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Poland and Eastern Europe: What Is To Be Done?

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The Basics

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

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

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

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The economic and political complexities of the transition to a market economy argue strongly for a decisive and comprehensive approach, such as the new Polish economic program, introduced on January 1, 1990. Poland's goal is to establish the economic, legal, and institutional basis for a private-sector market economy in just one year. Other countries should pursue programs of similarly rapid transformation, tailored to national circumstances; as one Polish economist has put it, "You don't try to cross a chasm in two jumps."

Reform and Financial Instability

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

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

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

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

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

The Way Ahead

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

There should be four simultaneous parts to a program of rapid market transformation. First, let prices find market-clearing levels, in part based on free trade with the West. Second, set the private sector free by removing bureaucratic restrictions. Third, bring the state sector under control, by privatization and by imposing tougher disciplines on such state firms as remain. Fourth, maintain overall macroeconomic stability through restrictive credit and balanced budgets. Thus:

- From the outset, governments should strive to create a set of market-clearing relative prices. Price controls should be ended, subsidies reduced or eliminated, and the economy opened wide to international trade. Sensible prices are vital for efficient resource allocation. And with market-clearing prices and competition from foreign trade, governments will have a strong and demonstrable basis for closing down enterprises that suffer chronic losses. That in turn will send ripples of discipline throughout the state sector. In order to have free trade, the currency must be convertible; importers must be able to receive foreign exchange on demand. Convertibility has long seemed a distant dream to many economists in Eastern Europe, yet it can be accomplished rapidly through sharp devaluation combined with restrictive macroeconomic policies and financial control over state enterprises. It is one of the most vital steps toward market competition. Since the East European countries are small economies close to Western Europe, open trade will provide an immediate source of strong competition for the state enterprises.
- The second part of the program is to eliminate restrictions on private economic activity. New commercial laws must be prepared, or old ones dusted off (Poland will begin by updating commercial codes from the

1930s); company laws should allow for the easy establishment of new enterprises; tax laws should remove the punitively high marginal tax rates that are now common; and various licensing restrictions now applied to international trade and domestic investment should be eliminated.

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

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

The Need for Speed

The transition program (except for privatization and Soviet trade) can be decisive and rapid. There are several reasons why it should be.

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

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

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

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

The Puzzles of Privatization

Even under the most accelerated timetable, the privatization of a large portion of state enterprises will take years. The macroeconomic control and opening of the economy to the West must therefore precede full-scale privatization. And yet the effort to privatize must proceed with full urgency. Macroeconomic stabilization, and liberalization of the state enterprises without creating real private owners for them, cannot succeed for long. If the enterprises remain in state hands, the industrial sector will fall back into financial chaos, and will create a cascading series of political crises as well.

The problem is straightforward. As central planning is eliminated, the economies will be left with enterprises that operate without any oversight at all, either from central planners or from real owners. Unlike Western firms, in which plant managers must respond to a board of directors representing the owners, the state managers in Eastern Europe will respond to no one at all, or in some cases to workers' councils within the firm. Either way, problems are bound to multiply.

Part of the problem will be the self-serving behavior of the managers, unchecked by a board of directors. Lazy or incompetent managers will face few if any sanctions. Worse still, opportunities will abound for self-serving managers who are freed to operate in the new market environment. Already in Hungary and Poland, there have been many cases of managers who have pocketed the proceeds of their state enterprises by channeling the profits (through transfer pricing schemes and other sweetheart deals) to private corporations in which they own a stake. Some managers have negotiated joint venture deals with foreigners that have sold out the firm at low prices in return for a promise by the foreign partner of a favorable personal contract for the manager. In enterprises with powerful workers' councils, the managers have been unable to maximize the value of the firm—say, by restructuring the labor force—if the workers' councils object.

These problems can lead to a political backlash. In Poland and Hungary, there is already a sharp (and appropriate) attack on so-called "nomenklatura takeovers," and part of the public have the growing feeling that a market economy will be yet another path to enrichment for the former communist bosses. The problems will also lead to a renewed financial crisis on a macroeconomic scale, since managers that are unencumbered by real owners are tempted to borrow recklessly or gamble with the firm's income. It is a sad fact of life that everywhere in the world, the state enterprise sector is prone to financial crisis. Such crises can be contained when the state sector is a mere 5 percent of the economy, but these crises wreak havoc when the state sector is 50 percent of the economy, as in Latin America, or 90 percent of the economy, as in Eastern Europe.

The essential problem, then, is to move rapidly on privatization. But there's the rub. Margaret Thatcher, the world's leading and swiftest privatizer, has overseen the transfer of a mere few dozen major state enterprises in a decade. Poland has more than 7,500 enterprises that should be candidates for privatization, of which the 1,000 largest have 1,000 employees or more. The great conundrum is how to privatize such an array, in a manner that is equitable, swift, and politically viable and likely to create an effective structure of corporate control.

One apparently easy solution, such as giving the enterprises to the workers, is no solution at all. Not only would this be highly inequitable (and therefore politically unpalatable) since industrial workers account for a mere one-third of the labor force, but it would condemn these economies to the inefficiencies of worker control. It would cut the worker-owned firms out from the capital markets, since outside investors would know that workers can vote themselves higher wages out of the firm's profits. As demonstrated in other countries, it would also condemn the workers to excess risk, because both their human capital and their financial capital would be tied up in the same enterprise.

Thus, there is a need to create more widespread ownership. Of course, many of the enterprises—especially the smaller ones—can be sold in an accelerated program of Thatcher-style privatization. But a large proportion will have to be handled differently. The most promising solution, though admittedly one that is quite unusual and untested, is to give away part of the enterprise shares in a free distribution to the public. A strategy might work roughly as follows.

Each of the largest enterprises would be converted into a limited liability company. A portion of the shares of each firm would then be distributed freely to the public. Perhaps 10 percent would go to the workers in the firms. Another 10 percent would go to the state banks, assuming that they too are on a path of privatization. Another 20 percent or so would be distributed into a group of newly created "mutual funds." These mutual funds (or more accurately, investment trusts) would themselves be share companies. The shares of the investment trusts would be distributed freely to the adult citizens of the country. In one swoop, each adult citizen would therefore receive a well-diversified portfolio of the shares of the industrial sector. Initially, the government would continue to hold the balance of the shares, but only under a legal commitment that it sell its shares in a defined time period, perhaps three years.

Based on such a share distribution, it would be possible to compose a board of directors for each firm, appointed by real owners. The managers would be brought under control; widespread ownership would be created; and the gradual development of share trading would lead to a building up of the stock exchanges in these economies. Within a fairly brief and well-defined period of time, the state would reduce its remaining claims, and become a minority shareholder.

Poland as Pioneer

At the beginning of 1990, Poland ushered in the first comprehensive program of macroeconomic stabilization and transition to a market economy. The Polish program, led by the Deputy Prime Minister Leszek Balcerowicz, is remarkable in its scope, with a broad and ambitious agenda on stabilization, liberalization, and privatization. Although the program is less than one year old, the Polish experience already points up several lessons.

The first phase of the Polish program emphasized stabilization and widescale liberalization of economic activity. By mid-1989, when Solidarity took power, the Polish macroeconomic situation had become desperate. Hyperinflation was raging, with price increases topping 50 percent in October 1988. The inflation was fueled by budget deficits on the order of 10 percent of GNP. Shortages were rampant, shops were empty. Industrial production was plummeting, and the prevailing system of wage indexation was threatening an even greater acceleration of prices.

The stabilization program called for an elimination of the budget deficit by sharp cuts in spending and subsidies and improved revenue collections. Energy prices were raised several hundred percent as subsidies were cut. The *zloty* was devalued to allow for instant convertibility on the trade account. At the same time, wages were sharply controlled in the state sector, so that the devaluation and subsidy cuts did not get dissipated in wage rises, a process that would have set off an explosive wage-price spiral.

The liberalization measures were equally dramatic. Almost all price controls in the economy were instantly lifted at the start of the year. International trade was freed by the elimination of almost all quotas, and by the introduction of a low and nearly flat tariff schedule. Limitations on private economic activity were eliminated.

After a sharp increase in prices in January 1990 (around 80 percent), inflation fell off sharply, and shortages were almost instantly eliminated as prices equilibrated supply and demand. By March, inflation was running at about 5 percent per month, and continued to fall to around 3 percent by mid-year. The stores filled with goods, and many consumer durables, long unavailable, were suddenly available and at discount prices.

Measured real wages fell sharply—by around 30 percent compared with the previous year—as subsidies and price controls were eliminated while wage controls remained in place. But this drop in the statistical real wage vastly overstates the actual decline in living standards. Actual living standards probably fell by no more than 10 percent or so. The reasons for the overstatement are straightforward. In 1989, goods were simply not available at the official prices. Queues and shortages were rampant. When prices went up in 1990, thereby eliminating the shortages and queues, the *real* effect on living standards was more modest than would seem from the official price statistics. In addition, during the hyperinflation in 1989, the apparent purchasing power of the wage each month was eroded by price increases during the month. By the time a household made its monthly purchases, prices had risen ahead of wages, and the real consumption power of wages was less than the statistical real wage suggested.

The early effects of Poland's "shock treatment" on production and trade are also notable. First, and of great importance, the exchange rate stability and convertibility have held firm. Poland has run a large trade surplus in the first six months, as a result of a rise in exports to the hard-currency countries as well as a fall in imports. Foreign exchange reserves have therefore risen measurably, strengthening the newly convertible currency. Individual enterprises are adjusting to their new trading opportunities, with many state firms seeking out new markets in the West.

Measured industrial production has fallen sharply, roughly by 25 percent over a year. Once again, however, the statistics must be interpreted with care. Part of the decline is simply a mirage. The official data cover only the declining state sector, not the growing private sector. Another part of the decline, perhaps as much as 10 percent year over year, is the result of dislocations in trade with the Soviet Union, not the result of the economic program itself. All of the countries in the region, even those not undertaking Polish-style reforms, have suffered a sharp drop in output as a result of the Soviet economic crisis. A third part of the decline, perhaps another 5 to 10 percent, is cyclical—the result of the credit squeeze imposed to end hyperinflation. The remainder is the result of some sectors being unable to compete with the new foreign competition, and therefore cutting back on output, a kind of adjustment which is necessary as Poland becomes better integrated with the world economy.

Since the beginning of 1990, unemployment has started to rise. At around 500,000 workers in mid-1990, this level of unemployment amounts to only 3 percent of the Polish labor force. Of that amount, most were new entrants to the labor market, or job quitters, rather than job losers. It is expected that unemployment will grow to between 5 and 10 percent of the labor force, comparable to the rates of Western Europe.

Of course, it is too early to predict the outcome of the 1990 reform program in Poland. There are reasons for profound optimism, but also reasons for worry. It is still possible that populism will take hold, with new demagogues convincing the public that there is an easy and painless way to a prosperous economy. Some of the old communist trade union leaders seem poised to try to play such a spoiler's role. There is also a risk that the growth of the private sector will be unnecessarily hampered.

A rapid and healthy development of the private sector will require two things: a favorable economic environment for new private firms, and a successful move on privatization. New firms are sprouting up—around 120,000 in the first six months. But they remain small, and so far have been cut out from bank credits. Poland urgently needs to develop its banking system, and to make sure that it is responsive to the needs of new private entrepreneurs. With regard to privatization of state enterprises, the big risk is that Poland will become bogged down by attempting to sell the enterprises one by one. That would be too slow, and would lead to too many controversies, while also leaving too many unsupervised managers in the state sector. The need is clear for more dramatic and decisive actions in the area of privatization.

The Role of the West

Western governments are only now beginning to recognize how much they must do to support the changes in the East. They must provide more leadership and vision, and far more generous financial support. The most fundamental support needed is a commitment to incorporate the East European countries into a common European market. As Eastern Europe ends trade restrictions and makes currencies convertible, Western Europe must be prepared to accept new imports from it. That means in agriculture as well as manufacturing: pig-farmers in the EC will just have to accept that free trade in Polish hams is a price to be paid for living in a united and democratic Europe.

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

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

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

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

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

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

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

The fourth kind of support needed is long-term finance for development. The Marshall Plan provided grants, not loans, for Europe. Grant aid is again needed, for spending on infrastructure and on environmental control. But most proposals from Western Europe are for loans. And the form of these loans could well set back the market reforms. Take a standard official export credit from, say, Germany to Poland. A German supplier contacts a Polish state enterprise, promising finance for a project. Though the loan is guaranteed by the German government, nearly always it must also be cross-guaranteed by the National Bank of Poland—just the sort of soft option for enterprises that Eastern Europe must avoid.

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

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

Towards Growth

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

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

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