

**U. S. Policy Towards Economic Reform
in Eastern Europe and the Soviet Union**

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LECTURE
by

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We live in momentous times, and President Havel's presence in the Capitol today should inspire us to rise to the times, by helping to complete the task of creating viable economies in working democracies across Eastern Europe.

Today, I want to address the economic questions that are a basic part of this challenge. How can the countries of Eastern Europe transform a disastrous economic system that has produced living standards far below those of their Western neighbors and left many of them in bankruptcy or hyperinflation? How can they make a transition, in an orderly way and in the context of democracy, to a regime of social, political and economic freedom?

It can be done. I am working in these countries, because I believe that, in the main, we know how to make it happen. But we will have to *make* it happen, and part of that responsibility lies with the United States. This process will not succeed without a great deal more engagement by the U.S. Government and the American private sector, than has so far occurred.

Social and economic freedom in Eastern Europe will require from the United States much greater, along with much more leadership and many more dollars.

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In the newspapers of New York and Washington this week, you could count a half-dozen cautionary stories about why America should not pour money "down the drain" in Eastern Europe. This may seem self-evident to those who don't want to pour money anywhere, even at home, but it is a fundamentally incorrect view. It shows an inability to distinguish between where money is likely to be well used and where it could be wasted, and beyond that, a profound misunderstanding of the nature of the problem in Eastern Europe.

Eastern Europe needs many things other than money, but money from the United States also is genuinely required. I want to make clear of what use American money can be, and how it should be integrated into a larger effort involving as well Western Europe, Japan and international financial institutions, especially the International Monetary Fund (IMF) and the World Bank.

Western assistance will be useful, critically so, if it builds on the existing assets and potential in Eastern Europe. These are societies of highly educated and skilled people, subsisting at standards of living that are one-half or even one-third of their Western neighbors 50 kilometers away. In addition to human capital, the natural resource base, the culture, transport costs, and other factors all suggest that these countries could enjoy a sustained boom while they converge gradually to the living standards of Western Europe. There is enormous potential for the fundamental growth that is the basis for a sustained rise in living standards, and that can undergird a democratic society and social peace.

In order to bring this about, there must be fundamental changes in these countries' economic systems -- changes of the sort that have never been successfully undertaken yet. So, while there are many positive factors, the challenge of designing the mechanisms, both political and economic, to supplant 40 years of failed Stalinism with new market arrangements integrated with Western Europe and the world economy, remains daunting.

There is one critical element that presents no problem: People in Eastern Europe know that they want to follow the direction of a market economy. In contrast to the ongoing debate in many Latin American societies about the direction for their future, in Eastern Europe there is almost no debate about the relative benefits of socialism versus free enterprise because the issue has been settled. They know what works and what doesn't work. They have seen it with their own eyes, by their own travels or by watching television. They know what the

economic norms are in the West, so they can compare what is normal just a short distance from their homes with the conditions they have suffered in for two generations. All their observations and experiences have produced an overwhelming convergence of opinion on the basic view that the hope for their countries Europe lies in becoming market economies and rejoining the economic institutions of Western Europe as part of an integrated whole.

This fundamental insight should be the key to the West's response in what will certainly be a very difficult process. It will be difficult because, first, the previous system has left many countries in utter bankruptcy. Their foreign debts, relative to the exports needed to secure hard currency for repaying them, are about the highest in the world. The previous system has also left them without the legal, administrative, political institutions that undergird a market economy. Moreover, reforms are like investments, requiring short-term sacrifices for longer term benefits. And so, the transition to democratic institutions and market arrangements will necessarily involve periods of real pain, including changes in relative living standards within the population.

And there are no certain blueprints for an orderly and efficient transition from state socialism to market democracy. It has never been done before.

Perhaps the most daunting aspect of this challenge lies in a paradox: By such typical measures as declining living standards, rising inflation and crippling external indebtedness, the countries in the worst shape are those that have followed proclaimed paths of economic reform for the longest time. This is a serious sign of how complicated a task reform is.

Since at least the late 1950's -- even earlier in Yugoslavia -- policy makers in Eastern Europe have questioned the Stalinist model of strict central planning, even under the Communist regime. Moreover, some countries have tried to back away from central planning and move towards a form of socialism which combined complete or near-complete state

ownership with decentralized economic management. The disturbing fact, when we survey the economic landscape today, is that those countries that moved furthest from central planning are now the ones in the deepest financial trouble. Understanding this must be the starting point for the reform.

The first instance is Yugoslavia, which adopted a decentralized planning system after Stalin expelled Tito from the Communist International in the late 1940s. It seemed promising for a while, but in time produced both hyperinflation and financial bankruptcy.

Second, Poland liberalized its economic arrangements rather extensively in the 1980s - - albeit under the fist of martial law -- and then closed the decade with an outburst of hyperinflation as well as the collapse of the communist regime. By the end of last year, prices were rising at monthly rates of 40 to 50 percent, extrapolated to several thousand percent on an annual basis.

Finally, there is Hungary, which introduced the "new economic mechanism" in 1968 and continued to retreat from central planning. Hungary today, while enjoying an inflation rate which is moderate compared to Poland, also has falling living standards and perhaps the world's highest per capita foreign debt.

In contrast, countries which hewed more closely to the Stalinist model, such as Czechoslovakia and East Germany, actually have greater financial stability today, along with smaller foreign debts and lower inflation.

In order to design an effective blueprint for reform, therefore, we must first understand why the early reforms went askew. I should mention that understanding this paradox will help explain why the recent Soviet reforms are not producing growing chaos, along with some improvement in living standards. In a sense, the Soviet Union simply is replaying the Polish, Yugoslav and Hungarian mistakes, only years later.

The lesson here is that decentralization in a non-market system solves little or nothing; it even may make matters worse. In order to work, economic reform must go all the way and embrace a full market economy with private ownership, free international trade and prices freely determined according to supply and demand.

Hungary, Poland and Yugoslavia recognized during their early reform periods that Stalinist central planning could not function -- precisely what Perestroika has also acknowledged. So, they allowed all their State enterprises to act with greater independence. But enterprise such as these are not really enterprises as we know them in the West, because they have no owners, or as they like to say, "everyone owns them." The result of allowing more independence to enterprises without owners is that those involved in these enterprises discover that independence can be used for their own benefit, but not necessarily in ways which correspond much to economic rationality.

As these governments withdrew their central controls over wages, workers figured out that this was a great time to press for higher wages -- and the managers of these firms figured that it was a good time to accede to these wage demands because labor peace was better than labor strife -- and anyway, it wouldn't come out of anyone's profits. The common experience when central controls have been lifted from firms in which workers are the only organized interest, has been that wage demands grow -- in some cases they grow explosively, as in Poland in the late 1980s. Now, it is the Soviet Union which is experiencing both much greater labor unrest and largely uncontrolled wage increases.

Managers also figured out how to make decentralization work for them. First, they did not have to account to any owner for the firm's performance or depend on it for profits to pay themselves. In fact, it turned out that with more freedom, it was a good idea to go on out and borrow whatever they could -- often from Western banks. So, they borrowed a great deal

of money and then didn't pay very much of it back, because the money typically was badly misallocated. Indeed, these loans went "down the drain" of ill-conceived investments that newspaper commentators are warning against today.

These foreign debts went sour precisely because the money was lent to a regime with no mechanisms for allocating capital efficiently, a regime without owners to scrutinize the uses of borrowed funds. Managers found that borrowing was a sure thing: the more they borrowed, the larger the firm grew, the more their incomes grew, the more their prestige expanded, and perhaps the more they could skim. And if the loans went bad, the central bank would take them over.

One lesson is that decentralization without changing the ownership structure won't work -- and the situation is even worse when there also is no market environment. Decentralization, per se, does not create a market. Industries in these countries are generally organized with a very small number of firms, though often there are many factories linked into one association for a particular industry. So, decentralization took place with monopoly producers unconstrained by domestic market forces -- and usually protected from foreign competition by extensive regulation. For example, there were artificial exchange rates that overvalued the domestic currency. As a result, the official price for dollars was relatively cheap in term of the domestic currency -- but since the government didn't have dollars to supply at the very low price, no one could buy foreign exchange. Consequently, anyone who wanted to import goods would have to secure a bureaucratic allocation of foreign exchange, rather than simply decide to import. Therefore, import competition in these economies could arise only when the bureaucracy agreed to allocate foreign exchange -- not according to automatic market mechanisms that attract inflows of competing imports when domestic firms raise their prices.

As decentralization proceeded in these countries, private sector activity was permitted

only to an extremely limited degree. For example, private ownership was allowed in Hungary and Poland in the 1980s, but always on a very restricted basis involving very small enterprises permitted to operate within very restricted segments of the economy. Often, these private operators arbitragued the commodity shortages and bizarre pricing produced by the communist sector of the economy. In Poland, for instance, there were hundreds of thousands of individual traders, operating in one man, self-employed operations. But the growth of large-scale private enterprises was either officially restricted for being contrary to socialist ideology, or practically stymied. Typical barriers include confiscatory tax rates on the private sector, and denying foreign exchange allocations to firms that had to import components for production. The result, in Hungary for instance, has been some visible growth in the private sector but limited to individual restaurants and shops -- while private ownership in the industrial sector or in construction has not developed.

Clearly, decentralization is not the same thing as a market environment. The state-owned firms faced no foreign competition, no competition from other state firms, and no real competition from domestic private firms. Once control was decentralized, these monolithic and monopolistic enterprises seized the freedom to do a great deal of damage, often by unwisely raising wages and imprudently borrowing from abroad, protected from an environment of competition that could induce them to respond to normal market forces.

The lesson is that Communist-style reforms or reforms under Communist regimes can not ultimately succeed if Stalinist ideology is preserved, because no matter how much decentralization takes place, the economy is not allowed to operate according to efficient market criteria. This model is unfolding very vividly right now in the Soviet Union, where state enterprises have been granted considerable freedom from central control. The situation continues to deteriorate, because these enterprises do not face any real market forces, and so

the freedom they have received does not promote competition or an efficient allocation of resources. And so, the reforms are haphazard, limited and eventually self-defeating. In time, the reforms may even die in the throes of a financial crisis triggered by, say, the very heavy foreign debt burden as in Hungary, or foreign debt and hyperinflation as in Poland and Yugoslavia.

The emergence of hyperinflation, a rare and extraordinary event, is a gauge of profound the problem is. In all of world history, there have been, by my count, only fourteen or perhaps fifteen hyperinflation. Monetary economists should feel very "privileged" to have lived and worked in the 1980s, when so many of them occurred in Latin America -- Argentina, Brazil, Bolivia, Peru and Nicaragua -- and now in the 1990s, in Poland and Yugoslavia. Hyperinflation are extremely rare, and extremely horrifying and destructive; fortunately, they are been destroying a horrible political and economic system. But if reasonable price stability can not be restored, they will destroy whatever comes next as well. That is the real danger facing Poland and Yugoslavia.

The hyperinflation crisis has brought home to reformers in those countries, as will become clear to reformers elsewhere, that there is no half-way house in "reformed Socialism." I believe that this finding will become clear, too, to the Soviet Union -- hopefully not by means of economic chaos which could threaten us all, but by the painful experiences of the countries before them in Eastern Europe. The recognition that half-way measures not only do not work but actually exacerbate the difficulties is, I believe, the guiding force behind the technical design of both Solidarity's current economic program and the program in Yugoslavia, and I hope that the rest of Eastern Europe will apply the same logic.

Beyond this recognition is the idea that one must not just decentralize, but create markets. Creating markets requires at least that state enterprises face free foreign competition,

as well as free competition from a vigorous private sector, which in turn means that the relative weight of the state in the economy must decline sharply. State enterprises can continue to operate as regular enterprises, so long as they are surrounded by a market economy; indeed, there are examples of efficient state enterprises in the world. But state enterprises cannot predominate. It is not to be expected that an economy can operate with any efficiency at all, with 80 or 90 percent of the economy in state hands, even if international trade were open and private ownership were allowed. There must be a deliberate policy of privatizing enterprises that are now part of the state sector, in order to sharply diminish the weight of the state in the economy.

Even in Latin America, which has shared some of the economic failures of Eastern Europe, it is a reasonable rule of thumb that when 40 percent or 50 percent of an industry remains in state hands, it is likely to end up in economic and financial chaos. So, the third plank of the program, in addition to initiating free trade and permitting free private firms, should be to introduce privatization at a rapid rate, in order to convert existing state industries into private enterprises.

These economies will not become predominantly private in one, two, three, or even four years, because an orderly process of privatization inevitably is slow. The world's greatest privatizer, Margaret Thatcher, privatized 15 firms over a decade, and each one required much preparation, planning, financial analysis and political debate. Poland has some 7,000 state enterprises on its inventory for privatization. They are not proceeding along the British model, in which one by one, enterprises are cleaned up for a public offering, because they do not plan to spend 200 years at it. But it will certainly be a complicated and daunting task.

Let me describe briefly what the Poles have done since the beginning of this year. On January 1, the Government introduced a comprehensive program for creating in a very short

time the institutional, legal and financial bases for private markets. This program has three basic elements. The first element is to end the financial crisis, chiefly by closing the budget deficit through deep cuts in public subsidies.

The second element is more complex, involving a series of measures to create the environment for free markets. This entails freeing up the private sector and freeing up foreign investment, while permitting the formation of all kinds of joint stock companies and other private arrangements. Establishing a basis for free trade also entails creating a convertible currency, mainly by a large devaluation of the zloty. In order to establish a sustainable exchange rate, the Government is prepared to defend the currency by selling dollars and by stopping the endless printing of zlotys.

The third element may be called, getting the state sector under control. This involves, first, hardening budget constraints so that state bailouts of losing enterprises end, and second, privatizing state enterprises as quickly as can be done responsibly and efficiently.

Undergirding all these parts of the program are thousands of legal and regulatory changes, to peel away 40 years of bizarre regulations and put in their place the legal structure for modern capitalism. Part of the task involves resurrecting the commercial codes from the 1930s, and part entails creating *de novo* a legal structure for bankruptcy, contracts, and so forth.

As the Government has moved to implement this program, perhaps the most disturbing event happened at the beginning of the year, when cuts in subsidies were closely followed by a huge jump in prices. The next response, in order to quell the hyperinflation while promoting the rest of the program, was to close the budget deficit and stop printing money. The results are being watched closely around the world. But inside Poland, for the man and woman on the street, the process is very painful. The Polish Finance Minister called it deep

surgery. In Argentina, the government described a similar process there as, "surgery without anesthesia."

But some of the pain may be more apparent than real, because some of the price increases are for goods that were never available at the old "official price." In short, some of the price increases merely validated what everyone already knew, that many real prices were far above official prices. Moreover, there are gains in supplies that offset some of the adverse effects of the higher prices. For example, if under the old regime a Pole had to wait in line for six hours in order to buy a liter of gasoline, and under the new order the price doubles but he no longer has to wait, it is true that the price is higher. But his real living standard may not have declined at all or certainly would have declined considerably less than is indicated by the price increase. In the real life of Poland, adjusting to the new program has been hard -- but not as hard as many official statistics suggest.

These statistics show that prices jumped about 75 percent, but they stopped rising after 10 days; and if the Polish people are patient, and the Government does not lose its nerve, there are good prospects that Poland's hyperinflation will have been brought to a very quick end. There will be some decline in real living standards, but not as large as the official data would suggest. And the fact is, the Poles are demonstrating enormous fortitude and patience. There are no strikes, but rather a growing recognition that prices have stabilized. In fact, in some areas Poland went from being a shortage economy to excess inventories of some consumer goods, in a matter of weeks, and for the first time in Polish history, some stores ran sales and discounts.

The Polish Government is also trying to start down path to privatization, which is technically very complex and politically very contentious. It involves both promoting more efficient operations in the economy, while distributing the assets of the economy. In many

firms, workers have said, "what is the problem in privatization -- we own the company," even though State enterprises are owned by the State Treasury, not by whomever happens to work there at the time. There are competing claims from former Communist managers, the so-called *nomemklature*, who continue to manage many of these firms. They say, "we own the firm, because we were given it," and have tried to trade off the assets for guarantees of golden parachutes, or nice retirements, or high management position in the future. In human as well as economic terms, privatization becomes a very complicated process.

Moreover, the goal of privatization is not to give away the firm to private hands, but to create a viable unit by finding managers who can manage, and matching firms with Western businesses, and finding partners to distribute the shares to. Walking the mine field of competing interests requires time, analysis, management consultancy, and political cleverness. If the process is pressed too quickly, as I believe it has been in Hungary, there may be a backlash when a democratic government discovers that many of the deals made the country look like an ideal investment haven at the cost of the nation's financial interest. Prudent privatization requires safeguards and constraints, so that the country's assets are sold at values reflecting their true worth of these assets, not at a haphazard and random price assigned by managers for one reason or another, including their own personal interests.

The process of reform will further differ from country to country. While the countries of Eastern Europe are moving toward a fundamental free market approach, the Soviet Union continues to follow the model of 1970s- and 1980s-style Eastern European reform. However, recently there have been signs that the Soviets are weighing seriously the introduction of private property and democratic pluralism, both of which would be fundamental to genuine reform, as opposed to the kinds of changes that almost surely bound to end in financial calamity.

Since the course of successful reform in each country is distinct, so the U.S. response should be tailored to each country's specific needs. Nevertheless, I can offer some general principles, focusing on the case of Poland, which I know best.

First, reforms that can succeed over a long term must entail reintegrating the Eastern European countries into a united Europe, with free trade, free mobility of the factors of production, and free movement of technology. The U.S. should assume a major diplomatic role in encouraging our European allies to support a broad, united European framework that could enhance the stability of the Eastern European countries; conversely, we should actively discourage opportunistic behavior by Western Europeans, which would exclude the East from their framework or restrict trade with them. This moment in history requires a bold, generous and comprehensive vision and policy of integration, and the U.S. must ensure that these fledgling democracies, with their weak economies, get a fair and effective shake in trade relations with the West.

To begin, the U.S. should repeal the restrictions on high- technology exports to these countries, once they accept appropriate safeguards to bar re-export. As they undertake arduous reforms, they should not be told by the U.S. that their next generation must invest in technologies that are already 15 years behind the West. It galls me when I discover that Solidarity's newspaper can not get a MacIntosh computer for typesetting because of trade restrictions. These restrictions are out-dated and should be removed far more expeditiously than the Administration currently calls for. There are no budget dollars at stake here. Moreover, our real security lies in providing these countries with the technologies they need to efficiently develop their civilian economies, and repealing these restrictions has become a matter of simple common sense.

The next step for the U.S. is to make certain that the burden of the old foreign debts

to these countries, especially Poland, Hungary and Yugoslavia, debt recklessly lent and recklessly borrowed, does not cripple reform. These debts cannot begin to be paid, and much of them must be cancelled. In private, everyone will say they can't be paid -- but then every creditor government also says, 'don't mention it in public.' The truth is, these debts must be reduced, because otherwise the overhang of bad debt will prevent these countries from absorbing the foreign investment required to reestablish their macroeconomic stability and provide their citizens with confidence in a stable future.

The fact is, this course costs nothing, because no money is being collected from these countries at present. The difference is, now the debts are kept on the books and every year there are cliffhanging negotiations in which we finally tell Poland, for example, that 'oh, you don't have to pay this year; do it next year.' However, regarding the foreign debts of Hungary and Yugoslavia, the bankers have told them they *do* have to pay, even if it creates great economic instability.

This is really an obvious course for Eastern Europe today -- as it was in 1953, when the West cancelled West Germany's debts. As it happens, today West Germany is Poland's major creditor. Now, the U.S. must press West Germany to do for Poland what was done for her in 1953, and we must signal that we will participate in a multilateral effort in which we, too, cancel our 10 percent share of Poland's debt.

In addition, the U.S. and our Western allies should provide new, emergency financing. Despite the easy political rhetoric that condemns all foreign-aid efforts, there are times when modest financial assistance, quickly mobilized, can provide very, very large pay offs -- as with the Marshall Plan. Under the Marshall Plan, we helped countries that were not long-term basket cases get back on their feet financially, mainly by providing working capital and by helping them create a payments mechanism and a viable money supply. The same approach

should be applied today to Poland, which urgently needs balance-of-payment support, as well as to Hungary and Czechoslovakia. These countries do not need to be bankrolled for long-term development; they need emergency, short-term assistance to see them through a very difficult transition process.

This is truly a matter of leadership, and the willingness to recognize the scale of the problem and the scope of the potential benefits. Today, the U.S. provides the second smallest amount of foreign aid, as a share of G.N.P., of all major Western countries -- barely ahead of Ireland and behind 23 other nations. Last year, the United States came up with \$200 million for Poland -- less than 1/100 of one percent of our GNP. We should be providing five times as much, from a GNP wallet of \$5 trillion. And we should be able to recognize that such short term emergency financial intervention, in order to help make market reforms work, will generate magnificent benefits for the U.S. -- not the least of which will be to help solidify a peace dividend many, many times the size of the proposed aid. The return in purely budgetary terms, I believe, would be one hundred fold.

Let's be serious about what the needs are, and let's be serious about what our capabilities are in a \$5 trillion economy. The U.S. can provide more assistance, and I believe that we will, once we recognize the economic merit of doing so.

Finally, Western business should provide technical assistance on a large scale. These countries need a massive infusion of management consultants, financial experts, and even lawyers, to help provide the management, legal and accounting bases for market economies as quickly as possible. In Poland, management and financial audits for 200 or 300 companies -- in order to understand these firms' financial situation, where their best markets are, and how they could pair up with Western firms -- could make all the difference in getting growth going again. The same is true for other countries. Once, again, this does not entail long term

financing by U.S. taxpayers; no Eastern European country need be an economic ward of our government. Rather, the private sector should be the source of long term finance. The role of Western government is to provide 2 or 3 years of help, to facilitate the transition to market economies.

This is a truly rare and historic opportunity to help nourish the roots of democracy and the growth of economic freedom. The countries of Eastern Europe will benefit, the countries of Western Europe will benefit too. And so we the United, and our children into the next generation.