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Market-oriented Systemic Transformations in Eastern Europe

Problems, Theoretical Issues, and Policy Options

With 20 Figures and 29 Tables

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For Pusia and Jola

PREFACE

After more than four decades of a socialist command economy model countries in Eastern Europe have embarked upon a systemic transformation process to market economy systems. The former Council of Mutual Economic Assistance (CMEA) was dissolved in 1991 and in late 1991 the USSR's history ended with the reemergence of Russia and the creation of the Commonwealth of Independent States. The politico-economic upheavals in Eastern Europe that began in 1989 (in Poland: 1980) - 200 years after the French Revolution - have developed their own dynamics, including the semantic reorientation, namely as most observers rediscovered that what used to be dubbed Eastern Europe (in European parlance this included the USSR) is really central and eastern Europe.

The socialist system collapsed for many reasons, and certainly the announcements made in Moscow in the 1960s to surpass Western Europe in terms of per capita output look strange today. In the East as in the West it had been overlooked that income growth was achieved in Eastern Europe at the expense of wealth destruction or neglect of wealth building: natural resources were increasingly exhausted and reinvestments not made (implying a "consumption" of the capital stock).

The social costs of producing goods in socialism were not correctly perceived by planners and the society. Indeed there were intertemporal external effects of production meaning that part of the social cost of production would become visible only many years after the date of production. If producing more steel today causes rising toxic waste, sludge and emissions that reduce the value of buildings today and the possibility of future production, the social costs are much higher than indicated by the momentary use of production factors. The Stalinist command economy model was an anarchy of cost accounting in which nobody really knew what the social costs (the opportunity costs for society) really were. The cost of environmental clean-up in Eastern Germany is at least $ 150 bill. which is more than its gross national product in 1989, the German Democratic Republic's last year of 40 years of existence. If one assumes a capital-output ratio of 4:1 and that 50 % of the capital stock in the former GDR is obsolete (often because buildings are physically decrepit or because of relative price shocks) one gets an impression about the enormous loss of wealth that was programmed by socialist production, but for decades did not become visible.

Socialism deemphasized individualism, focussed on mass production in state-owned firms and relied on a monopolistic party system whose bureaucrats were expected to organize production in accordance with central planning. In the end the USSR was the biggest producer of steel, tractors and energy worldwide, but its citizens enjoyed a very modest standard of living; moreover, with the state-restricted access to news and the outside world there was very limited information about the situation of their socialist islands and their position relative to the capitalist islands. In Eastern Europe life expectancy was shorter, weekly working hours much longer and holidays (a "time income") much shorter than in Western Europe so that the East-West income gap is much greater than suggested by a pure comparison of per capita incomes. Stock variables, namely wealth and money, have been neglected in socialist theory and by economic policy. Only in the Western world did the 1970s bring a theoretical shift towards conducting economic analysis less in terms of flow variables than in terms of stock variables (monetarism was influential in this). However, it seems that both in the West and in the East there is still a lack of political emphasis on preserving and increasing the value of assets: Wealth is more important than income in the long term.

Eastern Europe is now returning to market-oriented systems, and certainly - as shown by West European economies - life in a market economy is not without problems and pitfalls. However, for individuals, firms and society learning is easier, at least in an open society with a functional political and economic system.

Before a market economy is established one has to go through a difficult transition stage in which income and wealth positions of many could reduce. In most cases this should not be considered as indicating insufficient achievements and performance because the qualifications nurtured under socialism are of such limited use in a market economy. If one has trained for and successfully participated in the Winter Olympics one should not be disappointed if a sudden invitation to participate in the Summer Olympics does not bring too many medals.

The last time that Eastern Europe, excluding the USSR was a market economy as a whole was neither prosperous nor stable. In the interwar years there were many national and international economic problems in Eastern Europe, later compounded by the World Depression of 1929-1936. Turning back to market-oriented models of production and distribution raises many questions not only for Eastern Europe, but for the Old World in general.

With the advent of the Asian NICs and the Japanese model of capitalism, the world of industrialized market economies and the spread of international organizations, the capitalist world economy had changed in a different way than MARX and other socialist protagonists had anticipated. Eastern Europe's reintegration into the network of market economies takes place under conditions that are different from the time when Russia and later smaller East European countries left the market system. There are many theoretical issues that are associated with systemic transformation in Eastern Europe. This book can offer only some modest element of analysis, but we hope to demonstrate that Western economics can usefully be applied to the problems of transformation. Elements of a spontaneous economic order may emerge in Eastern Europe; however, lack of constructivism and deliberate system design could mean in certain countries falling back into the historical tracks and problem settings of the interwar years.

With the opening up to the Western world Eastern European economies are experiencing a series of economic shocks: price shocks, interest rate shocks, technology shocks and, in the case of the smaller ex-CMEA countries, an energy price shock - these countries face the problem of strongly reduced energy supplies from the ex-USSR and all countries have to live with the switch to much higher energy prices. For Eastern Europe the series of adjustment impulses certainly is stronger than the OPEC price shocks were for the rich OECD countries in the 1970s; then industrial output declined by 5-12 percent in major countries in one or two years, and the import price increase itself implied a resource transfer abroad of 2-3 percent of GNP. Adjustment problems and distribution conflicts were serious enough in Western Europe.

In the East European transition the magnitude of adverse macroeconomic developments in terms of the fall of industrial output and the degree of obsolescence of the capital stock is at least two or three times as much; the external environment, characterized by high West European real interest rates and moderate growth prospects for the OECD countries in the early 1990s is not very favorable either. Limited external support is available for a tremendous historical experiment, namely for transforming socialist systems into functional market economies. Despite these challenges Eastern Europe could become a new European growth pole if one could assume that it catches up with its own historical economic potential that was so poorly used and developed by the command economy model.

Eastern Europe could be a new growth pole in Europe and could - in an optimistic scenario - even catch up with the dynamics of Asian newly industrializing countries whose economic development has been so impressive since the 1970s and the 1980s (in 1991 Hong Kong's exports exceeded those of the USSR and Taiwan as well as Korea came close to the Soviet figures). However, a less optimistic scenario would be that East European economies rather follow Latin American disaster settings of the 1980s when sharply rising foreign debt, falling real income and wages as well as rising unemployment brought economic hardship and political instability for a whole region - finally spilling over into the OECD countries where banks, firms and governments faced adjustment needs, too.

When the market economy model has to be (re-)introduced one rediscovers some old advantages of this approach to organizing economic transactions in a decentralized way via private firms competing in contestable markets. A competitive market economy operates on the basis of the interplay of the invisible hand of anonymous markets and the visible handshake of innovative firms. With a well-defined framework of institutions, property rights and rules the market system generates enormous per capita output, sustaining growth and a never-ending creative development with many structural changes facing millions of individuals. From the perspective of socialist systems these changes mean facing the chilly wind of capitalist uncertainties to which not too many people in Eastern Europe are used.

It will take much time to change institutions, attitudes and organization modes in an evolutionary process; it also took decades to channel the dynamics of the capitalist industrial revolution in Western Europe 150 years ago. Only individual achievement was honored in early capitalism, but modern market economies have developed at least some ethics and institutions - in Europe state social policies as well - that are supposed to mitigate social and economic hardship; and finally, competition policies have been enacted in market economies that prevent excessive market power and generate competitive pressure that brings prices down and encourages innovative producers. Eastern European economies have to take many steps at the same time, and an adequate sequence, timing and consistency of reforms will be difficult to achieve.

This book is a contribution to the theory of systemic transformation and comparative economic systems analysis. We will consider the major impulses for the collapse of the socialist economies in Eastern Europe (chapter A), raise the question which challenges systemic transformation will pose (chapter B), which issues arise in the context of the prime tasks of organizing privatization and stimulating foreign investment (chapter C), what foreign economic liberalization could mean for Eastern Europe (chapter D) and finally what some of the global dimensions of the East European transition could be (chapter E). We can, of course, only touch upon some selected areas and issues; however, we hope to focus on some of the most important ones. As regards major issues I do not claim that my analysis is perfectly right or ideal in any way; however, the purpose is to make a contribution to the ongoing discussion in the economics profession about the problems and options in the transformation in Eastern Europe. Moreover, one may expect that the economics profession as such will correctly identify and analyze all major problems of the East European transition.

My interest in Eastern Europe dates back to two projects at the University of Duisburg where in the 1980s young economists as well as established professors developed a series of joint Polish-German research projects. I owe a sustaining professional interest in the East European developments to these projects and the personal contacts that emerged within this framework. In a strict sense, however, this book is based on several papers that have influenced various chapters. My paper "Allocation, Pricing and the Socialist Equilibrium Shadow Economy" presented in Pavia in 1988 (annual conference of the ASSOCIAZIONE ITALIANA PER LO STUDIO DEI SISTEMI ECONOMICI COMPARATI) is in part the basis of chapter A, whereas other elements have been developed in the following two years. Chapter B dates back to a paper whose first draft I wrote in Washington DC in 1990/91, when I enjoyed the hospitality of the AICGS/The Johns Hopkins University. Chapter C is a revised draft of a paper presented at the conference Eastern European Economies in Transition, organized by the Society of Government Economists in Washington D.C. in March 1991. Chapter D is based on a paper presented at the German Studies Association's annual conference in Los Angeles in 1991 as well as a paper (Some New Aspects of Foreign Economic Liberalization in the East European Transition) which I presented at a World Bank seminar in March 1992. The final chapter is from a presentation to a group of NATO reserve officers in Bonn in early 1992.

I am immensely indebted to all the people with whom I could discuss my views, approaches and ideas. Special thanks go to Piotr Jasinski, Oxford University, to Peter Murrell (comments on C) at the University of Maryland, to Martin Schrenk at the World Bank and to Helga Hessenius, UC Berkeley, who offered comments on certain chapters or the papers mentioned or supported my project with controversial discussions. The University of Münster where I held a professorship in Economics/Eastern European Economies in 1991/92 offered a stimulating environment for my research. However, this book would not have been completed without the assistance of Cornelius Graack, University of Münster, and the reliable and strong editing support of Tim Yarling, George Washington University. Finally, I am most grateful to my wife who encouraged my project with endless patience, tolerance and a good sense of humor.

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