actually weakening Germany's position in the negotiations over European Monetary unification. West Germany always emphasized that price stability should be the absolute priority of a future EC central bank and that on the way to creating such an institution policy convergence would be a priority; namely in the sense that other EC countries should also come close to Germany's low inflation rates and deficit-GNP ratios. With regard to both indicators France showed a better performance in 1991. The attempt of the Deutsche Bundesbank to regain EC leadership in price stability and ensure a

[10] The figures are taken from *Bis* (1991), p. 31.

low deficit ratio could impair a short term economic miracle in Germany by tight monetary policy and even higher interest rates. The monetary integration process in the EC is complicated not only by German unification but by changes in the former socialist countries of the CMEA.[11]

Orders or magnitude

If we assume that in 1991 Eastern Germany accounted for 10 percent of overall German GNP and will grow at 10 percent annually in the 1990s, this would imply that its contribution to overall German GNP would be in the order of 1 percentage point in the beginning and, in the late 1990s, about 1.5 percentage points. If one assumes that Eastern Germany's output will represent 20 percent of the overall German production in GNP at the turn of the millenium, a growth rate of 5 percent would still imply a contribution of not more than one percentage point to the overall German GNP. Whether German unification raises the overall German growth rate of course depends very much on the impact on Western Germany's output development. If unification reduces West German growth rate from a hypothetical 3 percent to 2 percent, the overall effect on German economic growth would be zero. Even under an optimistic scenario one may doubt that East German prosperity could bolster the short- and medium term economic growth of the overall economy very much. As regards Germany's international economic competitiveness, Eastern Germany cannot be expected to play a major role in the medium term because the non-tradables sector (construction, services etc.) will play a dominant role in the transition period in Eastern Germany. Increasing German trade with Eastern Europe will fall more on West German suppliers than on the East German industry which, however, in the long run could become stronger in this field.

Economic growth in Western Germany increased from 3.8 percent in 1989 to 4.5 percent in 1990, but slowed down to 3.2 % in 1991 and could fall to 1 % in 1992. The East German economy could grow at rates of 7–10 percent in the 1990s, which would indeed mean high economic growth in the united Germany and, moreover, generate growth impulses for Western and Eastern Europe as well. German unification raised the EC's real GNP by about 1/2 of a percentage point in 1990. However, it is an open question as to how much growth in Europe is reduced as a consequence of higher real interest rates and new conflicts over how to reduce excessive budget deficits or avoid an increasing tax burden.

In the short-term the massive intra-German transfer of know-how and management skills will contribute to high economic growth rates in Eastern Germany.

[11] New countries and new currencies are emerging in Eastern Europe at a time when the EC aims to create an EC currency.

With West German firms clearly dominating the aquisition process (or the process of privatization) in Eastern Germany, a strong East German link to West German technology pools, management resources and training facilities is being established. Only in the medium term will high investment output ratios significantly contribute to high growth rates in Eastern Germany. It will also take at least a decade before firms in Eastern Germany have positioned themselves well in international markets, thereby gaining access to greater markets and hence spreading R&D costs more effectively and becoming fully able to use dynamic economies of scale (unit costs are a negative function of the cumulated output). Such dynamic scale economies are very decisive in industries with short innovation cycles.[12]

The export-sales ratio in the new states of Eastern Germany are the lowest in overall Germany: while the top five positions are occupied by Bremen, Rhineland-Palatinate, Bavaria, Sareland, Baden-Wurttemberg and Hesse (with export-sales ratios of 40.9, 32.7, 30.9, 29.8, 29.4 % and 28.1 %, respectively) the last six positions go to the East German states: the figures for the first three quarters of 1991 are 18.8 % for Saxony-Anhalt, 15.4 % for Thuringia, 11.6 % for Mecklenburg-Vorpommern, 10.8 % for Saxony, 10.0 % for Berlin and 8.8 % for Brandenburg. Although it is true that firms in East German states still benefited from export subsidies to former CMEA countries in 1991, one may expect in the medium term that, despite the phasing out of these subsidies, exports to Eastern Europe will not collapse (namely because of rising per capita incomes in the former CMEA countries) and that a growing share of the investment goods industry—which in Western Germany show an overproportional export-sales ratio—will gradually raise the degree of openness in Eastern Germany. Hence the non-tradables industry, especially construction and service activities, will dominate the expansion process in the short term in Eastern Germany, whereas the tradables industry will only pick up after a certain delay. Eastern Germany's exports were less then 3 % of the all-German figure in 1991 (the same percentage as that for tax receipts), but the population share is 20 %.

Long term perspectives

As regards long term prosperity in the whole of Germany there are some risks: a first risk is associated with reduced competition and innovation in Germany as a consequence of East German industry being overtaken almost exclusively by West German firms. Other major risks for economic prosperity in the united Germany are the following: distributional conflicts in Western Germany, loss of policy credibility of the German government, and high unemployment rates in Eastern Germany

[12] If a firm cannot move down the learning curve fast enough to make the product profitable during its life cycle, the firm has usually not sufficient R&D resources for the next product cycle and would leave the industry in the long term.

(partly a consequence of unions which want to achieve wage parity for East German workers with those in Western Germany by 1995—way ahead of productivity parity). Furthermore, higher German inflation rates and increasing intra-EC monetary conflicts could create macroeconomic instability, especially if trade unions pursue an aggressive wage policy.

Without external shocks the whole of Germany can be expected to face prosperity and sustained economic growth. Poland, Hungary and the CSFR, as well as the former USSR and the Baltic States, should benefit from German prosperity, mainly because of increasing German imports and rising German foreign direct investment. Germany's historical trading patterns show a strong position in Eastern Europe before World War II (see *Table 4*). Although there are prospects for increas-

Table 4

German trade orientations in 1913 and 1989[a]
(shares for merchandise trade with selected countries)

	Country share in German imports		Country share in German exports	
	1913	1989	1913	1989
USA	15.9	7.6	7.1	7.3
Russia[b]	13.2	1.7	8.7	1.8
(Poland)		0.7	0.7	
Great Britain	8.1	6.8	14.2	9.3
Austria-		(A)4.1		(A)5.5
Hungary[c]	7.7	(H)0.5	10.9	(H)0.6
(CSFR)		0.5		0.4
France	5.4	11.9	7.8	13.2
Italy	3.0	8.9	3.9	9.3
China[d]	0.7	1.1	1.2	0.7
(Taiwan)		1.1		0.6
Rumania	0.7	0.3	1.4	0.1
Serbia[e]	0.1	1.3	0.5	1.1
Japan	0.4	6.3	1.2	2.4
Bulgaria	<0.1	0.1	0.3	0.2

[a]figures for 1989 are for West Germany
[b]figures for 1989 refer to the Soviet Union
[c]figures for 1989 are comprised of the country shares of Austria, Hungary and the CSSR.
[d]figures for 1989 refer to the People's Republic of China
[e]figures for 1989 are for Yugoslavia.
Sources: Statistisches Handbuch für das Deutsche Reich, Vol. II., Statistisches Bundesamt and Deutsche Bundesbank, own calculations. Adapted from *Welfens, P. J. J., ed.* (1992a).

ing Eastern Europe's share in German trade, a much diminished role for Eastern European trade—relative to 1913—can be expected because Japan and the East

Asian NICs nowadays play quite an important role in German trade relations, and this is unlikely to decline in the 1990s.

There is a real danger for sustained economic growth and stability in Germany and the whole of Europe—the risk lies in a rising intra-European income gap coupled with increasing migration in a situation in which the mood in Germany and many EC countries is already characterized by the feeling: the boat is full. Indeed, there is the risk that successful economic development in Eastern Germany could become the basis for the destruction of this very new prosperity. This could happen if a rising intra-European economic divide were to trigger increasing pressure for migration westwards in Poland, the USSR and other countries whose attempts at market-oriented reforms yield too slow an economic growth rate for reducing the East-West income gap. If we take into account that real GNP in Poland fell in 1990 by about 12 percent and is expected to fall by another 3–5 % in 1991/92, whereas Eastern Germany will record a growth rate of 10 %, it is clear that rising incomes in the former GDR will intensify the public pressure on the Polish government to generate visible and considerable economic progress. What holds from the German perspective with respect to Poland, holds *mutatis mutandis* for the Polish-Soviet economic divide. Economic stagnation in the USSR coupled with high economic growth in Poland is bound to generate high migration pressures in the USSR—a heavy influx of Soviet people into Poland could in turn destabilize the still fragile Polish politico-economic system and ultimately endanger the first economic success of reforms in Poland. Hence, a German policy concept which wants to ensure prosperity and stability in Eastern Germany and the whole of Germany must take into account Polish and Soviet economic developments.

German unification as a model for an economic miracle in Eastern Europe?

In Eastern Europe and the USSR there are high hopes that the move to a market economy will improve the economic situation within a few years. Compared to Eastern Germany expectations are certainly more modest as regards the speed of catching up with the West. However, there is little doubt that systemic reforms cannot be maintained politically if a critical minimum economic growth rate is not achieved. It seems that the prospects for the quick resumption of economic growth after the sharp fall of incomes in the immediate transformation period are not very bright in Eastern Europe. There are four main reasons for this: (a) the rate of obsolescence of the capital stock has been very high throughout Eastern Europe since output prices as well as input prices have rapidly changed on the one hand; on the other hand, the exposure to world market competition means additional adjustment pressure for upgrading products, increasing product variety and specializing along lines of comparative adventage—all this is a very time-consuming

process with high adjustment costs; (b) the costs of rebuilding the capital stock are high since the world economy is facing a period of high real interest rates. This problem is aggravated in Europe by the Bundesbank's policy of monetary restraint (adopted due to fear of inflation) and the need to finance record budget deficits in the united Germany; (c) there is limited access to West European markets, despite the improved access obtained by Hungary, the CSFR and Poland in the EC association treaties of 1991. At the same time the Eastern European economies are facing persistent problems in the former territory of the USSR, which also creates politico-economic uncertainty; (d) privatization can be organized only at a much slower pace than in Eastern Germany, the latter having benefited much from the presence of West German investors (moreover, the Treuhandanstalt's privatization plan enjoys the full backing of an internationally influential and internally strong German government). Thus in other parts of Eastern Europe competition as a driving force for economic efficiency must come to a greater extent, and at a slower rate, from import competition than is the case in the united Germany: a greater volume of import competition is necessary since national markets are relatively small and because dismemberment of former state monopoly firms is difficult to achieve, and import competition must come at a lower rate because external convertibility can be achieved only gradually (Eastern Germany is, of course, part of the DM area). The only advantage seems to be that the real exchange is still a policy in Eastern Europe. Among the group of smaller former CMEA countries only Hungary was able to attract significant inflows of foreign direct investment, the latter being one important element of technology transfer and hence economic growth. However, Hungary's investment-output ratio has fallen sharply in 1990/91 and no special attempts have been made to improve the industry's R&D capabilities or improve human capital formation. Public work programmes aimed at improving the deficient public infrastructure would be appropriate in all former CMEA countries, but they have not been envisaged by any government to a considerable extent.

There are, however, some prospects for increasing East-West trade (*Van Bergeijk and Oldersma* 1990, Welfens 1991b) and there is a gradual internal transformation with regard to privatization, developing functional market institutions and achieving monetary stability in Hungary, Poland and the CSFR. Their reform attempts, in combination with the East German experience, could lead the way towards sustainable reforms in Eastern Europe, too.[13]

Western Europe could look at the possibilities of launching a Marshall plan-type programme for Eastern Europe and the USSR. Germany indeed could raise the question whether successful approaches in Eastern Germany should not be applied to Eastern Europe in a modified form. What Western Germany is for Eastern Germany, the EC could become for Eastern Europe (including the USSR). As regards

[13] On German economic recovery and systemic transformation see eg *Giersch* (1991), Welfens (1990b, 1992b).

the German-German approach to systemic reforms and economic catching-up, it is clear that the order of magnitude could not be matched by an EC-East Europe approach. Western Germany's resource transfer to Eastern Germany amounted to about 6 percent of GNP; more than 50 percent of Eastern German incomes are based on a resource transfer from Western Germany.

West Germany's political system developed a generous transfer programme mainly because Western Germany would have otherwise suffered from enormous migration; this was because in many cases West German tax-payers realized that if they financed the catching-up of relatives in Eastern Germany, the West German economy would enjoy the greatest benefit from an economic boom in the former GDR, which above all needs investment goods produced in Western Germany; moreover, West German politicians are in many cases starting a second career in East Germany which means that—together with East German voters that account for about 20 percent of the all-German electorate—effective political pressure for generous federal support can be mobilized. In contrast to Eastern Germany, where GNP fell in 1990 and 1991 by about 20 percent in each year, it is not conceivable that governments in reforming East European countries could survive a drop of output of almost 40 percent within the first two years of transition. Given the limited volume of expected Western resource transfers and—except for the CSFR—high foreign indebtedness, the acceptable decline of output, income, employment and exports is relatively low in Eastern Europe and the USSR.

The high West German budget deficit which reached, expressed as a percentage of GNP, 4 percent in 1990/1991 (having been 0.4 % in 1989, and which will rise to 5–6 percent in 1991 and 1992) will impair rapid economic reconstruction in Eastern Europe, namely to the extent that it raises real interest rates in Europe and worldwide. The real interest rate effect of German unification could overcompensate the trade-augmenting effect of unification. While Western Germany's capital goods industry can be expected to match higher interest rates—at least to some extent with innovative investment goods that yield a higher marginal product of capital—one may expect that there will be a serious adverse impact of a real interest rate shock on Eastern Europe and some West European countries. Only to the extent that a higher public debt service would then encourage privatization (and this in turn would contribute to higher efficiency and economic growth) could one assume that first round negative effects in EC countries would trigger some positive adjustment measures, too.

A major element of systemic transformation in Eastern Germany has been the help obtained from West German civil servants who were dispatched to organize public administration in the "Neue Länder" (new states). Each West German state engaged in an administrative twin partnership with one of the new federal states and many government agencies dispatched up to 5 percent of their personnel and offered immediate access to manpower training facilities. This type of administrative support would be needed in Eastern Europe on a much bigger scale, but even

the concerted action of all EC countries would meet greater problems than in the German-German case, where no language problem was encountered and where help was—sometimes grudgingly—accepted. The practical, logistical and psychological problems on a Euro-Euro scale would be much bigger. This, however, does not imply that there is no role for administrative support of systemic transformation. However, the marginal benefits of such projects would be more limited than in the German-German case and certainly one would have to envisage a longer training and adjustment period.

One crucial problem in Eastern Europe is the lack of direct foreign investment. This would not only contribute to capital formation, but—at least as important—bring access to advanced technologies that are typically traded on an intra-company basis. Due to the imperfections in the markets for technologies and innovations, even a very prudent policy of technology imports through licences would imply a considerable time-lag in the transfer of advanced technologies. The former GDR enjoys the benefits of West German firms moving in and investing quickly, often driven by the oligopolistic rivalry for market shares in the united German market. It is an open question whether Eastern Europe can attract the amount of direct foreign investment that would be necessary to reach sustained economic growth. There is the risk that similar to the 1920s—when misalignment and protectionism prevented significant foreign investment in Eastern Europe (*Drabek*, 1985)—investment flows from Western Europe will remain small. Instead, resource transfer might be dominated by increasing foreign indebtedness and short term capital flows, both of which represent potential instability in Eastern Europe. Germany as a major partner in trade and lending would be much affected by this. In any case an external transfer programme would face greater difficulties in Eastern Europe in the 1990s than the Marshall plan did in the 1940s, when funds could be channelled into functioning market economies with strong existing international trade and investment links.

On the psychological side Eastern Europe suffers from the fact that its own history offers few historical precedents of rapid economic growth and prosperity. Another factor which is less favourable in Eastern Europe is the development of a market-oriented institutional infrastructure. Each country is creating its own system design in a time-consuming and often conflict-prone way. The establishment of the reputation of the new policy institutions is essential but, this tends toward policy measures that are more drastic than fully credible. Hence there is a tendency for too much state interventionism and induced economic instability in Eastern Europe. Eastern Germany saved political consensus capital—so to speak—by simply adopting the West German politico-economic regime. Entrepreneurial and managerial talents have to be actively promoted and encouraged in Eastern Europe (eg by new universities, tax incentives and newly created venture capital agencies), for it is clear that the former GDR is getting visible benefits from the West German transfer of managerial skills. A very sensitive area of instability in a market-based economic system is monetary instability, especially if high and fluctuating inflation

rates coincide with exchange rate volatility. Given the weak status of the central banks in most East European countries, the uncertainties of monetary policy in newly created two-tier banking systems, and the difficult transition problems, the advantage of monetary stability as gained by the GDR when it became subject to the Bundesbank policy can hardly be overestimated (despite the shock-like currency appreciation for Eastern Germany). A long term policy strategy is required for catching-up since even with a 7 % growth rate in Eastern Germany—given an assumed 1.5 per capita output growth rate in Western Germany—it will take about 20 years for full economic catching up.

While in the medium term Eastern Germany enjoys the full benefit of unrestricted access to the huge EC market and to some of the EC's funding programmes, East European economies that wish to join the EC are facing a complex and time-consuming approach to the Community. The association treaties with Hungary, Poland and the CSFR only represent the half-way support of the EC.

Summary and conclusions

A modest economic miracle in Eastern Germany can be expected in the medium term. West Germany's prosperity does not seem to be in danger for the medium term. However, the political process could become less stable because the national policy arena is less firmly embedded in a coherent EC policy frame. Too many conflicts of interests and diversities of views have become apparent in 1991, particularly when the Yugoslavia crisis and the Soviet crisis caused several nations to emphasize their specific national interest rather than those of common EC policy concepts. Eastern European miracles are unlikely, even more unlikely than in the former GDR. The conclusion to be drawn is that sustained reform trajectories are much needed in Eastern Europe. Catching up with Western Europe must be a process that is envisaged within a long term strategy. Active West European support is required, both in the field of debt restructuring and, more important, for the real opening up of markets of former centrally planned economies. Even the CSFR, Hungary and Poland still face import quotas of the EC, and although most of them are (not yet) binding it seems clear that any restriction in market access reduces the prospects for stimulating domestic and foreign investment in the industries concerned in Eastern Europe. Whether the EC's R&D programmes could be opened up for reforming economies in the former CMEA countries is an open question, but this could indeed be one element in the improvement of innovation and international competition in the long term.

Given the complex and long accumulated legacy of economic and political problems in Eastern Europe, one may suggest that a successful transition to a market economy would hardly deserve to be called a miracle. A growth-oriented

transformation strategy is required in the GDR and in Eastern Europe. Fortunately the German crash course in market economic transition demonstrates to Eastern Europe some of the pitfalls and risks encountered on a long and hilly way to prosperity.

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INDEXED MORTGAGES AND EXPECTATIONS: MATHEMATICAL ANALYSIS AND SIMULATION

A. SIMONOVITS

This paper examines the mathematical issues of Indexed Mortgages (IM: *Modigliani* 1976), paying special attention to expectations on factors of interest and wage growth. For perfect foresight the Dual Indexed Mortgage (DIM) ensures that the bank reimburses the total real present value of the loan, while the borrower's relative burden is constant in time. However, if the expectations are either persistently pessimistic or optimistic, then the DIM may demand too low/high relative payments, implying too long/short payback period. To reduce this problem, I propose two modifications: 1. The iterative DIM recalculates 'initial' relative payment each year, retaining maturity. 2. The combined method constrains the relative payments of the iterative method by lower and upper bounds.

I consider three types of expectations (perfect foresight, optimistic forecasts—both far-sighted; and naive short-sighted expectation), and I compare them with the corresponding version of Single Indexed Mortgages (SIM) and with the Inflation-Free Mortgage (IFM).

Introduction

In this paper I shall examine the mathematical issues of indexed mortgages (IM), paying special attention to expectations on factors of interest and wage growth. Many authors (e.g. Modigliani 1976) have already discussed the traditional Single Indexed Mortgage (SIM), which only indexes the nominal interest rate with inflation and analyzes its drawbacks: for high inflation rates the initial value of relative payment is very high, and its end value is very low. (I prefer the acronym SIM to the usual Variable Rate of Mortgage (VRM), since the DIM also works with variable interest rate.)

This anomaly is eliminated by the Dual Indexed Mortgage (DIM) which not only indexes the nominal interest rate with inflation, but also the payment according to the rate of wage-increase (Modigliani 1976 and 1991). (In fact, in Hungary, wage dynamics is much lower than income dynamics; thus the latter might be a better base for indexation.) This method ensures that the bank reimburses the real present value of the loan, while the borrower's relative burden is constant in time.

It is of interest that the World Bank supports the DIM for the specific purpose of reducing budget deficits; this stems partially from subsidization of payment or interest, caused by the SIM. Other experts oppose the DIM, arguing that its introduction fuels wage inflation.

Until now we have implicitly assumed that expectations on interest and wages are correct. What happens, however, if the forecasts are imperfect? For the traditional SIM (used in Hungary, too) the expectations on the interest factor are

annually revised, and the corresponding payments are recalculated every year, restraining the errors and their effects. In a surprising way, in the World Bank's description of DIM the lender sets out from given paths of expectation, determines and adheres to the same relative expected payment for the entire period. If the expectations are either persistently optimistic or persistently pessimistic, then this version of DIM may demand either too low or too high relative payments, implying either too slow or too fast pay-back period.

I propose two modifications: 1. Let us recalculate the initial relative expected payment each year by using the DIM for the remaining period and the remaining debt. This *iterative method* retains maturity but changes the relative (expected) payment in each year. 2. If we want to limit the relative payments, then we can combine the simple and the iterative methods as follows: define lower and upper bounds on the relative expected payment. If the iterative method yields a value lying between the two bounds, then it is accepted; if not, then that bound is chosen which is closer to the foregoing value. If the borrower does not pay back the loan in time, then the borrower should pay the maximum in the extension period. This *combined method* can simultaneously reduce the dispersions of the pay-back time and of the relative burden.

Both methods can be based on either far-sighted or short-sighted forecasts. In a given year, the far-sighted expectations for the coming years may be different from each other, while all the short-sighted expectations for the coming years should be equal. (However, the forecasts can change in time in both versions.) In practice the SIM is iterative short-sighted, while the DIM is simple farsighted, but these pairings can be changed.

We do not deal with the effect of indexation on the inflationary process. We also neglect the impact of inflationary expectations on the inflation.

The structure of the paper is as follows: Section 1 discusses the simple DIM, sections 2 and 3 present the iterative and combined DIMs, respectively. Section 4 explains the generation of different expectations. Sections 5 and 6 display the simulations with paths and summary tables. Section 7 analyzes the DIM's rival, the SIM. Section 8 presents a simplification of DIM, when both interest rates and payments follow inflation (Inflation-Free Mortgage: IFM). Finally, Section 9 contains the final remarks on the connection between indexation and average payment time, the conclusions.

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1. Simple DIM

In this Section we follow the World Bank (1991), but also introduce some modifications. For the sake of simplicity we calculate in years rather than months. (Note that Modigliani (1976) has calculated with continuous time and instantaneous compounded interests.) We assume that each payment is made at the end of the year, but its value is determined at the beginning of the year. The bank's interest margin (the gap between the interest rates of lending and borrowing) is neglected.

Notations

We shall distinguish expected values from actual values by superscript e. In this paper relative quantities are calculated according to wages. (Apart from side remarks and Section 8, prices do not even appear explicitly in the model.) We shall denote nominal, relative and discounted values of the same quantity by Roman upper case, lower case and Greek letters, respectively. We shall divide quantities into three groups: a) constants, b) exogenous variables, c) endogenous variables.

a) Constants

N = original maturity time,

C = ceiling on extension period,

$U = N + C$ = ceiling on extended maturity time.

b) Exogenous variables

W_t = wage growth factor in year t,

I_t = interest factor in year t,

${}_sW_t^e$ = wage growth factor in year t expected (forecasted) in year s, $s \le t$,

${}_sI_t^e$ = interest factor in year t expected (forecasted) in year s, $s \le t$.

When $s = t$, we shall use the simplified notations ${}_tW_t^e = W_t^e$, ${}_tI_t^e = I_t^e$.

We shall introduce *cumulated factors* compounding annual factors for several subsequent years:

$${}_rW_{st}^e = {}_rW_s^e \; {}_rW_{s+1}^e \cdots {}_rW_t^e, \quad {}_rI_{st}^e = {}_rI_s^e \; {}_rI_{s+1}^e \cdots {}_rI_t^e, \quad r \le s \le t$$

Further, ${}_sW_{st}^e = W_{st}^e$ and ${}_sI_{st}^e = I_{st}^e$.

c) Endogenous variables

T = actual maturity time,

D_t = nominal debt at the end of year t,

m_t^e = expected relative payment in year t.

Remarks. 1. We shall introduce the omitted versions of debt and payment in due time.

2. Listing the expectations in the group of exogenous variables, we forget about certain endogenous variables appearing in the possible dynamics of the expec-

tations: e.g. ${}_sW_t^e = W_{s-1}$ in short-sighted naive wage expectations. Nevertheless, from the point of view of the payment process, this classification is correct.

Equations

We shall divide the equations into two groups: equations which can be solved a) at the beginning (off-line) and b) during the repayment process (on-line).

a) Off-line calculations:

To evaluate any loan we have to know its *expected present value*:

$$Z_0 = \frac{M_1}{I_1^e} + \frac{M_2}{I_{12}^e} + \cdots + \frac{M_N}{I_{1N}^e}. \tag{1.1}$$

The main feature of the simple DIM is that *nominal payment* in year t is proportional to the expected wage level of year t:

$$M_t = m_1^e \, W_{1t}^e. \tag{1.2}$$

Assuming the equality of real expected present value of the payments and the loan ($Z_0 = D_0$), we obtain the *basic formula of the DIM*:

$$D_0 = m_1^e \left[\frac{W_1^e}{I_1^e} + \frac{W_{12}^e}{I_{12}^e} + \cdots + \frac{W_{1N}^e}{I_{1N}^e} \right]. \tag{1.3}$$

We shall need the total and partial sums occurring in the brackets. To simplify the expressions, we introduce the *relative discount factor* $a_t = W_t/I_t$, rather than the *discount factor* $1/I_t$. (Since the discount factor and the relative interest factor are equal to $1/I_t$ and $i_t = I_t/W_t$, respectively, $a_t = 1/i_t = W_t/I_t$.) Further, we shall use its *expected cumulators*:

$${}_sa_t^e = {}_s W_t^e / {}_sI_t^e \quad \text{and} \quad {}_ra_{st}^e = {}_ra_s^e \ldots {}_ra_t^e, \quad s \le t \tag{1.4a}$$

$${}_tb_u^e = {}_ta_u^e + {}_ta_{u,u+1}^e + \cdots + {}_ta_{uN}^e, \quad b_t^e = {}_t\, b_t^e. \tag{1.4b}$$

Formula (1.3) now reduces to

$$D_0 = m_1^e \, b_1^e.$$

Using the identity $D_0 = d_0$, this yields the *expected relative payment*:

$$m_1^e = \frac{d_0}{b_1^e}. \tag{1.5}$$

b) On-line calculations:

By definition the *nominal debt dynamics* is as follows:

$$D_t = I_t D_{t-1} - M_t, \quad t = 1, 2, \ldots, U, \quad \text{unless} \quad D_t < 0. \tag{1.6}$$

This formula determines the end of the DIM algorithm: if $D_U > 0$, then the loan is not fully serviced; if $D_U \leq 0$, then let T be the minimum of integers with negative debt. The DIM then stops in year T.

We shall also need the formulas for the *relative and discounted values of debt and payment*:

$$d_t = \frac{D_t}{W_{1t}} \quad \text{and} \quad \delta_t = \frac{D_t}{I_{1t}}. \tag{1.7}$$

$$m_t = \frac{M_t}{W_{1t}} \quad \text{and} \quad \mu_t = \frac{M_t}{I_{1t}}. \tag{1.8}$$

We have a system of ten (difference) equations (1.1)–(1.8), which contains both actual and expected values. Most of the equations are identities, but (1.2) and (1.3) (or the variant of the latter, (1.5)) are not.

Average payment time

Though the studies dealing with mortgages discuss the time-profile of the payments, they do not deal with the basic question of the *average payment time*. We shall define this quantity as the average time (elapsing from the opening of the loan) during which the discounted payments of the loan remained with the borrower. It can be expressed in the following formula:

$$t_k = \frac{\sum_{t \leq U} t\mu_t}{\sum_{t \leq U} \mu_t} \quad (\mu_t = m_t a_{1t}). \tag{1.9}$$

Remark. Note that the definition does not assume that the loan is fully serviced.

Role of expectations

We have already mentioned in the Introduction that the simple DIM is very sensitive to the expectation errors. If the expectations concerning interest and wages are fulfilled (perfect foresight), then the simple DIM ensures constant and planned relative payments. However, if these expectations are contradicted by the events, then the planned course of DIM changes. We shall see that if the interest factor is persistently overestimated or underestimated, then the pay-back time is reduced or lengthened (in the extreme case even to infinity), extending the payment formula to the extension period, respectively. If the wage growth factor is persistently overestimated or underestimated, then the relative burden is much

higher or lower than planned, respectively. (Though the World Bank (1991) does not deal with expectations on wage growth factor, I do not see much reason in modelling only expectations on interest.)

Relevant equations

Until now we have pretended that forecasting the dynamics of wages and interests is a very natural activity. It seems to be more realistic to work with other, related variables that can be better forecasted. We shall introduce the *ratios of expected and actual values of wage and interest factors* as well as, shortly, *the error factors*:

$$v_t = \frac{W_t^e}{W_t} \quad j_t = \frac{I_t^e}{I_t}. \tag{1.10}$$

Then

$$a_t = \frac{j_t}{v_t} a_t^e, \quad j_{st} = j_s \dots j_t, \quad v_{st} = v_s \dots v_t, \quad a_{1t} = \frac{j_{1t}}{v_{1t}} a_{1t}^e. \tag{1.11}$$

Let us rewrite the combined equations of (1.1), (1.5), (1.8) and (1.6)–(1.8):

$$m_t = \frac{\delta_0}{b_1^e} v_{1t}. \tag{1.12}$$

$$\delta_t = \delta_{t-1} - \frac{\delta_0}{b_1^e} j_{1t} a_{1t}^e, \quad t = 1, 2, \dots, U, \quad \text{unless} \quad \delta_t < 0. \tag{1.13}$$

Equations (1.12)–(1.13) reveal that the *unexpected* dynamics of the relevant variables m_t and δ_t are separately determined by the error factors $v_1, \dots, v_t$ and $j_1, \dots, j_t$. (Indirectly, however, $j_1, \dots, j_t$ also influences m_t, namely, by affecting the pay-back time.)

Forecasting the time series I_t and W_t (actual and expected) would be very difficult but fortunately we do not always need it. We can often approximate a_t by a_t^e, and confine the error factors within narrow bounds.

Time-invariant system and perfect foresight

In this subsection we shall examine the functioning of the DIM in the simplest case. We assume that the expected relative discount factor and the error factors are time-invariant:

$$a_t^e = a_e, \quad v_t = v, \quad j_t = j. \tag{1.14}$$

Remarks. 1. There is no need to assume the time-invariance of W_t, W_t^e, I_t, I_t^e; it is sufficient if they change together in an appropriate way.

2. The cumulated relative discount factors form a geometric series, thus b_1^e and, in general, b_t^e can be expressed in a closed form.

We also assume that the financial authorities have *perfect foresight* on the dynamics of wages and interests:

$$j = v = 1. \tag{1.15}$$

Then the relative discount factor is also time-invariant and equal to the expected value:

$$a_t = a.$$

Example 1. Golden value: $a = 1$. Then $b_1^e = N$. The DIM now yields time-invariant relative payments, and the discounted debt decreases uniformly:

$$m_t = \mu_t = \tfrac{d_0}{N} \quad \text{and} \quad \delta_t = d_t = d_0\left(1 - \tfrac{t}{N}\right).$$

Example 2. Improving (deteriorating) path: $a > 1 (a < 1)$. Then $b_1^e < N (b_1^e > N)$. The DIM's relative payments are increasingly smaller (greater) than the golden value, and the discounted debt decreases at an accelerating (decelerating) rate:

$$m_t < \tfrac{d_0}{N} \quad \text{and} \quad \delta_t > d_0(1 - \tfrac{t}{N}), \quad \text{if } a > 1.$$

$$m_t < \tfrac{d_0}{N} \quad \text{and} \quad \delta_t > d_0(1 - \tfrac{t}{N}), \quad \text{if } a < 1.$$

Having finished the discussion of the simple DIM, we turn to its modifications.

2. Iterated DIM

Method

Of course, the simplest solution to the expectation problem would be the following: each year the bank would compute the actual payment after the indexes have become known, and the calculated payments should be considered as forecasts. However, this solution is legally unacceptable.

In my opinion, the ex-post revision of the pay-back time (in the simple DIM) in itself is not a solution, either. Rather, I propose to *iterate* the simple DIM for every year for the remaining period, using d_{t-1} and b_t^e in (1.5).

Turning to the exposition, the relative debt at the end of year $t-1$ is given by (1.7), and the iterative application of (1.5) yields the expected relative payment:

$$m_t^e = \tfrac{d_{t-1}}{b_t^e}. \tag{2.1}$$

Relevant equations

Again, we can express the dynamics of relevant variables with the help of error factors:

$$m_t = \frac{\delta_{t-1}}{b_t^e} \frac{v_{1t}}{j_{1,t-1} a_{1,t-1}^e}. \tag{2.2}$$

$$\delta_t = \left[1 - \frac{j_t a_t^e}{b_t^e}\right] \delta_{t-1}, \quad t = 1, 2, \ldots, U, \quad \text{unless} \quad \delta_t < 0. \tag{2.3}$$

The separation of the error-effects is blurred now. By (2.3), the dynamics of the discounted debt δ_t is still independent of the wage forecast errors $v_1, \ldots, v_t$; but by (2.2), the relative payment m_t already explicitly depends on both types of forecast errors: $j_1, \ldots, j_t$ and $v_1, \ldots, v_t$.

Repeating the procedure for $t = 1, 2, \ldots, N$, the iterative method essentially stops in year N by repaying the remaining debt D_{N-1}. In case of persistent optimism, the errors of the last year might yield some closing debt, but it is practically negligible. In case of persistent pessimism, the process might stop before N years, but this is also insignificant.

Simplified algorithm

It is particularly important that the series $b_t^e = {}_t b_t^e$ $(t = N, \ldots, 1)$ can be determined by a double backward recursion:

$${}_t b_u^e = ({}_t b_u^e + 1)_t a_u^e, \quad u = N, N-1, \ldots, t; \quad {}_t b_{N+1}^e = 0.$$

If the expectations are static, then ${}_t b_u^e = b_u^e$; thus one round of recursions is sufficient to determine all the b_t^e's.

Evaluation

At this point we evaluate the iterative DIM.

1. For perfect foresight the two methods yield the same result (time-consistency). However, they produce divergent solutions for imperfect foresight. The difference depends on the values of certain parameters. We shall return to the graphical and numerical presentation of the differences among different methods in Sections 5 and 6.

2. To illustrate the importance of revisions, consider the following case: the initial expectations are optimistic, but from the second year the bank becomes more

pessimistic. Then the simple DIM assigns a lower relative payment from the second year than the iterative DIM does. Suppose that a second borrower replaces the first one in the second year. The new simple DIM (being identical with the iterative DIM) would require a higher payment than the old simple DIM does, locking the old borrower in the mortgage. The iterative DIM would assign the same payments to both borrowers, removing inconsistency.

3. For optimistic forecasts the iterative DIM generates smaller debts than does the simple DIM, but the former compels the borrower to pay relatively more and more (in wage units). In particular, in the last year the whole outstanding debt has to be repaid, while the simple DIM gives the borrower a grace period.

4. For pessimistic forecasts a common high initial relative payment may depress the borrower for both methods. The simple DIM now puts a heavier burden on the borrower than does the iterative DIM, since the former sticks to this high value, while the latter smoothly diminishes it.

Neglecting the interest margin, a rational debtor prefers an optimistic forecast to a comparable pessimistic one, since the former means longer, while the latter means a shorter than planned pay-back time.

3. Combined DIM

One can reduce the difficulty arising from temporarily low or high relative payments by imposing lower and upper bounds on the expected payments, and confining the iterative rule to this interval.

This modification can be conceived as a combination of the simple and the iterative methods. (If the two bounds and the simple value coincide, then the *combined method* reduces to the simple method. If the lower bound is zero and the upper bound is infinite, then the new method reduces to the iterative method.)

Let m^{el} and m^{eu} be the lower and upper bounds of the expected payments: $0 \leq m^{el} < m^{eu}$. Consider rule (2.1) as conditional, denote the corresponding value by m_t^{ep}. Let the actual payment of the year t be determined by *bounded control*:

$$m_t^e = \begin{cases} m^{el} & \text{if} \quad m_t^{ep} < m^{el} \\ m_t^{ep} & \text{if} \quad m^{el} \leq m_t^{ep} \leq m^{eu} \\ m^{eu} & \text{if} \quad m_t^{ep} > m^{eu}. \end{cases} \qquad t = 1, 2, \ldots, N \tag{3.1}$$

If the repayment process is not finished within the planned period, then we apply the *maximal expected payment*:

$$m_t^e = m^{eu} \quad \text{if} \quad t = N+1, \ldots, U \quad (\text{unless } \delta_t \leq 0). \tag{3.2}$$

If the lower and upper bounds are well-chosen (the interval of feasible values is neither too narrow, nor too wide), then the combined method simultaneously controls the actual payments and the pay-back time.

Now the separation of error effects totally disappear: since (3.1) is not linear, in addition to the relative payment, the discounted debt also depends on both types of errors.

4. Generating expectations

Until now we have taken the expectations and their errors as given. Now we try to relax this arbitrary assumption. To do this, however, we have to return to the original time series I_t, W_t and their forecasts ${}_sI_t^e$, ${}_sW_t^e$.

We shall examine three cases: (i) far-sighted perfect forecast, (ii) far-sighted optimistic forecast and (iii) short-sighted naive forecast.

Before defining them, let us see a family-tree, depicting the possible combinations of algorithms and expectation schemes (*Figure 1*).

Far-sighted perfect forecast

We speak of far-sighted perfect forecast if the bank knows the paths of the factors of interest and of wage growth right at the beginning. (It is also possible to consider rational expectations which perfectly forecast the *mathematical* expectations of randomly fluctuating factors; however, for realistically moderated disturbances this case is rather close to perfect foresight.) Assuming away the feed-back of expectations on reality, there is only one perfect forecast:

$$ {}_tI_u^e = I_u \quad \text{and} \quad {}_tW_u^e = W_u, \quad 1 \leq t \leq u \leq N. \tag{4.1} $$

Far-sighted optimistic forecast

Among far-sighted imperfect forecasts, we shall select a static optimistic forecast. This scheme is far-sighted, because it allows for changes in future values. It is static, because it does not change over time. Finally, it is optimistic, because, as a tendency, it underestimates interest factors and overestimates wage growth factors. (Evidently, optimism extends the repayment period.) In formula:

$$ {}_tI_u^e = I_u^e < EI_u \quad \text{and} \quad {}_tW_u^e = W_u^e > EW_u, \quad 1 \leq t \leq u \leq N, \tag{4.2} $$

where E is the operator of mathematical expectation.

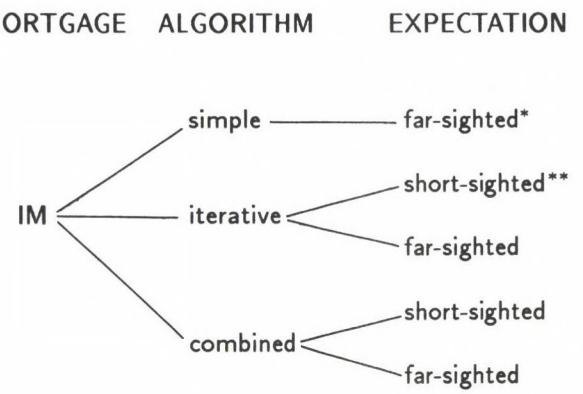

Fig. 1 Family-tree of indexed mortgages

Short-sighted naive forecast

We speak of short-sighted naive forecast if every year the bank pretends that it supposes that last year's factors of interest and wage growth will prevail—at least, till the expiration of the loan. In formula:

$$ {}_tI_u^e = I_{t-1} \quad \text{and} \quad {}_tW_u^e = W_{t-1}, \quad 1 \leq t \leq u \leq N. \tag{4.3} $$

Remarks. 1. The perfect foresight plays a theoretically distinguished role. In reality, however, the parameter values often change. Consequently, it is difficult to accept this assumption as realistic. Even in our age of rational expectation, it is difficult to believe that anybody can precisely forecast actual (or expected) interest rates 10–15 years ahead.

2. As was mentioned in the Introduction, in practice, short-sighted naive expectations are used in the most widespread method, SIM, where only the interest rate is indexed.

3. It is evident that for time-invariant systems short-sighted naive expectations boil down to perfect foresight, and all three DIMs coincide. This fact foreshadows a difficulty in qualitative comparison of the different DIM's.

If theoretical arguments break down, it is worthwhile relying on computer simulations. We shall apply the aforementioned three types of expectations to the simple, iterative and combined versions of DIM and SIM. (There is a single excluded case: for simple DIM or SIM the short-sighted expectation cannot be defined.)

5. Simulation of DIM paths

First we shall simulate paths for a given scenario, then turn to tabulation of summary characteristics of three scenarios.

Scenario for Hungary 1990–2010

Among the many scenarios, we shall only choose one, probably characteristic to Hungary, for the period 1990–2005: $N=15$, $C=5$. As a normalization, $D_0=100$. We assume that the trend of interest factors quickly decreases, while the trend of the wage growth factors slowly decreases, generating a U-shaped relative discount factor path. In the simulation we assume that the deviations from the asymptotic value form a decreasing geometric series (here superscript d refers to the deterministic component, while superscript t stands for an exponent):

$$I_t^d = I_\infty^d + (I_0^d - I_\infty^d)c_I^t, \quad \text{where} \quad 0 < c_I < 1. \tag{5.1}$$

$$W_t^d = W_\infty^d + (W_0^d - W_\infty^d)c_W^t, \quad \text{where} \quad 0 < c_W < 1. \tag{5.2}$$

$$I_0^d > W_0^d \text{ and } W_\infty^d > I_\infty^d.$$

In reality, however, the trends are disturbed by multiplicative *random errors*. Consider a series of totally independent random variables J_t and V_t, having a uniform distribution on the intervals $(-f_j, f_j)$ and $(-f_v, f_v)$, respectively. Suppose that the actual factors are

$$I_t = I_t^d \exp(J_t) \quad \text{and} \quad W_t = W_t^d \exp(V_t). \tag{5.3}$$

Apart from perfect foresight and short-sighted naive expectations, other expectations should be specified. As a simplification, we assume that the *optimistic far-sighted forecast* is fulfilled except for the initial trend values of factors of interest and wage growth, which are under- and overestimated, respectively.

$${}_sI_t^e = I_\infty^d + (I_0^e - I_\infty^d)c_I^t. \tag{5.4}$$

$${}_sW_t^e = W_\infty^d + (W_0^e - W_\infty^d)c_W^t. \tag{5.5}$$

$$I_0^e < I_0^d \text{ and } W_0^e > W_0^d.$$

I have tried to select parameter values which generate paths similar to those to be expected in Hungary in the future, and which highlight the differences between the different methods.

$I_0^d = 1.34$; $W_0^d = 1.25$; $W_\infty^d = 1.1$; $I_\infty^d = 1.08$; $I_0^e = 1.3$; $W_0^e = 1.28$. (Calculating with a time-invariant real interest factor 1.04, the underlying deterministic factor of inflation P_t^d drops from 1.29 to 1.04.) The half-widths of the error intervals are $f_j = 0.05$ and $f_v = 0.02$. The speeds of change in I_t and W_t are determined by the factors c_I and c_W: for example, the smaller the c_I, the faster the rate of interest converges to its asymptotic value. In our simulation $c_I = 0.9$ and $c_W = 0.8$. The resulting interest and wage dynamics are documented by *Table 1*.

Table 1

Time series of rates of interest and wage increase (in percent)

Year	Actual		Expected	
	Interest	Wage	Interest	Wage
	Rates			
0			30.0	28.0
1	36.5	21.3	23.3	24.4
2	24.4	18.5	21.8	21.5
3	23.2	19.7	20.4	19.2
4	25.2	16.4	19.2	17.4
5	28.3	12.9	18.0	15.9
6	19.4	13.8	17.0	14.7
7	14.9	14.0	16.1	13.8
8	13.9	10.6	15.3	13.0
9	17.7	11.7	14.6	12.4
10	15.1	10.7	13.9	11.9
11	13.4	10.5	13.3	11.5
12	15.9	11.8	12.8	11.2
13	18.6	9.8	12.3	11.0
14	13.5	11.0	11.9	10.8
15	18.5	9.3	11.5	10.6
16	12.7	10.1	11.2	10.5
17	9.7	9.6	10.8	10.4
18	14.9	10.4	10.6	10.3
19	15.7	10.3	10.3	10.3
20	16.2	10.8	10.1	10.2
Average	18.2	12.6	14.7	13.5

Far-sighted forecasts

First, we shall discuss DIMs which apply far-sighted forecasts. The order of presentation will be as follows: perfect foresight, and optimistic forecast with simple, iterative and combined methods. The main characteristics of these four

paths (as well as of others) are contained in *Table 2*. (The payments of truncated closing years are neglected.)

Table 2

Comparison of methods and expectations (Debt = 100)

	Real payment			maximal time	average time	Closing debt discounted
	initial	min.	max.			
Method/Variable	m_0	m_{min}	m_{max}	T	t_k	δ_T
DIM						
Far-sighted						
Perfect foresight	10.5	10.5	10.5	15	7.1	0
Imperfect foresight						
Optimistic	7.3	7.3	7.3	15	7.7	0
Simple	7.5	7.5	8.5	20	9.3	6.1
Iterative	7.5	7.5	13.8	15	7.8	0
Combined	7.5	7.5	9.2	19	8.9	0
Short-sighted						
Iterative	11.5	8.1	16.0	15	6.7	0
Combined	11.5	8.9	13.7	15	6.8	0
SIM						
Far-sighted						
Perfect foresight	21.1	3.9	21.1	15	5.0	0
Imperfect foresight						
Optimistic	16.6	2.7	16.6	15	5.4	0
Simple	17.0	1.9	17.0	20	5.8	14.6
Iterative	17.0	5.3	17.0	15	5.6	0
Combined	9.0	6.7	9.0	19	8.6	0
Short-sighted						
Iterative	30.4	3.0	30.4	15	4.3	0
Combined	13.7	8.9	13.7	13	5.7	0

For the given interest and wage dynamics, for *perfect foresight* the relative payment ($m = 10.5$) is much higher than that of the golden value ($m = D_0 / T = 6.7$), while the average payment time is a little bit shorter (7.1 vs. 8 years). From now on every method should be compared to this ideal case.

We shall compare three DIM methods under *optimistic forecast*, but first of all, we shall study what would happen if the optimistic forecast turned out to be true. *Table 2* shows that this *hypothetical* path is much closer to the golden path than the path of perfect forecast. Its relative payment is equal to 7.3, and its average payment time is equal to 7.7 years.

Due to the aforementioned discrepancy between the ideal and the optimistic paths, *the simple DIM* does not work well (*Figure 2*). Repayment is lengthened to the maximum (20 years). Moreover, the relative payment is slightly increased; nevertheless, (in discounted terms) 6% of the loan remains unpaid. To save space, from now on we shall only chart the payments path of the various solutions. *Figure 3* displays the four far-sighted DIMs.

In contrast, *the iterative method* maintains the original 15-year-maturity. However, the increased relative payment increases step by step and the end value is almost twice as high as the initial value (*Figure 3*). Let us remind the reader that the borrower prefers a path with increasing relative payment to its time-reverse: a path with decreasing relative payment. Nevertheless, there is a danger that the borrower becomes bankrupt just at the end of the process.

It would be nice if, for *combined DIM*, the bank selected bounds that flanked the relative payment of the perfect forecast ($m_1 = 10.5$). However, this choice is not always feasible in practice, since perfect foresight is only a theoretical construction. In our practice of modelling we also have to be satisfied with bounds flanking the initial relative payment of the simple DIM ($m_1 = 7.5$). On that basis we choose the following bounds: $m^{el} = 6$, $m^{eu} = 9$. *Figure 3* clearly shows that the actual payments hardly surpass the moderated expected upper bound, and within 19 years the borrower fully repays the loan.

Short-sighted forecast

We now turn to the examination of short-sighted expectations which dominate the practice of indexed mortgages. This method presupposes a dynamic approach, thus it cannot be joined to the simple DIM. Let us look at the two modified methods.

For borrowers short-sighted expectations are relatively more troublesome with decelerating inflation than with constant inflation, because in the first case the *iterative DIM* demands a too high initial relative payment ($m_1 = 11.5$ and $m_2 = 16$). *Figure 4* also demonstrates that this method generates wildly changing relative payments.

According to the remark made for far-sighted *combined DIM*, the bounds of the short-sighted combined DIM should flank the initial relative payment of the short-sighted iterative DIM. Working with a loose margin of ±20%, we select $m^{el} = 8.9$ and $m^{eu} = 13.8$. The relative improvement due to the combined method is now even more important than it was for far-sighted expectations. The path of relative payments is relatively smooth, and the maturity is preserved.

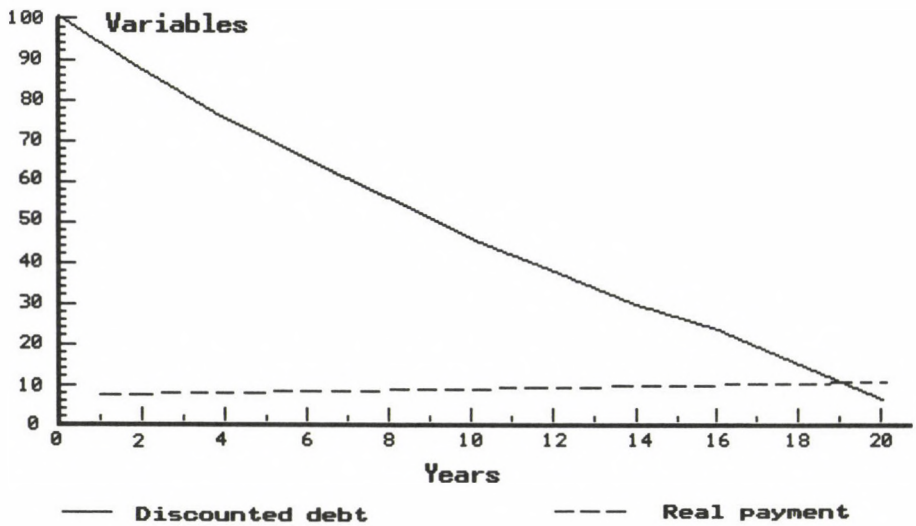

Fig. 2 Far-sighted simple DIM (optimist)

6. Tabulation of DIM

Until now we have considered only a single set of parameter values. Now we shall look at three different sets of parameter values, but we return to the assumption of time-invariance: (1.14).

Three (best, medium and worst) values are shown on *Table 3* for the vector of the three key parameters (a_e, j, v).

It is noteworthy that in our examples, the simple and the combined methods produce similar results, because for the worst (the best) set of parameter values the relative payment of the simple method is close to the upper (lower) bound of the expected relative payment of the combined method: $m_{20} = 11.6$ vs. $m^{eu} = 10$ ($m_{13} = 4.4$ vs. $m^{el} = 5$). For extreme parameter values, which lie even farther away from the medium values than our worst and best values, it may occur that the simple solution lies outside the feasible interval of the combined method. To avoid degeneration, when the simple method outperforms the combined method, the bounds need to be changed. (Recall that for the medium values all the three methods yield the same characteristics.)

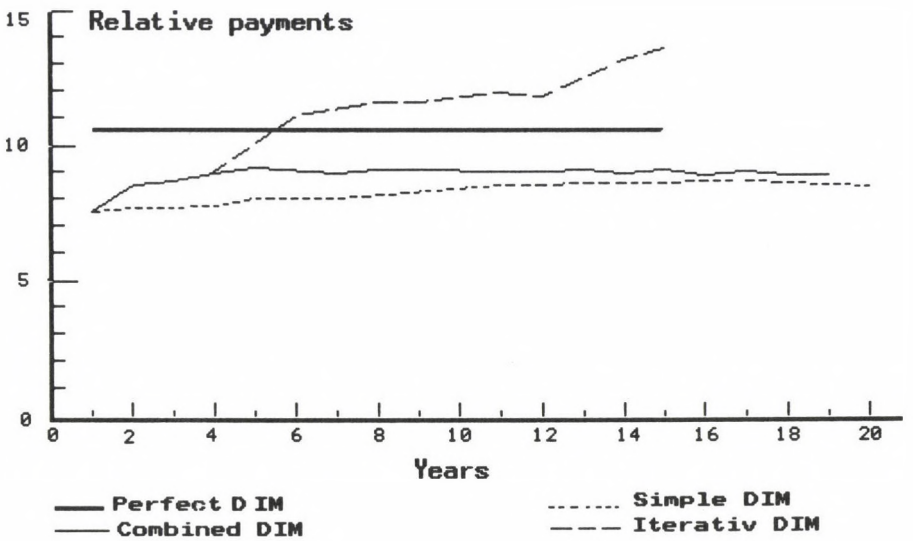

Fig. 3 Far-sighted DIMs (optimistic forecast)

7. Single Indexed Mortgage (SIM)

The *iterative* Single Indexed Mortgage with *short-sighted naive expectations* is the most-widespread indexed mortgage, and it has recently been adopted in Hungary (Simonovits 1992). We have already mentioned in the Introduction that for two-digit inflation this method strongly distorts the time profile of relative payments. To separate the triple effects of indexation, algorithmization and forecasting, in the full version, we also consider the SIM with three methods and three forecasts. However, here we confine ourselves to the summary results given at the bottom of *Table 2*, and *Figure 4* displays the iterative SIM with short-sighted expectations, which is the most important SIM.

8. Inflation-Free Mortgage (IFM)

It is the essence of the DIM that it takes into account both price and wage increases. While the former is quite uniform across the population, the latter has a huge dispersion. Small wonder that many lenders are reluctant to consider wage

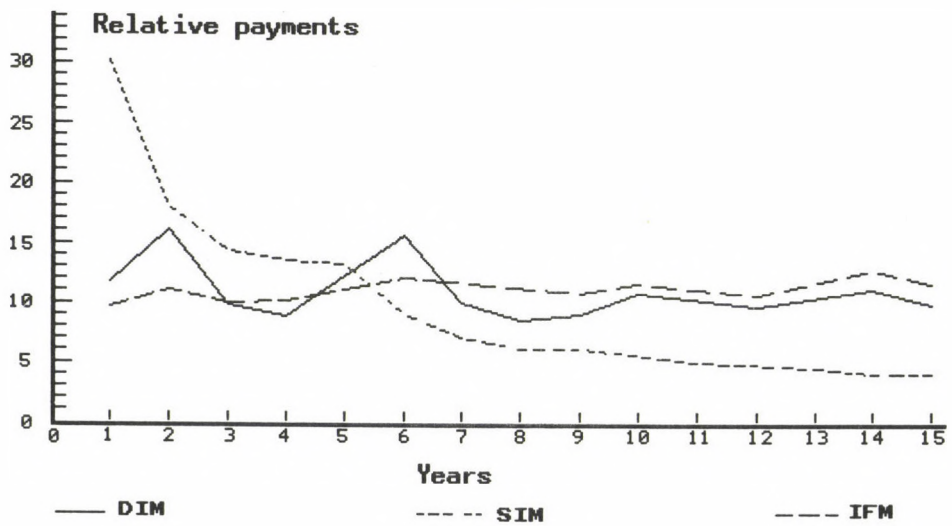

Fig. 4 Short-sighted iterative IMs

dynamics at all. As a simplification of DIM, we shall introduce a new method called Inflation-Free Mortgage (IFM) which also neglects wage dynamics.

Introducing P_t for the inflation factor of year t, we have two real variables: real payment $m_t^r = M_t/P_{1t}$ and real interest factor $i_t^r = I_t/P_t$. (Note: r is not an exponent.) As a further simplification, we assume that the real interest factor is time-invariant, e.g. $i_t^r = i_r = 1.04$. Then (1.2) becomes

$$M_t = m_t^{re} P_{1t}. \tag{8.1}$$

Assuming *consistent expectations*, we have

$$I_t^e = i_r P_t^e, \quad \text{i.e.} \quad b_t = \sum_{u \geq t} i_r^{-u}, \tag{8.2}$$

independently of expectations.

In the short-sighted version of iterative IFM the *relevant variables* satisfy the following equations (cf. (2.2)–(2.3)):

$$m_t^r = \frac{i_r^t \delta_{t-1}}{b_t P_t}. \tag{8.3}$$

Table 3

Characteristics of three DIM methods in the best, the medium and the worst cases
Time-invariant system (loan=100, lower bound=5, upper bound=10)

	Expected relative discount factor	Interest error factor	Wage	Real repayment initial	Real repayment end	maximal time	average time	End debt discounted
	a_e	j	v	m_0	m_T	T	t_k	δ_T
Method/Characteristics								
Worst case								
	0.98	0.97	1.02					
Simple				8.0	11.6	20.0	8.8	4.3
Iterative				8.0	17.8	15.0	7.7	0.0
Combined				8.0	10.2	20.0	8.6	0.0
Medium case								
	1.00	1.00	1.00					
Each method				6.7	6.7	15.0	8.0	0.0
Best case								
	1.02	1.03	0.98					
Simple				5.6	4.4	13.0	7.4	0.0
Iterative				5.6	2.9	15.0	8.3	0.0
Combined				5.6	4.9	13.0	7.5	0.0

$$\delta_t = \left(1 - \frac{1}{i_r b_t p_t}\right) \delta_{t-1}. \tag{8.4}$$

where $p_t = P_t/P_{t-1}$.

We shall illustrate the working of IFM with the short-sighted iterative version (*Figure 4*). Comparing it with its corresponding DIM-version, IFM outperforms DIM.

9. Final remarks

Before ending the paper, we shall make some final remarks.

Having compared the corresponding versions of the DIM and the SIM, the superiority of the former to the latter is striking. There is, however, a great problem with replacing the SIM with the DIM: retaining the usual maturity, the DIM significantly increases average payment time with regard to the SIM, causing serious liquidity problems to the Banks, particularly at the beginning of the transition.

There are two remedies to this problem. First, the maturity should be reduced. (In fact, in the present simulations I have already reduced the maturity time from 25–35 years to 15 years.)

Second, use should be made of a partial indexation on payments as proposed by some experts of the World Bank (Hendershon 1991), which lies between the SIM and the DIM.

I hope that the paper has convinced the readers that the DIM and IFM are promising methods of determining the time profile of payments on mortgages. However, their implementation needs further work. Contrary to the opinion of the World Banks' experts, the effect of forecast errors should not be mitigated by an arbitrary manipulation of the first members of the a_t^e-series. The introduction of the iterative or the combined method appears to be more efficient. (According to Modigliani (1991), the MIT mortgage also applies both iteration and variable nominal payment.) Of course, many simulation studies should be done before the practical introduction of the combined DIM or IFM.

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THE EXTENT OF THE ILLEGAL ECONOMY IN HUNGARY BETWEEN 1970 AND 1989—A MONETARY MODEL

M. LACKÓ

In her study the author tries to determine the extent of illegal economy with the aid of a model using monetary approach. The essence of the applied model is that the amount of cash in the hands of the population depends on several factors—among them, on the turnover of cash created by illegal activities. The method attempts to separate the latter and this allows an estimation of the extent of illegal economy. By the computations, illegal economy had increased between 1973 and 1987 expressed as a percentage of the GDP, from 13 to 18 percent. After 1987 the proportion of illegal economy pursued through the mediation of money jumped very high: it was 26 percent in 1988, 31 percent in 1989 and 34 percent in 1990. The calculations seem to prove our hypothesis, namely that the period of transition is characterized by an illegal economy, whose extent is higher than the one developed in the socialist system.

1. Introduction

Illegal economy is a concept increasingly known in the sphere of public opinion, and a phenomenon frequently analysed in economic literature. Illegal activities play a part in the market economies and also had a significant role in the command and reform eras of the socialistic economies. What is more, in the latter, parallel with the loosening strictness of the mandatory economy, the activities outside the sphere of those statistically recorded gained increasing importance.

The illegal economy includes the totality of activities which are not observed by statistical authorities. Some of these activities are productive and service jobs carried out against payment. Others are carried out without the mediation of money, in the form of exchange in kind, or bartering.

The development, maintenance and the proportion of the forms of the illegal economy have been supported by different motives in each system.

In the market economies it is usually the possibility of tax evasion that is linked to the operations of the legal economy, whereas the potential of pursuing some work alongside receipt of unemployment benefit promotes the illegal economy. In this economic system the prices of illegal activities are usually much lower than

The study was written in the framework of an OTKA research, entitled „Magyarország átmenete a piacgazdaság irányába" (Hungary's transition towards the market economy). The leader of the research project has been János *Kornai*.

the prices of the market of the legal economy. The chief purpose of illegal activities is to gain money income and the exchange in kind is less widespread.

In the socialist economies unemployment played no part in the organization of underground activities and the extent of tax evasion accompanying the legal private economy was much less than usually experienced in the market economies. Of course, the reason for this is not that the participants of the private economy that existed within the socialist economies were better taxpayers than in a market economy. What is more, since in the former system the legal private economy was barely tolerated and regarded as a rather non-desirable element, the state imposed on it much higher, prohibitive taxes. Hence, even here tax evasion became a significant—moreover it became a general phenomenon. However, from the aspect of its effect on the state budget, this kind of tax evasion was, in its totality, much smaller in the socialist countries than is customarily found in the market economies.

The cause of the development and growth of the illegal economy in the socialist countries is that while, in the legal state market, a significant shortage of consumer goods and services appears (queuing, waiting, low quality), the opportunity to turn to the legal private market is strongly impeded and restricted. The illegal market is developed for filling up this gap and its rapid growth is nourished by it. At the same time, the legal economy organized on the basis of state ownership is, on the input side (labour, material), fairly lavish, and provides room to the illegal economy from even more sides. On the one hand, it is easy to organize certain activities more effectively than is experienced in the legal state economy. On the other hand, it is possible that a portion of the lavishly provided inputs might be used up by the illegal economy. Experience shows that in the socialist economies the prices of illegal activities are higher than those applied in the legal state market, but still lower than the prices of the legal private market (at least in those areas where all three sources are available). In these economies earning money is also an important purpose, but at least as important as this is to obtain the consumer products or services which are difficult to acquire, owing to the shortage situation. It follows from this and from the relative price relations that in the socialist economies illegal activities pursued in the form of barter are much more widespread than they are in the market economies. (For instance, assisting each other in building homes, all types of repair work, medical treatment carried out at home, favours done for the exchange of some service or product: all these can be considered as such).

This latter fact (namely, the mixture of activities aimed at earning money and at exchange in kind) makes it difficult to find out which type of system,—i.e. the market economy or the planned economy—has the greatest extent of illegal economy. Besides, the difficulty of the comparison stems basically from the fact that measuring the illegal economy is not solved in either of the systems.

Some basis for the comparison can be presented by the historical process going on nowadays in the post-socialist countries. The transformation of the planned

economies into market economies in certain particular countries may help to estimate, in which type of economy we can find the operation of a larger illegal economy. However, it seems that we will have to wait a long time for this possibility of comparison—i.e. at least until state ownership in the post-socialist countries is significantly reduced and private ownership becomes dominant. Also, it will take time for the mechanism and norms of behaviour which developed in the socialist system to disappear and be replaced by new ones, suitable for the new ownership relations.

I am convinced that this transitory period will be characterized by a greater activity of the illegal economy than was developed in the socialist system, at least with regard to that part of it that was realized through the mediation of money. My conviction is supported by the fact that, already in the reform era of the socialist economies, similar phenomena could be experienced: the embryonic or distorted operation of the market institutions that came into being beside the dominance of state ownership, was coupled with a growing level of illegal activities. Taxation as a general commitment can be considered as a factor which increased and thus helped to extend the sphere of illegal activities built on tax evasion. In addition to the phenomena experienced during the period of the reforms in the process of transition further phenomena will also appear (for example, unemployment) which, even in the market economies, tends to enhance these types of illegal activities. Such an accumulation of motives encouraging illegal activities may, at the same time, be mitigated, if the opportunity of joining the private sector is made really easy and is free from limitations. This will stabilize the conditions of private ownership. However, the rapid narrowing of traditional markets, the fast-growing inflation, and high interest rates will (at least for the time being) make the process of transition rather uncertain.

In economic literature dealing with the illegal economies of both systems, extensive debates are going on concerning the proportion of illegal economic production, compared to the total amount of registered production. The participants in the discussion have so far only agreed on two points. One of them is the definition of illegal activities, and the other is the methodology for observing and determining the extent of them. Hence there are as many concepts and methodological descriptions that have been formulated about such activities as there are studies that have been written. In general, the concept follows from the applied methodology—namely, the methods determine which part of the multifarious illegal activities they are able to seize.

The essence of the illegal economy is that it is hidden from regular statistical recording, and consequently the methods applied for determining its extent may be based on either direct or indirect observations.

However, both methods raise specific problems. In the case of the methods of direct querying, the possibility is high that some illegal activities will be denied, or their significance underestimated (this may not be so much the case when making

time balances, but is more strongly asserted when questioning about incomes). The indirect methods are, however, forced to make assumptions, and thus the truth content of these is impossible to observe for such methods are practically uncontrollable.

In my study I wish to make an attempt to estimate, by an econometrical method, using a monetary model, the proportion of the illegal economy realized by the mediation of money. In the *2nd part* I shall review the former domestic quantifications. In the *3rd part* I wish to present, in detail, the monetary methods which are widespread in the market economies. In the *4th part* I will introduce the monetary model developed for the case of Hungary, the estimation of which, by using empirical data, will be found in *Parts 5* and *6*.

2. The extent of the illegal economy in Hungary—earlier quantifications

With regard to observing and measuring the illegal part of the Hungarian economy a series of surveys have appeared based mainly on direct methods or on expert estimates.

Some of these measurements took upon themselves the task of determining the size of the so-called second economy. The concept of the second economy, which was used first by *Gábor and Galasi* (1979) in Hungarian literature, sharply differs from the concepts of illegal, underground, shadow-economies—terms which are used in the market economies. Namely, the second economy includes the legal private sector, and there are some who also include within its compass the consumption of "home-produced" articles.

János *Timár* (1981) estimated the scale of the second economy on the basis of an analysis of the time balance of the population, and found its proportion to be approximately 30 percent.

A similar concept and method was applied by Rudolf *Andorka* (1990) who, on the basis of drawing up the time balance of 1986/ 1987, came to the result that "two thirds of the total time of the population aged between 15–69 years, spent in a wide sense on earning income, consisted of full-time work pursued in a job belonging to the socialist sector and one-third of it consisted of work pursued in the second economy." (Andorka 1990, p. 22). According to his survey, the most frequent form of the second economy is small-scale agricultural production (work performed personally or on household plots and in auxiliary farming). Other important items pursued in the second economy are building and the maintenance of homes, as well as other consumer services. Andorka, at the same time, made a time-comparison, beginning in 1963. He endeavoured to estimate the changing of the time spent on work in the second economy, on the basis of three national time balances.

According to this survey, by 1976/77, the average daily time spent on gaining complementary incomes had increased by 40 percent. Between 1976/77 and 1986/87 the time spent on activities to earn additional income, increased by 27 percent, ie. in this period it grew at a lesser rate than it did between 1963 and 1976/77.

The surveys show that in 1976/77, 25 percent of the time spent on work was used outside the sphere of the full-time job and by 1986/87 this ratio had been already 33 percent. He also drew attention to the interesting phenomenon that while the proportion of income-complementing activities linked to agriculture hardly increased (ie. increased from 20 to 22 percent), at the same time, the proportion of time spent on non-agricultural activities increased from 5 to 11 percent.

Of the non-agricultural activities the ratio of those spent on home-building and modernization is very significant. This sphere was mapped up by Á. *Vajda* and E. J. *Farkas* (1990).

In the course of their surveys they found that the ratio of flats built from private resources changed from 66 percent in the early 1970s to 90 percent in 1989. Within this, however, the role of the building industry hardly increased, while that of home-made work significantly increased (See *Table 1*).

As the authors stated: "The data indicate that the gap caused by the withdrawal of the construction enterprises from the market of home-building was filled up not by the entrepreneurial sphere but the 'make it yourself'-movement of the inhabitants." The authors also made an attempt to determine, by a secondary analysis of the data of the 1986/87 time balances, the number and annual inputs of the participants involved in home-building and renovation in 1987 (see *Table 2*).

According to this estimate, the number of hours worked by non-legal organizations was almost treble that of those worked within a legal framework and their ratio in 1987 was 74 percent of the total of accomplished working hours.

Measurements of the extent of the second economy were made not only by time balances but also by surveying the incomes. According to calculations made with the aid of income surveys, the proportion of incomes stemming from household- and individual plots, from other private activities and work was, within the average total income of a household, 16.7 percent in 1977 and 20.4 percent in 1987 (Source: *Andorka and Harcsa* 1990). Experience here also showed that the proportion of incomes stemming from individual and household plots decreased between 1977 and 1987.

As can be seen, on the basis of the survey on incomes a smaller ratio was indicated than on the basis of time balances.

Laki and Balázs (1990), in a piece of research carried out in 1989 with the use of questionnaires (with a sample of 1000 persons), tried to assess the share represented by the legal and illegal economies in the receipts and expenditures of households. Thus, they studied only those private activities that could be measured in terms of money. According to those questioned, the share of incomes coming

Table 1

Home-building by types of building contractors

	The proportion of flats from the total *in percent*, built up by			
	State-owned building contractors	Private contractors	From the private contractors: building companies	From the private contractors: private persons
1977	58	42	17	25
1980	58	42	15	27
1982	55	45	14	31
1985	46	54	14	43
1987	43	57	14	43
1988	36	64	16	48
1989	32	68	16	52

Source: Housing statistical yearbook 1982–87, Investments, construction and home-building statistical yearbook, 1988.

Table 2

The number and annual labour input of those participating in home-building and renovation

Building contractor	Number of participants 1000 persons	Ratio of participants percent	Number of hours worked million hrs	Ratio of hours worked percent
State-owned construction industry	68	7	100	17
Small-scale building enterprises	35	3	52	9
Population	900	90	432	74
Total	1003	100	584	100

Source: Vajda and Farkas (1990).

from the private economy within the total income ranged between 9 and 17 percent, while that of expenditures within their total was between 9 and 13 percent.

The authors were surprised at how little the share they discovered actually was. This result indicates the kinds of risks connected with surveys carried out by questioning: the survey was made at a time when, after the new income tax system had been introduced, Hungarian citizens had to fill out tax returns for the first time. Thus it is very probable that a significant proportion of incomes was denied.

A special historical opportunity in which denial was not a feature was provided in a survey based upon the Soviet Union, which was subsequently utilized by the survey made by Duke University, U.S.A. They questioned nearly 1000 emigrant households about illegal incomes and expenditures which were characteristic of their households in the second part of the 1970s, in the Soviet Union.

In this certainly special survey (which perhaps did not represent average behaviour) the ratio of informal incomes fluctuated between 15 and 66 percent, and the expenditures spent in informal markets moved between 29 and 72 percent.

In Hungary, estimates were made not only of the whole of the second economy. Many tried to chart the illegal part of the private economy. However, the results of this showed an even wider dispersion than those reviewed so far.

The Central Statistical Office, for instance, in its 1982 survey, estimated illegal incomes to total about 8.3 billion Ft, though they themselves admitted that "this is very likely less than the real sum of the invisible incomes". (*Éltető and Vita* 1987).

The extent of annual invisible incomes was estimated in the early 1980s to be between 17–23 billion Ft by R.I.*Gábor*, between 66–75 billion by M. *Petschnig* and between 70–80 billion by J. *Ékes*. E. *Sík* estimated the amount of invisible incomes to be double of the greatest one among the latter, in 1985—i.e. between 136.6–156.6 billion Ft. This equals 16–19 percent of the national income of the year in question. This is similar to the amount (100–200 billion Ft) figuring in the Parliamentary Report published by *Heti Világgazdaság*.

3. Measuring the illegal economy in the market economies

It stands to reason that in the market economies they do not measure the extent of the second economy in the same way as in the socialist countries, but they try to estimate the amount of illegal incomes.

In order to arrive at an estimation, direct questioning methods are used mainly by official bodies, like tax offices; researchers, however, prefer the indirect, monetary methods. The results of the two types of approaches, as well as the estimates produced by similar methods, show quite a large dispersion, even in the cases of the market economies. In a similar way no agreement can be found among those who employ indirect methods; the reason for this is that they work on the basis of different assumptions. Consequently, their results are also different.

Estimation of the illegal economy by using a type of monetary model showed an upswing in the market economies from the late seventies on, as evinced in the studies of *Guttmann* (1977) and *Feige* (1979).

The basic idea of the monetary approach is linked to the name of P. *Cagan* (1958); he analysed the factors that caused a situation in America, during World

War II, in which the C/M_1 ratio (ie. the proportion of cash within money) in its narrow sense increased significantly. He found that the main reason for this was the illegal economy, which had developed in order to evade taxation.

Cagan adapted the function in order to explain the development of the C/M_1 ratio. The explanatory variables of the function were: the expected net interest rate, the expected per capita real income, and the ratio of income subject to taxation. He made the survey based on the amount of cash in the USA from 1919 to 1955.

In the course of fitting the function he noticed that the ratio of cash is mostly determined by a price-effect (interest rate) and an income-effect (per capita real income): the increase of both reduce the cash ratio. However, these two effects gave him no complete explanation of the development of the proportion of cash. In his opinion the additional growth of cash demand can be explained by the increased cash demand parallel to tax evasion.

This idea was further developed by Guttmann, Feige and others. In the following we are going to introduce two methods which are widespread in the market economies, (although a debate is going on between these, too). One of them is the method developed by Feige (1986) in the early 1980s: this is the so-called general currency-ratio method. The other one is that of *Tanzi* (1982), which tries to eliminate precisely the faults of Feige's method.

Feige's general currency-ratio model is an equation system, consisting of 8 equations, which offers a general solution for determining the extent of informal incomes. In the equations he separates the formal and informal elements of the currency stock and the actual stock of demand deposits, and defines for both sectors the ratio of currency to demand deposits, the velocity of money in them, and the relations of the latter to each other. The general solution for the informal incomes, however, contains too many variables and parameters, for which no direct observations are available. In order to eliminate this problem, Feige applies five assumptions, which make the empirical estimation possible. These are the following:

1. The currency is the exclusive medium of exchange in unreported transactions.
2. The ratio of currency to demand deposits in the official economy is constant.
3. The velocity of money is the same in both economies.
4. There exists a golden age when the informal economy is negligible.
5. The income of the official economy is in conformity with that which was observed.

If these conditions are fulfilled, the extent of the informal incomes can be determined by the following formula:

$$Y_i = Y_r \frac{C - k_0 D}{(k_0 + 1)D}$$

where:

Y_i = informal income
Y_r = observed income
C = actual currency stock
D = actual stock of demand deposits
k_0 = ratio of currency to demand deposits in observed sector which is approximately similar to the value found in the golden age.

According to Feige's computations, the ratio of the informal economy in the USA in 1981 was between 20–30 percent.

The conditions allowing for this empirical estimation are very strict. The restraints—according to points 1, 3, and 4—can be somewhat loosened, while 2, assuming the invariability of k_0, cannot be easily released. Tanzi's model is aimed at releasing this condition.

Tanzi, when estimating the illegal economy of the USA, operates not with the C/D ratio, because he found that in the analysed period in America the C/GDP ratio decreased, and the D/GDP ratio decreased even more. Hence, the growth of the C/D ratio is caused by the reduction of D and not by the growth of C. In fact, Tanzi estimates a currency-demand function, the explained variable of which is the C/M_2 ratio and the explanatory variables are the per capita real income, the interest rate, the proportion of wages and salaries in the income, and the net tax payments expressed as a percentage of the gross income. With the aid of the latter variable he tries to follow up tax evasion. In other words, he tries to fit the cash ratio function with the aid of the above variables. After this, he quantifies a similar function, but assumes that the tax payment is 0. Multiplication of the value difference of the two functions by M_2 enabled Tanzi to obtain the amount of cash which has come into being due to tax evasion. He also assumes that the velocity of money is the same in the legal and the illegal economies. Thereby he can determine the illegal incomes. His calculations for 1981 resulted in a ratio of 5 percent.

As we can see, the estimated results of the methods described above produced very different figures. Feige obtained a ratio 4 to 5 times greater than that found by Tanzi.

Both methods employ several assumptions and restraints and the authors themselves also admit that they can only give very rough estimates about the illegal economy. In addition, Tanzi's method has some econometric problems, too.

In the professional literature a sharp debate is going on about the applicability of the above described methods. *Porter* and *Bayer* (1989) have found that both methods have weaknesses in their assumptions and in their econometrical aspects. However, their greatest fault is that within them the ratio of illegal economy is unaffected by the method of estimating the GDP. Thus let us imagine that, as regards

the GDP, two numerical estimates are available. The latter methods disregard this and measure the ratio of illegal economy to be always the same.

Reviewing the foregoing methods, we may state that the methods of Feige, which rely on the changing of the k = C/D ratio of the economy, cannot be applied to the socialist economies. In *Fig. 1* we can follow closely the C/GDP ratio in Hungary, and this shows an increasing trend which does not even fluctuate very strongly. This is because the indicator of cash shows mainly that money which is in the hands of the population, the enterprises being hardly provided with cash. In turn "D" (ie. the indicator of short-term deposits) means, in the majority of cases, the deposits of the socialist enterprises, and these are developing in accordance with mechanisms which are quite different from those in the market economies. The D/GDP ratio shows a fluctuation which is full of high amplitudes in the past period, and no trend can unequivocally be defined. Owing to the foregoing, to apply the "k" ratio indicator has practically no sense in the case of socialist economies. (As a matter of curiosity, we accomplished Feige's calculations with regard to Hungary, with reference to the period between 1973 and 1989. Calculated by his method the illegal economy increased from the necessarily assumed 0 for 1973, to 38–40 percent by 1989, and such annual fluctuations appeared which cannot be deemed plausible. For instance, according to this calculation, the ratio of the illegal economy grew from 23 percent in 1982 to 32 percent in 1983.)

Cagan's and Tanzi's methods are much more justified. However, due to their faults and to the particularities of the socialist economy, they need some modification.

In my study I make an attempt to estimate the extent of the illegal economy by quantifying a function which describes the development of cash demand. It is very similar to Tanzi's method.

I must in advance state that in the course of employing the monetary model I shall not be able to follow up the illegal activities which are carried out without monetary means of payment—i.e. those in the form of barter or self-consumption. Another point is that although it is a monetary approach to be made, illegal activities in foreign exchange can also not be taken into account; yet it is well known that nowadays this form is constantly increasing in Hungary.

All these restrictions give rise to the fact that the extent of the illegal economy estimated by myself can only be considered a bottom-level estimate.

3. A modified monetary model for the case of Hungary

With regard to the approach of the model to be presented in the following section, it is in many respects similar to that of Tanzi, but it also differs from it.

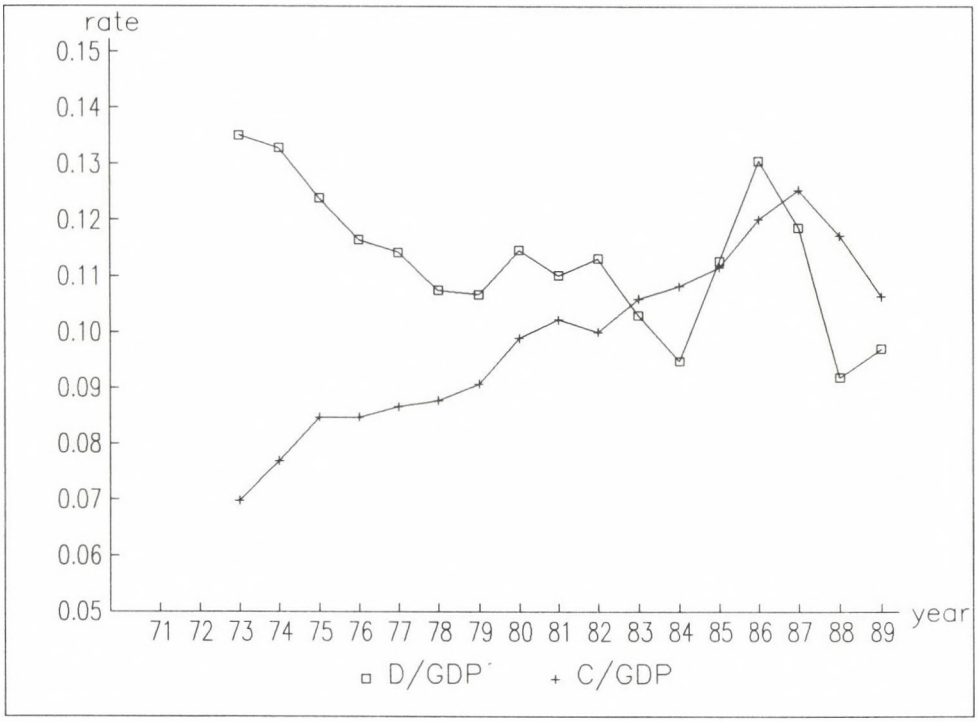

Fig. 1 The development of C/GDP and D/GDP in Hungary

First of all, we wish to study the proportion of cash in the hands of the population, in relation to the GDP. There is more than one reason for this: 1) In the Hungarian economy the companies have no, or only a negligible quantity of cash, and illegal cash turnover among enterprises does not exist at all. 2) We shall make efforts to eliminate the contradictions which can be found in the methodologies presented in the foregoing (such as the instance in which the estimated ratio of the illegal economy is unaffected by the method of estimating the GDP).

On the basis of assessments regarding Hungary, based on expert estimates, as well as on answers given to questionnaires that have already been presented in part 2, we can say that the three major spheres of illegal economy are: certain sections of small-scale agricultural production, home building and investments of the population, and consumer services. It is our assumption that the quantity of cash in the citizens' hands, in addition to the traditional factors (real income,

interest rate, the ratio of consumption) also depend on the non-registered cash turnover of the afore-mentioned spheres.

Accordingly, we shall define a cash demand function in which the explanatory variables are, in the first approach traditional variables: per capita real income, interest rate and the ratio of consumption.

In the traditional theory of demand, from these factors *the change in per capita real income* may have either a positive or a negative effect.

According to Friedman (1966) money is a luxury article, the demand for which grows at a rate higher than that of real income; this means that the sign of this parameter is positive. *Baumol* (1952) and *Tobin* (1956) approach cash demand from the aspect of stockpiling and, in their opinion, in keeping money, the elasticity of real income is negative. *Ando and Modigliani* (1956) admit the effect of both factors, and claim that they more or less equalize one another. *Modigliani, Rasche and Cooper* (1970) in their study point out that whatever the sign, it does not necessarily support one or another of the two above approaches (luxury article or stockpiling). According to them, the direction of the real income's effect is much more the result of the changes in the customs of payment, of the transaction costs, or of some similarly slow-moving change.

We note that both Cagan and Tanzi, letting this explanatory variable figure in their cash demand function, in the case of the USA, obtained a significantly negative parameter.

The direction of the *interest rate*'s effect is negative: the higher the interest rate, ceteris paribus, the lower is the stock of cash.

The third traditional factor is the *proportion of consumption within the GDP*. The greater this proportion, ceteris paribus, the greater is the actual amount of cash in the hands of the population.

With regard to this factor, another specific effect of the system has to be considered. It is well known that in a shortage economy people always keep more cash with them, so that if they catch a glimpse of some product deemed as an article in short supply, they are able to buy it immediately. When dealing with the fact that the growth of the ratio of consumption within the GDP, ceteris paribus, increases cash demand, we have to consider this phenomenon, too. The ratio of consumption within the GDP entails not only the cash demand for transactions (which is traditional in the market economies) but also the cash demand stemming from the normal shortage parallel with this consumption.

According to our assumption, parallel with the registered investments of the population (home building), with consumer services and with small-scale agricultural production, an extra cash circulation is going on, greater than the turnover of the transactions linked to the legal economy. This is what creates a part of the increment in the stock of cash—namely that part of it coming from the illegal economy.

Thus, our cash demand function is as follows:

$$c = f(y, i, v, 1, s, m)$$
$$+ - + + + +$$
$$-$$

where:

c = the ratio of the amount of cash in relation to the GDP
y = the change of the per capita real income, 1970 = 100
i = the net interest rate
v = the ratio of consumption related to the GDP
s = the ratio of the return from services in relation to the GDP
l = the ratio of the population's investments in relation to the GDP
m = the ratio of small-scale production in relation to the GDP

The + or − signs to be found below the explanatory variables represent the expected signs of the parameters.

Thus, a definition of the extent of the illegal economy is made as follows:

1. Accomplish the fitting of the above cash demand function.

2. Calculate the values of the above cash demand function, assuming that the extra money turnover is 0, ie. the last three factors in the cash demand function are 0. This means that we calculate the extent of the cash demand as if it were to depend on the traditional factors.

3. Taking the difference of function values gained under points 1) and 2), we multiply it by the value of the GDP. The result will be the quantity of cash which can be explained by the non-traditional factors, ie. by the extra money turnover.

4. Multiply the amount of cash gained under 3) by the velocity of money measured in the legal economy; the result will be the absolute amount of the incomes belonging to this extra quantity of money. Hence, we can assume that the velocity of money is the same in both parts of the economy.

5. Considering the incomes gained in point 4) as the incomes of the illegal economy, to calculate the ratio of the illegal economy, divide it by the GDP.

4. Estimating the cash demand function

We have carried out the estimation of the above mentioned function for the period between 1970 and 1989.

In order to prove that the traditional factors in themselves are unable to sufficiently describe the development of the cash ratio, let us show here an estimated function which contains purely the traditional explanatory variables:

$$c = \underset{(4.25)}{0.073y} - \underset{(3.21)}{0.0021i} + \underset{(2.65)}{0.189v} - \underset{(2.72)}{0.0898}$$

$R^2 = 0.78$
DW = 1.23
Relative error = 36.6 %
ro = 0.939
(15.73)
Time period: 1970–1989
Estimation method: AR 1

We note that in the course of the estimation, "i" was identified with the net value of the deposit rate found in the statistics of the IFS (International Financial Statistics Yearbook). (For the results of the estimation and the real cash ratio, see *Fig. 2*).

In the estimated function the value of the DW index is very low and that of the relative error very high (re = 36.6 percent). These circumstances prove our hypothesis—namely, that by using only these explanatory variables the development of the cash ratio cannot be explained. We have to note here that in the development of c in 1988 and especially in 1989, new trends started. Namely, the increasing trend of the cash ratio, which had been going on for twenty years, was now reversed. Two things may have emerged here. One is the attempt to "escape" from cash money, owing to the inflationary expectations. The other is not independent of the former one, because it involves the increase of the official purchase of foreign currencies. While in 1985 foreign currencies were officially purchased for 14.4 billion Ft, in 1986 this amount increased to 15.5, in 1987 to 18.8 billion, and in 1988, 45.2 billion Ft was spent on purchasing foreign currencies. We also tried to involve inflation (the past, present and the expected) in the above function but it proved to be in no way significant.

Now, for the estimation of the version of the cash demand function which was complemented by our propositions, a certain modification had to be accomplished.

The proportion of small-scale agricultural production as part of the GDP proved to be insignificant, therefore we left it out. The result was not surprising for us, for a study analysing the chronological development of the extent of the second economy (which we have dealt with earlier: *Andorka*), explained that after 1968, small-scale agricultural production became more or less legal. Thus from that time on it was especially the illegal economy not linked to agriculture that was growing. The fact that this variable—ie. the proportion of small-scale agricultural production to the GDP—produced no significant result in the cash demand function, does not mean that this sphere played no part in the development of the cash ratio. It seems probable that the ratio of illegal money parallel with this variable

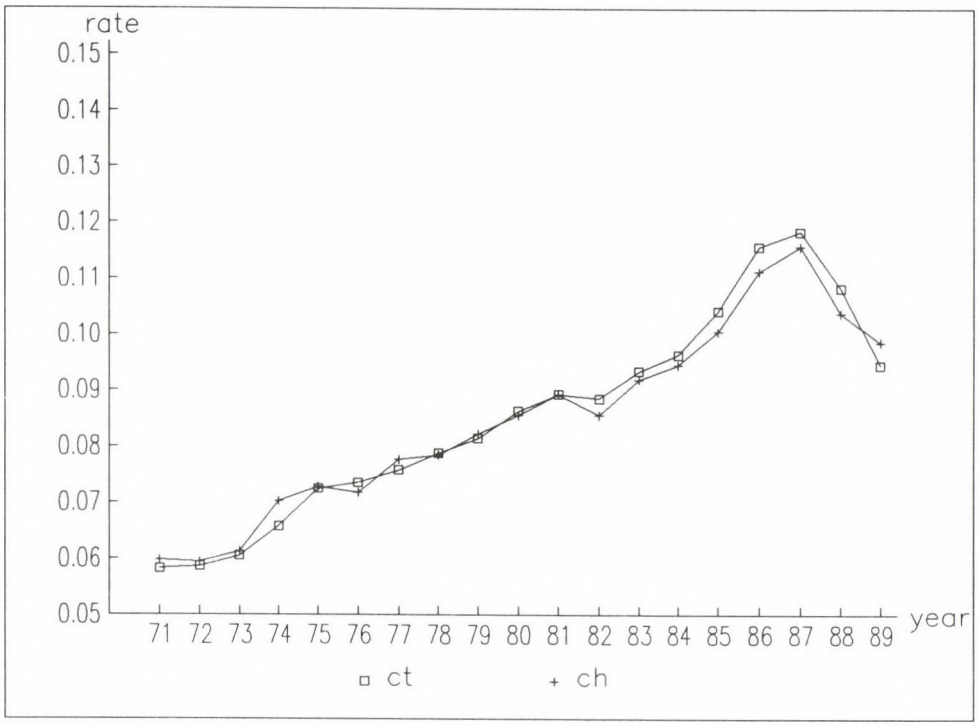

Fig. 2 The values of the function estimated by the traditional explanatory variables and of the real cash ratio

did not change over the course of time but remained constant, and this is why the computation is unable to demonstrate it.

In the sphere of consumer services we separated the state services and the services pursued by small-scale industry, ie. those coming from the private market. According to the calculations, the ratio of state services to the GDP proved to be insignificant; therefore, only the services of small-scale industry (sp) were included in the cash demand function.

In time the proportion of services performed by small-scale industry show an increasing trend. However, the increasing cash ratio parallel with it, (as is indicated by the parameter belonging to it in the function) shows not only the high cash turnover typical in this sphere, but also comprehends the effect of many other indices parallel with this variable. In general, it can even be considered as the *proxy-variable of the development of the non-agricultural private sphere* (private

retail trade, foreign tourism etc). As can be seen, in our function the non-traditional factors represent the development of the legal private sphere. Thus the series of our computations will exhibit the non-legal cash turnover parallel with this sphere's development. Namely, the bulk of illegal activities can be found precisely in those areas where the private sphere makes progress even in legal forms. This is due to the coincidence of two circumstances: on the one hand, these activities are not capital-intensive, but simple, easily being carried out by merely one or two persons; on the other hand, the supply of the state market lags far behind the demand.

Before carrying out the estimations, let us examine the dangers which can be raised by multi-collinearity. *Table 3* shows the correlations among the explanatory variables.

Table 3

Correlations among the explanatory variables, 1970–1989

	y	i	v	sp	1
y	1.00				
i	0.58	1.00			
v	0.79	0.23	1.00		
sp	0.69	0.89	0.50	1.00	
1	0.80	0.55	0.78	0.71	1.00

We accomplished another investigation of multicollinearity although this was fairly rough but simple. According to the suggestion made by *Klein* (1962) the following thumb-rule has to be asserted: when estimating linear functions with the aid of explanatory variables, it is necessary to fulfil the requirement that the adjusted R^2 of the so-defined functions should not exceed the adjusted R^2 of the examined cash function. The obtained adjusted R^2 are, consecutively, 0.77, 0.90, 0.83, 0.92, 0.68.

The estimated function is the following:

$$c = \underset{(18.1)}{0.069y} - \underset{(9.43)}{0.0046i} + \underset{(4.22)}{0.143v} + \underset{(11.9)}{1.58sp} + \underset{(4.68)}{0.50l} - \underset{(8.96)}{0.0974}$$

$R^2 = 0.998$
DW = 2.38
F(5.14) = 1531.6
Relative error = 1.3 percent
ro = − 0.458
(2.01)
Time period: 1970–1989
Method of estimation: AR 1

For the values of the estimated function and of the real cash ratio, see *Fig. 3*.

The indices of fitting and the DW index show good results, the relative error is 1.3 percent, the parameters are significant and even multicollinearity causes no problem.

We have already mentioned that growth began to slow down only after a long time: in 1987 and in 1988 the ratio of the stock of cash decreased and this trend continued in 1989 too. In order to find out the degree to which these three years influenced the results of our estimation, we also accomplished the estimation for a shorter period—namely for that between 1970 and 1986.

The estimated function is the following:

$$c = \underset{(13.1)}{0.068y} - \underset{(3.99)}{0.0029i} + \underset{(2.85)}{0.139v} + \underset{(5.33)}{1.40sp} + \underset{(2.72)}{0.38l} - \underset{(4.57)}{0.088}$$

$R^2 = 0.993$
DW = 2.31
F(5.11) = 478.9
Relative error = 1.8 percent
Time period: 1970–1986
Method of estimation: OLSQ

For the estimated function values and real cash ratio see *Fig. 4*.

The result shows that in the majority of parameters there is no difference between the two estimations. The only one which shows a great difference between the two estimates is the parameter linked to the interest rate. However, this is obvious because in the years 1988–1989, in relation to earlier times, the interest rate started growing very rapidly, and people adjusted to this by reducing the cash ratio.

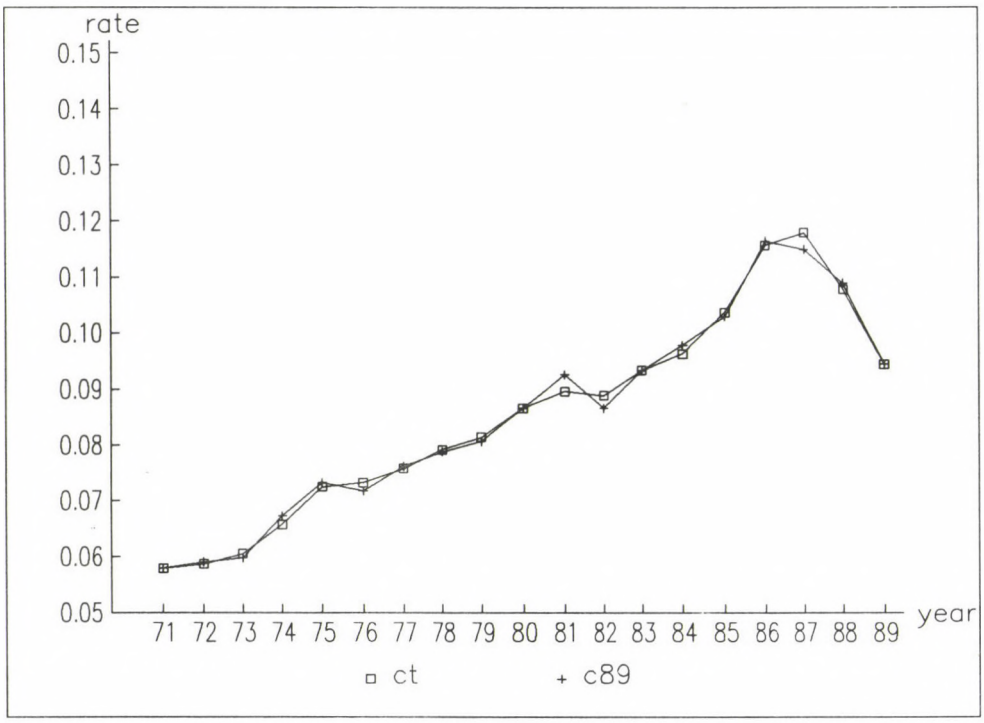

Fig. 3 The values of the function estimated for the period 1970–1989 and of the real cash ratio

In *Fig. 5* three curves can be found. The one marked (a) shows the simulation of the function estimated on the basis of the period 1970–1986, for the period 1970–1989; (b) indicates the values of the estimates made according to the period 1970–1989, and (c) shows the real values of the cash ratio.

It can be seen that the estimates based on the two periods of time—(a) and (b)—up to 1986 move with some difference but they are almost fully parallel and are also close to reality. The simulation of the 1970–1986 estimated function for the years 1987–89,—ie. the last three values of the curve (a)—are already much more distant from reality: in 1987 it underestimated, and in 1988 and 1989 it increasingly overestimated the truth. The reason for the overestimation was that the negative reaction to the changing interest rate that was customary up until 1986 was smaller than the reaction which developed after 1986. The last three values of curve (b) are rather close to reality.

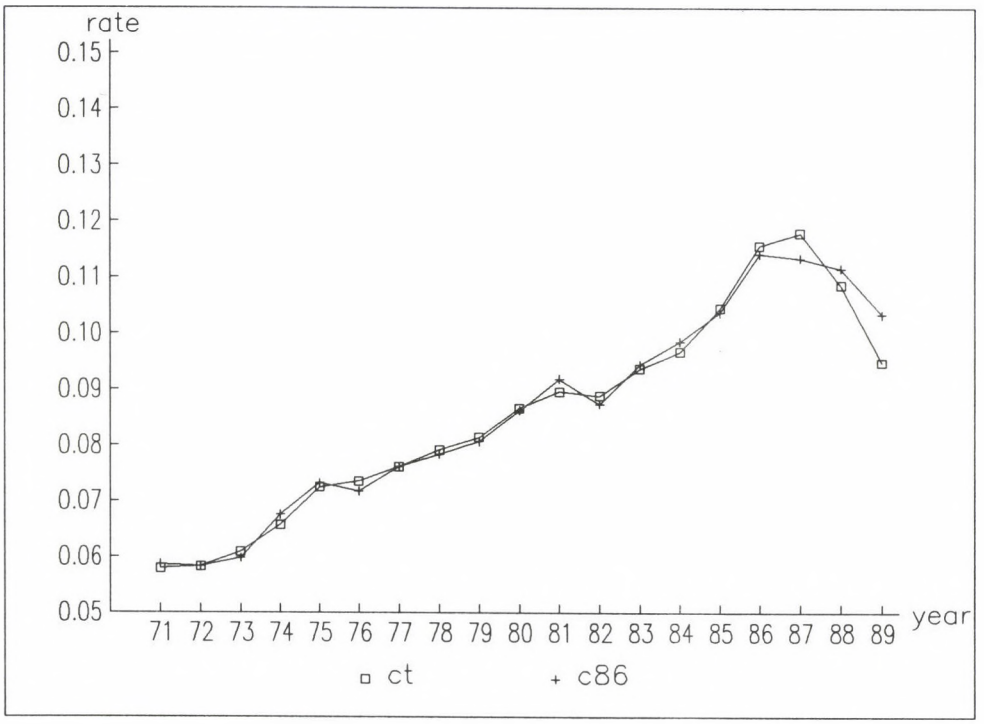

Fig. 4 The values of the function estimated for the period 1970–1986 and of the real cash ratio

5. Computation of the proportion represented by the illegal economy

In the following, based on both estimated functions, we can count up the proportion represented by the illegal economy and can also get an answer to the question as to what the difference was between the values estimated on the basis of the average behaviour in the periods between 1970–1986 and 1970–1989.

Having accomplished the fitting of the functions on the basis of the algorithm given earlier, we can now compute the proportion of the illegal economy, using the following steps:

1. Calculate the values of the estimated function (c);
2. Calculate the values of the estimated function by reducing the values of variables sp and l to zero; (c0)
3. Form the product cd = (c - c0)· GDP

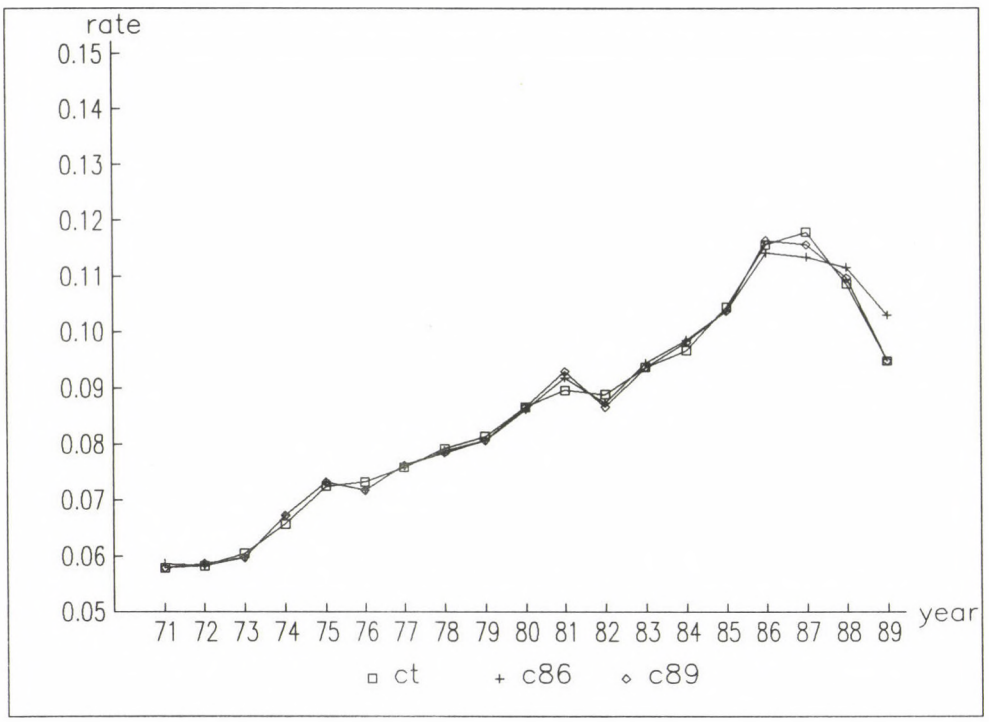

Fig. 5 The values of the estimated functions and of the real cash ratio

4. Form the product cj = cd·GDP/M1, where GDP/M1 is the velocity of money in a narrow sense;

5. Form the quotient gi = cj/GDP.

The results of computations based on the estimated function of 1970–1986 are listed in *Table 4* and those based on that of 1970–1989 in *Table 5*.

Following from the essence of our method, the extent of the ratio of the illegal economy is conditioned by the difference between the values of the cash ratio shown by the estimated function presented in detail above, and those of the cash ratio values which are due only to the traditional explanatory variables (ie. per capita real income, interest rate, the ratio of consumption). (The latter is called the traditional function of the cash ratio.) *Figures 6* and *7* show these functions, based on both computations.

The shaded areas in the figures represent those differences of cash ratios which are not explained by traditional factors. Thus they refer to the cash demand of

Table 4

Computation of the ratio of the illegal economy based on the cash demand function for the period 1970–1986

	c	c0	cd (billion Ft)	cj (billion Ft)	gi
1971	0.0584	0.0296	10.43		
1972	0.0583	0.0308	10.86		
1973	0.0598	0.0334	11.42	53.28	0.127
1974	0.0671	0.0409	11.94	57.85	0.127
1975	0.0727	0.0463	12.71	60.50	0.126
1976	0.0711	0.0453	13.62	67.38	0.128
1977	0.0755	0.0489	15.40	76.05	0.132
1978	0.0780	0.0510	16.94	83.45	0.133
1979	0.0803	0.0530	18.56	90.15	0.132
1980	0.0856	0.0559	21.41	96.05	0.133
1981	0.0912	0.0584	25.62	112.50	0.144
1982	0.0869	0.0527	29.10	125.42	0.148
1983	0.0939	0.0550	34.85	153.80	0.172
1984	0.0980	0.0560	41.06	188.70	0.193
1985	0.1034	0.0595	45.34	192.90	0.186
1986	0.1138	0.0665	51.40	193.93	0.178
1987	0.1131	0.0671	56.40	225.96	0.184
1988	0.1113	0.0524	83.04	375.68	0.267
1989	0.1028	0.0411	105.17	523.99	0.307

illegal activities. It can clearly be seen from the figures that though the functions move almost parallel with each other, the cash demand that cannot be explained by the traditional factors is constantly increasing.

We must draw attention to the fact that the 1971 and 1973 values of the traditional function made for the period 1970–1989 fluctuate to an unjustified extent. This also indicates the problem we have already touched upon; namely the estimate for the period 1970–1986 does not represent well the years 1987–1989 and the function which correctly estimates the years 1987–1989 does not approach the early past very well, especially not the traditional function of this period. Hence, we were right when computing the proportion of the illegal economy on the basis of the estimated functions with regard to both periods.

Figures 8 and *9* show the illegal incomes obtained as the results of the two computations and their proportions.

According to our computations, the proportion of the illegal economy between 1973 and 1986 increased from 13–15 to 18–21 percent of the registered GDP. It is important to note that the results we gained are similar to those of several earlier estimates. Endre *Sik* estimated 156.6 billion Ft for 1985, and the Ministry of

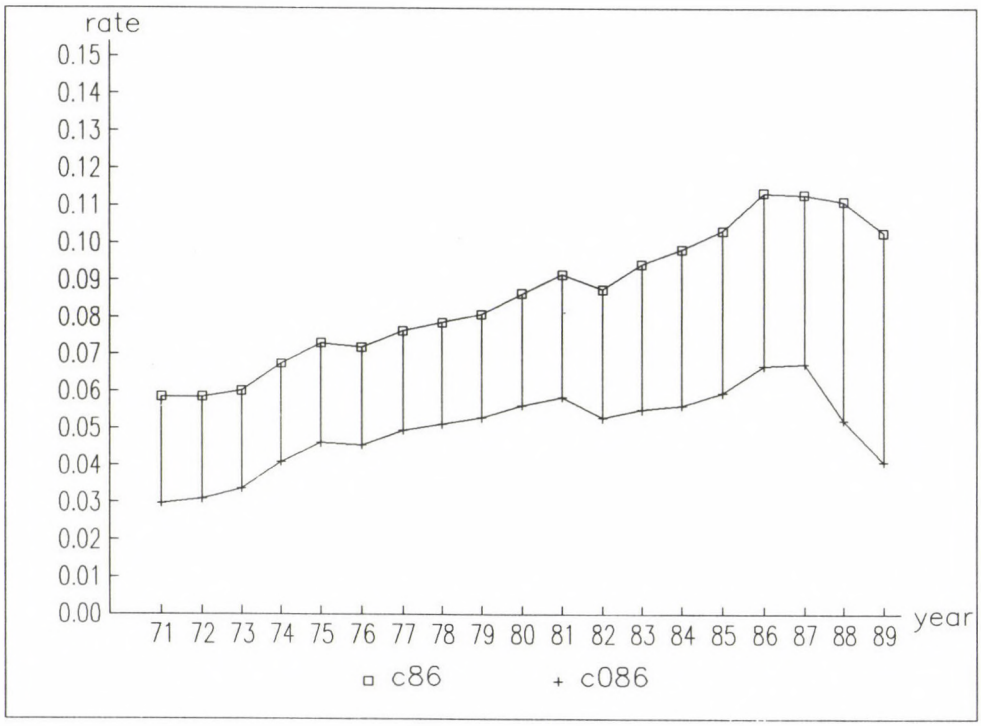

Fig. 6 The values of the cash ratio function estimated on the basis of the period 1970–1986 and of the traditional cash ratio function

Finance estimated 100–200 billion Ft for 1987. Our estimates are somewhat higher but, with regard to their proportion, it is understandable that they do not reach the 30 percent measured on the basis of time balances and labour calculations for the years 1986–87. Namely, the latter also include the illegal barter transactions, without a turnover of money, and the legal private activities, too.

The results obtained in the course of our estimates can be compared to earlier quantifications not only on the basis of their magnitude but also with regard to their dynamism. In the assessment made by Andorka (1990) the proportion of the second economy, with reference to time, increased between 1976 and 1986 by 8 percentage points, from which 6 points were linked to non-agricultural activities. According to our computations the illegal economy—which is narrower than the second economy—increased in the same period by 6 points.

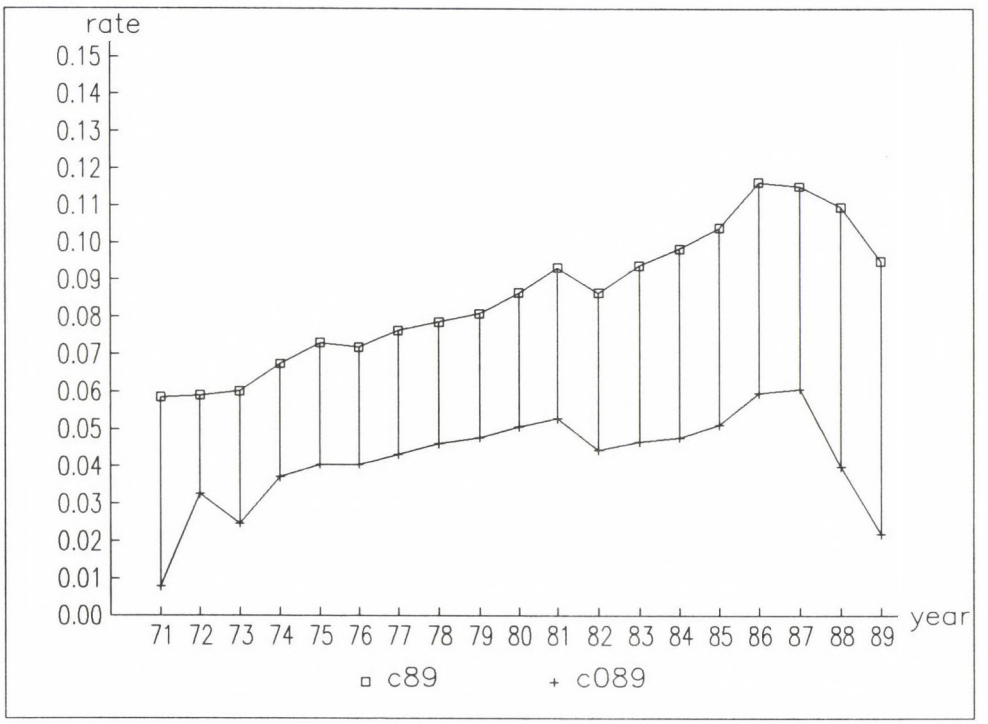

Fig. 7 The values of the cash ratio function estimated on the basis of the period 1970–1989, and of the traditional cash ratio function

At the beginning of our study we mentioned that by using our method only a bottom-level estimate of the illegal economy can be made. We can also draw attention to the fact that using a strong assumption in the method may be another cause of underestimating the extent of illegal activities. Namely, we assumed that the velocity of money is equal in both the legal and the illegal sector. It is very likely that the situation is different in reality and in the illegal sphere, the circulation of money being more rapid. The following table shows how the estimated extent of the illegal economy changes if we assume that in the illegal economy the velocity of money is 20, 50, or even 100 percent higher than in the legal sector.

So far we have only been speaking about the period between 1973 and 1986.

Looking at the results after 1986, both computations clearly show that in the years 1988–89 the proportion of the illegal economy started to grow very rapidly. Measured by the 1970–1986 function, it increased in 1988 and 1989 to 27 and to

Table 5

Computation of the ratio of the illegal economy based on the cash demand function for the period 1970–1989

	c	c0	cd (billion Ft)	cj (billion Ft)	gi
1971	0.0577	0.0076	18.16		
1972	0.0584	0.0322	11.32		
1973	0.0597	0.0242	15.26	73.84	0.171
1974	0.0671	0.0368	13.82	66.98	0.146
1975	0.0728	0.0400	15.82	75.30	0.156
1976	0.0712	0.0400	16.46	81.47	0.154
1977	0.0757	0.0431	18.82	92.93	0.161
1978	0.0782	0.0455	20.49	100.95	0.161
1979	0.0804	0.0475	22.44	108.98	0.160
1980	0.0861	0.0505	25.75	115.54	0.160
1981	0.0923	0.0530	30.72	134.87	0.173
1982	0.0861	0.0439	34.86	150.20	0.177
1983	0.0929	0.0463	41.77	184.33	0.206
1984	0.0976	0.0474	43.72	226.20	0.231
1985	0.1034	0.0509	48.54	230.75	0.223
1986	0.1162	0.0597	55.10	232.04	0.213
1987	0.1150	0.0603	61.23	268.90	0.219
1988	0.1093	0.0400	93.03	441.68	0.313
1989	0.0943	0.0220	118.42	614.82	0.360

Table 6

The ratio of the illegal economy beside different velocities of money

The velocity of money in the illegal sector was higher than in the legal one, by	1973	1986
20 percent	0.15	0.21
50 percent	0.19	0.27
100 percent	0.25	0.36

31 percent, respectively. In addition, on the basis of the 1970–1989 function, it increased to 31 and 36 percent, respectively. Let us consider the lower estimate as valid, based on the consideration that adjustment to the new interest rates was in reality perhaps not as fast as it was deemed in the computations.

Unfortunately, I could not include the year 1990 in my estimate, since certain data were not available. Hence, I was able to estimate the traditional function

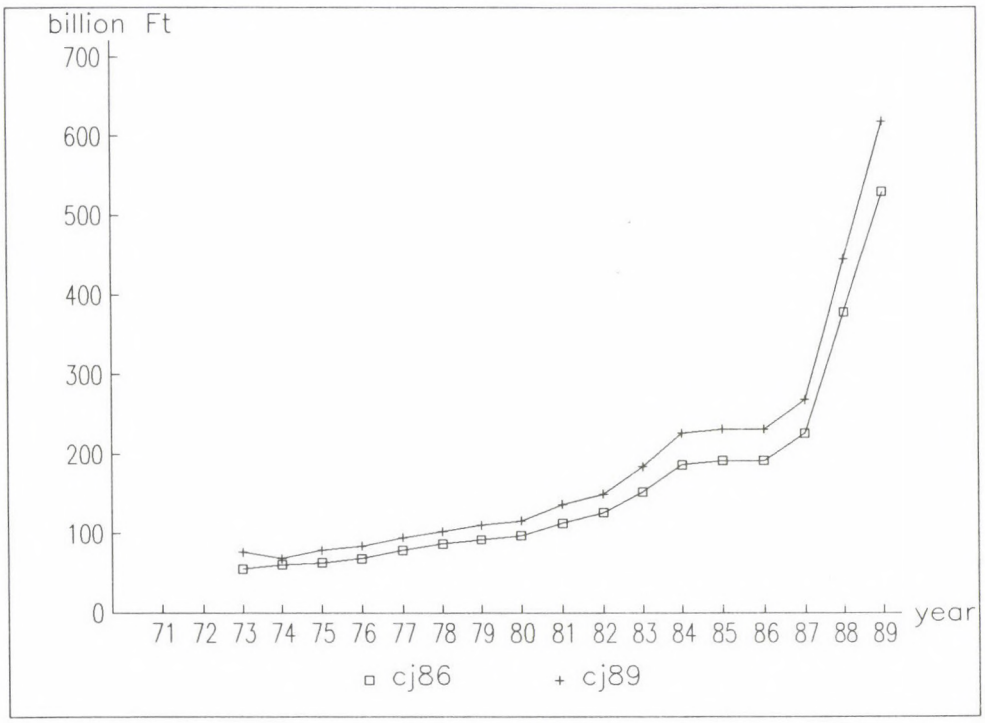

Fig. 8 Illegal incomes based on the two computations

value belonging to that year. I thought that if, for the years 1988–89, I used the parameters of the 1970–1986 function, for 1990 I would be able to somewhat deviate from them. Thus, instead of the parameter 0.0029 belonging to the interest rate, I counted the traditional function value by using the average parameter of two functions of behaviour (0.00375). Deducting the latter from the cash ratio measured in reality, I calculated the proportion of the illegal economy according to the already known algorithm. For the year 1990 I obtained 34.4 percent as the ratio of the illegal economy. Thus, according to my calculation, the proportion of the illegal economy continues to grow, though in relation to the pace in 1988–89 it has become somewhat slower.

There are several reasons which might have caused the proportion we measured to have jumped so high.

One of them is that, in all probability, as I referred to in the Introduction, parallel with introducing the general taxation system that part of the illegal economy

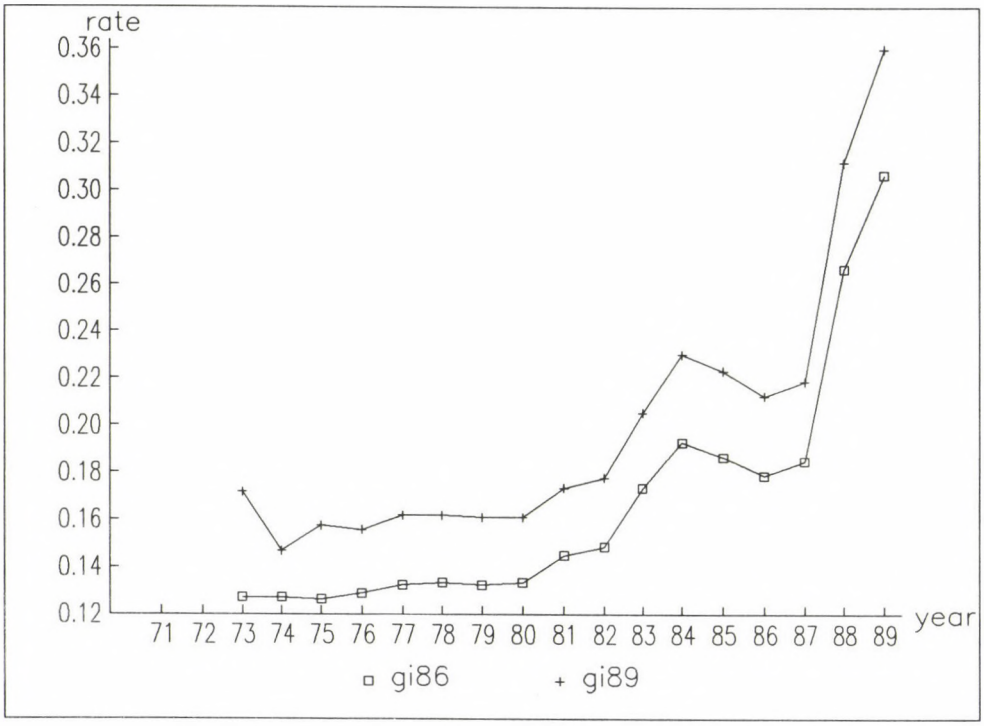

Fig. 9 The proportion of the illegal economy based on the two computations

stemming from tax evasion increased. This may also be supported by the sociological fact that, according to the behaviour developed during the era of socialism, to cheat the state was no sin. The introduction of the taxation system was made at a time much earlier than that at which such behaviour could be expected to have been transformed. This circumstance involves the possibility of the proliferation of such kinds of illegal activities.

Another factor may be that from 1987–88 on, the legalization process of the private sphere, at least regarding the services, commenced. This is clearly shown by the data found in *Table 7*.

However, the legalization process started in 1987–88 was at that time far from being accomplished and this impeded the arrangements for long-term, stable economic operations and nourished the illegal, undeclared activities.

The third factor is connected with the price changes that began to take place at that time. In 1988, while the consumer prices increased by 15.7 percent, the

prices in the services' state market grew by 26.8 percent, and in the private market by 18.9 percent. It was the first time that prices in the state market grew much more rapidly than they did in the private market. This, of course, does not mean that prices in the socialist sector had exceeded in absolute value those of the small-scale industry. However, the relative price changes have, in all probability, driven the consumers towards the legal and illegal private market.

Table 7

Increase in the number of craftsmen and their employees, in percent

	Increase of	
	Craftsmen	Employees
1985	4.8	8.1
1986	3.5	7.4
1987	2.2	57.7
1988	9.2	43.8
1989	3.9	31.5

Source: Statistical yearbooks

It is also possible that a certain restructuring came to pass in the illegal economy: some part of the illegal barter transactions, which could not be taken into account by us, came to be monetarized. This was due to the stronger reduction of living standards in the legal economy, to the mitigation of overheatedness in the economy, to increasing unemployment, and to other political factors. Very probably a part has also been played in this by the changing of rules concerning the keeping of foreign exchange: it is no longer obligatory to prove that foreign exchange was purchased in a legal transaction. This, on the one hand, increases the illegal activities carried out in foreign exchange—thus our method of estimation cannot follow this. Parallel with this, however, the illegal activities pursued by the mediation of domestic monetary methods may have been revalued; this, in turn, appears in our estimates.

6. Summary

In this study I have tried to determine the extent of the illegal economy with the aid of a model that uses a monetary approach.

My starting assumption was that the illegal activities which are carried out by the meditation of money are realized in cash. The essence of the applied model is that the amount of cash in the hands of the population depends on several factors—among them, on the turnover of cash created by illegal activities. The

method attempts to separate the latter and this allows an estimation to be made of the extent of the illegal economy.

According to may hypothesis the proportion of cash to the GDP is influenced, on the one hand, by factors linked to the theory of demand. These can be considered traditional ones: the per capita real income, the net interest rate, and the ratio of purchased consumption related to the GDP. The quantification of the cash demand function shows that the development of the cash ratio in Hungary between 1970 and 1989 cannot be explained by explanatory factors alone.

Earlier examinations implemented for the sake of determining the extent of the second economy made it clear that the three most important areas of illegal activities comprehend those activities which have created a path for themselves even in the legal private economy in the last 20 years: small-scale agricultural production, home building and the consumer services. This was the experience which prompted me to search for interdependence between the development of the cash ratio and that of these spheres. Inserting the turnover of these spheres in relation to the GDP into the cash demand function I have tried to determine: does it increase? If the answer is yes, to what extent is the increase with regard to the keeping of cash, the development of the private and the state market (ceteris paribus, and beside unvaried real income), the interest rate and the consumption ratio. According to my hypothesis the increasing turnover of the emphasized spheres would not entail extra cash demand if all the actions pursued in the legal market were to be registered and, thereby, involved in real income and consumption. However, if in addition to the traditional factors, in the cash demand function which also contains the turnover of the special areas, the latter are significantly positive, this shows an extra cash demand which may be the result of illegal activities.

We have accomplished the quantification of the cash demand function for the time period of 1970–1989. The major part of the explanatory variables proved to be significant, with the exception of small-scale agricultural production. This caused no surprise because this is the area that has grown to the least degree in this period, and also a sphere in which a significant part of the illegal transactions are realized in the form of exchange in kind. As a matter of fact, our method is unable to encompass these types of activities.

Successful quantification of the cash demand function allowed us to elaborate an algorithm which is suitable for determining the extent of that part of the illegal economy that is realized by the mediation of cash. The methodology itself, as well as the assumptions of the applied algorithm, are means which can serve as an estimate of the bottom level of the illegal economy.

According to the computations, the illegal economy between 1973 and 1987 increased, as expressed as a percentage of the GDP, from 13 to 18 percent—as an absolute value this can be expressed as an increase from 57.9 billion Ft to 226 billion Ft. After 1987 the proportion of the illegal economy pursued through the mediation of money jumped very high: it was 26 percent in 1988, 31 percent in 1989

and 34 percent in 1990. The calculations seem to prove our hypothesis, namely that the period of transition is characterized by an illegal economy, the extent of which is higher than that which developed in the socialist system.

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REVIEWS

THE HUNGARIAN PUBLIC ON THE ADVANCE OF PRIVATE ECONOMY

E. HANN-M. LAKI

Those analyzing the ground gained by private economy in Hungary tend to concentrate their attention on the privatization performance of the government. Debates between the coalition and the opposition are also conducted about the forms and techniques of privatization chosen by the government: whether these increase or, on the contrary, reduce the speed of privatization.

The failure of the so-called pre-privatization, the difficulties and even scandals related to the handing over of state enterprises into private hands indicate not only the disadvantages of the privatization techniques preferred by the government; they also signal that the speed of privatization is influenced considerably by non-institutionalized socio-economic forces independent of the government. (*Laki* 1991) Among them we find important natural and financial barriers. The speed of privatization also depends on the opinions held by the different groups of people. Such groups have different talents, varied approaches and contrasting interests in relation to the handing over of state property into private hands.

In this paper, some of the factors that are independent of the state will be analyzed. We will use results of public opinion polls conducted at different dates. The opinion poll company Median Ltd. first in November 1989 put questions concerning privatization to the members of a representative sample of 1000 people. (*Vásárhelyi* 1990) In January 1991 the views of 1200 adult Hungarian citizens about transition to free market economy could be learned; this was carried out in the framework of an investigation covering three countries. Finally, in May 1991 those questions of the two earlier surveys which seemed to be unvariably relevant were unified, repeated and complemented by a few new viewpoints. This research process also used a representative survey of 1200 people. The following analysis thus allows two comparisons over time—one covering a shorter and the other a longer period.

Our analysis seeks to measure the size of groups in society that respectively oppose or support the handing over of state property into private hands or even in to foreign ownership. We also tried to discover more about those groups in which the spirit of enterprise has taken roots.

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Opponents and supporters

By the end of 1989 only one fifth of those questioned supported the dominance of state ownership. Since then their proportion has somewhat diminished (*Table 1*).

Table 1

Opinions about privatization of state enterprises (percent)

The best would be	November 1989	May 1991
if enterprises remained in state ownership	20	16
if a part of firms remained in state ownership, while another part were not owned by the state	56	62
if state ownership of enterprises were completely abolished	10	12
do not know	13	10
Total	99	100

Partial privatization—a characteristic collective notion—has brought about a visibly popular response, but this covers up many kinds of contradictory ideas and uninformed opinions.

Thus it is not surprising that when the future owner is named, or the scope of goods to pass into private hands is more precisely defined, we arrive at a different result.

Those who believe it is not permissible that big state-owned enterprises should pass into private ownership represent a relatively large group. The majority—in May 1991 about two thirds of the sample—oppose the handing over of big estates to foreign investors. About three-quarters of the sample were against large private estates coming into existence in the course of privatization. (*Table 2*)

Table 2

Changes in the proportion of those rejecting privatization (percent)

It should not be allowed	January 1991	May 1991
that big firms should get into private hands	36	40
that enterprises should get into foreign ownership	43	46
that large immovables should get into private hands	46	51
that immovables should get into foreign ownership	60	64
that large private estates should come into existence	67	72

It is also apparent from *Table 2* that in these cases—which decisively influence the extent and speed of Hungarian privatization—the number of opponents increased by 4–6 percent in short time, i.e. in less than all a year. At the same time there was an unchanged or growing proportion of those who thought that the phenomena unavoidably accompanying privatization and the transition to free market relations (primarily the effects of growing inequalities) are unacceptable. (*Table 3*)

Table 3

Changes in the proportion of those rejecting some phenomena accompanying market economy (percent)

It shall not be allowed	January 1991	May 1991
that wages of employees should be determined by the market, and not by the state	15	14
that those not sufficiently competent should lose their job	34	39
that good managers should be able to enrich themselves	52	52

The group which opposes the basic condition of the coming about of a market economy—i.e. privatization—differs from the one which rejects the almost unavoidable social consequences of this process. This was indicated by the evidence of the cluster analysis of the answers to the eight questions asked.

The analysis by main components grouped the answers according to the above criteria. The first component (accounting for 39.4 percent of the variance) included the attitudes towards privatization, while the second (accounting for 13.9 percent of the variance) comprised the views related to the social consequences of a market economy. Thus, in connection with this transition we can present two basic dimensions of reasoning which are essentially independent of one another: first, the dimension of attitudes which refer to changes in ownership relations, and second, those showing a sensitivity to social problems (albeit with some generalizations).

In the next step, cluster analysis was applied to the two main components; this technique was suitable for identifying the types of attitude emerging along the two dimensions. The validity of the method (and the stability of the types of reasoning) is supported by the fact that both the separate analysis of the January and May surveys, and then their combined investigation, produced identical main components and identical clusters. It was only the number of individuals belonging to the types that changed.

The first type of reasoning comprises those people (representing a relative majority in the sample) who reject the different forms of privatization—that is, they oppose the handing over of state property into domestic or foreign private

ownership—but are relatively indifferent towards the social consequences. Their approach is presumably determined by the anti-capitalist communist propaganda that opposes private property, and also tinted by a kind of seclusion—i.e. a stand against foreigners and foreign countries. Henceforth in this paper they will be called *anti-privatizers*. Another group (much smaller than the former one) comprises those who have no particular problem with privatization itself, but reject the idea of large inequalities, unemployment and wages freed from state regulations. They will be labelled *social anti-capitalists*. The third group (practically as strong as the first one) comprises those who are inclined to show an antipathy towards both the above dimensions: that is, they are simultaneously characterized by their discarding of the market economy on both ideological and practical-egalitarian grounds. They will be simply termed *anti-capitalists*. Finally, those representing the fourth type of reasoning equally accept the different forms of privatization necessary for the development of a market economy, as well as the increasing inequalities which are concomitant with the change of economic system. This group will be called *market advocates*.

The fact that the advocates of privatization—who are also willing to face the concomitant inequalities—are not in a majority in Hungarian society is not at all surprising. This has already been indicated by the data of *Tables 2* and *3*. However, from the point of view of the success of, and social support for, the unavoidable economic steps still ahead of us, it is more significant and alarming that the number of those supporting the transformation is diminishing with surprising speed. This is evident not only from the various opinions, but is also embodied in a consistent restructuring of public opinion in general. This is shown in *Table 4*, which quantifies the distribution of the types of reasoning in January and May 1991, produced by cluster analysis. It can be seen that the ratio of those advocating a market economy and privatization fell—in the course of hardly half a year—from one third to one quarter of the population.

Table 4

Advocates and opponents of market economy (percent)

Group	January 1991	May 1991
Anti-privatizers	30	33
Social anti-capitalists	9	7
Anti-capitalists	27	34
Market advocates	34	26
Total	100	100

These modes of reasoning are determined largely by the sociological position of the individuals. According to the regression analysis performed, the following factors are the most significant (and in the order shown) in deciding whether an individual supports or rejects the private economy:

Variable	Regression coefficient
Sex	0.1424
Schooling (qualification)	0.1237
Income	0.1047
Age	0.0953

This means that the proportion of those advocating a market economy is higher among young people, among men and in the groups with higher education and income—in this order.

The distribution of the four types according to the above factors is shown in *Tables 5–8.*

Table 5

Advocates and opponents of market economy by sex—May, 1991 (percent)

Group	Men	Women
Anti-privatizers	37	30
Social anti-capitalists	5	9
Anti-capitalists	25	40
Market advocates	33	21
Total	100	100

It is evident that in Hungarian society there is a majority which generally endorses the—at least partial—demolition of state ownership. At the same time, the proportion that supports the handing over of state property into private hands is smaller—particularly in connection with the more important units of the state property. The seeming contradiction between the two standpoints is resolved by the fact that the majority of people believe that some kind of public (community) property is desirable. At any rate, in the last one and a half years there has been a definite increase in the number of those who have definite opinion about the way in which state property should be devolved—that is, about who the new owner should be. Namely, in the course of making more correct the opinions presented in *Table 1*, the answers shown in *Table 9* have been obtained.

Apparently, approximately half of the population are of the opinion that the employees of state enterprises should in some form become owners. One out of

Table 6

Advocates and opponents of market economy by qualification—May, 1991 (percent)

Groups	Less than 8 forms (classes)	8 forms (classes)	Secondary school	University and other higher education
Anti-privatizers	28	35	32	35
Social anti-capitalists	10	5	9	7
Anti-capitalists	48	39	27	20
Market advocates	14	21	32	38
Total	100	100	100	100

Table 7

Advocates and opponents of market economy according to income—May, 1991 (percent)

Groups	Lower	Lower--middle	Upper--middle	Upper
	income bracket (quartile)			
Anti-privatizers	29	35	32	34
Social anti-capitalists	7	4	7	9
Anti-capitalists	42	39	37	24
Market advocates	22	22	24	32
Total	100	100	100	100

Table 8

Advocates and opponents of market economy by age—May, 1991 (percent)

Groups	18–30	31–40	41–50	51–60	61 and over
	years of age				
Anti-privatizers	29	33	33	37	33
Social anti-capitalists	10	8	6	5	7
Anti-capitalists	27	28	30	41	44
Market advocates	34	32	31	17	16
Total	100	100	100	100	100

every four respondents would also approve of the existing workforce becoming the exclusive new owner. The majority (69 percent) of those advocating collective

Table 9

Who should be the owner? (percent)

Answer	November 1989	May 1991
The state	20	16
Workers' collectives	19	26
Private persons	17	23
Both collectives and private persons	26	22
Do not know	18	13
Total	100	100

property in May 1991 (48 percent of the sample) believe it would be expedient if employees bought the enterprise as shareholders. As against this, a 24 percent minority (11 percent of the sample) think it would be desirable if state enterprises became the property of employees free of charge. This indicates that the so-called unlimited privatization is not particularly popular in Hungary today. Free allocation of property is attractive mainly for the less educated social groups (*Table 10*).

Table 10

Support given by groups according to qualification for different forms of acquiring property—May 1991

It would be good if	Less than 8 forms (classes)	8 forms (classes)	Secondary school	University and other higher education	Total
enterprise collectives could buy the firms as shareholders	43	65	73	77	69
enterprises passed into the ownership of employees free of charge	45	30	21	12	24
do not know	12	4	7	11	7
Total	100	99	101	100	100

Experiences and opinions

The majority of Hungarians thus regard privatization and the devolution of state ownership to be generally desirable. However, a considerable proportion of those answering oppose the passing over of important parts of state property—i.e. big firms and large immovables such as land—into private hands, particularly if the new owner is a foreigner. The reason may be that a growing, albeit relatively small proportion of the Hungarian population has so far been directly affected (as employee or potential owner) by the handing over of state enterprises into private hands. Even in May 1991 more than one third of the economically active citizens were of the opinion that the passing over of their workplace into private hands was inconceivable (*Table 11*).

Table 11

Likelihood of privatization of their workplace according to those questioned (as a percentage of the economically active population)

Privatization of the firm	November 1989	May 1991
is conceivable	44	58
is inconceivable	47	38
do not know	9	4
Total	100	100

The lack of experience in these matters is also related to the fact that the legal private sector is today not yet particularly big. Beyond that, the proportion of those leaving in some form the state sector (as their full-time job) is small. Merely 16 percent of those questioned possessed some kind of income other than their wages (or pension) from the state sector, and the minority with some kind of capital income could hardly be quantified. Surplus income generally derives from "extra" work and one out of every four of those performing such surplus work finds the source of their complementary income in the state sector. Another quarter work with private firms, and one third earn additional income from their household plots or in complementary activities associated with farming.

Because of the frequent lack of experience it is fair to ask the question: how well-founded are the opinions related to privatization? It is worth recalling that, even in May 1991, the ratio of those who had not even thought about who should own the factories stood at 35 percent. At the same time, the gradual coming to the fore of the subject is undoubtedly indicated by the fact that one and a half years earlier this ratio was 40 percent.

Interest in the problem also indicates other things. For instance, those who are concerned with the problem of ownership answer concrete questions with: "I do not know", not only rarely but their views are also at variance concerning the possible form of privatization. (*Table 12*) Although people with higher qualifications said more frequently than the average that they had already reflected about the problem of ownership relations, the indicated interrelation is valid, independent of schooling background. When interest in the subject was also included in the regression equation that analyzed the background of the market-supporting attitude, it turned out that was the fifth most important factor beside the four already mentioned (regression coefficient: 0.088). In other words: among those consciously dealing with the problem the ratio of market supporters and advocates of privatization is greater at every level of school qualification.

Table 12

Advocates and opponents of market economy among those showing interest for and those indifferent to ownership relations—May, 1991 (percent)

Groups	Nowadays there is much talk about who should own the plants and factories. Have you ever reflected on this issue?	
	Yes N=766 people (65%)	No N=402 people (35%)
Anti-privatizers	34	30
Social anti-capitalists	7	8
Anti-capitalists	28	45
Market advocates	31	17
Total	100	100

The proportion of those supporting the market economy and privatization has also shrunk in the short run. This can be traced in those social groups which mostly accept the values of a market economy. In the first half of 1991 the ratio of market supporters fell from 42 to 34 percent among those under 30 years of age, from 45 to 31 percent among those in the upper income quartile, from 43 to 31 percent among diploma-holders. What still gives ground for some optimism is the fact that in these relatively active, mobile, and trend-setting groups the support for the private economy is still considerable—and they certainly are most capable of being involved in private enterprises.

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THE ECONOMIC ÉLITE IN HUNGARY OVER THE LAST DECADE

J. KISDI–R. KULCSÁR

In any social system the top spheres of power are always wrapped in a certain mystery. In the 20th century, however, it was perhaps in the countries which were governed by a socialist system that the élite was totally separated from the masses, allowing no insight into its working whatsoever. The "high society" in these countries was divided into two strata. One of them was the party élite, standing at the top of the ladder of power. The other one was the economic élite, differing somewhat from the party élite, but linked to it by virtue of its party membership; nevertheless, the economic élite had a lower share in the exercise of power, for the leading role was possessed by the party. Hence, the economic élite was, almost from every aspect, more heterogeneous than the party élite. The direction of economic life (on the basis of instructions obtained "from above") was in the hands of the economic élite. Throughout the forty years of its existence this stratum—mainly for political reasons—went through a great change: in the last years of the system the majority if its leading staff comprised personalities very much different from those of the 1950s.

Today, when this type of élite power is a thing of the past, and when other kinds of winds have begun to blow the dust off the "secret" portfolios, it has become possible—albeit with a limited amount of information—to get an insight into the life of the former élite.

The results of a survey carried out by the Central Statistical Office in 1987 contain data regarding the social origin, personal career, educational level, financial conditions, professional qualifications, knowledge of languages, and political career of state- and cooperative leaders (the leaders and high-ranking executives of ministries, organs with nation-wide authority, local councils, managers of large state-companies and cooperatives, cultural and public health institutions). The highest-ranking position covered by the survey was that of state secretary[1]; thus, ministers, members of the Political and the Central Committee and, in general, full-time party functionaries were not touched by it. The position of the members of the economic élite may be considered as being the "second level", after the political élite. However, even though the economic élite were obliged to act on the basis of instructions received from the top level, they were not merely obedient executives. In the final analysis they also belonged to the top-ranking stratum of cadres. In fact, according to their qualifications and professional knowledge, in the

[1] In Hungarian state hierarchy this is the post immediately below the minister. In some periods they were also called deputy ministers and also a first deputy existed.—Ed. note

eighties their credentials were already much closer to the intellectuals. Thus it can be argued that they represented a channel of transition between party power and the intellectuals.

Since the survey was carried out while the earlier system was still functioning, the data do not give sufficient information about the real characteristics of the leaders' positions. Very often the techniques used in questioning as well as those used for coding the answers, allow only a rough-and-ready analysis of the data.

The social background is determined by the gainful occupation characteristic of the head of the family. The latter might have changed during the course of his or her life and, in connection with this, the "cadre file" contains no definite, reliable and documentary evidence. Thus the social category "confessed" by the replying person, which appeared on the personal history form—and which seemed to be the category accepted by the person—was recorded as "social origin" when collecting the data of the survey. When analysing the results, the analysts had to form the social classes (strata) using these data. In other words, everybody stated his or her father's occupation as the most suitable yardstick for categorisation. In addition, the individual answers were, from the outset, "pigeonholed" into the then customary, and indeed roughly outlined class or stratum categories. Therefore, the data of *Table 1* which refer to social origin, do not really say much about the family background of the members of the leading élite of the 1980s, ie. they say what they were expected to say.

A somewhat vaguer picture is obtained if we examine separately those who belonged to the power élite up to 1983 (among these, many were of an advanced age: 65 percent of their total were more than 50 years old, and only 24 percent were under 40 years of age. Those who joined this class only in 1987—ie. the younger members of the "fresh" power élite, who cannot be considered as part of the older generation—show contrasting figures: 67 percent of these were less than 40 years old, and only 18 percent were more than 50). The division of these two groups according to social origin is shown in *Table 2*.

Thus, among the younger newcomers, the ratio of persons of worker-peasant-origin was "slightly lower" and, parallel with this, the ratio of those originating from the intellectual strata increased. However, since the particular categories cover fairly heterogenous groups (e.g. not only those who had higher school qualification and worked in intellectual occupations were classified as belonging to the intellectuals, but also those who, irrespective of their educational level, were in leading positions). These differences have to be treated critically, for the top-leading circles strongly emphasized their worker-peasant origin.

A really interesting study would be to compare these data on mobility with similar data on a national level, but there is no reliable basis on which to do this. The social and occupational categories (and the contents concerning background) usually applied in social mobility studies are basically different from those used in the surveys regarding the leading élite.

Table 1

Division of the leaders by social origin (percent)

Socio-economic group of father	according to the survey made in		
	1983	1984	1987
Worker	40	39	39
Working peasant*	25	25	22
Cooperative farming peasant	3	3	3
Intellectual	11	13	15
Employee (technical or clerical)	14	14	15
Small-scale producer (without working peasants)	4	3	3
Others	3	3	3
Total	100	100	100

*The definition itself is worth commenting on. According to the coding instructions, the categories of those engaged in agriculture and meeting the following criteria were grouped in this category: persons who pursued independent farming personally or with family members on their own or rented land (resorting only temporarily to foreign labour), and whose earnings for themselves and their family stemmed from these activities. (This form of questioning concerning the category of original occupation and social origin was created in a historical period when the cooperative peasantry had not yet existed or existed parallel with the working peasantry.) Using today's terms, they were the so-called agrarian independents.

Note. The sources of the data contained in the tables are the results of the survey made by the Central Statistical Office in 1987. Where data are taken from some other source, they are separately marked.

As we have already mentioned, the occupations related to social origin (ie. of the father), as well as the original occupations of the individual questioned, were taken into account very roughly and, from a professional standpoint, in a way open to criticism. Thus, it cannot be stated for certainty that someone in this survey who was classified as being of intellectual origin, would also have been classified in the same group in the framework of a national investigation. Therefore, we were forced to give up not only the comparison of the national data with those of this particular stratum, but also the analysis of this stratum's mobility, its origin, and the career prospects of those within it.

As much can be said about the mobility of the leading class within the generations (intra-generational mobility) as has been said about the mobility between the generations (inter-generational mobility). Where did they come from, and from where were they recruited? The first—ie. original—occupations of the members of the economic élite are available. Accordingly, the data collected by the surveys made at the three different dates show, like the data of origin, that one quarter of the individuals started their occupational careers as workers, and one third were employees (i.e. mental workers whose occupation needed no higher qualification).

Table 2

Division of the two generations by social origin (percent)

Socio-economic group of father	Division of those belonging to the power élite	
	up to 1983	from 1987
Worker	41	36
Working peasant*	22	19
Collective farming peasant	3	4
Intellectual	11	19
Employee	16	15
Small-scale producer (without working peasants)	4	2
Others	3	5
Total	100	100

*See *Table 1*

Table 3

Mobility of leaders within the generations (percent)

Original (first) occupation	According to the surveys made in		
	1983	1984	1987
Worker	26	25	25
Working peasant*	4	3	2
Intellectual	35	37	41
Employee	34	34	32
Small-scale producer (without working peasants)	0	0	0
Others	1	1	0
Total	100	100	100

*Including the members of agricultural cooperatives.

The proportion of the latter somewhat declined in the cases of those who occupied leading positions in 1987. A slight and even decrease of the ratio of those who started their career as agricultural physical workers is noticeable while a relatively conspicuous growth can be seen in the strata of so-called "intellectuals".

A comparison of *Table 1* and *Table 3* enables the conclusion to be drawn that inter-generational mobility was higher than the intra-generational one. In other words, the number of those who "leapt" from being workers to become high-ranking leaders was less than the number of those who actually came from a working-

class background, i.e. from worker families. It can also be said that the latter realized in two stages what the old party cadres achieved in one. Namely, by way of inter-generational mobility they first changed over to some kind of brain-work, and then came to be high-ranking leaders from such positions. In the majority of the old party cadres inter-generational mobility was lower, because in most cases the children of worker parents were also workers. Yet afterwards, these working cadres became, with a big intra-generational leap, top-leaders in the socialist system. This is a basic difference between the careers of the leadership of the older and the younger cadre generations.

Table 4

Intra-generational mobility of the two power élite generations (percent)

Original (first) occupation	Division of those belonging to the power élite	
	up to 1983	from 1987
Worker	31	25
Working peasant*	3	2
Intellectual	32	44
Employee	33	29
Small-scale producer (without working peasants)	0	0
Other	1	0
Total	100	100

*Including the members of agricultural cooperatives.

The same generational difference also appears in *Table 4*. Namely, if we compare the two extreme groups—i.e. the one holding leading positions up to 1983, and the group which came to hold such positions in 1987—a more differentiated picture can be obtained about the class (stratum) structure of those starting their career.

The power élite and the party

In the era of the monolithic party state the power élite consisted mainly of party members. It was also natural that the higher the leading position, the greater was the probability that it was filled by a member of the party. (Or, the other way round, one could achieve higher leading positions with greater probability if one was a member of the party.) With "lower level" leading positions the proportion of non-party members was somewhat lower (yet this provided verification of the principle

"it is not true that party membership is a criterion of becoming a leader"). The proportion of party members among the economic leaders was 79 percent in 1983, 78 percent in 1984 and 81 percent in 1987.

Table 5

Proportion of party members among the leaders by age-groups (percent)

Age-groups (Years of age)	Proportion of party members among those in leading positions		
	up to 1983	from 1987	continuously between 1983–87
29 or less	26	50	63
30–34	54	73	80
35–39	75	76	88
40–44	78	79	86
45–49	85	80	88
50–54	79	74	85
55–59	78	69	77
60 and older	25	63	62

In both the younger and the older generations the ratio of party members was highest among the so-called "stable" leaders, i.e. among those who belonged to the leading staff throughout the time of all three surveys. Following them later came new, young people. Among the latter, the proportion of party members was relatively high compared with those younger generations who were party members and in leading positions in 1983 (1983 being the first year of our analysed period). The medium generation shows a picture which is quite different from those of either of the extreme age-groups with regard to both the proportion of party members, as well as to temporal stability.

The members of the party were usually obliged to fulfil some party- or other mass-organizational function, or to undertake some state or public tasks (such as membership of Parliament, a position in the workers' militia, council membership, or people's control activites etc.). If from these we consider, say, the members of Parliament, what is immediately obvious is the "homogeneity" of the party state, ie. the concentration of everything in the hands of the party. Thus, in the monolithic state, the party kept its hands on ideological guidance, on economic management (as we have already mentioned, about 80 percent of top management were members of the party) and this was also the case in the highest—in principle democratic—institution, the Parliament. (The majority, i.e. 63 percent of the members of Parliament, were top leaders in economic life.)

When examining the year when they joined the party, in the case of state- and cooperative leaders, a rather interesting phenomenon can be observed. (Our

experience coincides with the findings of László *Bogár* (1990) which are mentioned throughout his study on the party élite.)

In the sphere of those who were in leading positions in 1983, the proportion of those who gained party membership in the years 1945, 1951 and 1966–71, was significantly high. In contrast to this, one age-group—namely that of the party members who joined the party in 1949—was represented by a very low number in relation to the others.

The "party age-group" which gained membership in 1945, was the one of the older generations that was represented in great numbers in the 1980s. Not one of them was younger than 50, but very old persons (over the age of 70) were also missing from their number. In fact, most of them were between 55–59 years of age (63 percent of those who joined the party in 1945 belonged to this age-group). Although they had not joined the movement before World War II, the oldest were already gradually falling out; in 1983 they made up not more than 0.7 percent of the top leaders, but from the aspect of cadre management (on the basis of their characteristics) they counted as being old. Among them the ratio of those with no diploma or educational level required for their position was high (25 and 30 percent, respectively). Compared to their average proportion, greater numbers of them were represented among the first deputy ministers, deputy ministers, deputy presidents and department heads or office leaders of ministries, and among the state secretaries. However, among the managers heading the large companies and cooperatives their representation was much lower.

The majority of the leaders holding high ranks in 1983 joined the party in the sixties. From the aspect of qualifications this generation was already in a better position, since 84 percent of them had an educational level higher than the secondary school final examination, and there was a decrease in the number of those who, for some reason, did not have the school qualification needed for their position (its proportion stood at 24 percent).

Since in this period the economic élite was increasingly striving for identification with the stratum of intellectuals, it is no surprise that the non-party but professional cadres occupying high power positions, increasingly achieved the highest school qualifications. The party generation that dated from the years 1966–71 was already able to show a higher proportion (88 percent) of persons having university degrees than was the case in 1983 (84 percent). However, the general level of education improved also in the sphere of the 1945 party generation. This was because, on the one hand, among those leaving their positions there were many who were cadres with lower qualifications. On the other hand, there were some who, in the meantime, acquired the higher qualifications necessary for their position.

Significant differences can be found with regard to social origin if we look at it from the aspect of the date of party membership. The majority of members "dated" from 1945 (60 percent) were of working-class descent, while of those who joined the party in the second half of the 1960s, only slightly more than 30 percent could

say the same about themselves. In contrast to this, those of peasant-origin among the later party members almost doubled in relation to those who obtained their membership in earlier years, and the same can be said about those of intellectual parentage.

School qualifications of the power élite

Among the leaders who retreated in 1983 (55 percent of them were more than 50 years old) the share of those who had no higher educational qualification was quite high (21 percent).

In the case of those who came to be leaders in 1987, the proportion of those without a higher educational qualification was only 14 percent. As a result, of course, in the case of the latter the highly qualified represented a higher proportion (86 percent), while in the first group—i.e. those retiring in 1983—the ratio was somewhat lower (79 percent).

Table 6

School qualifications of the leaders (percent)

School qualification	proportion of those in leading positions		
	up to 1983	from 1987	continually between 1983–87
8 classes of primary school	2.6	0.4	1.0
Skilled worker training school	0.1	0.2	0.2
Secondary school	18.6	13.2	11.9
Engineering college, other institution of higher education	25.6	22.6	25.6
University	53.1	63.6	61.3
Total	100.0	100.0	100.0

It is also proved by some other data that there were some leaders holding high economic posts and, at the same time positions of political power, who did not possess the school qualification needed for their rank. Among those who were in top leading positions up to 1983, the proportion of those having no adequate-level higher educational qualification was somewhat higher than it was among those who were members of the power élite in later years (26 and 24 percent, respectively).

Among the relatively young newcomers who first came to occupy higher leading positions in 1987, the ratio of those who did not possess adequate school qualifications prescribed for the scope of their activity was lower (16 percent) than the average of all those already in leading positions in 1987 (19 percent). As a matter

of fact, the lack of the qualifications prescribed for the activities to be pursued was most frequent among the presidents of large and other community (village) councils or farming cooperative presidents—all usually belonging to the older generations.

It follows from the specific lingual isolation of Hungary that for the implementation of policies, and an adequate level and quality of economic management, knowledge of foreign languages among leaders and managers would be highly advisable. Such knowledge might not be enough for the level of negotiations (this is generally pursued everywhere by interpreters), but to a degree suitable for obtaining information and acquiring the orientation obviously needed in the sphere of everyday activities. How good was the leaders' knowledge of foreign languages in the analysed period?

Of those who in all three periods covered by the surveys occupied high leading positions, three quarters spoke no other language except Hungarian. Among those who became leaders in 1987, this proportion had somewhat decreased (to 68 percent), but it was still intolerably high, for most of these new leaders belonged to a much younger generation.

One-third of those having foreign-language knowledge spoke English and another third did German.

Financial position of the economic leaders

This sphere of questions is the most difficult to evaluate, since we have no thorough statistics about the financial position of the economic leaders of the 1980s. The deficiency can be explained by the fact that at the time the surveys were made, such questions were taboos. One of the questions regarding financial situation which can be relatively well evaluated was whether or not the answerer possessed some real estate as property. The question concerned the possession of house, a ground-plot for building, a holiday-home or land.

Among the answers given to the questions there was only one which could be compared with the data on a national level: namely, information about who was the owner of the flats or apartments in which the representatives of the power élite were living. In 1983 45 percent of those belonging to the vanguard of the socialist society were living in dwellings owned by local councils, while the national average for this in 1981 was only 23 percent. The majority of Hungarian citizens were allowed to build their own homes, while those at the peak of the hierarchy had a much greater chance to receive housing free of charge. Looking at the older cadres who were leaders up to 1983, from among them the ratio of those living in council-(state-)-owned flats was more than 50 percent. Not many of them had plots or holiday houses (15–16 percent) and an even smaller number owned land (3 percent). The reason why they purchased no estates was not because of their

financial position (their income was not less than the average of their group); it was because they had no need to do this, since both housing and holidays as well, could be solved from state funds.

In 1987 the number of those living in their own flats were somewhat higher; they were mainly young leaders. Already "only" 39 percent of the hierarchy were living in flats owned by the local councils. With regard to the proportions of those owning real estate, the figure did not change.

For the purpose of characterizing financial positions, data concerning earnings gained by full-time work, by secondary employment and by part-time occupation are available; however, this has no real significance. The leaders were well paid—as is so in any country—in order to be able to answer their call of their duty with proper professional and ethical responsibility. Furthermore, it was not their income which provided them with the opportunity for a different, much better and easier than average, way of living.

In summarising, we can say that the group of the former economic élite was rather closed. With regard to their social origin, three quarters of them came from families of physical workers (among the youngest this proportion was somewhat lower) and, regarding their own previous social background, the ratio of former workers was also high. Among those who became economic leaders in the late 1980s, the proportion who started their career as intellectuals slightly increased. 80 percent of the leaders were members of the party, despite the fact that all of them were economic and not party leaders. Analysing their educational level it can be stated that the majority of them (60–64 percent) had attained a higher school qualification, while in the case of the older generations, this could only be said for a smaller number of the leaders. Their housing conditions were more favourable than that of the average Hungarian citizen, for many of them could live in flats and pay a relatively low rent to the owner—i.e. to the local councils.

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BOOK REVIEWS

CSABA, L. (ed): *Systemic change and stabilization in Eastern Europe*. Dartmouth. Aldershot, Brookfield, USA. 1991. 141 p.

For science historians of the future or for those dealing with the theory of science, the last decade of the 20th century will very likely mean an almost inexhaustible mine of treasures. Namely, the spectacular and rapid collapse of the communist system has exerted a significant influence on social sciences, among them especially on economics. We can say, with a little exaggeration, that the subject of the scientific surveys of those theoretical economists who were engaged in dealing with the planned economies and with their reformed types, at once ceased to exist. This is certainly not an everyday case. There is no longer anybody who would be interested in describing the operation of the planned economies. The normative approach has also changed; the question no longer centres on the way in which a planned economy can be reformed in order to become effective but how a market economy can be brought about. A large number of publications on this subject have already appeared and it can be expected that the number and range of scenarios will, for a long time, continue to increase. The magnitude, intellectual interest and, last but not least, vogue of the task prompts almost every economist to express his opinion.

The propositions in general—apart from the concrete instances—hope to build up the market economy by either gradual or rapid solutions. The theoretical experts who have not had too much to do with the problems of the planned economies, are inclined to suggest rapid implementation of the transition. On the other hand, those who have already dealt with these economies—and especially if they themselves, as proposers, lived through the reform attempts which occurred over many years in some of the East European countries—are much more sceptical with regard to the pace of the transformation. Even the experiences gained so far show that the process of transformation will not be a short one. Those preferring rapid solutions, like Jeffrey *Sachs* for example, seem to have paid little attention to two thoughts which are of basic importance for economic consultants. According to the first one: "from an economic theory ... no economic political suggestions of coercive power follow ... because theories contain general interconnections and the question as to which part of the theory is relevant in a given context can only be answered on the basis of empirical proofs". (G.J. Steigler: *Piac és állami szabályozás* (Market and state regulation) Budapest, Közgazdasági és Jogi Könyvkiadó, 1989. 429 p.) According to the other, however: "... in the sphere of economics and political sciences few can be found who are influenced by new theories after having completed their 25th or 30th year, though it is verisimilar that the ideas applied by civil servants and politicians, what is more, by agitators, to the current events, are not just the newest ones." (J. M. Keynes: „Általános elmélet" (General theory). Közgazdasági és Jogi Könyvkiadó, 1965. 407 p.).

The authors of the book edited by L. Csaba have all been studying the East European economies for a long time. This must be, by all means, considered a kind of empirical experience. In addition, the East European authors of the book have participated in the elaboration of various reform programmes; hence they have some experience of the relation of the apparatuses to the changes, too. These circumstances make the book especially interesting because with the exception of "The road to freedom" by János *Kornai*, the summarizing works regarding the transformation were in the main not published by former experts of the region.

The volume is a well arranged series of short studies discussing the most important questions of the transition, such as its purposes, the theoretical and practical problems involved in achieving them and furthermore, the external conditions of the transition. The introductory study written by the editor briefly summarizes the most important statements of the volume and outlines the limits of the analysis. This means, first of all, that the authors deal with the small East European coun-

tries and study the former Soviet Union only as far as it is an important factor in the external environment of these countries. According to Csaba, two important lessons can be gleaned from the book. On the one hand, there is no third path between the capitalist market economy and the socialist planned economy and, on the other hand, *we must finish with the illusion of a rapid transition.* It is very important to call attention to the latter, for some conceptions linked to a rapid solution are still held as being viable, both in the theoretical approach associated with them, and in the scenarios in which the aim is to implement them in practice.

The first study of the second part of the book, written by Anders *Åslund*, deals with the aspect of the transitory period of the planned economies that has elicited perhaps the greatest interest, i.e. with privatization. He reviews the general and specific reasons and circumstances which are characteristic of the transitory period and which justify the privatization. Referring to Hayek and Mises, he emphasizes the inseparability of democracy, market economy and private ownership, as well as that of private property and the innovative entrepreneur. Following McKinnon he draws attention to the fact that if the economy has no stable taxation system and state revenues are not formally defined—as was typical in the planned economy—privatization will entail a significant decline of the revenues of the state. However, even this author considers the theorem as an axiom—i.e. that the privatized companies will operate more effectively and will be more responsive to the challenges of demand than the state-owned ones. However, West European experiences of privatization draw our attention precisely to the fact that this is not true in all circumstances.

In conformity with other propositions regarding privatization, Åslund also leaves out of consideration the behaviour of various social groups and institutions in the course of privatization. He lays down a basic principle that privatization has to be accomplished as quickly as possible; therefore, state revenues produced by it are of secondary importance. However, a minister of finance who wishes to manage a significant budget deficit will never dispense with the incomes of privatization, even if this might slow down the process. Åslund also *suggests the rapid privatization technique*, also represented by the pair of authors *Lipton and Sachs*. According to this view, the shares of big companies have to be collected in state-owned holdings and then the shares of the latter will be distributed. Now, apart from the question concerning the extent to which such holdings will show up particularities of private ownership, problems are caused if the companies are divided evenly, with regard to risks, yield and sector. However, we know that at the time the bank reform was made, similar guiding principles were considered as starting points in developing the portfolios of the new commercial banks; nevertheless, the various bargains have led to entirely different results. We have no reason to assume that if this solution was applied to privatization things would be different.

Iván *Szegvári* analyses the Polish, Hungarian and Yugoslavian experiences with convertibility, and the results of East European stabilization that have occurred so far. He considers the question of East European convertibility as unprecedented. Namely, the earlier solutions offer no support, because in this region stabilization, liberalization and the restructuring of the economy are being carried out simultaneously. In contrast to post-war Western Europe, convertibility in the former planned economies is not being used as a means of liberalization, but of creating the market. West European convertibility was developed in a stable international financial environment, with the participation of growing economies. Hence, it is not by chance that when it comes to concrete measures, in Eastern Europe convertibility is applied to certain items of the current balance of payments, and the turnover of capital is completely excluded from this process. Among the starting conditions Szegvári separately points out the system of foreign-exchange deposits which, though the average observer deems it positive, is dangerous from the view of a stabilization policy and convertibility. In other words, if the confidence in economic pol-

icy is shaken and people strive to save their money in the form of foreign exchange, further destabilization is the result.

Szegvári lists the various economic problems to be solved and the results the three countries have achieved so far—all these results being connected with convertibility. He considers stabilization and the initiation of structural changes to be of basic importance. Thus without these an escape from the recession cannot be expected and stabilization in these countries may even deepen the recession. The stabilizing measures in the short and the medium run are, even in themselves, destabilizing. Therefore the author reaches the conclusion that *before the primary results of stabilization and structural change can serve as the basis of growth, it is not possible to maintain an even incidentally declared convertibility.*

The passage discussing the theoretical and practical relations of the systemic change and of stabilization is opened with the study of Gérard *Roland*. This deals with the potential series of measures for implementing the transition and dealing with tactical issues. This writing deserves special attention in that it deals with problems which so far seem to have been left out from the considerable quantity of literature on transition. Thus it focuses upon the problems of how different social and interest groups respond to the transformation of the economy, and which are the most suitable tactics for the successful implementation of transition.

He conducts his analysis within the framework of a verbal model. He assumes that the individuals know their present social status, their possibilities of work and consumption, but know these things very incompletely with regard to the future. However, they are aware of the volume of their own human capital—in other words, of their faculties. Those who, compared to their own human capital, are in a higher position, enjoy a positional rent which they would lose in a case in which a competitive situation would be likely to develop. At the same time, others in a worse position, may win by the transaction. If the individuals are able to assess the benefits and losses caused by particular government measures, they would in fact only resist the steps aimed at developing the market economy if the loss caused by these exceeded the cumulative benefits of earlier measures to a greater extent than if the status quo were to remain. What basically follows from this is that *in the course of an attempt at a rapid transition, it is very likely that a major part of society would feel they had lost and this would endanger the proper transition.* In the case of a slower transition there is a greater chance to accumulate profits and, consequently, for accepting a new system.

The author draws the conclusion that for the sake of success, privatization (which he imagines mainly in the way described by Åslund) has to be accomplished first, and suggests that the liberalization measures should only come after these. For him this follows from the fact that this method of privatization would imply a benefit for broad strata of society; the costs of the transition which would emerge in the first instance as the results of liberalization, would appear only later on. This statement is undoubtedly rather questionable, if only because this scheme was followed in none of the East European countries. Namely, it is much easier to introduce liberalization measures than to carry out privatization. In addition, it is rather doubtful that privatization can be carried out at all without liberalization.

A very interesting part of the book is the analysis of the IMF's Latin American and East European stabilization policies, written by Paul *Dembinski* and Jacques *Morriset*. The development of the theoretical background for the stabilization policy reaches back to the 1950s, when the monetary theory of the balance of payments was formed. On the basis of this, they wish to achieve a positive balance of payments, in order to stop external indebtedness, parallel with reducing inflation. According to experience, the former attempt is usually successful, but the latter is not always so fruitful. Also, due to the stabilizing policies of the IMF, the countries in general get into a deep recession. In the early 1980s, these problems became so obvious that even the IMF began to modify its conception, though traces of this are still not yet visible.

According to the authors the lack of success, or at least contradictory nature of the sta-

bilization policies of the IMF can be traced back to two fundamental reasons. On the one hand, the stabilization programmes based on the monetary theory of the balance of payments disregard the effects of a restrictive monetary policy that is followed in order to achieve an active balance of payments, and is exercised on growth. This applies especially to the medium- and long-range adjustment processes. Hence, they also do not examine its effect on inflation and on the balance of payments. On the other hand, *the recommendations of the IMF set out from the assumption that macroeconomic problems can be exclusively explained by factors that are based on the business cycles.* If these problems are also conditional on structural or systemic circumstances—as it is in Latin America and especially in Eastern Europe—these propositions do not solve the problems.

In the last study of the fourth part of the book Grzegorz *Kolodko* deals with the interconnections of theory and praxis. The scenarios made about transition are in general market-oriented. Kolodko maintains that this reaction of science is quite normal, since in the case of negative experiences linked to an economic system or policy, it is a type of necessity that theories based on ideologies radically contrary to it will emerge. Notwithstanding this the situation, according to the author, *in the case of any attempts that try to implement, in the East European countries, propositions that have been tested under basically different institutional conditions, the likelihood is that success will remain as only a vain hope.* If programmes that attempt to stabilize the unstable planned economies disregard these circumstances, they may even increase the problems. Thus, there would be a kind of necessity to prepare the scenarios on the basis of a certain creative phantasy, albeit taking into account the particularities.

To a certain extent, Kolodko's arguments can be labelled as being typical; yet, taking into consideration Stiegler's quoted ideas, it is perhaps better to also say that they are not quite accurate. Neither an extremely liberal, nor a less liberal, and certainly not a non-liberal theory has direct political relevance. This can only be made sure if there is empirical evidence, whereby the unviable propositions will fail. For this reason the above argumentation can be characterized a little bit as boxing with phantoms, especially if we recall that so far nobody has wanted to implement extreme propositions.

The last section of the book deals with the external conditions of transition. For the East European countries 1991 was the year in which the Soviet markets were lost—the shocking effect of which was practically equal to a "systemic change". The course of events was greatly influenced by the fact that, with regard to bilateral trade, the countries of the region changed over to dollar accounting. The study of Gábor *Oblath* analyses the macroeconomic interconnections of this, dealing first with the case of Hungary. It is not the bare fact of the change-over that is essential, but that hereby the planned economic character of trade ceased to exist, ie. a cessation of the process in which economic political decision-makers tried to determine concrete microeconomical actions. If the former system of trade had survived, beside the short-term costs of the change-over to dollar accounting, no profit could have been expected, even in the long run. This will come about first of all in the wake of a radical restructuring of trade.

The closing paper of the book deals with some theoretical relations concerning western capital import, and these are especially important for East European countries. The starting point and logic of the analysis by Raimund *Dietz* somewhat differs from other works dealing with this question. It deals not with questions centring upon how the inflow of venture capital will influence the development of the balance of trade and of payments, nor with its impact on economic growth, and it does not look at how stabilization can be promoted in these countries. Instead of these, it points out the role foreign capital plays in developing the market economy. In his study the author draws the conclusion that the gap created by the circumstance that the planned economy has already collapsed but a market economy still does not operate, can be filled up substantially by western capital. In this approach, with the intrusion of western capital the market economy also intrudes in these countries. Ac-

cording to this approach, *in the process of developing a market economy, foreign capital participates as a catalyzer.*

The problem of this train of thought is that experiences gained up to now do little confirm its feasibility. It seems that the operation of the market economy's institutions—at least on a basic level—is not the result but much more the condition of the inflow of foreign capital. In addition, by the effort to maintain monopoly positions and force protectionist measures, sometimes this in itself may make it more difficult to develop a market economy and to join the world market.

The authors of the book, who have all been dealing with the problems of the planned economies for a long time, believe that the transition will be protraced. What is more, they suggest that any attempt at an exaggerated acceleration of the transition will endanger the success of transition. Only the study on privatization represents a view different from this trend, in that it takes a stand for the possibility of rapid privatization. In judging how long it will take for a transition from the planned economy to a market economy, the approach of this book is much more sceptical than any other similar "summarizing" book. Its most important message is that to dive suddenly into a market economy is not only dangerous but might also be possible.

Á. VALENTINYI

KÖVES, A.–MARER, P. (eds): *Foreign economic liberalization, transformations in socialist and market economies.* Westview Press. Boulder, San Francisco and Oxford 1991. 288 p.

Today, when almost every week a conference dealing with Eastern Europe is organized, where mostly the same faces and repeatedly heard ideas emerge, it is a good feeling to offer to the reader a volume of studies compiled from the selected lectures of a conference which took place more than two years ago (October 1989). However, it is an exciting reading, and has a good chance of becoming one of the frequently cited basic works in the area of subjects collected under the title of foreign economic liberalization.

More than half the studies in the volume deal with the experiences of economic and, within it, foreign economic liberalization (in advanced and developing countries). Beside the studies that discuss the individual experiences of particular countries (Spain, Israel, Japan, South Korea and Taiwan), in the first chapter the analyses draw general conclusions and lessons from the detailed comparison of the individual cases. The writings in the second chapter of the volume deal with Hungarian problems. They present the plans and troubles which occupied the Hungarian professional public mind before the "great unknown" of changing over to dollar accounting in the trade conducted with the East European countries. Also presented here are the dilemmas of foreign trade deregulation and import substitution, which had reached a certain level of progress at the time the conference was held, but were still in an intermediary stage. In the closing chapter of the book, the papers discuss wider East European (and Chinese) relations with the topic, and analyses of the connections between liberalization and other tasks to be solved (stabilization, privatization, the changing economic system) can be found as well.

The main question which runs through the whole volume, and which is perhaps the most exciting one, is whether the experience accumulated up until now in various countries of the world economy can be used in the context of East European transformation and, within it, to foreign economic liberalization. The situation of those advanced and developing countries that were dedicated to liberalization was, in many respects, similar to that of the East European economies, where liberalization has started only recently or is starting just now. Namely, the former economies were also characterized by a high degree of state intervention, macroeconomic instability, and the lack of, or in the danger of losing, creditworthiness. They also suffered from underdevelopment, and a partial lack of a system of market institutions. Yet, in their introductory essay, *Köves* and *Marer* point out that essential differences can be seen between the East European countries and the other countries starting

liberalization in other quarters of the world, especially with regard to the extent and characteristics of state intervention. It is enough to refer to the absurdity of the state monopoly of foreign trade and, within this, to the so-called profile monopoly. (We might play with the idea of what would happen if, for example, in the United States the export of Pepsi Cola and Coca Cola could only be performed or, to be faithful to the epoch's usage, "transacted" exclusively by some authorized "Soft-drink-impex company"; the purpose of this being to avoid underbidding each other and prevent a competition which would do harm to the interests of the American economy.) A separate, also region-specific sphere of state intervention was the trade within the CMEA which, both in its theory, as well as its practice, was very far from the international trade carried on by the advanced and developing countries of the world economy. Köves and Marer rightly point out that "the Central and East European economies were isolated from the international market to a greater extent than even those developing countries which formed the most restrictive trading system. What is more, in contrast to the developing countries, where the commercial restrictions in typical cases take the forms of explicit quotas and similar rules, in Central and Eastern Europe the quotas are implicit and follow from the nature of the system. (p. 17)

For the reviewer the most interesting study in the book was that of *Papageorgiou, Choksi and Michaely*. This was titled "The successful stabilization policy", and it summarized the results of a then recently finished far-reaching world-bank research project. The research contained the comparison of 36 reform episodes (from the aspect of time, the well-defined reform episodes of 19 South-American, South European and Asian countries). It analysed separately some of the repeated starts of the particular countries. One of the key questions of the research was whether, on the basis of values measured on a liberalization scale of twenty grades, the "strong" or the "weak" liberalization plans were the more successful? The results of the authors' research work are conspicuously unequivocal. From the 19 programmes that were qualified as "strong" only 5 collapsed, while out of the 17 deemed to be "weak" 7 were regarded as relative failures. (pp. 41–43) It has to be mentioned that liberalization episodes which lasted less than a period of two years were not included in the research—in fact, the majority of these were also "weak" programmes. The conclusion of the authors was: "hence, the golden rule of a lasting reform seems to be: 'He who dares wins' ". How far does the foregoing justify the view according to which in Eastern Europe, within the framework of so-called shock-therapy, the foreign economic relationships have to be liberalized in a strong way? With regard to this, the cases of Czecho-Slovakia and Poland deserve attention. Here I wish to refer back to the essay of Köves and Marer. In this the two authors strongly emphasized the limits of comparing the countries of Eastern Europe with countries of other regions. True, the brave may win, but the extent of the risk must by no means be neglected: the more unbeaten the path, the less relevant are the programmes that started under radically different conditions. At the same time the risk associated with the "strong" programmes is greater in Eastern Europe, and thus there is a higher probability of that type of failure which can be characterized by saying that "the operation was successful, but the patient died." It is a warning sign that from the 36 models, the case which can most closely be compared to the present East European instances—namely the liberalization attempt in Yugoslavia in 1965–67—was a "strong" programme, and yet it was unsuccessful. At the time of writing this review—in November 1991—it is still doubtful whether the famous Polish shock-therapy will earn a place in any retrospective analysis that might be carried out in the early decades of the next millennium, should such a future study also deal with programmes surviving for more than two years. The next question is, of course, if it is dealt with, will it be classified as a model that supports the success of the "strong" cases, or as a—rather exceptional—model, in which a "strong programme" is coupled with "failure"? While we are on the subject of exceptions, it seems likely that even the Hungarian case—"looking back from the future"—will be an exception. In other words, the protracted import liberalization lasting over several years, the relatively long dura-

tion of the erosion of the state monopoly of foreign trade and of profile-monopoly, the gradual nature and moderation of the reduction of the customs duties do not justify the qualification of the Hungarian case as a "strong" one. What is more, for me a great question concerns the point of time of the changes with regard to their results in the direction of liberalization, and whether they can be squeezed into a programme that can be considered a unified one. However, this Hungarian foreign economic liberalization (which might be qualified as "weak") can, for the time being, be considered successful. What is more, with regard to the depth of recession and the adverse position of the budget, in the late autumn of 1991 the performance of the foreign economic sphere has been one of the, otherwise not many, sectors of the economy that has given some cause for optimism.

In another synthetizing study of the volume (*Liang, Marer and Batta*: "Foreign trade strategies of nations: a new interpretation") the authors give up the traditional two-pole approach to foreign-trade strategies, and contrast the export-stimulating and import-substituting strategies with one another. In addition to the well-known categories, they introduce the concepts of actual import stimulation and protected export stimulation. When the former is applied, both export and import substitution are counter-stimulated. Consequently, an excessive growth of imports becomes a permanent danger, while even exports do not increase properly. (According to the authors both the traditional and the reformed planned economies were characterized by this unfortunate combination.) Protected export stimulation is based on the protection of export sectors that have not been fully developed, and its essence is the promotion of import substitution with the aim of developing new export sectors. This strategy is primarily characteristic of the newly industrialized Southeast Asian countries. Protected export stimulation is also introduced in detail in another paper of the book, in a very interesting study of *Park*, who refutes several prejudices concerning the liberalization experiences of South Korea and Taiwan.

Finally, I would like to point out one of the writings in the book: namely, the study of *Inotai*, which is about the connection between liberalization and direct foreign capital investments. When he wrote his study in 1988, the significance of foreign direct investment in the Hungarian economy was marginal. At the time of writing this review, the monthly flow of foreign direct investment coming into the country is almost as much as the total from the early 1970s up to 1988. All the more worthy of attention is the interconnection emphasized in Inotai's paper, which shows that a positive correlation can be found between the extent of direct investments and the export performance of the receiving countries. Referring to a study that deals with the experiences of 23 developing countries, he says that each dollar of foreign investment on average resulted in two dollars of surplus exports. On this basis my own calculations suggest that in 1991 at least one billion dollars of foreign investments should flow into Hungary, while the volume of exports will be about 10 billion dollars. If the above described correlation applies to Hungary too, then the foreign direct investment alone of this year ought to result in a 20 percent increase in exports in the near future. Unfortunately, however, the limited applicability of other countries' experiences in the countries of our region is also valid in this sphere. Therefore it is advisable to be cautious with our optimism.

S. RICHTER

WILLIAMSON, J.: *The economic opening of Eastern Europe*. Institute for International Economics, Policy Analyses in International Economics, No. 31—May 1991. 92 p.

I picked up John Williamson's booklet reluctantly and with a certain suspicion. Its literary form is strange—it partly presents lectures given at a conference which lasted several days and took place at the beginning of 1991; at the same time it comments on these lectures, and its message is embedded in this narrative form. This message—as is illustrated by the contents—extends to almost everything: the major theoretical and practi-

cal questions of systemic change and adjustment can be found, as well as the experiences of the particular countries. However, this is in striking contrast with the small size of the study.

Reading over the work, my opinion changed. John Williamson's analysis—which took only three months to print(!)—is well suited to the requirements of our galloping age, and its explanations are right to the point. It is a useful piece of reading for all those who are dealing with the theoretical and practical questions of East European economic transformation and opening.

J. Williamson's analysis repeatedly proves that in the free exchange of money practically all essential elements of the market economy are condensed. Therefore, the argument concerning the sphere of question "when, to whom and what convertibility", turns out to be in fact a foundation onto which the author is able to build up the whole multifarious topic of systemic change and stabilization. With regard to the above theme, I would primarily point out the interdependences between exchangeability of foreign currency and domestic monetary policy, and between foreign exchange policy and inflation. Williamson deals with the key questions of world economic adjustment rather than attempting to develop a new type of ideological speculation, which is so typical of international literature. He fits the questions to the concrete situations of particular countries, and thus formulates his replies, which are original and well founded. Therefore the author—in conformity with the major international trend—gives preference to the one-step, large-scale changes in the cases other than Hungary and Czecho-Slovakia. In his opinion the gradual approach to change is justified; what is more, he considers the Hungarian practice, under the given conditions, to be exemplary. Yet Williamson passes a negative judgment on the monetarist propositions which urge the Central European countries to join the system of the EMS and the Central European payments union. The latter proposition is almost trivial, for the countries of the region do not want to contract a payment union with each other; however, the former one needs a more extensive explanation. The EMS, by demanding a disciplined financial policy, would make the stabilization policy of the Central European countries authentic and even successful. However, the cost of this would be—as can be seen from the cases of Poland and Yugoslavia—an unprecedented protraction of economic recovery, along with an unparalleled recession in production (as happened in Chile). According to Williamson, this is too high a price to pay and also involves the changing of one set of priorities for another set, since monetary stability on a German level is an exaggerated requirement for economies in the process of restructuring and change of system. At the same time it would postpone those tasks which society sees as most pressing, e.g. modernization. In addition, the strong recession and unemployment, and the soaring inflation which would accompany such a plan, would still force the given Central European government to make a devaluation. In such a situation the credibility of governmental commitment to reform—which is supposed to be the prime function of the whole doctrinaire exchange-rate policy—would be lost at once. By dealing with a question that is focused upon the viability of a given economic guideline, Williamson pleasingly turns away from the tendency of those specialists who usually produce textbook-tasting instructions for politicians.

The comparative review of the convertibility plans on a regional level is also instructive and very useful. Within this framework, the American author repeatedly warns against promulgating high-sounding plans, which are in fact professionally unfounded and based on expedience and impatience. He also warns against the proclamation of any promises which prove to be impossible to realize. He lays special stress on the responsibility of the West: without their opening the market and without the strengthening of the flow of capital from the west to the east, a reverse flow of people will be unavoidable. It is a fact that Williamson's ideas favouring the unity of the Soviet Union and of Yugoslavia have been overcome by time. However, we hope all economic authors will attempt to copy Williamson in giving their studies a lasting message and will also try to match his conciseness and finishing time.

L. CSABA

MAGYAR
TUDOMÁNYOS AKADÉMIA
KÖNYVTÁRA

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For more information, please contact: Jolande Sap, c/o University of Amsterdam, Dept. of Economics, Roetersstraat 11, NL–1018 WB Amsterdam, The Netherlands.

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DEBATE ON THE TRANSITION OF POST-COMMUNIST ECONOMIES TO A MARKET ECONOMY

This is the second time that *Acta Oeconomica* has carried out an inquiry involving leading figures of the international and domestic scientific community. In 1988–89 our question asked whether a socialist economy could be reformed, and we sought the opinions of respected social scientists both from Hungary and abroad. Then, the first question centred upon the extent to which the socialist system could be reformed, given the preponderance of public property within it; the second question asked the expert to identify the limits to reform.

History has provided a striking answer to those earlier questions, for since that first inquiry the socialist economic system has collapsed in a dozen countries. Today it seems to be an anachronism to ponder over the chances of reform in socialist economies. What is interesting for us today is transition: namely, the building up and strengthening of institutions necessary for a democratic legal state and market economy.

In 1989 optimism was overwhelming and people were confident that transition would be relatively rapid and easy. As time has passed enthusiasm has receded. Now the opinion prevails that the new countries arising from the ashes of the Soviet empire will go through a deep crisis, and recession will be longer than expected. There is a strong temptation to declare the region a crisis zone which will only close up with the developed part of the world in the remote future. With our questions the aim has been to rekindle and channel this hidden and fluctuating debate of optimists and pessimists.

We put to some sixty Hungarian and foreign social scientists—among them some who participated in the 1989 inquiry—the following questions:

1. What do you regard as the main barriers of the transition to a market economy in the post-communist countries?

2. What measures and techniques do you suggest to accelerate the transition process?

We did not get answers from everybody: some thirty answers reached the editorial office. They are published in this volume and the respondents are arranged in alphabetical order. Let us thank Wladimir *Andreff*, Anders *Åslund*, Aleksander *Bajt*, András *Bródy*, Jozef M. van *Brabant*, Ellen *Comisso*, Béla *Csikós-Nagy*, Marek *Dabrowski*, Bruno *Dallago*, Stanislav *Gomulka*, Philip *Hanson*, Arye *Hillman*, Branko *Horvat*, Béla *Kádár*, Michael *Keren*, Peter *Knirsch*, János Mátyás *Kovács*, Ferenc *Kozma*, Helmut *Kramer*, László *Lengyel*, Silvana *Malle*, Péter *Mihályi*, Alec *Nove*, Alfred *Schüller* and Dirk *Wentzel*, Márton *Tardos*, Ádám *Török*, László *Urbán*, József *Veress*, Hans-Jürgen *Wagener*, Jan *Winiecki* for sending in their answers.

Acta Oeconomica 44, 1992
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MAGYAR
TUDOMÁNYOS AKADÉMIA
KÖNYVTÁRA

Not all respondents stuck to the original questions, and readers will find accurate scientific analyses and comments filled with personal emotions. It would be wrong to complain about this diversity. In one of our future numbers we will publish an analysis of the different opinions.

Many authors did not give title to their papers so for the sake of a unified form the original titles are put into the footnotes.

WLADIMIR ANDREFF*

The answer one may give to your questions relies heavily on what is supposed to be the target of the transition in post-communist economies (PCEs). Saying that the transition aims at implementing a market economy is not a well-specified statement insofar as market socialism, a self-management system, welfare state capitalism, a "pure" market economy, monopoly capitalism and a mixed economy might well fit the definition of a market economy. Whatever my own view of what the transition outcome could be, I shall take it for granted in what follows that the target of the transition process in PCEs is to reach as soon as possible the state of a *capitalist-type market economy*, and a "modern" one, i.e. excluding something like primitive capitalism as it first spread through Western Europe in previous centuries. The transition should not (and fortunately cannot) be a return to this latter kind of pre-communist economy. In addition we have to keep in mind that developing a modern capitalist market economy has taken centuries in Europe and North America, and at least four decades in "late comer" countries such as South Korea or Taiwan. Therefore the quicker the transition in the PCEs the higher will be the cost. In my answer I shall assume that people are to some extent ready to bear this cost, especially if it is balanced by smooth and sustained progress towards a capitalist market economy. People would regard any procrastination, any stop and go, any turning back, as one more failure of economic reforms. Only a *"ratchet" transition* can be a success. A bumpy road to market capitalism would be a dead end.

Question 1

Barriers to transition are deeply rooted in the domestic economy of each PCE, but several hindrances originate from the world economy and the way PCEs are inserted into it. Let me call these hindrances external constraints.

*Université Pierre Mendes-France de Grenoble

I shall sketch first the main domestic barriers to transition. After a fifteen-year economic crisis (*Andreff* 1985; *Andreff and Lavigne* 1987), followed since 1988–89 by the unavoidable breakdown linked to any system-wide transformation, the economy has definitely been destabilized in Central and Eastern Europe and the USSR. Price deregulation has turned increasing disequilibria and shortages into open inflationary pressures and even hyperinflation (Poland, Bulgaria, Russia); and then an increasing lack of confidence in the smelting value—and even usefulness—of domestic currency has triggered a "dollarization" of the economy, i.e. an extensive flight of people from domestic currency to hard currency cash. Such a *destabilized and inflationary economy* hinders domestic and foreign investment, erodes savings and (fortunately) evaporates the currency overhang; hence it deprives people of any possible purchasing power when assets are on sale, and it undermines any mass privatization programme.

With or without the IMF's sponsorship, a harsh stabilization policy then becomes a necessity. It is based on subsidy cuts, restricted credit, a positive real rate of interest, and wage control. It is usually combined with the freeing of most prices, this being a necessary measure for the removal of the price system inherited from the shortage economy. Whether it is successful or not in putting a brake on inflation, this austerity policy has some unavoidable built-in drawbacks in any country where it is at work, including PCEs. First of all it causes a demand-pulled collapse in the GNP rate of growth (which may even fall below zero), and consequently an increasing rate of unemployment and an impoverishment of the most destitute social strata (retired people, youth, unskilled workers, etc.). Beyond a certain threshold, *recession and unemployment* stand up as crucial barriers to transition and pave the way for people's discontent concerning the path, or at least the agenda, of economic transformation.

This does not mean that the barriers of recession and unemployment are raised only by the cuts in demand. On the *supply side*, not all enterprises are accustomed or willing to adjust production to free and flexible prices, or to put a ceiling on wages and to lay off redundant workers. This is despite the fact their budget constraint (following the meaning given by Kornai) has been hardened by subsidy cuts and higher interest rates. As a result, several goods and many services remain in shortage while others, now too expensive, are out of reach for many consumer incomes. Unemployment is kept within limits because enterprises do not give up their behaviour of "boarding" labour, but an expansion of unemployment may be expected if the restructuring of the economy and privatization were to be a success (see below). A stabilization policy strengthens enterprise risk aversion; this feeling is even exacerbated by shorter and (for the first time) more uncertain outlets—thus *investment diminishes*. This factor adds to the above-mentioned barriers to transition. Moreover depressed investment sustains recession and unemployment.

Except in the fiercest primitive capitalism—and characteristic of its early age—increasing poverty and unemployment cannot stay unregulated. Today so-

cial *safety nets*—as they are called in the IMF's watchwords—must be conceived and implemented: namely, a minimum wage, some kind of wage indexation, unemployment benefits, lay-off compensation and pension revaluation. We would stress that in some respect the safety nets themselves make up additional barriers to transition. First, they contrast with the stabilization policy in increasing budget expenditures and in alleviating demand cuts. Second, they fuel two kinds of behaviour which recall the communist regime: state paternalism (towards consumers here) and the people's habit of receiving state assistance. Reformers have struggled steadily against such cornerstones of the communist social order, and they hardly consider these otherwise today, whatever necessary safety nets are called now. Anyway, without social safety nets people's support for transition might well weaken sharply before stabilization is achieved.

A last built-in drawback of stabilization policy deserves some comment and concerns *saving*. This latter is eroded first by inflation and then by a decrease in real wages insofar as money wages are now indexed at a rate lower than 100% of the inflation rate in all PCEs. Consumers are impelled to spend a larger part of their income on more expensive consumer goods, especially for consumer durables and services associated with the picture of a genuine market economy. As savers, they cannot be expected to rush in and buy newly issued shares or other securities in the framework of a privatization programme while their savings smelt and their basic needs are hardly satisfied. In general, the "marginal utility" of shares (*Filatotchev* 1991) is still low in PCEs. Mass privatization seems to be impossible on the basis of domestic saving alone. Just a happy few might be interested in buying assets or shares; they are those savers who concentrate the major part of their savings: in the USSR, 2 million people with the highest incomes held 53,8% of total savings in 1990, the next 9 million highest incomes held 15%[1].

Who were these big severs? No doubt most of them were former communist leaders, managers holding jobs on the *nomenklatura* listing, operators in the second economy and *mafia* members, i.e. champions in bargaining, bribery and speculation and not professionals in contracting, marketing and industrial risk-taking. This evidence raises two other barriers to transition. On the one hand, new PCEs leaders and many citizens consider it to be politically unacceptable for former leaders to become new owners of state assets, and morally unbearable that they may be speculators or *mafiosi*; such a standpoint throws light on why the so-called "spontaneous" privatization was doomed to failure in Hungary, Poland and Czechoslovakia. The purchase of state-run enterprises by their former managers has soon been prohibited or controlled. On the other hand, former leaders and *mafia* are the richest social strata in the PCEs, and thus they are the only ones who could finance a significant part of privatization. Political and moral feelings aside, if they were allowed to buy state assets, it would appear through their behaviour that

[1] Calculated from *EKO* (1990).

PCEs are short of a genuine social stratum—an *entrepreneurial upper class*—eager to maximize its wealth by earning profits from current industrial and market business. In other words, PCEs lack a wealthy capitalist class involved in production, exchange and finance. Such an economic class usually forms during the primitive accumulation of capital. Another absent stratum is a *middle class* (peculiarly an upper middle class) of would-be entrepreneurs ready to make money and to come into business. Such a social stratum is needed for reshuffling the upper class and keeping it under competitive pressure. The strong incentive of the middle class to invest in business is a permanent challenge for well-established entrepreneurs. At any rate, it will take many years, probably decades or at least a generation, for these new social strata to emerge in PCEs.

It is quite astonishing that new political leaders in PCEs have been so over-optimistic (or naive?) over the last two years as far *privatization* is concerned. Without inadequate savings and entrepreneurship, how could we imagine the success of big privatization? Indeed, the real privatization process is lagging far behind the scheduled privatization programmes. One may spell out several additional barriers to privatization in PCEs: the size of state enterprises, the tricky issue of valuating state assets, the absence of institutional investors, a still underdeveloped two-tier banking system, a too tiny capital market (where it exists), inaccurate business taxes and, of course, a still destabilized economy. I do not want to elaborate here on trends that are covered in the available literature (Andreff 1991; 1992a; 1992b). I would however focus on three logical consequences implied by these hindrances to privatization. First, the only enterprises that have a chance of being successfully privatized are the *most profitable*: a potential buyer will add a risk premium to expected profit, considering the economic turmoil in the PCEs. Second, the extent of big privatization is obviously limited—at least in its first stage—to a small sample of state run enterprises; namely, those which are profitable and competitive by world market standards. Industrial "lame ducks" in heavy industries cannot be privatized easily. Third, because the acceleration of big privatization is not workable, well-known Western economic advisers (*Sachs* 1991; *Blanchard, Dornbush, Krugman, Layard and Summers* 1991) have suggested measures such as giving away state assets (shares or vouchers) for free to citizens, workers or municipalities, or as franchising, leasing, contracting out, mutual funds, pension funds, employee-stock ownership plans, investment trusts and equity holdings. None of these schemes would achieve more than a *pseudo-privatization* if we regard the transfer of property rights on assets. Moreover, if investment trusts and holdings were to be state-run we can say that almost nothing would change in terms of property rights (for an elaboration on this point, see Andreff 1991; 1992a; 1992b).

The other barriers to transition are linked to a strong concentration of PCEs' industry in big state trusts and to a lack of market institutions. Concentrated industrial structure impedes the rise of competition even among newly privatized enterprises. As a result of concentration, these latter enjoy extra-profits that are

linked to a monopolistic or oligopolistic supply side. Enterprise and industry restructuration is a pre-condition for making state trusts profitable, for getting rid of "lame ducks", and for dismantling monopolies. Of course, all PCEs have attempted in recent years to establish market institutions such as commercial banks, stock exchanges, brokers, auditing offices, accountants, business lawyers, real estate agents, advertising and marketing agencies, export management companies and commercial courts. New legislation and regulation often include a company law, a new accounting system, a bankrupcy law, anti-monopoly regulation, laws securing private ownership, land ownership and contracting rights. Contrary to the most liberal trend of thought, reality shows that a market economy cannot work efficiently without a whole set of institutions and regulations. As these market institutions mature over a longer period of time this last barrier to transition should then vanish in PCEs.

In addition to domestic barriers, transition suffers from *external constraints*. The international specialisation of PCEs and product quality were heavily determined by trade within the former CMEA and they have turned out to be inadequate for coping with competition in Western markets. Restructuring is again a key issue here. Moreover, former Eastern outlets have collapsed due to the international disintegration of the CMEA and the USSR (which has split into independent states); decreasing trade flows among former CMEA members have not yet been balanced by an increase in trade with the West—up to now, increases can only be noticed in Hungary, Poland and Czechoslovakia (*Economic* ... 1991; Andreff 1992c). Shrinking foreign trade exacerbates the slowdown in economic growth. Trade deficit in hard currency hampers the stabilization policy by worsening conditions for stabilizing the rate of exchange (usually taken as the nominal anchor), and also raises the danger of inflation. Unbalanced trade does not improve foreign debt management, especially when foreign banks are less keen to loan new credits to PCEs and are anxious about having their previous loans repaid. All in all, it can be seen that international bankers have not reassessed the different risks of the different PCEs. Therefore, the major part of the transition cost will not be covered by a net inflow of foreign capital.

A high risk country, along with a destabilized economy, results in an investment climate not so welcoming for foreign investors. Capital is a shy deer which runs away from countries bearing political and economic instability, and looks for fiscal havens, free trade areas and "social paradises" (areas granting minimal labour rights, forbidding trade unions, etc.). Comparing the number of new joint venture projects started in Hungary and in the USSR in 1991, one reaches the obvious conclusion that foreign direct investment will only accrue to the less unstable PCEs. In these countries foreign capital will be of some help for big privatization, although it will fill the gap between domestic saving and the financial requirement of mass privatization. Other PCEs will depend, to some extent, on international economic aid. This latter is at the moment rather limited compared with the needs of transition

and privatization, but aid is heavily advertised in the West and this has stirred up increasing national feelings in PCEs. National pride and the feeling of dependency may put a brake on the new insertion of PCEs into the world economy.

Question 2

According to my personal assessment, there are so many barriers to transition that accelerating its momentum would endanger the whole process. If too many drawbacks (resulting from stabilization, increased competition and privatization) were to accumulate in a short period of time, they would destroy the social consensus supporting the transition process in PCEs. Hence, the first technique I suggest for any purpose linked to transition is: "Do not rush". Transition to a capitalist market economy requires two or three decades, not less. Any attempt at shortening the way out of transition is doomed to failure because PCEs would then reach a kind of distorted economic system, instead of an efficient capitalist market economy. By saying this I am aware that I am hurting many reformers, but they should not forget what acceleration has meant in countries where industrialization, collectivization, nationalization and even economic reforms have been accelerated ... and failed before being abandoned (including Gorbachev's first watchword of *uskorenie*). Put in a nutshell: better is a therapy without shock than a shock without therapy. Insofar as stabilisation policy is concerned I suggest some kind of gradualism; and where institutions and economic structures are concerned a "big bang" seems to me worse than a more evolutionary approach to change. Frankly speaking, Hungary and maybe Slovakia and Romania are more illustrative of what I would advise than the momentum of transition imposed by Polish, Czech and Russian shock therapists. I like to recall what Mr. Péter Ákos Bod, the President of the National Bank of Hungary said at an IMF meeting in February 1992 (*Bulletin* 1992): "If the transition is swift and implemented in a democratic framework, it must be financed from abroad. If, for lack of such finance, the country has to rely on its own resources, a swift transition must be secured by a strong and authoritarian government. Finally, a pacific and self-financed transition will necessarily take time". Hungary exemplifies, more than any other PCE, the last sentence, with which I completely agree.

I think that competition and competitive behaviour can only be fuelled into PCEs from abroad, given my assessment of industrial concentration and existing social strata. Consequently, I would focus first on measures likely to improve international specialisation and the competitiveness of each PCE and its insertion in the world economy:

1. A unified, stable and adjustable *rate of exchange*, neither fixed, nor flexible, must be backed with a stabilization fund in hard currencies obtained from

international aid. In case of a lasting balance of payments disequilibrium, the rate of exchange would be re-adjusted after agreement with other countries within a Central Eastern European union of payments (see below), in order to avoid "beggar-my-neighbour" policies. Some of these PCEs have not yet unified their rate of exchange (Romania, the former USSR) and some have recently had an unstable rate (Bulgaria). Inner market prices would then reflect international prices and competitive pressures.

2. An economy fully *open to foreign trade* must be based on the most favoured nation agreement with all partners, GATT-type tariffs and the absence of quantitative restrictions to trade. Combined with the first measure all this will to some degree make PCEs' markets competitive, at least when viewed from abroad.

3. International economic pressures resulting from measures 1 and 2 will soon show which enterprises are efficient and competitive by international standards, which ones can survive after being reshuffled, which ones need to be restructured and re-specialized on international markets, and which ones are definitely "lame ducks" to be closed down and liquidated. A part of this *selection* process might be achieved by foreign competitors if measures listed under 6 below were at work.

4. It is a crucial and urgent task to stop the collapse of trade among former CMEA members. A new kind of agreement, if not union, among them is necessary. Let me call it a Central Eastern European *Union of Payments* (CEEUP), calling forth recollections of the European Union of Payments (EUP) of the fifties. Membership would be optional, but we can think in terms of the following subset of countries: Poland, Czech and Slovak Federal Republic, Hungary, Romania, Bulgaria, Russia, Belarus, Ukraine, Moldavia and Slovenia (the question of membership of Asian Independent States resulting from the USSR breakdown obviously remains open). The CEEUP population would then reach almost that of the EC and the EFTA taken together. CEEUP could be more than ten separated markets if measures 1 and 2 were implemented in each of them and if, in a first and short stage, foreign trade balances were compensated among members in a common currency (why not the Ecu?); in a second stage, their currencies would be mutually convertible and in a third stage convertibility in hard currencies would be achieved, following the same path as EUP countries. Rate of exchange adjustments and stabilization policies would be negotiated with other CEEUP members, and not only with the IMF, the EC and the G-24. Moreover, the CEEUP might be a channel towards EC membership for some countries, yet probably no earlier than the year 2000 in any of the PCEs; CEEUP could at least attempt reach to a free trade agreement with the EC and the EFTA.

5. Without a new heavy burden of foreign debt towards other CEEUP countries, each of them would have to manage its hard currency debt with the West in the harshest manner. *Paying interest and repaying debt* would strengthen Western confidence and after a while would attract trade and capital; this inflow of hard currencies would be a pre-condition for reaching the target of convertibility. PCEs

leaders must harden the budget constraint on the state's management of foreign debt, just as they are attempting to do it for enterprises. Debt rescheduling and a moratorium of the Polish-type, for instance, are of course a form of foreign aid in the short run, but do not improve the business and investment climate. An increase in Western and international aid obviously has to be achieved by bargaining but it should finance restructuring, privatization and the development of market institutions as a priority. Anyway foreign aid should not be considered as a cornerstone for the success of transition, which must and can only be a domestic achievement first.

6. A comprehensive policy of insertion in the world economy would comprise the least restrictive regulation on inflows of *foreign direct investment*, including fiscal holidays, free trade areas or special zones with the most flexible labour legislation, and low wages (which would be reached by the stabilization policy). No industry, no enterprise, no asset must be kept closed to foreign direct investors, who should be allowed to participate in privatization programmes, even to the extent of buying a 100% share in a privatized enterprise. No doubt, exploitation of the labour force (as it was said before) would be the bill to be paid for attracting skills, technology and efficient management from multinational corporations to PCEs. No doubt, economic independence would be held at bay to some extent, just like in all countries well integrated into the world economy. However, when building capitalism the question addressed to capital is not "where are you from?"; it is "what is to be done?". Foreign capital's answer has frequently been more efficient than the one given by Lenin.

I suggest measures for the domestic economy which do not aim at accelerating transition as a first rank priority, insofar as I am convinced that the barriers to transition are too numerous, too deeply rooted in economic structures and in people's minds, to be removed overnight or through a short therapy, shocking or not. All measures are of course urgent, but they cannot be implemented in a rush. Any listed measure must entail its ratchet effect by helping to consolidate the whole transition process. This requires each measure to be a success. The listing below is not a sequencing; measures are ranked according to the length of the period of time required for their success.

7. *Stabilizing the economy* will remain for long the first task. Austerity will last ten years or more, not the three years as scheduled in IMF agreements. Yet austerity cannot be too harsh over such a long period of time, otherwise it would trigger two threats: one is a self-destroying stop and go policy (austerity-recovery and so on) in order to cope with popular discontent; the other is a slowdown of transition, if not its dead end, in the face of popular discontent and possible strikes or riots. A continuous austerity should be maintained, gradual and bearable for people, relying on classical measures such as cutting subsidies, balancing the state budget, modernizing the tax system (introducing a tax on profits with a stable and uniform rate, VAT, a personal income tax, a property tax), restricting and

controlling credit, and tightening everyone's belt except that of new private capital investors. Free market prices, linked to international prices, would be the rule, but 10 to 15% of all prices could be regulated as in developed market economies, including prices of a small basket of basic foods and other goods covering basic needs.

8. Some auxiliary measures should go with the stabilization policy. Bargaining and speculative behaviour must be broken by implementing fiscal controls on high personal incomes and an extra-taxation must be applied to personal revenues originating from speculative or unclear businesses. New incentives to work, aiming at efficient working procedures and fast growth in productivity, have to be implemented. "Positive" incentives like bonuses, extra-wages, profit-sharing and distribution of shares are not to be neglected, although two drawbacks are built-in: a loose allocation of these benefits would again fuel inflation on the one hand, and on the other hand many of these incentives have displayed their inefficiency in the communist regimes. Therefore "negative" incentives are needed: the ceiling of any wage increase must be the rate of productivity growth; individual inequalities among wage earners must be promoted, not as a threat of relative impoverishment, but as a reward for better, more intensive and productive work; the threat of unemployment might be of some help for imposing a new economic and capitalist discipline on workers. All measures must converge in creating a new employee-boss relationship within enterprises, in which bosses are "the only masters after God", and new social wage earner relations work like a stick and a carrot. Instead of Stalin's stick: "whoever does not work, does not eat" (1936 Soviet Constitution), the new stick should be "whoever does not work is laid off". The carrot should be a *new social consensus* summarized in the following phrase: "mass consumption and an affluent society as a reward for hard and industrious work", instead of the (implicit) communist consensus: "weak effort granted by workers for shortages and low quality in consumption".

9. Measures listed under 6, 7 and 8 require, as a counterpart, *safety nets*. Although I have already presented the safety net issue, I would still point to two necessary measures. The minimum wage should cover strictly defined basic needs and must be indexed on a basket of commodities including some goods with regulated prices (see 7 above). A wide gap ought to be maintained between (lower) unemployment benefit and the minimum wage, as an incentive for the unemployed to look for a new job. The new employee-boss relationship needs of course some countervailing power to prevent the fiercest "exploitation" of the labour force. A regulated right to strike, industrial tribunals and strong trade unions (independent from political parties and from the government should balance the increasing "power of capital" in PCEs.

10. Restructuring would be implemented according to the guidelines drawn from the new assessment of international competitiveness of domestic enterprises (see 1, 2 and 3 above). Concerning inefficient enterprises, unable to survive, again

a rush in close-downs and liquidations might be unwise, considering the necessary support needed from the people for the whole transition process. The bankruptcy law must not be too sharp and work like an instant chopper. (Are decisions taken in Hungary in May 1992 wise? A strict implementation of the bankruptcy law is expected to cause about 350 enterprise close-downs and 1,5 million lay-offs). The anti-monopoly regulation must be utilized carefully on a domestic market competitive for goods from abroad. The main push which will dissolve domestic monopolies will come from foreign competitors. Breaking up from the very beginning all state trusts might not be feasible because of either natural monopolies or economies of scale and economies of scope. Moreover, an innovative producer (domestic or foreign) always starts with a monopolistic position, at least for a while, when his new product is launched on the market. Anti-trust regulation should not discourage domestic innovators and new private owners involved in primitive accumulation of capital, even though they benefit from their temporary monopoly and the accruing extra-profits.

11. Willy-nilly, the fact is that a large scale restructuring can only be achieved by the *state*. In addition, restructuring is a pre-condition for profitability and competitiveness; its heavy cost would not attract private owners to undertake it. Except for state enterprises which are still profitable, restructuring ought to be completed before selling an enterprise to private stakes. Hence privatization will be slow. Meanwhile the great bulk of big enterprises will be kept in the hands of the state. Under the threat of redundancy their managers should have new management criteria imposed upon them, such as making profit (or at first reducing losses), maximizing sales, reducing turnover, exporting in hard currencies; on the other hand, the boss of a state trust will be given large autonomy in decision-making, especially decisions concerning prices, supplies, outlets, wages, and the hiring and firing of employees. This new management of state enterprises might succeed if market institutions develop continuously and increasingly shape the everyday life of economic behaviour.

12. *Privatization techniques* have to be based on sales. I have suggested elsewhere (Andreff 1991; 1992a; 1992b) that there should be a mix of techniques, including the sales of shares, tender price offers, direct acquisitions and take overs of state enterprises by private firms. The crucial issue is how to gather a stable hard core of monitoring shareholders, because small holders usually behave as sleeping partners and neither can nor will discipline managers and workers. Any other technique will lead to a pseudo-privatization. Free distribution of shares or vouchers should only act as an incentive to work. A capitalist market economy—everybody knows—operates according to the watchword "nothing for free": first of all, no ownership share for free!

13. Income inequalities, increasing wealth for the happy few, restructuring, privatization and primitive accumulation prepare the ground for a new social stratum to come to the fore in PCEs. However, the consolidation of a genuine en-

trepreneurial class, and a middle class as well, will nevertheless take decades. Meanwhile *vocational training and new teaching* might help to provide necessary management skills and thus change economic behaviour so that they can be fitted into a capitalist market economy. The suggested training and teaching must be concentrated namely on enterprise management, accounting, marketing, advertising, contracting, banking and finance, tax systems, business law, foreign trade techniques, and economic analysis. In my view, beyond financial aid, Western countries and international organizations are under a moral obligation to provide heavy aid in training and teaching of that kind. All the more so, because this aid will be the most efficient in adaptating the people of the PCEs very contentious, very debatable, very problematic to the coming capitalist market economy.

I would make two remarks in conclusion. I support a slow transition which has real chance of success because failure would lead PCEs to a very uncomfortable situation that I have called a congruence between economic system (Andreff 1992d). In short, this latter can be defined as a mixture of the worst features of capitalism and of former "existing socialism" (or shortage economy); it would probably be the worst performing system of the 21st century. My second remark is that the leaders and intelligentsia of PCEs should not confuse capitalism with either economic and political liberalism or the "pure and perfect competition" that is found in textbooks (or perfectly competitive markets). Capitalism always implies some degree of monopoly, at least as a result of innovation, often as the outcome of corporate growth. Capitalist development is often a rather fierce process whose worst effects, to be made bearable, call for either a strong political and social consensus or an authoritarian political regime. Here again I join the very accurate statement by Mr. Péter Ákos Bod that I quoted above. The most liberal thinkers are probably wrong: political democracy and market economy are not twin sisters.

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ANDERS ÅSLUND*

1. What do you regard as the main barriers to the transition into a market economy in the formerly socialist economies?

The formerly socialist economies have become ever more differentiated. For most purposes, Hungary, Czechoslovakia and Poland can be treated as one group, though the conditions in Poland are more difficult.

In all the formerly socialist countries the absence of secure *property rights* constitutes a key problem. As long as property rights have not been defined, little investment can be undertaken and the housing stock will not be improved significantly. The final solution to this problem must be the transfer of property into private hands, but how that should be accomplished is the most contentious issue in the discussion on transition.

A problem that is peculiar to Hungary is the very *high tax burden*. Together with Sweden, Hungary has the highest taxes in the world. Sweden in now trying to reduce the tax burden because the disincentives to work have become excessive, and Hungary would be well advised to do the same. The way to get out of recession and promote restructuring must be through lower—not higher—taxes than those levels commonplace in the West.

The category of labour that is in shortest supply is *lawyers*. It has many consequences. The solution of legal problems and disputes takes a long time; the

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quality of laws tends to be poor and the adoption of many laws is delayed; complex deals are tardy; the quality of court judgements tends to be low.

The combination of poor legislation and uncertain property rights provides fertile ground for *corruption*, in particular at the level of local authorities. These are involved in the sales of real estate, and this includes sales to foreigners who may be prepared to pay substantial sums under the table.

Statistics are becoming worse rather than better, as new private enterprises escape registration and rather less public money is being devoted to statistics. As a consequence of exaggerated belief in the fall of production, governments have tended to apply too lax monetary and fiscal policies in the misperception that the economy needs to be stimulated.

One of the functions of capitalism that has taken a long time to develop is that of *banking* and along with it, financial services. Even in Hungary, all foreign businessmen seem to complain about the poor standards of banking and this remains a major impediment to economic activity after successful liberalization.

All these problems are also present in the countries that have not gone so far on the road towards a market economy, but for them there are also more elementary problems.

The most vital issue is to construct a *political system* that is adequate for a change of economic system. These requirements tend to be neglected by economists. No decisive systemic change took place before democratization. Decisions are hard to carry out without a proper constitution, and once this is in place it should be adopted swiftly. Its absence may cause protracted political strife (such as in Poland) and hamper the introduction of necessary economic changes. Clear border lines should be drawn between executive and legislative powers. Typically, the legislatives tend to look upon all executive powers as illicit. An electoral system should be adopted that limits the number of parties that can enter parliament or at least setting a threshold requiring parties to have a minimum of 5 percent of the votes. Parliamentary elections should be carried out as soon as the constitutional base has been laid.

In all formerly socialist countries, apart from Hungary and Czechoslovakia, rampant *inflation* has prevailed since the exit of communism. The prime aim of economic policies must be to defeat inflation. The means are well known. Before that has been accomplished, no restructuring is likely, little investment will occur, and production is bound to plummet. In one country after the other, populist politicians emerge, sometimes draped in Keynesian flags, arguing in favour of "stimulation" of the economy by means of budget deficits and loose monetary policies. In effect, such demands are likely to provide a prolonged decline and stagnation.

Bankruptcy is too often seen as an entirely destructive tool, when in fact it can frequently be a key to the reconstruction of enterprises containing valuable assets. Little structural change can occur before bankruptcies become effective. Moreover, chronical problems with arrears can only be amended by stiff bankruptcy

regulations. To impose bankruptcy means to force enterprises to take financial responsibility for their actions.

The fear of *unemployment* is invariably exaggerated at the outset of systemic changes. In fact, it has taken a relatively long time for unemployment to develop, and its slow emergence has retarded structural changes that will raise the standard of living of the nation as a whole. In the 1980s, Spain had an unemployment rate of 20–25 percent, but this period is one that is now perceived as an extraordinary economic success, because the high unemployment facilitated badly needed restructuring. The main issues should be the effects on the economy as a whole and the assurance of reasonable economic standards for those who lose their prior employment. Restructuring is both necessary and vital for economic recovery. Similarly, the worries about social explosions have been pretty exaggerated to judge from the experiences to date. The issue is to pursue correct economic policies rather than make a sufficient number of political compromises.

The early reformers had *exaggerated expectations* and this was a severe problem. As the systemic changes have proved complex and costly, people in "latecoming" countries have realized that they are in for a hard ride, and their expectations have proved to be more realistic, thus facilitating social peace.

Misconceptions about systemic changes are dangerous barriers to economic reform. It is vital that people understand what the systemic change implies. In all countries except Czechoslovakia, information and popular education about the systemic changes have been poor. One explanation is that the new economic policymakers tend to be elitist academic technocrats with little regard for popular sentiments. Politicians must be reasonably honest to the population to maintain credibility and confidence. People must understand the implications of the systemic changes so that they can be convinced which of their demands would be unreasonable. It is important that people understand the costs of transition and what the aims are if they are to accept the transition politically.

Liberalization is relatively easy since it is a question of abolishing rather than creating regulations. However, it is vital to accomplish something concrete. All *licencing* should be abolished, with very few exceptions. Wherever liberalization has not gone far enough, corruption flourishes. This is also true in Poland, where liberalization has been relatively extensive.

Little foreign investment will occur before a currency is reasonably convertible and stable. As soon as the crucial hurdle has been jumped, substantial foreign direct investments tend to be forthcoming.

A general conclusion that we may already draw from the attempts at changing an economic system is that *the worse the mess is in an economy before the systemic change, the greater the costs of transition will be*. This is easy to understand on several grounds. The higher an inflation is, the more deflationary is the policy needed to bring it to a halt. The more distorted an economic structure has become under communism, the greater are the structural changes required to put it right.

The fewer the market-conforming institutions that exist, the more difficult it will be to develop them.

2. What measures and techniques do you suggest to accelerate the transition process?

1. Property rights must be firmly established in law, and conflicts should be solved by the easiest possible regulations. This is a strong argument against restitution; the latter is politically enforced, it should be limited to a certain period and preferably take the form of financial compensation rather than physical restitution of property.

2. The total tax burden should be brought down to less than 40 percent of the GNP, which is the average in Western Europe. In particular, personal income tax and profit taxes should, preferably, not be allowed to rise much above 40 and 30 percent, respectively.

3. The shortage of lawyers cannot be solved in the short run but will be a long-term problem. Legislation can be made as simple as possible, and limited to the most important aspects; the work of courts can be limited by various conventions. The main task, however, will be to educate a large number of lawyers domestically, because knowledge both of the native language and the laws of the country is necessary.

4. A large number of measures must be undertaken to limit corruption: Laws should be few but comprehensive and lucid; liberalization must be extensive so that civil servants have little to sell; the size of the public sector should be reduced severely; civil servants should be well trained in the rules of the new society in order to provide a basis for new ethics; civil servants should be reasonably well paid in order to reinforce their loyalty; corruption at all levels of society should be effectively prosecuted and severely punished.

5. In order to improve statistics, private enterprises should be encouraged to provide more accurate information in return for lower taxes. More public funding should be given to statistics. Even so, the awareness of how bad the statistics actually are must be emphasized, so that policies are not designed on the basis of wrong facts.

6. Banking cannot be developed quickly. Standard advice would be to establish good legal regulation and banking inspection and give scope to domestic as well as foreign competition.

7. To lay the political foundations for the systemic changes, a new democratic constitution should be adopted swiftly, with an electoral system which discriminates against small parties; also, parliamentary elections should be held soon after the change of system has been launched.

8. The main aim of initial economic policies should be to defeat inflation. For this purpose the orthodox cures, such as a balanced budget, strict monetary policies, a wage freeze and a pegged exchange rate should be used.

9. An early and simple bankruptcy law is required, and effective bankruptcy procedures should be introduced without delay (where they are still missing).

10. The attitude to unemployment should be to accept it, cater for the unemployed and retrain them.

11. Our knowledge to date suggests that the costs of communism both before and after its demise are much greater than previously understood. Therefore it is vital to bring down popular expectations to a realistic level and encourage the population to work for a medium-term recovery.

12. Massive popular education about the implications of systemic changes is necessary, if people are to go along with the radical shifts.

13. All licencing should be abolished instantly as part of the systemic change.

14. A convertible currency on current account, with some kind of pegging of the currency, should be accomplished as early as possible.

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1. My first reaction to the question of what may be the main barriers to the transition of post-communist societies into market economies is that no such barriers exist at all. Once a society becomes "post-communist", that is, transformed into a politically pluralistic one, the process of marketization is inevitable and cannot be stopped. The only questions that remain concern the speed at which marketization and the implied privatization will proceed and when, and at what level of marketization and privatization will the process be considered successful and the economy (re)integrated into the existing market economies. Indeed, in spite of their similarities with regard to economic efficiency, the most successful market economies (not to speak of the underdeveloped market economies) display different and variable market and property structures.

With the break-down of the mono-party control in the Soviet Union, political liberalization in Eastern Europe is an irreversible process—in fact, an irreversible good which represents a historic *change*. Institutionalization of political liberalism and more so its ingraining into the people's behaviour, and the democratization

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of individual and public life, will take decades. However, the shift from mono-party political control to political pluralism, in the sense of a multi-party system, is a once and for all breakthrough. The system simply is, or is not, a multi-party one. There is nothing in between, no transition period from the one to the other. Consequently, the processes of marketization and privatization are also irreversible. There is no ambiguity as to whether or not they will be interrupted, as was the case with the 1952 introduction of self-managed firms in Yugoslavia and the new economic mechanism that was introduced in Hungary in 1968.

2. People and professionals, particularly in the West, appear to be not too confident about all this. Trying to minimize the risks of any reversal, they press for radical changes in the legal ownership structure. Unfortunately, this is a *non sequitur*, not only because of the irreversibility of the political and economic processes of liberalization; if transition is conceived as a process whereby efficiency is improved in an optimum way, changes in the ownership structure—though needed in the sense of necessary conditions—are far from sufficient to achieve this. As a real process, transition is a change in economic relations rather than in legal forms, and for this reason it cannot be achieved with a single stroke of the pen. The only overnight change, and needed from the very beginning at that, is the giving of full *freedom* to legal ownership forms. In fact, even in the most efficient capitalist economies private ownership is not the exclusive ownership form and even within private ownership it varies substantially.

That transition *is* a process, and a time consuming one, can be adequately demonstrated. On an abstract level, economic efficiency depends on the quantity and quality of factors and their respective proportions. The nature of the economic system, which includes the property structure, is decisive for efficiency. The socialist system not only significantly lowered factor inputs into production processes: with the socialized personal factor prices ("uravnilovka") and non-economic promotion criteria it fatally deteriorated factor quality, most typically by preventing the creation of many top level factors. Much highly skilled labour, generally professional and managerial, is virtually missing in such a system. While intensity of labour may be improved over relatively short periods, improvement in quality will take decades and generations.

This can be better understood if we recall that with the above (and similar) institutions the socialist system—"under the banner of planned production and distribution"—*economically* nationalized *all* factors of production, most obviously skilled and professional labour (the innovators and managers in the first place) (Bajt 1974). If the property structure of socialist (and ex-socialist) societies significantly deviates from the private ownership property structure, thereby fatally damaging efficiency, it does it by these measures rather than by the *legal* nationalization of the means of production, and the transformation of the private ownership of capital

into state (or social) ownership[1]. Separation of management and ownership, which is execution of the ownership function by management and which has been known since the times of Berle and Means, minimizes the impact of the legal ownership forms on efficiency in capitalist economies as well.

Therefore, if we agree with privatization, we primarily have in mind economic denationalization of the *personal* factors of production, i.e. of people's skills and capacities. In this sense, privatization can most easily be achieved by (re)introduction of market evaluation of goods and primary factors. This seems to be most urgently needed in the process of transition. People have to be put in conditions in which they would be allowed to appropriate the full market value of the products of their economic activity, become the exclusive owners of those products, and also be aware that outside their own economic activity there is no other way of appropriation. Of course, neither the need for taxation nor social security is ignored by these postulates.

The above has still deeper implications. With the nationalization of personal factors the socialist system not only lowered the quantity and quality of people's human capital but handicapped people's material property creation and capital accumulation as well. Here I am overlooking the fact that private savings were necessitated by shortage rather than motivated by capital creation. Much more relevant is point that people lost sight of the facts that property gets created only through production and accumulated through thrift, and that these activities divert a considerable proportion of their energies from production to distribution. With the market evaluation of productive efforts people would then be induced to property creation, and only in this function are they able to become economic owners capable of making ownership a productive function.

Compared with this, the widely advocated distribution of all state property to the population, in the form of capital shares in investment funds or individual firms directly, not only perpetuates socialist appropriation via distribution as opposed to production, it also consequently minimizes its direct contribution to efficiency. Due to the fact that it nourishes hopes that formal privatization is the decisive step in the transition process, it implicitly minimizes the motivation to bring about both factor creation and input to production. Instead, the efforts of most entrepreneurial people will be entangled in the distribution and redistribution of property for years, with virtually zero contribution to efficiency.

Thus to repeat what has been said above: the priorities in the transition process are markets, of both products and primary factors, and consequently, independent enterprises; appropriation on the basis of market evaluation; and freedom and enforcement of contracts, together with full freedom of ownership forms. They will free the productive capacities of people and make transition both fast and successful. Legal private ownership in productive capital will *result* from all this, but

[1] On the difference between economic and legal ownership see Bajt 1993.

only on the condition that it takes a form which maximizes efficiency. In other words, in our view the common wisdom that marketization presupposes (legal) privatization tells less truth than the opposite statement that (economic) privatization presupposes marketization.

3. With almost full employment, high even in the case of Yugoslavia, low quality inputs presuppose an autarchic economy sheltered from foreign competition. Economists who favour shock treatment to speed up transition urge the exposure of the domestic economy to world markets. A radical lowering, if not elimination, of tariffs and export subsidies, and the lifting of other import controls, form part of the usual recipe. This will bring about the adjustment of domestic quality, design, marketing, and timely delivery necessary for facing foreign competition.

Since, as with the improvements in the quality of labour inputs, the adjustment of product quality to international standards also takes time (in some cases quite long periods of time), this is a second *non sequitur*. By demolishing the existing protection, a traditionally sheltered production unit loses its markets and is bound to go bankrupt and to disappear and/or become prey for foreign capital. This is accentuated by tight money policy, which is unavoidable if the initial price liberalization is not to turn into hyperinflation. A protracted period of excessively high unemployment is implied and this is likely to make the ensuing social and political problems untractable. It is not only the social and political effects, but also the economic reasons that are likely to make this unacceptable.

This problem has been addressed before. Instead of an abrupt demolition of protection, a basic policy involving a slightly undervalued domestic currency, which is able to adequately bridge the gaps in the average national productivities (for this reason alone, monetary systems of the currency board brand are ruled out), should be supplemented by policy suitably tailored for the protection of domestic industrial production. Schemes should be designed, preferably by making contracts with the firms in question, for a gradual tearing down of protection. Thus the transition process would be integrated into the overall efforts to lower the degree of protectionism in the modern world. When the most powerful national economy, the U.S., promises to progressively increase the textile import quotas in three successive three-year stages, and if developed countries with no imports of agricultural products are to make access commitments at the level of some 3 percent of domestic production (DFA 1991), some similar schemes would possibly be acceptable in the case of low developed and autarchic ex-socialist countries. The more so since, unlike in the highly developed countries which are well integrated into the world economy, a radical and general dismantling of protection would provoke acute depression alongside stabilization policies, push firms deeper into the red, and thus practically forestall any real adjustment. Consequently, it would expose firms to predatory take-overs, both domestic and foreign, and particularly to acquisitions for the purpose of resale. Since the issue has been addressed before (*McKinnon* 1991), we do not have to dwell on this.

4. In concluding we may say the following: whatever the quality of their products (and the efficiency of their investment), socialist countries were able to satisfy the basic needs of their populations, full employment included, and to export large quantities of goods. In most cases, right up to the 1980s they were also able to maintain a permanent rise in living standards. It was external shocks, the two oil price revolutions, the stronger dollar, and the rocketing interest rates that brought them trouble. With all these now gone, what keeps them in such deplorable conditions? For all of them the performances of the pre-80s remain unattainable achievements.

The Gorbatchev's long-drawn *talking* about reforms, thus nourishing people's expectations of a better life, no doubt deserves a top place in the adverse factor ranking. The relevance of the unification of the two Germanies similarly deserves considerable emphasis. The unavoidable breaking up of the "big brother constraint" precipitated development in all other socialist countries. Politicians and economic policy makers simply lost direction. Also, the most radical and frequently nonsensical advice coming from the West has gained ground with little difficulty.

However, while this helps in the understanding of the existing depression in ex-socialist countries, the main causes of these depression seem to be the uncritical preference for legislation and economic radicalism. The massive formal transformation of state (social) property into private property (or the years spent discussing projects to do it) and the general lifting of activity protection are cases in point. While the former distracted the interest of policy-makers from the really relevant measures (introduction of market evaluation of productive inputs) and true market solutions (selling of social property at market prices[2]), the latter, in conjunction with tight money, unmistakably depressed economic activity, making adjustments to international quality standards impossible.

So, if at the end we turn to the initial question, I would venture the answer that one of the main barriers to faster transition seems to be precisely the insistence on spectacular radical moves. These, by their very nature, are limited to legal forms and therefore are only capable of facilitating and not bringing about the real marketization and privatization processes. Consequently they lead to disappointing economic results.

[2]In Slovenia, for instance, socially owned apartments are being sold to tenants for one sixth of the cost price, although these via very low rents have for years been pocketing high incomes in kind. The once nationalized real estate is to be reprivatized regardless of its liability structure (indebtedness) on the eve of nationalization. On the other hand, workers who by opting for lower wages during the socialist era accumulated capital with their own self-managed firms, are going to be offered shares in that capital at market prices—though with a high discount. It is easy to see that it is the political power structure rather than the market that is at the roots of such redistribution processes.

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I am doubtful whether one can usefully identify *in abstracto* the main barriers to the transition to market-driven economic systems in the eastern part of Europe. I like to identify these countries as the planned economies in transition (PETs—no pun intended). But more general issues of design and policy making can be addressed as distinct from the more technical aspects on how to pursue the transformation in any particular PET. I deal only with the former issues here, owing to the remit assigned for this note.

In looking at more general statements applicable to most PETs three realities are critical. One is coming to grips with the entire legacy of the communist experience in terms of institutions and human attitudes, and heeding the positive and negative transition experiences gathered to date, notably in the Central European countries. Another is the determination of what precisely it is that society is willing—and able—to bear and how best to maintain the socio-political consensus on sharing the burden of the transition. Finally, the role of international assistance in conceptualizing and moving along the best—i.e. least costly and most effective—path to transition deserves to be reconfigured. Let me take up these themes in sequence, although I shall focus mainly on the apparent errors in the transition policies pursued to date and identify what could be done to remedy the situation without prejudicing the inherent importance of the two other identified clusters.

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"The Transition and Its Sequencing"

The legacies of the *anciens régimes*

I need not delve into all the details of what went wrong with the communist-run societies to gain concurrence on several critical facets. Arguably of central significance is that at their inception the PETs' peculiar economic structure was inefficient in terms of delivering goods and services to support steady gains in *per capita* incomes, they were not very competitive in world markets, and they had most resources committed to undertakings that were much too inflexible to shift expeditiously toward the competitive production of "new" goods and services.

The inflexibility of supply deserves special mention, regardless of the transition policies embraced, and this should form one critical element in thinking about the comprehensiveness, speed, and sequencing of the transition. Without firm action to influence the microeconomic sphere, notably production, the transition simply cannot be advanced beyond the measures that curb absorption. With such demand-management policies to regain macroeconomic stability at any activity level, a sharp cutback in effective absorptive capacity is inevitable. In several PETs, this may in fact amount to a low-level equilibrium trap from which managers of the transition will find it very difficult to extricate the economies entrusted to their care. Surely, domestic markets are better provisioned and the proverbial queues have gone; external balance has improved considerably, in many cases through sharp export gains in new markets; and new economic activities are mushrooming. But all this is taking place in an environment with substantial capacity under utilization, shaky budgets, and a still very high pace of (residual?) inflation. The latter, however, accelerates every time budget financing is required, regardless of the underlying causes. It is compressed demand that is feeding this low-level platform, and a firm jolt on the supply side will be required to change this state of affairs.

To change supply, pro-active policy measures need to ensure not only that existing firms are transformed through privatization, but also that new capital, from domestic as well as foreign sources, be invested in the best way circumstances allow. Transition policies in the beginning counted too much on sizable inflows of foreign capital to revive and restructure supply. This has not materialized for good reasons. Foreign direct investment (FDI)—for practical purposes, the only source of external private capital that can be tapped under the circumstances—is understandably leery about moving *en masse* into economically, politically, and socially unstable situations. It is also likely to seek considerable concessions in terms of tax holidays, protection against domestic and foreign competition, and other benefits that, at times, render the benefits of FDI for PETs rather dubious.

What should reformers do? Clearly, in case of severe imbalances at the outset of the transition, economic stabilization is a must before any serious restructuring of economic policies, institutions, instruments, and behaviour can be contemplated in earnest. This encompasses at the very least substantial price liberalization,

stringent monetary and fiscal policies, *de facto* wiping out of the monetary overhang if monetary reform must be shunned for political reasons, liberalizing the enterprise sphere, breaking the bond created by the lifetime job-guarantee system inherited from the past, loosening up access to foreign exchange and foreign markets, and holding firms and banks responsible for their own results. But stabilization should not be seen as an end in itself, however useful it undoubtedly will be. It should certainly not be taken as a signal to take advantage of realities and simply "loosen up" as many economic variables as possible without making firm allowances for progressing with structural reform. The latter is on the whole not a macroeconomic but a very fundamental microeconomic supply problem. That is to say, successful transition requires laying as rapidly as possible the microeconomic foundations for macroeconomic stability and sustained progress toward economic prosperity.

My preferred tie-in of stabilization and structural reform is through a more evolutionary transition than the abrupt shock treatment championed by many. If time is available, the Hungarian path first laid under communism could be trodden. But this is unlikely to be a feasible option for most other PETs. The immediate aim should be the beheading of the party and industrial ministries, including all of their appendages; also it needs to be ensured that political rents are simply not transferred to those now favoured by the changed political circumstances; and a solid environment needs to be created within which economic agents can operate on their own account. This requires an unambiguous legal infrastructure (hence making effective progress with the institution of the *Rechtsstaat*), and solid macroeconomic policies (at least monetary and fiscal, and in my view also price and incomes policies). That environment must hold for all agents and be enforceable. There is no point in introducing fiscal reforms while at the same time authorities are unable—or unwilling—to enforce the rules on new private businesses for fear of discouraging them, let alone on FDI for fear of scaring off the prevailing trickle.

In this connection, I should like to address five areas where managers of most transitions have made critical errors by omission or commission: (1) liberalizing the foreign sector, including currency convertibility and weak protection; (2) ignoring opportunities for gradually phasing out the heavy reliance on intragroup trade and payments in the transferable-rouble (TR) context and seeking to replace it quickly with "world market conditions" and/or near-instantaneous trade diversion; (3) not putting unambiguous property rights in place quickly enough and exploring alternative mechanisms for effectively enforcing them, regardless of ownership structure; (4) engaging in unnecessarily portracted, rather wasteful bickering over privatization while the main tasks of moving forward with building the market economy are being placed on the back burner; and (5) delaying radical reforms in the financial infrastructure that is so vital for the effective intermediation between savers and investors.

First, from the inception of the transition, it would have been desirable to set a clear legal framework, enforceable in the courts, on all property rights. In most

PETs this simple imperative was ignored—at least, not given its due attention. Without unambiguous property rights it is simply impossible to build a viable market economy. For the latter's essence is exchange, that is, handing over property rights from one party to another, possibly at a positive price. Ambiguity in property rights did not solely stem from denied property rights, such as through confiscation, but also from extremely lax monitoring of state property during the latter phase of communism. This gave rise to various kinds of property rights' claims and the new authorities have found it very difficult to tackle these head-on.

Second, because property structures provided the best-known demarcation between socialism and capitalism, privatization of state-owned assets has been prominent on the policy agenda. In spite of protracted debates in social and political forums and the entertainment of one fancier scheme to privatize than another, by mid-1992, on balance, comparatively little had been achieved even in the fast moving PETs, and the outlook for an acceleration in the near term, thus improving capital resource allocation, (though promised notably in Czechoslovakia, Poland, and Russia) is none too bright.

As far as the economics of privatization is concerned, the debates since the revolutions of 1989 have simply paid too much attention to the divestment of existing assets, most notably of the large state firms. That should have received comparatively little attention. Once bold progress could be advanced with the divestment of small assets (however defined), policy makers should have focused on two priorities. One should have been the promotion of small and medium-sized firms, preferably new undertakings financed through private and public gross savings. The other should have been the monitoring of state-owned assets to establish (again) residual property rights and the divesting of the state as rapidly as possible of the usufruct of these assets by corporatizing and commercializing firms. The first would permit greater distance between policy-makers and the various interest groups involved with economic affairs, and give the firm a legal statute through which it can seek to operate with some degree of independence, excepting the ultimate disposition of assets. The other should have placed state firms, both those eventually to be sold off as well as those to be kept in the public sector, on a commercial basis. Neither priority was given much attention. It would certainly not have been an easy task to implement either, given the shaky monitoring of property rights by the state over several decades which enabled managers and workers to assume full ownership functions, even though those had remained quite implicit.

Third, a market thrives on mediated exchange, including in intertemporal assets. Without effectively meshing the interests of savers and investors, it will prove difficult to bring about the so vital construction of new small and medium-sized firms that—rather than the privatization of state firms—will carry the transition process over the medium term. Without endowing the economy with an effective two-tier banking system, in absence of cleaning up the balance sheets of non-performing loans (which could be entrusted to a trust resolution agency), and

failing to put in place supervisory mechanisms, this effective intermediation could not begin to form. In some countries, moving too rapidly within a loose supervisory framework, as in Poland, invited all kinds of crises that could have been avoided.

Fourth, it is unrealistic to expect the foreign sector to be more than an auxiliary mechanism facilitating the transformation of the domestic economy. Direct competition from abroad can influence relative prices, in the first instance, only for traded goods, which in some PETs is a small share of the market. This is particularly so if allowance is made for the distorted prices emerging from managed global trade. Even in goods' markets, its salutary effects should not be exaggerated, if only because of the contraction in demand resulting from the sharply increased cost of foreign exchange and incomes. Changes in relative factor prices are likely to come about rather slowly, especially during the initial phases of the transition, when foreign competition could contribute most to the creation of effective markets. Yet the macroeconomic stance is rigidly anti-inflationary. That is to say, trade liberalization is a necessary, but by no means a sufficient condition to foster greater competition in domestic markets in the PETs. The changes will primarily have to be brought about through domestic economic policies.

The desirable transformation of the trade and payment systems of the PETs has been one of the most widely debated questions of designing comprehensive, speedy, and properly sequenced transition policies. There has been little disagreement about the need to disengage from the inherited trade and payment systems and integrate the PETs rapidly into the global economy. Equally unanimous has been the advice to open up the PETs and expose them to international competition to usher in the necessary competitive discipline. Trade liberalization has been advocated on the basis of the incontestable credentials of trade theory. But their practical realization will not be self-evident until the liberalizing economy has achieved an environment conducive to comparatively flexible adjustments to shifts in demand and supply—that is, *after* erecting an ambient market environment. Early during the transition, foreign competition may indeed eliminate domestic production, perhaps prematurely, without the freed-up resources being mobilized for growth-promoting activities. The outcome may then be a marked cutback in aggregate activity, which cannot but compress sustainable levels of welfare.

This orthodox case for trade liberalization calls for relatively low protection with an exchange rate that should help maintain equilibrium in the current account, at least over the medium run. Because the gap between pre-transition and "world" prices is considerable no single variation of the exchange rate will obviate the need to adjust demand and/or supply. And because future export and import schedules are unknown, it is unclear by how much the home currency should be devalued in order to enable policy-markers to sustain external balances at near-full employment. Yet the questions relating to the size of the devaluation and the degree at which the nominal exchange rate is fixed, perhaps to function properly as a key anchor

for the design of transitional policies, have been prominent in the debate on those policies.

Unfortunately, there are no unambiguous answers to these questions. The fact is that the majority of PETs have opted for an undervalued fixed rate and a limited form of current-account convertibility. Undervaluation has been suggested more by concern about infusing some anchored certainty into an exceedingly volatile socioeconomic and political situation, rather than by solid economic arguments. The choice is bad economics, but it may be wise political economy provided it does not become a fetish, as in some PETs. Convertibility after a massive devaluation and at a low level of employment has been comparatively easy to arrange. However, this hardly benefits the PETs. Foreign assistance can help in amassing the reserves. But its capacity to prop up comparatively high levels of employment, let alone contributing to the restructuring of production, is in doubt. For that, domestic economic forces must be sufficiently competitive. In all this, insufficient attention has been allotted to the potentially destabilizing effects of a fluctuating real exchange rate, which adds to the hazards—notably of trade-led restructuring.

I have no problem with the promotion of fast and far-reaching liberalization of access to foreign exchange over some period of time (months rather than years, of course), as distinct from seeking convertibility overnight. This can be accomplished through open auctions accessible to all duly authorized agents. This is a distinct option in PETs without much prior experience with auctions, and that are still governable. Through such "monitored" auctions those managing the transition can obtain a more solid grasp of the proper equilibrium exchange rate in the short to medium run, while safeguarding the procurement of essentials. This requires that they must confidently be able to set a reasonable exchange rate and, barring untoward events, maintain it over some period of time (perhaps 6 to 12 months) without being pressured by the quick erosion of the chosen level due to differential price movements. Also, the authorities must have in place adequate institutions and policy instruments to manage the exchange regime, preferably through a "crawling peg" or an otherwise adjustable exchange rate.

With regard to the nature of protection, I am in sympathy with those arguing for the case of a low *ad valorem*, relatively uniform tariff with few non-tariff barriers. Whereas some protection of existing economic structures could usefully be entertained under precisely defined conditions, formidable trade barriers would be counterproductive for the PETs. Certainly, this would permit policy-makers to alter economic structures gradually, hence avoiding sudden dislocations with all their attendant consequences. But it would also inhibit competition and the transfer of an effective system of relative prices for traded goods.

Furthermore, in view of the weak central actors in the PETs, credibility for the phasing-out of barriers would be elusive. Temporary income transfers permitting sectors potentially threatened by bankruptcy to operate below real cost would be preferable. At least, it would not saddle the government with full unemploy-

ment claims and valuable assets could survive the rigours of the transition. This would require a credible industrial policy and a more forceful role on the part of the state—both unnecessarily neglected in the transition policies.

Finally, a shared item of the transition is the repudiation of previous trade and payment regimes, be it anchored to the rouble, the dinar, or the transferable rouble. The rationale is that such trade should be dispensed with as quickly as possible. This is wrong for theoretical as well as policy reasons. As a matter of trade theory, it may be desirable in the short run for PETs to maintain at least part of the traditional turnover that must ultimately be displaced. As a matter of political economy, a very rapid, forced compression of trade, hence of production, of what may in the end have to disappear may stop a reform process cold in its tracks, as the recent experience has amply demonstrated. And, of course, trade warranted on economic grounds deserves to be accommodated in any case. Barring a quick move to "world market conditions", which is not realistic, this could be achieved only through a substantial degree of cooperation among the PETs themselves, perhaps with external financial and supervisory assistance, such as through a payments union. This has been categorically rejected by the PET leadership and others on rather flimsy grounds. The question has resurfaced notably in the case of maintaining the reciprocity rouble trade, for which the outlook is none too bright. It is of paramount importance to revive intragroup trade.

The adjustment cost and socio-political consensus

Regardless of the policies that may be embraced during the transition, there would now seem to be little doubt that change cannot be brought about without considerable adjustment costs. This can be digested only when there is a tacit or overt consensus on the magnitude of the cost that society at large is willing to shoulder, on the time period during which that cost will have to be borne, and on the distribution of the adjustment burden over society. One policy mistake was to go for populist slogans, intimating that the benefits of the western welfare state would quickly be emulated in the PETs, once communism had foundered. This provided a consensus for far-reaching reform, but a highly tenuous one.

Even when initially there was such a consensus, it should be borne in mind that expectations on the part of broad layers of society were optimistic as to the gratifications that the transition would bring while the delivery capacity remains rather weak. The result is frustration and apathy that, in conjunction with weak political structures, can only rupture the initial consensus. Thus there may be a call for political compromises that may end up in stalemate. In other words, the political setup of the PETs, however democratic, during the transition itself is an obstacle to moving forward with the implanting of market-based economic systems

in a pluralistic environment. This has important consequences, for example, in terms of the fiscal reform that can be brought about through a parliamentary system. Yet, it is urgently needed to help shoulder the burden of the adjustment, during which the traditional sources of fiscal revenues are drying up because of economic recession and the lethargy in state enterprises. At the same time the demands for fiscal outlays, even when price subsidies are being eliminated, might explode precisely because of all the adjustment costs that are being transferred to the state at a time of its severely weakened capacity to collect tax revenues.

Rethinking the transition and Western assistance

Western assistance was originally envisaged to ease the burden of adjustment in the PETs through various channels. To the extent that financing was involved or technical assistance was forthcoming, which would otherwise have called for outlays by the PETs, the net result was an easing of the foreign-exchange constraint. This was notably the case in accommodating debt-service obligations or in removing obstacles to the access markets in Western Europe, for example. Much of the assistance has been invaluable. But a considerable part has not been properly used for lack of adequate coordination. And much of the commitment has yet to be disbursed.

Coordination is required to ensure that whatever funds donor countries are willing to appropriate for the PETs are utilized in the most effective way in terms of assisting the transition. That is to say, it must be clear what funding from donors will be available and in what forms. Equally imperative is a clear concept of the transition in the potential recipient countries. Then, it is largely a technical and diplomatic task to ensure that the greatest bang for the "buck" or ecu is extracted.

There are two flaws in the approach of western assistance that, with some goodwill, could have been remedied. One is the overemphasis on demand management by making the disbursement of assistance contingent on each PET having in place an arrangement on adjustment policy with the IMF. Not only does this bias transitional policy making toward demand management, but it also tends to guide that demand management too much by what is required for the current-account balance. This is undoubtedly very important. But in countries where the external sector is small, or will become small because of the adjustment pains, it would not seem particularly useful to explore ways and means of having the "tail wag the dog".

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ANDRÁS BRÓDY*

Hungarian predilection for military potential and voluminous red tape, both inherited from the Habsburg empire, have been growing incessantly since that time. Our historical statistics confirm this, whether we look up the monopolistic demands for goods and services or the ever increasing number of institutions and policies that restrict the freedom of markets from many angles.

We prepared for World War II with an elaborate system of compulsory agricultural deliveries, an administrative allocation of materials, the fixing of rents and housing regulations. Rationing of food and clothing did not boost the markets either. An Office for Materials and Prices was established, foreign currency was regulated and then blocked "by the centralised state", and finally enterprises were placed under military command.

All these institutional arrangements paved the way for the power of the post-war Supreme Economic Council. Catering for the needs of the Red Army did not give much respite from the war economy. Thereafter the nationalization of enterprises prompted the omnipotence of the Planning Office and the Ministries. The process of nationalization itself in fact represented the final legal negation of property and markets, which in practice had been rendered feeble and toothless long before.

The further inroads into our everyday life have become the ordeal of the present generation. With every step of apparent reform we have been presented with new orders, rules, sanctions and institutions. To this day economic life remains overdetermined, with every move being actually punishable by some ominous regulation.

The question arises whether it is possible at all to halt this self-generating process. Some of the doubts are certainly justified. In the West, where economic and political circumstances are more relaxed, the same process of state proliferation could not be stopped at a much lower level.

One should not be taken in by what can be seen on the surface: the wider choice of goods (which can be afforded by less and less), the incipient ease of commerce, exports and smuggling (which can be revoked any time). The deeper problems show no signs of changing: the tax-free trade in arms and weapons, the chronic increase of the budget along with its separated, secret, sometimes illegal funds, and its confessed and denied deficits.

Our internal markets and the purchasing powers of the population are dangerously shrinking. The tax office already faces serious problems and has started to consider some medieval forms of tax collection.

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The privatization drive has turned out to be only the final and logical step of nationalization. Being unable to use, modernize and make profitable the confiscated assets, the State now is thrown back to the last property right: that of alienation. It is selling to make up for the missing income.

If now the Government speaks about markets, at the same time it dreams about tax incomes and shrewd financial manoeuvres. Its monopolies are staunchly guarded and we cannot see a shred of evidence that the manifestly overpriced industrial goods are going to sell for less, that depressed real wages might start recovering, or that the supply of services is going to grow or its quality improve. These would be the observable tendencies on a real market, given the known misallocation of resources.

The slumbering of the market forces can be traced back to the rigid economic policy which began to develop fifty years or more earlier. Governments have built up and fortified the public, military, administrative spheres to the detriment of the civilian spheres. Only a radical reversal of this misallocation will bring the possibility of democracy, markets, and an upturn of the economy.

Yet neither the inherited bureaucracy nor the feeble forces of the market will pull us out of the trap we are caught in. This would necessitate analysis, planning, purpose and action. Politicians with a broader grasp of the issues and of a greater calibre would be needed—and even the best of them could be easily thwarted by the mammoth State machinery, conjured up by forty years of so-called socialism.

ELLEN COMISSO*

By the term "transition" or "transformation" I assume is meant (a) a political order characterized by competitive elections with universal suffrage, the "rule of law," and constitutionally guaranteed and enforced civil liberties; and (b) an economic order characterized by relatively competitive markets in goods, services, and factors of production in which the dominant share of GNP is realized in the private sector. Bear in mind that the foregoing signifies a "minimalist" definition of "transition;" a "maximalist" definition might well contain many additional attributes regarding political participation, income distribution, social service provision, employment, inflation, and growth rates, etc. But since there seems to be general consensus only on what the minimalist definition of transition is, it is solely to this concept that my response will be addressed.

I would begin by noting that the barriers to even the minimalist transformation are by no means uniform in Eastern Europe (let alone Eastern Europe and

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the former Soviet Union). Outside of Hungary, it seems to me that the failure to successfully resolve political-institutional questions satisfactorily has made it impossible to make much headway on dealing with the economic aspects of regime change. In Czechoslovakia, there is still (May 1992) much uncertainty as to how authority will be divided between the federal and republic governments and even if there will continue to be a single state in the area. In a context in which the ability of the state to make credible commitments is subject to question, economic policy can at best be a set of stopgap, temporizing measures, no matter how dramatic and determined they may appear to be on the surface.

In Poland, the combination of a strong, directly elected president and multipartyism in the legislature is revealing itself to be as unstable an institutional mix there as it has been everywhere else (chiefly Latin America) it has been tried. At the same time, the failure of any party to capture more than 20% of the vote in the last parliamentary election (a phenomenon due in part to the electoral law adopted by the outgoing parliament) has meant a government coalition consisting of so many parties that it is extremely difficult for it to move decisively on key economic issues. In Romania, the commitment of the government to the political transformation itself is open to some question, and the tragedy consuming the former Yugoslavia needs no further comment. Even in relatively peaceful Slovenia, the fact that elections occurred within the constitutional order of the old system has meant that partisan disagreements over economic policy directions have been magnified by institutional disagreements between chambers of a tricameral legislature. The first casualty was the Peterle government, whose collapse was followed by a four-month hiatus after which a seven (!) party coalition government with a razor-thin parliamentary majority was finaly cobbled together—hardly a recipe for major economic reform.

Here we arrive at the small, central European oasis of Hungary. More precisely, thanks to a variety of ad hoc factors surrounding the collapse of socialism, Hungary does not suffer from the political-institutional problems that beset the neighboring states in the region. Insofar as the presidency is neither a popularly elected office nor endowed with major policy-making powers, initiative in policy formulation lies where it should be: in an executive that has a reliable base of support in the legislature. Significantly, the evidence on the few cases of successful economic reform we have suggests that exercising fiscal restraint requires a transfer of power from the spending to the non-spending branches of government, typically, from the legislature to the executive, and within it, to the non-spending ministries like Finance. The smoothest way this can be accomplished under democratic conditions is within a pure parliamentary system, such as the one adopted in Hungary. Furthermore, the electoral formula selected in Hungary is biased in favour of the larger parties in the allocation of seats in the legislature; in effect, the electoral law itself "manufactures" legislative majorities. It thus provides a basis for coalition government with a limited number of parties within it. As implied above in the

discussion of Poland and Slovenia, the smaller the number of partisan interests that must be accommodated in the policy-making process, the easier it is for policy to be made consistently in a variety of areas.

Unicameralism in the legislature was perhaps another wise institutional choice, although here the balance is a mixed one. On the one hand, the absence of a second chamber means there is no special institutional privilege granted to relatively narrow sectoral interests, be they regions or branches of the economy (for example, it is no accident that the French Senat has been dubbed "the Chamber of Agriculture" due to the systematic overrepresentation of small towns within it). On the other hand, the unicameral format means that virtually all interest conflicts must be played out as partisan contests, thereby exacerbating tensions between government and opposition parties and placing interests not associated with the government parties in a highly disadvantageous position. Equally important, the combination of unicameralism, a parliamentary system with a majority government, and a unitary state concentrates enormous power in the hands of the central government. The national government thus has plenty of power to act; however, if it fails to do so or takes inappropriate measures, there are few institutional vehicles available to counter it with.

Finally, the early establishment of a Constitutional Court was another fortunate institutional innovation. Given the extremely wide sphere for action the structural features of the political order concentrate in the hands of the government, the importance of a non-partisan, independent check on its decisions cannot be exaggerated. Particularly in the sphere of clarifying property rights, the need for such an institution is critical, and the active role played by the Court in this area in the past two years is ample testimony to its indispensability.

Hungary is thus an interesting case because it is the one instance in Eastern Europe in which the absence of a completed transformation cannot be blamed on political institutions as such. Rather, the cause must lie in either the specific actions of the government (i.e., that it has utilized its powers unwisely, substituting political rationality for economic rationality), the nature of the situation (i.e., that factors beyond its control are blocking more rapid transformation), or some combination of the two.

While hardly denying that one can make a long inventory of errors on the part of the government, I myself would tend to stress the nature of the current economic situation—domestic and international—as being at the root of the problem. I say this partly as one who always felt that the vision of a rapid transformation to so-called modern capitalism was illusory to start with. I say it also as one who feels that it is equally illusory to expect a government elected in competitive elections to select policies without regard for their political repercussions. Economic policy need not be "optimal" in the textbook sense; rather it needs to be viable, and to be viable, it must be politically sustainable. The long history of failed IMF stabilization programs is evidence at one extreme, as is the experience of "populist" policies

at the other. Neither proved viable because neither were sustainable. Hence, the fact that policies may be selected on political grounds should not necessarily be a sign of their irrationality; the question is what the concrete economic effects of the policy were.

In fact, it seems to me that the "transformation problem" consists of a number of "traps" or "vicious circles," and it is by no means clear how one breaks out of them rapidly. Privatization is a case in point. Here, it seems to me that the major reason for the state's inability to divest its assets more rapidly is a simple one: the buyers are not there. The reasons for this are many, and bureaucratic footdragging on the part of the SPA or the government is surely one of them. But far more important is rational reluctance on the part of potential investors: given future projections of growth, the likelihood that a large portion of the assets currently in the state's portfolio will generate future income streams large enough to outweigh the costs of acquiring and modernizing them is simply too small to attract buyers. Thus, one arrives at the first privatization trap: one needs to privatize in order to generate growth, but one needs an expanding economy in order to privatize.

The second privatization trap is related to problems of fiscal balance. Here, one of the primary reasons why governments all over the world are seeking to sell productive assets is because they are in debt. Yet it is turning out that insofar as the state sector is a key source of revenue for the government, privatization could have the counterproductive effect of increasing government deficits, at least in the short run. Thus, added to the rational reluctance of the buyers is the rational reluctance of the seller. Moreover, to the degree the debt is financed by domestic borrowing, it raises interest rates and makes it more difficult for potential investors to mobilize local capital. Thus, one needs to privatize in order to reduce the debt, but one needs to bring government debt down to manageable levels in order to privatize.

The third privatization trap concerns the legal and administrative procedures employed. The main argument for state-controlled privatization is that it allows the process to be more transparent and for the public interest to be protected. Yet the more transparent the process is, the more procedurally encumbered it becomes; the more procedurally encumbered it is, the smaller the circle of interested buyers becomes. In the end, the very procedures designed to protect the public's interest work to weaken the state's bargaining power and the attractiveness of the assets it seeks to market, thereby impairing the state's ability to meet its fiduciary obligations to the public.

A final privatization trap concerns its partisan consequences. On the one hand, a major argument for privatization is that it will insulate economic decisions from direct political control. At the same time, it is difficult to imagine how a massive transfer of property rights to private individuals can be accomplished except on the basis of a non-partisan consensus. On the other hand, however, it is equally difficult to imagine why a government elected on partisan lines would wish

to move aggressively to sell state assets if doing so would not help it electorally. In short, a privatization strategy based on strictly non-partisan considerations is not in the interest of the government which has to adopt it, while a privatization strategy based on partisan interests reproduces many of the more questionable practices of the socialist system and lacks wider legitimacy.

The foregoing is only a partial list of the various "traps" militating against a rapid transition to a market economy in the current conjuncture. Underlying them is perhaps the most central trap of all: governments can create institutions essential for the operation of competitive markets (from a commercial code to secure property rights), but they cannot create a market itself. The latter results from the decentralized actions of individual economic entities responding to economic incentives only partially provided by institutional structures. As a result, the microeconomic structure of a market economy can only evolve gradually.

From this perspective, the optimistic scenario sees the state sector diminishing gradually via sales and bankruptcies and the private sector growing slowly via accumulation and selective acquisitions of state sector assets. In this scenario, the fact that private ventures are currently small and concentrated in services and trade is predictable, and expansion into the manufacturing sector can be expected to occur with the passage of time. Likewise, the fact that much that is claimed to be "privatization" in the state sector consists of mixed organizational forms (the joint venture, the kft. spinoff servicing the still state-owned larger enterprise, the partially state-owned Rt., etc.) probably should be viewed less as a subversion of the market economy ideal than as rational adaptation to economic uncertainty, facilitating flexibility in production while reducing risk. That such arrangements reflect the "interests" of those who engage in them and that they can prove highly lucrative is not necessarily a reason for condemning them. While such ventures may have the immediate effect of prolonging the state's role in productive activities, they may also prove to be a key means of easing its departure over time.

The major problem in even the optimistic scenario is whether the decline of the state sector will be matched by an expansion of the private sector, both in terms of its contribution to the state budget and to its job-creation capacities. If budgetary revenues from the state sector cannot be made up by taxation from the private sector and/or if individuals currently working in the state sector cannot find alternative employment in the private sector, governments will be strongly tempted to call a halt to the whole process, baling out the state firms to save jobs and running deficits or heavily taxing the private sector to provide the revenues.

Unfortunately, accelerating privatization via artificial means neither avoids this problem nor escapes the "traps" noted above. The current crisis in agriculture, created in part by "instant" privatization without the creation of a financial and commercial infrastructure able to support it is a good example of what can happen. Attracting foreign investment is a partial solution, but ultimately a successful transition will depend on the mobilization of domestic capital, both human

and financial. Factor markets in both appear to be rather sticky, the former due to the almost total absence of a viable labour market policy and the latter due to a still monopolistic and inflexible banking system heavily biased in favour of large lenders. Infrastructure in all areas—transport, communications, finance, education, environment etc.—is badly in need of modernization as well.

It is here where the role of the OECD states can be important. At least some of the aid which is now self-serving (e.g., credits tied to the import of western goods) ought to be put to purposes of debt reduction (e.g., western governments can purchase the debt from private creditors at a discount). This would relieve the state budget somewhat and possibly allow interest rates to fall to a level where the return on investment can at least match the return to bank deposits, stimulating the expansion of the private sector.

Meanwhile, I think it is important to realize that the process of transition to a market economy does not simply involve reducing the role of the state in the economy; rather, it requires changing it. Public investment does not disappear in modern capitalism. But rather than being devoted to steel plants and chemical industries, it is put into infrastructure projects that have multiplier effects and into human capital that raises both the quality of labour and life. From this point of view, high unemployment is not simply a source of social tensions and of individual tragedies, it is a real waste of resources. Precisely because the state sector is declining, public investment—financed preferably through bond issues rather than out of direct budgetary expenditure—in social services and infrastructure should increase of the private sector itself.

My general impression is that the transition process in Hungary is going on as a series of individual adaptations to specific circumstances and opportunities, which is essentially the only way it can go on. As such, it can probably be accelerated only marginally, and the wisest role for government to play in the process is to refrain from grand designs and from forcing the process in favour of concentrating its activities in areas that facilitate that adaptation process on the part of as broad a portion of the population as possible. For this reason, I stress infrastructural and human capital investment so heavily. At this point, the danger is not that the process moves slowly, but simply that it does not come to a halt entirely. Cushioning the cost of the transition in a manner that can yield positive economic results seems to me to be critical in this regard.

BÉLA CSIKÓS-NAGY*

As part of the 1992 meeting of the Hungarian Academy of Sciences, the Economics and Law Department held its meeting on May 7th to discuss the questions of social and economic change. I read one of the four papers that provide the basis for the discussion: "The economic situation and the chances of recovery". I think the best way to comply with the request of *Acta Oeconomica*'s editors—which I consider an honour—will be to give a summary of that paper.

What can science give?

Economics was unprepared for the radical socio-economic change that is now taking place in the Central and East European countries. No research relevant for the post-communist coutries had been undertaken. Therefore the Harvard Professor Jeffrey Sachs' recommendation of a shock therapy came as a surprise: it was suggested as a means that could lead from socialist planned economy directly to social market economy. Deliberations concerning shock therapy brought liberalization, restrictive monetary policy, rehabilitation of finances, and convertibility of currencies to the focus of attention. At the same time, the fundamental and complicated questions of institutional and economic reorganization lost importance.

Sachs intended to transplant a model—albeit not in an entirely exact form—adopted in Latin America (despite the fact that the two regions had no similarities whatsoever). Poland and Yugoslavia accepted his recommendations, and Russia is experimenting with them. It may be the most important merit of Hungarian economic policy to have avoided this trap, even though some of its elements did show up in the late 1980s and the relevant dispute went on even after the change of the political system.

The reference made to the unpreparedness of science must be correctly interpreted. Economics has of course made considerable progress in developing politico-economic logic, revealing material and financial interdependencies, and describing the rationally functioning institutional order. All that serves as useful orientation for the post-communist societies in solving questions of detail. However, under the conditions of the change of the economic system, emphasis must be laid on the inner logical connections of thousands of issues. Things have their logical order and if this order is not adhered to, they may take a turn in the wrong direction. For the time being, no such conception exists which would show the complexity

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"The Crucial Points of the Change of the System"

of problems in the light of the interdependencies. The programmes which now exist only formulate the basic principles of the change of system, and thus represent chapters in a much larger book. At least they quantify some of the objectives. This may be useful for a government programme, but the main issue remains: what are the criteria for laying down an objective?

The lack of a scientific foundation for the programme of social and economic change is the weakest point of the economic policy. A conspicuous example of this today is the mass of winding-up and bankruptcy proceedings initiated. The bankruptcy act could have been passed a year ago, but in no way should it have been applied without a series of preceding measures. Anyone acquainted with this question knows very well that bankruptcy proceedings are extremely expensive and should be resorted to only if they will surely clear the economy. However, thousands of liquidations and bankruptcy proceedings should not be initiated if they then create a burden for the economy.

The social cost of the change of the system

In assessing the present situation of the economy, one should start from the social cost of the change of the system. It is a very serious mistake to believe that a substantial degree of change had already been made under the communist regime or at least had been prepared to such an extent that, after the democratic transformation, only the final touches needed to be added. The real weight of the problem is felt in Germany, where the one-time GDR is being integrated whith the one-time GFR. The social cost of the process has come to nearly $100 thousand million so far, and it is nowhere near being finished.

The social cost of the change arises from different sources institutional, reorganizational, and financial.

a) Switching over from a centrally planned economy to a market economy necessitates, as a matter of course, the reduction of the old institutional system and the building up of a new one in conformity with market conditions.

The costs of this in Hungary are much lower than in the rest of the former CMEA countries, due to the 1968 economic reform. Thanks to that reform, inflation in Hungary has not prevailed, managers are better prepared for working in the market economy, and supply is better. The institutional cost of the transformation could have been even lower had the 1968 reform focussed not only on decentralization, but also on the monetization of the economy.

b) The cost of the reorganization arises from a considerable fall of the GDP. In 1991 GDP fell by 16–18 percent. As a consequence, the rate of uneployment rose to nearly 10 percent and real wages fell by more than 10 percent.

c) Financial losses are substantial. The former GDR, Czechoslovakia and Hungary enjoyed monopolistic profits in their trade with the Sovite Union, which was due to the relatively advenced industries of these three countries on the one hand, and to the autarkic nature of the former CMEA on the other. They had a privileged position in the Soviet market. Now monopolistic profits have ceased, yet foreign debt burden remains as a grave heritage.

The positive features of the economy

The post-communist societies are tackling the problems outlined above in different ways and with different degrees of efficiency. As for the Hungarian situation, the positive features seem to be predominant in at least six fields.

1. Good progress has been made in setting up the framework of economic law for the transition to a market economy. Relying on this framework, a sound process of privatization and company transformation is going on, even though not at the required rate. The situation is especially favourable for small enterprises.

2. A radical change has occurred in household savings. Since 1990, the rate of household savings has been over 10 percent, which is the characteristic rate of the European market economies. Thus households' savings have regained the position in capital accumulation which they once had under the Austro-Hungarian Monarchy.

3. There is smooth supply. The shortage economy is no more—which was inconceivable just a few years ago. Parallel with this process, the black market rate of the forint has disappeared, which is important for the planned convertibility. All this has taken place with a constant revaluation of the forint currency: it has been devalued less than the rate of inflation would have justified over the period in which the devaluations have been made.

4. The country has been able to keep its financial credibility. The World Bank shifted Hungary over to the list of moderately indebted countries, even though a few years ago a crisis of payment was forecast for 1992. This is because of the maturity structure of the foreign debt stock: for instance, the Hungarian debt service will surpass $4 thousand million this year.

5. On the international scene, the country is on the whole favourably judged, politically as well as economically. This is indicated, among other things, by the fact that $1.5 thousand million flowed into the country in 1991.

6. Inflation has been successfully held between tolerable limits and, what may prove to be even more important, the danger of the price-wage spiral has been avoided. Inflation may fall to around 25 percent in 1992 as against 37 percent in 1991.

These are significant results, even if it has to be taken into consideration that the second economy has played, and continues to play an important role in the achievements of Hungarian economic policy. This could not have been otherwise, because primitive accumulation is an integral part of every change of system. Also, under the communist regime, financial sources in the private sphere could only come from illegal acts. Thus new sources were created by "smuggling" in the property sphere, and by tax evasion.

The negative features of the economy

There are also negative phenomena in the Hungarian economy. The most important ones are summed up in the three paragraphs below.

1. The sphere of trade is widening, while the sphere of production is shrinking; this is naturally concomitant with the change of system. However, if the widening of the trade sphere and the shrinking of the production sphere continues at the present fast rate, the process may reach a point where it disturbs the equilibrium of economy.

2. Investments remain at a low level. What is worse, the reserves of industrial reorientation are running out, and the primary actors of restructuring are still the small enterprises. Apart from one or two cases, there is no sign of multinational companies integrating Hungarian industry into their international network. Capital inflow is substantial and it is to be hoped that this will continue. However, only a part of it is for restructuring. Capital brought in so as to acquire a share in property does not feed production—rather, it serves to improve the status of the Hungarian National Bank.

3. Rising unemployment and sinking real wages have increased tensions: society is nearing the limits of its tolerance.

The government's motive in setting the objective of the soonest possible turn in production is thus quite clear. Scientific research can best help economic recovery if it points out the interdependencies which—if ignored—may counteract or at least delay it. In this respect, I propose the following as the main tasks to be solved:

— the elimination of the crisis symptoms in agriculture in the short run,

— the building up of a well-functioning capital market in the medium run,

— and budget reform: that is to say its successful implementation in the long run.

Elimination of crisis phenomena in agriculture

The imminent danger in agriculture is that attention is going to be diverted from production. If an urgent change is not made in agricultural policy, a situation may arise in which even smooth food supply becomes difficult. What is worse, the yearly $2.5–3 thousand million export commodity stock will not be available, even though it is a condition *sine qua non* of economic recovery and consolidation.

This problem has its roots in the years 1990 and 1991. In 1991 Hungary reaped one of its largest corn crops: 67 ql maize and 52 ql wheat per hectare. This should have been appreciated as a great success—but is was not. Instead, it was qualified as a crisis of overproduction. With such excellent results, the agricultural balance showed a deficit of Ft 15 thousand million. This should not have happened.

As for food economy, 1992 is a critical year even apart from that: the acts of compensation, tranformation and cooperation have already aggravated the existing social conflicts in agriculture.

Putting the capital market on a sound basis

Possibly, the worst conflict of the present situation may be that while restructuring is highly capital-intensive, the investment market is struggling with grave functional troubles. Investments do not reach even 10 percent of GDP at present. The problem can be traced back to the introduction of the Soviet-type economy: the capital market was eliminated as the state centralized all capital in the budget. The difficulties that arose from this have not yet been overcome.

Quite a stir was made by the Minister of Finance's announcement, shortly after the relevant Parliamentry discussions, which stated that the 1992 deficit would not be Ft70 thousand million as earlier approved, but may reach 110 thousand million. This is, however, not the main issue: such a deficit is still under 5 percent of the GDP. A number of capitalist countries operate a sound economy with such a deficit. The trouble is that the Hungarian deficit is coupled with receipts which characteristically draw out capital which is indispensable for the functioning of the economy.[1]

In 1992 a few important measures with a view to the recovery process have been taken. Acts dealing with accountancy, banking, and bankruptcy have been passed. A possible interpretation of these acts is that the budget must not draw out from the economy non-existent or non-realized profit, that it should enable modernization through accelerated depreciation, and that it should confirm the financial foundations of the banking system.

[1] According to the latest estimation the deficit might be Ft200 thousand million.

If consistently put into effect, these laws will of course reduce the revenues of the budget.

The former are, however, only the initial steps in the building up of the capital market. The next question to be asked is: what happened to the centralized capital? A part of it has been absorbed: for example, in the form of commercial capital. What happened is that in 1951, with the intoduction of the socialist price system, the commercial price gap was considerably narrowed, and the tax included in the price was raised. Thus the commercial capital enlarged the financial bases of public consumption. The capital of insurance companies and pensions offices were deformed. Under a universal warranty, the state centralized capital: it then determined its insurance and pensions policy, not according to autonomous and self-regulating mechanisms but on the basis of a general welfare policy, living standards policy, and other considerations. Some of the industrial capital was redistributed within industry. The greater part was, however, drawn out from the economy in order to finance public consumption as well.

This accounts for the fact that Hungarian industrial companies today lack sufficient fixed assets; they have to use active capital credit even when the raising of the fixed assets would be justified: and all this in a situation in which bank credits have exceedingly high interest rates. Queues, outstanding taxes and customs duties, etc. are a forced way out of the problem. Liquidity troubles face even such companies which are otherwise viable and can face international competition.

The functional troubles of the capital market have been further aggravated by the so-called inflationary gap, which is the consequence of the average yearly 10 percent rise in producers' prices and of the considerably higher rise in consumer prices. This is completely unknown in the West, and is the result of the fast elimination of price subsidies from the budget. Since nowadays domestic capital accumulation has its main—if not its only—source in household savings, the interest on money borrowed for investment is itself regulated by deposit rates. Because of the inflationary gap, capital had to turn over 3.5 times in 1991, so that credit could be reasonably raised, and in 1992 it will have to turn over 2.5 times. Upon such grounds, banks can do little to finance economic restructuring.

The inflationary gap and the conforming policy of currency revaluation may be the biggest stumbling-block in the way of an economically well-founded privatization process, and may also discourage multinational companies from making investments in Hungary. Reducing interest rates by a few percent would not do much to improve the situation. The important thing is to release capital policy and price policy from the grip of a fiscal policy which is fraught with inner conflicts.

Reform of the budget

Of the long-range objective, budget reform is of central importance. It has to be understood as a long-range objective, since it is organically linked up with an overhaul of the human infrastructure. Distributive systems that used to be organized autonomously have to be brought back to life and decentralized, parallel with cessation of the budget's income redistributing role or at least the reduction of that role to a minimum. With this reform or rather series of reform measures, care must be taken not to prejudice established rights. In so doing, we will pass from old to new ways slowly and gradually.

In scheduling the budget reform, it is important to ensure that capital consumption induced by the budget starts to decrease as early as possible. Otherwise, the capital indispensable for restructuring will not be made available.

MAREK DĄBROWSKI*

The transition from a planned economy to a market economy in Central and Eastern Europe is proving to be far more difficult than most politicians and economists in our region expected three or four years ago. The deep and long recession, slow enterprise adjustment, rising social tensions and growing political instability are evident signals of these difficulties. The above statement concerns all the countries, even those (like former Yugoslavia, Hungary and Poland) in which advanced market reforms had already taken place before the collapse of the communist regimes.

What are the main barriers to the transformation process? One can distinguish economic and socio-political factors. It is necessary to specify the concerns of the first group: chronic macroeconomic instability, social obstacles against liberalisation (especially in attitude to price deregulation), the absolute domination of the state sector, the lack of market institutions, structural distortions, microeconomic behaviour of enterprises, and the collapse of the CMEA and the USSR. Among the political barriers we can point out the absence of a middle class, strong economic and social interests connected with the former economic system, the problem of education and the mentality inherited from the centrally planned economy, instability of young democratic systems, and national connflicts. Now I would like to describe some of these factors in more detail.

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"Main Barriers to the Economic Transformation in Eastern Europe"

1. Macroeconomic disequilibrium

The lack of macroeconomic equilibrium, both domestic and external, can be seen as a standard feature of the typical centrally planned economy. Of course, there were countries with relatively better balanced economies (Czechoslovakia, GDR and Hungary) and countries which pernamently suffered strong difficulties in this respect. The source of a structural monetary imbalance was connected with the priority given to output growth and other physical targets specified in the central plan. Financial flows were only intended to "follow" physical targets.

This factor plus total price control contributed to the repressed inflation and forced savings, which seemed to be quite normal phenomena in a traditional command economy. The monetary overhang was neutralised to some extent by the internal (or commodity) inconvertibility of the domestic currency, especially in the enterprise sphere. I have in mind the total rationing system (administrative allocation of material resources and of investment goods) as well as the rigid control of different kinds of spending of state owned enterprises (wage fund, investment money etc.)

Economic reforms that tried to make the communist (socialist) economic system more market-oriented did not improve the macroeconomic equilibrium. In many cases in the "reformed" socialist economy the central planning system did not work as a mechanism of microeconomic discipline and macroeconomic coordination, even though the new market mechanism had also not taken this role. We had a typical syndrome of non-plannned and non-market economy without sufficient microeconomic motivation and without the possibility to achieve elementary macroeconomic equilibrium. Moreover, weak governments— which had already lost the power associated with political dictatorship and terror and which did not have political legitimation in the society—were ready to buy temporary social peace in exchange for inflationary money. It was the case in Poland in 1987–1989, Romania after the collapse of Nicolae Ceausescu's dictatorship, Bulgaria, Albania and in the former USSR in 1989–1991.

The above-mentioned partial economic liberalisation increased the level of internal convertibility, allowing enterprises to use more flexibly their financial assets; therefore, it increased money velocity. The state budget started to lose some traditional sources of revenue (e.g. individual contribution of enterprise profit) and at the same time expenditures rose sharply due to continuing price control and due to the development of some social programmes the purpose of which were to "buy" social acceptance. The rising budget deficit, financed exclusively by credit from the central bank, led to hyperinflation or almost hyperinflation. At first this was hidden, and then after price liberalisation it became open.

To stabilise such an economy at the beginning of the transition process is not an easy task. *First*, it needs radical elimination of the budget deficit, and this must be connected with sharp reduction of subsidies and consequently with price

liberalisation (see next point). *Secondly*, it is also necessary to change radically from a philosophy in which monetary policy is extremely accommodating to one in which it is restrictive. *Third*, the social coalition in favour of macroeconomic stability is usually not very strong. It seems to be affected by the lack (or the weakness) of a private sector, the lack of a private financial market and of rather limited private savings.

In the later stages of transformation macroeconomic stability is seen by many East European economists and politicians as a competitive target for output growth (or rather a possibility for limiting output decline). Yet this is not true because the sources of recession are far more complicated (see point 4).

2. Price liberalisation

This is probably the most difficult and politically most painful decision which has to be taken at the very beginning of the transformation process. The price structure inherited from a centrally planned system is usually very distorted. Liberalisation combined with the removal of price subsidies means, in this situation, a significant change in relative prices with all the implications this has for income stratification of different social groups. Moreover, if the extensive price control is connected with a macroeconomic disequilibrium and big monetary overhang the overall decline of "real" income is unavoidable. I put quotation marks around the word "real" to emphasize its formal, statistical sence. In reality the "real" income level is not real because it does not have its product equivalent on the consumer market. Thus statistical decline of "real" incomes cannot be connected with the proportional decrease of real consumption and with worsening of living standards. However, social perception can differ from this point of view and create real political constraints for price deregulation. This is the reason why many governments try to postpone this operation or to make it step-by-step.

Without real price liberalisation, however, it is hard to think seriously about consistent elimination of the command system, restoration of market balance, elimination of the budget deficit, demonopolisation and privatisation. The often presented demant to demonopolise and privatise the economy first, and only after that to liberalise prices seems unreal for at least two reasons. First, liberalisation of prices is usually necessary much sooner than is the possibility of significant progress with demonopolisation and privatisation. Second, it is hard to imagine a real development of the private sector—seen as the most significant factor of internal demonopolisation—under conditions in which the control of prices is omnipresent. So there is no practical possibility of avoiding deregulation of prices before the monopolistic structures of the domestic market have been removed and the economy has been made more competitive.

3. External liberalisation

The need for liberalisation of foreign trade and introduction of a convertible currency seem to be inseparable elements accompanying the liberalisation of the domestic market and deregulation of domestic prices. That not only means allowing foreign competition into the monopolised domestic market but also making it possible to adjust the structure of domestic prices to the structure of prices in the international market. In that way the real reallocation of resources based upon the criteria of the world market can be initiated and comparative advantages for the economy from international trade can be achieved. Also the market valuation of enterprises starts to be feasible and this provides rational ground for privatisation and investment.

If the general necessity of external liberalisation is rather difficult to question, the rate and the level of opening the domestic market to the outside is the subject of hot controversies. Transition from the multiple exchange rate regime to the unified exchange rate is connected with a strong price shock, thus eliminating earlier distortions. This creates problems similar to those connected with domestic price deregulation.

Foreign trade liberalisation creates fears about balance of payments crises in the early stages of transformation when monetary and foreign exchange policy are not credible enough. Later, attempts to protect domestic industry and agriculture against foreign competition become the main argument against free trade. Of course, many industries in post-communist economies are not only unprofitable in terms of world market prices but very often represent even the negative value added. After opening the domestic market they are not able to survive. However, preventing them from collapse means accepting economic fiction and of real losses in GNP. Without trade liberalisation it is difficult to think about real restructuring both on the macro and micro level. External liberalisation also provides room to develop new sectors, especially trade, transport and services.

In dealing with barriers to external liberalisation one must also mention trade barriers in industrially developed countries causing limited export possibilities for post-communist countries, and therefore retarding their economic restructuring and output recovery.

Another barrier to restructuring is connected with the political resistance in some countries against foreign investment.

4. Structural distortions and microeconomic behaviour

In the previous point I mentioned the existence of industries with negative value added. Generally, communist economies suffered overindustrialisation and

underdevelopment of the trade and service sectors. Many industries could exist due to almost unlimited domestic demand (an effect of the shortage economy) and due to the similar type of market in the whole of the former CMEA. The elimination of a shortage economy by price liberalisation and macroeconomic stabilisation, as well as the collapse of CMEA, dealt a serious blow to many industries and enterprises. Some additional factors—like external liberalisation (see above), the end of the Cold War (affecting the military industry) and the internal political crisis (in the case of former Yugoslavia and former USSR)—should be also taken into account.

What concerns a micro level the collapse of the former motivation system in state-owned enterprises, and difficulties in finding a new one, must be seen as the main sources of slow adjustment and the rather passive behaviour of this sector. The starting of the privatisation process also creates new problems. *First*, many active managers with real entrepreneurial spirit prefer to go to the private sector rather than to continue their careers in state enterprises. This represents a process of negative personal selection in the public sector. *Second*, most of the privatisation procedures initiated at the government level create a negative motivation in state enterprises—the worse the economic position of the enterprise before privatization, the easier it is for the management and the employees to buy it out at a low price. To solve this dilemma it is probably necessary to create strong incentives for insiders (managers and employees) which would link the privileged participation in the privatization process with the economic result of the enterprise before privatization.

Some countries (like Poland) have strong trade unions which can be seen as a social and political force trying to protect ineffective economic structures. In other countries (like Russia) the strong industrial lobby plays a similar role.

5. Economic mentality and intellectual opposition

General criticism of the socialist economic model does not imply that there is a consensus over the directions of transformation. In all the countries which started to go rapidly towards an authentic market economy this decision met immense resistance from intellectual and political elites, including even people who earlier had a reputation as advocates of radical reforms and who struggled for them for many years. This interesting phenomenon should be explained in more detail.

First, one can say that this attitude, found among a significant proportion of political and intellectual elites reflects the expected huge social costs of economic transformation: costs which appeared in reality to be even more serious. It is true, however, that the opposite influence should also be taken into consideration. Public opinion in post-communist countries is very fragile and unstable. One can observe its heavy dependence on the opinions presented publicly by popular political leaders and intellectuals.

Secondly, the lack of political culture and democratic experience plus frequent elections stimulate social demagogy, political and economic populism and even cynicism.

Third, society was taught for more than 40 years to distrust and show prejudice towards the laws of the market and principles of private business. Unfortunately, the same concerns professional economists—even those (may be they are in the front line) with high academic status and who were engaged for many years in the political economy of socialism. Extreme professional ignorance is connected mainly with macroeconomics.

Fourth, different variants of "market socialism" or "third way" concepts formed, for many years, the intellectual model of economic reforms. Many former reformers, especially from the older generation, have diffeculties in accepting the radical breakout from these ideas and the transformation towards a real capitalist economy.

6. How to remove barriers?

Let me give some specific suggestions how to accelerate the transformation process and how to remove or to weaken some of barriers.

First, it is important to use, optimally, political credit for a reform policy and time which is usually given only to the first post-communist government and for a limited period of time. It implies shock therapy rather than a gradual approach, especially in cases when it is necessary to remove extensive price control and to make serious macroeconomic adjustment. From the psychological point of view it is much better to concentrate most on the painful decisions in the first decisive stabilisation and liberalisation package than to make a lot of shocks over a longer period of time. The successful transformation policy also needs a consequential, comprehensive approach and long-term orientation. Too frequent changes and concentration on selected short-term solutions can undermine the effectiveness of the transition process.

Secondly, a quick privatisation process plays a crucial role in speeding up the systemic transformation. Until now there has been no definite answer about how to privatise quickly. Hungarian, East German and Polish experience shows positive aspects of the pragmatic, non-ideological attitude to privatisation. A multi-way approach, with a significant role for decentralised schemes of decision-taking, seems to guarantee faster privatisation.

Third, it is necessary to underline the importance of an adequate diagnosis of current economic events. Mistaken interpretation can lead to the total collapse of a transformation policy. It concerns, among others, the interpretation of recession in Eastern Europe. Hitherto, experiance has shown that deep recession after collapse

of a communist economic system is unavoidable even without stabilisation and external liberalisation. There is no trade-off between recession and inflation. Deep institutional changes and quick privatisation seem to be the only way out from a transformation depression; however, these do not produce the immediate results. Attempts to postpone stabilisation or to relax macroeconomic policy after the first stabilisation successes, with the purpose of avoiding or to limiting output decline, usually lead to hyperinflation and to an even larger collapse of output in future.

Fourth, massive and popular economic education can be another instrument for speeding up systemic transformation and softening psychological and intellectual barriers against radical changes. This task, however, is not easy. East European reformers are usually engaged in preparing and monitoring fundamental policy changes and in solving day-to-day problems and they do not have time to be active in public relations and educational campaignes. Moreover, mass-media, universities and academic institutes also need serious restructuring and very often represent resistance rather than support for radical changes.

Fifth, the transformation process needs a political umbrella. I have in mind a political movement or party which would stand consistently behind the transformation course. However, until now this problem has not been solved, in most of Eastern European countries. Apart from the Citizen's Democratic Party (*Obcianska Democraticka Strana*) in Czecho-Slovakia there are no cases of successful political movements created around leaders of economic reforms. The election success of ODS was, however, confined to Czech lands. In 1990 Poland lost its unique political chance to preserve the political consensus around economic and political reforms as an effect of the "War on the Top" and decomposition of the "Solidarity" movement.

BRUNO DALLAGO*

1. Introduction

Throughout history, economic systems have constantly modified themselves in response to new challenges originating from the environment external to them, and to the actions and decisions of individuals and groups internal to them. Change may come about regardless of the will of society as a set of responses not consciously decided upon or programmed, or else it may be structured.

The countries of Central-Eastern Europe are currently undergoing one of the most rapid and structured changes that has ever occured in history. Nevertheless, it

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"Transition in Post-Socialist Economies: Can the Barriers to Change Be Overcome?"

is by now evident that a leading role has been played by unexpected consequences, by bad decisions taken because of underestimation of non-planned behaviour, by the reaction of various components of the economic system, by the continued effective functioning of the old system, and by the interests and real intentions of the West. These factors, along with the often poor and in any case simplistic formulation of programmes for transformation, with the revival of a monolithic and deterministic vision of the economic system and the way it works (this time by the dominant neo-liberal ideology), and certain objective difficulties in the outside world, have led in two years to the failure of initial expectations. The crisis has proved to be more profound and more long-lasting than was thought, and changes to the institutions—and hence to the economic system as a set of institutions—have been much more limited than was anticipated.

In this paper I shall seek to illustrate the main obstacles to change and the alternatives now to hand by which transition can be satisfactorily accomplished. My analysis will centre mainly on three countries of Central Europe—Poland, Czechoslovakia and Hungary—given that these were the first countries to set off on the road to transition and are therefore those that have accumulated the largest amount of experience.

2. The obstacles to transition

The obstacles to transition are numerous and take different forms. They vary from country to country, although the major differences reside in the absolute and relative weights of individual obstacles rather than in their presence or otherwise. A possible classification of these obstacles is the following.

1. Obstacles due to the characteristics of the previous system and to the contingent situation. These in turn can be divided into five subgroups. The first includes all those factors which can be defined as the resilience of the old Soviet-type system. An economic system is constituted by institutions and therefore consists of a set of norms, rules of behaviour, habits, roles, and deeply-rooted ways of thinking and acting which form a stable and enduring structure of social relationships and which, by influencing the formation of preferences, induce the individuals belonging to a given society to behave in a uniform and therefore predictable manner. Now, with transition, many of the old institutions have been abolished or transformed, but will take time before the behaviour underlying them is also radically changed. Indeed it is probable that the old institutions will undermine the new system by somehow influencing and shaping the new institutions. In addition to this, mention has to be made of the drawbacks associated with the fundamental organizational features of the previous system: its distorted industrial structure, relative to the rational industrial structure of a market economy, and the monopolistic organization of the economy.

The second component in this first group involves the well-known lack of the institutions and social figures typical of a market economy, the entrepreneur in particular. Building the operational structure of a market economy takes a considerable amount of time.

The third component comprises various technical problems left behind by the old system which cannot be dealt with rapidly because they require time and huge amounts of capital. They include the often disatrous state of physical capital, the underdevelopment of infrastructures, often backward technology which wastes resources and produces poor quality goods, and disorganization in factories.

There may exist, as the fourth component, structures which deliberately seek to delay transition because it damages their interests or even threatens their existence. I refer here to the previous power structure in enterprises (former managers and trade unions) and the underground economy. These structures can be partly eliminated or transformed or can change spontaneously, but many forms of behaviour and interests still survive to delay and deviate the transformation process.

Finally, there are a number of contingent factors. These are due more to the progressive breakdown of the old system during the 1970s and 1980s, and to its opening to the West, than to characteristics intrinsic to the Soviet-type system. Chief among these factors that characterize the Central-Eastern European countries are the severe foreign indebtedness and the high propensity to consume goods imported from Western countries.

2. The second group of obstacles derive from the characteristics of the transition process itself. The most important of these can be divided into four categories. First of all, there are problems created by the complexity of transition—which involves various processes, not only economic but also political, social, legal and international. These processes must somehow be coordinated, since they presuppose each other and are mutually influential. Moreover, they require a certain amount of time to be activated and to achieve the critical mass that renders them irreversible.

A further obstacle to transition stems from the inexperience of the new governing groups which have emerged in these countries since the overthrow of the old system.

Thirdly, there are various technical problems, partly still unresolved, that must be dealt with before transiton can effectively get under way. The main problems include the coordination, sequencing, speed of introduction and radicality of measures; also, decisions should be made on the future role of the state and who should undertake the necessary restructuring of the economic apparatus, and establishing when, how and by whom the stabilization of the economy should be tackled. Other crucial decisions concern the valuation of the enterprises to be privatized, the objectives of privatization (the pace of privatization, increased efficiency and restructuring, boosting state revenues, whether to give priority to one social group rather than another) and its scope; they also concern the techniques to use and the

selection of the new owners (whether and how to restore property to its former owners, whether to restrict or give incentives to foreign capital, whether to encourage or accept the concentration of ownership or whether a diffused pattern of ownership should be established). There is, finally, the major problem of constructing and financing a social security net in order to defend and retrain those that have been expelled from the productive process because of the transition.

Lastly, there is what can be called the paradox of privatization, namely that privatization is much more straightforward when the enterprise is put up for sale in good productive and financial condition. For this to be possible, however, managers and workers must cooperate to achieve this end. An unlikely outcome is that, because privatization puts many jobs at risk, it often threatens the mass expulsion of the former managers, and means substantial increases in discipline and work rhythms within the enterprise. One can therefore expect the resistance, sometimes strong and not merely passive, by workers and managers in firms to be privatized; resistance which may be manifest in the worsening of production quality, in blocked investments, in rising absenteeism, in the use of financial resources to increase salaries and wages, and in many other ways. The situation of the enterprise will deteriorate rapidly, so that it is less attractive to potential buyers and so that its privatization becomes difficult or even impossible.

A third group of obstacles to transition derive from measures taken and the policies implemented. Some of these consequences have been sought after, others are the secondary and inevitable result of measures taken to solve problems believed to be more important, and yet others are the unwanted and unexpected outcome of these measures, or of badly calibrated policies. Among decisions taken consciously, though often with scant regard for all their implications, mention should be made of the decision to base transition on a strongly centralized and complex plan (this, paradoxically, grounded in liberal principles). The inevitable slowness of the privatization process has placed control of the economy in the hands of a small group of people, often lacking in expertise and with insufficient means, and has opened up a serious cleavage between the centre and the state-owned enterprises. Other deliberately-taken decisions have been the rejection of any industrial and structural policy, acceptance of rapidly growing unemployment, and the lack of support for new private firms (so-called "ground-up" privatization). By exacerbating the depressed state of the market and by heightening uncertainty among new entrepreneurs, these decisions have restricted the chances of entry by new firms.

Other obstacles to transition have been the inevitable consequence of decisions taken to achieve what are deemed to be priority objectives. The most significant of these are the uncertainty over property rights that has spread throughout the economy since the decision to restore property confiscated after World War II to its former owners, and the uncertainty generated in state-sector firms (over property rights and over expectations of future developments in the situation of individual enterprises) by the decision to centralize the management of privatization.

A third set of obstacles in this group have been created by errors committed in economic policy with unwanted or unforeseen consequences. Apart from the uncertainty provoked by changes in the directions and provisions of economic policy, special mention should be made of the negative consequences for transition of the programms of macroeconomic stabilization and for the liberalization of foreign trade and the convertibility of currency (above all in Poland, in terms both of firms' reactions and of economic depression and inflation.

4. The fourth group of obstacles are foreign in origin, and derive from three principal factors over which the countries in question have no influence. The first of these is the collapse of the market in the East. The second is the slow and small inflow of foreign capital. The third factor is the protectionism practised in the West, especially in the markets most crucial for the countries of Central-Eastern Europe, namely agricultural markets.

5. There are, finally, a series of obstacles that are non-economic in nature but none the less of major importance for economic transition. Those obstacles that are internal to these countries are political and ethnic instability, administrative disorganization, a certain ideological rigidity in the new governments, social discontend and apathy, the resurgence of populism and opposition to the inflow of foreign capital, and legislative uncertainty. Externally, undoubtedly, the most significant factor is the explosion of nationalist conflicts, with the consequent warfare and tensions that we are presently witnessing, and the reluctance of individual countries to cooperate.

3. Dilemmas and possible solutions

The process of transition is objectively difficult, and many of its components can only be satisfactorily accomplished in the long term. Nevertheless, the period since transition first began has been extremely fruitful and instructive, and it should induce, after the initial enthusiasm and ingenuity, general reassessment of the way in which transition has been handled. Below I examine the seven principal kinds of dilemma raised by transition from the point of view of the central government. Three of them are in fact false dilemmas, whilst another three require appropriate decisions and measures. The seventh dilemma can only be resolved with the help of the rest of the world.

1. The first dilemma sums up the whole philosophy and general approach of transition. It is the dilemma of the stick and the carrot: is it better to force economic agents to assume the behaviour and implement the decisions that favour transition, or is it better to seek for their active cooperation? This is a false dilemma, for without the active collaboration of economic agents (enterprises, workers, consumers), based on their direct interest and on their unconstrained will to

cooperate—this being the very essence of the market economy—transition cannot succeed. This is not to say that the gevernment cannot and must not sometimes resort to coercive instruments in order to change agents' behaviour and decisions, but it should do so only when it proves impossible to use indirect instruments. The governments of the countries in transition have so far made too general and too frequent use of coercive instruments in their dealings with the state-owned enterprises, imposing decisions which have hampered the development of the market behaviour conducive to privatization.

2. A second false dilemma consists of the contraposition between rapid and violent policies ('shock therapy') and gradual policies. The falseness of this contraposition lies in the fact that certain measures can only be introduced 'at a stroke', while others can only be implemented gradually. Stabilization, for example, must necessarily be rapid. However, great care must be taken over the degree of restriction imposed by certain measures (money and credit restrictions, for example), so that the economy is not depressed and the realization of other objectives (for example, the birth of new private enterprises) is not impeded. Experience has shown that it is also important to combine stabilization measures with others designed to change microeconomic behaviour (see below). If this is not done, and if only stabilization measures are used to achieve this effect, the consequences in terms of recession will probably be severe and enduring, and in any case there remains the danger that political and social pressures for relaunching the economy will succeed before microeconomic behaviour has been changed. If this happens, an essential part of the old system will be revived, but now under greatly deteriorated economic conditions. Lastly, it makes no sense to talk of accelerated privatization. Acceleration here should instead apply to the creation of the institutional and legal framework required for privatization: by issuing the necessary laws and rules, by defining property rights also in the state sector, by deciding the legitimacy or otherwise of the restitution of property (possibly to a limited extent and in non-physical form), by defining the techniques and forms of privatization, and by building a credit system which principally favours the birth of new enterprises. The actual sale of firms and the construction of a new, stable structure of property rights takes a considerable period of time to accomplish.

3. The third false dilemma is that between liberalization and protectionism and between competition and the maintenance of a monopolistic structure. The rapid broad-gauge liberalization of economic relationships with other countries including convertibility, may worsen the situation of the economy rather than improve it or at least increase the costs of transition. On the other hand, there is no denying the importance of opening up these economies to provide further stimulus for competition. There is, therefore, only one approach by which the advantages of liberalization can be secured with risks and costs reduced to the minimum possible: the government must liberalize the economy progressively and differentiate among industries, taking account of differing degrees of competitiveness and working on

the basis of a pre-established or publicized plan in order to forestall collusion between government and enterprises—such collusion being aimed at maintaining the protection of individual markets. Gradually decreasing protection will enable enterprises to restructure themselves and to prepare for the challenge of international competition—progressively strengthening the stimulus of competition. It is much better to begin slowly and then accelerate, than to be forced to retrace one's steps, thereby anti-monopoly policy managed by the centre has by now revealed its weaknesses (for example in Poland, but in other countries as well). The anti-monopoly offices and the government lack the means to take wise decisions and are even less able to implement them. It is much better to decentralize this task, placing it with the market. This will encourage the birth and growth of new, especially private, firms to the maximum extent and will use the progressive liberalization of trade, i.e. foreign competition, for the purpose. Moreover, as regards the medium-small sized countries of Central and South-East Europe, and in view of the progressive opening of markets, domestic monopolies may be firms which are relatively small on a world scale and which should not always be split up.

4. The next three dilemmas instead require political decisions for their solution. The fourth dilemma concerns the manner itself in which transition should be conducted: should it be rigorously structured and regulated by a central plan, or should it involve a set of processes decentralized and managed pragmatically and flexibly? The first approach has been tried in almost all the countries of Central-Eastern Europe, with the partial exception of Hungary, and has yielded rather disappointing and often counterproductive results. It is based on the conviction that market forces can be introduced from above by means of special measures which force the situation, especially as regards privatization. After this initial phase, however, the state must withdraw almost entirely from the direct management of the economy and severely restrict the economic policy interventions. The second solution, advocated by the present writer and already adopted to some extent in Hungary, maintains that market forces cannot help but develop spontaneously, and that the task of the state is to define all the institutions, including the laws and rules, necessary for the efficient functioning of a market economy. In addition, as the owner of a large part of the means of production, the state must act as a good owner, as discussed in the next point. During transition the state should have a substantial—but possibly indirect—role in the supply of capital to the economy and in economic policy, thereby complementing regional policy. For instance, the state could finance the economy on a market basis through the establishment of a number of public (or mixed) financial companies which could contribute to capital funding and the investment of new or already established companies.

Knowledge of the historical processes of development, the nature of the Soviet-type system, and the experience so far accumulated during transition should induce the adoption of the most pragmatic, decentralized and flexible approach possible; namely, one which encourages all economic agents— including the present

state-owned enterprises—to make an active contribution to the bottom-up development of a market economy.

5. A further important dilemma concerns the strategy of privatization and the management of the firms that will remain, temporarily or permanently, state property. To date, it is obvious that priority has been given to the privatization of the state sector rather than to the birth and growth of private firms (ground-up privatization). The new private firms and those that existed earlier have not received serious support from any government in order to counter the depressive effects of the general crisis of the economy and to foster the economic take-off of the sector. This is a grave error of strategy, because it is above all new private firms that can generate entrepreneurship and substantially contribute to the growth of competition and to the restructuring of the economy. Consequently, the new firms—significant in number, but generally of very small size and often existing only on paper— have been concentrated into sectors with low capital intensity and yielding quick returns (mainly shops and restaurants). These developments have had a certain positive impact on the quality of consumption goods, but have not done much for the process of economic growth.

The priority given to the rapid privatization of state-owned enterprises has had another, perhaps even more damaging, effect: the state is largely indifferent to its enterprises, apart from bringing about their sale. This has created grave confusion over property rights and generalized uncertainty in firms—which have reacted in a rational manner to the situation by decapitalizing and increasing indebtedness. The strategy adopted by the state has been to strengthen state control over firms via state agencies or specially-created ministries for privatization. However, this decision has not solved the problems and has created new ones.

These negative consequences can in part be avoided by adopting a more pragmatic and flexible approach, above all by reorganizing the state sector with a view to selling it wholly or in part, based on business decisions. This reorganization can probably be best undertaken by assigning to the state exclusively the function of owner, while control of enterprises is delegated to specially-created holding companies (possibly in mixed ownership) after the transformation of these enterprises into joint-stock companies. It is important that such holding companies should be in sufficient numbers to avert the danger of excessive monopolistic concentrations. They should be completely autonomous in their management of the firms and therefore responsible for their results, and they should only be able to finance themselves via the market. That is to say, financing out of the state budget should be prohibited, and if necessary the management bodies should sell their own shares or raise their own capital. This would bring the progressive privatization of the economy, dictated by the rules of the market and not by interventions from the centre, and the management bodies should sell their own shares or raise their own capital. This would bring the progressive privatization of the economy, dictated by the rules of the market and not by interventions from the centre, and

the management of the state (now mixed) sector should improve substantially. It would also generate revenues for the state budget which could be made available to the new private firms. However, this solution should not be generalized to the whole of the economy, otherwise there would arise the above mentioned danger that excessively strong concentrations of monopoly may form. Other approaches that could be adopted simultaneously are well known: institutional investors, investment vouchers and employee participation schemes, sales to private entities (including foreigners), and liquidation. It is advisable, however, that privatization should not be cost-free, both in order not to deprive the state of resources which it can put to good use, and also not to instil the idea in the population that public property is still free.

6. A decision should also be taken concerning the consequences of transition on the labour market and on the distribution of incomes. Specifically, the government should decide whether to implement a policy designed to curb unemployment and create new jobs, or whether it should refrain from takint measures to attenuate the rising unemployment caused by privatization of former state enterprises and economic depression. If the government decides to intervene, it must define the means and end of such intervention. It must decide whether the aim should be the safeguarding of already existing jobs, whether it should be the creation of new ones (in the public administration, through a programme of public works, by encouraging the expansion of the new private firms), or whether it should simply consist of the provision of unemployment benefit and retraining schemes. As regards the distribution of incomes, the government must decide whether to accept widening income gaps or whether it should intervene (whith progressive taxation or a transfer policy) to reduce these disparities. At stake here are not just moral and social issues, but the incentive and demoralising effect of employment and incomes redistribution on workers and firms. If one accepts the idea—sustained by many and backed by empirical analysis of these economies—that a substantial part of unemployment both now and in the near future is by nature structural, it is evident that the state must make a major effort to provide retraining for unemployed workers. Unemployment can also be effectively combated by encouraging the birth and growth of private firms. Moreover, in order to narrow the rapidly growing regional gaps in these countries, it may be advisable to adopt wage restraints and employment subsidies (in the form of state subsidies for social security contributions or similar) which lighten the wage burden of firms investing in disadvantaged or backward areas. Even though a certain level of unemployment has an educational effect on workers by spurring them to greater productive effort or by imposing greater discipline, and even though it facilitates the restructuring of the economy, excessive unemployment exacerbates economic depression, as well as being the source of grave social problems. The same applies to wage gaps, in that the excessive polarization of incomes may take away the incentive from workers and

reduce demand for consumption goods produced in the country, to the advantage of demand for luxury goods, often imported.

7. The final dilemma concerns the role of the rest of the world in the transition process, and is therefore largely beyond the control of the countries in question. There are three aspects to consider here. The first is the role of the West, specifically in terms of whether it should resort to a massive aid plan or to more selective measures. Although the danger of a new 'Marshall Plan' has, fortunately, been largely superseded, it needs stressing once again that this solution represents a colossal waste of money, that it gives renewed vigour to old forms of behaviour, and that it blocks transformation of the economic system. Much more suitable are selective measures aimed at specific sectors (in particular the development of infrastructures) and at specific activities (for example, by providing aid for the retraining of technical cadres in firms and in the financial sector). Moreover, of fundamental importance—but much more difficult to implement because of opposition by the West—is the non-discriminatory opening of Western markets to exports from the countries of Central-Eastern Europe. The second component to this dilemma is the manner and pace with which these countries are to be integrated into the international organizations, above all the European Community. The answer here depends largely on the objective situation: the gap between the economic system of the countries in transition and that of the Western countries is still so wide that any idea of accelerated integration is pure fantasy. It was instead important, from a politial and economic point of view, to associate the countries of Central Europe with the Community. This link must now be strengthened, spelling out to the countries concerned what their next steps should be and giving them the technical and financial aid needed to take these steps. Finally, careful consideration should be made of whether to continue their integration with the other countries in the region. After their initial reluctance, the countries of Central Europe have finally set up a scheme for regional cooperation, which they do not see as conflicting with integration into Western Europe, but as an intermediate stage towards it. I believe this is the correct option to choose, and that these countries should seek the concrete cooperation of the Community as they pursue it.

4. Conclusions

The first years of transition have brought a wealth of experiences which, although often disappointing, should provide valuable information for the countries of Central Europe to adjust their sights. Progress has been made along the road of transition, although unfortunately some of the decisions taken by these countries have led them astray, damaging economic resources and sapping the endurance of their citizens.

Of course, any decision taken to change the economic system is a step forward. Nevertheless, the final outcome (the objective effectively pursued) and the price to pay in achieving it (in economic, social and political terms) may vary greatly. If the objective is transition to a modern mixed economy—for transition to a purely market economy is an illusion under these countries' present circumstances—not all solutions and decisions are equivalent.

It is still not too late for the countries of Central Europe to achieve this objective, even though the price they have already paid is higher—in Poland considerably higher—than they expected. However, in order to attain a mixed economy and, where possible, accelerate transition towards it, a less ideological, more pragmatic and decentralized approach to transition is required.

STANISLAV GOMULKA*

Table 1

Gross National Product (GDP) and Gross Investment (I), 1989=100

	GDP actual		GDP expected		I
	1989	1990	1991	1992	1991
Bulgaria	100	88	68	64	57
Czechoslovakia	101	101	85	78	76
E. Germany	98	84	58	65	
Hungary	98	95	87	87	89
Poland	100	89	81	81	83
Romania	92	78	67	63	52
USSR (CIS)	102	98	81	70(?)	91
Yugoslavia	101	90	72	65(?)	74

Sources: National official

Data in *Table 1* indicate that a reform-induced recession lasts about 2 to 3 years. Following this, the East European economies should enter a consolidation phase which should evolve gradually into a *recovery phase*. In the consolidation phase we would expect the following: the level of activity is stable, inflation is high but declining, and unemployment is high and increasing; choice, accessability and

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"On the Design of Economic Policy: The Challenge of Eastern Europe"

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quality of goods and services are all much improved; the readjustment of foreign trade away from the former CMEA over to the EC area, is completed; the quality of the price system is close to EC standards; the levels of international reserves are sufficient to support current account convertibility of local currencies at unified and fairly stable rates; a substantial share of the GDP—typically between a quarter and a half—is produced by the private sector, and the share continues to increase rapidly.

How to initiate recovery

What is needed is to initiate a positive cycle whereby existing savings finance new innovations, thus reducing unit costs and/or increasing demand. If these can be achieved there would be an increase in profits which, augmented by bank loans, could be used to finance further investment. For this to happen these savings should be available to the right investors, and they should be substantial. The right investors should be numerous and they should have strong incentives to undertake the effort to search for innovations and implement investment projects, despite the associated risks.

The typical ways for policy-makers to assist the process is by creating a stable macroeconomic environment, and by implementing low direct taxation of personal incomes and profits. These, I think, are also very important in Eastern Europe. Low nominal interest rates are, in fact, essential to stimulate investment in larger investment projects. They are also needed to create demand for private housing. Increased housing construction has the potential for providing a major stimulus to an overall recovery. However, the main problem is the fact that due to the fall of profits and the shrinkage of the economy, total savings are rather small. Moreover, in the post-reform economy a significant part of these savings is (or will be) used to finance government budget deficit—effectively public consumption. To stimulate savings, real interest rates should therefore be encouraging to the savers. In order to safeguard savings for investment purposes, the authorities must strive to restrict public consumption to a level which can be financed by taxes alone.

Nominal interest rates can only be low if inflation is low, and this in turn is related to the growth of wages and the size of the budget deficit. A restrictive, tax-based wage policy in state-owned enterprises and a prudent fiscal policy are therefore necessary to achieve low nominal interest rates. The policy should also help the managements of these enterprises to make profits for restructuring purposes. The scope and restrictive nature of the policy can be reduced with the progress of commercialization and privatization of state enterprises and the increase of unemployment.

A very important macro instrument to be used for the purpose of initiating recovery is, of course, the exchange rate. Initially, the exchange rate is typically set at a highly depreciated level. During the liberalization and stabilization phases of transition, the dollar wage increases rapidly, stimulating imports of manufactured consumer goods. In Poland, for example, these imports increased about threefold during 1990–91 alone, causing a reduction of industrial output by some ten percent. The fixed exhange rate serves as a nominal anchor during the initial part of this period, and there is a strong temptation for policy makers (and the IMF) to overburden the rate with that role, which was the case for Poland in 1991.

The temptation should be resisted. The prime nominal anchors should be the wage policy and the supply of money, while the exchange rate should be used primarily to achieve a desired outcome in the balance of payments. Eastern Europe is not and should not be expected to be placed yet, nor for a considerable while, under the strict discipline of the Exchange Rate Mechanism. Liberalization of trade is likely to lead to an increase of both export to, and imports from areas having convertible currencies. However, exhange rate policy should strive to achieve a sizeable trade surplus, in line with the export-led growth strategy. The surplus would be a reflection of the current recession (low imports of intermediate inputs), would limit the depth of recession, and would be needed to build and maintain adequate international reserves in the region while servicing its large foreign debt.

The experience of Western Europe, Germany in particular, suggests that the success of the transformation may hinge on a rapid expansion of the sector comprising small- and medium-sized firms. There are already hundreds of thousands of such firms in Central Europe, most of them in the private sector. They form the testing ground for a wide spectrum of innovations. The most successful of these firms could become the basis for the flexibility and dynamism of the region's economies.

The problem seems to be that, so far, "the growth is mostly in very small firms, mostly in non-tradeables, and mostly outside manufacturing" (*Berg and Blanchard* 1992, p. 28). One implication of this is that "private sector growth cannot, in the short or medium term, substitute for the restructuring of state firms" (op.cit. p. 28). One of the reasons is that "as the non-tradeable sector grows and the tradeable sector stagnates or shrinks, pressure from a growing trade deficit will require either steady real depreciation, or a further contraction". (op.cit. p. 28).

One should recognise, however, that privatization and restructuring have their own sequencing. They occur first in the sectors, such as trade and construction, in which the transaction cost of privatization is small and where the investment cost of restructuring is manageable for the (new) private owner. In Poland, this phase has nearly been completed in the first two years of reform. The trade sector becomes then a major innovative force for the entire economy. Private traders identify the products which are in demand and transmit this information to domestic producers. They also import higher quality goods, thereby putting pressure on domestic firms,

most of which are still state-owned, to upgrade their own products and stand up to external competition. In the second phase, therefore, many state-owned firms also begin wake up, starting to restructure and innovate. In Poland this phase, it seems, has recently begun in key consumer sectors—such as food processing, leather products and textiles. This has led to a considerable recovery in these sectors in terms of output and financial indicators, as well as to a strong export performance. In the meantime the privatization process continues, and it has begun to embrace medium-sized state enterprises, through either employee and/or management buy-outs or the liquidation and sale of assets. To use the Polish example again, this route was the main channel of privatization in 1991, involving about 1000 enterprises. The total pool of enterprises in this category is still about 6000, out of a total of about 8000.

Another potential problem is the behaviour of banks in their choice of the firms and investment projects they are willing to support. Profit-maximizing banks may have a perverse incentive to finance the less-efficient projects of firms which are in debt, as opposed to the more efficient projects of debt-free private or state firms. The reason is that the banks calculate that new money to old firms should also improve the chance of recovering some or all of the under- or non-performing old debt, while if they lend to debt-free firms this additional potential benefit is absent (*Perotti* 1992, develops a formal model that leads to this proposition). Banks also show a limited willingness to lend to new entrepreneurs with no proven reputation of business success and limited collateral. In this situation, as *Svejnar* (1991, p. 133) suggests, "there is strong economic justification for a government to step-in and provide credit insurance or other measures to stimulate bank lending to this sector".

The bad debt problem is one of the most serious matters to be addressed in the consolidation phase. (In Russia and other former Soviet republics, the debt of the enterprise sector was already large at the start of the liberalization and a near hyperinflation during this phase, coupled with higher negative interest rates, is assisting in reducing its real value). As reform progresses, profitability tends to decline and the proportion of state enterprises which are loss-making and therefore no longer creditworthy, increases. In Poland this proportion reached a maximum of about 50 percent in early 1992. The reformers have responded by implementing programmes which involve the closure of some of the state enterprises, compensation of some bank losses by the Treasury, and greater participation of banks. They have also acquired shares in the restructuring of those enterprises still regarded as viable. The financial position of state enterprises depends on the ability of managements to withstand pressure to increase wages. Commercialization, incomes policy, and the credibility of the threat of closure are the key instruments to strengthen that ability. If these instruments are strong and work, then lowering external competition by devaluation may also be used to improve profitability.

How to sustain recovery

There are various important 'structural' reforms which the post-communist countries have started to implement and with which they need to progress much further in order to develop a solid basis for a sustained growth. The programme of these reforms includes above all privatization of financial institutions and production enterprises, and privatization of the housing stock in order to increase labour mobility. However, one politically sensitive area which requires determined policy action is public finance.

Some of the countries concerned, such as Czechoslovakia and Hungary, entered the transition with total public expenditure claiming more than 50 percent of GDP. As we noted earlier reform governments kept direct taxation low in order to have an incentive system that encourages effort. For the same reason welfare benefits and pensions should not be high in relation to wages. The full wage indexation of these benefits and pensions cannot be maintained during transition. The reason is that the revenue of the social security system is a proportion of wages, and the number of wage earners is declining sharply while the number of pensioners and unemployed has increased sharply. The present reform governments may, however, fall victim to the legislative inertia fuelled by the political pressure of interest groups. In Poland, the number of pensioners and unemployed increased from 6.8 million in 1989 to 10.7 million in 1992, while non-agricultural employment declined from 12.6 million to 11.0 million in the same period. The total expenditure on pensions and benefits increased from 9.1% of GDP in 1989 to 15.8% of GDP in 1991, and is expected to reach 20.9% of GDP in 1992. These developments have had a devastating impact on public finances, forcing a sharp diversion of government expenditure from investments on infrastructure to the funding of pensions in particular, and therefore to consumption. A large fall of revenue from profit taxes is also causing the Central European governments to reduce expenditure on research and development, education and investment on restructuring.

Therefore, it seems that a greater mobilization of savings than at present will be necessary for sustaining recovery at a growth rate compatible with "full employment".

At the moment, the size of the savings deficiency is difficult to estimate. In the immediate aftermath of the reform, the savings ratio is likely to range between 15 and 20 percent of GDP, depending on the country. If post-1950 experience of Western Europe is to be a model to follow for Central Europe now, this ratio should be between 25 and 30 percent.

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1. *Barriers.* I'd like to postpone a direct answer for two paragraphs, and try to put the question in context. There are enormous difficulties about the attempt to cover the economies of ex-communist countries into effective capitalist market economics. Liberalization of prices; opening the economy up to imports and foreign direct investment; de-monopolization; macro-economic stabilization; privatization; the development of market institutions—all are problematic.

Economics has been able to say what should, in very broad terms, be done. But in the absence of any similar experience in the past, there has been no basis whatever for providing guidance to policymakers on the time-lags. Therefore nobody can confidently predict the human and political costs involved in these changes. The sad truth is that political and economic analysis between them can provide no assurance that the attempted changes in any one of these mutant economies will deliver in first year or ten years or twenty years an effectively-functioning market economy. By "effectively functioning" I mean that it is not only recognisable as a mixed market economy, but one in which most people are experiencing rising prosperity.

We do now have, however, about three years' experience of attempted transformation in several countries. My impression from (mainly) Russian, Hungarian, Polish and Czech experience is that the *main barriers are in the development of appropriate institutions* and *skills*.

By "institutions" I mean a wide range of accepted, operational rules, procedures and organizations, from inter-bank clearing arrangements through banking regulation to the legal basis of contract, liability, loan security, etc, and from modern accounting firms to tax inspectorate. By "skills" I mean the knowledge, both theoretical and practical, required to operate these institutions and procedures. I do not mean entrepreneurship. Like other forms of opportunism, entrepreneurship is not in short supply. The economic environment, however, determines what the entrepreneurs do.

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The reason why institutions and skills are especially important is this: they cannot be provided out of thin air by the decisions of the most enlightened policymakers, but at the same time they determine the practical results of those decisions that reforming policymakers can make.

This can be illustrated from experience in the Reform Triangle. In Poland, Hungary and Czechoslovakia, transformation efforts started from different initial situations at different times, and have been made with differing degrees of coherence. Poland embarked on rapid liberalization and stabilization in 1990 from a position of extreme internal and external imbalance. Czechoslovakia began a year later from a position of near-macro-balance domestically, and with little foreign debt. Hungary, by contrast, had a long history of pre-"transformation" reform efforts dating back to 1967. By mid-1992 the situations in the three countries differed in ways that reflect their differing recent histories; but in all of them the continued absence (effectively) of key institutions—especially banking, capital market and tax institutions—remains a crucial problem.

In particular, the prevalence of bad debt in the banking system and between enterprises threatens, even in Czechoslovakia, to undermine the effects of serious stabilization efforts by government; so do weaknesses in tax collection; and weaknesses in both legislation and capital-market institutions have the effect that clear, decisive changes in the property-rights regime are still not guaranteed.

In other words reform governments can abolish past controls; they can, with luck and determination, cut state expenditure and introduce privatization programmes. But these actions then operate through institutions that are either ill-adapted to stabilization, liberalization and privatization or where they are appropriate, are weak, under-developed and not appropriately staffed.

Hungary, for all its problems (and Hungarians' propensity to stress the problems), has been the first ex-communist country to attract a healthy-looking inflow of foreign investment. This is surely not a reflection of superior transformation policies, but of the somewhat stronger environment of appropriate institutions and skills that has developed over a quarter of a century of partial reform and relative openness to the West.

2. *Accelerating the transition.* If the weakness of institutions and skills is the binding constraint on effective transformation in the medium term, then a more rapid growth in the numbers of people in the ex-communist countries who have the relevant skills and knowledge is especially important. (It is tempting to recommend specific technical solutions such as currency boards, but my guess is that technical fixes won't fix anything without a reasonable basis of other institutions and skills.)

This growth can come about in four ways: through technical assistance from Western governments and international organizations, funded by Western taxpayers; through foreign direct investment into ex-communist countries; more indirectly and less reliably, as a by-product of foreign direct investment *from* the ex-communist countries (not, of course, pure "capital flight"; but how better to learn

about operating in a developed market economy than by doing so?); and as a by-product of temporary emigration to the West.

There are plenty of examples: Hungarian (and to a lesser extent Russian) banking expertise acquired abroad; the training of locally-recruited accountants by Western accounting firms operating in the region, and so on. Expertise does not necessarily come from the developed West above—witness the Kazakh government's use of Middle Eastern expertise in its now-completed negotiations with Chevron over the Tengiz field, or international accounting firms' deployment of Latin American staff to Eastern Europe to use their skills in coping with accounting problems generated by high inflation.

So far as Western state-funded assistance is concerned, provision of know-how has been less controversial than other forms of aid. There are good reasons for this: not just the primary nature of the need for skills that I have been arguing, but also—given that other forms of aid entail more state intervention—our fashionable, but well-founded, scepticism about the effectiveness of state intervention.

Scepticism about the state as the agent of transformation, however, does not justify the current, rigid Anglo-American doctrine that all assistance should be targetted wholly or largely at the private sector. It is obvious that in most ex-communist countries there are some crucial weaknesses of skills and institutions in state or quasi-state activities like tax collection, central banking, the drafting of legislation and the provision of economic statistics.

So my priority would be for anything that accelerated the build-up of modern economic institutions and the skills and knowledge to run them. This is long-term process in which Western governments and taxpayers have a role, but where that role entails next to no direct intervention in the workings of the mutant, ex-communist economies. My guess is that know-how and training are the forms of assistance where resources are least likely wasted. That isn't saying much, but it's something.

The questions you have asked are very broad, and I can't give a nice precise answer to them. The only obvious *policy* implication of what I have said is that Western governments should be aiming at a high resource allocation (relative to other forms of aid) to technical and training assistance, should sustain this over a number of years and, preferably, increase it over time.

In picking out institutions and skills, I do not want to suggest that all the other ingredients in the recipe for capitalism are unimportant. Trying to turn the former communist economies into viable capitalist economies is, paradoxically, a grandiose, utopian project of the sort that usually turns out badly. In other words, there is no end of ways in which the recipe can go wrong. The development of the necessary skills and institutions is simply the element in the whole attempt that seems a shade more fundamental than all the others.

ARYE L. HILLMAN*

For many questions, economics provides answers that are both simple and elegant. The simple elegant answer to the question, "how can we carry out the transition from socialism?" is to declare a market economy, and to let the market, guided by the invisible hand of Adam Smith, facilitate the transition. To follow this advice, the democratically elected government declares that the market will from now determine the incomes that people earn and the prices of the products that they buy.

However, after the pronouncement that "we have abandoned the old system and moved to a market economy," inhibitions to transition remain. So the questions raised are the ones that have been posed here—what are the barriers to transition when the intention to make the transition is present, and how can these barriers be overcome in order to accelerate the transition?

It is, to begin with, well understood that the market will not live up to the expectations we have for it without ownership transformation. A clear specification of property rights is required to ensure that the seller has the right to sell, and that after payment has been made the goods belong to the purchaser. For productive assets, property rights further provide the incentive to maximize value. This role of privatization in achieving efficiency of markets is supplemented by the relation between privatization and the requisites of an effective stabilization policy (*Hinds* 1992).

The policy announcement of a government cognizant of the central role of privatization will therefore be: "The government has decided to privatize the state's assets, to establish the private property rights that facilitate market activity, to provide incentives to maximize value of productive assets, and to lay the foundations for effective conduct of stabilization policy".

However, while there is consensus that the efficiency of markets, value maximization, and policy effectiveness are desirable objectives, the distributive effects of privatization are, in general, controversial. People may, understandably, care more about their absolute incomes than the value of the total national income available to be shared. Privatization intentions therefore give rise to concern by individuals that the assets of society are shared or allocated in a way that is "fair" to them. It is the different conceptions of what is "fair" that makes privatization proposals controversial, and which leads people to attempt to influence how privatization takes place. The time and effort allocated to activities needed to influence and monitor

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"Barriers to Transition"

distribution are however at the expense of activity that generates new income and wealth. It is nevertheless rational for the individual to allocate time and effort to ensure a distributional decision in his or her favour, even though from society's point of view redistributive activity is non-productive. A reflection of redistributive activity at the expense of productive activity is a moderated supply of responses when prices are liberalized.

There are various means of designating ownership of the state's assets—perhaps too many different means (for a review of the different means, see *Milanovic* (1992). Of course, if efficiency were the only concern, the assignment of ownership would not matter. Via the market, the state's assets ultimately find their way into the hands of those who value them the most highly.

A procedure which avoids incentives to engage in the activity of influencing assignment of ownership, and ensures that assets are immediately assigned to those who can use them most productively, is to sell to the highest bidder. By this means of privatization, the state also maximizes the value of its property.

Selling to the highest bidder may however entail sale to a foreigner. The communists were in general quite successful in ensuring that no one accumulated excessive wealth, at least not legally. Since socialist equality made everybody poor, foreigners have an advantage in being able to outbid citizens in acquiring the large enterprises. It is also the case that foreigners may value an enterprise more highly than "domestic" citizens, because it can complement the production and marketing in their ongoing operations, and because of the relative ease with which they can upgrade technology and quality of the enterprise. So even if citizens were not constrained by lack of means, they would still be outbid by foreigners. For reasons that economic theory alone has difficulty explaining, the people may not wish the states' assets to be sold to foreigners. This is a worldwide phenomenon—some Americans are upset that the Rockefeller Centre in New York belongs to a Japanese company rather than to Rockefeller.

If the state's assets are sold, there is a question of what the government does with the money. It has not taken long for the citizens of the post-communist countries to realize the presence of the principal/agent problem in the system of representative democracy—that is, the member of parliament is supposed to represent the interest of the voter, but how does the individual voter monitor the behaviour of his elected representatives? People may ask, "what good it is to me that the government has secured the money from the sale of assets that in principle belonged in part to me?" The collective property has been transformed into collective money, but not money that the individual can spend. He or she must rely on the government to spend it for him. These concerns are beyond those that citizens may have regarding monitoring the sale itself of the state's assets, to assure that full payment has been made to the collectivity of the state, and not part payment to those close at hand in negotiating the sale.

If there are objections to sale to foreigners, and citizens do not have the means to buy, then the assets must be given away to citizens. But proposals to give away the assets will be countered by objections based on: the need for concentrated holdings to ensure monitoring, or on the need for foreign ownership to ensure technology transfer, or on paternalistic arguments that the people will not know the true value of their holdings and will be exploited via market transactions by knowledgeable insiders, or that the people will sell off their shares immediately without realizing their true value because of myopic time preference, or other variants of paternalistic arguments that the people should be protected from themselves.

It is only to be expected that, under the circumstances, privatization will be a long, drawn out process. Some countries will proceed more quickly than others, and the fastest progress will be made where an objective criterion—how much will you pay—dictates the assignment of ownership, and where there is little concern about who the owner is. Among sovereign states (of which the former GDR is not one), Hungary has made the most progress here, and has attracted the most foreign investment (for documentation, see *Dervis and Condon* 1992).

Privatization is one source of the efficiency-equity conflict that potentially inhibits the transition to a market economy. There is an associated source of social conflict that complements privatization of assets. This is inequality of income flows. The neo-classical theory of how competitive markets function describes how, under competitive conditions, individuals are paid the values of their marginal products in production. That is, individuals are paid what the competitive market indicates they are worth. The market can be a very cruel judge, since, in competitive circumstances where markets are not protected, some people by their nature and ability are not worth very much. But they may have large families. At least individuals may have felt equally treated under the old system; for example unemployment was shared on the job and not designated to particular people while others have jobs. So even if a social safety net eliminates the fear of starvation, it will not eliminate envy.

Communism aimed in principle to eliminate envy. In a post-communist society in the stage of transition from the old system, envy returns with a vengeance, as some people can hardly survive the month on their incomes or transfer payments from the government, while others are seen to be driving their exclusive cars and renovating their exclusive houses. Also, the people with the exclusive cars and houses are also the people who will have the means to buy the state's (or people's?) assets; or they will be the ones who have bought the state's assets and taken risks with their money.

Envy can be eliminated, by forbidding the private ownership that underlies unequal wealth, eliminating the markets that are the source of unequal incomes. However, the failed system that was based on these foundations is the one that it is intended to be replaced. So, to make the transition from the old system, inequality has to become socially acceptable.

While a market economy does not promise equality of incomes and wealth, it should provide equality of opportunity. This means that there should be no artificial barriers to entry into competition for jobs or for customers—there were many such barriers in the old system.

The old system's barriers to entry protected rents of specific individuals—here rents refer to payments above what an incumbent would have received, were he or she not protected from the competition of others by the entry barriers. It is to be expected that the incumbents from the old system should seek to preserve their rents. If their rents derive from state ownership of an enterprise, they will seek to impede privatization of the enterprise. If the rents derive from monopoly power in the domestic market, they will use arguments about protecting the workers' jobs to impede more domestic competition. If the rents derive from protection against import competition, they will seek to impede liberalization of trade.

Rent protection is a principal barrier to a transition to a competitive market, but Adam Smith told us that it is the *competitive* market that is the invisible hand of efficiency. Competition is a new concept in post-communist societies. The emphasis in the past was always on cooperation, not competition. According to the past ideology, competition was wasteful, destructive, and a source of social instability. The *competitive* market had to be avoided even if, as in Hungary, markets of some sort were to be introduced. The "socialist" market was therefore not a competitive market, and there is no surprise that the "socialist" market could not do what Adam Smith had claimed for the competitive market. People who know each other well and trust one another are not led easily to depart from cooperation. The citizen as worker also views cooperation to be to his advantage, since competition could threaten jobs and incomes. Adam Smith's invisible hand may therefore encounter difficulties in establishing its competitive preconditions.

Cooperation is also a means of avoiding uncertainty. People who all their lives have been told what to do, and have lived and worked in an environment of predictable certainty, can find it difficult to know how to exercise their new found discretion and freedom of choice in the market economy. What should they produce? To whom should they sell? How do they know that there will be a "market" for their output? If they decide to build a plant today, how can they be sure that the market will still be there when the plant is completed, or that a new technology will not have appeared that will make the new plant obsolete?

One response is to keep doing today—if possible—what was done yesterday. The domestic plan and the CMEA system of international trade facilitated this continuity and stability. The "socialist" market did the same. However, a change in the institutional framework with the intention of implementing a true market economy means the continuity is lost and adaptation to the new conditions is required. Lack of adaptive behaviour, in particular the inability to confront and deal with uncertainty, can lead the economy to inertia and possible collapse, especially in the presence of pre-privatization ambiguities.

So, given these inhibitions that impede change, how can the transition process be accelerated? There are necessary preconditions for institutional change that the economist, when called upon, will list. The list has familiar components—privatization, an appropriate legal system, a financial and banking system with an independent central bank, a tax system based on privately earned incomes and private expenditures, a framework for macroeconomic management and monetary policy, a social safety net, and a market framework for conducting international trade. The list, which goes on, is the subject of World Bank and International Monetary Fund technical advice.

However, the elements of the list may not suffice to establish the conditions for accelerating the pace of transition, because of potential inhibitions that derive from the accompanying inequality. Inequality arises as the market rewards entrepreneurs and investors for their success. This success will be reflected in a more efficient, competitive, technologically advanced economy, and the benefits of this will spill over to the population at large in terms of greater incomes—but not greater equality. The market economy can yield inequalities that some people may regard as extreme. Consider the following statistic (reported by the Economist, April 1992, source U.S. Congressional Budget Office)—in the Unites States, during over the whole of the 1980s, over half of the increase in after-tax income was received by the richest one-percent of the population. This shows how Adam Smith's invisible hand cannot promise equality.

There were numerous undesirable aspects of socialism, none of which have to be recounted to those who lived under the system. It is said however that in particular socialism failed because the system was contrary to the nature of man. It tried to suppress greed and envy. The old system did provide stability, security, predictability, and some sort of equality. From time to time, there may a need for gentle reminders that the loss of this stability, security, predictability, and equality is inconsequential, given that the old system gave little else, except to the privileged few who were successful in manipulating political monopoly to their advantage.

Finally, although I have chosen to focus on domestic aspects, the role of foreign governments should not be neglected. Foreign governments have a role here, in resisting protectionist pressures of their own industries and allowing the post-communist countries to take advantage of their international comparative advantage. The claims that are made for the invisible hand are equally applicable in international trade as in the domestic economy, and there is little consistency in western governments' praising the virtues of the market but denying the realization of the international division of labour.

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BRANKO HORVAT*

1. What do you regard as the main barriers of the transition to a market economy in the post-communist countries?

First of all let me point out that the socialist system did not collapse because a system that did not exist could not cease to exist. A socialist project can be characterized in various ways, but mentioning only two of these will suffice. Socialism is a society in which the freedom of every individual is a precondition for the freedom of all (*Communist Manifesto*) and where the state, as an apparatus of oppression, will "wither away" (views generally held by early 19th century socialists). It is clear that the system which existed was as contrary to the socialist project as it could possibly be and *therefore* it collapsed. Journalists and sloppy politicians continue to talk about "socialism". The term used in scientific studies is *etatism*, because the state was (almost) the only employer, the ruling party the only political party and the state controlled the entire society. That this is not only a semantic issue demonstrates the current intellectual confusion which is responsible (in part) for the slow pace of the necessary reforms.

The second misunderstanding arises from the changing historical circumstances. In the last century economic processes were relatively simple: national economies were largely based on agriculture, workers were uneducated, national income statistics and econometric models did not exist, no information technology was available, technological progress was slow and economic science was in its infancy (an "art" not a "science"). It was quite natural to mistake household economy for national economy and to believe that the most rational and efficient way to conduct business was to nationalize everything and to entrust the state with the development of the economy according to a central plan. The state was to manage things not people (Saint-Simon). That belief was a great mistake because the real world functions differently. However, post-war nationalization occurred not only

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in Eastern Europe but in the West as well. Nowadays, the described situation no longer exists. Changed historical circumstances are responsible for a large scale deregulation everywhere. Market transformation in Eastern Europe is just a part of this general process of deregulation, the purpose of which is to enhance free initiative and efficiency.

The third misbelief concerns the knowledge available for proceeding with this deregulation. It was said that examples of nationalization were numerous and we knew how to carry them out; however, it is also held that the reverse process has never been undertaken and knowledge concerning this does not exist. Thus the lack of knowledge is replaced by mere imitation which, however, is more appropriate to apes than to economists. Yet this contention about having no previous examples is not true. By 1950, the Yugoslav economy had been almost completely nationalized and agriculture to a large extent collectivized. Due to a break with COMINFORM, it was decided to disconnect firms from the state by establishing self management in the firms, and these were to become independent market agents. Over the next two years the reform was prepared and from 1952 onwards the economy developed at the highest rate in Europe. There was no unemployment and no inflation. However, in the large literature on "transition", I have not found a single reference to this experience, not even in my own country.

What was basically wrong in Eastern Europe was an undemocratic political system, inappropriate to European societies. A rational reaction requires new governments to introduce redesigned political systems that bring forward economic changes only gradually. Abrupt changes in any economic system are always catastrophic. They generate a drastic fall in output, great unemployment and inflation. Besides, there was a lot of good in the former etatist system, otherwise they would not have survived for so long. The good features of the system were: full employment, social security, and education and medical care for everybody. These features of the system must be preserved and not destroyed. However, governments—and the general public—have not reacted rationally (as they never do). Reactions of frustrated individuals were emotional, revanchist and intended to negate every single feature of the former system. If the system was *politically bad, everything* is now considered bad! The ideology has remained fundamentally the same, only the moral signs have changed their places: what was considered good earlier has turned out to be bad now and vice versa. Half a century ago everybody was enthusiastically nationalizing—nowadays everybody is equally enthusiastically privatizing. Class differences and conflicts were once considered bad, now they are justified as promoting efficiency and curing inflation (as in the contention that a private owner will not increase the wages of his employees)!

The answer to the first question is unequivocal: ideology is the main barrier, and the ideology cannot be corrected by economic arguments.

2. What measures and techniques do you suggest to accelerate the transition process?

Psychiatrists, social psychologists and priests are professionally more qualified than an economist to answer this question. Thus, I can answer it only conditionally: what could be done if the people could be persuaded to do it.

Perhaps the main confusion revolves around the general insistence on privatization. The institution is understood as a form of 19th century proprietorship, existing in a laissez-faire environment. To any educated economist it is immediately clear how completely wrong this aim is. Let me only mention the main constituent parts of the problem since I have written extensively on this topic elsewhere. (Horvat 1990; 1991a; 1991b)

In America and Europe, two thirds of the modern economy consist of corporations, not of proprietorships. Proprietorships can be useful for small scale production, but they do not and cannot organize large-scale production. In this sense corporations are a driving force of modern economic systems. There are definite reasons for this, but the space allotted here does not allow me to explain in more detail. What was economically wrong in the former etatist systems was not that the economy did not consist of proprietorships but that it consisted of state enterprises. In order to establish a market, we need first to "deetatize" the economy. It is well known that all "privatisation" schemes envisage state ownership for the next 20–30 years.

Secondly, ownership is a relatively unimportant and passive element in the process. It is confined to buying and selling shares and its function is to supply capital. What is crucially important is entrepreneurship, and privatization schemes do not take care of that at all. Since the appearance of the book by *Berle and Means* in the early 1930s, economists have become aware of the process of separation between ownership and management, with the latter playing the active part. Amalgamating the two components into one means committing a disastrous mistake. Managers own less than one percent of the stock of their corporations but are in complete control of their operations. The disciplining agency is not the board of directors (itself controlled by the managers), but market competition.

Thirdly, instead of succumbing to an inferiority complex that "everything is better down there", a rational attitude is to take advantage of the initial conditions that already exist. No new capital—which does not exist anyhow—is necessary in order to buy state enterprises. They should only be proclaimed common ownership (social) enterprises. No search for an identifiable owner is necessary, because everywhere in the world in a market economy the firm acts as an owner (buys raw material, sells products, borrows, lends, exports, and employs; the firm is registered with the court and, generally, is responsible for all its economic activities). It is true that we also need someone who will own the firm itself. However, there is no need for the state to decide who that should be; in fact, this is extremely dangerous. Why not let the market select the most viable forms of ownership? Apart from proprietorship and state ownership the possible forms are: partnership, cooperative, limited liability company, ownership of employees and common (social) ownership.

Consequently, the economic part of the second question can also be answered rather unequivocally. The state should *immediately* divest itself of all enterprises, except of those which functionally belong to the state sector (such as railways and post office). Severing enterprises from the state means *de-etatization*. Enterprises should be left in the market as independent economic entities. This is what is meant by *marketization*. Except for small enterprises all the others should be legally organized as corporations. This may be done in a couple of months and the statute of *societas europea*, recently prepared by the European Community, may be used for the purpose. The new corporation, call it *social corporation*, will differ from the old corporation in the West in only two respects:

(1) It will be commonly owned and therefore its shareholders will be all members of society; for that purpose no paper shares and no distribution of shares are necessary. Social corporations may raise additional capital by issuing new shares and selling them to anybody. As long as the controlling stock is socially owned, the firm remains a social corporation. Whether it will remain social or not depends on its viability in the market and not on the arbitrary ideological decisions of governments.

(2) The management is appointed and controlled by the employees acting on behalf of shareowners (all citizens). This means shifting the legitimation of management from the ownership of capital to the participation in the work process. It is obvious that employees have the greatest stake in their enterprise and that they are vitally interested in its prosperity. It is also obvious that self management is the world trend, and numerous participation schemes (co-determination, profit-sharing, etc.) in European countries demonstrate this fact. It may also be shown that enterprises organized in this way have certain other economic advantages (i.e., inflation can be curbed more easily and investment expanded in order to provide full employment).

In short, if it really is a market—and not something else—that is wanted, this can be achieved in less than a year and without all those dreadful economic and social losses due to unemployment, falls in the standard of living, state driven bureaucratic "restructuring" and "privatization". Two legitimate and extremely important functions remain for the state: the overcoming of market failures by equalizing the starting positions of economic agents and the steering of the economy along a high growth path. It is symptomatic that the East European states do not perform particularly well in these two most important functions.

The transformation of state enterprises into social corporations that engage independently in market transactions is the most important but not the only measure. It is also necessary to create an environment in which a market can work properly. For that a legal title is a first precondition—as it is for the functioning of political democracy. Next, commodity markets must be supplemented by financial markets. Finally, it must be said that laissez-faire markets will not work. Although regulations ought to be avoided as much as possible, a responsible and competent

macroeconomic policy is indispensable. It is hard to say which of the elements enumerated is lacking mostly.

Zagreb, 4th April 1992

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BÉLA KÁDÁR*

1. What do you regard as the main barriers of the transition to a market economy in the post-communist countries?

In my answer to the question of *Acta Oeconomica*—Vol. 40, Nos 3–4 (1989)—concerning the nature of the socialist market economy, I first stated that the concept in question was becoming a "magic word". Since then, profound changes have taken place in Central and Eastern Europe in terms of market economy. It is, however, a paradox of historical continuity that the concept of a transition to a market economy is becoming empty: politicians, political scientists and economists interpret it in widely different ways, vest it with a wide range of attributes, and attach to it many different meanings.

I have stated many times in my writings that a change of economic system, i.e. the transition to a market economy, may not be reduced to replacement of the socialist model by the market model. Beside the change of economic model, a further important aspect of the transition is the change of political model, the change of path of economic growth, and the change of emphasis in foreign trade. The main obstacles to the development of a market economy are related to these aspects (or dimensions) of the transition, and further, to the population's psychic

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"The Main Obstacles in the Way of the Emergence of a Market Economy in the Post-Socialist Countries. Techniques and Means of Speeding up the Transition Process"

and economic endurance and the peculiarities of economic reasoning and concept formation.

Dual rationalities are well known in the history of economics and politics. The rationalities of economics and politics raise different demands and may come into conflict over a rather wide field. In dictatorial political systems, the course of economic growth can be changed, *ceteris paribus*, without particular difficulties: sectors and subsectors or indeed any economic activities that are inefficient by world economic standards can be reduced, or streamlined. In democratic political systems, however, only such economic policy measures aimed at economic stabilization or development of a market economy can be taken, which are backed by the majority of the population; if things were otherwise, the political legitimacy of any change would be doubtful. Owing to the nature of things, this circumstance narrows down the scope of manoeuvring of economic policy.

In the successor states of the Soviet Union and Yugoslavia, and to a smaller extent also in Czechoslovakia, the transition to a market economy is made more difficult by the conflicts of nationalities and ethnic minority groups; and in the states of the CIS and those of Yugoslavia, it is hindered by necessity of adjustment to a changed, or reduced, framework of the state.

In Central and Eastern Europe market economies began to be formed under the pressure of external shocks. The change of economic model and economic stabilization had to be effectuated simultaneously. Hungary has struggled through the difficulties caused by the disintegration of the CMEA cooperation system, the economic crisis of the partner states, and the beginnings of a new type of East European division of labour. These factors, however, still hinder transition in several post-socialist countries.

In the course of developing a market economy, national psychological aspects should not be disregarded. Society is a complicated system in which every intervention has its far-reaching consequences in the future. In the politically and economically centralized systems, the social system of values became distorted, albeit to different degrees in the different countries: discipline, self-discipline, and orientation towards performance were not considered values, and the population's initiative fell to a low level. Besides, in the socialist system, people attributed an independent social value to full employment, preferring a safe job to higher living standards. Transition to a market economy infers a change in old attitudes and values, as well as the handling of unemployment, which jeopardizes social and political stability. However, it is not possible to accomplish this from one day to the next. Thus the entire region needs a long period of time to make the transition.

The transition to a market economy from the so-called socialist model is without historical precedent and cannot rely on either theoretical or practical experience. The political forces that came to power did not have, and in fact could not have had, in their hands the concepts necessary for the elaboration and effectuation of the transition strategy. The initial hesitations can largely be ascribed

to these factors. The total lack of precedents posed a serious challenge to those in charge of organizing the change of system, of elaborating the economic policy concept of the transition.

The emergence of a market economy is, however, delayed not only by the lack of ready-made formulas but also by the uselessness of the earlier accumulated knowledge concerning the functioning and regulation of the various kinds of socialist model: i.e. their theory, economic policy regulations and management techniques. Of course, this is not quite so pertinent to Hungary since there, the 1968 reform of economic control and management has enabled experience to be gathered which is to a considerable extent usable now. Nevertheless, the general circumstances indicate that it is by no means accidental that increased interest is shown in the practice and functioning of the market economies of other countries.

However, a significant difficulty for the transition emerges from the fact that the foreign sources drawn upon have been comprised almost exclusively of the economic philosophy and economic policies of the advanced market economies. There are many reasons for this, one of them being the desire to totally negate the centralized planned economy. Old habits, particularities of economists' training and postgraduate training, the methods of revealing real-life facts, and the expectations of the global international financial organizations have all played a part in creating a situation in which economic thinking has not concentrated on strategy, but on one or another kind of liberal approach to a market economy, or reducing economic processes to only a few factors, or overemphasizing the monetary sphere and the role of the legal and institutional framework. The details of these are applicable to advanced market economies, where there is equilibrium in both the home and the foreign economic spheres.

Attempts at a fast introduction of the market economy by applying a shock therapy of 15–20 measures, and relying exclusively on market factors during the transition period have had a dramatic effect. This can be seen in the immense social costs of building up the new political and economic model and the creation of an economic policy which reacts to external shocks by bringing about internal shocks: the consequences of these unsettled developments will be felt for a long time in several East and Central European countries. At the same time, neither the economic policy experience of medium-developed countries, nor the social market economy which largely contributed to the "economic miracle" of post-war Germany have been given sufficient attention, compared with that given to the liberal market economy. The narrowness of the economic policy approach, and the limits to the automatic application of foreign models are essential obstacles in the way of developing a market economy and add to the social costs of transition.

2. What measures and techniques do you suggest to accelerate the transition process?

The stage of development of the legal and institutional system is an essential—though not absolute—indicator of the stage of development of a market economy. Another important indicator is the degree to which real economic processes can be influenced. The development of a market economy being a complicated and diversified process, the transition must be guided under a comprehensive strategic conception. By means of such strategic control, the transition can be accelerated and its social costs reduced. The strategic management of developing a market economy demands the periodization of the transition process, the elaboration of economic policy priorities; the coordination and harmonization of the economic policy objectives and instruments. The market mechanisms of the Central and East European countries have not yet reached such a degree of development that transition can take place exclusively on such a basis.

The new political systems of the East and Central European countries can be legitimized by improved economic performance. In the population's judgement, elements of the institutional framework and of management techniques are not values in themselves: success is judged by the facts of economic growth, inflation, changes in real wages, etc. In order to improve real economic performance, it will be useful to rely more on the stimulative elements of economic policy beside the deregulation, liberalization and restriction that up until now have been applied extensively—and even excessively in certain countries of the region. Fast privatization cannot be expected to take place in a stagnating or depressed economic environment. Initiative will not grow, or what is there will ebb away, if no prospects of improvement are held out. What is more, in this region of Europe short supply in general and in particular of export goods, and the inadequate structure of those exports, have traditionally presented the bottlenecks to economic growth. This again calls attention to the importance of encouraging an export-oriented and selective export supply. It is a question of judgement of values as to the price the economic policy can afford and society is prepared to pay—in terms of budget balance and the rate of inflation—to improve the supply conditions.

Finally, with a view to promoting the development of the market economy, I attach great importance to determining the character and degree of cooperation between economic actors: entrepreneurs, employees, banks, and the state—which, of course, are changing in space and over time.

To accelerate transition and to provide for the necessary funds (resources) it is indispensable to transform the banking system into a vehicle for modernizing production processes, as well as technology and structure. There are no made-out formulas for the development of a market economy, applicable anywhere and at any time. Every country has to do its utmost to elaborate the economic policy best suited for the purpose. One of the important trends in the history of economic

workshops is concerned with revealing and exploiting capacities that are specific to a country. The same holds for the transition to a market economy.

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It is now almost unanimously agreed that a private market economy has to replace the monofirm that all but monopolized production under the old regime. There is therefore no need to belabor this point. It is also widely believed that this entails the privatization of the constituents of the monofirm, the existing state enterprises. I shall argue below that there are more urgent short-run goals that are likely to be suffer if all attention is focused on the long run goal of privatization. This is because privatization in only one part of the problem, the other being closing down those enterprises that have no chance for continued existence, and they are many; and because at the best of times privatization is bound to be a very long process, and that the urgent task of support to the fledgling new private sector must not be delayed. And once this is realized it becomes clear that the hard task ahead is how to deal with the existing state sector, as yet unprivatized, so that it does not impede the growth of the new sector. It is this last task which I see as the hardest one of the transition process, and I shall try to provide an economist's views on the way this task should be carried out. I am aware of the fact that this is also (or mainly) a political task, and I am deeply aware of the limitation that my sphere of qualification imposes on me.

Marxist socialism aimed at constructing a new society that was for ever to replace the old order. As we look at the ruins it has left behind, there is not much that is positive that it has managed to build; we can be sure that it has destroyed within a short span of under fifty years the economic foundations of any alternative order in its area of domination. The building from scratch of a market economy is sure to take a long time, require both patience and scarce economic resources, and cost much human sufferings and pain.

Socialism has not only destroyed the institutions necessary for the proper functioning of a competitive market economy; it has created a lot of worthless, even positively harmful capital. It has built heavy industry where none is profitable, it has constructed human organizations that in themselves cannot function efficiently and hinder the development of effective new organizations, and it has invested in a misshapen human capital, providing it with the wrong skills and inculcating in it the wrong attitudes and expectations. All of these will hinder the progress back to that organization of society which, according to Marxian prophecies, should forever have

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"Is Privatization the Remedy?"

been banished by socialism. As the epitome of the sort of harmful capital shaped by the old regime I see the socialist enterprise: it is a major hindrance to any change, and on the obstacles on its replacement by competitive privately owned firms that I choose to focus in this brief note.

I wish to concentrate on a single aspect of the socialist enterprise, on its functions as an investing organization. Consider the existing state firms as machines whose aim is to build the capital of the future. It is not only physical capital that this investment leaves behind: investment in human capital, including the very human capital that is the enterprise itself, may have an even more long-lasting significance. We should view the firm as the network of humans, a network grouping people who have learnt to interact among themselves in a given way. This network tends to perpetuate itself as the organizational capital of the firm, an important part of the firm's capital. As with any capital, the social value of this human capital lies in its ability to create a flow of social values in the future, and if prices mirror scarcities, this flow equals the stream of profits which the firm is expected to generate. The value of the firm is the expected value of this stream of profits. This is why a profit maximizing firm in a competitive market invests in a socially desirable way. Firms whose mode of interaction leads them to making low or negative profits are also making a small or negative contribution to society. Firms in the socialist economies were not structured with profits in mind. What motivated them under the old regime was the need to obey orders or rules of behaviour. They either had to fulfill plan targets or to supply what was demanded under the "responsibility to supply". Cost did not count, or did not count for much. As a result enterprises have learned to design and create capital that is not cost saving, that tends to squander inputs. They have not had to care for quality and for innovation in order to protect their existence in the market, because their level of operation was exogenously determined, and their market thus assured. They were "relieved" of one of the main responsibilities of a firm in a competitive environment, the responsibility of conquering a market, fighting over a market share. They were also guaranteed continued existence, because the socialist economy did not (and, I believe, cannot) find ways of facilitating exit, as it cannot provide for decentralized entry. Unlike the capitalist firm, the demographics of the socialist enterprise do not depend on its activities.

This has led to the development of firms, i.e., of networks of individuals, that have built-in modes of operation that do not lead to useful investments and do not accord with competition in the market. And this mode of operations cannot be changed without a massive effort in reorganization and re-schooling (as well as of re-tooling of the physical capital). And, by and large, this heavy investment in human (as well as physical) capital cannot be done successfully unless these firms cease to be state-owned. The reason for this should be clear: it is the firms themselves that need first to be changed, to be reorganized in a way that will revolutionize their mode of investment. This is not likely to be done by themselves as long as they

continue to be state-owned and protected from the cruel demographic pressures of the capitalist market, because the exit decision, the bankruptcy verdict, has to be provided by a bureaucracy. Regardless whether this bureaucracy styles itself socialist, it will always be under political pressures that make it next to impossible to declare a firm unsalvageable. The enterprises subordinate to this bureaucracy will know that the very inability of their superiors to declare them bankrupt gives them an indefinite lease of life and *ipso facto* softens their budget constraint.

In other words, the economies of Eastern Europe cannot enter a path of serious growth unless they start growing a private productive sector. This is a necessary condition. It is not sufficient, because a private sector that is not exposed to competition is as free of demographic pressures as a state-owned one, and the proper market environment of competition and free entry is therefore an essential ingredient for efficient growth. However, it is the other necessary condition that I would like to focus on, i.e., on the elimination of obstacles to the construction of a private sector.

I am sure the reader has noticed that, except in the opening paragraph, I have not mentioned the word "privatization". The reason is that I believe that the first order of priority is to lead to the rise of a new, home-grown, private sector of industry and services. There are several reasons for this:

1. Privatization cannot be effected within reasonable time. Enough evidence exits for that, and suffice it to say that even the *Treuhandanstalt* in East Germany, with unlimited resources at its disposal and hardly any constraints of fairness, i.e., of the need to convince the electorate that no state properties are sold too cheap, even they have not managed to sell the main part of their industry. And they have an easier task, because instead of earning income for the national exchequer from sales proceeds, they can allow themselves to spend many billions of DM to entice investors to purchase firms on their terms, i.e., with an undertaking to continue a given level of activity and, above all employment.

2. Most state firms need to be reorganized before they can be privatized. This, again takes time. They have to be reorganized because they are too large, both horizontally and vertically. They are too large horizontally because they are monopolists without the saving grace of reaping scale economies. Vertically, because for reason of insurance against the non-arrival of supplies they have branched into producing (inefficiently) their essential inputs. Both reasons lead to a scale of operations far above the efficient level.

3. A large part of the existing stock of capital in industry, i.e., many of the existing firms, are not salvageable at all. This is the obverse side of the need to reduce the weight of industry in GDP, in particular that of heavy industry. To decide whom to close down and whom to continue in existence is bound to be a long drawn out affair, as the *Treuhand* is finding out, both because of the pure economics of the decision process (i.e., of the need not to err on the side of haste in writing off valuable capital) and its politics. Decisions that the centralized political

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hierarchy could not take before the political change do not become any easier after it. No examples are required.

4. The new service industries that need to be set up cannot be created out of the existing state firms. They have to supply the very services that the state sector found so difficult to produce, among them business services that are essential for a market economy. They require a small scale of operations, and could best be supplied by newly created private firms.

The development of a home-grown productive sector is not unrelated to what happens to the old monofirm. The two will be competing for the same resources, and unless the new sector receives precedence, it will find it very difficult to take root. Consider first the land and premises needed for the new firms. Many of these resources are the object of "small privatization". The *Treuhand*, which is surely as advanced as any other agency in Eastern Europe, has sold some 40,000 small objects so far: this number is minuscule in relation to the number of private firms which need to be set up. Clearly, many of the assets which are required are still in the possession of the old enterprises. To pry them from their grip must be one of the priorities of any industrial policy.

Credit is next in line. It is difficult to provide the new firms with equal access to credit, let alone priority. The existing firms have old established ties to the providers of finance; they may seem to have assets which can serve as collateral; and they can always threaten that bankruptcy and unemployment may follow if loans are not granted. The potential new entrants lack all these connections, and may find it very difficult to obtain finance.

This problem has a macroeconomic counterpoint in the soft budget constraint. Since the as yet unprivatized state firms are likely to be, at any point in time, those organizations whose value is low or even negative, i.e., enterprises that prove to be unreformed and poor at selecting profitable investments, they are the firms that should be starved of any new resources. Otherwise they will squander them, invest them in useless capital, and deprive the national economy of the ability to use them productively. These firms have to be denied the ability to invest and the ability to raise the incomes of their workers. Their budget constraints have to attain a degree of hardness which at least equals that of the communist regime. The Gorbachev period may have been required to prove that there are degrees of budget constraint under the Stalinist regime or under the Hungarian NEM may have been soft in comparison to that under classical capitalism, and the loan guarantees to Chrysler may have shown that even under modern US capitalism some softness may creep in. Events after 1985 have shown that these budgets can become immeasurably softer when central control breaks down. Hence what is required is a return to NEM-time hardness, with strict control over the wage fund and over investments. And here begins the hardest part of the transition policy: how to chaperon these enterprises into either liquidation (of the majority) or radical restructuring prior to

either eventual sale, or to transformation (of a very small minority) into a public corporation. This raises serious administrative problems:

1. Who should oversee the enterprises? Each firm's monitor will have to be a single agency that will be able to gather all the needed information on each firm, and thus remove the possibility that the firm will try to play off one agency against the other. It would, on the other hand, be preferable if state industry could be divided among several competing agencies. The success of these should be judged by the number of state employees who were transferred into the private sector, or relieved from dependence on the public sector. The choice of success criteria and incentives for the privatizers is all important, because these agencies are to take the place of the old ministries but should not follow in their footsteps. The natural aim of such an organization is first and foremost to remain in employment, i.e., to keep their job through a slow privatization process. Appointments to these boards should therefore be for a strictly limited period of time, with payment tilted toward the end of service, so that monitors would look forward to the end of their stint. On the other hand, the stint should not be too short, so that the overseer would be handicapped in negotiations with his subordinates by unfamiliarity with details. This is a particularly difficult incentive structure to build into a bureaucracy.

2. The reconstruction and reorganization should consist of stripping the enterprise of all assets that are not required for the immediate and principal task of the firm. Those parts stripped off can be hived off into separate enterprises or sold off as individual capital assets. One of the disadvantages of the vertically merged enterprises is that the internal units,which supply inputs that the market can produce more cheaply, often lack a sufficient scale of operations: the required re-amalgamation should not be performed by a public agency, because it is the task for an entrepreneur, not one in which a public agency is likely to excel.

3. The splitting up of large, horizontally integrated, enterprises can be left to private entrepreneurs, unless these units pose monopolistic threats, or unless the very size of the undertaking would exclude too many local entrepreneurs from the bidding for them.

4. The first priority is to remove from state ownership any enterprise that poses no monopolistic threat and that has potential buyers. Although the proceeds of the sale are of some importance, the very removal of as many as possible enterprises from the public apron strings is of greater priority. This will free the monitors to pay more attention to those enterprises that have to be reorganized prior to sale, or to make the painful decision on the closure of those that are beyond salvation. Unfortunately a large part of state industry belongs to the latter class, and political resolve is needed to convince the population that closure is really in the best interests of society. This task would be much more palatable if there were proof that a vigorous private sector was sprouting and offering some promise for alternative employment to those who lose the place of work to which they have been tied for many years.

If an efficient monitoring agency can carry out a credible hard budget policy, and if state enterprises are seen to be less pleasant and secure work-places then the new private sector, and if the threats of termination of employment of unsuccessful enterprises are seen to be real, then the pressures for reorganization and privatization may come from within the enterprises. The problem of what to do with those who have worked for decades in unprofitable heavy industries, especially in regions where such industry is concentrated and there is little alternative employment, remains. It is not one that is easy or painless to solve. However, if it can be isolated from the mass of salvageable state industry, it may be easier to pay attention to it when the time comes.

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Only a few years ago—up until about 1989/90—economists and politicians were of the opinion that the former socialist countries of Central and East Europe should quickly change their economic systems into a market economy. The general economic stagnation in these countries, which more and more became a general crisis, had convinced most of the supporters of a centrally planned system that it was not suitable for satisfying the economic needs of a society and its members. The extremely dynamic development in western industrial countries—in contrast to decline in socialist countries—gave the impression that their economic system was obviously the only real alternative. The transfer of former state-owned means of production into private ownership and the replacement of the obligatory central planning by market mechanisms were the widely accepted goals for the necassary change of the economic system.

Today, after two or three years of the reorganization process in at least some of the former socialist countries,[1] some reform-oriented groups are alarmed by the difficulties occurring in this process. There were those who were against reforms and had—while watching their system go to pieces—become rather quiet. They concluded from the difficulties of the reforms that this transformation process would be connected with great social toughness. However, if they were to behave in a blind

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"The Long Way Back to a Market Economy"

[1] Most noticeable in the former GDR, where—due to unification with the former western Federal Republic of Germany—her system has been quickly and fully taken over. A quick system change (often referred to as "shock therapy") has also been tried in Poland since the beginning of 1990. Serious, but so far slower and more partial changes of the economic system can be found in Hungary and the CSFR and—less clear to me—in Bulgaria. In the successor states of the former Soviet Union this transformation process is only hesitantly taking place due to the politically and economically unstable situation.

or malicious way, these transformation problems suggested that it would be possible to force back the old centrally planned economic system.

Indeed, there are extremely serious difficulties in the transformation process. The critical economic decay, which started under, and was caused by, the old system continues in all transformation countries and has increased in most fields. The real social product and the production in the most important economic branches are in recession and inflation rates are high. Since the nominal income has not grown accordingly, the real income of the population has declined. Companies have dismissed many of their workers or have completely closed down. Unemployment of inconceivable extent—inconceivable for these countries under the old system—is the consequence. The fixed capital investment is recessive. All these indicated negative economic effects in the transformation countries occur with varying intensity but are painfully noticeable everywhere. Somewhat different is the development in the foreign trade of those countries; yet here, too, recession predominates, especially as far as exports are concerned.[2]

These extremely negative events affect the social condition of a large population group and have resulted in corresponding discontent. On one side this has led to a refusal to change the economic system; but—and more significant—on the other side there is little confidence in the simultaneously established parliamentary-democratic political system. This is very dangerous for the social and political stability of the transformation countries and creates the threat of growing extremist political movements from right and left.

There are various causes for such an unfavourable economic development in the reform process. It is the economic structures that originated in former socialist countries that are most often named as the most important reason for the problems. The extensive economic development of the former system stressed quantitative gowth and this led to a neglect of quality, and antiquated factories with low productivity were dominant when compared with developed industrial countries. In addition to these points, the transformation of national economies to a market system is taking place with an opening to the world market and this is only serving to demonstrate that the former production systems of the reform countries were competitive to a very little extent. The 'easy' markets of the other former socialist countries (CMEA-countries) abruptly ceased to exist, especially when mutual deliveries had to be paid in convertible currency. On the domestic side (especially in the former GDR, but also in Poland) the competition of qualitatively higher estimated imports from the west has limited potential domestic markets, and this has resulted in a decline in production, the closing downs of factories, and unemployment.

Additionally, enterprises in the old system seldom produced on a low-cost-basis. On the contrary—their production costs were very high when compared

[2] For more detail, see *Gabrisch* 1992.

internationally. The low productivity is an essential reason for this fact, but the underdeveloped infrastructure (especially communication and transportation systems) has also played its part. In the old political system this was (and in some cases still is) compensated by state subsidies. Since in most of the reform countries the central bank has not yet become independent the state budget loses only very slowly—if at all (e.g. Russia)—the potential for money creation, due to the economically unjustified maintenance of enterprises by subsidies. The latter led to surplus money and demand.

This is the beginning of a vicious circle: the introduction of a market economy presupposes free price formation, i.e. the abolition of former price setting by the state. The surplus money, due to social or political reasons, then leads to inflationary processes—to a dramatic extent in Poland and Russia.

Thus the bad, antiquated, uncompetitive situation of production plants and infrastructural institutions in Central and East European countries is certainly an essential handicap for the transition to a market economy. Naturally, it is also the essential reason for the fact that privatization, as a second important component of the transformation process, makes so little progress, no matter how it is intended that it should be achieved: neither domestic investors, most of whom are also not able to raise enough new capital, nor foreign ones want to buy and run inefficient enterprises. However, privatization becomes unsatisfactory and somewhat strange if only the relatively few economically working enterprises can be sold and all unprofitable businesses rest with the state. Beside that, obscure questions of ownership and the necessary removal of environmental impairment (both of special importance in East Germany) stand in the way of privatization.

In a short and sketchy article such as this one could leave it with this argumentation: the hereditary burden of the old system is too immense to be overcome by just changing some institutional elements of the system. To change a system presupposes immense investment means; this is the only way to achieve a promising economic basis for the realization of the system change toward which the reforms aspire. It cannot be done simply through an individual country's own efforts. If the rich West European countries want to have politically and socially stable conditions in neighbouring East Europe, they must help to create these preconditions.

Today we often hear such abbreviated argumentation—even some western politicians argue like that. This attempt to explain the transformation difficulties is correct to some extent but it does not satisify me, because is shows a biased economic orientation. Beside that, according to my understanding, a significant barrier to the transformation process is represented by the disagreement and confusion about reform goals and how to get there. Also post-communist societies do not sufficiently—if at all—accept the very fundamental system changes. In my view this situation causes much higher barriers to the aspired system change which, unfortunately, will not, or only to a limited extent, be overcome by foreign aid.

I think that the ways in which a thorough acceptance of the system transformation is to be brought about are already difficult to compare, due to the different opinions about reforms held by leading politicians and economists in the transformation countries. Here, the only basic tendency of the transformation process that is unquestioned is privatization of state enterprises and the coordination of economic processes on markets. However, the huge transformation problems disconcert many a reform-willing force and conservative-communistic groups become open reform opponents again. Especially in Russia the basic decision to press ahead with reforms is more and more questioned, and this hesitation stands in the way of getting started with the system change.

But even in the transformation countries, where the system change is the goal, we find a great number of opinions on the future economic system. Still more confused is the controversy on how to achieve this transition. The new economic system is often called "market economy" or "social market economy". Naively speaking, this system is thought to come close to the liberalistic model of a state-free economy. In the reform countries this happens sometimes with conservative-liberalistic groups. Here the confusion of the model and the possible reality (ideal and real type) can be understood as a pendulum swing reflecting the wrongs of the former system. Not quite so easy to excuse is when western politicians, scientists or "councellors" advise a quick and complete transition to a "market economy", such as would fit into the above model as a solution to transformation problems. They ought to know the economic systems in which they live, to realize that—in the western world—a state-free market economy does not exist, that state intervention in the economy as reaction to a market failure is obviously inevitable in some aspects. This necessity is mostly justfied by monopolist structures, destructive competition, external effects, and distributional concepts.

Every supporter of the market economy will regret this necessity of state intervention, either for efficiency reasons or for political fears (at the moment I am reading "Road to Serfdom" by Hayek in a semminar, as always with great intellectual gain), but if he is realistic he will admit that politico-economic interventions take place in the interest of social and thus also political stability in all "market economies". Today all actual economic systems are mixed systems where state subsidies, respective tax systems, and also prices, are directly administrated by the state[3] and can be regarded as far-reaching interventions. When realizing these facts it is dishonest to recommend to the East Eurpean transformation countries a quick and possibly total change-over to market economy. The most frequent ar-

[3] Even if the necessity of state economic policy is realized it is shocking to read that the percentage of prices administrated by the state in the consumer's basket in Germany today amounts to 40% of all prices in the basket. Here the authors draw a very narrow circle around the administrated prices, i.e. they neglect the state influence on food prices, resulting from the EC agricultural market regulations. See *Informationsdienst...* 1991.

gument, that the efficiency immanent in the market mechanism would be the right means to overcome all transformation problems ("The market will settle it all"), underestimates the connected social instabilities. Beyond that, it can be said that western recommendations in this extreme situation often lack real knowledge[4] of the very unfavourable structural and politico-psychologic circumstances in the East European reform countries.

Fortunately, the Central and East European reform countries are not mainly oriented towards a "pure" market economy—this is more often found in the minds of single persons rather than in the politico-economic reality. Sometimes Poland is the exception to the rule. It is typical that at times the East German change-over to the economic system of the old Federal Republic is connected with such extreme thinking; however, the character of West-German regulations prevents a radical application of such ideas.

Its is true, that the idea of a market economy totally based on competition is unrealistic, but at least it is definite. For state regulatory decisions the conceptions of a "social market economy"—as mostly met in the reform countries—are more vague. This system should, on one hand, contain political corrections in cases of "market failure" and on the other hand make the transformation process "socially tolerable". Here, the political decision-makers are confronted with a number of ideas as to how the system they are aiming for would be politically stable and economically efficient.

Generally speaking privatization of former state property is estimated to be necessary for the transformation, but there are differing views about the extent of the privatization, and about which branches of state property should be maintained. Those who simply want to keep alive inefficient enterprises under state ownership conditions for social reasons (job preservation) impede necessary structural changes, and in the long-run pursue a "social policy of poverty". Similarly difficult is the "right" decision about the price release needed for actually creating the basis for a market economy. As far as foreign economic opening is concerned, and closely connected with the fact above, there is also a wide range of opinions. Free trade and the introduction of convertibility is suggested as well as protectionist policy and forms of exchange control.

The lack of a consistent concept for the change-over to a social market economy is often lamented. Certainly, for the reform process this is unfavourable inasmuch as the reform plans are changed as difficulties arise and there soon exist more programmes than serious efforts for reforms—this has become a special problem in Russia in recent years. In spite of that, I believe that this uncertainty around the concept of transition is necessarily connected with the inevitability of mixed systems—only extreme forms are clear, but cannot be realized or are inefficient. The new economic systems will probably turn out to be very different in each Cen-

[4] See also, very informative on the subject *Laski* 1992, esp. pp. 18–20.

tral and East European country. They will develop by "trial and error" and the errors will definitely cost a lot, but they will certainly be a good experience on the way to a somewhat efficient system. They will not be the result of champion economists, who make blue prints but ignore reality.

The missing detailed conception for the transformation process, of course, carries a great danger: structural changes connected with the change-over to the market system bring along high costs which in general have to be borne by the population of the reform countries. This is true even if there is considerable western support (East Germany easily receiving the largest and Russia—when considering the task—the smallest support). In spite of all social measures a low living standard will be inevitable in the reform countries for a longer period of time that commonly anticipated. The resulting discontent can easily be abused by conservative circles to discredit all reform efforts.

I think the main barriers to the transition to the market system in post-communist societies exist politico-psychologically. Although everywhere the political power of the communist parties is broken, its economic structures are still preserved in most places. The acting functionaries have little reason to use their abilities for the organization of a new economic system: a system that so far has been presented as hostile, socially detrimental, which they cannot understand and in which they cannot behave in the way they have been trained. The system change makes them socially unnecessary, individually jobless in general. This is not only true for the economic bureaucrats connected with the Soviet economic system—in the case of any reform efforts they are the first who can be dismissed. It also largely applies to all employees—certainly for the management—who have to re-orient themselves: so far they have been used to fulfilling their plans; now they have to search for a possible market and to react quickly to market signals—at the same time they have to act efficiently and be sensitive to costs. In a market system all white- and blue-collar workers are expected to show a greater sense of responsibility, performance efficiency, and self-initiative than in the old centrally planned system.

This enormous transformation process in economic behaviour—in German we would speak of a revolution of the "Wirtschaftsgeist"—can only be carried out very slowly and with great difficulties, at a time of huge economic problems and when sanctions are threatening (e.g. unemployment). It is also not easy when positive motivations (higher standard of living, better supply) at best stand out as hopes on the horizon. So far—i.e. in the two to three years of reforms—these changes in economic performance have not been carried out decisively in the post-communist countries. Together with structural problems and conceptional difficulties I think these are the main barriers to the transition to a market economy. A considerable degree of information, education in the workings of a market economy, and—especially important— better individual insight into its liberties and obligations seem to be the most important task for guaranteeing the transformation process

and getting it going. All members of the old post-communist countries must realize, that political freedom and welfare as we understand it can only be achieved under market economy conditions, but that this requires total and unconditional engagement and the full commitment of each member of society.

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How can the transition to a market economy be accelerated in Eastern Europe? The question raised by the editors of *Acta Oeconomica* seems to dominate post-communist economic thought today. (*Laski* 1991; *Portes* 1991; *Wiles* 1991) I would almost say "unfortunately", because I am afraid that—however justified it may be in daily politics—the anxious desire for a rapid transition may encourage the "transformer"[1] to lose sight of a) his original goal of assisting the emergence of a *liberal* economic order; b) the *logical* dilemmas/paradoxes inherent in this goal.

Two kinds of acceleration. Below I would like to emphasize several—not expressly political—difficulties concerning the pace of economic transformation. It is clear that in the field of politics, and by politics I mean current economic policy as well, the liberal transformer cannot help but lobby for faster institutional change while criticizing the "retarders" in the new governments. These government politicians tend, with some academic backing, to introduce deregulation by new state regulations, privatization by renationalization and decentralization by recentralization. Witnessing this dialectical twist, the liberal economist must work hard to determine whether what he sees is merely a provisional slow-down or a gradual reversal of the transition process. In recognizing the clear signs of the emergence of new authoritarian (clientelist, party-state) structures, it becomes difficult for him *not* to call for an acceleration of the transformation.

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"Money is Time (On the Pace of Post-Communist Transformation)"

[1] For a distinction between the terms "reformer" and "transformer", see *Kovács* 1991.

Paradoxically, the same liberal economist must also distance himself from those of his colleagues who advocate not deceleration, but another kind of acceleration, i.e., increasing the rate of economic growth rather than the scope of economic liberalization. In challenging such suggestions, he relies on, and justly so, similar arguments to those applied in the recurrent debates about "selective industrial policy", "export-led growth", "structural modernization", etc. from the last decades of the *ancien régime*. (Ironically, his counterparts are often the same people as before.) The essence of his arguments is the following: insisting on economic growth would most probably not only lead to recession (like in so many cases in the past), but it would also give the "visible hand" and the mighty lobbies in the state sector a golden opportunity for restoring their alliance which was damaged by the collapse of communism.

A new uskorenie? Unfortunately, the twin dangers of a slow-down of liberalization and old-new expansionism prompt even the most liberal transformers to *force* institutional change in the hope that it might reduce the power of the state bureaucracy and the new authoritarian-populist parties. It would, of course, be going too far to suggest that a new kind of *uskorenie* is being preached by liberal-minded economists in this part of Europe. They know from experience how much damage the forced acceleration of economic processes (the Great Turnarounds and Leaps Forward) caused in establishing and managing the old system. "Growth rush", "taut planning" and "administrative campaign" were indispensable terms for any serious inquiry into the behaviour of economic actors in a command economy. The word "acceleration" was compromised again—some years ago by Gorbachev, and more recently by Walesa. By using the term, both of them resorted to the old tactic of blurring the distinction between long-term institutional reform and short-term political struggle with their opponents.

Yet now, when—to quote Lenin—we could really make "two steps backward" to capitalism, many economists of liberal convictions tend to direct these steps with a *radical activism* that reminds the observer of the interventionist zeal of the proponents of market socialism, not to mention the earlier non-market socialists. *Dognat' i peregnat'* (catching-up and overcoming) capitalism again?

Undoubtedly, there is a whole series of legitimate arguments in favour of some, I would say, "sound" goverment interference in the post-communist economic system. It would be futile to dispute a theory of transition based on moderate, temporary, and permissive state involvement supporting and protecting liberalization. (Kovács 1992) Any liberal economic transformation left to the *ultima ratio* of spontaneous evolution may be derailed at the very outset if it begins under extremely illiberal conditions. This is why so many economists in Eastern Europe are seeking to accelerate institutional change at the beginning of the transition with the aim of arriving, as quickly as possible, at a point of no return—a point beyond which liberalization would prove irreversible, and spontaneous market processes would predominate. Similar to the former reform economists, they assume that this is a

life-and-death race between those who build up the market and those who try to prevent the deconstruction of the state.

At this juncture, let me offer a counter-factual hypothesis, and suppose for a moment that the transformer does not have to face authoritarian temptations in politics. Would he still prescribe "injections" to the economy in labour to accelerate the birth of the market? Should he not fear the harmful side-effects of supportive intervention?

Time is short. My impression is that the imminent danger of new authoritarianism only reinforces the traditional interventionist attitudes of economists in Eastern Europe. (Kovács 1992) "We are under enormous time pressure", "You cannot cross an abyss in two leaps", "Amputation should be done all at once rather than bit by bit", "If we do not hurry, we can get stuck in a no more communism—not yet capitalism' vacuum"—journalistic truisms such as these have mushroomed in the literature of post-communist transition during the last three years. Fortunately, the haste is usually explained in a more sophisticated manner, casting the menace of authoritarianism (neo-communism, populism, Balkanization, etc.) as only one of the relevant causes.

For example, in arguing for shock treatment, its proponents often refer to the technical interdependence of moves towards liberalisation, the need for a *tabula rasa* and a critical mass of the initial transformative measures, the inertia of the decomposition of the Soviet-type system, and the neutralization of partial changes. (*Kornai* 1990; *Lipton and Sachs* 1990) Nevertheless, "time is short"-style justifications for quick, concentrated moves are not restricted to across-the-board operations. Moreover, one hears these arguments not only in Hungary, Poland, Romania or Russia—where liberal transformers are most frightened by the liaison of the old and the new authoritarian pressures—but also in Czecho-Slovakia, where the leading economists justified the initially influential role of their government in the process of liberalization by additional political considerations. For example, they defended their *kupon* privatization scheme, including its collectivist elements, by emphasizing its contribution to a *rapid* "production" of a new entrepreneurial middle class. (*Klaus and Jezek* 1991; *Klaus* 1991)

The "beauty" of slowness. Three years ago, when the Czech transformers discussed a "negative reform" that would deconstruct the old system without "engineering" the construction of the new one, I listened to their reasoning with great sympathy. Later, when they authorized their government to give the first strong push to the transformation and promised that it would withdraw from the day-to-day management of the transition soon thereafter, I began to doubt their allegedly neoliberal credentials. I asked myself: Would the Hungarian, Polish, etc. liberals urge the "building up" of the market and the "production" of entrepreneurs if they formed the next governments in their countries? Would they fall into a now-or-never panic, or would they sit back and relax after having taken the essential steps towards a negative reform—a reform, in the wake of which markets and

entrepreneurs would already be able *to create themselves* without the help of the government?

To facilitate this relaxation and self-restraint in the future, I would like to suggest the following brief reflections on the *risks* of accelerating institutional change:

(1) Let me refer first to the conventional "*Austrian*"-type arguments about the market as a "discovery process", entrepreneurship as "creative destruction", the importance of "spontaneous human action", the role of uncertainty and the danger of "social engineering". One does not have to be a blind disciple of Mises, Hayek and Schumpeter, or their neo-Austrian followers, to agree with at least *part* of their theory about the evolutionary (organic) character and the natural slowness of market transformations.[2] Similarly, if we accept at least *part* of the historical observations made by Weber, Polányi or Hirschman on the long-run accumulation of the legal, anthropological, and ethical preconditions for modern market behaviour, and the short-run vulnerability of market institutions, we will measure time not in four-year election cycles but in decades, if not centuries. Also, we will think twice before launching large-scale marketisation campaigns or privatisation drives based on Grand Designs.

Time is money, but the reverse proposition is also true: money as a principal institution of a market economy needs time to develop. The emergence of a refined exchange system of a monetized economy with its complex organisations, including all the skills, habits and attitudes of the main economic actors, may last an entire historical period.

(2) Forcing liberalization is not simply futile but may also be counter-productive; it can lead to *"empty" institutions* which only simulate secular trends in economic history. Market institutions may prove empty not only because they were either designed in an uncoordinated fashion or were not fine-tuned, but also due to the sheer fact that they *were* designed. In other words, having been introduced from above and in advance, they may lack human input (interests, routines, moral values, etc.) from below. Entrepreneurs who do not take risks, business agreements which are not observed, dormant companies which serve tax evasion, stock exchanges in which no transactions are made—one can cite numerous recent examples from Eastern Europe to show how the quick introduction of capitalism can result in its similarly quick discrediting.

If I were an arch-libertarian, I would suspect a behind-the-scenes socialist conspiracy to effect premature liberalisation. Imagine our conspirators, intent on eliciting new government interference, saying: "Let's create a dysfunctional market economy with Wild-Eastern overtones in order to demonstrate the importance of state regulations to the public". Institutional change, like any investment, has to

[2] János Kornai is one of the few economists in Eastern Europe who has most recently stressed the need for an evolutionary approach to privatisation. At the same time, however, he has not ceased to recommend quick stabilisation and marketisation policies. (Cf. Kornai 1990; 1991)

be absorbed by the economy and the society, or it will be resisted as a foreign entity. Not only is public frustration with liberal transformations at stake but rapid liberalization may also create institutions, which themselves will impede further liberal change. (This might well be the case with the new regulatory bodies monitoring deregulation, and privatisation in Eastern Europe.) To counter-balance such organisations, you will probably have to reinforce old institutions or create new ones, thus never escaping the treadmill of interventionism.

(3) Accelerating post-communist transitions presupposes intelligent scenarios of liberalisation which include a well-defined sequencing of transformation, appropriate coordination of the simultaneous tasks (shock treatment), and above all a "*tachometer*" measuring the velocity of institutional change. Who should decide when the economy should shift gears? Which country should serve as a basis for comparison? Germany, Chile or South Korea?

I think it is not only the unprecedented nature of the post-communist transition that prevents the transformer from designing adequate programmes or the proper instruments to assess the tempo of their implementation. Here I would leave aside the technical and political obstacles to writing good, or even second-best, scenarios for the transformation. I will also disregard the legacy of the old regime and the intellectual history of the scenario writers themselves. Instead, by way of conclusion, I would like to point briefly to the *logical* dilemmas/paradoxes of liberalization.[3]

The general dilemma of political democratization versus economic liberalization is unfortunately all too familiar in Eastern Europe today. We are no longer surprised when democratically elected parliaments vote down, almost instinctively, radical proposals for liberal economic change. Another dilemma, that of interventionism (if the government intervenes, it endangers the new, liberal order; if not, it cannot dismantle the old one), has already been mentioned. The dilemma of simultaneous versus sequenced change (you can call it the shock-treatment paradox), however, requires further discussion. Most surveys of the recent shock experiments in our region emphasize exclusively the old issue of gradual versus comprehensive/immediate reform. Within this context, if you opt for step-by-step modification, the non-reformed parts of the system will offset your efforts; if you attempt across-the-board change, a) you cannot realize it technically, and b) you run up against the wall of political resistance.

These dilemmas would be more than sufficient to prevent the transformers from advocating acceleration. Nevertheless, simultaneous change hides another paradox—one I would call the paradox of interdependence. This stems from the fact that in the short run the parallel tasks of the economic transition (privatisation, marketisation, stabilization, restructuring, etc.) may not only presuppose or support but also exclude or counteract each other. To cite the one example that

[3]For more detail, see Kovács 1990.

has probably most embarassed the liberal economists in Eastern Europe recently: market reforms (e.g., price liberalization) have—to put it mildly—not always assisted privatization; at the same time, private property has sometimes contributed to the perpetuation of distorted markets.

Therefore, one cannot be confident whether accelerating one of the transformation processes will not slow down another. If we consider that the counteracting effects are usually stronger in other spheres (e.g., marketization and stabilization), and that the tasks affect each other in every imaginable way, a scholar or a politician urging the acceleration of institutional change has to be very courageous. He must be prepared to select which specific transformation moves should be speeded up, and to reassure his colleagues that such an acceleration will still leave something to be accelerated in the future.

P.S.

* To avoid any misunderstanding, my sceptical approach to accelerating institutional change does not imply tolerating restoration of the old regime. The *new* obstacles to liberalization must be removed even faster than the old ones.

* Similarly, it would be a mistake to reject any careful or balanced acceleration of *certain* sub-processes of the economic transition. My argument only challenges a comprehensive demand for acceleration.

* I am aware that substituting "limited liberalization" under decaying communism for "*self-limiting liberalization*" under slowly-emerging capitalism cannot be particularly appealing to liberal-minded politicians or their economic advisers. As a Hungarian citizen, I feel sorry for them. As an analyst of their transformation scenarios, however, I am curious to see if the new Eastern European liberals will be able to reconcile their scholarly and political agendas.

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FERENC KOZMA*

First of all it seems to me necessary to clarify what is to be understood by the term "market economy". This is because some of the professional opinion is inclined to understand it as a synonym for the idea of an "entirely unrestricted free market". Consequently, such opinion regards any formation a non-market economy in which the relations of demand and supply are subject to individual, tangible influences—regardless of whether they stem from entrepreneurial institutions (large companies, banks) or from power structures (local authorities, state or international organizations). In my opinion a market economy is—at least in its form at the end of the 20th century—a system in which the first dimension is the network of sales relations, and the second dimension is the network of oligopolistic, monopolistic and economic political effects exercised on the mesh of the first dimension. Neither of them excludes the other one: what is more, they are preconditions of each other. Beside the productive forces, the division of labour, and the social structure of today, if attempts are made to eliminate this complementary relationship, the economy ceases to be functional. In other words, what I understand by the term "market economy" is a formation which is simultaneously a selling and buying automatism imbued with conscious interventions, and a manipulation system inseparably built into the multitude of spontaneous business transactions that take place on a highly detailed level.

Thus, taken in this sense, the building up of a market economy in Central East-Europe has indeed very serious obstacles. Let me describe three of them.

1. *The organic development of the Central-East European economies has been accompanied by permanent troubles and regular interruptions.* As a result of these both the structures and mechanisms, as well as the ways of behaviour, have become

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unbalanced and distorted. This exacerbates the backwardness of development stemming from the peripheral position of the region, and makes it very hard to improve the situation. All this creates a specific market structure, in which:

a) the effect of pre-capitalist social relations can be found;

b) the marks of peripheral backwardness are also present;

c) the remnants of various ephemeral and now abandoned *attempts to break free*—which can be found in the production structure, in the internal economic mechanism and in the institutional system—settle upon one another;

d) also significant is the remainder of the specific model used for breaking loose, which was typical of the past four decades and adds to the foregoing; namely, a model which tried to overcome peripheral backwardness with the aid of a social structure based on economic and social *security and welfare equalization.*

It created masses of technical, legal, and behaviourial systemic elements which, under the circumstances of a market economy, are simply unable to function.

2. This very particular market—the economies developed under more or less harmonious circumstances look at it as a "distorted", "incomplete" one—could, from time to time, start proceeding on a development path of self-correction. Going along this path, it could be accelerated by consistently applying an adequate economic policy that would lead back the economy in the original direction, after the cataclysms which afflicted the economies following this pattern. Over the course of history "postponed demands" have accumulated in the region: in the economic, social and political spheres. This is probably due to the peripheral position of the region in relation to highly advanced Western Europe to whose common cultural sphere these countries still belong. This compels *every* regime and government in the region to concentrate its efforts on *rapidly achievable* results. The conscious influence exerted by the Central East-European societies on the relations of their distorted markets requires a consistent strategy which has been thought over from every aspect: in other words, preparations can be made for cultural "surf riding" and the superficiality this entails, or efforts can be made to find long-term "fixed points" by absolutizing some elements of the possible strategies. Another alternative is to continue out desperately towards the "rich relatives" in the West. Such attempts usually fail. The highly sensitive economies of Central and Eastern Europe falter or even collapse at the very first sign of an unfavourable economic cycle. A panacea that is selected on a political basis, by the nature of its origins or due to its side-effects, it causes more harm than good. Finally, it is not in the interest of the wealthy western neighbours to lift up the "poor relatives" to their own level. Hence, *politico-economic struggles—instead of relieving the original functional disorders of the market, that have been caused by organic (anatomical and physiological) developments—heap them up with new ones.*

3. All these circumstances require a profound *analysis*, that focuses entirely on the specific conditions and the powers motivating development in the area, and

looks carefully at the societies that live there. Furthermore, some of the economic-political models built upon such an analysis need to be elaborated. These models ought to give priority to the following "questions":

a) how, and for what development targets, *can a concrete Central East-European market be relatively smoothly operated*?

b) how can an optimum be found between the *effects of market automatisms*. At present these work in a distorted form, under distorted relations—yet in the short-term they are irreplaceable; also there are the impacts of *"underdeveloped" aspects* (of large enterprises, banks or the state). An optimum has to be found so that the working capacity of the market should not worsen, and development should turn into a "self-correcting" direction.

c) how can an optimum be found among the *external and internal influences on the national market* so that the main point of decision-making on the trend and pace of development does not shift outside the frontiers of the country? At the same time, this optimum should ensure that the economies are not deprived of the stimulating effect of integration. In other words, the economies should feel the stimulating effect of the international market, but at the same time competition from the developed world must not paralyse domestic forces and thus weaken activities that have prospects for long-term development, and which were introduced at the cost of big sacrifices.

So far every "success strategy" has put the above three questions to itself, including the Danish and also the South Korean ones. Of course, many economies from different economic-political eras have produced many answers to such questions, and these strongly differ from one another. This means that the necessary analyses have to refrain from imposing the model of some respected theoretical school upon the practical solution of the Central East-European problems; nor is it a solution to choose some standard- or model-country or economic policy which may be promising because of its simplicity, popularity and fast adaptability, when in fact it is impracticable, and would necessarily lead to new failures, confusion and frustration. Building up the Central East-European market economies requires a new independent model-family, just as both the North European and the East Asian markets have for themselves. It also needs *security for introducing and seeing it through*, and a background to political and public life which is exempt from any inclination to adventurism. Such factors are needed to guarantee the success of elaboration and implementation.

I am convinced that creating this specific model is not a question of inventing or skilfully adapting some "techniques". First of all, it is necessary to see clearly in matters of "self-knowledge and environmental knowledge". Great emphasis has to be laid on clearsightedness, for if we try to find responses to our market and economic political opportunities (or some means suitable to influence the market) based on prejudices or political self-suggestion, we would merely lengthen the series of abortive attempts once again—at a time when we are, indeed, in the state of

ultimate possibilities. Being familiar with the short- and long-term trends of domestic public life, unfortunately I am not too optimistic about forming in Hungary the socio-political medium so fundamentally necessary for achieving this.

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1. What do you regard as the main barriers to the transition into a market economy in the former socialist countries?

The transition process of a system that strongly influenced not only the economic mechanism but more or less all fields of society in Central and Eastern Europe cannot be regarded as a mere economic model exercise. It has to be seen rather as the transformation of very fundamental attitudes and aspirations of most groups of the population and its individual members. To reduce this task to the construction of institutions that allow market forces to play in a certain way means misjudging the magnitude of the problem.

The magnitude is of such a dimension that one cannot expect satisfying results in a short while. In the first enthusiasm engendered by the break-down of the Soviet bloc there occurred extrapolations both in Eastern and in Western countries that led to very premature visions. They suggested that if the economic growth of former socialist countries could be expected somewhere around 7% p.a. for a time-period extending up to the year 2000, much if not all of the delay in economic development compared to Western countries could be caught-up. Also, there were assertions that such a perspective was not only realistic and convincing but also natural in some of the processes associated with market forces.

By now, such illusions may already have led to disappointment. It is true, however, that some Western European countries that were heavily affected by World War II succeeded in observing growth rates of around 7% p.a. between the late 1940s and mid 1950s. Some other countries outside Europe succeeded in fostering very rapid economic development even after that period, at least up to the 1970s. But even in these cases the catching-up processes took more time than 5 to 10 years.

Let me take the examples of Austria and Switzerland. By economic standards the level of incomes and of productivity in Austria at the beginning of the fifties was less than half that of Switzerland. Since then Austria has been a relatively rapid growing economy whereas Switzerland's growth is below the Western European average. This indicates that Austria has caught-up impressively. Yet even so, forty

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years later, there remains a difference in incomes, and obviously an even bigger one in material assets levels between the two neighbouring countries (about 25 percent, as measured in purchasing power parities), to the advantage of Switzerland. I might add that this process in which some European economies caught-up with the most progressive countries took place under comparatively favourable international circumstances: many markets for internationally traded goods could be described in the initial phase of the take-off as sellers, markets. Everything they produced also could be sold all over the world at good prices. Furthermore, the international sensibility against all sorts of protection of domestic production was well below the level that is nowadays observed in international trade disputes and negotiations. Markets were not characterised by oligopolistic competition to such a high degree, implying that barriers to market entry were comparatively low compared to the expectable situation in the 1990s. My next argument is that many countries—among them Austria—having the highest intensities enjoyed significant unilateral capital transfers from abroad on the basis of the European Recovery Programme and some other schemes. Another significant point is that, the rupture of institutions formed and experiences gathered between the pre-war period and after was not so deep and so extended as it is now for many Central and Eastern European countries.

All these aspects look considerably less favourable for the former socialist countries. Yet apart from those mentioned so far, there are new problems with which they are faced now in contrast to the situation of the 1950s. For example, there is an urgent need to invest huge amounts of capital into the natural environment in order to improve ecology and human health in some regions.

Such arguments might point to more realism, but they may also lead to scepticism and even resignation as to the changes of success of the transition process. However, I think the picture would be one-sided if we left it like this.

The basic economic paradigm of the multilateral advantages of the increased international division of labour has to be qualified under circumstances like those sketched above, but nevertheless its main messages still hold. There certainly are advantages and favourable differences between the current situation and that of the post-war decades: e.g. the greater amount of knowledge and technology available internationally at comparatively low cost, the much higher efficiency of international capital markets and of international economic policy institutions, the experience accumulated and applicable to economic and social problems that can be drawn from Western countries and that could enable avoidance of at least some of the mistakes they made, the possible reduction of military spending because of the end of East-West-tensions and the consequent higher proportions of public finance for more productive purposes, the shortening of cycles of production, and the segmentation of many markets due to special qualities offered by the chance of niche production. I would even say that a general lack of capital need not be seen as the main barrier to a more dynamic growth process. The inflow of foreign capital, in the post-war experience of my country, has at no point of time played

the dominating role in financing the necessary investment. The Marshall Plan can be regarded as having operated as an initial ignition for take-off; yet its main value was that it gave credibility to the economic policy and confidence for private investment. If, as unfortunately it looks at the moment, the Western countries for various reasons are not ready to offer a package of that size, then it can be replaced by countries making their own sound, longer-term oriented economic policy efforts. However, the basis for these should be the broadly shared conviction within the population that by renouncing maximisation of consumption for quite a long time, and by a country's own strategic efforts, the goal of catching-up with the Western neighbours is by no means unrealistic.

Yet when making this statement I have to try to understand what it means to a generation that has already been forced to renounce some of the not always very convincing consumer aspirations of Western people. It indeed means a prolonged sacrifice to provide advantages for the welfare of the next generation.

2. What measures and techniques do you suggest to accelerate the transition process?

I have to confess that I do not see acceleration as the top priority. Hungary has made slow but steady progress in the reform of her legal, institutional and behavioural characteristics over a number of years and she has done well in choosing this approach. The final reason for this argument is that this has provided time for learning and adapting to social and psychological parameters. The other approach, chosen by Poland and—under differing circumstances—by what was East Germany, that of a "Big Bang", in my opinion not only incurs higher political and social costs and risks, but it even means higher economic costs and frictions. There are two reasons for this: it wears down physical and human capital that could otherwise be used more profitably once the correct adaptations have been made. Also, in the case of a step-by-step process not only the political basis can be stabilized but also the expectations of private economic planning and investment, thus contributing to the domestic capital formation and to capital inflow from abroad.

Having said this I hurry to assert that a longer-term orientation of policy-making must not mean the postponement of necessary reforms. It obviously has to be coupled with clear and immediate steps and an ambitious time path. Postponement of the full effectiveness of market forces has to be limited in time. There should be no doubt about that. In Austria, many types of direct political intervention have been developed in a variety of markets. They have been developed over the course of recent decades, reacting to the different international and domestic circumstances that have emerged at different times. In many cases we realised after a while, and after their original cause was no longer existent, that such regulations

show a tendency towards unjustified self-reinforcement. This reduced the capacity to react promptly to shifts in markets. One should be well aware of the fact that regulations lead to vested interests and they in turn lead to self-perpetuation.

Nevertheless, the average productivity increases in Austria have turned out higher than in many Western European countries. The argument brought forward for this, in spite of what we observed about petrification of interest structures, is that stable social relations and a climate of mutual understanding of social groups makes solutions possible that could otherwise be blocked under less consensual or less corporatist circumstances.

In a paper written by Professor *Yoshitomi* (1991) of Tokyo, he asks whether there are elements in the economic policy developed by Japan that could be of use for the growth strategies of Central and Eastern European economies. Certainly, the situation and the characteristics of Japan were and are different from them in a number of very fundamental instances. Nevertheless, in view of the convincing success of the Japanese example, the question is appealing. Indeed, much to the surprise of those spectators who are used to blaming Japan for an implicitly protectionist approach, Yoshitomi concludes that he sees four basic principles that could be applied to Central and Eastern Europe. From our Austrian experience, both from the success and from the failures of our approaches, I could subscribe to his conclusions.

He calls them the four C's: Competition, Comparative advantage, Capital accumulation (both physical and human) and Consensus building. In contrast to those advocating the sole priority for the working of market forces and neglecting the role of the government, we would be inclined to stress that it is necessary to develop a close working relationship between the government on the one hand and business and labour unions on the other in defining national development strategies. This may well imply (fiscal and other) incentives for capital formation (to curb the propensity to consume) and, possibly even more important, the encouragement of competition among suppliers on the domestic market.

Needless to say, such a model only promises positive results when it is developed on the basis of sound macro-economic (fiscal and monetary) fundamentals, and on the careful assessment of static and dynamic comparative advantages in an international context.

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"The age of cactuses and sand is approaching"
György Petri: Inscription

Why does the transition from the dictatorial socialist planned economy into a liberal mass democratic market economy seem to be failing or at best succeeding with great difficulty? A timely and valid question. Yet some East European sceptic might even put the question: why should it succeed at all? Can it succeed? In other words: are we not searching for a way where there is in fact none, or are we not attempting something that is impossible? When, before the change in 1989–90, we asked each other and ourselves whether existing socialism could be reformed, and whether a socialist market economy could be realized, our questions came to the same impasse. At that time many observers answered that there could be no such thing as a socialist market economy and thus it was not even a possibility. Just as then it was said that existing socialism could not be turned into some kind of socialist market economy, so today it is said that existing socialism cannot be turned into a liberal capitalist market economy; in other words, it cannot be reformed and it cannot be revolutionalized.

However, I think it typical that those who try to answer the question today, do not say this straight out. The experience of the past two or three years have been bewildering and the East European societies have been disappointed not only in Gorbachev's perestroika and reform-socialism, but also in the ideas of a liberal market economy. It seems that the attempt at a liberal market economy has only continued the poor results of the reform-socialism. Yet, just as earlier it was not thought fitting to criticize Gorbachev's socialist market economy, so today it is not becoming to malign the solutions of a liberal market economy. It is not seemly to openly declare that there is no way leading to this type of economy. Also, it is not at all popular to say that there is no leap from a shortage economy into an economy of abundance, or from a centralized economy into an individual market economy. It is like saying to the believers that there is no redemption. Yet the fact seems to be that in Eastern Europe there is no redemption, either of a socialist, or of a liberal type. From this, one should not draw the conclusion that a market economy is not, historically, more effective than a centralized planned economy or that a society of mass democracy and a constitutional state do not provide better living standards than one or another type of dictatorship or authoritarian division of rights. However, just because something implies a better life, it does not mean that it is easier to attain it.

It was in 1988 that C. Castoriadis summarized why the big leap is impossible. It is true that at that time he was speaking about reform-socialism, but we can see

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that he could repeat his arguments even today. He pointed out the reasons for the impossibility of transition in four points.

1. The picture of a *bureaucratic market capitalism* can be coherently described in a scenario. According to this scenario, prices and wages can be liberalized, profitability can become the centre of economic activities, enterprises (below a certain size) can pass into private hands, and land (from the divided collective farms) can become the property of peasants and voluntary cooperatives; also, foreign-trade monopoly can be eliminated, the quantity of money can be regulated by the central bank and by monetary means, and public expenditures can be covered by taxes. Monopolistic giant companies can be decentralized and a "war economy" can slowly be turned into a civilian one.

2. However, the logic of such changes is only apparent. First of all, how can we get "there" from "here"—e.g. from the real Russia of today to a fictive Russia? In principle, there is some solution for this transition but it has not been properly elaborated because it is so difficult. The short- or long-term results of the measures waiting for implementation, even if they were to be gradual, would shock the model and the consequence could be dramatic: mass unemployment, the significant rise of consumer prices and the collapse of regional, professional and social groups.

3. An actual reform cannot be realized by resolutions coming from above—i.e. without the support of broad strata of the population, and their active participation. In other words, such a reform ought to achieve the unfolding of a deep social movement. However, it is not only the case that such a social movement does not exist in Russia but there are not even any measures which could start turning the scenario into reality, nor the conditions which could create a coalition of those who ought to be able to realize the reform. Such a coalition for the reform is needed against those who oppose it—namely, the vast majority of bureaucrats and almost all workers.

4. The most important thing is, however, that it is impossible to recognize the type of society and political system which would suit the economy of bureaucratic market capitalism.[1]

"Why is the transition from here to there difficult, or why is it impossible?" This question is based on the concept that history moves from something towards something else, that there is a certain regularity of modernization from the less perfect to the more perfect. An earlier theory emanating from social philosophy proclaimed that universal progress, though with detours and transitions, tends towards a corporate society and economy where there is no private property and no

[1] In his study *Castoriadis* (1988) did not or did not want to see a picture of society with bureaucratic market capitalism, even though historical prototypes of it were already well known. Such were, for example, the dictatorial form: German national socialism, Italian fascism, phalangism or Salazarism in the Iberian penninsula or the various Latin American populist dictatorships; and the democratic form: the French model of "planned capitalism" or the Japanese one of a controlled economy.

state. Today, some ideologists and politicians take a simplistic approach and call to account certain societies and economies for their imperfection, claiming that these societies are still not ripe for the summit of human progress—i.e. the market economy of private property and individual competition. East European societies may, with some surprise, experience that they are living in a continuous state of *transition* of society and economy—except that yesterday it was a transition towards socialist society, and today it is a transition towards capitalist society. Yet when are we going to be in our own society and economy? (There is something ironically woeful in that in 1918 young economists and politicians wished to achieve a modern system based on a doctrine of salvation, involving the elimination of money. Today, young economists attempt the same, through the "introduction" of money. The result of the laws and interventions is tragically the same.) Hence, would it not be reasonable to consider the proposition that, just as the preceding system was not a transition from capitalism into socialism and communism, so even the present one is not a transition from socialism into capitalism, but something entirely different. The Soviet-type society is not some hybrid made up of socialist and capitalist elements, but a system which can be explained from itself; in my opinion the East European systems being built up today are also not simple hybrids but autonomous forms. In terms of world history, they are not tending from something to something. For instance, Italian fascism or German national socialism were also not transitory societies and they were not born to constitute the foundations of the later liberal market economies of Italy and Germany. Analysts of societies and economies cannot proceed by trying to measure the distance of one given system from another. East European economic science attained majority when it came to deduce the laws and rules of real socialism from the lived experience and not from a hypothetical system. It became a science when it understood why and how a system can work which, from the aspect of the rationality of the market economy, is nonsensical, as well as comprehending what the rational regularities of that system are. In other words, when it began to examine not to what extent the system departed from or approached an ideal system, but what the basis of its operation is. Today's East European system deserves a similar study.

Observers of the present situation—among them also some who have already provided answers—have repeatedly summarized what is missing in the East European societies for the assumption of a market economy. They deem the social elements to be at least as important as the direct economic ones. Out of these they emphasize the low level of social development, the lack of a real middle class—i.e. the entrepreneur, the consumer and the civilian citizen—and the behaviour of the "homo sovieticus": the authoritarian, risk-avoiding, state-controlled man. Furthermore, the social conflicts stemming from the growth of social inequalities, as well as from regional and sectoral inequalities, are becoming increasingly open and are leading to the disintegration of the existing social systems. From the economic aspect, they point to the lack of a market with price markings, the risk of turning

the prices into market prices, the unregulated monetary systems, central monetary and fiscal policy, the lack of financial institutions and their disfunctional operation. A third set of problems to which they draw attention is the unprepared nature of economic policies, their inconsistent implementation, and their lack of social support. All these are perfectly true. They were true even before 1989. Thus what cannot be understood, having taken these facts into account, is that commentators in the East and the West are actually surprised by all that is going on. Another curious assertion, despite knowledge of these facts, is the conclusion that there exists a transition to the market economy and mass democracy, but it requires a longer period than was originally assumed. In practice, the path away from the classic Soviet-type societies—including the successor states of the Soviet Union, Bulgaria, Romania, Slovakia, Albania—and towards market economic systems is one that is hedged with the most extraordinary circumstances. (Such is, for example, the case of East Germany, which also belongs to this category. It is being changed by West Germany into an ill-matched market economy, with huge sacrifices. The same could also be imagined—though it is not very likely—in the case of some Baltic states, if a helping hand were to reach out from the Scandinavian region.) Great Serbia has similarly no chance of becoming a market economy. The next "gradation" is represented by those national economies which, a few years ago, separated themselves from the leading tenets of the Soviet-type society but proved to be unable to transcend their national limits. Such are the two "riddle" countries, Poland and Croatia.[2] It sounds a mockery if I say that the countries which comprise the third group, and which in recent decades have not followed the model of the classical Soviet-type society and economy and are suitably small and geographically close to the market regions, are waiting in the "transition of transition"—i.e. in the anteroom of the market economic transition. These are Bohemia, Hungary and Slovenia.[3]

At the same time, the societies and economies which have developed since 1989 are transitory ones in the sense that the norms and laws inherited from the previous system act in different ways; concomitantly, the new norms and partic-

[2] The "riddle countries" are Poland and Croatia. There, the political culture and erudition of the intellectual elite, as well as the economic, cultural and political knowledge of what is happening in the West have been on the highest level in Eastern Europe. However, their struggle for medium power status, along with the nationalist basis of their political and economic thinking, have tended to push aside liberal concepts and even led to xenophobia; thus they have been thrust into an intermediary position.

[3] At various periods these three countries have attempted to construct a human-faced socialism, and all of them are adjacent to the western countries and provinces of the region, i.e. to Austria, Northern Italy, Bavaria and Baden Württemberg. The West has neither the desire nor the power to admit Eastern Europe into its camp. If it admits anybody, he will have to be small, close to the market economies, and will be subject to a thorough testing. The test will determine whether any of these countries have achieved the intermediate situation and can thus be admitted into the anteroom.

ipants are uncertain and difficult to recognize. They are transitory societies in that political and economic stabilization and order have not been fully achieved. Therefore they cannot be studied as mature systems. In fact, they are by no means determined to grow into one or another type of a system. (For instance, to state that Russia or the Ukraine will *necessarily* become models of national socialist societies is an unfounded exaggeration. Although certain conditions attract them in this direction, it is not as yet a necessity that they will become national socialist societies.) We would be in an easier position—and I, as a Hungarian economist, am inclined to believe this is so—if we could measure the societies and economies of the East European countries in terms of the Hungarian chronology. In this case we could say that Russia, the Ukraine, Romania and Bulgaria are at about the same level as Hungary in the late fifties; in other words, they are tending towards the stabilization of the early 1960s and the 1968 reform. The model is a dictatorship sprinkled with a certain liberalism, in which the centralized state starts bargaining with local company and sectoral powers, and acts more like a peace-maker and even imitates market behaviour. In addition, this model begins to recognize certain small liberties and creates opportunities for consumption. Poland and Croatia are in the state of Hungary in the 1970s where there is some autonomy for companies, a certain level of consumer demand exists, and a struggle is going on in order to decide whether recentralization or the process of a market development should be implemented. Finally, based on this chronology, Hungary and Slovenia are similar to Austria in the seventies. As I say, it would be easy to introduce this chronology if such historical progress actually existed. Yet it does not exist; therefore my chronology is merely exciting guesswork, nothing more.

The riddle of the East European situation is at the same time a riddle of our economic knowledge. Our formulas and descriptions do not comply the facts. New experiments are needed in order to get acquainted with what exists, and to review the norms according to which, for example, Romania or Bohemia are run. These are neither norms of the planned economies nor of the market economies, and not even mixtures of them. But then, what are they? Who are the important participants in the economy—namely, the real ones and not the imagined ones? Let us confess that we do not know. This is why it is worth studying economics in Eastern Europe.

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For some time scholars referred to market socialism and thus a qualification of "market" is needed. I consider the market to be a decentralized coordination mechanism which needs a proper system of incentives, risk bearing attitudes and financial responsibility in order to work properly. The capatalist market is the most developed form of this mechanism. Property rights ensure more effectively than any other arrangement—such as leasing, usufructum or any other mix—the combination of incentives and financial responsibility. The market is also the most effective tool in revealing different or opposite economic interests and bringing them to a compromise. To that extent, the market is in the economy what democracy is in the polity. Both institutions need fundamental laws, to protect individual rights and contractual committments.

"Transition" also needs some qualification. Transition necessarily implies a gradual approach, in contrast to changes of a revolutionary nature. In the discussion of transition the time span, order and preferability of changes matter most, rather than graduality itself. To that extent transition cannot be anarchic, but needs government guidance, if not control.

Lastly, barriers need to be qualified not only from an economic point of view, but also from social and political points of view, since the same people and institutions which should support the economic benefits of transition could be antagonistic from a social or political standpoint.

Among the barriers to transition it seems to me that the following ones deserve special concern.

1. *Distortion of the production structure.* Capitalist market economies have emerged historically along a continuous path in which domestic and/or international demand have provided the correct signals to investment and new technology. Obsolete production branches and enterprises were gradually replaced by new sectors during a period of time which permitted the economic survival and restructuring of some of the obsolete firms. The other firms went bankrupt. The patterns of demand changed as gradually as the pattern of supply.

The socialist economies have produced a dramatically irrational production structure from the point of view of market allocation of production factors, distribution of goods and of market capital/labour ratios. Transition to market means essentially the change of this structure. However, this very structure represents an obstacle to *mobility* which is the main component of transition. I insist on structure rather than on scale (monopoly), since in my opinion the latter is less important as

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a barrier. Not only heavy (or military) industry is overexpanded compared to consumer goods industry or trade, but within each main sector, products and allocation of resources do not bear any relation to market demand as it emerges with price liberalization. Even within firms, the allocation of capital and labour in different workshops may be quite irrational. Reallocation of resources requires mobility of all factors, from labour to management, from capital to land use, because without this the reliability of new and rapidly changing price ratios are reduced. Much of capacity must simply be scrapped. This brings about the short-term worsening of all relevant economic indicators.

2. *Soft-budget constraints.* As argued in the case of the economic structure, transition schemes should introduce hard budget constraints, but—as experience shows not only in ex-socialist countries—the lack of financial discipline is not only the product of government policies and disregard for financial equilibria (which characterized central planning and should be reverted by systemic changes) but its absence is also an obstacle to such changes. Efforts made in Poland to introduce some sort os financial discipline have failed. A particular conspiracy between the management and workforce of public enterprises against financial responsibility reflects not only labour claims to job rights but also the persisting rent-seeking approach of state managers; the latter can still find some sympathy among the unchanged upper state bureaucracy.

3. *People's socio-cultural background.* Different groups have different interests in the transition to a market economy. One should not generalise about peoples psychology. Nevertheless, my impression is that people tend to fear dramatic changes and thus emphasize the importance of whatever they acquired in the previous system, even though they do not rate very highly the quality of any present asset, including their personal job. The fear of losing social status in comparative terms turns into suspicion and hate for anyone who is improving his/her position. The magnitude and rapidity of changes in individual economic fortunes produce social strains which become a major factor of political instability. Similar strains were produced after the war in Western countries. However, rapid growth sustained by reconstruction and capital inflow from abroad helped to smooth the differences in relative gains.

4. *Enclaves of conservative political-bureaucratic power.* The former system was based, on the one hand, on the rule of communist parties and on an egalitarian ideology and the catch-words which constituted its method of demagogic mobilization. On the other hand, it was also based on the networks of personal favours and informal relations among the rulers. These provided an effective coordination mechanism, in default of 'the rule of contract'. The political changes have brought to power in most ex-socialist countries other parties and a new leadership. Yet the informal network still exists and might even have been strengthened as a defence mechanism against the institutional vacuum. This network does not need to coincide with the nomenklatura, though it shares with the latter an interest in the

status quo against systemic changes. Any change which needs government impulse and/or guidance is filtered through the informal network of bureaucratic power which can either delay and distort implementation or vilify it.

5. *Extent of the state-owned economy.* The more pervasive and more deeply rooted the state-owned economy, the higher the barrier to transition. In some ex-socialist countries private ownership or forms of usufructum of land have spared part of the economy from the distortions and inefficiency introduced by public enterprises. The existence of a domestic foodstuff market is an important advantage for transition, since, on one hand, part of the population is already prepared to work with market rules and incentives and, on the other hand, the inflationary impulses of price liberalization are reduced.

Large-scale privatization encounters the hostility of enterprises which resist financial responsibility, and entails time and often short-term losses due to the immediate need for restructuring. Privatization does not solve immediately the problem of management. If property rights are to provide the correct incentives to proper market behaviour, they need to be earmarked in some way. This needs time and delays transition. If property rights are obtained as a free good, there will be waste and abuse of property. Misuse of private property may altogether damage the programme of transition to a capitalist market.

6. *Role of the state.* If the capitalist market is an alternative to state managemenet, the role of the state in the economy should diminish. But all the above points, from 1 to 5, suggest that government guidance is needed and must be firm. Therefore, in the short-term, state intervention and some degree of public mismanagement are still to be expected and may affect negatively the expectations of the most adventurous entrepreneurs and of the domestic and foreign investors.

7. *Lack of credit, financial and insurance institutions as well as the lack of a coherent corpus of laws based on the principle of the contract* which constitute the dividing line between primitive or 'bazar' market and capitalist market. The term "regulated" market is often used as an alternative to pure market economy, but this seems to me to be inappropriate in so far as it conveys the idea of extra-market forces, ideas or values introduced by governmental wisdom to correct market behaviour. In their efforts to reduce the cost of misinformation, price fluctuations, investment risk and exogenous variables, market economies have 'over time' developed and incorporated new institutions and behaviours. These have made it possible to increase the number of actors in the market compared with the number of spectators. Governments have been important in interpreting these changes and adjusting legal institutions to match new demands. The different behaviour and organization of banking, credit and insurance institutions among developed market economies suggest that each country has found in its own history and culture the institutional response required by each stage of capitalist development. The interruption of this process in the socialist countries is perhaps the worst obstacle to

the transition to a market economy. The importation of such institutions from the most developed capitalist economies is not necessarily the best policy.

Other barriers which should also be listed, but with no special emphasis, are the monopolistic structure of production, preoccupation with equity and justice, lack of funds for social security, and prejudice against foreign investment. These features and concerns may indeed make transition more complicated, but I do not think they should be considered as the main obstacles. Private monopolies have an advantage over similar socialist structures in that they are constrained at least by demand and their own budget equilibria. Equity and justice in the previous regimes—which some have considered to be the basis for social consensus—must not have been either so evident or crucial to people if the overwhelming majority, when free to vote, had been able to opt for non-communist systems. As to foreign investments, the experience of the United States, Canada, and Australia in the past, and South East Asia more recently, suggests that direct investment from abroad has been the motor of development and growth, up until the time that these countries became foreign investors themselves.

Measures and techniques to accelerate transition

During the transition to a capitalist market economy, the effectiveness of any measure should be rated according to its impact on the economic structure. The transformation of the irrational economic structure needs a proper system of indicators and incentives.

1. The liberalization of prices and, to a certain extent, of foreign trade provides new price ratios which are needed for decision-making on production capacity and its utilization. In many schemes of transition, this stage has preceded privatization and the installation of credit, financial and legal institutions. Much has been already said on the sequencing of reforms. Price liberalization is a necessary, but not sufficient condition for market forces to develop. To accelerate this development market operators, both entrepreneurs and labour, must be given proper incentives to use mobility. Branches which, due to new price ratios, remain or become inefficient, must be induced to disinvest. Labour must be stimulated through new wage ratios in order that it moves to new expanding sectors. This means that one should avoid wage regulations and ceilings as well as punitive taxation of profit-booming activities.

2. Indirect taxation (tax on consumption) seems better suited in this phase than direct—profit or income—tax policies. Income tax should not be highly progressive. Proportional income tax could even be most suitable to avoid or minimise tax evasion and introduce competition in the labour market. Nevertheless, in the transition phase tax evasion should not be targeted against with particulat empha-

sis. If the mobility of all factors of production is what is mainly needed, emerging private individual or entrepreneurial activities must be encouraged, even if this entails some damage to the state budget. Short-term treasury bonds can be used for budget equilibrium purposes. Some degree of shadow economy for the purpose of tax evasion can be tolerated.

3. The "hunger" for consumer goods experienced by socialist shortage economies remains even after prices have adjusted to the market. It is likely that the supply of labour will increase and help to contain wage increases in expanding markets. Obstacles to holding more than one job should be removed, while at the same time the institutional barriers to redundancies should be relaxed. Needless to say, the most needy must be protected. The very high participation rate for women in the workforce suggests that some of them could retreat for some time from the labour market, provided the family income is adequate.

4. Property rights should be approved at once, including the right to own land. Tax rates on income earned from leasing and subleasing flats, houses and land should be kept down, to stimulate geographical and occupational mobility in a situation still characterized by shortage of residential space. The leasing of land should not be limited to specific utilization, except that agreed by the private parties.

5. Public enterprises, whether or not on the list for privatization, must be stimulated to get rid of excess capacity, through the application of harder budget constraints and freedom to dispose of part of the equipment, tools, stock of materials and attached facilities in order to repay debts. Some privatization laws stress that the selling of enterprises should include all their premises, whether assigned to production or to service purposes. These provisions prevent the emergence of some adjustments in the phase preceding privatization; these could benefit both the main production unit and the customers for its products and services. The poverty of the service and trade networks in most ex-socialist countries and the importance of these sectors as main vehicles of market incentives based on consumer goods availability suggest, indeed, that not only state shops and department stores must be first on line for privatization, but enterprises must be induced to sell these facilities, either to repay debts or to recapitalize the main production unit. Liberal legislation on worktime and opening hours for services could help in increasing the flows of services and, in the clearing of local markets.

6. There exist several privatization schemes largely discussed in the literature and in part already implemented. The advocates of rapid privatization even support the free distribution of property shares. I do not believe that this will help to accelerate the transition to a market economy. The process of transition must be one in which everybody starts thinking in terms of opportunity costs. An unearned claim to property does not seem to be the most propitious start. The selling of large-scale state-owned property could be prepared by the separation of production from non-production capacity and by the transfer of the latter to local governments.

The latter should carry out the selling through open auctions. Some privileges to workers can be agreed upon, provided hard budget constraints apply to them as well.

7. Credit policy must be subordinated only to the central bank monetary policy. The latter must be made independent from the government.

8. Convertibility must be pursued firmly and implemented as soon as possible to attract badly needed foreign investment. However, convertibility should be accompanied by a discriminatory tariff policy. Pending the creation of solid financial and credit institutions, the absence of protective tariffs could hamper the development of domestic consumer goods industries which, primarily for the reasons listed above, should be encouraged.

9. To carry forward the similarity between the institutional feature of market and democracy, one also needs to develop common transitional features. Highly imperfect and incomplete markets in the phase of transition accomplish the necessary restructuring. Some degrees of unpleasant direction from above may still be needed and should not be regarded as a step backwards, provided the goals and policies are clearly stated and duly implemented.

PÉTER MIHÁLYI*

1. The real question

In all probability, the emergence (or revival) of a market economy in the countries where Soviet-type socialism has failed will not be possible to hinder. Therefore, it seems to me pointless to talk about any "main obstacles". As we near the end of the 20th century, the market economy has grown to be a natural element of human existence, just as book printing, alcohol drinking and the use of fire arms. The market economy will come—there is no question about it.

I surmise, however, that the editors' question is in fact concerned with the following points:

a) what are the main obstacles to the emergence of a *successful* market economy?

and

b) which circumstances hinder the development of a *free* market economy?

These are, obviously, two different questions, and it is not easy to answer either in a few words. Namely, the criteria of success are not self-evident, and not even the all too often voiced assumption is justified that the closer a country

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can get to the textbook model of a market economy, the more successful it can be considered. Economic history shows that the basic institutions of a market economy are very well able to coexist—in some cases even for decades—with certain control mechanism alien to the nature of the market, while in other cases such market-alien elements do in fact exert a paralyzing effect.

For reasons of limited space, I will only try to answer the first question: will there be a successful market economy in the post-communist countries? I am afraid not. *If left alone in the transformation process, Eastern Europe will have no chance of closing-up in the worldwide competition.* Yet, up until now, there has been no trace of any substantial assistance.

The countries in question have been out of the race for much too long, and wasted their time in "inventing" their own competition and own special rules. Although differing in degrees of seriousness, the problems of today are very similar in each country.

— The value of the material and intellectual assets accumulated in the preceding decades has fallen dramatically below that needed for market conditions. An over-sized war industry, expensively working mines, stables and cowsheds built according to the demands of collective farming are not needed any longer. The old forms of control and management must gradually disappear: the party apparatus, the planning boards, the ministries, state-owned foreign trade, as well as the legal, accounting, and statistical frameworks, which were all based on the logic of a planned economy. Specialists familiar with these frameworks have ceased to be useful. The case of the former GDR clearly shows that, in the short run, there is a close connection between the rate of converting a system to market economy and the intensity of the process of asset erosion.

— East of the River Elbe a second industrial revolution is needed. However, the reserves wanted for growth have run out: the masses of undemanding agricultural workers accustomed to hard labour are now town-dwellers; environmental pollution is beyond all acceptable levels; the countries are up to their eyes in foreign debt.

— It is not just an accidental circumstance that the nations of Eastern Europe and of the former Soviet Union have got rid of their socialist economies at almost the same time. This fact is a disadvantage rather than an advantage. The list of European countries queuing up for Western aid is already frightfully long—19 countries altogether, with the GDR included[1]—and it is only a question of time before Cuba, China, Korea and Vietnam join the queue.

— After decades of forced symbiosis, the nations of the region do not seem to be prepared for peaceful coexistence, political and economic cooperation based

[1] Albania, Belarus, Bosnia-Hercegovina, Bulgaria, Croatia, Czechoslovakia, Estonia, (ex-GDR), Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia (?), Slovenia, Ukraine.

on trust and self-limitation. This lays a burden beyond endurance on the democratic institutions, which are still rather fragile. In the race for the goodwill of the voters—or, in a worse case, for the support of the mob and the armed paramilitary troops—old wounds are easily reopened. The West looks on, shocked and irritated: "Euphoria has given way to violence: minorities are victimized, frontiers contested and barbarity rekindled. Wars have broken out and still rage among several of the countries gathered here."[2] As the conflicts between nations are worsening, the costs of intervention are rising exponentially in the political as well as in the economic sense.

2. What can be done?

The international assistance needed for the recovery of the post-communist countries is not just a matter of money. Determination and intellectual conviction are also lacking. A favourite phrase with Western politicians and "experts on Eastern economies" refers to the bottomless barrel into which no one should pour money; and another favourite is the Chinese parable saying how much more wise it is to teach the hungry to fish than to give him one fish. Three years after the turning point of 1989/1990 these two platitudes still determine the policy of the West.

This summary statement needs, of course, to be qualified. First the fact should be mentioned that the West clearly feels the political pressure weighing on it, and therefore, when talking about assistance, each country and each organization quote the largest possible amounts deliberately mixing fulfilled promises with unfulfilled ones. This, however, does not in any way change the fundamental statement. Second: it is an easily demonstrable fact that the majority of the Western economists seriously engaged in research on the post-communist economies do not agree with the opinion stated above. J. Sachs, J. Williamson, as well as G. Soros use every possible forum to emphasize that the costs of transition are on the scale of thousands of millions of dollars, and the West must shoulder a substantial part of these costs. They also point out that it is hypocritical as well as economically absurd to advise the post-socialist countries to liberalize their foreign trade, while the West refuses to open its markets to the agricultural products, textiles, steel products, etc. of these countries. A real exception is the German case. The politicians in Bonn knew from the beginning that the costs of unification would run high, and they actually foot the bill.[3] For the other 18 countries, however, Western assistance

[2] Statement by Mr. J. *Attali*, President of the EBRD, at the Opening Session of the First Annual Meeting (13 April 1992, Budapest)

[3] Taking the net value, Bonn will have spent DM300 billion supporting the five Eastern provinces over two and a half years, from July 1 1990 to December 31 1992.

has so far not represented any considerable additional resource. The major part of the assistance that has been offered is simply credit with strict business conditions.

The coordination of the Western assistance programmes is also problematic. A large number of frightful examples could be mentioned to show the amount of waste, damage, and abortive ideas that can arise if an organizational mechanism is burdened with the handicaps of national selfishness and of a clumsy supra-national bureaucracy. The negative examples are of course amusing and not without their own moral, but they do not answer the question: "What is to be done?"

Of the international organizations, the United Nations Economic Commission for Europe was the first to suggest, in spring 1990, that the West should set up a new international cooperation organization for the economic recovery of Eastern Europe and the Soviet Union—at the time still a legal unity. (UN 1990) The idea was not approved then, nor has it been approved since. Most Western governments were of the opinion that the way to promote the spread of the market economy idea was not by adding one more aid-dispensing super-bureaucracy to the already existing ones. That there is *a grain of truth* in this opinion can hardly be denied. The arguments against it are, however, also rather substantial.

At present, the coordination of Western assistance is a function of the Brussels Commission of the European Communities, and the control of macro policies and reform programmes is the responsibility of the International Monetary Fund. It could be clearly seen at the start that such a division of labour would pose problems from two aspects. The first difficulty is caused by the amount of overlapping in the functions of the two organizations. An even greater difficulty is that support of the post-communist transformation is, in the final account, a secondary task for both organizations. Brussels is occupied with the integration process of Western Europe, and the clients of primary importance for the IMF are the developing countries in the traditional sense.

The experience of the last two years provides another, perhaps even more important, argument in the hands of those who think that a Western assistance programme on the scale of the Marshall aid plan should be worked out and adequately coordinated. It is worth quoting the 1991 report of the United Nations Economic Commission for Europe:

"Another advantage of a clear and more coherent framework for organizing Western assistance for the transition process is that it could play an important role *in building confidence* in the various reform and restructuring programmes. In some countries, especially some of the members of the CIS, there is a problem of confidence on the part of the populations who have seen a series of "plans" come to nothing (or very little) and remain very sceptical towards new sets of proposals. In such circumstances, the credibility of a new reform programme could probably be enhanced with the support of a major international group, such as the IMF or the G-7. However, to have a significant effect on expectations, the programme should be seen to have been thoroughly analysed and discussed and the support of the

international community must be publicly known. More broadly, a clearly defined framework could provide a more "general safety net" for the transition process, in which the inevitable mistakes could occur without damaging confidence." (*UN* 1992)

That safety net is, however, still missing. After one or two years' activity, the democratically elected governments are, one after another, running out of whatever vitality they had. Even those that have really accomplished a lot are forced to quit—see the Czechoslovak and the Polish cases. Yet it should be remembered that their successors and the successors of their successors will have to start from ever more difficult positions, and with even less room for manoeuvre.

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ALEC NOVE*

It is hard to generalise about what are "the main barriers" to marketization, as the answer is not everywhere the same. For Russia, much more than for Hungary, a major obstacle is lack of a market culture, among a people who have not known a real market for over seventy years. Also in Russia, to much greater degree than in Hungary or Czecho-Slovakia, the attempt to marketize takes place under conditions of monetary and fiscal chaos and political disintegration. In Hungary and in Poland there was already a sizeable private, market-oriented sector in the last decades of communist rule, contrasting with the situation not only in Russia but also in Czecho-Slovakia. Within the former Soviet Union, it is clear that the Baltic republics were more closely attuned to a market economy than were either Russia or the Ukraine. There were and are also important differences between countries in respect of the attitudes to marketization of the former nomenklatura, and of orinary citizens too.

In Russia and Poland in particular, market reforms are associated with a painful shock therapy, involving a steep decline in output and in real incomes. It

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is surprising in the circumstances that there has not been a political-social explosion. It may yet occur. In Russia effective action is inhibited by lack of political power: many sources speak of paralysis, and a few days ago (May 1992) Shakhrai resigned, complaining that the government is "100 % impotent". How can a market be introduced under hyper-inflation, supply breakdowns and in the absence of a constitution and legal order?

But there are plenty of problems which, in varying degrees, are common to all the ex-communist countries. One is some ambiguity as to aim. To restore capitalism? But of what kind? When I was in Harvard, the "Boston Globe" published an article with the title: "In rejecting Lenin it is not necessary to accept Milton Friedman". (I do not recall the name of its author). The market is indeed essential, but one finds many, in my view too many, whose former faith in Marxism has been replaced by a naive faith in markets as a cure for just about everything. Social services such as health and education, essential transport and other infrastructure, environmental protection, scientific research and much else are the responsibility of public authorities from San Francisco to Stockholm. I was recently on a road in a beautiful part of California; on one side was a regional park with public access, on the other a series of notices stating PRIVATE LAND: TRESPASSERS WILL BE PROSECUTED. Which was the road to serfdom?

But the triumph of laissez-faire raises more directly economic problems. Hungary, Russia, Romania, all the ex-communist countries, have inherited a distorted capital structure. To change it requires large investments in industrial and environmental and infrastructural perestroika. They have also inherited a society in which legitimate private capital is scarce. And while foreign capital can certainly help, it is very unlikely to be forthcoming in sufficient volume to make a decisive difference. The scale of investment need can be seen in the vast sums which West Germany is now devoting to the reconstruction of East Germany. If in the single year 1991 this expenditure amounted to 150 billion marks, i.e. roughly 80 billion dollars for a population of some 16 million, then Russia, with nearly ten times the population, and on a lower level of development, cannot even begin to solve many of its deep problems through the promised level of foreign aid.

What is surely needed is an investment *strategy*, directing or inducing scarce domestic and foreign capital into selected priority sectors. This is what happened in the postwar years in Western Europe, Japan, South Korea. They did not rush into immediate full currency convertibility. The free market is not necessarily the most effective way to get to the free market, to create the preconditions for its existence. Competition is indeed desirable, indeed essential, outside of a few areas of natural monopoly. But the closer one approaches the conditions of perfect competition, the greater are the obstacles to investment: in conditions of equilibrium there is no profit to justify the risk. In the real, and not textbook capitalist world, investments are made in expectation of disequilibrium or of other so-called mar-

ket imperfections: temporary monopoly, collusion with potential competitors and suppliers of complementary inputs, coordination by government, and so on.

Yet for believers in laissez-faire the role of government should be confined to the task of macro economic stabilization, and therefore the very idea of an investment strategy is ideologically unacceptable, reminding them of socialist planning. Of course it is true that "socialist" centralised investments distorted the economy and polluted the environment. But it does not follow that the necessary corrective action will follow automatically. Apart from the earlier-quoted examples of Japan and South Korea, there is also the activity of Treuhand in East Germany. (It is said that Vaclav Klaus regards Treuhand as unacceptably "socialist". If so, then so is the German chancellor!).

The above remarks imply a partial answer to your second question, but also to be considered is the nature, scope and speed of privatization. Again, different countries face different situations. Thus restitution to former owners is not a problem in Russia, it is in the Baltic republics, as well as in Hungary and Czech-Slovakia. There is everywhere a shortage of private capital, and it would surely be most unfortunate if most of it, and bank credits too, went into the purchase of what already exists: how then would new investment be financed? Small scale privatization, and free entry of private enterprise, can and should proceed fast. But two other questions arise. First, what of large state-owned firms? Could not leasing plus commercialization of their operations be a short-term solution?

Second, what of employee buy-outs, an eastern version of the so-called ESOP (Employee stock ownership), which has been making some progress in the United States? It is odd that all ideas of self-management and workers' participation are out of fashion in ex-communist countries, and both Kornai in his recent book and the Russian law on privatization expresses clear opposition to employee control (In Russsia their shares are to be non-voting). Why? Yugoslav experience is not relevant, in that the workers there were NOT co-owners, and naturally sought to maximise income.

Mathematical models abstract from the human factor, or treat employees as a species of robot. Surely, for economic as well as for political-social reasons it is desirable to secure the willing participation of the work force. A loyal and committed worker is more efficient and productive than one who is indifferent and alienated. If Friedman (and Kornai) are to be believed, co-ownership by (say) twenty doctors, or taxi-drivers, plumbers, builders, must be inherently less efficient than if one of them employed the other nineteen. The American car hire firm Avis advertises that it is employee-owned. Must conclude that it is less efficient than Hertz, which is not? Given that many employees in Russia and other ex-communist countries retain a feeling that "their" enterprise is or ought to be theirs', one might achieve a greater degree of social consensus if this form of de-statization were given encouragement, or at the least not be ruled out by law, as it seems to be in Russia just now.

Finally, there is a tendency in many of these countries to a degree of income inequality which must offend many reasonable people. This is not due, or not only due, to envy, or residual egalitarianism. In Russia at least, most of the very rich have not become so through producing anything, and bribery and corruption have reached unprecedented levels. At the same time the "safety net" is full of holes, and medical services have all but collapsed, and death rates are rising. An emergency is more bearable if there is at least an attempt to achieve greater equality of sacrifice. In the last war the King of England had a ration card. Its importance was, of course, purely symbolic, but symbols sometimes matter. Hungary and Czecho-Slovakia are not in so dire a situation—though unemployment may grow—but in Russia over half the population are suffering real hardship. One hopes for government-imposed priorities, as well as necessary efforts to achieve macro-stabilization. But has the Russian government the power to impose such a policy, indeed any policy? Laws and decrees are many, but will they be implemented? There is little sense in recommending policies which cannot be put into effect. Things are very different in Hungary.

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Obstacles to transition

General obstacles

The current process of transition in the former socialist countries requires the replacement of the political, legal and economic conditions of the closed systemic world of the centrally planned economy with the institutional framework of the market economy. This is—as a precondition for the welfare which is desired—an expression of the principle of freedom, which is characteristic of the open society and its legal constitution.

The unavoidable and even necessary consequence of this transition is a far reaching social disintegration. It is combined with a revaluation of all sources of income and with the exposure of all negative economic developments caused by the old system, e.g. hidden unemployment, suppressed inflation, shortage of adequate housing space, and other manifestations of an economy of shortage. During this time of disillusion the old political system might collapse quickly, and the new one can easily gain new structures. However, the construction of a new economic system

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will take a considerable time. A latent demand of the people for so-called "socialist achievements" (e.g. guarantee of employment, state-fixed low prices, cheap housing space, protection of the domestic industry) complicates the task of formulating a strategy for transition as an expression of consequent political action.

Even if the "know how" for the creation of all kinds of institutions of a market system can be taken over "for free", like in the process of the German unification, the institutional arrangements need time to develop the intended welfare-maximizing results; and this depends on the human capital, which makes institutions more effective and which changes the state-economy into a free market economy of competitive enterprises.

The obstacles on the road to the interlacing of all interactions between state sector, private households, private enterprises and all other relevant groups of the society come out in the overlapping of elements of the old and of the emerging new system. This "jungle of different institutions" is unstable and has to face the danger of falling back into the practices of the old system.

Obstacles through "denial coalitions" and "distribution coalitions"

The liberalization of prices and the newly distributed property rights will, in any case, lead to rearrangements of wealth and of the main sources of income in all parts of the society. Certain groups will surely turn out to be the permanent "losers" of transition. This "group of losers" can rapidly become a group of "transition resistants", for example:

— communist party leaders who have lost their privileges,

— employees of ministries and other administrative bodies, formerly responsible for the organization and control of central planning,

— the managerial personnel of the former state-owned enterprises, who lack experience in modern managerial decision-making,

— other groups, which had certain benefits from the socialist system, e.g. the leaders of the unions, teachers of Marxism-Leninism and so on.

These groups try to organize resistance to change in order to secure their sources of income. The least they try to do is to preserve elements of the former socialist system in order to retain their influence during the period of transition for as long as possible. These groups might not be very numerous, but as the leadership of the old system they can be—if they stay in charge—a very important qualitative factor with a far reaching influence on the administrative structures of the state. This factor of resistance to change can be extended, if the old "nomenclatura" succeeds in getting power over those groups which are temporary losers of the transition. These are the people who have to accept lower incomes in the short run due to the urgent process of restructuring the economy, but who have better

opportunities in the long run than they ever had in the old system. These groups consist of:

— unemployed persons, looking for new jobs during the process of demonopolization and privatization,

— unskilled workers and older employees,

— families with many children, students, pensioners and disabled persons, who might get into difficulties during the period of transition through the lack of a social security system.

A very significant obstacle to transition may be caused by a "coalition of distribution", which has direct political power and emerges on the side of the transition losers. The power of these groups can be strengthened by the fact that the people within them suffer from an asymmetric perception of the costs and benefits of transition:

— the "costs" can be calculated directly and individually (e.g. unemployment) and usually the groups react immediately with political action,

— the "benefits" of the new system cannot be calculated directly and individually (e.g. the general rise of welfare), and people quickly feel a decreasing perception of the benefits of transition,

— it is impossible to compare exactly the costs and benefits of the old system and the new one. Such comparisons of real income in the former communist system and in the new market economy usually systematically neglect aspects of quality and availability of goods and services.

Asymmetric perception of the advantages and disadvantages of the transition process and the asymmetric "abilities to organize affliction" encourage a coalition of transition losers, and thus the latter become a severe obstacle to transition. The problem increases due to the fact that in the beginning the establishment of the new economic order has to be done without a social security system. The old order was socialist, but not social. That is the reason why it is very important to build up a social insurance system in accordance with the principles of a free market economy, i.e. a system which is able to reduce the social hardships of those afflicted. Institutions like these can promote the acceptance of the new system and reduce the problems of asymmetric perception.

The political system as an obstacle to transition

Governments, which originate from communist traditions and experience, will hardly succeed in creating the conditions for a market economy, even though they might express their willingness to do so. The reason for this is the fact that the legal and moral basis of a free society is rooted in individual rights and values. It can be expected that governments which represent and stand for collectivist values, will search for indirect and direct opportunities to implement corresponding

organization forms, e.g. the dominance of state-owned firms. They will prefer a regulation of markets which aims at income distribution but in fact brings about a close interlacing between the ruling party, the state and the economy. Those governments that fight for political power will tend to distinguish themselves by adopting populist measures, which lead to a retention of protectionism and subsidies.

Non-communist governments and their supporters in multiparty parliamentary democracies no longer stand in the magnetic field of the old system. Nevertheless, they also have to face the problem that it is much more difficult to create a market system than build up a pluralistic political system. During the implementation of the institutional framework of a market economy, the members of government have to behave in such a way that they can win the next election. This is a well-known pattern of Public Choice Theory. Yet the circumstances of economic policy are extremely difficult, right from the beginning with the first transitional steps, when the effects of price liberalization reveal the bad legacy of socialism. In this situation, the government has to inform the people about the unavoidable negative short-term effects of transformation policy. The success of these measures is by no means assured, even if the economic policy of the government is sustained by a free press.

The alternative "solution", financed by an evasive and inflation-pushing economic policy, increases the social differences, which directly lead to new dirigistic interventions of the state. As we know from experiences in western countries, the political process in democracies tends mainly to prefer expansive measures of fiscal policy. Facing the enormous tasks and financial efforts that every post-communist democratic government has to fulfil, the well known recommendation of Public Choice Theory gains in significance to constrain the endogenous tendencies of a democracy, and this leads to a fiscal policy of "soft financing". Appropriate constitutional arrangements, leading to self-constraint and hard budget rules for economic policy would certainly help the government to resist the pressure of interest groups.

Non-communist, but strong-handed (authoritarian) political systems are sometimes considered to have better chances of success with a consistent and appropriate transition policy. The argument is the following: the concentration of political power permits a strong policy against the selfishness of organized interest groups. Strong-handed regimes do not have to think about the next elections. They can plan and act over a longer period of time. Contrary to this argument stands the fact that the transformation countries have the experience of several decades of dictatorship. Establishing a new strong-handed regime could revitalize the old "nomenclatura", including the army, the secret services and the administrative bureaucracy—all having strong interests in an economy dominated by collectivized enterprises.

Accelerating factors

The transition can be accelerated and advanced in equal proportions in the following areas:

— establishing an overall economic calculation, driven by market prices of producer goods and consumer goods, as a precondition for rational economic behaviour and rational allocation of resources in terms of opportunity costs,

— accumulation of the necessary capital for investments in human and real capital—above all by private owners—as the vital basis for competitive firms,

— international interlacing of the national price system, in such a way that structural adjustments in domestic and foreign trade follow simultaneously,

— focusing on public and private initiatives so that shortages in all parts of the economy act like magnets for foreign investors.

These improvements can only be achieved if prices are liberalized, if a free entrepreneurship is established, and if foreign trade is liberalized.

Acceleration through price liberalization combined with monetary policy

The first consideration must be to adjust the money supply to the real volume of production, avoiding any inflationary or deflationary effect. The question concerning the way in which this can be managed is without doubt one of the most important problems of macroeconomic policy. The issue is this: the adequate market-type solution of the problem of economic calculation begins where we find the existence of prices representing real relative scarcities of the commodities available for exchange.

One strategy could be the free adjustment of prices to the existing volume of money. However, depending on the extent of the monetary overhang, it can happen that price inflation gets out of control, with the consequence that the "coalitions of denial" get strong support. A strategy of controlled inflation (like in Poland) combined with a stability-oriented, hard monetary policy might be socially more acceptable. However, depending on the difference between regulated and free prices, a flight of the supply out of the sectors of shortage could be the result. The success of this strategy is extremely dependent on the political and psychological abilities of politicians in official positions.

The strategy of a radical currency reform has to face strong resistance in the political process of a democracy. Some arguments and experiences (e.g. in post-war Germany) underline that a "cutting" of the monetary overhang in connection with tough monetary and hard privatization policy seems to be the most effective way to reduce income and price insecurities. A stability-oriented monetary policy plays a key role in this context. In a situation in which there are free prices, but often

limited financial and real capital operations, connected with extremely high transaction costs caused by a precarious property rights-structure, a strong anchor of stability is needed for efficient economic calculations and decisions. This condition is a necessity for bringing about an increase in real production, and also, of course, for the decrease of unemployment. During a time of high elasticity of demand combined with a limited elasticity of supply, it can be expected that the adjustment process will show an asymmetric slope. The rise in unemployment will lead to an extension of state activities. Without constitutional self-protection for a tight money-policy the political process, with its immanent tendencies for government job-creation programmes, will cause an early inflation-pushing "fiscal socialism". The necessary adjustments will be shifted into the future, and the achievements of transition would be jeopardized. Inflation enlarges the crisis, because it is quite impossible for the economic agents to develop rational expectations about the future. The short-term "success" of expansive monetary policy turns into the opposite. Inflation has never solved any problem, but always created new ones.

Acceleration through free entrepreneurship

The establishment of free enterprises and the redemption and avoidance of unused production capacities will grow out of the newly emerging small and medium-sized businesses. These enterprises, managed in accordance with the owners' interests, are very flexible. They will attract a lot of workers who are looking for employment and education opportunities. Smaller units can easily adjust to new conditions, and this flexibility will turn out to be a pace-maker for innovation and imitation, and thus for economic and technical progress. These effects, which can be recognized daily in the western countries, recommend an intensive promotion of small-sized firms. This should not implicate expensive, state-bureaucratic programmes. More important is the removal of all discrimination and burdens facing small firms, especially those laws which impede new foundations. In this situation, it is advisable to work with tax privileges which help the accumulation of equity capital. In the early stage the new firms will suffer from a lack of equity capital, and this cannot be compensated by any kind of material security. Combined with undefined property rights, corporate finance turns out to be complicated. Following this argument, it is obvious that instruments for the collateralization of loans gain in significance—e.g. instruments like discount credits, reservation of the right of disposal, the right of lien and so on. Following this, it is clear that the best help for the new small businesses will be the existence of a strong and competent private banking system, which is responsible for the provision of loans. This can only be achieved if private savings increase. Yet this can only be expected if the government succeeds in creating a stable monetary policy.

The chances of the new private enterprises being successful are worsened due to the existence of a variety of larger state-owned firms receiving subsidies from the budget. The competition between the new emerging firms and the old combines is distorted, especially in the case of enormous tax burdens for the new private firms. Following the strategy of acceleration by enforcing new foundations, it is obvious that the state should follow a policy of "hard" privatization. This implicates that firms which cannot be privatized should be closed. In this case, the managers of firms will try to give a positive image of their firms in order to attract investors, especially from abroad. Taking into account that the directors do not participate in the privatization-proceeds, it is to be expected that they will act on behalf of the acquiring company. This stimulates the transformation of the state-owned enterprises into competitive firms.

In the case of "smooth" privatization, responsibility for appropriate activities is given to the managers. In such cases the managers try to follow a survival strategy, together with the employees, to the debit of the state budget. The management and the workers always intend to document the possibility of revitalizing the firm and to struggle for the survival of "their" firm by mobilizing protection and subsidies. Plants can continue to operate despite wasteful investment, low labour productivity, insufficient self-financing and liquidity. If large state-owned enterprises can always expect help from the state, as has been the case up till now, tendencies of both internal and external economic instability are unavoidable.

Generally speaking, in the case of "smooth" privatization, the strategy of preventing a takeover would be dominant, with all its negative implications for the whole transition process. On the road to a free economy one has to take into account strong persistencies and distribution conflicts. In order to attain a competitive plant size structure, with the intention of overcoming monopolistic supply structures, it is necessary to have measures of demonopolization, privatization, takeover and sometimes bankruptcy of state-owned enterprises. The time these proceedings require tends to be much longer than expected, especially considering the fact that no well-functioning markets for assets and no capital market exist. The state-owned enterprises, which had, for decades, certain substantial privileges, will try to keep an important role in the political process. To weaken the inherent forces of persistence and denial, it is necessary and appropriate to mobilize private entrepreneurs by opening the economy to foreign investors. This may help to put pressure on the policy-makers responsible for the privatization.

Acceleration through open foreign trade markets

Direct contact with foreign competition would ameliorate the functions of free prices in their motivational, allocational and distributional dimensions. Further-

more, the opening to foreign trade would take away the power of the bureaucrats involved with the foreign trade organizations of the Central Planned Economy. The international pressure of demand and supply would force the monopolistic state-owned firms to adjust to the new situation, and the former closed economies with a high degree of monopolization would soon have to demonopolize. In short: foreign competition could replace the control of domestic competition. In the first stage of transition foreign competition is limited because of the lack of initiative for starting new enterprises in large quantities.

Free trade also implies confronting the country with the critical judgements of foreign countries, concerning the quality of the constitutional arrangements in the field of property rights, labour markets, enterprises and foreign trade laws. Reservations against foreign investors in order to "protect the domestic industry from foreign infiltration" would be extremely disadvantageous for a successful transformation and integration in the world market, if this retention cannot be justified with arguments concerning the competitive structure of the economy. Reservations against foreign investors discriminate against the most permanent form of capital import, namely the inflow of foreign direct investment. The politicians, who are responsible for the transition process, should improve the conditions for direct investments, also with regard to foreign participation in state-owned enterprises. The strategy of attracting foreign investors seems to be the most efficient one for enabling firms to receive a "kind of competitiveness", derived from foreign enterprises.

Profitable foreign trade relations in combination with an efficient capital allocation—which stimulate the dynamics of transition—need essentially a realistic exchange rate. Realistic rates of exchange are represented by prices of foreign currencies, which are dominated by market forces. The special framework of transition is characterized by an enormous uncertainty about important data of economic activities and by various asymmetries; consequently, the early fixing of exchange rates appears as a "corset" for the economic policy. The argument that fixed exchange rates lead to an import of confidence, is only valid when the exchange rate is the result of market forces. If this condition is not fulfilled, the result would be misallocation of resources, inflation, as well as internal and external capital flight. These effects complicate the task of privatization and they increase the uncertainties and costs of transition, which are big enough anyway.

A fixed, overvalued exchange rate acts as an artificial import subsidy and as an export duty. The competitiveness of domestic industry is weakened, as the first experiences of German unification illustrate. The overvalued exchange rate makes imports cheaper, and this has the effect of reducing incentives for foreign investors to come into the country. This of course, stands in conflict with the task of privatization.

Undervalued exchange rates work just the other way round. They operate like a bonus for exports and an import levy. Artificial pressure to export and a price

increase of imports decrease the supply of goods on domestic markets. The people have to face a smaller ratio of absorbtion. The social acceptance of transformation policy will be weakened. Especially problematic are undervalued exchange rates concerning monetary stability, because the defence of the exchange rate against the market forces can lead to a larger money supply with inflationist consequences. However, if monetary stability is endangered, privatization will be complicated.

The choice between an undervalued and an overvalued exchange rate is a very good example of a dilemma which policy-makers have to face during the transition process. The acceleration of transition can easily turn to deceleration. An overvalued exchange rate can support monetary stability, but it surely impedes privatization. An undervalued exchange rate can support privatization, but it surely impedes monetary stability. This results in a vicious circle.

A flexible exchange rate can prevent the causes of a vicious circle. Flexible exchange rates support the hardening of the currency and they reduce price fluctuations. The transition policy will be both: relieved and promoted.

The integration of the transition economy into the field of international competition can lead to shocks, which are perceived as overcharging. Flexible exchange rates work as a buffer against such shocks, particularly in combination with a moderate tariff protection. It results in a double-protection against foreign competitors with the advantage that it does not conflict with the logic of market-determined prices and the conditions of convertibility. Using tariff protection, the government has the opportunity to offer compromises to certain interest groups, and in this way the government can secure the transition politically too.

Another important argument for the immediate opening of the country to foreign trade is the opportunity to import know-how: unlimited contacts with developed market economies are very helpful in finding ways to solve the actual problems in all spheres of the society. The search for joint venture partners or direct investors is easier. Furthermore, the foreign trade opening has to go hand in hand with more transparency in external relations. This, of course, is very helpful in getting into closer contact with the international finance institutions such as the International Monetary Fund and the World Bank.

Last but not least, the opening up the post-socialist countries permits their citizens to travel to foreign countries. People can see with their own eyes the prosperity and the welfare of an open society. This should increase the acceptance of the temporary hardships of transition and contribute to a general consensus in society.

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The difficulties of transformation

In the wake of the ruins of communism, there are many obstacles to the transformation to a market economy. The difficulties can be summarized in one statement:

The political management of the change will be done—and indeed should be done—by a political structure legitimated by a democratic parliamentary system. However, in the short run the task of transformation is very painful for society. Citizens who elect parliaments do not like to opt for long run interests or, in other words they do not like to vote against their short run interests. To examine and systematize thoroughly the reasons for this is not a simple matter. In the following I shall undertake to highlight only five of the more significant factors.

1. The collapse of communist rule ended a regime which, many decades ago, held promises for many. From 1917, and reinforced from 1945–49, it was a functional system in its own way, and one which, from many perspectives, produced positive results. Yet communism was neither capable, in accordance with the professions of Marx, to bend the world to the power of man nor was it capable of conquering the capitalist countries in the field of economic competition.

In spite of the fact that the application of communism was characterized by a low rate of efficiency, the insufficient exploitation of factors of production and disregard for citizens' efficient demands, it proved to be capable of the following:

— it raised standards of living, albeit at a lower level than that of the European and American standards,

— it ensured full employment, albeit at the cost of hidden unemployment,

— over a large area it created conditions which, from the standpoint of society in general, enabled a fair distribution of goods. Also, despite many undeniable injustices, countries at the level of development of the Central-East European region were able to create some significantly advantageous conditions, even when compared with those prevailing in the free world. Thus the social-political legacy of the dictatorial communist system also sets not a small task before the newly forming legitimate plural democracies.

2. The targeted system of the post-communist transformation—i.e. plural democracy, and within it the market economy—notwithstanding its undeniable successes, is not ideal equipment for a social system. It may be better than all existing ones, but it is still imperfect. It has a few well-known negative features which I shall mention. These are especially apparent in countries at lower and middle levels of development; therefore it is likely that such negative consequences

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could affect the countries in the process of the post-communist transformation. These are as follows:

— it is not capable of ensuring full employment,

— it is not capable of creating equal conditions for the population, and this inequality starts from childhood.

— the successes and failures of the individual and the family are often random, and thus they are not the results of efforts (or the omission of such efforts) recognized by society.

3. The newly forming market economies will be most successful in those societies where there is a developed culture of awareness and technical knowledge. However, the latter point, in many aspects, only demonstrates formal results, and it is in a state of quasi-development. This has the unpleasant consequence that the requirements of the population are not harmonized with the efficiency of the society, but with the assumed high technical level of the economy and with a cultural state of citizens which has not yet been reached.

From this it follows that the citizens, who were already discontent at the time of dictatorship because they were poorer than their neighbours in the market economies (despite similar skills and training), will be faced with the fact, without comprehending the reason for it, that there is no opportunity to fulfil their wants. This is not only because the forces that were in power utilized the factors of production for their own use—for example concentration on the promotion of the military industry—but primarily because the capability of production of the economy was and really is weak.

4. Perhaps the most shocking feature of the unavoidable decline of the standard of living is the emerging crisis of the public services in the post-communist period. The characteristic feature of communist society, as is common knowledge, is that it bolsters the role of the redistribution of the revenues of the national budget. The national budget has two functions: the subsidization of free or low-priced services and the provision of support for select branches of the state. Both principal channels of budgetary expenditure contributed to the income of the population; the system considered these to be guiding steps towards the realization of communist redistribution. The scale of the budgetary redistribution exceeded even the usual rates in those welfare states with the most developed social networks. Under the effect of extensive redistribution the population became accustomed to free or inexpensive goods and services, and overlooked the fact that the societal consequence of this was a particularly poor rate of efficiency in the sustained sectors. It also led to the often severely critized low level of goods and services—yet it was not by chance that the population was forced to suffer the negative consequences.

Following the disintegration of the communist regimes, the newly developing weak regimes (in any event, weaker governments than former ones) are not capable of concentrating on the budgetary revenues necessary for the operation of the system of redistribution which had been functioning for decades. This is impossible

partly because one consequence of the transformation of the economy is that GDP unavoidably decreases; also, the income from tax collection shrinks. The inevitable consequence of the state budget's crisis is the decline or cessation of subsidization of the individual branches of the economy. Furthermore, there is a dramatic decline in the quantity and quality of public services. However, these abrupt changes manifest themselves not only in the inflationary effect but also in the appearance of illegal activities and corruption in the field of public services.

5. Finally, it is also difficult to transform a communist economy into an efficient market economy because, following the collapse of communist rule, an economy dominated by state property is no longer viable. The new system has to face a decline up until the point when new institutions (in first place, private property) have not just been established but have also taken roots. The obstacle to the formation of these institutions that satisfy the requirements of a market economy is that, with its extreme ambitions, socialism either eradicated all institutions of a market economy or weakened them to such an extent that their reconstruction has to begin right from the start. However, private ownership is not capable of making quick progress.

Yet the point is that only the growth of the role of private ownership can lead to the success of a market economy. The effective controlling mechanism which is based on private ownership, however, came about over a period of decades, even centuries in successful market economies. The unparalled task of the rapid creation of this mechanism in the post-communist societies (and the chances of success with this cannot be truly predicted) is whether or not it can be brought about without a persistent decline of economic output.

The difficulties related to this arise from the fact that the domination of private ownership needs to be created by a society in which technical development or the general state of development are on a relatively high level. However, the operation of the institutions of the formerly centrally directed economies became impossible due to the weakening of the state, and in addition, at the beginning of the transformation private ownership played only a marginal role.

Thus the change in ownership in connection with the transformation of the political system may neither be compared to the position of the state of a typical capitalist economy, nor to redirection of ownership following denationalization of state-owned industries in the capitalist welfare states (which is also referred to as privatization). Thus we are encountering new tasks, unknown up to this point in the process of the socially acceptable realization of privatization. This makes it necessary to execute the process rapidly and on a mass scale.

What may also make the change in the system of property rights more difficult is the fact that in the process of the breakdown of the dictatorship there appeared (or there was a strengthening off) so-called "second" norms of behaviour, which exhibited themselves amongst entrepreneurs in the private economy (e.g. avoidance of the payment of tax returns and social security, the receipt of stolen

goods as a method of trade on a wide scale, etc.). This behaviour not only retards the successful functioning of a market economy, but also produces a great deal of antipathy in wide circles of society towards the future middle classes and the truly wealthy people, who are supposed to constitute the foundation of the new order.

What is to be done?

The most important thing to be recognized is that, although the above-mentioned 5 features of post-communist society could also be discovered in other social and historical situations, the collection of tasks, and within this the task of rapid and mass privatization, still creates a unique situation. This means that the value of experiences gained in other parts of the world can only be partially relevant here, and then only after very thorough examination.

1. The solution of transformation is related to privatization. The structure of ownership inherited from the previous regime cannot be managed by the weakened pluralist state. The latter naturally rejects the ideology of central planning. The growth of efficiency cannot be accomplished without property owners who are conscious of their own interests and who are capable of realizing them. The citizens, even if they have opted for a capitalist market economy, do not like privatization. This means that the new government has the task not only of privatizing efficiently but also of convincing people to except privatization.

2. It must be made clear who is to be the new owner, and this means that one serious contradiction must be overcome; namely, that in order to avoid the former regime's system of nationalization and a rapid economic decline following the change in the governmental form, there has to be conscious clarification to show society as a whole for whose benefit how it is being carried out and by whom. This is in spite of the pure ideology of markets, which prefers spontaneity and trusts only in spontaneity. Only the state, with a well-designed management strategy, is capable of liquidating the domination of state ownership at a rapid pace. My thesis supports a well-regulated privatization with many private firms, which can eventually lead to "privatization of privatization". In connection with this, it is necessary to open up the possibilities for the mobilization of domestic private savings and to encourage the influx of foreign capital. Moreover, in the process of privatization it is indisputable that it is necessary to clear the way for ownership controlled by company employees and managers (the so-called "manager buy-out"). The voucher system has to be worked out for citizens and groups of citizens, for municipal governments, foundations, and non-profit organizations etc.

3. Budgetary expenditures must be reduced. It is not only the budget of the state administration and the subsidization of industry that must be reduced, but it is also necessary to effectively limit other areas of subsidization (health, education etc). A tax system is needed which does not lessen entrepreneurial spirit and which

society is able to except voluntarily; yet at the same time it must limit budgetary expenditures.

It is precisely for this reason that municipal, cultural, social security and health institutions must be involved in privatization. This is not only because in this way it is possible to create many new legitimate owners without major resistance by the society, but also because in this way, together with tax preferences offered to public investors, it will be possible to overcome the crisis of public services related to reduced budgetary expenditures.

4. Strong monetary and market building policies must be pursued, which in turn ensure control over inflation and the evolution of competition among business agents. Liberalization, demonopolization, and market and banking regulation can bring about profit-orientated economic growth.

5. Until the point is reached which makes it possible to construct a comprehensive network of social services capable of covering the entire society, some protection must be provided. For the middle classes protection must be provided against individual government measures, and positive help has to be offered to the strata of the newly poor, who will suffer serious losses in the process of the transformation.

Budapest, June 16, 1992.

ÁDÁM TÖRÖK*

Although the question refers to the post-communist societies in general, my answer will cover only the Hungarian case—since it is the only one I know in depth—and even that in only some of its aspects. Without aspiring to completeness, I shall deal with eight points, each treating a particular problem and, where feasible, I shall also put forward a proposal for solution.

1. The government is justly criticized for its wrong selection of economic policy priorities, for slow privatization, and for the maintenance of central influence in several fields. At the same time, it is quite obvious that the government's scope for movement in the field of economic policy is rather limited (in a few instances, of course, this is because the legal framework for enlarging that scope is missing due to the mistakes of the government: for example, their delay in presenting the bill for the budget, and the resulting budget crisis). More important than levelling criticism at the economic policy instruments and targets in general is, in

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my opinion, to point out that economic policy itself is in fact not a first priority for the government.

This is manifest not only in the distribution of the acts passed, and in the strongly "political profile" of the government as it is seen in the mass media, but in the institutional-organizational system of decision-making as well. One peculiarity is that an "economic Cabinet" is working on its own: that is to say, the larger section of the government plays only a limited role in economic decision-making. The other peculiarity: the Prime Minister, whose main interests obviously lie in fields far away from economic policy, is not followed in the government's hierarchy by any clearly outstanding economic policy leader. The Minister of Finance is head of the economic Cabinet, but in his person only one aspect of the economic policy stands out as against the other ones. As it is, the sectoral interests, or the sectors having different weights in the government cannot be integrated, nor is there any guarantee that the head of the economic Cabinet will represent, as a quasi-equal partner of the Prime Minister, economic policy interests, as against, for example, party or domestic policy interests.

2. Government propaganda and the economic press too, like to dwell on the abundant inflow of foreign working capital and, though with less unanimity, on the results of privatization. Facts are not to be contested but, the seemingly favourable image notwithstanding, I think that private capital—especially Hungarian private capital—has not yet gained strong and lasting enough confidence in the country's economic transformation. The population's savings have largely remained immobile, turning only slightly towards privatization or the foundation of private enterprises, and they are not present on the instititutional capital market to a sufficient extent, either.

To win the confidence of private capital and especially of small investors, ambiguous advantages offered but often withdrawn in a few years' time are not suitable. Such indications of economic policy are needed which can prove the government's preference of capital incomes as against other kinds of incomes. Such indication could be the source tax levied on incomes of interest payments, or the abolition of the income tax on the increment of prices of securities (in any case difficult to collect and to check). At present, the overwhelming part of the population's capital stock may be considered quasi-frozen in foreign currency accounts and forint savings deposits. In addition, it is totally immobile in that part of the housing stock which came into existence with a view to saving in the chronically overheated boom of the real estate market; the latter was fed by cheap credits, but the capital is now incapable of flowing out from there, because of the crisis of the housing market.

To encourage investment, a government programme is needed, without, however, the intermittent character of a campaign. It should exempt from taxation the widest possible sphere of capital incomes and beside these, that part of earned incomes which are deposited for a long term (at least three years) with banking

houses. It would further be useful to support savings for pensions and life insurance by granting tax reliefs, to a much higher extent than they are supported now. Finally, substantial tax reliefs should encourage the population's participation in national and local infrastructural investments.

3. To all appearances, the implementation of the above proposals would overburden the budget, which is already in a precarious position. A programme that encourages savings and investments can of course be introduced only if the long due reform of public finances is put into effect. The government should at last treat this as a task of the utmost urgency. A near total consensus has already been reached on the principles of the budget reform. Obviously, however, halfway through the election cycle, the government will carefully weigh every measure that may lower its popularity index, and a comprehensive budget reform would surely do so in the short run. It is not only the prospects (possible income sources) and liabilities (financial burdens that will have to be borne) of the budget that the reform is to newly and precisely regulate, but also their possible tendency in case of a change in the market.

For example, with a lowering of output the tax base is shrinking while demand for subsidies from the budget is rising. This is because, among other things, of rising unemployment. In the case of an upward trend, what may cause difficulty in the system is that the demand for subsidies fall at a slower rate than the growth of the tax base. That is to say, the demands for subsidies disappear from the system at a slower rate than new sources are accumulated for the fulfilment of such demands.

Therefore, a form of budget regulation has to be found which grades the various proposals of concerning the change in the pattern of resources and expenditures. In a system which has a dynamic approach, if—say—recession comes and it is not possible to reduce expenditures, it will not be company or income taxes that are raised, but the tax items of accumulated unproductive assets and of current consumption.

4. Not even the passing of a suitable budget act will bring about a solution if the prevailing system of taxation remains. Its structure is basically wrong, and for several reasons: first, disadvantageous proportions of the various incentives, and second, the high need for control that is "integrated" into the system.

Households ought to be encouraged to increase their incomes and savings as well as their investments, while their expenditures on current consumption should grow more slowly. Taxation would work to that effect if the personal income tax weighed less and turnover tax more in revenues.

Such a change would also reduce the costs of control of the taxation system, turnover tax payments being easier to control than personal income tax returns. The disadvantageous orientation role of the source tax has already been mentioned. The introduction of a kind of property tax is, however, to be considered. Such a measure may not be successful politically, but it may well promote a model of growing richer through investments rather than accumulation of unproductive

property (such as oversize or excessively expensive housing, a car, or a holiday house). In a number of advanced industrial countries (for example, the U.S.), property tax is applied. However, this should not be centrally levied.

With or without a property tax, the important thing is to raise the rate of local taxes as against central (national) ones in the tax burdens of the population. Namely, the population can more directly control local taxes, their levying and their use, and can better express their opinion at elections (at national or parliamentary elections, votes are cast for parties and programmes, while at local government elections for individuals of personal acquaintances). For this purpose, of course, the tax administration ought to be reorganized and considerably decentralized. On the other hand, the stressing of the local elements in the taxation system may well contribute to growing confidence in the system, and to the improvement of tax morale.

5. The reform of the revenue side of the budget may be extended so as to change the existing priorities of the privatization strategy. At present, privatization of the state-owned sector is carried on with a view to the current income that the government can gain from it. On the other hand, state-owned enterprises are, for the most part of low tax- (and dividend-) paying capacity; it is these that are being transformed into privately owned companies, in the hope that a change of owners alone will considerably improve their income generating capacity and, consequently, their tax paying capacity. This is a mere illusion as regards a large number of Hungarian industrial companies, since the change of owners is usually followed by substantial rationalization, and reorganized companies rarely raise good profits in their initial period.

Therefore, the new and large privately owned sector in Hungary ought to be established by creating new capacities rather than by reorganizing old ones. The improvement of the income-producing capacity of the productive sphere ought to rely, beside privatization, on the new private companies: their support should not be a strategic priority of secondary importance. Even apart from this, the government's present treatment of the privatization seems inadequate since, because of the long drawn-out process, the bureaucracy living by it may strike roots and grow into an independent factor of interests. With some of the state-owned property, slowness of the process involves the risk of consuming the property. It may not be an overradical proposal to strongly delimit the scope of the ÁVÜ (State Property Agency) and to considerably reduce its size, parallel with the implementation of a fast and overall privatization programme relying on a large number of professionals.

6. The effects of the lasting crisis of economic growth can clearly be seen today. Prudence is needed, however, in searching for a process that will lead to an emergence from the crisis. Attempts at stirring up the economy by relying on productive sectors, right from the beginning create the risk that the government will select such sectors which hold out prospects for the employed rather than the

investors. In other words, it will select sectors in which fast absorption of labour is expected, with far less prospects of reasonable profits.

In the stirring-up process, the state's role should be confined to launching such investment actions—not sectorally selected—which contribute to development, through private capital, of the national and local infrastructure, and of certain regions. In such cases it is inevitable, of course, that certain regional or professional lobbies will get a role in planning and implementing the actions. The economy may, however, profit more from this than from the earlier strong positions of the energy, agrarian, or metallurgical lobbies.

7. In Hungary, a new industrial policy has still not been formed. The government's efforts should not to be blamed entirely for this state of affairs. In any case their efforts should be directed only at laying down the rules of game for structural development; in other words, they should provide a set of means, but in no way should they devise objectives dealing with specific sectors. It is very important to reveal the foreign economic aspects of industrial policy. Overstressed export incentives are hardly necessary; nevertheless the government should take a stand in the question, indicating to what extent it will tolerate the disturbance of foreign influence on the domestic market, given the existing highly liberal import regime.

In establishing the minimum of a necessary industry and market protecting system, the traps of protectionism should be avoided. This could be the first area of economic decision-making in which the government would rely on a regular and extensive reconciliation of interests. The forum for such reconciliation could have three or five sides: government, producers, consumers, or: government, basic material producers, finished product manufacturers, traders, consumers.

8. The present monetary policy has been widely criticized for being restrictive and it is held by many to be the primary cause of the crisis of growth. Deregulation may, however, entail very serious risks of destabilization in an economy where "soft money" is still flowing to many economic units and, the generally bad social welfare situation notwithstanding, not a small part of household incomes still accrues from work which hardly represents genuine performance. Softening the constraints placed on the earning of incomes may increase the suction effect of demand. This will not enable the supply of capital available to investors to grow, but will either raise consumer goods imports, or elicit another sudden growth of demand on the housing market, at an accelerated rate of inflation.

The slowing down of inflation must continue to be treated as a first priority; however, the proportions of the instruments applied must be changed. The incentive that ought to be given to investment propensity by fiscal means is to be stressed at this point again. At the same time, the role of the rate of exchange policy as an instrument in the fight against inflation must be reconsidered. The policy of real revaluation can be justified as long as the inflow of foreign direct investment is strong, and the pressure on producers to supply is primarily directed towards export markets, due to the limited demand on the domestic market.

Nevertheless, it has to be remembered that for non-competitive sectors real revaluation provides an ever widening umbrella, since the prices of their imported inputs will rise more slowly than the domestic consumer (wholesale) price index. Thus, without competition, they can raise their prices at least to the level of the domestic consumer (wholesale) price index. That is to say, inflationary pressure may start in the non-competitive sectors and this may in the end undermine the entire antiinflationary policy. This problem deserves attention, especially when considering the revival possibilities outlined above: if the non-competitive sector (domestic public transport, telecommunications, ets.) becomes a first priority target of the domestic flow of capital, its import demand may rise faster than the average, while the growth of its supply will not necessarily be concomitant with a specific fall of supply prices following capacity increases.

LÁSZLÓ URBÁN*

1. What do you regard as the main barriers of the transition to a market economy in the post-communist countries?

I wish to begin by stating my opinion that it is the *internal* qualities of each country that determine the obstacles. External conditions are, in the main very favourable both politically and ideologically, since the external impulses that affect these countries are invariably ones that work towards the development of a market economy. Some analysts cite the world economic depression and a general shortage of capital as external difficulties. In my opinion, however, these do not represent the real obstacle.

Turning to the internal factors, it can be seen that significant differences exist between the post-communist countries and these must be stressed. I see the decisive difference lying in the way cultural attitudes have developed through each country's history. First of all, we should mention the susceptibility to *individualism* as forming the basis of a market economy. Its counterpole is the *collectivist* attitude, inasmuch as it puts in the shade the logic of competition. Competition selects by individual performance, and is the predominant organizing principle of economic activities. I do not contend that the ambition of competitive individual performance, and a collectivist attitude that is sensitive to social communities are in antagonistic contradiction. In real life they co-exist in every society, and that includes the countries of this region. I do contend, however, that in the countries in which the political scene is dominated by ethnic and religious ties and conflicts (in some cases

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as bad as civil war), the development of a market economy will encounter extreme difficulties.

In connection with the above a somewhat different factor in the social system of conditions is presented by people's expectations from politics and politicians in coping with their economic difficulties. The greater the conviction that the government or other politicians are responsible for the economic troubles, or that they alone should provide solutions (thus implying the need for political struggle and pressure such as demonstrations and strikes), the less the chance for the development of a working market economy. The more people *try to find individual solutions to the difficulties of making a living*, the better the chances.

The above-mentioned social attitudes are, of course, not independent of the initial economic capacity standards of the countries of this region, since some of them suffer from serious shortages in primary energies and foods. Low standards of *initial economic capacity* may alone render the situation hopeless, and in such a situation the individual initiative that is indispensable for the development of a market economy will surely not appear. Another important factor is the macroeconomic stabilization of the economy, for it is impossible to establish the institutional framework of a well-functioning market economy in a situation fraught with grave shortages, galloping inflation, and an unmanageable foreign trade deficit.

Having mentioned the factors above, the next point that has to be considered is the role of the *institutional framework*. It has to be established through political decisions and with central resources, and its profile and way of functioning needs to be adjusted to the social environment in which it has to operate. A successful importation of the institutions of advanced market economies is not possible.

Had this inquiry covered a narrower field, such as Hungary only, I would have discussed the conditions of the institutional framework. This is because Hungary is practically the only country of the region in which the social and political conditions have brought about an institutional framework worth analysing.

2. What measures and techniques do you suggest to accelerate the transition process?

My opinion is that the social conditions mentioned above cannot, or can only very slowly, be changed through any techniques. Therefore I see the situation of some of the countries in the region as being quite hopeless with regard to the emergence of a competitive market economy. Thus in answering this question, I shall focus on Hungary since there it seems that the conditions for developing a market economy are in place.

I disagree with the implicit assumption of the question—namely, that speed is the most important criterion of a successful transformation. The intensity of the

process, and the degree to which adjustment is made to the new rules of the game seem more important to me. What matters is not how soon the majority of the state-owned enterprises and their property pass into the hands of private owners in the legal sence, but: what kind of corporate governance structure evolves on that level. Also relevant is the selection process the economic actors will adopt, and what progress can be made in restructuring.

"Fast" privatization techniques have shown that they make no change either in the efficiency of control over managers, or in the companies' liquidity position, or in their chances of acquiring capital; thus they are not really steps forward.

In the present Hungarian situation the crucial point for me is whether the government will have enough political patience and determination to cope with the *bankruptcy and liquidation wave*, sort out the economic actors, and by its own means help to accelerate the process. If not—if it yields to political pressure—it will use its resources to save certain companies and to restrain the selection process. Thus, from the start the transformation will lack intensity. The liquidation wave must be allowed to make its sweep because this is a factor of decisive importance for company restructuring, for the restoration of discipline with respect to payments, and for the breaking of the still existing and harmful bargaining position of a few large companies and lobbies. Government action for economic revival which starts out prematurely may prevent the necessary selection, which in turn may prevent the emergence of a market economy based on geniune competition.

It is quite easy to name the fields in which the government can promote the development of its supposed aims with concrete actions (for example, infrastructural construction, or assisting the growth of the number of market actors with credit guarantee funds to help small enterprises to receive credits). Nevertheless, I do not think that the government can best help the economic transformation simply by its own actions. What it must do is create favourable conditions for the economic actors to adjust themselves to the rules of game of a market economy based on competition. The two most important conditions which are in the government's competence may be a *stable system of legal regulations*, and a *stable currency*—these, at least, the government should not deliberately destabilize.

JÓZSEF VERESS*

1. At the risk of simplification, by treating the advanced market economy and the modern mixed economy synonymous, the governments of the former socialist countries in Central Eastern Europe are trying to solve an extraordinarily difficult

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task. Standing on the ruins of a system that has collapsed both socially and economically, they have to develop a strategy which can lead to modern capitalism. The problem is not simple even from a psychological aspect. Namely, it must be made clear to the citizens that the desires linked to a rapid ascent of the economy and society are illusions. Of course, all this has to be presented in such a way that it avoids replacing initial enthusiasm with permanent apathy.

It should be obvious that the first obstacle is a historically inherited economic and social backwardness. The second one is—beyond the declarations—a really positive intention to attain a market economy. The picture immediately grows varied and multicoloured. After the two obstacles, and taking into account the political, moreover warlike realities in the first part of 1992, the Czech and Slovak Republic, Poland, Slovenia and Hungary constitute the group for which other obstacles seem to be less problematic. The future Czech Republic will have even more chances. The general trends of economic policy in the cases of Albania, Bulgaria and Romania are, for the time being, not clear enough. The Baltic republics are making huge efforts at maintaining the viability of their national economies, though the former Soviet internal connections—seen through today's eyes—are proving to be very strong and often hard to replace. The members of the Commonwealth of Independent States (FIS) as well as the other successor states of the Soviet Union are also struggling with serious internal political and economic crises. It is not impossible that the shock-therapy in Russia will result in much graver circumstances than it has in Poland. In the area of former Yugoslavia—with the exception of Slovenia—the situation is practically impossible to survey. The former GDR cannot be, of course, the subject of our analysis.

Setting out from the state of affairs in 1992, it has to be mentioned here, even if this is not correct from the didactical point of view, that within the former European socialist region the growing number of independent countries has had the effect of reducing the importance of the particular countries in the eyes of the developed world. Hence, there is no other way than to become increasingly attractive for the potential investors and those ready to grant financial aid. This, in turn, means that the thinking behind the chosen economic policy has to rely on:

— the general interdependencies of transition, which have only recently begun to crystallize

— the regularities of the market economic system that serves as our model;

— the parameters of the given economic management basis (this means there is no—or at least means not under any conditions—a so-called national way) and

— the economic policy measures of the government, in order to secure attractiveness.

The problems which logically follow from these points can be derived from the misinterpretations and from the "wildings" of the everyday functioning of the newly-introduced political pluralism, freedom and democracy. Namely, the common characteristics of these countries are the following:

— the economies in question are crisis economies;
— the weak inclination for performance-orientation and adaptation;
— political overheating, which is harmful to the operation of the economy.

In a critical situation—in principle—some kind of unity and a high degree of elasticity ought to be an especially high priority. Paradoxically, in this region this is not easy to attain.

If we disregard all these problems, we have to start dealing with the economic realities of a market economy.

First of all, economic and legal frameworks have to be developed which ensure the operation of a real market-price system. Developing such frameworks is rather difficult partly because of the characteristic circumstances mentioned in the foregoing. On the other hand, it is very difficult to determine and agree on the logical order which would most effectively and consistently help implementation of the goal. The core of this sphere of problems is privatization. Without the overwhelming dominance of private ownership, or of ownership which can be directly and unanimously traced back to private ownership, we cannot speak about a market economy. It has to be immediately declared that competition must be a very strong, relevant factor for the actors of the economy—it is at least as important as private ownership itself. In the economies in question competition is far from being an internal, immanent feature of the participants of the economy.

The ideas about privatization are varied. In addition to two quasi-gratuitous solutions (Czech and Slovak Republic, Poland), in Hungary the arsenal of privatization techniques is, fortunately, ever growing; however, with regard to the State Property Agency and the state, bureaucracy has still not been reduced to a minimum. It is very difficult to strike a balance (not at all sure to exist) which can be achieved between the desirable pace of privatization (the fastest possible one) and the greatest possible proportion of genuine and not artificial proprietors.

The redistribution and allocation functions of economic policy are complicated by a specific problem. In the countries in question, besides applying the inherited methods, it is necessary—within the medium of non-improving budgetary positions—to develop a new one too. This should contain at least three elements: the reform of public finances, measures concerning foreign trade and development to be taken in conformity with the market by the government that is now under Parliamentary control, and finally, placing the role of money—from the aspects of economic policy—into a central position.

Finally, in most of the countries concerned an economic policy aimed at stabilization is also needed. This may take various forms, from gradualism through shock-therapy to the so-called 'big-bang'. Obviously, without a satisfactory solution of the innumerable problems, modernization is impossible.

2. Whatever the technique or means to be implemented, these can only be built on an economic policy based on political compromises and on a policy which reflects consensus and also contains a logical order for each of the measures. A no

less important condition is a high degree of tolerance from the population. This is, of course, difficult to interpret from an economic point of view, yet the lack of such tolerance may render unfeasible even the most promising economic policy.

It is very important to face the significant fact that none of the countries will be able to solve their immense problems from their own resources. Thus, it is clear that the advanced world can, individually or collectively upset the chances of realizing a modern mixed economy in Central East Europe. The amount of minimum aid in venture capital—or in any other form—that the governments, banks or enterprises of the advanced countries are ready to grant is, of course, another question, particularly with regard to the attractiveness of this type of assistance from their point of view. A necessary condition for such readiness is the existence of a definite, clear and consistent economic political programme on the part of each Central East European country.

It is necessary to speak separately about the accelerating factors, given the nature of the constrains i.e. the seriousness of the situation, especially considering the problems associated with strict monetary restriction and shock-therapy. Here one has to pay attention to two dangers which are very serious whether taken together or individually:

— the trade-off between the—temporary—success of forced measures and economic recession (in the background of which the very slow change of the obsolete economic structure is a looming burden);

— the extremes of both overdosing or too low doses may be equally harmful: the former, by giving in under the pressure of the population, may turn into its opposite,

— and the latter will certainly be unable to repress inflation.

Behind or rather beside both dangers it is necessary to reckon with one of the classic South American syndromes: stabilization may be successful, but the strength for modernization becomes exhausted.

Paradoxically, the pace of the transformation process can be defined by the economic political mixture of prudence and determination, especially in the following spheres:

— treatment in parallel, and with equal importance, of privatization and competition, the avoidance of artificial solutions, and the unequivocality and stability over time of social and legal frameworks;

— the radical reformation of the state's direct and indirect role—with regard to the budget, and drastic reforms of the public finances and the so-called large distribution systems (with special attention being given to social insurance);

— rapid development of trading relations with the world, but with realistic expectations with regard to the possibilities of the domestic participants of the economy; domestic assertion of international standards;

— special preference for the development of the infrastructure, with the aid of foreign capital and know-how, and linked with the reduction of unemployment;

— for the sake of increasing the job-creating ability of small- and medium-size private undertakings, tax burdens should be lessened, parallel with making taxation open and controllable;

— attention must focus on the macro-level regulation of the quantity of money, through concentration on and/or building up of the intellectual and technical infrastructure;

— making the economic and service structure more versatile and rebuilding it in a portfolio-like manner, with special respect to the various regions of the world market;

— elaboration of a time-table (time schedule) which can be followed up and controlled by public opinion; also, consistent implementation of it in order to win—albeit gradually—public confidence.

HANS-JÜRGEN WAGENER*

Over the last three years a lot has been written on the transformation or the transition from the planned to a market order of the economy. The question concerning which elements and institutions are necessary in order to have a workable market economy can be considered as settled. Important are:

— people who are prepared and willing to act on their own account;

— well defined decentralized property rights with a leading, albeit not exclusive, role for private property;

— a judicial order which guarantees freedom of contract and well defined liability rules (which is the juridical counterpart to well defined property rights);

— a well functioning administration which provides public goods, accounts for externalities, and is financed by a rational tax system;

— a stable system of money and banking;

— a social security system.

Professional economists are less unanimous about the process of transition, the problem of sequencing, the speed of transition, and appropriate policies for liberalization and privatization. On the one hand this may reflect the preoccupation of economics with equilibria and comparative statics rather than with dynamics. On the other hand it may be due to the fact that the process, other than the general objective, is dependent upon the starting conditions—and these differ from country to country.

It has soon become quite clear that the process of transition is neither instantaneous nor is it determined wholly by the desired final state. Certain shock

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"The Legacy of the Past and the Uncertainty about the Future"

therapies seem to be inspired by the idea that a market economy can be negatively defined: abolish all restrictions, regulations, interventions and a well functioning market will be the spontaneous result. This is certainly not the case. Where it works with reasonable success the market economy is a very complex system which has evolved from the interaction of social, economic, and political forces. That is to say, it is the result of deliberate political bargaining and decisions that have structured the framework of economic activity, and it is at the same time the result of the behavioural adaptations of economic actors, and the latter also includes the fine-tuning (or degeneration) of the institutional framework.

A market economy can be characterized as a decentralized decision-making structure which generates by spontaneous interaction processes involving the development and ordering of economic activity. These processes are self-sustained. We know, of course, that it does not work without bumps and crashes; thus the state, along with its constitutional and administrative role, has subsidiary tasks of regulating the interaction and repairing its failures. Having said this, it can be stated that the transformation is about the institutionalization of this decentralized decision-making structure and the task of getting it past a point of take-off or a point of no return in order to start the self-sustained process of development of welfare production and further institutional selection at the same time.

There are two major sources of barriers to this transition and to the take-off: the legacy of the past and the uncertainty about the future. Once it is recognized that transformation is path-dependent—and this implies two things, first that it heavily depends upon the starting conditions and secondly that decisions now taken reduce the choice set in future times and hence bar possible efficient solutions—the identification of the legacy of the past and the uncertainty of the future as barriers to efficient and rapid transformation is more or less tautological, but this does not make it less real. As to the former, all which does not conform with or is not adapted to the market order and which cannot be changed by the stroke of a pen has to be enumerated here. Important structural and behavioural peculiarities of the old system are:

— The product and capital structure of the economy, which was characterized by its specific mode of central administration and its (lack of) evaluation criteria or implicit prices. Under the regime of the market-price mechanism a sizeable share of productive assets would be partially or totally devalued and taken out of operation by rational decentralized decision makers. From a political and social point of view it cannot carried out instantaneously because of the accompanying high levels of unemployment. This problem on the one hand impedes privatization and on the other hand calls in the state to protect the old structures in the new environment or to administer an orderly process of structural change.

— The lack of an entrepreneurial "class". (Private) individual initiative was institutionally and morally sanctioned under the communist system as a disturbing anti-social activity. Yet the resilience of the market system relies heavily upon it.

If Keynes was right when he said that "animal spirits" are at work, we need not worry. For if this is true a reasonably well functioning market for ownership titles and for managerial abilities would bring rather soon the right men and women to the nodes of the decentralized decision-making structure. If we nevertheless do worry, it is because we think that, next to animal spirits, culture, values, and techniques play an important role in the emergence of an entrepreneurial "class". For instance, one of the basic entrepreneurial techniques, accounting, was only of secondary importance under the old system, but is indispensable *Herrschaftswissen* under the new.

— The lack of a civil society. By that we mean above all the lack of an objective set of rules to which all citizens including the rulers are subjected and of a reasonably predictable interpretation and application of these rules. Despite the existence of arbitration courts under the old system, important conflicts, also in the business sphere, were arbitrated within the party, and this implied *partijnost'* and a lot of voluntarism. It is the administrative and personal infrastructure of civil society rather than appropriate norms which are lacking right now. The market process, relying upon freedom of contract and well defined liability, cannot do without it. The Weberian ideal-type of *Beamte* impersonates the state of such a civil society, guaranteeing impartiality and reducing administrative uncertainty to a minimum.

— Capital shortage and the lack of financial markets. The necessary process of restructuring needs an awful lot of capital. This capital could be accumulated by way of forced centralized saving and distributed by state agencies. It is generally held that such a solution would be a waste of time and money. The alternative is the formation and distribution of capital via the market, i.e. by decentralized forced saving and an independent banking system—the Schumpeterian solution. It looks as if financial markets are needed prior to the transition to goods markets. Financial markets, however, are the result of a very complex evolution in which well defined property rights, liability, credibility, expectations and a reasonably stable monetary and fiscal policy play a major role. This boils down to the conclusion that a well functioning market system is a precondition for the transition to a market system. The solution of the conundrum is time. And a major barrier to transition in this case is the desired speed of the process. We are reminded here of the argument for Stalin's transformation policy 1928–30: it was the desired speed of industrialization which made Stalin "necessary".

— The lack of competition and the lack of competitiveness. The first is due to the high degree of concentration of the firm structure and the complete abolition of medium and small-sized businesses on which the flexibility and innovative powers of a market economy are based. I do not think that a high degree of monopoly is really an immediate barrier to transformation. It may later impede further development and accordingly be dealt with. However, for the moment free trade can supply some competitive pressure. This possibility, however, is constrained by the

low competitiveness of the East European economies. Therefore some protection is necessary for domestic industries. Apart from that it also makes necessary a severe austerity policy which depresses real incomes in order to be able to pay for urgently needed imports and to service the debts inherited from the past. This does not enhance popular support for the new market system.

In sum, we can conclude that the legacy of the past in Eastern Europe is a system, a structure, and a concomitant economic performance which does not lend itself to a smooth transition to a market economy. Compare with it the starting conditions in West Germany after the war or in Spain after the fall of the Franco-regime and the differences become quite apparent.

A crucial element of the market system comprises the people who are prepared and willing to act on their own. This presupposes confidence in the future and as little market and institutional uncertainty as possible. If people do not trust in the success of the transformation operation or if they are uncertain about the future regulative framework for profit making, they will refrain from long-term engagements and try to make a quick profit by speculating.

Confidence is a rather irrational element in the economic system. Once it exists, it will have strong self-enforcing and self-fulfilling effects. Schumpeterian entrepreneurs live on it. A country in whose success the business community trusts will also attract foreign capital engagements, thus improving the chances of this very success. The problem, of course, is how can confidence be created or how can the inborn caution and scepticism of investors be overcome. An unambiguous answer to this question was already a lacuna in business cycle theory, where the lower turning point should have been explained. It will be even more difficult to find a satisfactory answer in the context of developmental take-off after the complete collapse of an old economic order.

If we look at the post-war success stories in Western Europe and East Asia, we see that there was everywhere a national exertion and effort towards reconstruction, industrialization, and growth in general. This effort was supported by government policies:

— different forms of global, macro-economic, indicative planning as in The Netherlands and France—and this type of planning should be discerned from the rather unsuccessful structural policies during the 70's, which are now often quoted disapprovingly;

— industrialization and recovery drives like the Austrian energy programme and West German reconstruction or the Japanese administrative guidance of industry;

— even a confidence-inspiring personality like Ludwig Erhard could not dispense with appropriate tax and exchange rate policies.

Success was greatest where national consensus included the working class, as in Scandinavia, The Netherlands, Germany, Austria and Japan. For it made the

necessary austerity acceptable over quite an extended period, at least till the first half of the 1960's.

Market and institutional certainty sounds almost like a contradiction in terms when structural and institutional change is the main objective of the transformation process in the economic as well as in the political system. The natural uncertainty of the future, together with the path-dependency of the transformation process, means that decisions will have to be adapted to future situations and hence they will be more efficient the later they are taken. This creates a dilemma between the desired degrees of stability and flexibility. Shock therapies tend to fix institutional structures at a very early point in time while gradual approaches are more open for adaptations to later situations. The solution to this second conundrum could be confidence: the objective uncertainty of the future cannot be reduced, the subjective uncertainty about the future can. What is needed is a stable socio-economic framework which leaves room for institutional adaptations.

If we look once more at the countries just mentioned, it becomes evident that political stability and hence long-term credibility of policy measures was one of the outstanding features of their post-war economic history. The evidence suggests that it is the stable state, and not the minimal state, which creates favourable conditions for the development of a self-sustained market process. A stable state is the result of a national consensus about objectives and instruments of economic and social policy. The minimum requirement is clear and lasting political majorities, and they were to be found in the quoted cases. We might point to a third transformation dilemma here which, although it resembles the second, should be distinguished: the dilemma between stability creating unanimity and flexibility creating pluralism. Consensus supported by indoctrination and the Gulag certainly can be ruled out, as well as those forms of pluralism which break up the coherence of society and the state. Some tentative and historical solutions to this conundrum were already hinted at: an open society which is integrated by a certain national identity drive, social fairness, and commonly shared confidence in the solvability of economic problems.

Stability of laws, rules, and regulations in a process of transformation calls for a kind of shock therapy, or a more or less sudden and integral switch of order which then remains untouched in its essence. It is doubtful whether such a constitutional switch can be realized in all the countries of Eastern Europe. First, it would be necessary for the objectives, laws, and rules to be known and specified right from the beginning of the transformation. They would need to be worked out, disputed, and bargained over in the course of this process. Secondly, differentiation of political opinions, missed for such a long time, cannot be expected to result immediately in the great and stable coalitions necessary for establishing a stable state. There may, on the contrary, be a danger of populism, which in most cases leads to a high degree of uncertainty.

It is not so difficult to identify barriers to the transition from plan to market in Eastern Europe; however, it is not so easy to suggest measures which could accelerate this process. I have already hinted at the problem of whether acceleration in itself is to be wished for. If the desired speed determines the instruments and policies, and if the chosen path is irreversible, at least in the short and medium run (as it was the case with Stalins's 1928–30 second revolution) a slower transition may sometimes be preferable. Yet what most people imply by acceleration is a rapid overcoming of the transformation crisis and catching up with Western welfare standards. It is by no means impossible that this objective is partly served while the transition from plan to market is still going in. Systemic change and growth are considered to be interrelated, but they are not perfectly parallel developments. It is certainly not true that the first has to be completed before the second can get under way. It is of primary importance that stagnation of both processes is avoided. This in any case makes it necessary that economic growth gets started again in Eastern Europe.

Given what has been said about the political economy of transformation, dependency on initial conditions, and irreversibilities, a rather consequential measure would be to get foreign consultants out of the country. Foreign advisors, certainly if their credentials include successful monetary stabilization policies—for example, in Bolivia or somewhere else in that area—create the impression of a quasi-objective transition strategy which does not in reality exist. They also appear to be impartial and independent of national political interests, but this is not what is needed. The transition from plan to market is not a transition from the objective laws of socialism to the objective laws of capitalism and a switch of elites who are able to interpret them. It should be a transition from totalitarian centralized decision-making (with accompanying chaotic adaptations) to democratic decentralized decision and policy-making. In this process there can indeed be situations—the so-called prisoners' dilemma or locked-in situations—where a "benevolent dictator" would be needed for efficient solutions. I doubt very much, however, that such efficient solutions can be identified and successfully imposed by external agents (independent advisors or IMF officials) in the present case. Although it has to be mentioned that elements of the post-war economic order in Germany and Japan were successfully imposed by the United States. The necessary support needed in the form of an internal political consensus was perhaps less of a problem after total defeat, and it was backed by a stable state.

Let me add that I would ascribe a similarly marginal, although not totally unimportant role to foreign credits—in contrast to foreign venture capital, which together with foreign entrepreneurship can be an expression and reinforcement of confidence. Given the enormous capital needs for structural reforms, foreign credits can cover only a very small share. This was also the case with the often quoted Marshall-Plan aid at a time when the capital needs perhaps were much smaller. The problem which was solved by the Marshall-Plan was the dollar gap or the lack

of international liquidity of Western Europe after the war. This is not exactly the problem of Eastern Europe today. If the West really wants to support the process of transformation in Eastern Europe, and indeed it can do so, it ought to open its markets to those products which the East is able to supply.

The main thrust of transformation lies with internal national policies, internal accumulation, and with time. In order to bridge the time and to get decentralized activity at work, stability seems to be a prime requirement:

— political stability,
— stability of rules and regulations,
— monetary stability,
— stability of expectations.

Stabilization policy is conventional wisdom. We would like to understand it here in a very broad sense—and this may not be what the people in Eastern Europe initially hoped for when they came out for democracy and freedom. For let me remark as an aside: the 50's and early 60's which produced this stability, together with growth in Western Europe, were quite dull and uninspiring, and finally resulted in the upheaval of 1968.

Stabilization cannot do the whole job. In order to avoid stagnation, and the danger which always looms behind stabilization, some more measures are needed. First, the initial transformation crisis or downturn of economic activity has to be reverted. Secondly, a spirit of reconstruction and growth has to be created and sustained. The role of the state in both is not conventional wisdom, although the role of the state in the post-war success stories is all-apparent, as we have already mentioned. Possible measures are:

— credit- and tax policies which favour accumulation and investment,
— exchange rate policies which stimulate foreign demand,
— incomes policies which avoid wage hikes and support international competitiveness,
— some "new deal" projects which signal national commitment,
— social policies which signal fairness, although they cannot totally nullify the hardships of transition.

All this will be conducive to growth and not directly for the transition from plan to market. Given the firm intention to instal a social market economy in the countries of Eastern Europe, and given the necessary initial constitutional decisions, including the decentralization of economic decision-making (corporatizing state firms before they can be privatized for instance), it is success with economic growth will stabilize and speed up systemic transformation.

It should be clear by now that the policy options of shock treatment versus gradualism ought not to be interpreted in a dichotomous way, thus leaving aside the practical impossibility of instantaneously effective policies. Stabilization calls for shock treatment in the monetary and fiscal sphere as well as in the constitutional sphere. Inflationary uncertainty and uncertainty about property rights,

for instance, do not stimulate long-term investment engagements. Political and economic transformation, on the other hand, is a learning process and a searching process which takes time. Gradual adaptations to changing situations will certainly improve efficiency. Negative examples are more easily understood than positive: the institutional (and personal) fixation of the Soviet political and economic order after Stalin's shock treatment in 1928–30, to quote it once more, resulted in long-term inflexibility and inefficiency.

Within the European Community we can observe a strong convergence of the economic order. From this one may infer that the "European economic order" could be obtained most rapidly by the association and ultimate integration of the East European countries in the European Community, always assuming that it is not the very economic order which is the stumbling stone for integration. Indeed, we do not think this to be the case. Rather the huge structural problems inherited from the past make the EC hesitant to accept the countries of Eastern Europe immediately as new members. Also, seen from this angle, the legacy of the past is a major impediment for the transition to a market economy. Anything which can reduce these structural problems will further integration and implicitly transformation. Again, it is growth which is needed most to achieve this objective.

JAN WINIECKI*

Main barriers

There are in my opinion four different *types* of barriers (problems, obstacles) to the successful transition of post Soviet type economies (post-STEs for short). They are the knowledge barrier, the institutional barrier, the structural barrier and the mental barrier. I will deal with them in that order.

The *knowledge* barrier is associated with the unprecedented situation of having to bring about transition to a market economy. As a result, the received economic theory devised in capitalist market economies is not always directly applicable. I have expressed myself on the subject several times both in scholarly articles and in the press (including a Hungarian article)[1] and will shortly stress again the main theoretical weaknesses that are adversely affecting the transition.

A major distrubance with respect to the stabilisation programmes that are being applied in post-STEs has been generated by a direct transplanation of standardised stabilisation programmes recommended by the IMF. Devised for economies

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[1] See, for example *Winiecki* (1992a) as well as two press articles (Winiecki 1992b and 1992c).

with an overwhelmingly dominant private sector, they did not take into account the structure of property rights in the economies in question. Where both banks and industrial enterprises are state-owned their behavioural traits are different. Consequently, the former did not care about the creditworthiness of their clients and the riskiness of financed projects; the latter, especially the larger ones, accustomed to "soft" budget constraint, did not care about the level of interest rates.

It is here that more innovative blending of the received theory of macroeconomic stabilisation with what we know about STEs would bring better results. For example, we know that it is the largest enterprises that have historically been the least efficient ones and simultaneously have been the recipients of the largest financial aid from the state. Consequently, we could try to devise a credit rationing scheme that would supplement traditional monetary instruments, and would limit access of these wasteful mastodonds to scarce credit.

There have been other intellectual slip-ups, some affecting the outcomes of pursued policies, other generating policies that may have resulted in failures. In the former I would include first of all another feature of the stabilisation 'package', namely fixed (or pegged) exchange rates. Students of economic development and transitions from inward to outward orientation, (which are usually accompanied by stabilisations), have noted that the shift to stable low inflation lasts a few years at least.

In the meantime exchange rates should support the shift to export orientation; the use of exchange rates as an antiinflationary weapon usually adversely affects the reallocation of resources toward exports. This has been happening in East-Central Europe, alleviated to some extent by discretionary devaluations, but nevertheless undermining in turn the time horizon of foreign trade transactions. (Winiecki 1992a)

Another type of intellectual errors, due to the misunderstood legacy of the STE regimes, is the generating of political pressures for reflation. Steep output fall at the start of the transition (not foreseen in stabilisations taking place in market economies), results in assessments that claim there is a deficiency of effective demand, and Keynesian-type reflation is posited as the answer.

However, this fall is largely—although not completely—the one-off adjustment to a more efficient economic system by both producers and consumers. In STEs the level of input inventories was equal to 60–90% of actual GDP, while in the West it is about 30–40%. Obviously, with budget constraint becoming harder and credit less accessible, enterprises started adjusting downward both their input and capital demand. The result has been a steep initial fall in orders and, subsequently, of output. (Winiecki 1991a; 1991b) This kind of output fall cannot be remedied by increasing aggregate demand, for neither enterprises nor households will return to more wasteful behaviour (without the return to the STE regime, of course!).

These were major examples. Other cases of the knowledge barrier may also be expected to emerge within the framework of the transition process.

The *institutional* barrier is of a different sort from the first barrier analysed here. The painful lack of market institutions is clearly on the minds of social reformers and they face two different issues of importance. The first is the implementation of a range of institution-building measures than can be undertaken rapidly. Even in the short-run a post-STE needs to get at least some of these institutions (and not only prices) right in order to get things moving according to market rules of the game.

The problem is: which institutions should be tackled first? From the 1989–1992 experience of post-STEs in transition, it has transpired that two institutional measures of primary importance were not sufficiently appreciated at the start. The first is the reform of the tax system.

Since the old tax system depended so much on quasi-corporate income tax (tax on profits of state enterprises), there was a clear necessity to adjust the tax system to the prospective fall in profitability of that state enterprise sector (and to the shrinkage of the sector). A diversification of tax revenues was also important, for with this a sudden fall of revenues would not make such a dent in the volume of revenue and would not force expenditures to be reduced to such an extent. The difference between having and not having a more adapted and diversified tax system may clearly be seen in the developments in Hungary, where some changes were already made in 1988, and Poland, where they were not. The impact of the drying up of revenues from state enterprises has been clearly much stronger in the latter case.

Another problem indicates that the reform of the banking system is need right at the start, and the pile of bad debt incurred by state enterprises has to be anticipated at the start of the transition—and later on. This problem is linked to the ownership structure issue, stressed with respect to monetary policy under state ownership. Procedures have to be elaborated to begin the financial restructuring of both state banks and state industrial enterprises, for without such measures privatisation of either cannot proceed quickly (if at all). I have already signalled this issue some time ago. (*Beksiak, Grzelonska, Tybczynski and Winiecki* 1991; Winiecki 1992a)

The second issue of importance is the role of the time factor. There is clearly a difference between sowing, i.e. building minimally efficient institutions of one sort or another, and harvesting—that is, bringing about a rise in the efficiency of performance of the economy. For no matter how strenuous the effort of social reformers, there is a certain 'critical mass' of market institutions that must be in place and function with minimal efficiency in order that the economy can enjoy a visibly better performance. (Winiecki 1992d)

This is a well nigh insurmountable political barrier. With costs of transition appearing right from the start and better aggregate performance needing time, the government managing the transition has to survive the period of mounting costs without feeling the benefit of commensurate results. Since nothing can be done

about that (even faultless institution-building efforts cannot overcome the timefactor presented here!), remedies against disillusionment should be sought elsewhere (see the last section).

The *structural* barrier is usually perceived in terms of the larger average size of the firm in post-STEs. The distorted structures are, however, much more varied and their impact on transition is accordingly larger (and more painful).

Only very recently has the oversized industrial sector of post-STEs (in terms of its share of GDP and employment) been recognized as a serious barrier. Its being larger than in market economies that are at a comparable level of economic development, the inevitable structural change affects a larger percentage of labour and capital than elsewhere. Accordingly, the costs of such change are going to be greater.

On top of the oversized industrial sector, come more often stressed oversized firms because—again for system-specific reasons—firms are on the average larger than their counterparts in market economies. It means making even larger employment shifts under the transition to a market economy.

In addition to the foregoing the occupational structure in STEs also deviated from the pattern registered in the West, for it displayed a distinctly higher manual/non-manual workers' ratio in industry. This ratio, a consequence of a system that generated particularly strong excess demand for manual labour, had a strong impact on relative wages. Not only were wages in industry higher than elsewhere but also the wages of manual workers were relatively (as compared with the West) or absolutely higher than those of non-manual workers.

The impact of the structural barrier on the transition of post-STEs can be summarized as follows: more workers were employed in industry, and a much larger proportion of those who were employed in large firms were, on top of that, relatively better paid than their white collar colleagues—and even superiors. The structural distortions in question promise to be an extremely tough nut to crack. For it means larger employment shifts in the face of greater resistance due to the political strength of large workers' collectives which, in turn, have (or had) more favourable relative wages to defend.[2]

The *mental* barrier will most probably be the longest lasting barrier of all and it may linger on even when all other barriers have already been overcome. Knowledge may be absorbed fairly easily, institutions will emerge over time, and as the years go by even structures may be dismantled and new ones erected—but mental habits generated by the Soviet system will not disappear quickly.

Three major mental problems with which post-communist societies are forced to cope concern work ethics, expectations under systemic change and the need for self-reliance. Nearly half a century of communism (in the former USSR, a quarter

[2] On structural characteristics of STEs, see a collection of articles (*Winiecki and Winiecki* 1992).

of a century more) had a corrosive influence on work ethics and human initiative. Moreover, near total isolation from the advanced societies created very distorted images of the capitalist market system.

Employees got accustomed to indifferent if not actually negligent attitudes to work and to a lack of wage differentials for good or bad work. As decades passed by, indifference, negligence and undemanding work pace came to be seen almost as a right of employees in STE enterprises. This attitude is difficult to eradicate within the short-to-medium term.

The fear of decent work shows through on many occasions when privatisation or foreign investment is resisted, even if for those who are really needed in the enterprise it means significantly higher wages. Also, many public opinion surveys reveal a telling split attitude where general support for privatisation is much stronger than for privatisation of one's own firm (a phenomenon also revealed in Hungary).

Expectations of the work force, and the population at large, have not only been high in terms of higher living standards—and fast rising ones at that—but have also been rooted in corroded work ethics. It has meant that disillusionment has set in fairly soon because not only have expectations of a rapid rise in living standards not been fulfilled but also hopes for 'capitalist wages for socialist work' have almost inevitably been disappointed. But in the meantime exaggerated expectations will cause many a tension in the privatised or foreign-owned sector of post-STEs.

The last of the major mental barriers is that of overcoming the fear of something almost unknown in the communist regime (in fact, it was banned): namely entrepreneurship, initiative, or otherwise taking one's own life in one's own hands. No matter what the communist propaganda said, passive waiting for orders from above was a rewarded virtue under the previous regimes. In a system in which there were no rules of the game (*Szymanderski and Winiecki* 1989; Winiecki 1991d) any decision, no matter how small, was a danger to its maker. Therefore, decisions were to be avoided at any cost.

The resultant passivity appeared as a strong disadvantage once transition began. It is manifested in many ways. Non-adjustment at the state enterprise level, doing nothing and waiting for economic policy to change course or cutting employment and output rather than looking for new products, markets and channels of distribution are strongly present in the behaviour of management and workers of state enterprises. Less visible but probably even more often present is the fear of leaving a 'socialist' enterprise and 'going private'.

This fear is stronger, the longer one has been subjected to the debilitating passivity of the old regime. Yet even if they 'go private' they shun entrepreneurship. Therefore it is much more common to find in private firms a young boss and older employees rather than the other way round. A lot of time has to pass to change

that; it may even be that the generations diseased with passivity by communism turn out to be to a large extent incurable.

Remedies:

The "remedies" part of my contribution is much shorter than the analysis of barriers to transition. This should not be construed as indicating that there are no remedies. There are *some*. But a no less important reason is that a proper posing of a problem by itself suggest remedies.

Thus, if I submit that intellectual errors were made in devising (not only implementing) the strategy of transition, then I at the same time offer a remedy: a better use of knowledge. If I stressed many times that an unintended effect of stringent monetary policy under a drastically different structure of ownership would be the crowding out of smaller and better-performing state enterprises, there is an implicit remedy suggested here. Credit limits should be established that would reduce access of wasteful state-owned giants to commercial credit. This is, in fact, what I suggested in early Spring 1991.[3]

The knowledge barrier is, quite obviously, the easiest barrier to remedy (theoretically at least, since people tend to cling to their views, however erroneous, quite tenaciously). The same cannot be said about the institutional barrier. Although major omissions in most transition programmes can to a certain extent be remedied (changes in the tax system and the restructuring of the banking sector), some others cannot.

I have in mind, first of all, a different speed for carrying out institution-building and improving the performance of the economy. The disillusionment and 'reform fatigue'—known from non-post-STEs that stabilised and liberalised earlier—cannot be remedied directly. However, it is here that various policies, not only economic ones, may help *indirectly*.

Properly designed unemployment compensation schemes, taking into account both incentives to work and the family status of the unemployed, are one such policy measure. It may alleviate the consequences of the fact that the shift to a more efficient system entails general welfare gains but simultaneously individual welfare losses.

In theoretical terms policy-makers and their advisers should stop treating the economy in a neo-classical manner. They should accept the fact that behind each aggregate allocational shift there are *people*. They are both gainers and losers; and losers, as Douglas North rightly stresses, tend to resist changes that affect them adversely. This is the reality. Therefore a sensible transition strategy should try

[3] See my paper, prepared for the Political Advisory Committee of the President of Poland.

to *minimise the resistance* of losers. Otherwise, they may slow down or even abort the transition.

Unemployment compensation schemes are one example. Retraining-oriented employment policies are another. After all, as an analysis of the structural barrier suggests, the extent of employment shifts will be much larger in post-STEs than in other countries that earlier underwent structural change. The percentage of industrial labour that will be forced to change both workplace and occupation is expected to be very high.

Social policies should also be drafted into the service of overcoming the resistance to the transition process. Introduction of schemes supporting low-income families with dependent children (especially those with single parents) should become a part of social assistance systems, since it is these families rather than those of pensioners that are at the bottom of the income distribution ladder.

The broad capability to arrange local development schemes in areas affected by closures of the only large employer in the area could also become a part of the effort to overcome the resistance to change. Schemes should focus on encouraging entrepreneurship and the expansion of the private sector as the fastest (and healthiest!) way to reduce unemployment.

One caveat is in order here. All this should by no means amount to an 'overall development strategy', 'industrial policy' or any other all-encompassing scheme. Since post-STEs are only beginning to discover their competitive advantages, their emergence is better left to the market in order to avoid new distortions. Retraining schemes or regional schemes are in the nature of 'rapid deployment forces' that quel local disturbances rather than large armies that march according to the plan elaborated by the general staff...

A broad set of measures should be aiming at overcoming the resistance of losers by making the landing in the new system softer than it otherwise would be. Effects would be reinforced by the fact that certain measures accord with what is vaguely perceived by the general public as just. This is, however, only one set of recommendations that should be in high demand here. Another should concern measures (both of policy design and policy implementation-type) that *increase the probability of success* of the transition itself.

The present writer does not have in mind specific policy areas or instruments. Rather, it is a sensible design and/or implementation of already existing policies that matters here. Two examples are illustrative of what this author has in mind. First, in no country has there been the case of a bankruptcy of a large state enterprise. Yet both empirical research and conventional wisdom point at large state enterprises as the least efficient ones.

As time goes by, the credibility of governments that are afraid to allow a wasteful giant to go bust begins to decrease. The consecutive statements on the intention to pursue tight monetary or fiscal policy will be received with decreasing seriousness. In consequence, state enterprises may be tempted to continue their

reckless wage increases and borrowing policies. If a sufficiently large number do that, the efficacy of macroeconomic policies is weakened and problems of the state enterprise sector multiply.

Another example is from Poland, where the central bank was pursuing interest rate policies *vis-à-vis* commercial banks that contradicted stated macroeconomic goals pursued (presumably) through macroeconomic policy measures. The term structure of interest rates was such that the longer the period for which money was deposited, the higher (and sharply higher at that) was the interest rate offered. Thus, while the Polish government continued to proclaim under Deputy Prime Minister Balcerowicz the steadiness of its anti-inflationary policy, the central bank was signaling the opposite, i.e. it expected inflation in the medium run (6–24 months) to increase.

Overall, governments of economies in transition have devoted too little attention to the *credibility* factor.[4] It is the belief of the present writer that the whole credibility issue was largely misconstrued by the architects of transition in the respective post-STEs. They seem to have mixed up broad political support for the direction of change and personalities involved with the credibility of particular transition related policies.

To give an example, Mr. Mazowiecki enjoyed extremely high regard in all public opinion surveys (approval ratings were around 90% in the first half and 70–80% in the second half of 1990). Yet he got—to the surprise of many—only 17% of the vote. He, also, I am afraid, mixed up popularity with credibility. Governments may be popular but if their polices are not seen as credible, the probability of success is not going to be very high.

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AN OPTIMISTIC REASONING ON INFLATION

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Accelerating inflation in recent years has caused suffering for many and has distorted the structure of the economy. It seems that it is neither worth-while, nor possible to completely eliminate inflation. Even otherwise highly desirable factors, like export surplus, inflow of foreign capital, eliminating former covert inflation, boost inflation. Of course, inflation has to be curbed but an anti-inflationary policy is only worth considering if it can be maintained. It follows from the nature of inflation in Hungary that classical means of demand restriction alone cannot reach even the desirable stabilizing effect, nor break the path for later growth. An anti-inflationary policy will be successful only, if by creating institutions and building up markets, it clears the way for its own assertion and offers rational alternatives for economic agents, whether companies or households.

On the preliminary assumptions[1]

Anyone may say that a reasoning on inflation can only be optimistic, since sooner or later any inflation stops or, at least, diminishes. The period of cheap money and expensive bread is usually ended by making the money dearer and then the bread, too.

The point of our discussion will be that the dangerously accelerating inflation which reached the Hungarian economy more than three years ago, can be overcome more easily and rapidly, and with less sacrifice, provided that, in addition to the restrictive, negative means of the classical stabilizing economic policy (i.e. not after but parallel with them) the positive tools of market reform and the building up of the market are also deployed.

Following from our selective approach to the subject it would be superfluous to enumerate the economic arguments which can be raised against the fashion of shock-therapies. However, two of their characteristics, though they are not entirely economic ones, are worth mentioning. One of them is that, though shock therapies are useful for extinguishing the unhealthy reflexes of generating inflation, at the

[1] I felt it unnecessary to intersperse this writing with literary references. There are, however two authors—quoted rarely nowadays—whom I wish to draw to the attention of all those who speculate on the nature of today's inflation and on how we could get rid of it. They are: Frank *Graham* and Mancur *Olson*. The works by them which fit into our theme are: Graham 1930; Olson 1982; Olson 1984. The concept of secondary inflationary effects of anti-inflationary policies is taken from an unpublished paper of Mr. Béla *Greskovits* written about a possible programme of stabilization.

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same time they paralyze, for a long period, the ability to make active adjustments. The other one is that shock therapies are favourable only for the state bureaucracy and officials, nourishing their laziness and lack of imagination. Namely, they have nothing to do but occasionally make some adjustment to the mechanisms of the state finances and monetary policy, and afterwards idly await the effects.

Even if it were to be true that in this way stabilization could be achieved and would permanently survive, (what we, in the cases of the Central and East European countries rightly doubt) shock therapies would have the drawback that, when applying them, most of the necessary reforms would probably be postponed for a long time. The reason for this is that in a society paralysed by shock therapy there is nobody to press for establishing reforms or to make use of them. Hence it is not possible to save time with shock therapies; on the contrary, they slow down the transition. Where there has been no, or at most only a rather imperfect market, the building up of the missing market institutions and the making of market relations more intensive and comprehensible, is only possible if the state bureaucracy also works to this end and many economic units which remained intact or able to renew themselves, actually respond to the reforms. The shocks usually destroy this sensitive medium and they are certainly unable to create one.

The main points I wish to expound in this article are: the most important harmful effects of the current inflation; the question of whether it is worth-while and at all possible to completely eliminate inflation in the Hungarian economy; the nature of the Hungarian inflation and the potential means for repressing it; the conditions necessary for a successful use of the classical means (restrictions) of dealing with inflation, as well as of the non-classical ones; the questions of stabilization and growth.

It is necessary to mention right at the start that the economic policy called upon to lead the economy towards stabilization and onwards to the period of economic growth has to be a lasting expansion of exports,—in view of the present position of the Hungarian economy characterized by a narrow domestic market and high external indebtedness. This can be supported by rapid privatization, the strong inflow of foreign capital and by building up the institutions and infrastructure of a modern domestic market.

Why is the present inflation dangerous?

The rate of inflation we have reached in the 1990s jeopardizes even the chances for stabilization itself and, especially, the transition into economic growth. An inflation rate of thirty or forty percent is dangerous also because under such circumstances a relatively trifling, internal or external economic or psychological shock may lead to a sudden breaking loose of inflation. This would be a serious disaster,

even if technically the danger of a so-called hyperinflation is not an actual threat yet, for it would necessitate the unbridled operation of the banknote press (the unlimited issue of money).

Of course, those who suffer most from inflation are people whose salaries or pensions are traditionally moderate or on a minimum level and who have no other income with which they could counterbalance the decreasing value of their money. The situation is the same with small-scale producers or servicing firms whose input prices grow faster than their selling prices. These groups cannot be consoled by the fact that some of the price rises are caused by the abolition of consumer price subsidies, i.e. by the assertion of world-market prices.

Many of those who, based on their inflationary expectations, strived to rapidly raise their own prices, were disappointed when in the early months of 1991 they noticed that their price increasing intentions could not be realized in a narrowing domestic market. However, this is obviously insufficient for significantly mitigating the destructive effects of inflation. The most important of these effects are the following:

When both costs—among them interest rates representing a considerable weight—and prices are rapidly growing, entrepreneurs are forced to think in the short term. Whether their enterprises are big or small, they put aside their long term development and business strategies, and begin to live from day to day. This is in itself enough to stop structural changes, because such changes can only be based on a carefully considered technological development and market policy.

Yet even if some changes in structure are actually implemented, with few exceptions they will be distorted or only temporarily viable. Namely, in an inflationary period not only does the general price level rise but the price proportions (relative prices) may also shift incalculably, leaving companies without support in making decisions that could prove to be reasonable even in the long run.

Inflationary expectations, especially if they come true one by one, prompt unsound business behaviour on the part of the firms, and wasteful purchasing conduct by consumers. These phenomena also contribute to the increasing number of crashes and bankruptcies.

During the period of inflation neither the companies nor the households invest their savings in projects maintaining or increasing production or service activities; rather, they stow them away in immovable property, in other goods of stable value, or in foreign currency. All this usually has the effect of rushing up their prices, which also nourishes inflation. A further result of this is that the investments needed to enhance the supply which could mitigate, to some extent, the growth of unemployment, also fail to come about.

Finally, it must be mentioned that, owing to the above listed effects, the income proportions also become distorted, and this plays a noticeable role in the growth of poverty, which was mentioned earlier.

What extent of inflation can we coexist with?

What has been said so far suggests that it is absolutely necessary to put a brake on inflation. The question is only whether it is possible or justified to make efforts in order to ensure that inflation—or price rises—should completely stop, i.e. the price level should become fully or almost fully stable during the period of transition.

In my opinion it is unnecessary to strive after this. Important as it is that in the near future inflation should decline to a reasonable and bearable level, it is certainly not desirable that all kinds of price rises should cease. In fact, this would not even be possible.

The major arguments for saying that it is better to tolerate a certain level of inflation are the following: by applying the currently known arsenal of economic tools, the complete stopping of inflation would entail a level of unemployment which many would rightly consider to be unbearable. Furthermore, owing to the narrowing of demand and the reduction of incomes, the revenues of the budget would also drop. Thus it would no longer be able to perform its functions, particularly that intended to mitigate the situation of the poor and of those slipping into impoverishment. From this bottom level the economy could no more be stabilized or start growing as it could not in the case of an inflation higher than that of today.

I must also refer to the fact that, as experience shows, it is easier to bear the burdens of the necessary structural changes, if both prices and wages are growing (even if the latter at a lower rate), rather than if they are not. Namely, with the progress of restructuring both relative prices and income proportions will be modified. In the case of a stable level of prices and wages not only certain prices but also some wages ought to be reduced. A wage decrease always gives rise to strong dissatisfaction and it is more difficult to adjust to it than to a lower than the average wage rise, since it is not sure that the person whose wage is reduced is primarily the consumer of that commodity which has its price lowered.

The complete stopping of inflation—at least for a longer period—is not even possible. First, because in the economy factors enhancing inflation are permanently at work. Second, because the means which can and have to be deployed against inflation, themselves also cause, to a certain extent, inflation. Let us review in detail these two groups of inflation-causing factors.

A lasting inflation-boosting factor is that Hungarian foreign trade, in order to pay the interest on foreign credits—or even perhaps to pay off a certain part of the debts—has to achieve export surplus regularly and over a long period of time. The domestic outflow of money needed for producing the export surplus creates a demand which by no supply, either domestic or imported, can be met. A budget surplus, or a lasting investment of money that equalled the amount required could counterbalance it. However, it is more realistic to see that this can only be counted upon to a very small degree—if indeed at all.

Another desirable but also inflation-strengthening factor is the inflow of capital from abroad in money form, especially if it is not accompanied by surplus imports. The inflationary pressure that stems from this will only cease if the growth of the economy and of domestic supply actually take off.

Both factors may necessitate the devaluation of the domestic currency, which again has a price-raising effect. Of course, external processes may also ripple into the economy (such as interest rates operating on the world market, and the rising prices of essential import products). These all have the effect of increasing prices in the domestic market. These are simple cases of price- or price-level rises, because neither the foreign-trade surplus, nor the inflow of capital can be considered as factors which will necessarily set in motion certain self-inducing inflationary mechanisms. However, in the eyes of the participants of the economy the price rises elicited by them are added to the rate of inflation—hence, they increase the inflationary expectations.

Even some tools of anti-inflationary policy may in themselves have inflationary effects.

The most simple case is that in which interest rates are adjusted to the rate of inflation. Though this reduces the demand for credit and, in fortunate cases, also the propensity of the budget for overspending, it appears as cost in the prices. This affects a much broader sphere than is justified by the amount of credits actually demanded, and thus it imposes a new burden on the budget itself, too, via both the interest rates and prices.

The other case (which accompanies the whole process of stabilization, but may also extend beyond it) is when the inflationary pressure inherited from the planned economy (covert or repressed inflation) can only be reduced or stopped by increasing prices and wages. The matter in question primarily revolves around the fact that in order to reduce the budget's deficit—and to reveal the real cost relations—certain price subsidies and the gratuity of some services have to be abolished. This is a well-known fact. It is less often mentioned that the open or covert allowances in kind, in the form of grants and favours, customary in the planned economies (which also have to be eliminated), usually come to light only step by step, and every time cause new tensions between wages and prices.

An especially clandestine type of inflation that has come into being is one in which wages do not cover the costs of using or consuming certain goods or services (such as housing, transport and, earlier, even food). At the same time neither the producers nor the servicing firms received the countervalue. Hence, the stock of dwellings and public utilities fell into extremely bad condition, the natural environment was ruined, while manufacturing industry and agriculture, working with low wages, appeared productive and profitable. The correction of these distorted proportions (or the spontaneous process leading to it) entails price and wage increases the same way as does the postponement of cost adjustment. In addition, all this takes place without any increase of the value of the goods

or services concerned, and without any prospect for stopping the deterioration of the stock of dwellings and public utilities and damage to the environment. For the duration of this adjustment process, repeatedly new and newer sectors and activities are likely to fall into a crisis. It is a separate problem that these are not, or are only occasionally those sectors or activities whose critical position has been caused by failing to adjust to the world market or by the collapse of the East European market.

In order to eliminate the covert inflation, it is necessary in all cases to drastically increase, or allow the rise of the prices of a number of products and/or services. These price rises, or a certain proportion of them have to be counterbalanced by wages rises. The effects of all these can no longer be distinguished from a normal cost-inflation or from a wage and price spiral. What is more, in a certain sense the elimination—or revelation—of the earlier existing covert inflation becomes the most important factor inducing open inflation. It is worth mentioning that under such circumstances not even an improvement in the position of the budget can be guaranteed. The development of the budget's position depends upon the extent to which the budgetary institutions use up formerly subsidized goods (sold therefore at low prices), how many of their employees will be entitled to get increased wages or salaries and, finally, on how these measures will influence the selection among the companies in the competitive sphere. It may happen that the amount of tax that can be collected from the enterprises will decrease, while the number of the unemployed to be granted an allowance, will grow. (If, instead of a wage increase, the government decides for selective social support—which has a lesser inflationary effect—by doing so, novel groups will be shifted over into the category of those who cannot sustain themselves. Thus this represents a serious intervention in the structure of society.) This is why even the international financial institutions (IMF, World Bank) recommend caution—at least with regard to eliminating consumers' subsidies. It would be better if the government put some of these on the agenda only after economic growth has started; it is especially advised not to carry out such eliminations when the acceleration of inflation appears to have stopped.

The nature of the Hungarian inflation

The chief characteristic of the inflation we are now suffering is that it gathered speed after a long stagnation of performance in the economy (stagflation), and now it is accompanied by a general recession of economic activities.

It follows from the foregoing that the present inflation—in addition to a few permanent factors having minor effects—has three major constituents.

The first one of them involves the inflationary expectations themselves. They are nourished not only by the actual price rises but by every dreary prognosis and

by the growing uncertainty of companies and households, too. (Several participants of the economy feel that they are not faithfully informed about the actual situation and about the government's intentions and thus they have no idea how they could help themselves.)

The second constituent derives from the fact that the inherited economic structure was almost prised apart even earlier by the artificial proportions of prices and wages. Hence the ongoing liberalization of prices and the elimination of state subsidies force up the totality of costs and, together with them, prices, much more than would be justified by the existing demand.

The third constituent is partly derived from the foregoing and partly from all kinds of rigidities present in the economy: namely, under the given conditions when the answer to the declining demand can be the raising of prices, the costs of the transformation of the economic structure—either desirable or forced—are also extremely high.

One of the generally known sources of inflation (or, to a certain extent, its result) is the deficit of the state budget. A further factor that incites inflation could also be the changeover to dollar accounting in East European trade.

What we have mentioned so far shows that one cannot speak about a pure wage-price spiral or a mere demand-pulled or cost-pushed inflation in the sense outlined in the textbooks. The three enumerated major constituents may all entail a decline of current economic activities as well as of productive (servicing) investment projects but all that without being able to state that there exists a level of recession (and unemployment) that could stop inflation.

Following the same train of thought backwards, there must be, in all probability, an anti-inflationary economic policy which is able to put a brake on the process of inflation, without causing significant economic recession and unemployment, what is more, a policy which opens up the way towards economic growth precisely by strongly repressing the inflation.

The objectives of the anti-inflationary policy

Given the overall situation in Hungary, what objectives should be set for a serious anti-inflationary policy?

Above all, price rises have to be slowed down within a short time (within one or two years) so that, from that time on, the level of wages and prices and their potential future movements can provide proper information to the participants of the economy, with regard to both their current activities and their decisions on investments.

The anti-inflationary policy has to aim to achieve lasting results. For that, tools are needed which can be applied over a long period without harming pos-

itive economic developments, for the economy has to work alongside permanent inflationary trends even after economic growth has started.

This means that an independent objective of the anti-inflationary policy has to be to reverse the inflationary expectations and the decision making reflexes following from them. This is the only way that offers hope that, after later on mitigating some of the seriously restrictive anti-inflationary tools, growth will follow a sound trend. This objective can be formulated in another way, too: the successful exporter deserves reward, and not penalty; likewise does he who in these times spends money on technical development and makes business profits through cost reduction; furthermore, the thrifty housewife, who buys what she needs then and there, when and where it is the cheapest, has to become the subject of praise.

The stimulation of savings has to be treated as one of the main objectives of the anti-inflationary policy. Also, companies and households should invest an ever increasing part of their savings in such permanent investment forms which increase the supply of material goods and services. If this succeeds, it will start a self-strengthening process which can help economic growth and against inflation.

What kind of anti-inflationary policy is needed?

As has already been mentioned, the present Hungarian inflation cannot be pressed into the conceptual frameworks of classical demand-pull or cost-push inflation theories. This is why it cannot be considered mere speculation to state that the classical instruments of the anti-inflationary policy in themselves are insufficient for a significant and lasting repression of this type of inflation. The classical means of anti-inflationary policy include the restriction of budgetary expenditures and money supply, for the sake of reducing the aggregate demand appearing in the economy. Should, however, the demand for money for some reason, drift away from aggregate demand and should aggregate demand itself, (beside the growth, stagnation or minor decline of money demand) begin to regress rapidly, and should as a result of this, the volume of economic activities also decline, meaning that beside inflation, a recession evolves, the policy of restricting the demand enters a vicious circle.

As a result of recession the basis of taxation (the assessable income) would grow narrower. Consequently, the budget is increasingly forced to augment its revenues by issuing money and increasing the pressure of taxation.

The two phenomena together elicit the feeling of defencelessness in entrepreneurs and consumers as well. They have no faith in the anti-inflationary policy, and this further strengthens inflationary expectations.

This applies especially to the Hungarian economy, since the demand-restricting economic policy (or at least it is declared to be demand-restricting) can look back

upon a past of more than a decade, although its real aim throughout most of the 1980s was the repression of supply. (The then financial government was deeply convinced that the tools necessary for regulating aggregate demand were not available, and that less production meant less imports. It was believed that the latter would result in a lower deficit in the balance of foreign trade and in the balance of payments.)

If enterprises and households have to experience the same that they have done so far, yet on a larger scale than earlier, it would not be a surprise if they came to the conclusion that this policy would be likely to bring about an accelerating inflation, recession and unemployment. For, they would see that when it was implemented earlier on a lesser level, it caused a decade of stagnation and inconvenient inflation—thus what would ensue if it was deployed more powerfully?

Therefore, the only type of anti-inflationary policy that count on general acceptance and can be successful, is that which sets definite targets with regard to the duration of the inflation and the rate at which it should decrease. In addition to the classical restrictions of money and demand, it should also be able to deploy other tools. These have to bring about a situation such that the anti-inflationary policy will—as far as possible—operate in such a way as to promote the objectives of the economic policy in general, including those of the transition. All this should be comprehensible for the enterprises and households and, if possible, should offer them opportunities for rational actions.

Thus, we have to be careful not to let the budget be built on the imposition of taxes on the inflation, or on "skimming" it. Budget revenue must not be strongly dependent on inflation, otherwise the state budget would become interested in maintaining it. (In this respect it is rather thought-provoking that, owing to the strange structure of public finances, at the time of sinking oil prices on the world market the budget was threatened with disturbances.) The budget has to show moderation in pumping over the inflationary profit and must not become a participant in the inflationary competition. Instead, it has to endeavour to widen assessable incomes, taking efficient measures for stopping the decline on the supply side, and aiming to initiate economic growth.

It might also contribute to the widening of basis of assessment if, as a result of the necessary liberalization and deregulation, it became advantageous for a possibly great part of the participants in the grey (informal) economy to enter into the primary economy. Thus, they would become law-abiding, taxpaying enterprises and citizens. This would also make it easier for the authorities to take a strong line against those evading taxation and the defrauders; consequently, respect for the regularly taxpaying citizen should develop.

The only anti-inflationary policy which is likely to receive the support of broader social strata is that which strives to reach a decrease in aggregate demand not only by strengthening the pressure of taxation and through growing monetary strictness. For instance, it should try to increase the scope of privatization, for

this may also help to absorb domestic incomes. The acceleration of privatization also has an anti-inflationary effect due to the fact that if state property is sold with proper care, it may enhance the opportunities for developing competitive situations in the domestic market, as well as creating a climate suitable for making reasonable economic decisions.

The classical means of anti-inflationary policy

The regulation of budgetary deficit and a rigorous monetary policy are regarded as the classical tools of anti-inflationary policy. However, the conditions necessary for applying the classical tools still have to be created, namely by various non-classical means and methods.

With regard to the budget: it has been proved true that, if only for the sake of making matters more transparent, it is necessary to free both revenues and expenditures from the elements that do not belong to them, e.g. that part of social insurance and other insurances which have some effect on the budget. In addition to the law on public finances as a legal action, this will obviously be accompanied by significant institutional changes.

If most of the deficits have to be financed by effective savings, it is worth considering earnestly that, even with regard to the earlier accumulated state debts, only those which are backed by real domestic or foreign savings should be recorded as such. There is no guarantee that this will reduce the total amount of state debts (or with the same amount) since in 1987 the credit accounts of the commercial banks were charged with amounts that implied an increase of the capital of the state enterprises on behalf of the state as owner (and which were declared to be repayable only subsequently or formally). Neither the desirable extent of financing by the banks, nor the measure of dividends to be paid by state enterprises or the value of state property to be privatized, can be correctly determined until these amounts are charged on the banks' credit accounts instead of being added to the state debts.

Taking into account that such changes would very probably effect the data base of the agreements made so far with the IMF, it seems advisable that they ought to be also discussed with the IMF.

We have already mentioned that as far as possible, the budget should not aim simply to skim the inflation, but at increasing the assessable income, to extend the tax base. However, it is worth calling attention to the immoderate inflationary profits of the banks, which also pass into the budget. In turn, on the side of expenditures, the fact should be noted that the budget is and will remain for a long period the greatest buyer and investor in the economy. Though in the meantime the partners have considerably changed, there has been little change in the tradition

according to which the forints of the budget as a buyer lose their value more rapidly, or are less valuable than those of other buyers. For this reason the methods of having the suppliers compete, i.e. of tenders, and of controlling the expenditures have to be modernized.

When, for several reasons, the structure of the budget also changes rapidly, it is probably not worth-while to set year by year targets for the decreases to achieved in the *amount* of the deficit. Instead, effort ought to be made to ensure that the ***summarized amount*** of both sides of the budget should come to less than in the preceding year (in real terms, i.e. by taking into account the rate of inflation of the preceding year). It is not impossible that in this way the opportunity would open up for mitigating the pressure of taxation, or more money could be spent on services that aid new ventures.

A strict monetary policy has a sense only if the monetary system fulfils its basic functions, which means that it provides the economy with cash and credit. At the same time, the built in institutional and regulatory hindrances should cease to exist, because these senselessly increase the expenditures of the participants of the economy, especially the expenses of being present in the market (the transaction costs). The Hungarian banking system in its present state does not fulfil its functions. This is clearly shown by the phenomenon known as "the circle of mutual debts" (queuing), and furthermore by the fact that an increasing part (at least two-thirds) of the medium-size and large companies carry out their economic operations without any credit. Also, after 1987 the commercial banks withdrew from financing agricultural production and procurement. One of the causes of the circle of mutual debts is that for some years the government has been unable to decide on the future of a few dozens of big companies (and, together with them, of a few sectors) approaching or already being in a state of bankruptcy. Besides, the increment of capital granted to them (and to other companies) is charged to the banks' accounts (partly on those of short-term credits). Other problems are due to delayed remittances, the defective, inferior and bewilderingly expensive bank services, the irrealistic credit amounts manipulated by the banks, mechanical current financing of firms, and undifferentiated refinancing policy of the National Bank. Of course, this style of banking leaves its mark on the foreign exchange transactions too, for it hampers exports and makes them more expensive.

At the same time, the remarkably high banking costs appear in the calculations of those receiving the loans as a high real interest rate and, as a result, not even the credits intended to be favourable are exploited. Based on all these points, it is unthinkable that a rational monetary policy could be implemented without reforming the banking system.

Beside a normally working banking system, and after having gained a clear picture of the real money demand of the economy, when the government determines the particular elements of monetary policy, in the first place it should look at the position of the current balance of payments and the balance of capital, the amount

of the foreign exchange reserves and the position of the budget. It should not immediately concern itself with the stock of bank credits. In the case of an economic policy aimed at the expansion of exports, priority must be given to adequately determining the exchange rate of the domestic currency. The interest rate and the measure of taxes cannot be restrictive to the same degree: in the case of a declining inflation and, if there is a potential for broadening assessable income, the taxes first have to be somewhat mitigated. If the credit demand still increases and, in parallel, savings grow, we may presume that an increase of supply will appear which will not strengthen inflation.

The realization of an increasing domestic supply can be promoted by the following factors: the part of the foreign-trade balance surplus which the government does not wish or is unable to collect into the budget; the part of the inflowing foreign capital which is not covered by surplus imports; the investment demand created by the privatized or new domestic enterprises; efficient import substitution; and finally, by tourism.

The non-classical means of an anti-inflationary policy

The makers of stabilization recipes have, in general, been of the opinion that in the period of stabilization (i.e. the period in which the inflation is stopped) the rigidity of the economy cannot be relieved, its operation capacity cannot improve and, the more rigid an economy, the stronger are the restrictions that have to be applied for the sake of stabilization.

Consequently, and also in accord with the view widely held in the relevant literature, in transition economies similar to the Hungarian one, the financial (monetary) measures (e.g. devaluation of the national currency) have to be more drastic and the restrictions (e.g. the limitation of credits) more strict, than in a going market economy. This is because milder ones would not even be noticed by the clumsily moving state enterprises.

However, the experience of the few past years indicates that Hungarian enterprises, if a small gap opens up for them, will seize even the slightest chance for survival and continued evolvement, provided that the authorities do not render it unbearably difficult, costly, or simply impossible; or do not deprive the economic units of real information (as the leaders of the agrarian sector have done with the agricultural producers). We have every reason to believe that by avoiding hindrances to responses given by the enterprises, as well as implementing smaller restrictions, the aims of transition would be better served (and would, in the meantime, cause less damage) than they would by implementing the greatest strictness, if at the same time the way leading in the right direction is blocked.

This conclusion can also be formulated using other words: it is precisely in such transition economies, like the Hungarian one, that the desired stabilizing effect cannot be reached by applying restrictions alone; furthermore, the more reasonable alternatives for choice show up before the participants of the economy the more successful a restriction will be.

Hence, what we need is not the classical stabilization policy, the main tools of which are restrictive budgetary and monetary policies, but such an ensemble of economic political instruments which, beside the unavoidably necessary regulation of demand, favour the growth of supply. In the interest of later economic growth, the policies should also undertake positive steps to create institutions and build up markets.

Of the economic political means that accompany stabilization, the outstanding ones are: privatization, the liberalization of economic activities which were earlier licensed or controlled by the state, and liberalization of bargaining processes—especially the bargains on prices and, as far as possible, on wages; furthermore, the monopoly positions and exaggerated power of the state bureaucracy should be eliminated (deregulation). All these are aimed at facilitating entry into, or exit from the market. They also help the development of competitive situations, and effective selection among the participants in the economy and their activities. Under domestic conditions the above listed steps have to be complemented with a bank reform, the main objective of which has to be to ensure that the banking system fulfils the functions normally expected of it in a competitive economy. Finally, several other programmes are needed: for example, in order to have appropriate flows of market information, to create commercial infrastructure, and to build up wholesale markets. There should be greater dissemination of the knowledge linked to economic operations, too. Due to such programmes the markets should become more transparent and more integrated, market contacts should become more frequent. By a many-sided development of market relations the small and the big, the old and the new enterprises should be comfortably working together. With these conditions fulfilled, it will be easier to oust destructive forms of speculation and unfair business behaviour (since those involved in this are especially interested in maintaining inflation).

A political comment

Inflation cannot be broken down by a government that says: we will do everything possible to reduce the expenditures of the budget, to terminate price subsidies, to impose fairly high taxes, and to determine the exchange rate, the interest rate, wage levels, and the extent of bank credits; by all this we will attempt to lead the country out of the crisis and in exchange we will expect nothing but

patience and tolerance from everybody. In Hungary, people are well aware of the fact that the success of any type of economic policy depends on their everyday actions and decisions. People, in turn, can only act and make decisions if they can do something in their company, farm or household in order to improve their situation, even if this involves going somewhere else in the country to begin a new life. Only if they can feel that they themselves as well as others in their environment have the opportunity to do so and, that there is some way out, may we count upon the unfolding of those human activities which can be the supreme source of power leading to a stabilization and beginning of prosperity.

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MONETARY POLICY AND SEPARATED MONETARY CIRCUITS IN A MODIFIED CPE (THE CASE OF HUNGARY)

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The economies of the formerly socialist countries can be characterized by separated monetary circuits. In establishing behavioural relations and building macroeconomic models one must be careful with using aggregate categories because of this separation. The existence and the extent of the separation of household, enterprise and government monetary circuits is an empirical question. This paper provides several statistical tests of hypotheses related to the effects of monetary policy on various economic variables at different levels of aggregation.

Introduction

The title suggests that money and monetary policy may have some role in a modified centrally planned economy (CPE). This is, however, not a uniformly accepted view in the literature of CPEs. Some authors (e.g. *Birman and Clarke* 1985) go as far as to regard macroeconomics as meaningless and misleading tools of analyzing the behaviour of these economies. The resistance to macroeconomics of CPEs stems from theoretical, institutional and data considerations. Due to this resistance, macroeconomic theory of CPEs, if it exists at all, is poorly developed (*Portes* 1983) and very little empirical evidence is available. This is especially true for the demand side and for our present topic, which is for the role of money and monetary policy.

Traditionally, money in CPEs played a limited role and was fully passive outside the household (cash) payment circuit. As a consequence, the few theoretical and empirical studies available focused on this segment of the economy. In the present study, this framework is broadened and money is not regarded *a priori* passive in the enterprise payment circuit. This, of course, implies assumptions on the natures of enterprises and central planners (economic policy-makers) rather different from the ones in the literature.

The two spheres in a CPE have rather different features and Hungary, although showing several specific characters, is not an exception in this regard. The relaxation of the assumption of passive enterprise money and the still remaining different features of the two parts of the economy together suggest a disaggregated framework. A basic problem of such a framework is the nature of interactions of the two parts of the economy. In particular, we have to investigate carefully the linkages of monetary flows in the two spheres. In this respect, the presence and

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extent of segregation is of particular importance and this problem will be in the focus of our discussion of the literature and also our empirical investigation.

The purpose of this paper is twofold. Firstly, it attempts to summarize and interpret the main views and suggestions on the macroeconomics of CPEs from the viewpoint of a modified CPE like the Hungarian economy in the 1980ies. Secondly, it provides empirical evidence on some of the hypotheses central to any theoretical framework.

The empirical investigations are conducted by applying the method of Granger causal ordering. This implies an atheoretical approach (in the *Cooley and LeRoy* (1985) sense) which is thought to suit the situation in which a firm theoretical background is lacking and the aim is hypothesis-seeking. The specified models are regarded as non-structural ones, and consequently the empirical results presented here neither prove nor directly suggest any sort of structural relations. Even so, they might be useful references and inspirations to further theoretical works, and they certainly indicate a lot about the dynamic characteristics of the Hungarian economy during the period under investigation (1974–1985).

Dynamics, especially short-run dynamics, is a widely neglected characteristic of CPEs. This neglect might stem from several sources. One source is the widely accepted view that CPEs are stable and free from business cycles. While this might be true for other CPEs, in Hungary the rather cyclical and volatile nature of investments and inventories has long been recognized (*Bauer* 1978, *Chickán* 1981, *Soós* 1986). Another reason is the lack of higher frequency (quarterly, monthly) data. Again, while for other CPEs it might be a reason, for Hungary a great deal of quarterly and monthly figures are available for quite a long period of time.

Central plans also aimed to set plan targets determining the behaviour of agents in CPEs for at least a year ahead and consequently, resulted in very slow adjustment. Finally, the few theoretical frameworks developed for CPEs, provided neither stimulus nor guidelines to the theoretical or empirical investigations of the problem.

The paper is organized as follows. First the main hypotheses raised in the literature and relevant to our purpose are discussed. Then the methodological approach of our empirical investigation and the statistical data used for the calculations are described. The empirical results are presented in a separate section which is followed by conclusions summarizing the findings of the paper.

Money and monetary policy in CPEs

The aim of this paper is to provide empirical evidence for the development of a theoretical framework relevant to a modified CPE. As a first step, we concentrate on some of the basic points concerning the role of money and monetary policy.

There are too many points in the macroeconomics of CPEs which have been neither theoretically nor empirically investigated (*Pickersgill* 1977; *Allen* 1983). As we shall see, there are conflicting views even on the basic issues and in many cases the assumptions are based on unacceptable generalization of CPEs.

The description of an economy, beside the important institutional aspects, should be equally based on the ways these institutions function—that is on the nature of structural relations. This approach recognizes the differences among CPEs which might exist in spite of the similarities in the institutional structures.[1] A common problem is the nature of central control.

Does macroeconomics make sense at all for CPEs?

Although this question would perhaps be even more interesting if the last two words were dropped, here we concentrate on the problems raised by the application of main-stream macroeconomics to CPEs. The conflicting views centre on the forms and nature of adjustment process in CPEs. Some analysts seriously doubt the applicability of any of the aggregate behavioural relations established by main-stream economics (Pindak (1983), Birman and Clarke (1985)). They argue that due to full capacity utilization, controlled prices and the persisting shortage induced by them an underdeveloped financial system, centrally decided savings and centrally controlled labour supply macroeconomic indicators and/or relations are simply meaningless and misleading. In their view, the centre (central planning) controls the economy (the agents) directly at the micro level and does not leave anything to behavioral macroeconomics.

Others argue that in spite of the dominance of central control (planning) there is a scope for autonomous adjustments by economic units (Allen 1982) and, consequently, macroindicators and relations do make a great deal of sense (*Portes and Winter* 1978; 1980; Portes 1983). Due to autonomous adjustments, the centre has a limited degree of freedom (Pickersgill 1977) and has to be aware of, and take into account, the macrorelations representing these limits. Market, in this approach, does have a certain role to play in resource allocation, and shortage (and forced saving or substitution) is not a general and prevailing feature but rather confined to certain short lasting periods and specific markets (Portes and Winter 1980; *Nadrai et al.* 1985). Hidden and suppressed inflation are also temporary phenomenon, if they exist at all (Portes 1977; 1978), and the underdeveloped financial system makes certain proposals concerning main-stream economics that are even more suitable to CPEs than to market economies with highly sophisticated and

[1] *Charemza and Király* (1988) give an excellent example of the importance of this point. They show that central planners' behaviours were rather different in different CPEs.

rapidly changing financial systems (Portes 1983; Nadrai et al. 1985; *Chow* 1987)[2] They also point out that most of the rejected relations have been neither theoretically nor empirically investigated to provide convincing results (Pickersgill (1977), Portes (1983)).

In this paper we concentrate on the empirical investigation of the actual functioning of the Hungarian economy after the introduction of the New Economic Mechanism (NEM) in 1968. The well-known presence of pseudo or non-functioning institutions and regulations in Hungary during this period is an important reason for carrying out a thorough examination of the actual functioning. Institutional and theoretical descriptions are not very informative in this case.

Resistance to macroeconomics for CPEs also stems from data problems. Several important micro and macro figures are simply not available for some CPEs and the quality of the available figures is questionable. As to the availability, the situation will perhaps change radically rather soon, for a considerable part of the missing figures should obviously be available at certain places. Naturally, they will not be compiled in the form requested by researchers but this work can be done gradually. In the case of Hungary, although some important figures are still not available, the extent of the problem is not so large as to make macroeconomic modelling an unrealistic adventure. The problem also concerns higher frequency data (monthly, quarterly), but in this respect too, the availability of data is not a bottleneck—at least not yet.

Separated monetary circuits

Separation of the household and enterprise spheres in CPEs has long been recognized in the literature and has been regarded as one of the characteristic features of CPEs. From the viewpoint of our present investigation, the segregation of money circuits (called household (cash) and enterprise (deposit) money circuits), the different roles and regulations of prices, and imports are of particular importance. While the separation of money circuits has long been recognized, it was perhaps Portes (1977) who first stressed that separation had an important role in controlling the economy in these countries. He, in fact, finds the successful separation of money circuits as one of the factors explaining the successful control of inflation in these countries until the mid-seventies. As one can expect, there are contradicting views concerning this respect as well. Some other researchers (Allen 1982; *Pindak* 1983; *Wanless* 1985) suggest different sorts of overflows or interlinks between the two money circuits or spheres of the economy and doubt that the centre would be able to break these connections (Wanless 1985).

[2] Chow (1987), by comparing models based on quantity theory for China and the US, supports this view empirically.

Most of this dispute is of no importance to our approach, for most of the conclusions are based on institutional arguments and/or *a priori* assumptions on the nature of certain institutions. In our view, the existence, name or declared functions of an institution (e.g. price control as embodied by the Price Office) by no means determine the actual functioning of that institution, and the mere fact that the centre attempts to control something in the economy does not imply that it will succeed in doing so. Returning to separation, its actual functioning has not really been investigated empirically, and as a consequence we have hardly any empirical evidence supporting or rejecting any of the views mentioned above.

Our framework is different from most of the ones drawn up in the literature in that we drop the assumption of passive money in the enterprise money circuit and allow for (partly or fully) active money. There are some vague hints, even for traditional CPEs, that money in the enterprise circuit might not be fully passive (*Farrell* 1977; Pickersgill 1977) and for Hungary Portes (1978) emphasizes the importance of the NEM in this respect. The Hungarian literature shares Portes' views (Soós 1986; *Hagelmayer* 1987; *Tardos* 1987) but on the extent to which money is supposed to be active in the enterprise sphere, views are quite different. What all the mentioned views have in common is that arguments are not supported by statistical evidence.

Arguing for perfect separation in traditional CPEs, Portes (1977; 1978) points to several sensitive points where the central control has to cut linkages. For example, the link between costs and consumer prices. Price control is supposed to perform this task. Another example is the link between prices and expenditures via factor incomes. This channel was controlled by wage regulations. In the case of Hungary, Portes calls attention to profit related incentives which might have restored this link as well, being the one between excess demand and labour market (wage) pressure via supply response. For Hungary, the most important link of this sort is, perhaps, the one between excess investment demand and labour incomes. For Hungary, Portes also allows for producer prices related to consumer prices, but emphasizes that this relation could be weaker than expected. Pindak (1983) stresses this link for all CPEs, but provides no empirical evidence supporting his view.

In the separation of money circuits, the state budget has a central role. It is an important and growing source of income for households (Allen 1982; *Király* 1988) as well as for firms (Tardos 1987). These incomes, especially those transferred to households tend to be hedged inflation creating an endogenous component of money supply. In fact, the state budget appears to be one of the most important links between the two money circuits. This link via the state budget has long been recognized, as well as the likely strong impact of automatic financing of the state budget.

Pindak (1983) was, perhaps, the first to emphasize the likely presence of a hidden and massive budget deficit and the strong impact of its financing on the

whole economy. He also underlines the endogenous nature of the state budget-related component of money supply. *Feltenstein and Farhadian* (1987) also stress this point, and for China they specify a money supply function which explicitly takes into account the overflow from domestic financing of state budget deficit to household money. The estimation results, which are the only empirical evidence known to us in this respect, show that in China, out of each additional yuan, 0.427 was channelled into the household money circuit. We can introduce a third money circuit, called the state budget (government) money circuit, and investigate the interlinks among these three money circuits.

Money supply in CPEs

On the applicability of monetarism in CPEs, Portes (1983) says that if policy makers are in a position to control money supply anywhere, it is in CPEs and consequently they can use it as an economic policy tool. The highly centralized and simplified financial sector is more like an "advantage" than a drawback (Birman and Clarke 1985) in this respect.

While money and credit gained an increased importance in Hungary during the period under investigation, the structure of the financial sector remained fundamentally unchanged[3]. The option of some kind of monetarism as described by Portes remained at hand for economic policy-makers. However, from the very beginning of the period there appeared to be some leaks in the credit system which created built-in and autonomously increasing components of the money supply. The state budget financing was one of this kind. Another one was the housing credit. In most works concentrating on credits in CPEs, credit provided to households is regarded to be negligible and strictly controlled. While for other CPEs it might be a plausible assumption, for Hungary it is true only for consumer credit but not for housing credit. To a great extent housing credit fuelled the private construction industry[4] and on the other hand, was easily retainable by the credit takers themselves[5]. All this means that a considerable part of this credit was channelled back into the household money circuit.

[3] In the present paper, we focus on the actual functioning of the Hungarian economy in the 1980's, which is strongly influenced but not determined by its institutional structure. For a detailed description of the Hungarian monetary system see *Ábel and Székely* (1988). Descriptions for the other CPEs are given in Portes (1983), *Hartwig and Thieme* (1985), *Peebles* (1986), Feltenstein and Farhadian (1987) and *Portes and Santorum* (1987). The present changes in the monetary systems of CPEs are discussed in *Nuti* (1989).

[4] Which, during the period of investigation, was one of the, if not the, most important private industries in Hungary.

[5] The reason for this was the fact that the bank (NSB) providing the credit accepted self-construction as an eligible expense item and allowed credit takers to draw credit on this basis.

The literature on CPEs concentrates on the enterprise money supply when regarding the nature of money supply and suggests that it simply accommodates plan targets; in case of any conflict between (physical) plan and monetary targets (taut planning) the former enjoys absolute priority (Wanless 1985). The differences in views, as discussed in the previous section, mainly concern the mechanisms through which monetary laxity in the enterprise sphere spreads over the whole economy. Those who argue for overflows speak of endogenous (total) money supply determined by the enterprise money supply (*Cassel* 1984; Wanless 1985). These views, due to the fact that their holders deal with traditional CPEs where investments are out of the scope of the banking system, concentrate only on working capital credit. In Hungary, however, a part of the investment decisions was left at the discretion of the enterprise managers and partly financed by credits. This means that enterprise credit consisted of two components, namely working capital and investment credits. Since there is no good reason to believe that these two components behave in the same way, in any empirical investigation they should be regarded separately. The strong investment cycles in the Hungarian economy, that were mentioned earlier, give importance to this distinction.

While western researchers almost uniformly opt endogenous money supply in the enterprise sphere, Tardos (1987) envisages a selective easy-money policy (which is part of the soft budget constraint) and an overall tight-money policy. He regards discriminative credit launching as a means of levelling. This view correlates state budget deficit and state initiated investment financing with monetary laxity.

Empirical studies of money supply like Portes and Santorum (1987) provide some evidence on the likely endogeneity of household money supply. Their finding is in line with the results of Feltenstein and Farhadian (1987), who report household money supply function with budget deficit financing, current account of BOP, total wage bill and procurement payments as RHS variables; they find these both theoretically and statistically satisfactory. Both investigations used yearly figures and consequently the results do not provide information with respect to short-run dynamics.

Money-price relationship in CPEs

Prices are one of the most widely discussed aspects of CPEs and, as usual, conflicting views can be found. Two main issues of the debate are: what factors determine price changes and what effects, if any do the price changes (or stable prices) have?

Concerning the first question, the debate centres on the nature of price control and on the reliability of price indices. The latter issue is known as hidden inflation which one side finds typically and to a considerable extent present in CPEs (Pindak

1983), while the other side regards its extent negligible (Portes 1978). While for other CPEs it might be hard to take a stand on this issue, for Hungary even the most prominent supporter of hidden inflation (Pindak 1983) admits that its extent was inside tolerable limits.

With respect to suppressed inflation (Nuti 1986) a similar disagreement can be found (Portes 1978 vs. Birman and Clarke 1985) together with the same reservation made with respect to Hungary (Pindak 1983). These opinions exclusively concern consumer prices, as prices in the enterprise sphere are almost uniformly regarded as having no role to play. Again, while for other CPEs it might be a plausible assumption, for Hungary it does not seem to be the case. As mentioned earlier, we regard money and consequently prices to be, at least partly, active and thus they influence resource allocation (Portes 1978).

With regard to the relation between money and prices, we have to put the problem into a framework based on different—i.e. partly or perfectly separated—money circuits. In other words, we should equally consider the possible relations between aggregate money terms and different price indices, as well as the ones between the different components of money and the investigated price indices. Several hints on possible relations (or on their absence) can be found in the literature.

At the one extreme we find those who suggest that a simple form of quantity theory might well describe the relation between money and prices in the household sphere provided that the indicators (money, quantity and price) are suitably defined (Portes 1983; Chow 1987). At the other extreme there are those who argue that both monetary growth and price level are determined by the central planners' reaction to inflationary imbalances which, in turn, might show up in an empirical investigation as a spurious causation running from money to prices (Peebles 1986). Remaining still with consumer prices, Farrell (1977) argues that the whole and not only the household money supply should be taken into account when consumer prices are explained, and also stresses the importance of structural and organizational factors (also stressed by Portes 1977; 1978). The problem with the statistical evidence that supports his view is that there is no report of any serious diagnostic checking and model selection procedures, nor is there any thorough investigation of the main conclusions.

Farrell's conclusions call attention to the fact that separation (or its absence) also appears in the money-price relation. Considering the enterprise money circuit alone, the situation is almost the same. Pickersgill (1977) argues that here money has no impact on prices in a traditional CPE and we are left only with Portes (1978), who hints that in the case of Hungary money might have become (partly) active in the enterprise sphere, which might also be interpreted as a suggestion of a likely money-price causal relation. On the other hand, Hungarian economists explicitly or implicitly (yet clearly) assume causation running from money to prices also in the enterprise sector (Nadrai et al. 1985; Hagelmayer 1987, Tardos 1987).

However, they also fail to provide any thorough empirical investigation for this assumption.

Another point where separation is of relevance is the relation between producer and consumer prices. Portes (1978) finds this as an important relation to be broken by central control in a traditional CPE. He suggests that for Hungary, although only to a moderate extent, this connection is likely to have been restored. Pindak (1983) finds this link typically present in CPEs.

The impacts of prices on money or credit are an almost untouched point in the literature. Transfers in Hungary tended to be, at least partly, hedged inflation. This suggests price-money causation in the state budget financing related component of money supply. This relation might constitute a link between money circuits, and Portes (1978) points to it when for Hungary he envisages a relation between prices and expenditures via factor incomes. Apart from this exception, the price-money relation also appears to be a neglected point in the literature.

The money-price relationship is investigated in the section on empirical results.

Money, inventories and imports of inputs in CPEs

The behaviour of inventory investments is also a hardly explored aspect of CPEs. The neglect of this is partly due to the way firms are treated in theoretical frameworks designed for CPEs. Although in a plan bargaining approach, inventories might appear as an important adjustment factor even in a traditional CPE, in a modified CPE like the Hungarian economy, where there is a room for autonomous adjustment in the enterprise sphere, inventories have a very important role to play.

Inventories appear to be practically the only asset capable of taking up the missing store-of-value function of money in the enterprise money circuit (*Asztalos* 1987). Due to the confiscatory practice of fiscal policy (Nadrai et al. 1985; Asztalos 1987) enterprises try to minimize their money holding (*Vincze* 1988), and as a consequence excess liquidity tends to translate itself into inventory hoarding (Allen 1982; Nadrai et al. 1985; *Ábel and Szalkai* 1989) and through this, into imports. The latter effect is expected to be entirely directed toward hard currency imports. Ábel and Szalkai (1989) provide some evidence on these impacts. Cassel (1984) finds hoarding and hiding of resources to be an important cause of unstable patterns of monetary aggregates in CPEs. For inventories, this suggests a causation running from inventories to money supply or, more precisely, to working capital credit.

Until now, we have treated inventories as a homogeneous category. However, some empirical results for Hungary (Ábel and Székely 1990) show that input and output inventories in Hungary are of rather different natures when compared with

each other and also with market economies. These results suggest a more disaggregate analysis that makes a distinction between input and output inventories.

Inventory cycles not only play an important role in market economies (*Blinder* 1986) but also in CPEs. In Hungary, inventory cycles have long been recognized (Chickán 1981) but their empirical investigation, especially that of their dynamics, has been neglected.

Granger causality in practice

The empirical analysis presented here is based on *Granger*'s definition of causality. According to this definition, a time series X_t causes another series Y_t if current Y_t can be predicted better by using past values of X_t than by not doing so, all other relevant information like past Y_t being used in both cases. (For a further discussion of the concept in a broader framework see *Hendry and Richard* 1983.) In what follows, whenever we speak of causality, we mean causality in the Granger sense, even if it is not emphasized.

To detect causality, the Wald variant of the procedure first suggested by *Sargent* (1976), and based on Granger's (1969) approach, is applied. The procedure involves estimating the regression

$$Y_t = a_0 + \sum_{i=1}^{m} a_i Y_{t-i} + \sum_{i=1}^{n} b_i X_{t-i} + e_t. \tag{1}$$

Under the null hypothesis that X_t does not cause Y_t, the standard procedure is to test if $b_i = 0$, $i = 1, n$. In our analysis, the usual F-test (denoted by F-test in the tables) is used for these restrictions.

As mentioned earlier, this choice is rather arbitrary since not too much is known about the robustness of the different causality tests available. However, Monte-Carlo experiments (*Guilkey and Salemi* 1982; *Geweke et al.* 1983) give some support to this choice. Beside the small sample performance of the test it does not require correction for serial correlation and avoids some of the dubious decisions involved with the use of parameters.

As discussed above, the approach in interpreting our models is an atheoretical one, for we regard them as non-structural models.

Taking into account the experiences of causal ordering summarized earlier and the sharp criticism on these experiences (*Jacobs et al.* 1979), to a given specification, we apply the following specification analysis.

As a general diagnostic check, the RESET test (see *Ramsey* 1969) is used. The test statistic is the standard F-test for omitted variables with $(p, T-(m+n+1))$ degrees of freedom, where p is the number of variables added to the equation. In the calculations, the second (denoted by Y2) and the second and third (Y3) powers

of the fitted LHS variable are added to the equation. The RESET test is also expected to detect improper functional form and data transformation. Due to its popularity, the values of the Durbin-Watson test statistics (denoted by DW) are also shown in the tables, although they are not taken into consideration. In fact, the use of the DW test in this context cannot be justified on theoretical grounds and its small sample performance in Monte-Carlo experiments is also against this practice (*Kiviet* 1986).

To test for the normality of the residuals, the Lagrange multiplier (LM) test suggested by *Jarque and Bera* (1980) denoted by JB in the tables) is applied. The asymptotic distribution of this test is $\chi^2_{(2)}$.

Following Kiviet's (1986) recommendations, the absence of autocorrelation in the residuals is tested by using the LM test in its F-distribution form. This test consists of estimating the regression

$$\hat{e}_t = a_0 + \sum_{i=1}^{m} a_i Y_{t-i} + \sum_{i=1}^{n} b_i X_{t-i} + \sum_{i=1}^{p} c_i \hat{e}_{t-i} + u_t \qquad (2)$$

and testing if $c_i = 0$, $i = 1, p$. Under the null hypotheses, the test statistics are of F distribution with $(p, T-(m+n+1+p))$ degrees of freedom. In the calculations, p is set to 1 and 4—namely, the absence of first and fourth order autocorrelation is tested. (In the tables these tests are denoted by LM1 and LM4 respectively.) In addition, the *Durbin*'s (1970) m (denoted by M in the tables) test is applied to test the absence of first order autocorrelation. Under the null hypothesis that there is no first order autocorrelation, it is distributed as $\mathcal{N}(0,1)$.

To test for the absence of heteroscedasticity, the *Breusch and Pagan* (1979) LM test (denoted by BP in the tables) is applied. Under the null hypothesis that the disturbances are homoscedastic the test statistics are asymptotically distributed as $\chi^2_{(p-1)}$, where p denotes the number of explanatory variables in the function describing the standard deviation of the error term. In the calculations, this function is assumed to be linear in the explanatory variables involved in the regression under consideration, and consequently p is always equal to $n+m+1$. The Breusch-Pagan test can also be regarded as a general diagnostic test and we are inclined to follow this interpretation.

The absence of structural change in the parameters is tested by the well known Chow (1969) test (denoted by CH in the tables). It is distributed as $f(n+m+1, T-2(n+m+1))$, where T is the number of observations. The breaking point is detected as suggested by *Quandt* (1960). (Denoted by Q in the tables). The procedure consists of computing the likelihood rations for different periods and choosing the time point where it takes its minimum value. Similarly to other tests, a significant value of the Chow test statistic is regarded as a sign of misspecification, and is not necessarily a structural break in the parameters. As we shall see, in some

cases a structural break is uniformly present in all specifications considered but in other cases it is confined to certain specifications.

The general diagnostic tests and the specification tests are completed with a series of LM type tests for omitted variables. The general form of these tests is the same, as it consists of estimating the regression

$$\hat{e}_t = a_0 + \sum_{i=1}^{m} a_i Y_{t-i} + \sum_{i=1}^{n} b_i X_{t-i} + \sum_{i=1}^{l} c_i Z_t^i + u_t \tag{3}$$

and testing if $c_i = 0$, $i = 1, l$. The variables Z_t^i $i = 1, l$ are the omitted variables. Under the null hypotheses, the test statistics are of F distribution with $(l, T-(m+n+1+l))$ degrees of freedom. The first (or first two) of these tests serves the lag length selection directly, as it tests for the indicated lag length (denoted by (8,8) or (6,6)).

It is followed by tests for omitted variables involved in other relations. Finally, a test for seasonal dummies and time trend as omitted variables is conducted. As we shall see, we are not always free to choose the way seasonality is treated in our study. To detect any remaining seasonality and/or trend effect this test is applied. The results of tests for omitted variables, due to space constraints, are not reproduced in the tables but are mentioned in the text if they indicate misspecification.

The authors must confess that no tests for multicollinearity is applied. The omission of such tests is not due to their absence or non-feasibility but simply to their programming and computational burden. Unfortunately the softwares available to the authors do not contain these tests and are not designed for their inclusion.

Probably the most important conclusion we can draw from the experience of causal ordering is that the principal problem of this type of analysis is to find the model the causality test can safely be based on. For this, a well performing model selection procedure is needed. In the narrowest framework, model selection concerns lag length selection.

Our lag length selection procedure is a very simple and admittedly *ad hoc* one. Following the suggestion of Guilkey and Salemi (1982), we start from the shortest version considered ($m, n = 4$) and apply to it the specification analysis described above. If there is any sign of misspecification different from the omission of other economic variables, we first interpret it as a sign of improper lag length selection and move toward a longer lag length version ($m, n = 6$) and repeat the whole procedure. Due to the length of the data series and to the data requirements of the tests applied to the specification analysis, the longest lag length is set at eight ($m, n = 8$).

If none of the specifications considered prove to be acceptable (free of specification error revealed by the specification analysis) then we can conclude that stable

(reliable) model is found for causal ordering. If a specification containing longer lag length suffers from specification error, it is rejected even if the test(s) for omitted lags suggest the use of it.

In a broader framework, the model selection procedure should concern all the choices practitioners face. The fact that in the present study, model selection concerns only the lag length selection leads to the situation that in a considerable number of cases we have to conclude that no stable (reliable) model can be found. These failures might be due to different reasons and a further analysis of these cases is undoubtedly desirable.

Data

The monetary data used here for the period 1974–1986 are calculated on the basis of the Hungarian National Bank (HNB) accounts, and these are consolidated monthly. The quarterly figures are derived from these figures in a straightforward way.

We divided broad money (M2) into three categories. Household money circuit (denoted by MH in the tables) comprises currency, demand deposits, and time and savings deposits help by the household sector. Enterprise money (denoted by MF in the tables) consists of different kinds of enterprise deposits. Compulsory reserve fund deposits are excluded. Total money stock is defined in line with the conventional definition of broad money. This means that in the case of Hungary the compulsory reserve funds of the enterprises (as a means of confiscating practice) and the clearing account of the budget (as a fund-like-account which is a discretionary instrument of the fiscal and not the monetary system) are *excluded*, but savings notes (as a savings deposit-like bond) held by the household are *included*.

Four types of credits extended by the financial system are analyzed in this paper: investment credit (denoted by IC in the tables) and working capital credit (denoted by WCC in the tables) as the two major components of claims on enterprises, credits to households (denoted by CH in the tables) and credit to the government (denoted by CG in the tables).

Change in input inventories (DINP), output inventories (DOUT) and change in total inventories (DINV) of the Hungarian manufacturing industry is based on the quarterly income statements of companies. The effect of revaluations on inventories is handled in accordance with the method used by the Hungarian National Bank—that is, inventory changes are *net* of centrally set price changes but include the effects of revaluations due to other factors. The reason for this is that financing roles are always adjusted to the changes caused by administered price changes in order to eliminate the profits and losses from the administered revaluations. As only the changes in, and not the level of, inventories are known, in the empirical

investigation related to inventories the changes in credits and imports are used. This is again a forced solution but it also ensures a stationary state.

The Hungarian Central Statistical Office (HCSO) publishes, in the Monthly Review of Statistics, a consumer price index of retail trade and a producer price index of state-owned manufacturing. The quarterly data we used are aggregated from monthly data.

Unfortunately, no precise information is available on the extent to which measurement error is present in our data. However, it must be mentioned that the monthly figures published by HCSO are not regarded to be of the best quality. The figures originating from NBH are said to be more reliable although not always free from non-statistical considerations.

With regard to seasonal adjustment in the relations involving prices, we were left with no freedom because the price indices published by HCSO (CPI and PPI) are of the x_t/x_{t-12} (or x_t/x_{t-4} for quarterly figures) structure. This, in itself, is a seasonal adjustment although not necessarily correct. Since from such series, the unadjusted series cannot be recovered, the same adjustment was used to the money figures. Of course, in the specification analysis of the regression equations the appropriateness of this seasonal adjustment should somehow be investigated. In the other relations, no seasonal adjustment procedure is applied.

Most of the economic data series are not covariance stationary although this is a prerequisite of causal ordering. To deal with this problem, some standard data transformations are used. With the exception of equations involving inventories (where changes are measured) $\Delta\log$ (or $\Delta_4\log$ where prices are involved) is used as data transformation.

Empirical results[6]

Separation of money circuits

Empirical investigation of separation needs an interpretation which is statistically testable. The descriptions of the financial sector of the Hungarian economy (Ábel and Székely 1988) clearly show that the institutional prerequisites of separation were given throughout the whole period under investigation (1974–85). However, this fact in itself does not imply that the different money circuits were separated in practice.

The dynamics of a money circuit can be observed at any of its points and consequently we have to allow for any sort of interconnection between the observable points of the different circuits. On theoretical grounds, we could rule out

[6] This Section of the paper is based on the results of Ábel and Székely 1988; 1989; 1990.

many of these interconnections (at least the ones appearing in structural relations) but this is exactly what we want to avoid as much as possible. This approach, together with some (admittedly *ad hoc*) assumption on the functional form leads to VAR models. Proceeding this way, we turn separation into Granger causality in quite a straightforward manner. This has several advantages. Firstly, Granger causality, although not without problems, is indeed a very operational concept and its empirical application has a long tradition (*Sims* 1972; *Jones* 1989). Secondly, it is intimately related to dynamics. Its empirical implementation is also relatively simple.

Table 1

Causal relations between money held by households (MH), by firms (MF), and by government (MG)

	(a) MH→MF	(b) MF→MH	(c) MG→MH	(d) MG→MF
m,n	6,6	6,6	6,6	4,4
F-test	1.53	1.06	2.11[c]	3.98[a]
$\overline{R}^2$	0.59	0.65	0.70	0.65
SE	0.054	0.013	0.012	0.05
DW	1.91	1.85	1.94	1.78
R E S E T Y2	2.74	3.86	1.54	0.27
R E S E T Y3	2.60	5.14[b]	2.60	0.97
JB	37.51[a]	0.08	2.52	1.89
LM1	1.45	3.32	0.23	1.75
LM4	1.58	1.03	1.32	0.94
M	1.28	1.85	1.04	0.91
BP	28.07[a]	13.70	17.17	11.59
CH	4.91[a]	3.76[a]	1.92	1.68
Q	82Q3	80Q1	81Q3	82Q4

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

General notes to tables

m,n	lengths of lags in eq. (1)
F-test	usual F test for non-causality test.
$\overline{R}^2$	corrected R^2
SE	standard error
DW	Durbin-Watson d test
RESET	
Y2, Y3	RESET test
JB	Jarque-Bera LM test for the normality of the residuals
LM1, LM4	LM test for first and fourth order autocorrelation
DM	Durbin's test
BP	Breusch-Pagan test for heteroscedasticity
CH	Chow test
Q	time point where the Quandt ratio takes its minimum value

The equations are estimated for the following time periods:
For money-price relations:

(8,8)	1977.1	–	1986.2
(6,6)	1976.3	–	1986.2
(4,4)	1976.1	–	1986.2

In *Table 8*, for the MF-to-PPI relation, the first four observations are dropped while for the reversed relation the last two.

For other relations:

(8,8)	1976.1	–	1985.4
(6,6)	1975.3	–	1985.4
(4,4)	1974.1	–	1985.4

As a first approach to separation, we look at the causal relation between household money (MH), enterprise money (MF) and government money (MG). The results are summarized in *Table 1*. Concerning causation between MH and MF, the results are rather undecisive because none of the specifications presented is free from specification error. Nonetheless, it is correct to conclude that there is no sign of causation in either direction.

Taking into account the state budget as money holder, we can also investigate causation running from MG either to MH or to MF. As can be seen from the results also presented in *Table 1*, causation can be detected in both relations, although the one from MG to MH is rather weak. The results support the description of the role of the state budget given by Allen (1982), Tardos (1987) and Király (1988) and show the importance of fiscal policy tools in the functioning of the system.

The components of enterprise money supply, namely working capital credit (WCC) and investment credit (IC) might have different characteristics. To capture this aspect, we also investigated their relations to household money. The results in *Table 2* show that, making this distinction, two important directions of causation can be detected.

Table 2

Causal relations among working capital credit (WCC), investment credit (IC), government credit (CG), money held by households (MH), and by firms (MF)

	(a) WCC→MH	(b) IC→MH	(c) CG→MH	(d) CG→MF
m,n	4,4	6,6	8,8	6,6
F-test	3.38[b]	3.85[a]	0.54	0.80
$\overline{R}^2$	0.74	0.76	0.64	0.68
SE	0.11	0.011	0.013	0.044
DW	1.90	2.01	1.97	1.91
R E S T Y2	1.19	0.02	0.08	0.89
E S T Y3	1.28	0.60	0.05	0.57
JB	2.00	1.10	1.15	3.16
LM1	1.47	0.04	0.02	0.47
LM4	1.22	1.70	1.04	2.39
M	0.31	-0.11	0.11	-0.71
BP	9.55	15.37	6.08	6.28
CH	0.93	1.10	1.92	1.53
Q	82Q4	80Q4	81Q1	81Q4

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

To make this part of the investigation complete, we look at the causation running from government credit (CG) to MH and MF. The results shown in *Table 2* suggest there is no causation in either direction. This result is somewhat in contradiction with the findings of Pindak (1983) and Feltenstein and Farhadian (1987), although the earlier results on causation running from MG to MH and MF show the importance of their point.

Figure 1 summarizes the results presented in this section. There are several important conclusions we can draw from them. Firstly, a framework allowing for different sorts of overflows from enterprise money circuit into household money circuit, suggested for CPEs in general by Allen (1982), Wanless (1985), Pindak (1983) and specifically for Hungary by Portes (1977; 1978), seems to be a suitable one for Hungary for the period under investigation. Secondly, investment and current production related overflows are of different natures and dynamics. This might be an explanation for the different results derived from relations involving aggregation over them (MF-MH). The different results for government money and credit with respect to household and enterprise money might also be due to this phenomena because government credit, as shown in *Table 1*, to a great extent

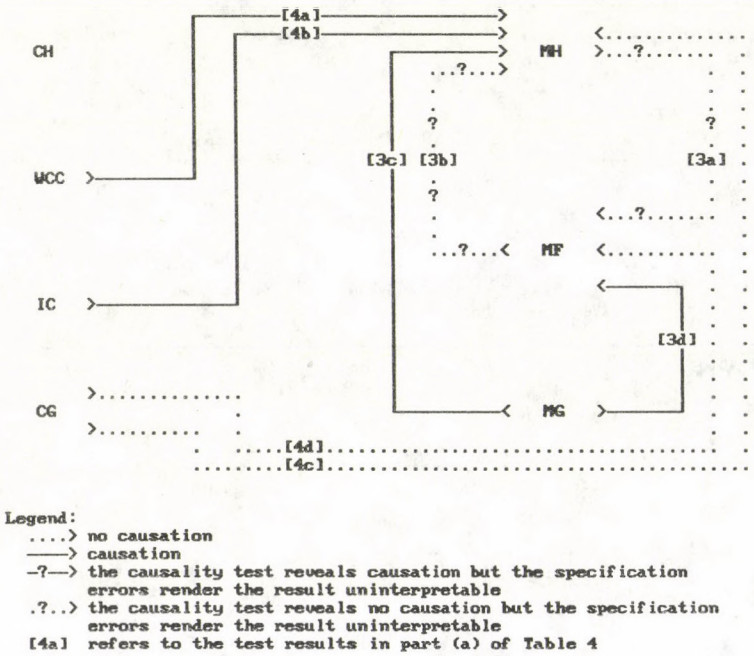


Fig. 1 Bivariate causal relations tested

includes state investment related credit. Of course the relations investigated so far do not cover all the aspects of separation. The remaining ones will be regarded in the subsequent sections.

Money and prices

To tackle the problem of separation nested into a money-price relation, we approach the problem from two directions. Firstly, we investigate the relations between (total) money and consumer (CPI) and producer prices (PPI) and secondly, the relations between disaggregate money terms (MH, MF, MG) and prices (CPI, PPI).

Aggregate analysis of money and prices. Considering the causality running from money (M) to CPI, no stable relation can be established. The results in *Table 3*

show that the heteroscedastic nature of the residuals detected uniformly in all specifications considered renders the results of the Granger causality tests uninterpretable. Regarding the results for the reversed relation also presented in *Table 3* the specification containing the shortest lag lengths ($m, n = 4$) seems to be a solid base for the causality test. Based on this specification, CPI does not Granger cause M.

Table 3

Causal relations between money (M), consumer price index (CPI), and producer price index (PPI)

	(a) M→CPI	(b) CPI→M	(c) M→PPI	(d) PPI→M
m,n	4,4	4,4	6,6	6,6
F-test	1.86	1.51	4.01[a]	0.82
$\overline{R}^2$	0.55	0.64	0.78	0.63
SE	0.017	0.022	0.015	0.023
DW	1.90	1.75	2.13	1.98
RESET Y2	4.20[b]	2.93	9.32[a]	2.64
RESET Y3	2.23	2.48	4.64[b]	1.73
JB	43.3[a]	0.29	0.62	3.26
LM1	0.74	0.08	0.38	0.36
LM4	1.04	0.43	0.40	0.20
M	0.56	0.84	-0.70	-0.18
BP	24.5[a]	11.5	9.74	16.2
CH	0.55	2.10	2.26	1.05
Q	78Q4	80Q2	82Q3	81Q4

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

The Granger test indicates a causal relation running from M to PPI (producer price index) although the results shown in *Table 3* also suggest some kind of incorrect specification. Since the specification tests do not show any specific type of specification error, but the tests for omitted variables point to money held by households (MH) and firms (MF) as omitted variables, we conclude that the misspecification indicated by the general diagnostic test (RESET) is due to the use of the aggregate money term. Reversing the relation again, we can conclude that PPI does not Granger cause M. As shown in *Table 3* the specification with six lags ($m, n = 6$) seems to be free from any specification error considered, and consequently provides interpretable results.

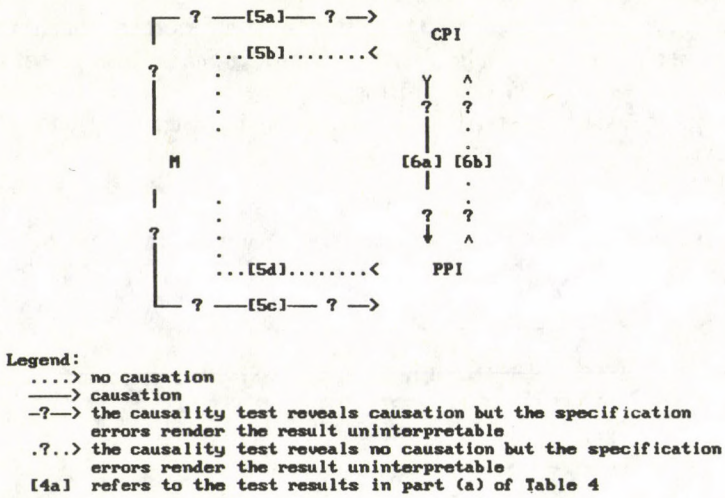


Fig. 2 Bivariate causal relations tested

Taking together these results (shown in *Figure 2*), we can conclude that aggregation of money circuits might be misleading in the investigation of the money-price relation, and causation running from money to prices at this level (Farrell 1977) suffers from specification errors. The only firm conclusion we can draw from the aggregate analysis is that M is not Granger caused either by CPI or by PPI. The regressions for the other relations suffer from specification errors that question the results of the performed Granger tests. Structural break and improper aggregation are found to be the origins of misspecification.

Producer and consumer prices. As discussed earlier, the relation between CPI and PPI is anything but clear, especially in a modified CPE. Our empirical results presented in *Table 4* are also rather vague. The Granger tests suggest a causal relation running from CPI to PPI but the specification analysis indicates structural break and perhaps some other specification errors. The tests for omitted variables suggest that the latter might be due to the omission of money.

In the reversed direction, PPI seems not to Granger cause CPI but the strong non-normality of the residuals as revealed by the Jarque-Bera test renders this result uninterpretable. The tests for omitted variables show again that a multivariate framework that includes disaggregate money terms is needed.

These results do not seem to suggest causation running from PPI to CPI, found to be typical in CPEs by Pindak (1983) and possibly present in Hungary by

Table 4

Causal relations between consumer (CPI) and producer price indices (PPI)

	(a) CPI→PPI	(b) PPI→CPI
m,n	4,4	4,4
F-test	4.83[a]	1.46
$\overline{R}^2$	0.74	0.54
SE	0.016	0.018
DW	1.73	1.91
R E S E T Y2	27.2[a]	2.32
R E S E T Y3	15.0[a]	1.13
JB	7.46[b]	41.6[a]
LM1	0.09	1.35
LM4	1.13	0.82
M	1.57	1.17
BP	5.84	10.7
CH	2.25	0.83
Q	80Q4	80Q2

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

Portes (1978). A possible causation in the other direction indicated by the results needs further interpretation. For market economies, *Colclough and Lange* (1982) report similar findings.

Disaggregate analysis. Splitting up money and introducing money held by households (MH), firms (MF) and government (MG) changes the picture we got above quite substantially. The results clearly show that the different components of money are of rather different natures in this respect.

Based on the specifications with the longest lags considered ($m, n = 8$) and shown in *Table 7*, we can conclude that causation appears in neither direction between MH and CPI. On the other hand, a unidirectional causality running from MF to CPI can be detected. As the results in *Table 5* show, in the MF-to-CPI relation, the specification with lag length six, and in the reversed relation, the one with lag length eight can be selected for the Granger causality test.

The role of MG is undetectable in this respect. In both directions no specification without indication of specification error can be found. The only conclusion we can draw from the results presented in *Table 6* is that there is no evidence sug-

Table 5

Causal relations between consumer price index (CPI) money held by households (MH) and by firms (MF)

	(a) MH→CPI	(b) CPI→MH	(c) MF→CPI	(d) CPI→MF
m,n	8,8	8,8	6,6	8,8
F-test	1.30	1.72	3.62[a]	0.65
$\overline{R}^2$	0.56	0.76	0.67	0.67
SE	0.018	0.010	0.015	0.058
DW	1.92	1.89	2.15	2.05
R E S E T Y2	0.11	0.01	3.41	0.20
R E S E T Y3	0.06	0.04	1.81	2.78
JB	4.73	4.31	3.02	2.56
LM1	1.04	0.95	0.84	0.81
LM4	1.25	0.14	1.24	0.19
M	0.39	0.48	-1.34	-1.10
BP	25.0	17.2	18.7	23.7
CH	2.85	1.34	1.14	0.67
Q	81Q2	81Q4	80Q4	81Q3

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

gesting causation in either direction between MG and CPI. The tests for omitted variables suggest that the rather vague results might partly be due to the bivariate nature of the investigation.

Considering the producer price index, the Chow test indicated a structural break near the beginning of the sample period in the MF-to-PPI relation and near the end of sample period in the PPI-to-MF relation, so we conducted the calculations for the truncated periods indicated in *Table 6*. Doing this we can detect a unidirectional causation running from MF to PPI.

The results of the Granger causality tests shown in *Table 7* suggest a bidirectional causal relation between MH an PPI, but the detected specification errors render these results uninterpretable. As a structural break appeared among the detected specification errors, the calculations were repeated for truncated sample periods. In spite of this modification, the regression equations remained misspecified leaving no room for firm conclusions on causation.

Similarly to CPI, the nature of causality running from MG to PPI is anything but clear. As the results in *Table 7* show, each specification considered appears to be misspecified. As structural break was again among the detected specification

Table 6

Causal relations between money held by the government (MG) and consumer price index (CPI) and money held by firms (MF) and producer price index (PPI)

	(a) MG→CPI	(b) CPI→MG	(c) MF→PPI	(d) PPI→MF
m,n	4,4	4,4	8,8	6,6
F-test	1.12	2.05	4.40[a]	0.41
$\overline{R}^2$	0.52	0.33	0.83	0.81
SE	0.018	0.107	0.013	0.047
DW	1.88	1.99	2.00	1.89
R E S E T Y2	1.31	0.92	3.34	0.00
R E S E T Y3	0.76	2.62	2.85	0.13
JB	57.1[a]	0.53	0.27	0.72
LM1	1.02	0.17	0.29	0.18
LM4	1.28	0.63	1.33	0.23
M	0.88	-0.34	-1.41	0.56
BP	6.10	17.9[b]	14.4	9.04
CH	3.21[b]	1.39	-	1.35
Q	80Q2	80Q3	-	82Q1

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

errors, the calculations were repeated for a truncated sample period. However, as in the previous case, this change did not help. The only conclusion we can draw from these results is that there is no statistical evidence suggesting causality in this respect.

In the reversed direction, PPI seems to Granger cause MG. The model selection points to the specification with lag length of six ($m, n = 6$) given in *Table 7*.

Figure 3 summarizes the results presented in this section. Introducing the existence of separated money circuits into our framework we are led to a more tinged picture. In the household money circuit, causality appears not to run in either direction between money (MH) and price (CPI). The spurious correlation between money and prices (Peebles 1986) does not seem to appear for Hungary.

On the other hand, money in the enterprise money circuit seems to be active in this respect. Causality appears to run, although for a truncated sample period, from money held by enterprises (MF) to PPI without feedback. The fact that the same is true for the relation between MF and CPI shows that MF indeed played an active role. This characteristic appears as an important difference between traditional CPEs, where enterprise money is assumed to have no impact on producer

Table 7

Causal relations between money held by households (MH) and by government (MG) and producer price index (PPI)

	(a) MH→PPI	(b) PPI→MH	(c) MG→PPI	(d) PPI→MG
m,n	4,4	6,6	4,4	6,6
F-test	4.57[a]	2.49[b]	0.97	4.61[a]
$\overline{R}^2$	0.73	0.72	0.63	0.55
SE	0.016	0.011	0.019	0.089
DW	1.83	1.98	1.75	1.89
R E S E T Y2	8.08[a]	0.18	10.7[a]	0.73
R E S E T Y3	4.36[b]	0.76	5.68[a]	0.35
JB	13.8[a]	0.81	19.5[a]	2.26
LM1	1.08	0.00	2.09	0.66
LM4	1.80	1.67	1.04	0.31
M	0.85	0.11	2.06[b]	0.83
BP	14.7	21.6[b]	3.28	7.99
CH	1.38	9.16[a]	2.28	1.36
Q	81Q4	81Q3	81Q4	81Q3

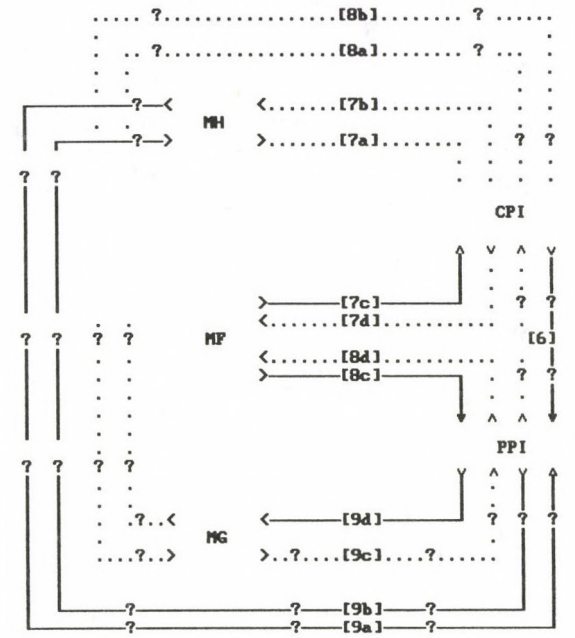
Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

prices (Pickersgill 1977) and a modified CPE. The findings support Portes' (1978) suggestion and give empirical evidence to the generally accepted view in the Hungarian literature (Nadrai et al. 1985; Tardos 1987; Hagelmayer 1987) concerning the money-price relation in the enterprise sphere.

The impact of government money (MG) on prices remained unclear, although there is no evidence suggesting causation. The important finding for MG is the detected feedback from PPI, casting serious doubt on the exogeneity of MG. Causation running from prices to money constitutes an important aspect of the nature of money supply. Results referring to this aspect will be regarded in more detail later in the section focusing on this problem.

Money, inventories and imported inputs

The first set of causal relations investigated here is related to the connections between the different components of inventory accumulation and the change in



Legend:
....> no causation
——> causation
–?—> the causality test reveals causation but the specification errors render the result uninterpretable
.?..> the causality test reveals no causation but the specification errors render the result uninterpretable
[8a] refers to the test results in part (a) of Table 8

Fig. 3 Bivariate causal relations tested

working capital credit. The results are summarized in *Table 8*. Regarding the causal relation running from changes in working capital credit (DWCC) to changes in input inventories (DINP), the results show that the Granger test should be based on the longest version of it $(m, n = 8)$ for the shorter versions $(m, n = 4, 6)$ suffer from specification errors as indicated by the results of the Breusch-Pagan test. Based on the longest version, the null hypothesis of no causal relation cannot be rejected. Concerning the other component of inventory accumulation, all of the three versions of the Granger test of the causal relation running from changes in working capital credit (DWCC) to changes in output inventories (DOUT) suffer from specification errors as indicated by the RESET tests. It means that no stable relation can be found, and consequently the Granger test cannot be performed.

Table 8

Causal relations between working capital credit (DWCC), input inventories (DINP) and output inventories (DOUT)

	(a) DWCC→DINP	(b) DWCC→DOUT	(c) DINP→DWCC	(d) DOUT→DWCC
m,n	8,8	4,4	4,4	4,4
F-test	1.67	2.32[c]	2.24[c]	4.12[a]
$\bar{R}^2$	0.87	0.95	0.87	0.88
SE	2484.9	1534.15	4.18	3.90
DW	1.94	1.99	1.91	1.79
RESET Y2	3.96	14.84[a]	0.06	0.46
RESET Y3	2.00	7.88[a]	0.38	0.46
JB	0.02	1.07	7.99	1.36
LM1	0.25	0.08	0.19	1.36
LM4	0.79	2.15	1.32	0.55
M	0.52	-0.19	0.43	1.15
BP	23.92	4.80	11.58	14.87
CH	1.06	1.76[a]	4.28[a]	1.20
Q	81Q4	79Q1	81Q4	76Q2

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

Reversing the direction of causality, no stable relation can be established to test the causality between changes in input inventories (DINP) and in working capital credit (DWCC). Although the shortest version of relation ($m, n = 4$) would indicate weak causality, the Chow test indicates a strong structural break around the end of 1981. On the other hand, output inventory accumulation (DOUT) seems to Granger cause changes in working capital credit (DWCC), as shown by the results based on the shortest version of the test ($m, n = 4$).

The second set of the investigated causal relations is related to the effects of changes in working capital credit on the imports of materials and intermediates. The results are reported in *Table 9*. Changes in working capital credit (DWCC) seem to Granger cause changes in imports of materials and intermediates from the convertible currency area (DMD), although there might have been a change in the nature of this relation. The Chow test indicates a structural break in the parameters around 1982. Regarding the causal relation running from DWCC to changes in imports of materials and intermediates from the non-convertible (ruble) area (DMR), no stable relation can be found and consequently the test result presented in the table is not decisive.

Table 9

Causal relations between working capital credit (DWCC), import of production inputs from ruble area (DMR) and from non-ruble area (DMR)

	(a) DWCC→DMR	(b) DWCC→DMD
m,n	8,8	6,6
F-test	2.34[b]	2.70[b]
$\overline{R}^2$	0.85	0.80
SE	1169.60	2894.84
DW	2.04	2.06
JB	1.86	0.21
LM1	0.54	1.27
LM4	0.58	0.70
M	-0.49	-1.04
BP	28.74[b]	11.98
R E S E T Y2	2.45	0.04
R E S E T Y3	3.54	0.02
CH	2.85	1.35
Q	81Q1	81Q2

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

To close the circle, finally the relations between input inventory accumulation and imports from the different areas are investigated. The results are shown in *Table 10*. Neither the changes in imports of materials and intermediates from the non-convertible currency area (DMR) nor those from the convertible currency area (DMD) seem to Granger cause the changes in input inventories (DINP). In order to investigate the direct effect of changes in input inventories on changes in imports, these relations were reversed. Changes in input inventories (DINP) seem to Granger cause changes in imports of materials and intermediates from the convertible currency area (DMD), while results related to the imports from the non-convertible area (DMR) are not decisive. The strongly significant values of the Breusch-Pagan test clearly indicate the presence of specification errors in these equations.

The results are summarized in *Figure 4*. They do not seem to support causation running from money to inventories suggested in the literature (Allen 1982; Nadrai et al. 1985; Ábel and Szalkai 1989). It shows that inventory cycles were not likely to be initiated by monetary factors. The importance of the behaviour of inventories is also shown by the traced causation running from input inventories to

Table 10

Causal relations between import of production input from ruble area (DMR), from non-ruble area (DMD) and input inventories (DINP)

	(a) DMR→DINP	(b) DMD→DINP	(c) DINP→DMR	(d) DINP→DMD
m,n	6,6	4,4	6,6	6,6
F-test	1.32	1.49	2.51[b]	9.29[a]
$\overline{R}^2$	0.84	0.83	0.84	0.88
SE	22753.51	2708.54	1172.27	2183.21
DW	2.13	2.13	1.93	1.90
RESET Y2	0.03	0.13	1.32	0.03
RESET Y3	0.19	0.37	0.11	0.20
JB	19.42[a]	15.39[a]	1.24	0.49
LM1	3.21	0.50	0.17	0.65
LM4	1.84	1.97	0.39	1.33
M	-1.86	-0.93	-0.52	0.81
BP	23.18[b]	12.28	26.71[a]	10.83
CH	0.97	1.90	2.72[b]	1.91
Q	81Q4	81Q3	79Q4	80Q4

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

non-ruble imports of production inputs. This component of imports is also Granger caused by working capital credit showing that credit (monetary) policy did have a role to play in the determination of imports as suggested by several authors (Nadrai et al. 1985; Ábel and Szalkai 1989; Hagelmayer 1987). The results also show that the different components of inventories were of quite different natures (Ábel and Székely 1987).

Money supply

Before discussing the conclusions we can draw for money supply from the results presented earlier, we first present some further evidence on the impact prices have on the different components of credit supply. The results are given in *Tables 11* and *13*.

Concerning producer prices, no causation can be detected. Due to the specification errors in all investigated relations, the results lend no support to any of

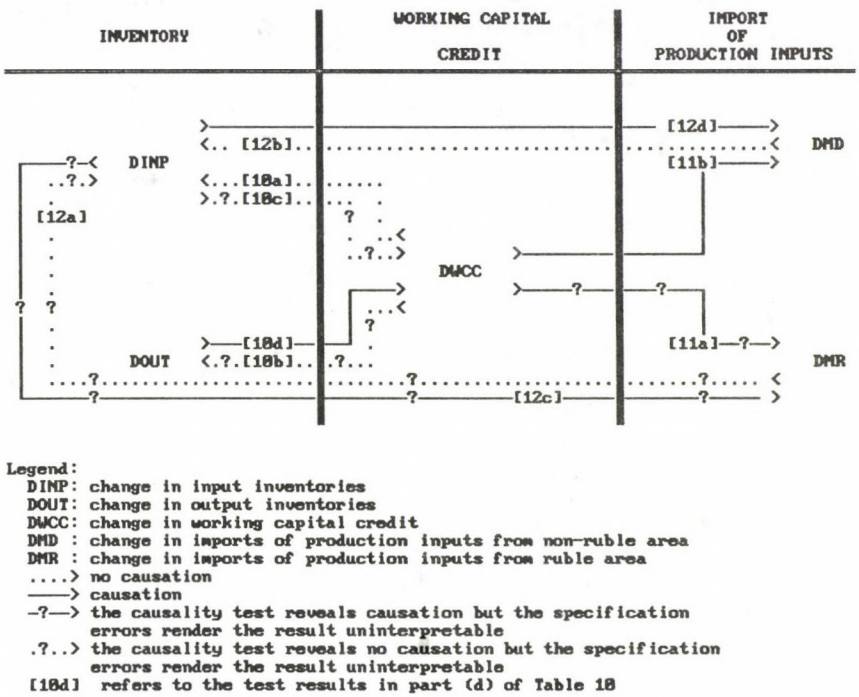


Fig. 4 Bivariate causal relations tested

the hypotheses in this respect. As to the consumer prices, the only decisive result is the one showing causation from consumer prices to government credit. In the other directions, there is no sign of causation, but the specification errors detected do not render this finding decisive. The lack of causation running from consumer prices to the household credit envisaged earlier might partly be due to the fact that CPI is not an appropriate price index to capture this aspect.

The results are summarized in *Figure 5*. They, together with the ones referring to the different components of money and credit stocks presented earlier, allow us to describe some aspects of the nature of money supply. Three main conclusions can be drawn. First, there are several results suggesting that money supply might well have been endogenous in Hungary. This finding supports those arguing for endogenous money supply in CPEs in general (Cassel 1984; Wanless 1985) and seems to justify the distinction made by Portes (1983) between the possibility and plausibility of exogenous money supply.

Table 11

Causal relations between producer (PPI) and consumer price indices (CPI), investment (IC), working capital (WCC), and household credits (CH)

	(a) PPI→IC	(b) PPI→WCC	(c) PPI→CG	(d) CPI→CH
m,n	4,4	4,4	4,4	4,4
F-test	1.56	1.43	2.37[c]	0.26
$\bar{R}^2$	0.78	0.52	0.97	0.77
SE	0.032	0.044	0.019	0.008
DW	1.85	1.69	2.30	2.00
R E S E T Y2	0.11	2.81	0.33	4.72[b]
R E S E T Y3	1.36	1.48	0.27	6.37[a]
JB	26.63[a]	1.39	3.32	24.40[a]
LM1	0.85	5.76[b]	2.09	0.37
LM4	1.08	1.34	1.33	0.84
M	1.11	1.91	-1.49	-0.40
BP	49.63[a]	8.32	17.89[b]	21.03[a]
CH	3.70[a]	4.84[a]	0.41	3.24[b]
Q	79Q3	79Q4	82Q1	79Q1

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

Second, the different components of money supply or credit were of quite different natures. Consequently, an analysis based on aggregate monetary indicators might be quite misleading in this respect, too. Third, the state budget played the central role in creating endogenous money supply. Money held by the government is Granger caused by producer prices while credit to the government is Granger caused by consumer prices. The latter result shows that in Hungary, endogenous money supply was not entirely attached to the enterprise money circuit (Cassel 1984). If we also recall the finding that government money caused both enterprise and household money we can see the importance of the role that the government played.

There is one more decisive sign of endogenous money supply, namely the causation running from output inventories to working capital credit, which gives some support to Cassel's (1984) view in this regard.

The results presented here also suggest an inflationary circuit in the money-price relation running through government money, enterprise money and producer prices and being similar to the one hypothesized for some developing countries (*Parikh* 1984). On the one hand this finding again underscores the central role of

Table 12

Causal relations between consumer price index (CPI), working capital credit (WCC), credit to the government (CG), and investment credit (IC)

	(a) CPI→WCC	(b) CPI→CG	(c) IC→CPI
m,n	4,4	8,8	8,8
F-test	1.63	2.89[b]	6.50[a]
$\overline{R}^2$	0.53	0.98	0.81
SE	0.043	0.013	0.011
DW	1.75	1.78	1.96
R E S E T Y2	1.91	1.24	1.67
R E S E T Y3	1.27	1.75	0.97
JB	0.15	2.34	5.24
LM1	3.58	0.33	2.49
LM4	1.20	0.55	2.16
M	1.64	0.93	-0.15
BP	8.64	5.27	20.60
CH	10.56[a]	2.85	1.34
Q	81Q4	81Q2	81Q4

Note: [a] significant at 1% level; [b] at 5% level; [c] at 10% level.

the state budget, and on the other hand gives some explanation as to the nature of price changes in the enterprise sphere.

Conclusions

The main purpose of the paper has been to provide empirical evidence for further theoretical works on modified CPEs by testing different proposals emerging in the literature of CPEs for Hungary for the period 1974–1985. An additional aspect touched upon by the empirical investigation has been the dynamics of the investigated relations. In both respects some very important conclusions can be drawn.

The results in almost every respect show that in establishing behavioural relations and macroeconomic models of a modified CPE, one should be very cautious with aggregation over money circuits. Relations in different spheres and even inside one circuit might be of rather different natures, leading to uncertain or mislead-

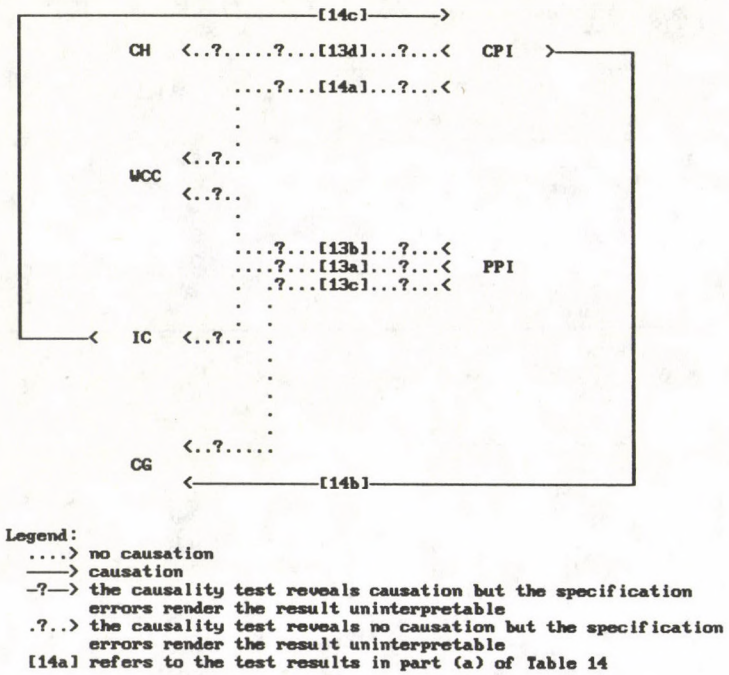


Fig. 5 Bivariate causal relations tested

ing results in an aggregate analysis. The different sorts of interconnections among the money circuits detected in our analysis suggest that a disaggregate framework should allow for such interconnections and in designing a framework this problem should be considered carefully. Another important finding of our analysis is the central role of the state budget, which appears in the mechanism of interconnections between the enterprise and household money circuit.

There are several findings suggesting endogenous money supply but which also show that the different components of money supply are subject to different sorts of feedbacks. The central role of the state budget appears in this respect, too.

Analyzing the relations between inventories and monetary aggregates our main finding is that inventory movements did not originate from monetary factors but did have influences on monetary aggregates, namely on working capital credit.

Taken as a whole, our analysis suggests that money had an important role to play in the enterprise sectors and consequently should be incorporated in any model or theoretical framework aiming at explaining the behaviour of this sphere.

Both the aggregate and disaggregate analyses show that different relations have quite different dynamics which, together with the detected interconnections, suggest a rather complicated dynamic structure for a macroeconometric model for Hungary. Improper aggregation might have serious consequences in this respect, too.

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BOOK REVIEWS

UNGVÁRSZKI, Á.: *Gazdaságpolitikai ciklusok Magyarországon 1948–1988* (Economic political cycles in Hungary 1948–1988). Közgazdasági és Jogi Könyvkiadó, Budapest 1989. 191 p.

Ágnes *Ungvárszki*'s work is written in a rather reserved style, containing analyses conducted in a well circumscribed area, using well determined means. Commenting on her findings, she writes in one of the last pages of the book: "We do not really know the causes and motive forces of the regularity of these processes as they have appeared up to now" (p. 161). This is indeed a truism, for the causes are, for the most part, political ones and the political management of the country has almost always attempted to keep its dealings hidden and secret. In her book (finished in summer 1988) Ungvárszki does not go into the detailed political background but shows that during the forty years she has analysed the Hungarian economy went through three periods in which the reins were tightened (i.e. movement closer to the Stalinist model) and three periods of loosening (i.e. withdrawing from the Stalinist model). She states that the subject of her research, as well as its conclusions, had to be adjusted to the possibilities of the research work" (p. 16). Investigations were allowed to analyse the factual data linked to the main processes of the economy, and they were also given the possibility to analyse national economic plans and their modifications (which usually followed in a series). Furthermore, it was possible to write about central decisions which were available in generally obtainable publications, as well as the declarations of leading politicians. However, materials concentrating on the preparations lying behind the central decisions, as well as debates carried out within the decision-making organizations, and deeper arguments for the decisions: these were not available for the scientific researcher; moreover, even some of the decisions themselves remained hidden.

Á. Ungvárszki reveals two types of economic political trend—these following each other in consecutive sequences of 6 or 8 years. She calls one of them a doctrinarian trend and the other a reformatory trend. The *doctrinarian trend* (which I referred to above as a "tightening of the reins") is, with regard to the *direction of structural development*, characterized by the strong emphasis on the development of heavy industry. Within it, the basic material industry is given such emphasis that other sectors are pushed into the background; with regard to the *policy of growth*, the growth rate of production—is accelerated, especially that of the heavy industry and of industry's "A" sector. This means that priority is given to quantitative growth, instead of the requirements of equilibrium. With regard to *developing the proportions of national income consumption*, the characteristic of this trend is the raising of the rate of investments (accumulation), and justifying this by "creating the basis" for the future growth of living standards; concerning *foreign economic policy*, typical developments involve the strengthening of the CMEA-orientation regarding production, the endeavour to achieve self-sufficiency, preferential attention for imports-substituting developments, and an express concern for political and economic safety; finally, in forming *ownership relations*, priority is given to state—(large-scale enterprise) property, and cooperative ownership is considered as a "lower rank" in the socialist forms of ownership; thus the autonomy of cooperatives is reduced and the private sector is suppressed.

In contrast, the *reformatory trend* (the period of "loosening the reins") accelerates the development of manufacturing industries (within this sphere, that of the "B" sector), as well as that of agriculture and of the infrastructure. Based on the concept of a "permanent" increase in living standards, "simultaneous" with the growth of production, and "anticipating" the growth of productivity, it increases or, at least, maintains the rate of investments (accumulation); this trend extends the foreign economic relations with non-socialist countries; it acknowledges the equal ranking of state—and cooperative ownership and the multi-sectoral nature of the economy, and tolerates the private sector.

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The research demonstrates that within the analysed forty years the following periods can be regarded as purely doctrinarian: between 1947/48 and 1953, between 1958/59 and 1966, and between 1972 and 1979. In the periods between 1953 and 1958, between 1966 and 1972, and between 1979 and 1984 the reformatory economic policy was dominant. However, of the reformatory periods, only the one between 1966–1972 can be considered a complete and *pure* one (p. 112). This is because, in the period between 1953 and 1958/59, from March 1955 on, sometimes smaller and sometimes larger concessions were made to doctrinarian policy; finally, in the period between 1979–1984 there was permanent ambiguity due to the lack of suitable foreign political—i.e. Soviet—conditions for a reform policy.

In addition to the three reformatory waves, Ungvárszki also analyses in detail the *three waves of Stalinism*. She calls attention to their lasting heritage, to the capital tied up in large organizations with anachronistic structures, and furthermore, to the interests and behaviour of employees and leaders working in big organizations, including the retardatory effect of these (pp. 179–181).

The details of the first wave of heavy industrial development between 1948/49 and 1953 are well-known. Less known are the two other waves of industrialization, which also gave preference to heavy industry. Ungvárszki deals with them in detail. She demonstrates that behind every wave of heavy industrial development three political *motives* can be found: (1) realization of the greatest possible self-sufficiency of the socialist countries; (2) the fastest possible increase of military potential; (3) the principle and practice referred to as the "policy of big leaps". According to this, the period of transition from capitalism to socialism can and has to be achieved in the shortest possible time. In order to do this, the mechanism of large industry, regarded as the material-technological basis of socialism, had to be implemented as rapidly as possible, even at the cost of some sacrifices (pp. 31–32).

Detailed analysis is provided of the wave of heavy industrial development of the seventies. Ungvárszki states definitely: "politico-economic" management was forced to change the direction of economic development, but not in line with the price explosion on the world market" (p. 50). Studying the changing sphere of centrally decided large state investment projects, she points out that the vast majority of the individual large investments started during the plan period 1971–73 served to increase the production of material and energy; on the other hand, the investments that were cancelled or postponed affected the building materials industry, light industry and the non-productive sectors (p. 53). The endeavours at structural development that were asserted from the early seventies, were well reflected in the Central Development Programmes accepted and started in 1970–71. The programmes tied up a significant proportion of the resources available for development and unequivocally expressed the efforts that aimed at the self-sufficiency of the CMEA countries (pp. 54–55). In addition, the strengthening of CMEA-orientation was marked by the fact that between 1972 and 1975 the agreements were signed for five common CMEA investment projects with Hungarian participation (p. 55). The final proof given to demonstrate the changing trend prior to the price explosion in the world market is the following: "When searching for the antecedents of the changing trend in the early seventies, and of the new wave of heavy industrial development that unfolded as a part of it, we repeatedly meet statements referring to the *accelerating growth of military expenditures*" (p. 55.—italics mine). All this shows that in practice the doctrinarian trend had been dominant in development policy since the early seventies. The result was a "reverse" adjustment to the changes in the world market.

The strengthening of the Stalinist economic structure in all aspects of heavy industrial development set a trap involving of the sudden increase of capitalist credits to the economy. This resulted in constraints being placed on the increase of capitalist exports in the short term. In turn, this meant a further reinforcement of an inadequate structure, such that it could not even become free of constraints in the reformatory periods.

In the wake of activities pursued during the periods of the doctrinarian trend serious tensions were always accumulated. Linked to the changes in 1953 and 1979, this is ob-

vious and widely known. The economic tensions in the background of the 1966 change of trend are less known; therefore, I must mention that the deficits of the foreign-trade balances in 1963 and 1964 were rather significant (1.8 and 3.3 percent of the produced national incomes respectively) also in 1965 the half-percent growth of the national income was unprecedented and alarming at the given time (pp. 84–85). Thus, in the wake of the strengthening of internal economic tensions (this does not apply to 1979), after 6–8 years, the time of the doctrinarian trend was running out. For the sake of overcoming the tensions, the reformatory economic policy, described at the beginning of my review, came into force. Its results were poor, being of a "fire-fighting" character, and it had the negative effect of exhausting reserves. This was perhaps because the policy very soon went into reverse (like in March 1955), or because, from the outset, it was contradictory. Yet one of the most important elements of Á. Ungvárszki's book is that it pronounces the point that it was not merely for the above reasons.

Writing in 1988, she states: "so far, the reformatory trend has not succeeded in finding or elaborating the means by which economic growth could be kept within the limits defined by the requirements of equilibrium, or could be driven into a channel ensuring permanent equilibrium. In other words, it has no arsenal of tools which could provide growth and equilibrium in parallel. One of the reasons for this is that the economic political management did not have enough tolerance for the tools that needed to be applied. The other reason, of at least the same significance, is that *such methods are not clear theoretically, let alone their practical implementation.* In all three periods of the initial upswing of the reformatory trend there very soon appeared a slackening of impetus, and arrival at a defensive state was caused by the fact that it also collided with its own limits (p. 75—italics mine).

Have any of us ever read any normative work on the economic system of market socialism, where plan and market are able to complement each other and successfully operate the economy? Or, have we read a book which consistently describes the various sectors and participants of the economy, as well as their motivations? Such a book would prove, by its own theoretical means that in such an economy supply automatically adjusts to demand, there is no shortage, and market and planning work together. However, I do not think we have ever read one, for no such book exists.

We may put the question in another form: Is it possible to operate "cleverly" a large state sector, or to form the investments of state- or community-owned enterprises in a more enlightened manner, free from politics: for example as was done in the seventies? *Is it possible now, when it can be done with no external political influence?* Of course, I cannot answer this question. I can only point to what Á. Ungvárszki says: from three reformatory waves of the past forty years we have not inherited the *economic* tools that would make this possible.

In addition to the presentation of the two economic political trends, the analyses have produced some additional products—one might say, "by-products". For instance, there is the imbalance stemming from overdistribution, as well as the imbalance caused by structural causes (pp. 72–75). The in-depth study of the seventies and the period 1985–1988 demonstrates that the motions of consumption and incomes were, up to the 1970s, no more planned than the motions of investments (p. 96); presentation of the frequent modifications of the five-year plans show that the economic trend usually changed to the opposite of its starting variant; this proves that the worsening conditions of agricultural production led—among other things—to the decrease of the real income of those living on wages and salaries; finally, there is a description of the learning processes involved in the two trends.

In her book Á. Ungvárszki has concentrated on proving a well-defined fact (namely that in Hungary there were 6 to 8-year economic political cycles between 1947/48 and 1988). In my opinion, she has in fact succeeded, for I can hardly find anything to be criticized in the volume in question. True, she does not touch upon the economic political cycles in the surrounding countries—among them, in the Soviet Union. True, she cannot sufficiently explain why such economic political cycles took place in Hungary; she "only" de-

scribes them and does not become engrossed in their explanation. True, she does not mention the economic cycles of the capitalist countries, and the theories that describe and explain them. However, she did not promise to do all these and, even without dealing with such questions, her book forms an organic, logical unit.

However, I do think the omission of one subject is unjustified. This is the relationship between the 6–8-year economic political cycles that Ungvárszki reveals and the 3–4-year investment cycles that are multilaterally analysed in Hungarian economic literature. Did the turning points coincide—i.e. did two small cycles precisely create one 6–8-year cycle? What does the explanation of the turning points of the small cycles mean for the explanation of those of the 6–8-year cycles, or the other way round? What relevance does the running out of the small cycles mean in the running out of the 6–8-year cycle, and what about the reverse? As far as I can see, the two types of analyses—regarding the two types of cycles—would strengthen each other; therefore, I find it a significant omission that Ungvárszki does not deal with their relationship.

Coming to the end of the review, I am tempted by the feeling that the existence and changing of the two economic political trends may seem too simple for the reader. What can be the answer to this? Is it that good books are mostly built on simple truths? Yes, it is perhaps really as simple as that. In the course of the analysed forty years we were a satellite of the Soviet Union, revolving around our "Sun". Sometimes this was in a doctrinarian way, and we were closer; at other times—in a reformatory manner—we moved further away from it. Now, the attraction has ceased to exist, and we have passed out of its influence. Whereto? This will be but another history, separate from the periods of tightening and loosening of the reins—although not independent of them. Therefore, with regard to the "heritage", Á. Ungvárszki's book is worth reading.

J. SZABÓ

IIVONEN, Y. (ed.): *The changing Soviet Union in the new Europe.* Edward Elgar. Aldershot 1991. 250 p.

This book has been published as part of the series of "Studies of Communism in Transition". It undertakes an unenviable but inevitable task: that of analysing the unprecedented, complicated process of transition of the Soviet Union into the "De-Sovietized Non-Union" in its international context. The main focus of the book is Soviet foreign policy in the Gorbachev era with a special emphasis on its European direction.

The book is based on the proceedings of an international conference organized by the Finnish Institute of International Affairs at Tuusula, Finland, in November 1990. This very fact reveals two problematic issues. The first is related to deadlines; in other words, the objective fact that the articles could only deal with events prior to 1991, made it impossible to carry out an analysis of a more comprehensive complete period—say, until the coup of August 1991. Such a situation multiplies the danger of being overtaken by the events and being mistaken in evaluations. Secondly, while presentations that overlap each other are natural parts of a conference procedure (being clarified in discussions), it is much less meaningful to put together presentations dealing largely with the same issues in a book. In spite of these reservations, this book is a useful instrument that contributes to analytical thinking about what is at present one of the most challenging topics of political science and international relations. The articles contained in the book can roughly be divided into four groups. The first part deals with wider historical and conceptual issues of Soviet policies toward Europe. The second one is dedicated mainly to the military issues, examining the military doctrine, changes in the army and conversion. The third part concentrates on certain economic problems in Soviet foreign policy: the changing Soviet attitude towards the European Community and Soviet–East-European economic relations. In the fourth part the issue of Baltic regional cooperation is examined and an updated paper

on the Soviet attitude towards German unification concludes the book.

The first group of problems is examined according to a classical cold war pattern, at least as far as the authors' geopolitical composition is concerned: one Russian, one Finnish, one British. There are both coinciding and conflicting views in their presentations.

H. *Trofimenko*'s (Institute of the United States and Canada, Moscow) article is rather descriptive and less analytical and sometimes fairly apologetical. In his historical background he is very keen on proving that Russia has always been part of Europe. Of course, this is true, but at the same time it is also a typical reflection of the fact that Russia has always been a *special* part of Europe and the Russians themselves are not even uninamous about their relations towards the rest of the continent. The Finnish contributor, J. *Iivonen* (The Finnish Institute of International Affairs, Helsinki) reaffirms this latter point by stating that there have always been two schools of thoughts in Russia *vis-à-vis* Europe: that of the Slavophils and that of the Zapadn'iks (Westerners), and perestroika has caused this earlier frozen dispute to reappear. N. *Malcolm* (Royal Institute of International Affairs, London) adds to this by indicating that a cyclical pattern is to be noticed in Russian history: isolationism, stagnation, military defeat, reform and Westernization, followed by the return to isolationism.

There seems to be agreement among these authors as to Soviet European policy. All three affirm that in the pre-Gorbachev period Europe was not a high priority in Soviet foreign policy and relations with the rest of the continent were subordinated to Soviet–American relations. As Trofimenko puts it, "the Soviet Union treated Western Europe as a hostage in its big power game against the United States".

The question of when and how Soviet–European relations changed is answered differently by this group of authors. Trofimenko sees a marked change as early as October 1985, when Gorbachev visited Paris and claimed that the French connection was of a privileged character. Iivonen puts emphasis on the fact that Soviet–European relations could only change after 1987; that is, after big power relations improved.

Malcolm approaches the question from the point of view of the Soviet concept of a Common European Home (CEH). He puts forward the thesis that this concept has gone through three stages of transition: the first reappraisal occurred between 1985–89. It meant breaking with the post-1945 approach which treated Western Europe principally as a subordinate element of a US-dominated alliance, and replacing it with a view of Europe as increasingly becoming a power-centre in its own right. The second reappraisal occurred in 1989–90. It meant abandoning Gorbachev's initial "one Europe, two (slowly converging) systems" view and accepting that the countries of the Eastern block would inevitably fall into the West European orbit. The third reappraisal has been under way since 1991, and it involves the Europeanization of the Soviet Union itself.

One of the most challenging and least elaborated issue of the general question of Soviet–European relations is that of Soviet–East European relations. The academic community has not yet produced a deep analysis of this issue, and as yet it has only resulted in a series of superficial and consequently false evaluations. Unfortunately, neither our authors are exceptions from this. There is a widespread myth that the Soviet Union was the catalyst for reforms in Eastern Europe and that Gorbachev carried out a creative policy *vis-à-vis* Eastern Europe. It is also extremely interesting that Soviet and Western views largely coincide in fabricating this false vision. Trofimenko's words are very typical in this regard: "Perestroika in the Soviet Union struck a responsive chord in the hearts of millions of people in the Central European countries including many dissident intellectuals ... the years of totalitarian rule accumulated very strong forces of discontent, which had been waiting for their hour to come" (etc.) As opposed to this interpretation, I argue that the Soviet policy towards Eastern Europe was typically reactive and the catalyst role can be proved only in certain cases and in certain periods, but not as a general rule.

Furthermore, the question of Soviet policy towards Eastern Europe has to be examined within a wider framework. First, one has to point out that the pre-Gorbachev Soviet–East European relations were characterized by

a special dual nature—namely, the domestic affairs of the latter countries (as units of the same socio-economic system) automatically became international problems of the "socialist community". On the other hand, problems that surfaced among these countries (internationally) had an immediate significance at the domestic level. This unique convertibility of domestic and foreign policies was the reason why the Soviet Union was able to handle the region with means typical for handling domestic disturbances (the most spectacular examples are the use of force in 1953 in Berlin, 1956 in Budapest, and 1968 in Prague. In the final analysis, these actions represent the restoration of order by a domestic police force).

It is also important to understand that the peculiar feature of this situation was that Soviet policy towards Eastern Europe was not part of Soviet foreign policy but of Soviet domestic policy. Soviet policy *vis-à-vis* Eastern Europe continued to be the function of domestic policy in the Gorbachev era. This explains to a large extent why Eastern Europe was a low priority, and why the Soviet approach to it was always the last to change in the Gorbachev era. If we compare the dynamics of reforms in the field of domestic policies and in the field of policies towards Eastern Europe it becomes quite evident that the latter always followed the former with substantial delay. In this perspective, the reforms of Soviet policy towards Eastern Europe were part of a process in which Eastern Europe was emancipated from domestic captivity and integrated into general "normal" foreign policy.

However, in spite of all these scholarly discussions, the final outcome of Gorbachev's and the Soviet Union's merit in the East European changes of regimes will be measured by other standards. As Henry Kissinger puts it—being quoted by the Russian author—"Gorbachev would not be the first revolutionary to set in motion events that swept beyond his design... since history judges results rather than intentions, it will be kind to Gorbachev".

In the second chapter G. *Wettig* (Federal Instutite for East European and International Studies, Cologne) sets a wider framework to interpret one of the best known Gorbachevian notions, that of "new thinking". His main thesis is that "new thinking" as put forward in 1985–86 was clearly in the old mould of advancing progress towards worldwide transition to socialism by putting Western security in jeopardy. However, the idea of "new thinking" also had the potential of inviting conclusions that deviated from previous security postulates. The imperative that the challenge of global problems had to be met could equally be understood to imply that the Soviet Union was giving up antagonism against the West in order to allow joint efforts against common challenges such as modern war and constantly growing environmental destruction.

In Wettig's understanding "new thinking" can be viewed as characteristic of the period from early 1987 to mid-1989, which preceded the subsequent fundamental change of Soviet relations with the outside world. It was only during this period that the different ideas coming under the label of "new thinking" were practically tested, and they took a clear direction. The meaning of what had been theoretically thought out was concretely determined in the process. What resulted was not mere implementation. More often than not, emerging realities created a dynamism of their own, forcing the Kremlin to adapt itself to new conditions and to accept results that had not been originally intended.

The article by R. *Allison* (Centre for Russian and East European Studies, Birmingham) concentrates on the processes and perceptions that have shaped the reformulation of Soviet military doctrine. He points out that Soviet military thinking was in a crucial transitional phase and thus identification of its specific content is an uncertain task. Nevertheless, he distinguishes three major phase of evolution.

First was the endorsement of the idea of non-offensive defence from early 1987. This meant the doctrinal abandonment of the possibility of surprise attack and large-scale offensive operations. However, these shifts were still to be implemented within the framework of the Warsaw Pact.

The second and probably the most important shift in Soviet military thinking occurred in mid-1990. It signalled the end of Soviet military planning involving the Warsaw

Pact alliance. The decisive impulse for this dramatic change was determined by the agreement on German unification. This was a mortal blow to the concept of integrated coalitional defence between the Soviet Union and the East European states.

From an Eastern and Central European point of view, Allison's vision on the role of this region in the European security scene is extremely curious. In view of the abandoned Soviet perception of an East-West conflict, Allison speaks about a common response (by the West and the Soviet Union) "to shared threats and instabilities in Eastern Europe". In this context, he proposes that "NATO could consider the idea of East-West guarantees on the non-intervention of forces in Eastern Europe and possibly on the non-extension of the NATO structure further into Eastern Europe". This is nothing else but the "finlandization" of Eastern Europe, a proposal that coincided with the intentions of the conservative wing of the Gorbachevian centre. Later, in early 1991, it was publicised as the official line of the Soviet leadership and caused tensions during the talks on new bilateral treaties between the Soviet Union and its earlier allies. Fortunately, this peculiar coincidence of Western and conservative Soviet security interests was just a temporary phenomenon. Still, it is a warning sign for Eastern and Central Europe that this region should make common efforts to avoid a return back to ideas that carry such bad memories.

The third phase of change in Soviet military thinking is connected to the issue of republican defence. The first challenge to coordinated Soviet defence planning arose in the Baltic republics during their assertion of independence in 1989–90. This had a catalytic effect: declarations of intent to establish their own armed forces appeared in other republics: first, on behalf of the Ukraine, then it spread to the Transcaucasus and Moldavia. As in other cases, the decisive role was to be played by Russia. When this book was published answers to this question had not been clarified but in the post-coup situation it very soon became evident that the Russian leadership was going to take a similar stand.

In the chapter dealing with economic aspects H. *Timmermann* (Federal Institute for East European and International Studies, Cologne) examines Soviet attitudes towards European institutions. He approaches this issue through the perspective of a surviving (though renewed) Soviet federation and thus he cannot but characterize Soviet–European institutional links other than in terms of rapprochment; the possibilities for joining are not considered. This, however, does not seem to be the case now, and in many respects the relations of European institutions with the successor-states of the Soviet Union must be viewed in terms of joining rather than just approaching.

The economic chapter goes on with the analysis of the "rise and fall of the Council of Mutual Economic Assistance" by L. *Csaba* (Kopint-Datorg, Budapest). The Hungarian author's starting thesis is that this organization was originally set up for political reasons, as an attempt to create a kind of command economy on an international scale. The main paradox of CMEA was that the integration between the member states was never carried out through supranational planning or through the market.

After so many years of renewed attempts to improve CMEA, a qualitatively new approach was finally registered in this organization due to the pressing problems that had accumulated. Reorientation, as an overall strategy, emerged as a definite concept in both Hungary and the Soviet Union in late 1988. Reorientation implied, by definition, a systemic change, in which the methods of command planning were abandoned; it aimed at giving up the primacy of ideology in politico-economic decision-making and, consequently, looked for growth in the share of trade of those nations that constituted the mainstream of the worldwide technological and economic development. As one side of the reorientation strategy Csaba examines, in details, the problem of intra-block trade in convertible currency. This was an idea put forward by the Hungarian leadership in early 1989 and approved as a general rule in 1990 by the Soviets.

Finally, Csaba considers what will remain of the CMEA as a multinational organization. Well, his forecasts have not come true since then. He is for the maintenance in some form—say, in an OECD-like way—of

the CMEA. He puts forward arguments which try to prove that there is an economic rationale both for East and West European countries to bring this about. It is easy to pass judgement now, but the fact is that what has happened is nothing less than the total dismantling of this organization. This has been an inevitable result of the logic of the political processes under way in this region. CMEA was born by political will and died for political reasons as well.

The closing chapter of the book is dedicated to the question of Baltic cooperation and a summarizing article that updates thinking on the German question. As to the first theme, P. *Järve* (Institute of Philosophy, Sociology and Law, Tallinn) suggests that Baltic cooperation dates from 1917. Further, he makes it clear that the notion "Baltic" has had different meanings. In linguistics, the "Baltic languages" refer to Latvian, Lithuanian and old Prussian but excludes Estonian. In history, the "Baltic Provinces" stand for three "guberniya" of Tsarist Russia dating from the beginning of the 18th century; roughly, these include present-day Estonia and Latvia, but exclude Lithuania. "Baltic" has also been applied to the Baltic-German sub-population and, finally, the term "Baltic states" has been used to refer to the independent interwar republics of Estonia, Latvia and Lithuania. The Soviet era produced the term "Baltic republics". Most recently "Baltic" has been used as a notion to designate all the countries and nations bordering on the Baltic Sea.

P. *Visuri* (Finnish Institute of International Affairs, Helsinki) formulates the thesis that, contrary to the general perception, German unification has not solved the so called German question. The topical question of a divided Germany has been solved by this act but the historical German question remains or will come back. This latter boils down to the problem of how a power like Germany can exist in the middle of Europe, without dominating the whole continent, especially the neighbouring countries. In the context of the Soviet Union the author suggests that there will be a return towards a traditional Russo-German policy of interest-sharing—though there will be a potential great power rivalry as well. He argues that Soviet policy *vis-à-vis* Germany was at a crossroads. The Soviet leadership—by agreeing to German unification—chose the path of traditional cooperation with Germany. This now lacks any ideological elements though there is no guarantee that some kind of ideology could not become important again. His forecast that this traditional course of policy can survive even the collapse of the Soviet Union has turned out to be correct.

L. PÓTI

BOFINGER, P. (ed.): *The economic consequences of the East.* A conference organized by the Centre for Economic Policy Research and the Deutsche Bundesbank in Main-Frankfurt, March 20–21 1992.

These days Eastern Europe has become fashionable, and it is difficult to find time to pay attention to the proceedings of the numerous economic conferences. In fact, we are often fed up with studies which hide ignorance behind a veil of self-confidence. However, this conference was different, and this volume can be useful even for the experts.

The volume is a collection of ten studies, summarized in an introduction by the editor, P. *Bofinger* (Würzburg). It consists of four parts: I. the political economy of economic transformation, II. the experiences of selected countries, III. the role of economic policies and IV. policy responses of the European Community.

In this review I shall first summarize what I consider to be the five best papers. Then I deal with the other papers and make some critical remarks.

Gérard *Roland* (Brussels) looks at the *issues of the political economy of transition.* He has written several papers on this topic, coauthored with, in general, excellent mathematical economists (e.g. Patrick *Bolton* and Thierry *Verdier*, who had not studied Eastern Europe before). One of his important theses is as follows: Individuals and institutions know their own rents quite well, but the government only knows the average and the dispersion of these rents. At the same time, though the govern-

ment promises that it will compensate the losers over several years, the claimants, not trusting the administration, want total compensation immediately. Modern economics refers to this pair of contradictions as follows: asymmetric information and the lack of governmental precommitment make the compensation of the losers of transition difficult.

He asks the question: what is the tradeoff between the speed and the costs of transformation? According to the author, it is only the ex-GDR which can be transformed quickly. The speed of transformation in other East-European countries is *ab ovo* limited by the constraints of macrostabilization.

Roland proves that political decisionmaking can cause reversals and even paralysis if the government does not have sufficient power to determine the agenda; the *status quo* causes biases which can be countered by suitable sequencing; finally he explains how to privatize and how to harden the budget constraint.

Horst *Siebert* (Kiel) studies the *real adjustment in the transformation process: risk factors for East Germany*. First he considers the basic risks, of which unification policy and inflation have already been eliminated by the united Germany. However, East German wage dynamics is still a problem: although the big multinational firms are able to pay the exorbitant wages, wage inflation seriously menaces the success of the newly formed small and medium scale enterprises.

The next question is as follows: will the self-sustaining growth start and will the successful privatization continue in the East? Siebert opposes the state structural policy, warns on the unsolved problem of enterprises' debts, and expresses his hope that the ex-GDR will follow the New Frontier of the U.S. rather than the Italian Mezziogiorno.

Michael *Burda* (Fontainebleau) commented on this lecture. Earlier he was afraid that the ex-GDR would copy the Mezziogiorno, but under the impact of the high level of infrastructural investments, the lagging price level of the East relative to the West and the exhaustion of the West German trade unions' wage claims, he became an optimist. In contrast to the majority of experts, he not only revised his former ideas but openly admits it.

Holger *Wolf* (Cambridge, USA) deals with *miracle prescriptions—postwar reconstruction and transition in the 1990s*. It is quite well known that many experts have expected the same economic miracle from the East European economies that have got rid of the command economy as that produced by West Germany after 1948. Wolf tries to eliminate the myth which identifies the miracle with the destruction of the administrative constraints. I can only list the most important special factors analyzed by him: After the war the economic capacities were much higher than before the war; it was only the utilization of capacities that was terribly low. The recovery effect (analyzed by Ferenc Jánossy in the sixties) sped up the economic development. The boom following the Korean war arrived just when the transition hit the bottom. Indeed, the supply effects—like good industrial relations, etc.—exerted a favourable effect. Considering the possibilities of Eastern Europe, he excludes a West German scenario: the private sector is not dominant and the revitalization of the former COMECON trade is not welcome. Nevertheless, significant economic recovery is possible if these economies can adopt such elements of the West German miracle as good industrial relations, and if the external conditions also develop favourably.

The paper is based on serious international statistics and econometric analysis. Several tables contain estimations of the recovery and convergence effects, quantify the good state of industrial relations, and try to estimate the supply side effects.

Commenting on the lecture, Rudolf *Richter* (Saarbrücken) concentrates on the two German monetary reforms. 1) The FRG had three years to prepare for the reform, while the GDR had only a half year. 2) Notwith-standing the fascist militarization of the economy, the (West) German economy remained a market economy. 3) The role of the trade unions changed unfavourably between 1948 and 1990. 4) In 1948 there was no TV to show the West German workers the lives of their Swiss colleagues. In contrast, the East German workers, partly educated by the TV, want to catch up with their Western brethren, at least with regard to consumption.

The lecture of the celebrated expert on the shadow economy, Vito *Tanzi* (Washington), dealt with *financial markets and public finance in the transformation process.* Without mentioning by name those "experts" who not so long ago assured the public that the transition and convergence would only take few years, he underlines that decades will be needed. As an explanation, Tanzi argues that in addition to material goods, market economies also produce knowledge. In the same way as the market economies devoted considerable time to the education of economic actors, such that they would be capable of working in a modern environment, the ex-socialist countries will have pass through decades of organic development. Tanzi describes the traditional socialist monetary system and its transition, then turns to some neglected issues: how can the underdevelopment of the financial (monetary) institutions limit the efficiency of the monetary (financial) policy? The example of Latin America also demonstrates that the less developed the economy, the more difficult it is to separate the two spheres. He warns of the danger caused by channelling the privatization revenues into the financing of the budget deficit; he proposes the adoption of German and Japanese bank systems rather than Anglo-Saxon solutions.

Among those involved in the discussion Alfred *Steinherr* (London) called the attention of the East European countries to the monetary control of the European Community, while Hans-Werner Sinn (München) criticized Tanzi's lecture for failing to describe the transitional institutions.

In the introduction to his lecture on *The European Community's response to Eastern Europe*, Richard *Portes* (London) underlines the large differences between the East European countries. He emphasizes that the construction of an analytical framework has just been started, and in addition to the traditional historical and gravitational calculations he proposes the more sophisticated Computable General Equilibrium Modelling. So far, no one is sure about how much the level of East and West European trade will develop. Referring to the much quoted (and much criticized) calculations by *Hare and Hughes* (1992), Portes does not see any West European industry seriously menaced by East European competition. Discussing capital exports, Portes alludes to the competition between East and South Europe. He demands a lowering of EC trade barriers against East European exports, more economic aid, and increased support for the Central European countries to join the EC. Finally Portes evaluates the economic transition and the present priorities. Acknowledging the initial successes of the transition, he warns of the problems and underlines the depths of the depression and the slowness of structural transformation. Referring to the priorities of the EC policy, Portes criticizes Brussels for not supporting the expansion of the EC. Of course, Portes does not want new poor relatives in the Common Market either, but he quotes Hughes projections: namely, that a suitable structural transformation would yield an additional annual increase of 3% in Eastern Europe.

Some words on the remaining lectures. John *Flemming* (London) assesses *Eastern Europe in the year 2000: hopes and fears.* Domenico Mario *Nuti* (Florence) and Jean *Pisani-Ferry* (Brussels) analyze *Post-Soviet issues: stabilization, trade and money.* Dariusz K. *Rosati* (Geneva and Warsaw) discusses *Problems of post-CMEA trade and payments.* Commenting on the latter, P. Bofinger agrees with Rosati that there is no need for a payments union among CMEA countries, but adds that the ex-Soviet republics need one. In connection with this we can quote the main point of Otmar *Issing*'s (Main-Frankfurt, Bundesbank) *Note on the monetary reform*: "Monetary reforms cannot be repeated at will. Indeed, the first attempt must be successful." Peter Bofinger analyzes a very timely topic in his lecture, which deals with *The experience with monetary policy in an environment with strong microeconomic distortions.*

Having read all the papers in the book, we may be satisfied that there are good Western experts, too, who discuss the region's problems with due scientific and political responsibility. I noted that only one Eastern (Polish) speaker was invited. It is an open question as to the extent to which this selection was justified.

At the end of the review I would like to mention two deficiencies in the field: 1) There are no macromodels which are capa-

ble of describing the transition, even models with large errors. (The large number of "back of the envelope calculations" is suggestive—i.e. experts use models which are so rudimentary that they can be solved on the back of an envelope.) 2) We are as far from having reliable output (GDP) data on the ex-COMECON countries (which is the same situation as earlier). The elimination of this deficiency would help to solve the following problems: a) It would provide good data for models (e.g. Rosati's gravitational model): b) It would eliminate the psychological burden which the unrealistic underestimation of the region's development tends to produce. Perhaps neither Czechoslovakia nor Hungary is poorer than Portugal or Greece. Poverty per se would not be a barrier to our joining the EC (see Portes).

The editor of the volume went round collecting the papers written by the speakers. Thus it is not surprising that it does not contain a joint format, nor is there continuous page numbering. It quite frequently occurs that the Anglo-Saxon decimal points are replaced by the continental decimal comma! These formal errors, however, are more than counterbalanced by the excellent content.

A. SIMONOVITS

KIM, D.–JUNG, K.–JEONG, K. (eds): *The role of market and state: economic and social reforms in East Asia and East Central Europe.* Institute for East and West Studies. Yonsei University. 1991. 340 p.

Much has been written on the economies of East Asia and Eastern Europe. The economic success of one of the regions and the economic collapse of the other have generated worldwide interest and both have become popular research and conference topics. Despite the vast amount of research done on both regions, no clear consensus on how to characterise the growth experience of East Asia nor how to transform Eastern Europe have emerged in the literature. This book is a timely effort, but as is often the case with books of this kind, it is difficult to discern any very strong single theme. The book contains eighteen chapters, organised in five parts, covering East Asian and Eastern European experience. It is a loose collection of papers that were presented at two different conferences. Most of the contributions seem all to be competent individually, but when taken together, they look more like a conference proceedings than a book.

In the introductory chapter (which refers only to the first two parts of the book) *Jeong* discusses government intervention in the planned economies of the socialist world. These achieved "equity" at the high expense of "inefficiency"; market economies which have achieved high efficiency at the cost of equity and social balance. Finally, analysis is made of the innovative state intervention in the market system in Asian Newly Industrialised Countries (NICs), which led to high dynamic efficiency. He believes that only a balanced mixture of market and government can meet the challenge of bringing about a successful transformation of the East-Central European economies into a market oriented system and also dealing with the social problems in Asian NICs, without weakening the dynamism of the market economy.

The first four chapters in part I deal with Central and East European reforms. Béla *Kádár* first describes the multi-causal analysis of the decay of socialism, and then explains that the region has to change its political system, economic model and external economic partners simultaneously. The process has become more complicated due to aggravating crisis phenomena. Instead of copying he feels that "East European countries can shape their transformation strategies on the basis of individual endowments, possibilities and limits of their actions" (p. 3). Regarding sequencing he believes that it starts with the political sphere and only later arrives to the economy where it shakes the previous "machinery" and creates tensions in order to stabilise the new order and revert decay. He noticed that there is no unanimity concerning spontaneity or structural manageability of the process. For a good transformation strategy regarding the targeting, timing and sequencing of the process he suggests four basic conditions: a legal framework, ap-

propriate economic mechanisms, suitable personnel and external support.

In *Kouba*'s paper one fails to discover any fresh insight or new information on the subject of Czechoslovak economic reforms. *Rosati* in his analysis of Polish transformation asserts that the "shock versus gradualism" dilemma in the Polish context is not always interpreted "correctly". He feels that "shock" referred essentially to the stabilisation programme, while the institutional part has in fact been implemented only gradually" (p. 58). In the middle of conflicting claims regarding the success of the programme, he feels that the final results are at best mixed and ambiguous. He believes the reason for this can be found in the fact that the concept and structure of the stabilisation package were probably not designed to suit Polish conditions; the adopted sequence for actual implementation was wrong in the sense that necessary institutional changes were delayed; the external environment deteriorated and there were miscalculations regarding "inflationary overhang". The conclusion he draws from Polish the transformation is that it "is a long term structural process, apparently involving high social and political costs" (p. 53). For desirable outcomes he believes that this approach should be revised mainly with regard to stabilisation, large-scale privatisation and the sequencing of implementation. He should be pacified by the events of 1992, because this is what has happened in Poland.

Babic explains that the high costs of transformation have frightened the region but maintains that relatively high costs should not become discouraging factors. He holds that transformation in Yugoslavia has become difficult because, along with socialist failures, every federal government has annually formulated at least one stabilisation plan since 1985 and all have failed. He is right in saying that the idea of privatisation has become very fashionable in the former socialist economies and is regarded as a panacea which will solve all structural problems in the region. It was a pleasant surprise in the race to embrace new market systems. It has been taken for granted by many "neo-liberals" both in Eastern Europe and in the West that productivity and efficiency solely depend on ownership and private run firms are necessarily more efficient than government owned enterprises.

The key to the second part of the volume, which concerns social and economic reforms in East Asia, is a chapter by *Hsiao*. In his excellent analysis he concentrates on the critique of various theoretical studies that have attempted to resolve the so called "Taiwan puzzle". He argues that what Taiwan has achieved was not expected by the West at the end of the war and it contradicts both modernisation and dependency theorists. For him the story started with the land reforms of the 1950's, was developed further through the first import substitution strategy and later Export Oriented Industrialisation (EOI) in 1960's. Thus it met the upswing in the capitalist world with a particular and unique set of state policies. The traditional cultural factors—as demonstrated in family and enterprise organisations—made enterprises adaptable and flexible for the EOI stage. However, he believes that the unique state society relations and specific historical timing may not be exactly produced elsewhere. According to *Chu and Lin* the challenge now facing Taiwan is how to maintain equitable distribution, balance between growth and implement environment protection. It also has to cope with the rising demands of labour and higher expectations for social security and welfare. They explain that there is a rising demand for increasing the role of the state in the areas of market failure.

Jung looks at the response to new problems which have arisen during the process of industrialisation and democratisation in South Korea. There is a strong demand by various groups of the populace—mainly the press, the intelligentsia and citizen groups—for more equal distribution, better industrial relations, a smaller role for the government and new adjustments to global competition. He further demonstrates that throughout her history South Korea has never been a model of free market economy (obviously contradicting the arguments of neo-liberals), but a mixture of state and market or regulated market economy. In the last three decades, the government has been very active in resource allocation, direct ownership of enterprises, and price and wage controls. However, it has been rather inactive in income distribution and controlling pollution. In the ma-

ture stages of economic development the regulated market has shown many instances of government failures. At the same time big businesses are highly unpopular among the population. He suggests four alternative scenarios: intervention (which represents the status quo), welfare, free market and green. However, he believes that eventually there will be a compromise among the different alternatives. Soon also explains that the successful development of the city state of Singapore as a welfare state has been facilitated by pragmatic development-oriented policies, an extremely open economy, and the intervention of the state in the provision of infrastructure and social services.

In parts III, IV and V there are papers that were presented in 1990 and unfortunately events have moved ahead (and are moving ahead) so quickly that many of the papers look outdated. Part III deals with changes in Europe and East-West relations. Kádár's paper is devoted to the single European market and its implications for Hungary. He argues that this historical milestone demands immediate adjustment to new realities from all countries that are sensitive to foreign trade, particularly Hungary does most of its trading with European countries. However, he hopes that this will not be too difficult because "internal conditions of responding to the EC challenge do not significantly differ from the general requirements of the Hungarian renewal process" (p. 178). Although Csaba wrote his paper a few months before the collapse of CMEA he states that "practically nothing remained from among the factors which had conditioned the existence of Comecon" (p. 158). His paper makes interesting reading for someone familiar with prevailing ideas circulating in the period leading up to Comecon's final collapse and he gives a valuable review of the problems faced by individual countries. Roh's contribution is on East-West relations in the context of South Korea's so called "Northern Diplomacy", and the changing political and economic relations with China, the Soviet Union, North Korea and other socialist countries. Obviously, as the former sentence indicates, he is dealing with the situation before the final collapse of the Soviet empire. He predicts the emergence of a multipolar world replacing the bipolar power balance (but for the time being we witness only a unipolar world as the Gulf War has demonstrated the global hegemony of the United States). Jeong's paper is about the possibility of economic relations between Eastern Europe and East Asia. He argues that although East Asia shares common cultural and historical roots, there are differences in economic and political systems, levels of development and economic policies. As a result, cooperation is likely to develop on a single country basis rather than East Asia–Eastern Europe regional cooperation.

Part IV again deals with the the socioeconomic changes in Hungary and Korea. Here Erdős first argues for radical ownership reforms, liberalisation and an up-to-date tax structure in Hungary. In the revised version of the paper he says that now, instead of reforms, a change of system is on the agenda. However, the new process has advanced with many contradictions and this has resulted in inflation, unemployment and problem of equilibrium, especially during the opening of the process. Hernádi emphasises, the geopolitical pressures on Hungary and his frustrations with socialism in a journalistic manner, and is somewhat overoptimistic regarding the dynamism of capitalism and the possibility of Western help. Do-Hyung Kim, in his paper on South Korea, explains how the redistribution of land and other assets, the expansion of education, and a package of different trade, agricultural and regional policies helped Korea on the road to development. However, having reached an advanced stage, Korea faces many difficulties because of sluggish exports, slow investment and labour management disputes. Dalchoong Kim writes on South-North Korean relations in the 1990's. Compared to Eastern Europe he feels that changes in the Korean peninsula are less dramatic. Although South Korea is emerging from its authoritarian rule, there are few signs of change on the Northern side. However, with an uncertain future it cannot for long go against the mainstream of history. In these circumstances the author hopes that a new order may be institutionalised in the Korean peninsula by the end of the decade. In the last part of the volume there are two papers on economic relations between Hungary and Korea by Hámori and Lee.

Both have articulated their views on the economic cooperation in the areas of direct investment, trade, joint ventures and technological cooperation.

This is a book that has come at the right time. In fact both economic liberals and interventionists are now claiming their ideas have played a part in East Asian success and perhaps both are right. Even *The Economist* (Survey of Asia's Emerging Economies, Nov. 16, 1991) has acknowledged that the fundamental lessons of East Asian success show that without a commitment to markets and private property rapid growth is impossible, but also points out that markets do not have to be completely free. Therefore if transitional economies want to repeat the phenomenon they have to deal with the delicate combination of liberalism and intervention with equal care. The task is quite difficult in Eastern Europe because popular sentiments are against bureaucracy.

On the whole this is an interesting collection of papers, even if the editors are not very successful in collecting papers of uniform quality that address an important single subject in a concise and comprehensive manner. Except for the introduction and a few chapters in the second part of the book nobody has made a simultaneous analysis of the role of the state and the market—particularly in the East Asian and East European context, as the title of the book seems to suggest is necessary. Instead one can find papers ranging from foreign trade to foreign policy. Therefore instead of going to title of the book, the reader should select papers of his/her own interest from the contents, as most of the papers are diligently presented. Amidst the enthusiastic rush in Eastern Europe for the so called "back to Europe" syndrome (ignoring all worldwide experiences), this is a welcome attempt by the editors to present East Asian analysis, explaining its relevance for Eastern Europe. Yet, it has to be said that they have only been partially successful in their endeavour.

G. SACHDEVA

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*We acknowledge the receipt of the enlisted books. No obligation to review them is involved.

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