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Transition from the Command to the Market System: what went wrong and what to do now?

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This paper is a final account of results of a research project begun at WIIW in 1991.[1] Background research for the report was carried out by a study group under the direction of **Kazimierz Laski, Research Director of WIIW,** with the participation of consultants to the WIIW: **Amit Bhaduri and Friedrich Levcik,** and of external experts: **Dragoslav Avramović,** Rockville/USA – Belgrade, **Janos Fath,** Vienna, **Michael Landesmann,** Cambridge/UK, and **Dariusz K. Rosati,** Geneva, as well as the staff of WIIW. The present paper has been compiled by Amit Bhaduri, Kazimierz Laski and Friedrich Levcik.

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Fath, Janos, "Industrial Policies for Countries in Transition", *WIIW Forschungsberichte,* No. 187, November 1992

Hunya, Gábor, "Speed and Level of Privatization of Big Enterprises in Central and Eastern Europe – General Concepts and Hungarian Practice", *WIIW Forschungsberichte,* No. 176, October 1991

Landesmann, Michael A., "Industrial Policy and the Transition in East-Central Europe", *WIIW Forschungsberichte,* forthcoming

Laski, Kazimierz, "Transition from Command to Market Economies in Central and Eastern Europe: First Experiences and Questions", *WIIW Forschungsberichte,* No. 181, March 1992

Laski, Kazimierz, "Fiscal Policy and Effective Demand During Transformation", *WIIW Forschungsberichte,* No. 189, January 1993

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Levcik, Friedrich, "The Thorny Path of Transition from Command to Market Economy", in *The Transition from Command to Market Economies in East-Central Europe,* ed. by Sándor Richter, Westview Press, Boulder – San Francisco – Oxford 1992

Levcik, Friedrich, "Privatization and Restructuring of State Enterprises", *WIIW Forschungsberichte,* forthcoming

Rosati, Dariusz K., "Foreign Trade Liberalization in the Transition to the Market Economy", *WIIW Forschungsberichte,* No. 193, March 1993

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Transition from the Command to the Market System: what went wrong and what to do now?

I. Introduction

The former centrally planned economies exhibited a peculiar economic paradox. Although in a formal sense these economies were utilizing their productive resources including labour more or less fully, i.e. the level of production tended to be supply-constrained, they were plagued continuously by the problem of shortage and poor quality of the goods produced. This is striking when contrasted against the market economies, which despite their high levels of unemployment and under-utilization of capacity at times, seem not to suffer from shortage but from the lack of an adequate market. Paradoxically, full employment and full capacity utilization in the former socialist economies failed to produce enough; whereas despite unemployment and excess capacity, the output level of the capitalist economies tended to outpace systematically demand.[1]

From an economic point of view, a central problem of transition has been to transform the supply-constrained shortage economies characterized by sellers' markets into demand-constrained systems of buyers' markets where consumers' choice would rule. Ultimately, this would require adjustments both on the demand and on the supply side. However, since expansion in supply, or the speed of positive adjustment on the supply side compared to adjustment on the demand side, tends to be relatively slow in general, in the short run at least compression of demand rather than stimulation of supply has been the basic thrust of conventional stabilization programmes. Applied in the context of the former command economies, such a programme for reduction in demand through various public and private austerity measures seems justified up to a point, as it is required for making the necessary transition from a supply-constrained to a demand-constrained economic system.

Almost all variations in the strategy to transition, therefore, seem to have a core area of agreement regarding the need to compress demand to some extent in the short run. However, the accumulating experiences with various stabilization programmes in the former centrally planned economies suggest that the scope for disagreement is even larger. It may be no exaggeration to say that the relatively narrow area of agreement is overshadowed by a much wider area of disagreement. Disagreements arise on several fronts, e.g. the extent of demand reduction necessary; the policy instruments to be used for compressing demand in the short run; their implications for supply stimulation in the

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[1] There exists yet another paradox: The previous socialist economies utilized labour force and capacity fully but inefficiently (in terms of their productivity). In contrast, market economies utilize their labour force and capacity efficiently, but not fully.

short to medium run as well as additional instruments needed, as they would influence crucially the prospect for longer-term economic growth; and finally the political and social consequences of mounting adjustment costs during the process of transition. These are complex issues, in most cases specific to each country, which cannot have unequivocal, general answers. It is essential to avoid intellectual dogmatism in the form of catchy slogans like "shock therapy" versus "gradualism" as they derive from simple intellectual schemes or models incapable of handling country-specific complexities. Theoretical models of manageable simplicity are undoubtedly needed for defining the overall direction of a transition strategy. But it would be a dogmatic error of over-simplification to adhere rigidly to the prescriptions following from any such model in the face of experiences to the contrary. The purpose of the present paper is neither to provide nor to justify a particular model; rather it aims at evaluating some of the analytical schemes and models currently in vogue and policy prescriptions in the light of the "stylized facts"[2] of recent experience, first of all in Czechoslovakia, Hungary and Poland, the three countries for which the best statistical information exists (in the text they are sometimes referred to as "leading reform countries"). It is hoped that this will enable us to design better policies which would minimize further adjustment costs during transition and quicken the pace of economic recovery. This is especially relevant for those countries whose transformation process is still at an earlier stage.

This paper is organized in three parts. The stabilization problem is the topic of part A. Here the stabilization policies so far adopted are critically evaluated and alternatives are presented. We start this part by presenting the theoretical model of financial programming lying behind conventional stabilization (chapter II). In the countries undergoing stabilization some "stylized facts" can already be detected. They are presented in chapter III. In the next chapter a model of aggregate demand, alternative to the method of financial programming, is outlined. Using this model some special questions arising now in countries undergoing stabilization are analysed: the nature of inflation and the method of its control (chapter V), budget deficits, their causes and potential role in intelligent demand management (chapter VI) and the related issue of dangers involved in excessively contractionary monetary policies (chapter VII).

Part B is devoted to selected issues of institutional and systemic changes. An important institutional change is the liberalization of trade. The advantages and dangers involved in trade liberalization are analysed in chapter VIII. The main systemic change is the replacement of collective ownership of productive assets by private ownership. This problem and the difficulties related to privatization of larger state enterprises are presented in chapter IX. As state-owned enterprises are to remain with us for some time, proper methods for their management and restructuring have to be found. This question is

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[2] The "stylized" facts are those which the authors consider to be typical. They can be found in most countries, although not necessarily in all of them. They apply to all the countries of reform to a certain extent, but do not exactly correspond to a single country where details are concerned.

dealt with in chapter X. It can hardly be assumed that the whole process of institutional and systemic changes may succeed without a general strategy fixed by the government. The related question of industrial policies is treated in chapter XI.

Part C, the last part of the study, is devoted to the basic issue: How to move from stabilization to growth of output and welfare – the final goal of the transition from a command towards a market economy (chapter XII). Sources and references and two methodological annexes close the study.

PART A: STABILIZATION

II. The Model Underlying Stabilization and the Derived Policy Package

The stabilization programmes pursued in the economies in transition (EITs) are similar to those practised in developing countries when their financial and monetary system, particularly balance of payments, gets into difficulty. In the case of EITs they were meant to serve the additional goal of creating the proper conditions for the transition to a market-oriented system.

Stabilization programmes in the EITs have tended not to be country-specific, or tailor-made with respect to principal structural factors of these countries or their initial conditions. They rather tend to be uniform and stereotyped as far as the hard-core macroeconomic policies in the stabilization programmes are concerned. This uniformity permits identification of the theoretical model behind the stabilization programmes and the policy implications that follow from it.

At the intellectual core of conventional stabilization policies lies the procedure of financial programming derived from the influential paper of Polak (1957).[3] Financial programming suggests policy measures based exclusively on the double entry accounts of external trade and banking. The money supply is determined by international reserves, by credit to the business sector, normally from commercial banks, and by credit to the public sector (or government), normally – though not always – from the central bank. If it is assumed that central bank lending to the government acts as "high powered" money, i.e. as a credit base for commercial banks, the former also determines the latter. Money demand on the other hand is derived from the exchange identity. Also known as the "quantity theory of money", it shows money demand as the product of price level, aggregate output level and velocity of circulation.[4]

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[3]   Lance Taylor (1988) says: "Certainly in terms of the numbers of countries and people it affected, Polak's work is the most important piece of macroeconomics since Keynes. As such it merits substantial respect." (p. 154).

[4] $M = (1/v)PT$ in usual notation.

Supply of and demand for money are equal, as long as we assume that people are willing to hold money at all. This implies that either the velocity of circulation or the price level or the level of output adjusts freely to equate demand for and supply of money.[5] Under these conditions, if the international reserve and/or central bank lending to the government increases, then either the velocity of circulation decreases and/or the price level and/or the aggregate output level must increase. Financial programming assumes, however, that the velocity of circulation is roughly constant (or at least predictable) and that aggregate output is given exogenously from the supply side. In such conditions money supply changes must lead to corresponding changes in the price level.

Money supply depends, as was said, on the volume of credit granted as well as on international reserves. Reserves change, given net capital inflow (including here also net factor incomes, workers' remittances, net interest payments from servicing external debt etc.), according to the trade balance (including here besides goods also non-factor services). If now the rate of growth of credit advanced to the government (and con-sequently to the private sector also) decreases, financial programming predicts a slowing down of inflation and/or improvement in the trade balance. Thus (a) credit restraint becomes a central element of the stabilization programme. However, the package of policies usually recommended goes beyond credit discipline alone, although they are supposed to reinforce the basic goal of reducing inflation and solving balance of payment difficulties. The package usually contains additionally the following elements:

(b) The requirement of reducing the "fiscal deficit" of the government or the "public sector borrowing requirement". Thus, cuts in government subsidies and increases of prices of basic public utilities usually constitute another typical element of the stabilization package.

(c) Insistence on "price rationing" of credit, i.e. a high interest rate, in addition to "quantity rationing", i.e. restraint on the volume of loans advanced by the financial sector. This is designed to be a double-edged weapon. On the one hand, it is supposed to encourage (private) saving and thus reduce total borrowing requirements from the banking sector. And on the other hand it is expected to reduce the demand for loans from the banking sector due to the higher cost of borrowed funds.

(d) Devaluation of the domestic currency, in the hope that this will directly improve the trade balance by making export cheaper to foreigners and import dearer to domestic residents. This is recommended as a policy instrument in addition to domestic credit rationing, because the latter can reduce inflation so radically that even an increasing trade deficit may follow.

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[5] The last condition was not fulfilled as a rule in command economies. Thus, a more or less important monetary "overhang" existed, i.e. money was hoarded as idle cash which lowered the velocity of circulation correspondingly. In these conditions it was difficult to sustain equal demand for and supply of money.

The devaluation of domestic currency, as is well known, can become an effective instrument for dealing with balance-of-payments problems, provided that (i) exports and imports are sufficiently price-sensitive (e.g. to satisfy the Marshall-Lerner condition) and (ii) domestic supply for exports is sufficiently elastic. In this respect, the stabilization package aims at reinforcing two interdependent objectives: while devaluation is to improve international price competitiveness by reducing the export price to foreigners, domestic credit restriction tends to achieve the same target by reducing the domestic rate of inflation.

(e) Liberalization of the trade regime. This consists of two elements: first, moving from bureaucratically controlled quantitative restrictions and quotas to price-induced restrictions in the form of a more uniform tariff structure; second, dismantling of the protectionist trade regime to create a more liberal regime with lower tariff (and quota) restrictions. The movement from quantitative restrictions to price (tariff) restrictions seems to be associated with the view that more transparent rules based on more or less uniform tariffs are better than a maze of bureaucratic discretions in the form of detailed quantitative restrictions. In this sense, it touches on the familiar debate on rule versus discretion in macroeconomic management, with typical stabilization policy generally favouring the former.

However, a liberalized trade regime is sustainable only if it does not tend continuously to widen the current-account deficit. The support for trade liberalization is often sought on the ground that a more liberal import structure would not only promote exports, but higher exports would outweigh quantitatively higher imports to improve the trade balance in the longer run. The issue of sustainable trade liberalization thus becomes intimately connected with success in export promotion and a general shift in the output composition from non-tradables to tradables.

(f) The introduction – in some programmes – of two nominal "anchors" preventing the development of an inflationary spiral. The first "anchor" is often the constancy (for some limited time) of the exchange rate. This constancy is intended at breaking inflationary expectations by linking domestic to foreign currency in a stable relation. In this way confidence in the domestic currency should increase. Also, the constancy of the exchange rate keeps prices of imported goods more or less constant and thus puts some brake on cost-push domestic inflation. It should, however, be clear that the exchange rate "anchor" can work only if the initial devaluation is large enough in percentage terms to exceed domestic price inflation, which is very high especially at the beginning of the stabilization policy, because only that will ensure that international price competitiveness is enhanced through devaluation.

The second "anchor" is usually represented by a policy of restraining nominal wages. Money wages are often indexed during stabilization periods, with an indexation coefficient allowing only partial compensation for inflation. This is motivated also by the desire to discipline state-owned enterprises, which have been traditionally more interested in wages than in profits. The indexation rule means that the real wage rate will fall continuously as

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long as inflation persists. In some countries less severe wage regulation measures are used.

While these are the typical elements of stabilization policy packages practised in EITs, there have been some differences in their sequencing over time. The first step in the sequence, however, is always the introduction of a significant degree of price liberalization, preceding all other stabilization measures. This is so because in command economies prices did not as a rule balance demand for and supply of goods and services. At the same time the price structure in these economies was quite artificial and had to be adjusted to economic necessities, first of all to relative costs of production. These economies were in reality only half-monetarized shortage economies in which purchasing power was a necessary, but not sufficient condition of acquiring a good. Therefore, the transformation of money into a real transaction medium (and, hence, a store of value) is an absolutely necessary step on the way from a command towards a market economy. A major element of the monetarization of the economy is price liberalization. In the context of the EITs, therefore, the policies of stabilization and of price liberalization became strongly interlocked. Consequently, stabilization and price liberalization should be treated together in evaluating actual experience even if, in the analytical construction of the model, they have a somewhat separate existence.

III. Some Inferences from Stabilization Experience

It will be noted that the basic logic of fighting inflation and/or improving the balance of payments through conventional financial programming and credit restriction depends on two critical assumptions: (a) the restriction on credit affects basically the price and not the output level; (b) in turn, this requires us to assume that the output level is exogenously given or at least predictable, and also that the velocity of circulation of money is reasonably stable so that there is a predictable positive relation between the supply of "money" and the price level, given the level of output. These classical assumptions of the monetarist framework do not seem to have been borne out by the recent experiences with conventional stabilization policies in the EITs.

To start with, in every single case the economic depression, characterized by a fall in output during stabilization, turned out to be significantly more severe than was predicted, i.e. the exogenously predicted fall in output was systematically and grossly underestimated as shown by Table 1.

In practical terms this means that the massive social and political costs of stabilization were miscalculated. And, in analytical terms, it implies the need to modify the framework of analysis so that the impact of restrictive credit policies and other related measures of stabilization can be more appropriately accounted for, especially in terms of their negative impact on the output level.

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Table 1

Predicted and actual decline of output in Hungary, Poland and CSFR
1989-1992, annual change in per cent

gross domestic product

	1989 predicted	1989 actual	1990 predicted	1990 actual	1991 predicted	1991 actual	1992 predicted	1992 actual
Hungary	-1 to -2	0.4	0 to 0.5	-3.3	-4 [1]	-12	3 [1]	-5 [2]
Poland	4.2 [3]	0.2	-3.1 [4]	-11.6	3.5 [4]	-7.6	0	0.5 to 2
CSFR	1.8	1.4	2.5 [3]	-0.4	-5 to -10	-15.9	.	-8.5

industrial production

	1989 predicted	1989 actual	1990 predicted	1990 actual	1991 predicted	1991 actual	1992 predicted	1992 actual
Hungary	-1 to 0	-1.0	-1 to 0	-3.3	.	-19.1	.	-10
Poland	4.2	-0.5	-5 [4]	-24.2	.	-11.9	.	2
CSFR	2.0	0.3	.	-3.5	.	-21.2	.	-16

employment [5]

	1989 actual	1990 actual	1991 actual	1992 Sept.
Hungary	-2.5	-6.5	-13.3	-19.9 [6]
Poland	-3.7	-6.4	-8.5	-5.6
CSFR	0.0	-3.6	-13.5	-12.0 [7]

1) "Programme of Conversion and Development for the Hungarian Economy", the government of the Republic of Hungary, Budapest, March 1991. - 2) Official estimate. - 3) Net material product. - 4) Economic Survey of Europe in 1991-92, p. 46. - 5) Wage and salary earners in total economy. - 6) Employed in material branches. - 7) For enterprises with over 25 employees.

Source: WIIW databank.

The inherent conceptual and statistical difficulties of defining the "quantity of money", especially due to special features such as inter-enterprise credit in the EITs, make categorical statements about the relation between the quantity of money and nominal GNP (or GDP) problematic. Nevertheless, our analysis of available evidence in some of these economies suggests that no stable relation exists, i.e. evidence in favour of a quasi-constant or predictable velocity of circulation is virtually non-existent (see Table 2).

However, the assumed constancy of the velocity of circulation is the mainstay of the quantity theory of money. It is not usually realized that a relatively small **absolute** change in the velocity of circulation can mean a relatively large percentage change, given the small base. As a matter of fact, the relevant quarterly data exhibit large percentage variations in almost all cases. In terms of the quantity equation, this may mean some percentage change in GDP and, given the large magnitude of GDP, this implies large absolute change in the volume output. Therefore, from the point of view of the application of the quantity theory to the problem of predicting inflation, it is necessary that the velocity of circulation should be a constant, i.e. with **negligible** percentage change.[6] This almost certainly has not happened, as is abundantly clear from Table 2. As a rule the velocity of circulation, estimated quarterly, changed from quarter to quarter. This applies to all countries and almost all periods. The data in Table 2 prove beyond any doubt that changes in velocity of circulation are far from being "negligible".

Despite these difficulties with the intellectual basis of the conventional stabilization framework, the policy packages associated with the programme proved to be relatively effective in three directions, which must be considered to be its positive achievement. First, the transformation from a sellers' to a buyers' market constrained by demand

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[6] In usual notations, writing the exchange identity in percentage terms we get

$$\frac{dM}{M} + \frac{dv}{v} - \frac{dY}{Y} + \frac{dP}{P} \qquad \text{(a)}$$

It should be stressed that the conventional stabilization in the EITs tends to keep the real quantity of money constant; thus

$$\frac{dM}{M} - \alpha \frac{dPe}{Pe} \qquad \text{(b)}$$

where Pe denotes the expected price level and dPe/Pe the expected inflation rate and where the parameter α is near to one. On the other hand the expected inflation rate is related to the actual inflation rate by the equation

$$\frac{dPe}{Pe} - \beta \frac{dP}{P} \qquad \text{(c)}$$

where β is the inflation elasticity of expectation. Thus, using (b) and (c) we get from (a)

$$\frac{dY}{Y} - \frac{dv}{v} + \alpha\beta\frac{dP}{P} - \frac{dP}{P} - \frac{dv}{v} + (\alpha\beta - 1)\frac{dP}{P} \qquad \text{(a')}$$

It can be seen from (a') that the changes in v are a good estimator for changes in Y if expectations in respect to the inflation rate are correct (i.e. $\beta \approx 1$) and the policy of keeping the real quantity of money constant is reasonably successful (i.e. $\alpha \approx 1$).

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Table 2

The velocity of circulation of money[1] 1989-1992 estimated for: Hungary, Poland and CSFR

growth rates of velocity in per cent, against previous quarter

	IQ89	IIQ89	IIIQ89	IVQ89	IQ90	IIQ90	IIIQ90	IVQ90	IQ91	IIQ91	IIIQ91	IVQ91	IQ92	IIQ92	IIIQ92
Hungary															
dV1/V1	-2.6	5.1	-8.4	3.7	-2.2	6.0	-8.3	10.2	4.7	-8.6	-13.3	-3.4	n.a.[2]	-2.6	-7.8
dV2/V2	-3.7	6.0	-7.1	4.8	-4.0	7.6	-10.5	10.9	-1.3	-8.6					
Poland															
dV1/V1	49.6	-13.5	-1.1	66.0	-7.0	-30.6	-22.8	13.4	-6.3	-12.1	-4.7	46.1	na[2]	-2.5	0.3
dV2/V2	41.5	-14.6	-14.6	16.3	26.8	-13.2	-13.3	12.2	-2.9	-17.9	-3.5	42.9	na[2]	-0.8	0.1
CSFR															
dV1/V1	-5.7		-8.9	2.6	12.2	-5.9	-1.1	21.7	24.3	-10.1	-22.9	-6.9			
dV2/V2	-3.9		-8.1	4.4	5.3	-2.9	-3.0	18.4	19.1	-12.4	-19.5	-3.7			
CSFR - original data															
dV1/V1					7.4	2.2	5.6	15.2	14.4	-6.7	-15.3	-6.4	-7.4	-5.3	0.0
dV2/V2					0.9	5.2	3.6	11.9	9.7	-9.3	-11.7	-3.0	-13.1	-4.2	0.0

1) V_1 = GDP/M_1; V_2 = GDP/M_2; M_2 = M_1 + quasi-money – 2) Not available prior to publication of GDP in current prices for the whole year.

Source: see Annex 1 to this paper, Tables A1, A2, A3.

appears to have been largely achieved, as many of the traditional symptoms of the shortage economy began to disappear. However, this was mostly achieved through measures such as price and trade liberalization, which is a different element than the restrictive monetary and fiscal policies of stabilization. Second, in most cases, after an initial jump in the price level due to price and trade liberalization with devalued domestic currency, inflation began to slow down. However, evidence presented in Table 3 is not especially encouraging regarding the sustainability of a low rate of inflation in the near future.

Table 3

Inflation rates 1989-1992 in Hungary, Poland and CSFR

	1989	1990	1991	1992
		previous year = 100		
Hungary				
consumer prices	117.0	128.9	135.0	122.0
food	117.7	135.2	121.9	117.8 [1]
services	116.6	125.6	141.9	127.2 [1]
producer prices				
industry	114.6	120.9	131.5	110.7 [1]
agriculture	119.1	128.5	99.1	108.3 [1]
Poland				
consumer prices	351.1	685.8	170.3	143.0
food	420.0	674.7	146.1	136.9
services	271.0	880.0	231.5	167.6
producer prices				
industry	312.8	722.4	148.1	136.1
agriculture	351.5	396.4	128.9	162.0
CSFR				
consumer prices	101.4	110.4	157.9	110.4 [2]
food	100.1	110.8	145.3	106.9 [2]
services	100.8	107.5	139.6	126.2 [2]
producer prices				
industry	99.3	104.5	169.9	108.6 [2]
agriculture	.	104.1	99.7	106.3 [2]

1) Jan.-Oct. - 2) Jan.-Sept.

Sources: Statistical Yearbooks and Statistical Monthly Bulletins of Hungary, Poland and CSFR.

Finally, following initial price and trade liberalization along with devaluation, the convertible currency trade balance showed in most cases some distinct improvements at the beginning of stabilization, although it is uncertain how established this trend is (Table 4).

In empirical terms, therefore, the macroeconomic consequences of stabilization policies have been somewhat mixed and confusing – much poorer performance in terms of output and employment recession than was anticipated, but positive gains recorded, at least in the short run, in terms of reducing inflation and trade deficits in most cases.

Table 4

Balance of trade by currency of payments 1989-1992
for Hungary, Poland and CSFR

	1989	1990	1991	part of 1992
Hungary trade balance				
US$ mn	587	1,094	-1,111	-441.3 [1]
TRbl mn	523	23	-233	.
Poland trade balance				
US$ mn	767	3,766	-823	734 [2]
TRbl mn	2,111	4,374	548	.
CSFR trade balance				
US$ mn	.	.	634	-1058 [2][3][4]
TRbl mn	.	.	978 [5]	.

1) Jan.-Oct. - 2) Jan.-Nov. - 3) Balance of trade from current-account statistics. - 4) Of which US$ -268.2 mn balance of non-convertible currency. - 5) Recalculated from Kcs 8.8 bn to transferable roubles (TRbl) using the exchange rate published by the National Bank of CSFR.

Sources: For Hungary: Hungarian Statistical Yearbook 1990, p. 193; National Bank of Hungary, Annual Report 1991; Monthly Bulletin Tájékoztató, Oct. 1992.
For Poland: Foreign Trade Yearbook 1992, p. 4; Daily Rzeczpospolita, 30/31 Jan. 1993.
For CSFR: Statistical Bulletin, No. 1/1992, No. 10/1992.

A better understanding of these diverse facts is required to enable policy makers to minimize the adjustment costs of further stabilization and to quicken as far as possible the pace of transition from stabilization to economic growth through structural adjustments.

IV. The Role of Aggregate Demand

There is a certain irony which goes almost unnoticed in the current transition debate. Perhaps the most enduring positive feature of the transition so far has been the radical transformation of the command economy based on scarcity and sellers' markets into an economy largely characterized by buyers' markets and responsive to consumers' choice. This implies two things, one frequently emphasized, but not the other. The commonly understood point relates to the microeconomic aspect of consumers' sovereignty in choosing among alternatives subject to the budget constraint. However, the less understood aspect so far has been the fact that, in a buyers' market, the level of output and employment tend to be increasingly demand-determined, i.e. aggregate demand becomes critically important in determining the level of output. We intend to argue in this chapter that conventional stabilization policies failed to anticipate the severity of the

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economic recession (see Table 1) largely because its analytical scheme did not assign the appropriate role to the analysis of aggregate demand and the size of the market during the early phase of the transition process.

For an analysis of aggregate demand, we need to rely more on national income accounting in the usual double entry format than on the balance sheet of the financial sector used in financial programming. It is well known that the characterization of equilibrium between aggregate demand and aggregate supply in terms of national income statistics requires equality of investment and savings in a closed economy. When the argument is extended to an open economy with an economic role for the government, we have

$$GDP = W + R$$

and

$$GDP = C + I + G + E$$

where W and R denote wages and profits, both before taxation, i. e. non-property and property incomes into which value added is distributed. On the demand or expenditure side C, I, G and E denote (private) consumption, (gross business) investment, government expenditures for goods and services and trade balance on account of goods and non-factor services, respectively. Hence,

$$C + I + G + E = W + R \tag{1}$$

and subtracting on both sides taxes (including social security payments and net of government transfers) T and consumption C we get,

$$I + (G - T) + E = [(W + R) - T] - C$$

or

$$I + D + E = S \tag{2}$$

where the right hand side represents savings (net of taxation), and $D = G - T$ on the left hand side denotes the budget deficit. The interpretation of the above equation (2) in a demand-determined economy with buyers' markets is crucial. Since expenditure determines income (and output) in the demand-determined situation, equation (2) shows that in every period, what is saved is determined by investment plus budget deficit plus trade balance.

We denote additionally by s the (average and marginal) savings ratio, i.e.

$$s = S/GDP$$

hence

$$GDP = (1/s)S. \tag{3}$$

If s is constant, the change in GDP can be obtained from (3)

$$\Delta GDP = (1/s)\ \Delta S \qquad\qquad (4)$$

and if s is not a constant, i.e. in the general case,

$$\Delta GDP = GDP(gS - gs). \qquad\qquad (5)$$

In equation (3) the term (1/s) denotes the multiplier measuring the impact of changes in savings, i.e. in combined investment, deficit spending and trade balance, upon GDP. In equation (5) gS and gs denote the rate of growth of S savings and of s the savings ratio, respectively (i.e. g represents the operator for proportional change of a variable). Equation (5) does not apply when annual changes in S and s are large, in which case we obtain from (3):

$$1 + gGDP = (1 + gS)/(1 + gs)$$

where gGDP denotes the rate of growth of GDP. Rearranging, we obtain

$$\Delta GDP = GDP(gS - gs)/(1 + gs) \qquad\qquad (6)$$

the equation which can be applied when yearly changes of S and s are large.

The way in which investment, budget deficit and trade balance determine savings and, via the savings ratio, GDP would be quite complicated. There are, however, two extreme cases – that of pure quantity adjustment and that of pure price adjustment. In the first case prices maintain constant relation to costs, especially labour costs, thus the distribution of value added between wages and profits (and taxes) remains constant. This results in a more or less stable savings ratio even if we assume that savings out of profits (e.g. retained profits of enterprises) and out of wages are significantly different. In this case the volume of GDP increases more or less *pari passu* with savings, while prices remain constant, if costs remain constant too. This is the case of pure quantity adjustment because prices, given costs, do not change. In the second case prices in relation to costs, especially labour costs, change. When prices increase in relation to costs the value added is shifted from wages to profits resulting in increased savings, while the volume of GDP remains constant in real terms. The expansion of investment, budget deficit and trade balance leads in the second case to inflation through pure price adjustment because, by assumption, quantities do not change.

Which case prevails in a given situation depends mostly on the level of capacity utilization and is strongly related to factors determining prices. As far as the latter are concerned it is very important to differentiate between demand-determined and cost-determined prices. Prices of raw materials and energy and agricultural prices tend to be demand-determined. If demand increases (decreases) these prices tend to increase (decrease) too, while the

quantities of goods remain given in the period under consideration. However, in an industrial economy most prices, namely prices of industrial goods and services, do not belong to this group; instead, they are cost-determined. These prices tend to be relatively insensitive to demand in relation to costs, while their quantities increase or decrease in response to demand changes.[7] Cost-determined prices are also called mark-up prices because they are fixed at a level covering direct unit costs plus a mark-up. As long as capacity is under-utilized, direct unit costs may tend to remain constant, but only if money wages and labour productivity are not strongly influenced by variations in the degree of capacity utilization. In that case quantity adjustment would prevail at low capacity utilization, and price adjustment would be the rule if utilization of capacity is high. Of course mixed cases cannot be excluded. In mixed cases both the savings ratio and the volume of real GDP would tend to change, the former through price adjustment and the latter through quantity adjustment.

The preceding analysis, highlighting the role of aggregate demand in determining the output level, is helpful for understanding one of the crucial aspects of the recent stabilization experience in the EITs. As already noted (chapter III, Table 1) the decline of GDP was much stronger in all countries than predicted in the stabilization programmes (for example by 8 and 11 percentage points in Poland in the years 1990 and 1991, by about 10 percentage points in CSFR and Hungary in 1991). The unanticipated depth of the recession was, however, not subsequently explained: this failure represents the most important theoretical weakness of the stabilization programmes pursued.[8] In particular, no effort has been made to evaluate, even approximately, the combined effects of the proposed curtailment of total demand on the level of output and employment. This, as will be shown subsequently, has been the main reason for the wide gap between anticipated and actual recession of stabilization policies. This conceptual shortcoming of conventional

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[7] This is quite convincingly illustrated by data concerning price and quantity changes in industry and agriculture. In 1991, in the three leading reform countries (and already in 1990, in Poland), when the effects of restricted real demand were already fully felt, agricultural procurement prices declined sharply in relation to industrial producer prices (see Table 3), while the agricultural output dropped much more slowly than industrial output (in Hungary and Poland agricultural output stagnated while industrial production fell by 21 and 11 per cent respectively; in CSFR agricultural output declined by 9 per cent, but industrial output by 25 per cent – WIIW databank). Hence, industry reacted to decreasing real demand mostly by volume changes, agriculture mostly by price changes.

[8] This deeper than anticipated recession is often "explained" away in terms of "special factors", e.g. the collapse of CMEA trade, or the poor quality of products in the EITs. However, all these special factors relate basically to supply or demand as captured in the national accounting framework and need to be analysed in this context. It should be recognized that the major impact of these special factors is to reduce demand. Thus, the extent to which the collapse of CMEA trade meant a reduction in the export surplus for a country or the poor quality of domestic production induced substitution of domestic by imported foreign items in a more liberalized trade regime, our analytical framework would capture this negative aggregate demand effect through an overall decline in the export surplus of a country. However, these special factors could also mean a sudden disruption on the supply side, e.g. reduction in the supply of raw materials or spare parts needed for domestic production, due to (say) reduction in CMEA trade. It is doubtful that such a negative supply shock can account for the unanticipated depth of the present recession, especially because a liberalized trade regime provides alternative supply sources in some cases.

stabilization policy arising from its failure to take into account the full impact of reduction in aggregate demand on output must be remedied for better designing of fiscal and monetary policies during transition.

We do not yet avail of enough data in all countries to provide alternative estimates for an adequate analysis of the curtailing of demand resulting in the decline of GDP. So far such an analysis has been made only for Poland – the first country to start the shock therapy – in 1990. In 1989 Poland's GDP was Zl 118.3 trillion; it included investment in the enterprise sector of Zl 41.5 trillion, an export surplus of Zl 4.6 trillion and a budget deficit of at least of Zl 3.6 trillion. (According to the methodology used by the World Bank, the budget deficit was much higher.) Total savings S came to Zl 49.7 trillion; the savings ratio s was 42 per cent (Table 5).

Table 5

Gross domestic product in Poland
trillion zloty, 1989 prices

		1989 (1)	1990 (2)	(2)-(1) (3)	(3):(1) (4)	1990 (5)[1]
1. Gross domestic product	GDP	118.3	104.6	-13.7	-11.6%	
2. Investment of the business sector (including changes in inventories)	I	41.5	30.3	-11.2	-27.0%	-4.1
3. Export surplus[2]	E	4.6	7.4	2.8	60.9%	-5.6
4. Budget deficit	D	3.6	-0.4	-4.0	-111.1%	-3.6
5. Savings of the business sector and private households	S	49.7	37.3	-12.4	-24.9%	-13.3
6. Saving ratio (5:1)	s	42.0%	35.7%	-6.3[3]	-15.0%	

1) Changes in I, E and D as forecast in February 1990. - 2) Trade balance only. - 3) Percentage points.

Source: Own estimates based on data from the Central Planning Commission, Warsaw, and WIIW databank.

There was no forecast in the stabilization programme for investment in the enterprise the expected decline in the export surplus in 1990 would have amounted to $\Delta E =$ $= -1.0-4.6 =$ Zl -5.6 trillion. Finally, the plan assumed that the government's budget would balance, meaning a reduction in the deficit of $\Delta D =$ Zl -3.6 trillion. Hence the expected reduction of savings in 1990 was $\Delta S =$ Zl -13.3 trillion (Table 5, column 5).

If the savings ratio s in 1990 were to remain the same as it was in 1989, the decline of GDP could be calculated using our previous equation (3):

$$\Delta GDP = (1/0.42)(-13.3) = Zl \ -31.7 \ trillion$$

or a relative decline of about 27 per cent of GDP. This is a rough estimate of the combined results of the measures anticipated in the stabilization plan. However, this is an over-estimation of the depth of recession, because in reality neither the export surplus nor the budget deficit are independent of GDP. Thus, if GDP were to decline more than anticipated in the plan, then imports, being an increasing function of GDP, would decline (or increase less than expected) and the import surplus should have been assumed smaller than estimated above. This factor would moderate the expected change in GDP. The same applies to the budget deficit. If GDP were to decline more than anticipated, then budget revenue would be smaller (primarily because of taxes related to income and output) and expenditure larger (because of unemployment benefits). As a result the budget would not balance and the budget deficit would moderate the expected decline in GDP. If proper account had been taken of both factors, the resulting estimate of the decline of GDP would have been somewhat less than 27 per cent. In addition, the estimate needs to be corrected by changes in the savings ratio.

Concerning the assumed constancy of s, the savings ratio in our calculation, it is true that at the beginning of 1990 nobody knew for sure how the savings ratio might change, but the factors which influence these changes were generally known and should have been analysed for the stabilization programme. These factors are: the share of taxes in GDP, the distribution of value added (after taxation) between wages and profits, and the propensity to save out of profits and wages. Thus the main point of this simple exercise has been to show that predictions based on aggregate demand analysis would have prepared us better for the deep recession that occurred.

The analysis of the internal consistency of the stabilization programmes for the three leading reform countries could be carried further in terms of available statistical data presented in Table 6. Table 6 shows savings ratios and the composition of savings for CSFR, Hungary and Poland. They make possible an analysis of the sources of recession in these three countries. We investigate the changes in savings S and then changes in the savings ratio s in 1990 and 1991 for Poland and Hungary and in 1991 for CSFR; these are the years when the stabilization policies were introduced in these countries.

The most important element by far of S is investment I (standing here as explained before for business investment only). Indeed it constitutes in all countries and in all years on average about 90 per cent of S (and about 20 per cent of GDP). Hence what happens to S depends as a rule on I. The restrictive monetary policy and high interest rates (as

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Table 6

Savings ratios and components of savings
for CSFR, Hungary and Poland 1988-1991

	Savings ratios s = S/GDP		Savings (Investment) S (I)		GDP	Components of savings as % of GDP at constant prices		
			previous year = 100 constant prices			D Gen. gov. deficit	I Invest-ment	E Bal. of goods & NFS
	constant prices	current prices						
CSFR								
1988	0.253	0.247	106.0	(97.7)	102.6	0.3	22.4	2.6
1989	0.256	0.246	102.5	(103.6)	101.4	0.8	22.9	1.9
1990	0.211	0.211	82.2	(109.1)	99.6	-0.9	25.1	-3.1
1991	0.229	0.247	91.3	(67.9)	84.1	1.1	20.3	1.6
Hungary								
1988	0.208	0.209	100.9	(97.3)	99.9	0.7	18.0	2.2
1989	0.240	0.255	115.6	(105.8)	100.4	2.8	18.9	2.3
1990	0.212	0.217	85.3	(93.1)	96.7	0.03	18.2	2.9
1991	0.189	0.193	78.7	(75.9)	88.0	4.4	15.7	-1.2
Poland								
1988	0.298	0.292	107.3	(112.6)	104.1	0.2	26.0	3.5
1989	0.346	0.389	116.4	(114.4)	100.2	3.5	29.7	1.3
1990	0.298	0.321	76.1	(63.3)	88.4	-0.2	21.3	8.7
1991	0.255	0.237	79.2	(90.2)	92.4	3.8	20.7	1.0

Source: WIIW estimates; see Annex 2 to this paper.

CSFR - constant prices of 1986
Hungary - constant prices of 1985
Poland - constant prices of 1990

well as the unclear legal situation of state enterprises) could not but depress the level of investment during the stabilization period. Indeed in all investigated countries, investment decreased sharply: in the first year of the stabilization programmes by as much as 37 per cent in Poland and by 32 per cent in CSFR. As far as budget deficits are concerned the following pattern seems to have occurred. At the beginning the deficits declined (in Poland and Hungary in 1990), in line with the goals of stabilization policies, then, however, they increased (reaching the level of 3.8 and even 4.4 per cent, respectively, of GDP). In the CSFR the budget deficit increased in the first year of the shock therapy, but in this country the preparations for stabilization had been under way already in 1990 and resulted in a budget surplus. The same pattern may be observed in the net export balance of goods and non-factor services E. The balance of trade tends to improve in the first year of stabilization policy, because of devaluation of the national currency and the limited internal market, and to deteriorate thereafter.[9] There is, however, a difference between the pattern of changes of D and E, namely the structural character of the budget deficits. (For a more detailed discussion on fiscal policy see chapter VI.) It should be stressed that some changes in D and E partly cancel each other (e.g. in Poland in 1990 and especially in 1991 as well as in Hungary in 1991). Taken together, S decreased quite strongly in 1990 and 1991 in the countries under examination (by 40 per cent in Poland, 33 per cent in Hungary and 25 per cent in CSFR).

We now need to move to the second part of our analysis, dealing with the savings ratio s. With a constant savings ratio the changes in GDP are proportional to changes in savings. As for the three transition economies this was not the case. In these countries we observe a reduction of the savings ratio (in constant as well as in current prices) over both years (1990 and 1991), less pronounced, however, in the CSFR. It is possible that the observed reduction of the savings ratio was provoked mainly by the decline of the relative share of profits of state enterprises (with a propensity to save equal to unity) in the value added. But this hypothesis requires further investigation.

The number of cases observed is by far too small to attempt any serious generalizations. It seems, however, that two hypotheses can be formulated concerning the tendency of changes of S and s during transformation. It is possible that changes in investment will be compensated by changes in the budget deficit and the balance of trade. But the size of these factors is limited, so that for any longer period of time the decline in investment must result in a decline of savings S. This decline is a necessary result of the conventional stabilization programmes, especially of the monetary and fiscal policies implied in these programmes. As far as the savings ratio is concerned, especially if we take into account the years preceding the stabilization programmes, a tendency for savings ratios to decrease seems to be well-founded. This tendency was an important factor in softening the decline in GDP caused by the strong reduction of savings in the course of the stabilization process.

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[9] It should be mentioned that the balance of trade was heavily influenced in 1991 by the shift to hard currency settlement of payments inside the former CMEA.

To sum up the main thrust of our discussion, a better appreciation of the role of aggregate demand in determining the level of economic activity through the "multiplier analysis" would have predicted more accurately the depth of the recession – which turned out to be much more severe than anticipated – caused by conventional stabilization policies. At the same time, such a framework would have been better suited to distinguish between the autonomous (or exogenous) and the induced (or endogenous) components of aggregate demand, which is essential for the design of appropriate fiscal, monetary and trade policies during the transition (see chapter VI). Thus, the budget deficit and trade balance should be recognized as partly endogenous variables which adjust as a consequence of changes in the level of income and economic activity. This view is in contrast to conventional stabilization programmes which tend to treat the government budget deficit as an exogenous policy variable and base much of the fiscal policy for stabilization on this assumption. Similarly, reduction in import was induced by recessionary output contraction. Since conventional stabilization programmes failed to anticipate the severity of the recession, they also failed to predict the consequent improvement in the trade balance in several countries during the first phase of stabilization through slackening of import demand due to recession. The improvement of the trade balance was attributed entirely to relative price changes through devaluation whereas it should have been realized that it was, at least partly, the consequence of declining aggregate income. This also points to the fragile nature of the improvement in the trade balance achieved which may begin to deteriorate again as soon as the economy starts to expand or the compression of import reaches its limits.

Conventional stabilization policy failed not only by not predicting correctly the consequences of reduced savings (the sum of investment, budget deficit and trade balance) upon aggregate demand. It also failed by excessively reducing consumption, by far the major part of GDP. It is true that in command economies effective demand of private households, given the price level, was as a rule higher than actual (and potential) supply of consumer goods. The resulting excess demand had to be removed and this goal was rightly an important part of the stabilization policy. However, the removal of excess demand does not necessarily mean a decline of real consumption if it is really limited to the excess part of demand only. This removal implies an adjustment of the monetary overhang (the stock part of excess demand), where it existed, and of the current monetary incomes, wages and other incomes (the flow part of excess demand). It should be stressed that in countries with a significant monetary overhang high inflation often preceded stabilization measures and decimated really the stock part of excess demand. Thus the main problem was, nearly everywhere, the adjustment of the flow part of excess demand, mostly wages.

Let us introduce an important difference in the shortage economy – the difference between "statistical" real wage and "available" real wage. This difference is related to nominal wages (and other nominal incomes) being too high at the given level of consumer goods prices. The basket of goods represented by the "statistical" real wage is higher than that represented by the "available" real wage but is partly a fiction because the nominal

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wage comprises some forced savings. Additionally the "available" real wage implies queuing and painful efforts for the buyers, characteristic of a sellers' market. Adjustment of nominal wages (as well as other nominal incomes) and prices under these conditions requires a rise in consumer goods prices in relation to nominal wages to such a degree that the "statistical" real wage is being reduced to the level of the "available" real wage. Hence, the wage earner suffers only a "statistical" cut in his real income and is additionally compensated by the passage from a sellers' to a buyers' market.

The main conclusion to be drawn from this discussion is the following: while the "statistical" real wage must be cut in the framework of the stabilization policy, this does not apply to the "available" real wage (and to other incomes, respectively). This conclusion was quite popular at the end of 1989 when the stabilization plan for Poland was discussed, and it became part of this plan. But after the start of the shock therapy, it disappeared from the discussion for reasons which are not clear, giving way to the argument that a drastic fall of real consumption out of wages (and other incomes) was an absolutely necessary measure in the successful battle against inflation. A development similar to that in Poland with respect to real consumption out of wages (and other incomes) occurred in other EITs as well and was defended with similar arguments. This applies even to a country like the former CSFR, in which the difference between "statistical" and "available" real wage was rather negligible. Still, also in this country the decline of real wages during the stabilization period has been very strong.

It has been shown already (see Table 6) that the reduction of savings and the related fall of aggregate demand provokes a decline of GDP and employment. Under these conditions, even with given real wages, consumption – disregarding unemployment benefits – decreases *pari passu* with employment. If, in addition, real wages fall, then consumption decreases more strongly than employment and deepens the recession. It is not clear at all why some recession, even if it is accepted as an unavoidable step on the road from a command to a market economy, should combine reduction of employment with reduction of the real wage. If for whatever reasons such a decline is nevertheless intended, its effect upon aggregate demand should be taken into account when cuts in savings S are planned.[10]

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[10] The real wage declined in the stabilization period in all EITs absolutely and probably also in relation to the labour productivity. If this were the case then the share of wages in value added would have diminished and that of profits increased. As the propensity to save out of profits is higher than that out of wages (and in the case of profits of state enterprises equal almost to unity), these changes in the distribution of value added between wages and profits should have resulted in an increase of the savings ratio s. As we have seen, however, this was not the case. On the contrary, the savings ratio rather declined. A possible explanation for this alleged contradiction could perhaps be found in the strong expansion of the private sector during stabilization. Prior to the start of stabilization almost all profits were earned by state enterprises. With stabilization and transformation progressing an increasing part of profit was shifted to private firms, whose propensity to save is much lower than that of state firms. Under these conditions the increasing relative share of profits in value added and the decreasing savings ratio do not necessarily contradict each other.

V. The Nature of Inflationary Price Adjustment: How to Control Persistent Inflation?

While the conventional stabilization programmes failed to anticipate the depth of the recession in the EITs, their policy package turned out to be relatively more effective in fighting inflation. An immediate, though partial explanation of this phenomenon in the light of our preceding discussion would run along the following lines: the measures, aimed at curbing credit, budget deficit and related restrictive monetary and fiscal policies (see chapter II), contracted demand. That demand contraction showed up partly in negative output adjustment (see chapter IV) resulting in recession, and partly in price adjustment resulting, after an initial jump, in the slowing down of inflation. Moreover, the slow-down of inflation was helped further by a nominal wage anchor and by the international price discipline imposed by the newly liberalized foreign trade regime, both of which kept a check on nominal price rises.
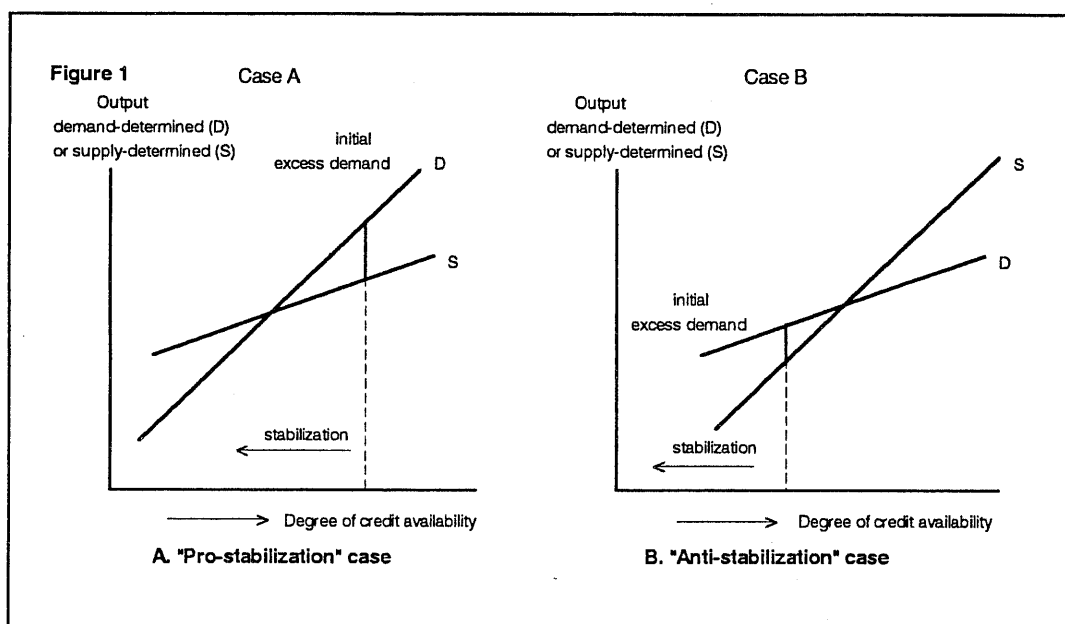
This simple explanation, and the strategy of massive demand contraction for the sake of price stabilization, is probably valid and unavoidable in situations of hyperinflation (or acute inflation) with an overhang of liquidity with the public, as was the case in some EITs in the initial phase of stabilization. However, it is equally important to realize that this policy of almost indiscriminate demand contraction may not only cause avoidable recession, but may actually turn out to be counter-productive in the changed circumstances of massive recession and relatively moderate inflation now facing some of the EITs.

The central analytical reason why massive demand contraction, if pursued for long, may turn out to be counter-productive is not difficult to appreciate. This strategy may end up not only by eliminating **excess** demand, but may begin adversely to affect the supply side of the economy in a way that makes the task of controlling inflation increasingly difficult.

Since the actual level of aggregate output might be constrained either by the demand or the supply side, some measures of the conventional stabilization programme could affect both sides. For instance, restraint on domestic credit through quantity rationing as well as price rationing in the form of higher interest rates would adversely affect the demand-determined level of aggregate output by restraining the budget deficit and also by discouraging private investment. It would at the same time reduce availability of working capital, especially for the smaller production units, and for sectors with long gestation periods, e.g. housing and shipbuilding, affecting their supply-determined level of output. Thus, for different reasons, both the demand-determined and the supply-determined output levels are likely to decrease with greater degrees of credit squeeze. This, of course, implies that changes in the level of output – either from the demand or from the supply side – are not independent of changes in the degree of credit restriction imposed.

Once it is recognized that both aggregate demand and aggregate supply may tend to fall as a result of lower availability of credit, the basic objective of conventional stabilization through financial programming may be lost. Figure 1 displays clearly this possibility by contrasting the "pro-stabilization" with the "anti-stabilization" case. So long as aggregate

demand responds more strongly than aggregate supply to credit availability, starting from an initial situation of excess demand – recall, the initial situation is characterized by the economy of shortage in the former centrally planned economies – the lowering of credit availability due to stabilization (financial programming) will reduce the excess demand gap, because demand will fall more sharply than supply, as credit is reduced in conformity with Case A, Figure 1. Such narrowing of the excess demand gap will, in turn, be helpful for containing inflation and/or improving the current-account position. However, as the anti-stabilization Case B in Figure 1 demonstrates, if supply falls more sharply than demand, the excess demand gap keeps increasing as a result of more severe credit restriction through stabilization. This may fuel both inflation and deterioration in the trade balance; conventional stabilization fails unambiguously in this case.

Figure 1   Case A

Output
demand-determined (D)
or supply-determined (S)

initial
excess demand   D

S

stabilization

⎯⎯⎯⎯→ Degree of credit availability

A. "Pro-stabilization" case

Case B

Output
demand-determined (D)
or supply-determined (S)

S

D

initial
excess demand

stabilization

⎯⎯⎯⎯→ Degree of credit availability

B. "Anti-stabilization" case

Three comments are in order in this context. First, a usually implicit assumption underlying demand and supply elasticities/responses is that they are defined with respect to a given time period. This also holds for Figure 1, where the outcome of stabilization depends critically on the relative response of demand and supply to (say) credit squeeze. In general, supply responses in terms of output expansion (as a result of, say, easier credit conditions) are likely to be considerably slower than demand responses, e.g. supply may hardly increase if the time period considered is short enough. Nevertheless, supply response in terms of output contraction (as a result of, say, tighter credit conditions) may be more or less as fast as demand contraction in some cases, e.g. lower supply due to non-availability of working capital. This asymmetry, i.e. supply usually expands considerably more slowly than demand, but may contract almost as fast as demand, makes the simple analysis in Figure 1 not too misleading in the case of **downward** adjustment of demand and supply in the course of stabilization. It may be noted in passing that it also makes the transition from stabilization to growth much more

problematic, because the expansion of demand is governed usually by a dynamics much faster than that of supply.

Second, although the argument has been illustrated only with respect to restriction on the availability of domestic credit – a centrepiece of conventional stabilization pro- grammes – it applies also to some other major instruments used in stabilization. For instance, with liberalization of import (i.e. a more liberal trade regime), aggregate domestic demand may fall through a widening of the current-account deficit. At the same time, domestic supply may also fall as inefficient domestic firms go out of business due to competition from superior and/or cheaper foreign products. As already pointed out (Case B, Figure 1), if supply declines faster than demand, the excess demand gap may widen to aggravate problems for the trade balance. Without repeating the argument, it is easy to see how a higher interest rate – usually an important aspect of financial liberalization – may create similar destabilizing dynamics if higher interest leads to reduction in both demand and supply. Thus the central analytical point deserves emphasis: Several of the important instruments of conventional stabilization, e.g. domestic credit control, or trade liberalization, lead to downward adjustment **both** on the demand and on the supply side. Unless these adjustments are well synchronized (i.e. Case A, Figure 1), the stabilization programme may actually contribute to destabilization (i.e. Case B, Figure 1).

Finally, note that general policies like greater restraint on the availability of domestic credit, higher interest etc., without further discretion and fine-tuning can create contradic- tory and awkward problems in different sectors. Thus, in some sectors demand and supply responses may be such as to reduce the excess demand gap (Case A, Figure 1) while in other sectors the same gap may increase (Case B, Figure 1) as a result of applying the same general policy. To illustrate the point by an important example, supply may typically decrease more slowly than demand in the agricultural sector to make excess supply a typical outcome of stabilization (see Case A, Figure 1). However, at the same time supply may fall more sharply than demand in some manufacturing sectors like housing, shipbuilding, etc. due to non-availability or unacceptably high interest cost of working capital, or due to closing down of inefficient domestic firms in face of foreign competition etc., so that in these sectors "stabilization" would result in even greater excess demand (see Case B, Figure 1). While fine-tuning and bureaucratic discretion are admittedly unpleasant, the problematic nature of general policy rules without discretion should not be minimized either, especially in the context of fighting inflation through stabilization. It must be emphasized, however, that even when supply is relatively less responsive than demand to the instruments of stabilization (e.g. credit control) – to conform to the basic logic of demand contraction (i.e. the "pro-stabilization" case A in Figure 1) – there is always the danger of over-kill through a contractionary policy.

For ready reference, this case is presented in Figure 2, which reproduces the "pro- stabilization case" from Figure 1. With initial lax credit policy OA there exists an excess demand gap a and the supply-determined output equals Qa with accompanying shortage

phenomena. With credit restricted from OA to OB an equilibrium output Qb could be achieved. The lost output (Qa – Qb) is the cost of moving from a supply- to a demand-determined system and represents *int. al.* some reserve capacity assuring the necessary flexibility of supply with respect to demand. If, however, the credit availability is limited further to OC (OC<OB) an excess supply gap c materializes with demand-determined output Qc and avoidable loss of output (Qb – Qc).

Figure 2
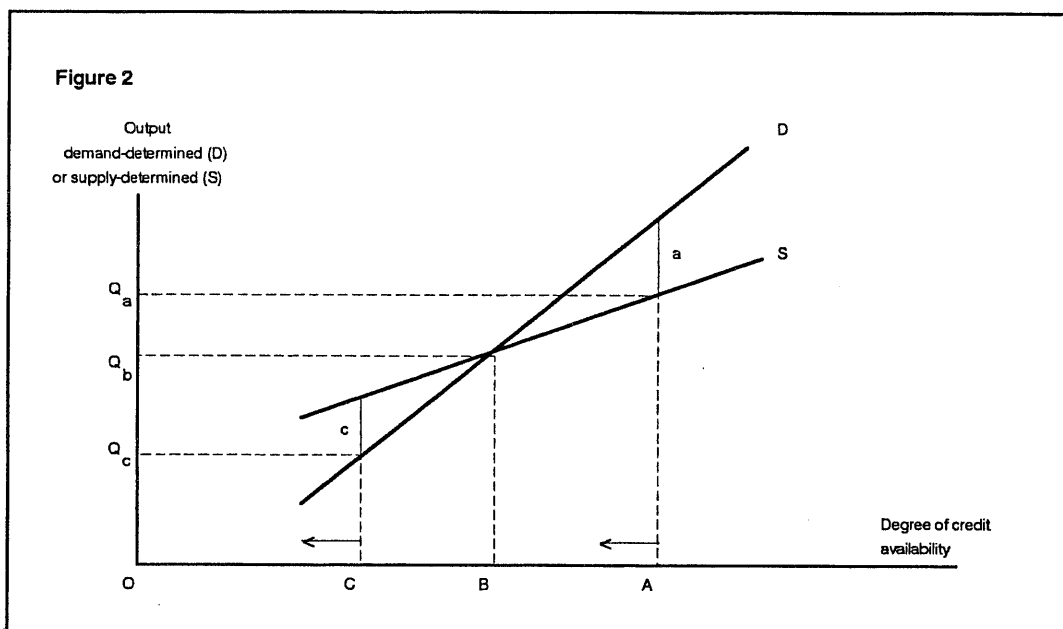
We believe this configuration corresponds reasonably well to the present situation in the three leading reform countries after the stabilization policy has been started. In Poland, in 1990-1991, the GDP fell by 18.3 per cent creating excess capacity, but inflation, although slowing down, has remained quite high. In 1992, GDP recorded slight growth (0.5 to 2 per cent). The rate of inflation (in relation to the previous year) was 589 per cent in 1990, 70 per cent in 1991 and reached 44 per cent in 1992.[11] In Hungary the GDP shrank by 14.9 per cent in 1990-1991 and likely by a further 5 per cent in 1992; the inflation rate was 29 per cent in 1990, 35 per cent in 1991 and 22 per cent in 1992. In CSFR, the fall of the GDP in 1991-1992 amounted to 23.4 per cent and the yearly inflation rate, increasing from 10 per cent in 1990 to 58 per cent in 1991, reached 11 per cent in 1992. Thus in no case the potential excess supply brought about by demand deflation eradicated inflation.

[11] It should be added that the stabilization programme expected the slowing down of inflation in this country already in the second half of 1990 to 1-1.5 per cent per month. The over-optimistic mood at the beginning of the stabilization programme is well documented by an excerpt from an interview given by Sachs (1990) on 24 November 1989: "Once that monetary reform is finished, a tight budget based on ending subsidies, a big devaluation, and a very tight credit policy, Poland will be able to move from current hyperinflation to price stability by next spring (i.e. spring 1990, our remark, WIIW)." (p. 27)

Since in the monetarist framework of conventional stabilization policy it is the supply of money which determines the price level, continuing high inflation, as is the case in the three leading reform countries, may induce the supporter of conventional stabilization to conclude that credit restriction has not gone far enough. The monetarist framework requires that it should be continued, and even tightened further, *coûte que coûte*, till inflation is eradicated. This policy stance is symbolized by the left arrow in Figure 2 and, if followed, would provoke a further decline of GDP and a further increase of the excess supply gap. It should be added that losses of output may partly be irreversible if the capacities concerned are destroyed (e.g. existing supply of specialized intermediary inputs gets lost, workers with special skills change jobs, factories are closed down etc.). In all these cases a later restoration of effective demand would not easily restore the unnecessarily lost potential output.

Nevertheless, there would be some intrinsic logic in the monetaristic approach if all prices were demand-determined. But, as was already stressed, the prices of most goods in a modern society, excluding primary products like agricultural products and raw materials, tend to be cost-determined and remain constant if unit direct costs remain constant. The latter is quite likely if firms produce below their capacity. Under this condition unit direct costs remain constant and are equal to marginal costs. Marginal costs – and, though more slowly, unit direct costs – start increasing only when output approaches the capacity level (second shift, use of less efficient equipment etc.). Hence, the assumption of constant unit direct costs is related to the existence of reserve capacity in industry, services etc. Only this reserve capacity makes it possible that increased demand causes mostly quantity and not price adjustment.

The fact that actual output as a rule stays behind potential supply, resulting in some reserve capacity and unemployment, is characteristic of the market economy and makes it demand-determined. On the other hand, in a command economy demand as a rule is ahead of potential supply, capacity reserves and (open) unemployment do not exist, the system is supply-constrained. Hence, there exists an important asymmetry between the transition from a market economy towards a command economy and the reverse process. In the former case the previously idle factors of production can be activated by a drastic increase in effective demand, leading to a quick increase in production, employment and consumption. These short-term gains made the transition to a command economy attractive and supported early illusions concerning its alleged superiority over the market economy. In the latter case demand has to be limited to a level below that of potential supply, resulting in some reserve capacity and even unemployment, allowing for the necessary flexibility of production. Some decrease of actual GDP is thus unavoidable if the economy is to be exposed to the demand constraint. Although this short-term loss can be overcompensated by an increase in efficiency and creativity in the longer run, it makes the process of transition to a demand-determined system quite difficult.

At the level of credit availability OB and at output Q_b in Figure 2 prices need not remain constant if unit direct costs increase. With a given mark-up ratio these prices would

increase *pari passu* with costs. The same applies to a level of credit availability OC with an excess supply gap c. Although at this level aggregate demand is below potential supply, prices may not fall or even remain constant if unit direct costs are on the rise. Moreover, it should be noted that the stabilization policy itself often exerts a strong influence upon labour and non-labour costs. Let us start with the latter. The most important factors recurrent in all stabilization cases are drastic increases in prices of energy, transport tariffs, rents and, especially, of the working capital (in the form of exorbitant high interest rates), all fixed directly by the authorities. All these measures as well as the sharp increase of indirect taxation aim at improvement of the budgetary balance but fuel at the same time inflation by increasing non-labour costs. Also the continuing devaluation of national currencies plays a role in increasing the costs of imported inputs.

This increase of non-labour variable costs is not the only reason for persisting inflation. It is seldom realized that labour costs are often also pushed up by the stabilization policy. If labour productivity were to remain constant, then the non-full indexation of nominal wages, implying decreasing real wages, would lead to a decline of unit real labour costs. However, it is typical in all countries undergoing stabilization that drastic cuts in output, especially in industry, are often not compensated by parallel cuts in employment, mostly for social reasons, as unemployment becomes a politically explosive issue. Thus redundant labour inside enterprises increases further and labour productivity decreases. Under these conditions unit real labour costs increase if real wages remain constant, or even decrease but less than labour productivity. The dynamics of labour productivity and real wages in industry in the three leading reform countries is shown in Table 7. These data show that declining labour productivity due to the faster recessionary contraction in output than in industrial employment is quite a general phenomenon in some periods of stabilization policy. Thus, there is an upward pressure on unit real labour costs whenever real wages do not fall as quickly as labour productivity does.

Table 7

Labour productivity and real wages in industry 1989-1992
annual change in per cent

	labour productivity				real wages			
	1989	1990	1991	1992 Jan.-Sept.	1989	1990	1991	1992 Jan.-Sept.
Hungary	0.7	-0.4	-9.4	4.4	0.7	-5.0	-8.3	-2.1
Poland	-0.5	-15.8	-3.8	7.5	9.1	-32.1	-1.4	-3.9
CSFR	-0.2	-0.3	-14.4	-4.9	0.9	-6.8	-25.7	7.6

Unit real labour costs are influenced by the stabilization policy in yet another way. As already mentioned, this policy implies sharp increases in prices of services fixed by the

government (rents, heating, electricity, transport tariffs). As their share in services is rather high, prices of services very often increase faster than the overall consumer price index. On the other hand, industrial producer prices very often increase more slowly than consumer prices (see Table 3). If, then, average money wages increase faster than industrial prices (i.e. real product wages increase) but more slowly than consumer prices (i.e. real consumption wages decrease), unit labour costs would increase even at given labour productivity.[12]

Increase of labour costs (related and unrelated to labour productivity) in addition to increases of energy prices, transport tariffs and imported inputs prices, as well as very high interest rates, make EITs extremely prone to a new type of cost-push inflation which is different from that in industrially advanced countries. Characteristic of these economies is also the decline of mark-up ratio and profitability in industry, provoked by the increase of costs in relation to prices. This proves additionally that after a short initial period we are now confronted with a special type of cost-push rather than demand-pull inflation in the leading reform countries. But yet the stabilization policy continues addressing demand-pull inflation as the main danger. An erroneous theoretical diagnosis of the real causes of the existing situation leads to the continuation of an erroneous policy.[13]

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[12] Analysing data for Poland, for three quarters of 1992, Instytut Finansowy (The Finance Institute) in Warsaw stresses that industrial prices increased by 15.5 percentage points (and building prices by even more percentage points) less and services prices (in which the share of state administrated prices is very high) by 30.3 percentage points more than consumer prices. The demand of private households in the same period increased rather slowly (the average money wage in the so-called material production sphere increased by 35.7 per cent while consumer prices increased by 42 per cent resulting in a fall of the average real wage by 4.5 per cent). The Institute concludes that "... we are confronted with an inflation generated by something different than an increase in wage revenues ... The direct and indirect factor that substantially influences inflation is the systematic increase of prices, regulated by the state, as well as of taxes and charges aiming at a forced improvement of the government budget balance... The potential demand determined by a relatively slow increase of total wages, salaries and social security payments not only does not fuel inflation now but on the contrary limits the price increases in those segments of the market which stay outside governmental control" (*Raport Instytutu Finansow*, 1992, p. 5).

[13] A good example of this situation is provided by Poland. In the fall of 1990 inflation accelerated and the government was rather quick in attributing this acceleration to some relaxation of income and monetary policies, and decided to strengthen anew monetary restrictions. This interpretation is shared by many economists in and outside Poland and has since been used as a standard argument against any relaxation of income and, especially, monetary policies, as leading not to output recovery but to more inflation instead (see e.g. M. Dabrowski, 1991, Rostowski, 1991, Calvo & Coricelli, 1991).

Rosati (1992) has shown that the facts hardly support this interpretation. The growth of net domestic assets of the banking system was in autumn 1990 only marginally higher than earlier that year. Moreover, he did not find any statistical evidence which might have supported the hypothesis that monthly inflation rates were correlated with monthly changes in average money wages and incomes, or net domestic assets of the banking system. Rosati argues that the acceleration of inflation in the fall of 1990 was caused rather by factors like sharp increases of energy prices in the wake of the Gulf War, the shift to dollar prices for CMEA, especially Soviet, imports, the increase of government-controlled prices, including turnover taxes, and last but not least the seasonal increase of food prices mistakenly taken as another symptom of demand going out of control. "Hence [he concludes] macroeconomic demand reducing measures were used to attack cost-push inflation, with the inevitable result being the economy sliding further into a deep recession, with no significant gain on the inflation front" (pp. 13-16).

It also deserves to be emphasized here that policies of further labour market flexibility, i.e. allowing employment to fall more or less in proportion to output, to maintain – or even increase – labour productivity, will not only be socially disastrous, but even economically a self-defeating proposition. Such a fall in employment and/or the wage bill would further aggravate the contraction of effective demand, resulting in even greater decline in output and labour productivity as the degree of capacity utilization decreases further. There would be the danger to create a spiral of recessionary fall in output induced by demand contraction coupled with inflationary price rises induced by cost push. In short, the danger is the worst kind of stagflation, unless it is recognized soon enough that excess demand is no longer the main cause of inflation in the EITs.

In the light of our preceding argument a different policy of easing credit restraint might not only help to ease the output recession but remove at least some elements of cost-push inflation in these economies. Indeed, if effective demand increases, enterprises having free capacity and redundant labour force would react by increasing output rather than by increasing prices. With employment lagging behind the output expansion, labour productivity would increase in the short run and, given real wages, unit labour costs would tend to decline. A lower rate of interest would play a similar role. At a given (or even slightly rising) mark-up ratio, and at expanding demand, cost-determined prices should therefore increase not faster than before but probably more slowly. True, food prices, which are demand-determined, would tend to behave differently, but in an open economy (as e.g. presently in the leading reform countries) they are under some pressure of international price discipline and could therefore not rise strongly either. We come to the conclusion that by relaxing demand restriction, inflation would not accelerate but rather decelerate. The real problem with relaxing demand restriction is the foreign trade balance because increased production would require increased imports and thus deteriorate the external position of the country. But this is a different problem which should not be confused with the problem of controlling inflation in these economies.

VI. Fiscal Policy and Budget Deficit

In its traditional role in a market economy, fiscal policy tries to achieve two interrelated objectives. In the short run, it tries to synchronize demand with supply, primarily through demand management, so as to minimize the incidence of inflation, unemployment and balance of payments deficits. In addition, the role of the fiscal system is to influence the income and wealth distribution pattern in a socially acceptable way and to create an appropriate incentive structure so that the supply side of the economy becomes flexible and responsive to the requirements of high growth and structural change. All these short- and long-term demands on the fiscal system are never easy to reconcile. However, it is necessary to keep both aspects in view, especially during the process of transition, which requires short-term stabilization to be combined with long-term structural adjustment for growth.

It is important to recall that almost all EITs inherited from their earlier command system an unviable fiscal structure. This was mainly due to subsidies, which increased sharply with rising costs while the administered prices were kept more or less constant. The problem became worse as the governments in many countries began to lose control over nominal wage increases. The net result of these developments was that in the final stage, before the collapse of the command economy, budget deficits became unmanageably huge in many countries. In these cases it is understandable why the stabilization programme stipulated the need to reduce the budget deficit.

Against this background, the implementation of the stabilization plans produced, at the beginning, a rather spectacular improvement of the state budgets in most EITs. However, the reasons for these improvements turned out to be short-lived and vanished after a few months. First, the surge of so-called "corrective" inflation (fuelled mostly by an abrupt withdrawal of most subsidies) registered at the beginning of the shock therapy led to the accrual of capital gains to the enterprises derived from the new assessment of inventories, piled up at old prices (Lane, 1992, p. 12). Second, a sharp devaluation of national currency increased the profitability of exports and – additionally – firms which disposed of foreign exchange assets reaped significant capital gains in terms of national currency. Third, the dramatic early decline of real wages – initially often stronger than the decline of labour productivity – improved additionally the net earnings of firms. As most taxes were related to firms' incomes, budget revenues soared at the beginning of the stabilization programme. As at that time the great majority of firms were state-owned, the increased profitability and capital gains of the state sector became the main source of increasing budgetary revenues. At the same time subsidies and defence outlays were sharply cut, leading very often not only to declining budget deficits but even to budgetary surpluses (see Table 8).

Table 8

General government deficit as per cent of GDP
(denotes budget surplus)

	1988	1989	1990	1991	1992
Hungary	0.7	2.8	0.0	4.4	7.0 [1]
Poland	0.2	3.5	-0.2	3.8	6.0 [2]
CSFR	0.3	0.8	-0.9	1.1	1.5 [1]

1) Official provisional data. - 2) Own estimate, based on official data.

Source: WIIW databank.

The initial reduction of budget deficits was primarily the result of a sudden surge in revenue to which the higher profitability of the state enterprises contributed significantly. However, as already noted, this higher profitability was transitory in nature. It began to decline sharply for several reasons; declining labour productivity (see Table 7) coupled with rising real wages after the initial shock as well as very high nominal interest rates began squeezing the profit margin. At the same time, the tax revenue collection by the

government weakened with the increasing share of the private sector in the economy. On the one hand, the incentive of tax exemption offered to foreign as well as domestic private firms narrowed the base for tax collection; and, on the other, an inexperienced fiscal administration failed to cope adequately with the rising incidence of tax evasion by the private sector.

But the crucial issue of correct fiscal response during transition does not lie in these details. Instead it rests on the central question which arises in this context: Is it the correct fiscal response to reduce government expenditure when government revenue, for whatever reason, declines sharply? Common sense as well as conventional stabilization policy seem to suggest that expenditure reduction in face of declining government revenue is the natural and correct response for restoring balance in public finance. However, we maintain that this view is based on faulty macroeconomic reasoning; nor is it supported by facts, as attempts to reduce the budget deficit by compressing government expenditure produced even larger government budget deficits in 1991 and during 1992 (see Table 8).

The misplaced emphasis on trying to balance the budget **under all circumstances** stems from the inadequacy of the monetarist macroeconomic framework underlying conventional stabilization which fails to cope with the problem of demand management in a sufficiently **flexible** manner. As already pointed out in chapter IV (see equations 2 to 4), in times of recession due to deficient demand, a larger budget deficit, compensating for the decline in private investment, may help to stimulate the level of economic activity. Since the budget deficit is usually the most powerful policy instrument available to the government for stimulating demand in times of recession, it is simply unwise to surrender it under all circumstances, irrespective of the nature of the economic malaise, just because of some ill-founded, abstract principle of "sound" public finance.

Ideally, from the point of view of demand management, budget deficits should be allowed for in times of demand deficiency causing a recessionary fall in output. Conversely, budget surpluses should be achieved in times when the economy is overheated, resulting in inflation and/or trade deficits from excess demand.[14] However, since such fine-tuning of budgetary policies at the discretion of the government may not be feasible, particularly in the EITs, it is easier to follow a rule which, like in most advanced market economies, incorporates an automatic built-in-stabilizer mechanism. This essentially requires a system of public finance in which government expenditure is less sensitive than government revenue to variations in economic activity or GDP. Thus, as Figure 3 exhibits, during times of low economic activity, i.e. GDP<$\bar{Y}$ ($\bar{Y}$ stands for high-employment output), government expenditure stays above government revenue (i.e. budget deficit) to stimulate economic

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[14] As already pointed out in chapter V, inflationary price rises may be caused by too little and not by too much demand if prices are largely cost-determined. The current inflation in several EITs does **not** represent in general a situation of excess demand that needs to be fought by balancing or by achieving a surplus of the government budget.

activity automatically. Obversely, when the economy is overheated, i.e. $GDP > \bar{Y}$, government expenditure automatically falls below government revenue (i.e. budget surplus) to reduce the pressure of demand.[15]

Figure 3

government revenue (T)
and
government expenditure (G)

T

G

G_1

d

GDP

Y_1 Y_0 $\bar{Y}$
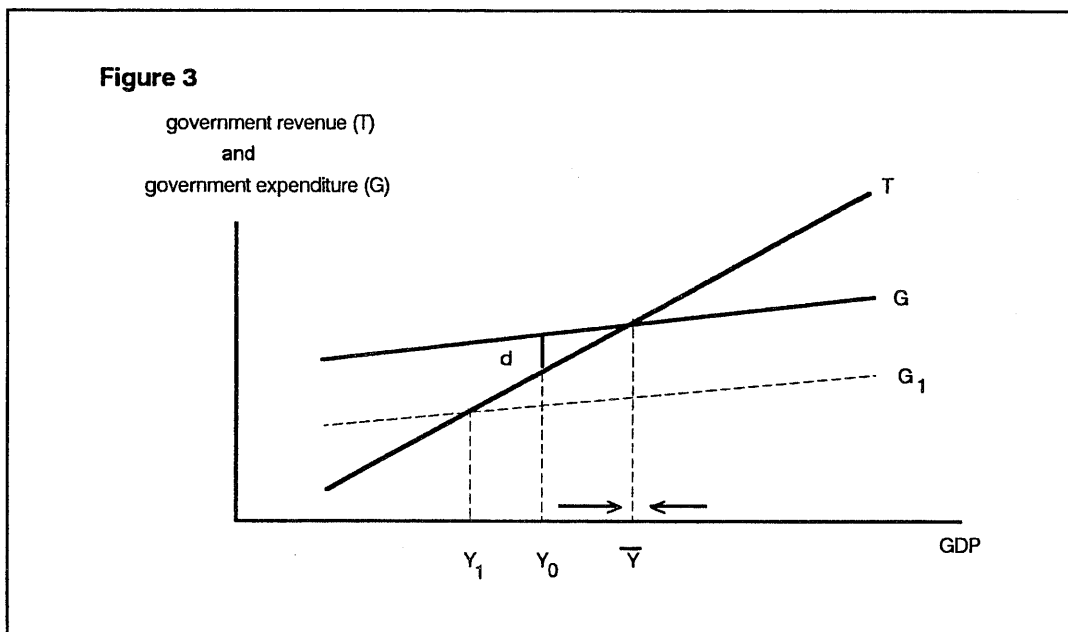
Unfortunately, this built-in-stabilizer property of the public finance system, instead of being continuously strengthened in the EITs, is being misunderstood under the stabilization programme, which pays inadequate attention to intelligent demand management. Thus, as Figure 3 illustrates, during any deep recession, the **autonomous** fall in GDP to a very low level (e.g. Y_0, $Y_1 < Y_0 < \bar{Y}$ in Figure 3) would imply a correspondingly large budget deficit, in conformity with the automatic built-in-stabilizer property. Instead of taking advantage of this automatic stabilization property, budgetary policies in the EITs have often tried to eliminate the deficit during recession by depressing government expenditure even further (shown by the downward shift from G to G_1) which only worsens the recessionary situation. Indeed, it is easy to demonstrate analytically that the attempt to balance the budget at the margin by cutting government expenditure by an amount equivalent to the revenue loss during recession only deepens the recession by creating an even larger multiplier effect, which works in reverse to depress income further (e.g. $Y_1 < Y_0$ in Figure 3).

To illustrate our argument in a way that takes into account the impact of budgetary policies on effective demand, we return to our model in chapter IV. We make some

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[15] Figure 3 is the most simplified description of the stability property of high employment (at $\bar{Y}$) through the design of a public finance system. For simplicity, it is assumed here that imbalance in public finance is the only reason for discrepancy between total expenditure and income (output).

additional simplifying assumptions to highlight the essence of the problem: the economy is closed, no part of wages is saved and no part of enterprise profits is spent on consumption. Moreover, only profits are taxed at the proportional rate t, hence the revenue from profits tax is, $T = tR$ and profits after taxation (i.e. savings S) are $R-T = (1-t)R$.[16] With these additional assumptions, earlier equation (1) of chapter IV reduces to

$$I + G = R \tag{7}$$

because $W = C$ and $E = 0$. Hence profits are determined by the sum of investment and government expenditures. We assume further that the share of profit in GDP is constant at $r = R/GDP$, i.e.

$$GDP = (1/r)\,(R) = (1/r)\,(I + G). \tag{8}$$

By subtracting taxes T from both sides of (7) we get

$$I + G - T = I + D = R - T$$

and

$$I + D = S \tag{9}$$

because savings equal profits minus taxes and the budget deficit is denoted as before by D. According to (9) savings are determined by the sum of investment and budget deficit.

Let us now assume that investment changes exogenously by $\Delta I < 0$ and that the government does not adjust its expenditures to decreased budget revenues (Case A). Thus profits according to (7) change by $\Delta R = \Delta I$ and GDP according to (8) changes by

$$\Delta GDP = (1/r)\Delta I < \Delta I, \quad 0<r<I. \tag{10}$$

GDP decreases by more than investment because, in accordance with the multiplier mechanism, employment and wages decline not only in branches producing investment goods but also in those which produce consumer goods for the former. Thus consumption suffers from decline in investment too. Profits after taxation, i.e. savings, change by less than profits before taxation. Because taxes change by $\Delta T = t\Delta R = t\Delta I$ the change in savings according to (9) is

$$\Delta S = \Delta I + \Delta D = \Delta I - t\Delta I = (1-t)\Delta I > \Delta I,$$
$$\Delta I < 0 \text{ and } 0 < t < 1.$$

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[16] Besides, in some of the former socialist countries direct taxation of wages did not exist.

Savings fall less than investment because they are supported according to (9) by an increasing budget deficit $\Delta D = -t\Delta R = -t\Delta I > 0$.

Let us now assume that the government adjusts its expenditures to decreased budget revenues, avoiding in this way a deficit (Case B). As before $\Delta I < 0$ and additionally a change of government expenditures by $\Delta G = \Delta T = t\Delta R$ occurs. Under these conditions profits would change according to (7) by

$$\Delta R = \Delta I + \Delta G = \Delta I + t\Delta R$$

hence $\quad\quad\quad\quad\quad\quad\quad \Delta R = [\Delta I/(1-t)] < \Delta I,$

$$\Delta I < 0 \text{ and } 0 < t < 1.$$

Profit falls more strongly than investment because they suffer additionally from reduced government expenditures. GDP changes by

$$\Delta GDP = (1/r)\Delta R = (1/r)\Delta I/(1-t). \quad\quad\quad\quad (11)$$

The decline of GDP (as well as of consumption) is now stronger than in the first case. Indeed the multiplier increased from $(1/r)$ in (10) to $(1/r)/(1-t)$ in (11).[17]

Profits after taxation, i.e. savings S, change by $\Delta S = \Delta I$ because according to assumption the budget deficit does not change. Thus savings in the second case also fall more strongly than in the first one. Now we contrast the two cases A and B: Case A – autonomous recession through decline in private investment and no adjustment in government expenditure; Case B – autonomous recession through decline in private investment (as in Case A) but downward adjustment in government expenditure in accordance with the fall in revenue.

	Case A	Case B
	$\Delta I < 0; \Delta G = 0$	$\Delta I < 0; \Delta G = \Delta T$
ΔGDP	$(1/r)\Delta I$	$((1/r)/(1-t))\Delta I$
ΔC	$(1-r)(1/r)\Delta I$	$(1-r)[(1/r)/(1-t)]\Delta I$
ΔR	ΔI	$\Delta I/(1-t)$
ΔS	$\Delta I + \Delta D$	ΔI
ΔD	$-t\Delta I > 0$	0

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[17] The multiplier $(1/r)/(1-t)$ is bigger than 1, as r and t are positive and smaller than 1. This might appear strange since it seems to contradict the famous Haavelmo theorem on the balanced budget multiplier – which is not the case. It can easily be shown that our result derives from the differentiation between taxation of wages and profits. (See Laski, 1993, pp. 30-31)

The central point of our argument now becomes evident. When government expenditures do not shrink and a budget deficit is tolerated, not only do GDP and consumption decline less, but this applies also to profits and savings. However, the recession provoked by the decline of investment is multiplied by the policy of cutting government expenditures *pari passu* with government revenues. To stress its political implication, this policy harms not only the workers but also the firms and businessmen and thus worsens conditions necessary for reversing the decline in economic activity. However, this conclusion does not mean that expenditures should, as a rule, not be adjusted to budget revenues, it only stresses the need to take into account aggregate effective demand while reducing government expenditures. Generally such expenditure reduction should be deferred until the level of economic activity is high and secured through corresponding increases in investment and/or export surplus to generate adequate effective demand.[18]

Therefore, compressing government expenditure in line with government revenue makes sense in circumstances where a decline in effective demand is envisaged, but not in all circumstances. It is really this which should be recognized as the principle of "sound" public finance, and not the crude idea of blindly balancing the budget under all circumstances. Nevertheless, in most EITs deficit spending has been opposed frequently on many different grounds, e.g. some believe that it "crowds out" private investment, others hold that it fuels inflation through the creation of high-powered money by the Central Bank to cover government deficit, still others argue with the burden which debt service would allegedly put on coming generations[19], and finally, for some it contradicts the ideology of the "minimal state".

Ideological beliefs apart, our preceding argument – by contrasting cases A and B – shows that not only output and consumption, but even profits might be lower in some circumstances due to the pursuing of a balanced budget strategy. This suggests that

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[18] This conclusion also applies to a situation in which the lowering of the share of government revenues and expenditures in the GDP is envisaged because the level of state involvement in these economies is considered too high. In this case a parallel cutting of government revenues and expenditures makes sense if a decline of aggregate demand is aimed at. However, if related losses in output and employment are to be avoided revenue cuts (e.g. profits taxes) without parallel expenditure cuts could be a preferable strategy. Indeed, given investment and government expenditures, the GDP and profits before taxation would not change but profits after taxation would increase by the amount of the budget deficit caused by profits tax cuts. With increased net profitability the investment in the next period should increase and provoke a higher level of economic activity. Under these conditions the delayed cutting of government expenditures can take place.

[19] The servicing by the government of the accumulated (internal) debt does not mean that coming generations have to pay back the debts made by previous ones. If the share of debt service in the GDP is adjusted to some basic parameters (rate of growth of GDP, interest rate and inflation rate) and the government claims every year a constant part of GDP for new credits, then the accumulated debt and GDP can increase *pari passu* indefinitely. The main problem with debt servicing is the redistribution of income from those who pay taxes, necessary to finance interest, to those who own government bonds. Another problem is the necessity to increase taxes when the share of debt service in GDP is raised. These are the reasons why deficit spending may be opposed. If, however, the alternative is a deep recession accompanied by large unemployment, deficit spending is by far the better solution.

intelligent demand management by the government may actually benefit private business – something which the ideological supporters of the free market often tend to overlook. Similarly, our preceding discussion shows that there is no evidence of an automatic transmission link from the quantity of money to the price level. Undoubtedly, tight monetary policy helps to control inflation by curbing excess demand. However, as pointed out in chapter V, the root cause of the current inflation in several EITs is not excess demand but rising costs, mainly due to the sharp decline in labour productivity and to high interest rates. The strong decline in labour productivity has been related to the massive fall in output, so efforts must be made to stimulate the economy and not to reduce aggregate demand even further. Thus, the fear of inflation through the creation of high-powered money seems largely misplaced in the present circumstances. As a matter of fact, the main mechanism for the "crowding out" of private investment through government budget deficit operates mostly through a non-accommodative monetary policy. To put it simply, higher deficit leads to higher demand and economic activity, which would tend to increase interest rates and discourage ("crowd out") private investment unless a correspondingly accommodative monetary policy is pursued. In these circumstances a relatively easy monetary policy in unison with the stimulation of demand through moderate budget deficits would, in all probability, help to "crowd in" rather than "crowd out" private investment. The problem arising from a large budget deficit lies no longer in inflation but in the sustainability of the balance-of-payments position during such an expansionary policy in the EITs.

VII. Issues in Monetary Policy

A crucial element in the design of macroeconomic policy is the choice of an appropriate mix between fiscal and monetary policy. The conventional stabilization programmes in EITs used both monetary and fiscal policies which were highly contractionary in terms of their impact on aggregate demand; for instance, the contractionary fiscal policy of reducing the government budget deficit (see chapter VI) was combined with restrictive monetary policy in terms of a high nominal interest rate and a ceiling on the expansion of the supply of money (however defined). While it is reasonable to assume that, under normal conditions, fiscal and monetary policy should tend to work in unison, i.e. in the same direction of contracting or expanding demand, this reasonable assumption needs to be examined more carefully in devising the monetary-fiscal policy regime in the transformation process of the EITs. This is because their economic conditions are far from being "normal" during the transformation process, with varied and often contradictory pulls on the fiscal and monetary system.

The first problem to which we drew repeated attention in the course of our preceding discussion is the consequence of the simultaneous use of highly contractionary fiscal and monetary policies during stabilization. It resulted in "overkill", as is evidenced by the massive and continuing recession from which there seems to be no automatic escape (see Figure 2, p. 22). In this context, it is necessary to reexamine whether either or both

fiscal and monetary policy should be reversed and, if so, in what sequence the reversal should take place.

Second, and of greater importance, is the fact that the long-term objective of transformation, i.e. generating economic growth with accompanying structural changes on the supply side, would require the use of fiscal and monetary policies in a more discriminating fashion than simply restricting demand. It is in this context that the main thrust of our argument may be summarized briefly: the exercise of restrictive monetary policies is becoming increasingly counter-productive in EITs, not simply because it contributes to the prolongation of the current recession through demand restriction, but also because it is hampering the supply-side adjustments essential for economic growth.

There are two different sets of evidence in several EITs that suggest that the restrictive monetary policies are hindering supply side adjustments severely through creating strong disincentives for private investment. First, despite the fact that in some countries, e.g. Hungary, the "effective reserve ratio"[20] of the commercial banks was increasing sharply — from 33.8 per cent in 1989 to over 55 per cent in 1991 — this reduced ability of the commercial banks to lend was accompanied by an even greater decline in the demand for bank credit (see Valentinyi, 1992, p. 987). It indicates essentially the extremely low demand for investment finance at the high nominal interest rate. The shortfall in demand for bank credits is reflected in the excess liquidity or free reserve at the disposal of banks despite the operation of the tight money regime restricting bank lending.[21] In short, the demand for longer-term investment loans seems to be declining even more sharply than the reduced availability of credit under stabilization. It is indeed difficult to imagine rapid supply-side adjustments through new investment under these circumstances.

Second, the high interest rate and other restrictions on bank credits seem increasingly to have forced existing enterprises to cover their working-capital needs through inter-enterprise loans. Inter-enterprise credits increased rapidly during 1991 in absolute terms in all three countries, and in relative terms (as a percentage of bank credits) both in CSFR and in Hungary (but not in Poland where, however, this proportion was already extremely large in May 1991) (see Table 9). Not only does this tendency increase further the future problems of "cleaning up the balance sheet" of enterprises and commercial banks but it

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[20] The effective reserve ratio has been calculated by Valentinyi according to the formula (Monetary base − Cash)/(M2 − Cash). The increase of this ratio, given the changes in the relation of Cash to Monetary base in the period under consideration, amounts to the decline of the relation M2 to the Monetary base, i.e. the money multiplier. The effective reserve ratio should of course not be identified with the mandatory reserve ratio. The latter was 15 per cent at the beginning of 1989 and 16 per cent at the end of 1991, reaching a value of 18 per cent for several months in between.

[21] In a publication of the National Bank of Hungary, Monthly Report, September 1992, we read: "The paradoxical situation, in which domestic borrowing of the entrepreneurial sector fails to grow, the credit stock of enterprises hardly increases at all (what is more, it is decreasing in real terms, considering inflation) while some banks have substantial excess liquidity, is still present." (p. 30)

also shows how monetary restrictions can have countervailing consequences in the absence of appropriate institutional reforms.

Table 9

Inter-enterprise credits as a non-registered component of the money supply in 1991

	inter-enterprise credits	bank credits granted to enterprises[1]	inter-enterprise credits as per cent of bank credits
	as reported in the official bank statistics (billion national currency units)		
Czechoslovakia[2]			
March	76.4	.	.
June	123.5	489.7	25.2
September	147.0	500.5	29.4
Hungary			
March	119.4	432.5	27.6
November	160.0	486.0 [3]	32.9
Poland[4]			
March	109,100	65,588	166.3
June	126,200	78,180	161.4
September	143,100	87,326	163.9

1) In Hungary and Poland bank credits granted to enterprise refer to credit for working capital only. - 2) State sector only. Only arrears, including an unspecified amount of debt held by the commercial banks. - 3) October 1991. - 4) Inter-enterprise credits include loans not in arrears.

Source: UN/ECE, Economic Survey of Europe in 1991-1992, p. 100.

Both the evidence of excess liquidity with the banks and the necessity on the part of the enterprises to create inter-enterprise loans for meeting their working-capital requirement at lower borrowing cost, point to a general problem concerning monetary policies in the EITs. It stems from a serious lack of synchronization between price rationing of credit in the form of very high nominal interest rates and quantity rationing of credit, e.g. in the form of restriction on monetary aggregates. Thus, at very high nominal interest rates commercial banks find it difficult to lend what they are permitted to lend even under restrictive monetary policy. At the same time, enterprises try to avoid bank borrowing for working capital through inter-enterprise loans because of the high nominal rate of interest charged by the banks. There seems to be a strong case for reducing the nominal lending rate by the commercial banks to the enterprises and the new industrial investors.

There are two common points of misunderstanding which deserve comment in this context. First, it is often argued that the real interest rate, adjusted for the rate of inflation, is relatively low in the EITs. This misses the obvious point: any long-term investment will

not be encouraged by a low real rate of interest, unless the investor firmly expects the high inflation rate to continue for a long time, e.g. over the life-time of fixed capital investment. As a matter of fact, if inflation actually slows down, as has been declared repeatedly by all governments in the EITs, not only would the real burden of bank debt increase for the borrowing investors but also nominal profit would likely go down with the inflation rate, making repayment of loans correspondingly even more difficult. Therefore, the stress on a positive real interest rate in the EITs tends to discourage private long-term investment essential for economic growth through structural adjustments in these economies.

Second, the high nominal interest rate might attract those investment projects that have a high return in the very short run – which comes typically not from enterprise investment in expanding production capacity but from speculative investment involving short-run capital gains in real estate business, trade and commerce. Anecdotal evidence suggests that this phenomenon is not at all uncommon in the EITs. At the macroeconomic level, at least part of the rapid growth of the – anyway much underdeveloped – tertiary or service sector in the EITs (see Table 10) may probably be accounted for by this unhealthy trend towards "short-termism" based on speculative rather than productive investment in trade, commerce and real estate. Indeed, if this phenomenon turns out to be of sufficient quantitative significance, then the high nominal interest policy would seriously hamper the process of transition to sustained economic growth and structural adjustment in these economies.

Table 10

Shares of tertiary[1] activities in total output and employment

	1988	1989	1990	1991
Hungary				
GDP	43.9	44.7	47.7	n.a.
employment	43.6	44.2	46.7	n.a.
Poland				
GDP	35.1	36.1	38.4	40.1
employment[2]	35.2	35.4	36.5	37.9
CSFR				
GDP[3]	33.7	33.3	34.2	n.a.
employment	39.8	40.3	41.1	42.2

1) All activities excluding industry, construction, agriculture and forestry. – 2) Wages and earnings in terms of full-time jobs. – 3) At current prices.

Sources: Statistical Yearbooks of Hungary, Poland and CSFR, various editions, for Poland 1988: Statistical Yearbook of Employment 1990.

PART B: SELECTED ISSUES OF INSTITUTIONAL AND SYSTEMIC CHANGE

VIII. Trade Liberalization and Speed of Integration into the World Economy

In formulating the strategy of transition to the market economy, there seems to have been a tendency to confuse policy objectives with instruments. There is little disagreement that the market system requires close integration with the global economy on the one hand and substantial extension of private property rights on the other. Thus, as the ultimate **objectives** of economic policy, trade liberalization and considerable privatization of state-owned property (enterprises, factories etc.) are widely accepted. However, the real policy issue is somewhat different: it is concerned with the question whether measures such as trade liberalization and privatization, viewed as **instruments** of policy, applied at an early stage of the transition process do actually help or hinder that process. As a matter of fact, their early application may actually make objectives unsustainable in the longer run.

According to the prevailing mainstream thinking in many EITs domestic price liberalization and the introduction of at least current-account convertibility ought to be placed at the very beginning of the transformation process, with other measures (like privatization and tax reform) necessarily relegated to a later stage. Such a policy is generally advocated disregarding the differences in the initial situations in the individual countries. The obviously more gradualist policy pursued by Hungary in this respect is either disregarded by the upholders of early price and trade liberalization or is explained away by supposedly specific circumstances. On the other hand, shock tactics in price and trade liberalization are being advocated in some EIT countries even despite a huge monetary overhang and related hyperinflation, without attempting to stabilize the situation first of all by a currency reform.

Experience has shown that the sudden freeing of the bulk of domestic prices by itself, under the prevailing structures of monopolistic suppliers, induces large price increases even if the monetary overhang and open inflation were small prior to the introduction of the liberalization (e.g. in Czechoslovakia). When linked up with the introduction of current-account convertibility and import liberalization, the price increase tends to be even larger: the more the currency has to be devalued for achieving an equilibrium exchange rate adjusted to the exchange rates in the secondary (black) market, the higher becomes the pressure of imported inflation. Nevertheless, this inflation is often considered to be of a corrective nature in so far as it is essential to rectify distortions in the domestic price system inherited from the command economy. At the same time, accompanying trade liberalization is expected to impose the discipline of international prices on the domestic inflation.

In actual practice the sudden price jump resulting from such "corrective inflation", which is induced by both comprehensive price liberalization and early introduction of current-account convertibility, had to be contained in the EITs by severe contractionary fiscal and

monetary policies. These contractionary policies not only resulted in unacceptably high output and employment losses (see chapters III and IV) but they also turned out to be counter-productive by failing to eradicate the problem of emerging cost-push inflation (see chapter V). The continuing high domestic inflation relative to inflation abroad is eroding international price competitiveness and poses again the awkward choice between further devaluation and import control. In the light of the above, there is reason to suggest that the introduction of current-account convertibility and the liberalization of foreign trade should be undertaken gradually during the transition process, if they are to be sustainable. The early introduction of these measures – often because of the said tendency to confuse policy objectives with instruments – might make them an unsustainable objective in the longer run, particularly because the exceedingly contractionary fiscal and monetary policies become increasingly unacceptable in the longer run.

Based on historical experiences of Western Europe after World War II as well as on the recent reform experience in Hungary there are strong arguments in favour of introducing convertibility and trade (especially import) liberalization in stages, *pari passu* with other transformation measures. Hungary started the process by unifying the commercial exchange rate with the tourist exchange rate, then introduced a realistic exchange rate, finally relaxed import controls in stages and – after some adjustment of the exchange rate to the difference of the respective inflation rates in the market economies and in Hungary – arrived at *de facto* current-account convertibility after several years. During this period other transition measures, especially in the institutional set-up, were undertaken, thereby somewhat softening the adverse impact of sudden liberalization measures. One of the main advantages of this more gradual approach is the possibility for the enterprises and the whole economy to adjust to the radical changes in the external environment. It is, in our opinion, not by accident that Hungary was better prepared than the other EITs to switching its trade from the collapsing CMEA markets to the West and that it has also been better prepared for attracting foreign direct investments from the West. Most of the EITs in Central and Eastern Europe have already made their choice in favour of early and sudden introduction of current-account convertibility and extensive trade liberalization. In so far the discussion on this issue may seem to be beside the point. However, analytically it is necessary to pinpoint one of the causes of the high output loss. As to policies, there are still some EITs (in the former USSR) which will have to formulate a transition strategy in this respect. As to trade liberalization some backtracking (e.g. in Poland) from the initial ultra-liberal position can be observed (see Rosati, 1993, pp. 34-39).

The acceptance of the idea of a more gradual liberalization of trade, especially of imports, sheds some light on a related though somewhat separate issue, namely, how far some of the domestic industries ought to be protected against foreign competition during the adjustment period, after (limited) current-account convertibility has been introduced. The prevailing opinion seems to be that the substantial devaluation of the currency provides sufficient protection and any additional protection – if permissible at all – ought to be imposed only through an undifferentiated and temporarily levied import charge. While the case for uniform tariffs is based primarily on administrative simplicity and minimization of

bureaucratic discretion (for which there is much to be said in the EITs), it fails to come to grips with the crucial issue that in the EITs different branches of production are usually in very different positions for coping with international competition from trade liberalization. Thus a strong case exists for imposing either a differentiated tariff structure or a differentiated time horizon for undertaking the required adjustment in domestic industries to face international competition. Within the specified time horizon in a particular industry, domestic producers – often with the support of state policies and imported techno-logy – would be required to "modernize", to improve productivity and quality sufficiently to become internationally competitive and to be able to penetrate foreign markets for exports.

It is increasingly being recognized in the EITs that the cost of premature and in-discriminate trade liberalization may be extraordinarily high. There is no question that, given the unfortunate heritage of the command economy, it is essential to expose these economies to the pressure of international competition. However, unless this exposure is brought about in a gradual manner through a judicious combination of trade and industrial policies, exposure to foreign competition will mean primarily only destruction of domestic industries without any creative reorganization of the domestic production structure.

In this context one should also notice that the EC, in concluding association agreements with some of the EITs, has chosen just this gradual approach in the mutual relaxation of tariff and non-tariff restraints, while keeping in place some quantitative restrictions in sensitive areas almost to the end of the century. If economically much stronger economies with market-economy structures of a long standing take this stand, it is not quite clear why the still weak and unstable EITs should choose an ultra-liberal path of sudden introduction of convertibility and of (almost) complete trade liberalization at one stroke.

A major problem, related to trade liberalization, is the strengthening of the former socialist countries' position in the world economy. These countries require an active policy, facilitating imports of modern technology and promoting exports and changes in export structure towards manufactures, especially machines and equipment of an up-to-date technological standard. This policy cannot simply follow the conclusions of the con-ventional theory of comparative advantage of the Ricardo and Heckscher-Ohlin types, consisting in free trade policy. It should rather concentrate on dynamic factors, which are missing in all these static theories, first of all on technical progress. In the case of technically backward countries the main problem is not only the choice of an optimal point on the already existing production possibility curve, but rather the shift of this curve outward from the origin of the coordinate system. Thus both international learning and international trade are under these conditions most important gains from interaction between nations (see Pasinetti, 1988, pp. 139-147). This is a rather fundamental proposition for the former socialist countries when they turn towards a market-oriented economy, because it shifts their attention from pure static to dynamic problems, and from pure free trade policy prescriptions to efforts of learning and adopting technical knowledge from abroad.

This policy, if sound, must **support**, not replace the market mechanism. It is known that Japan (and later on most of the newly industrialized countries) followed two basic rules in its policy of selecting and supporting export-oriented industries. First, the selected industries should be those that are the most promising from the point of view of the expected rate of growth of labour productivity; these are mostly young industries where the potential for further technical progress is still unexploited. Secondly, export promotion should concentrate mainly on goods that are characterized by an expected high income elasticity of demand. These two rule have not much in common with the traditional theory of comparative advantage and with the postulate of state abstention from foreign trade. They seem, however, mostly to deliver the results, although mistakes cannot be avoided.[22]

Government intervention can be – but is not necessarily – benevolent. Import substitution (supported by import restrictions creating a climate favourable for private domestic and foreign investment) can make sense in well-chosen cases, first of all in larger countries. But this strategy is of limited applicability only. If used indiscriminately for all industries and for all time an artificial production structure would be created and ossified; consequently it could survive only as long as the protection lasts. Additionally, vested interests of protected industries (usually in the state sector) would be articulated and would demand the perpetuation of protection, endangering the achievement of original policy targets of the whole manoeuvre.

The same applies to export promotion policy. Export capacities can develop only concurrently with an overall expansion programme. Thus the creation and enlargement of the internal market is a precondition for successful export promotion. Efficient import substitution and export promotion must be flexible and selective; they must also be part and parcel of an integrated expansionary policy if they are to be successful.

Many professional economists and international institutions tend to think in terms of two standard concepts. "In the field of economic development, two mutually exclusive set of associated ideas are often juxtaposed against each other: one set consists of capitalism, free trade and export promotion and the other, socialism, State intervention and import substitution" (Datta-Chauduri, pp. 76-77). This opposition is simply wrong. On the one hand socialist countries failed completely not because they were interventionist but because they killed the private entrepreneurship, the very medium which their intervention should have moulded. On the other hand Japan and the NICs are examples of highly

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[22] The above-mentioned policy – according to Daniel Okimoto, a Stanford University professor who has written a book on MITI's high-tech role – was quite successful during the first three decades after World War II, when Japan lagged far behind the West and MITI guided, subsidized and protected industries that were striving to catch up, such as steel, automobiles and semiconductors. This policy has become more difficult after Japan has reached the cutting edge of technology (see *International Herald Tribune*, 8 March 1993, where Professor Okimoto's views are quoted). The example of Japan seems valid for EITs which are as a rule far behind the "cutting edge of technology". (Cf. also the opinion, expressed in 1972, of Mr. Ojimi, Vice Minister of MITI, quoted in Bhaduri, 1992, pp. 26-27.)

interventionist states promoting capitalist development through selective intervention in both export promotion and import substitution.

IX. The Privatization Issue

The transition from state socialism to a capitalist market economy requires *inter alia* the legal and institutional establishment of clear property rights in the hands of autonomously acting economic subjects, the majority of whom should be private property owners. This pertains in the first instance to the privatization of state-owned enterprises in industry, construction, trade, other services and to financial institutions. Land, real estate and other business assets will also end up to a large extent in the hands of private owners. During transition new private firms will emerge and will be the prime movers in forming a new property-owning middle class.

Earlier attempts at some kind of market socialism based on public ownership of almost all productive assets, such as occurred in the former Yugoslavia and in Hungary, were not particularly successful. But other widely-held earlier beliefs that "getting the prices right" and opening up the economy to foreign competition would create by themselves the necessary conditions for growth-promoting behaviour on the part of economic subjects acting under the influence of market signals, turned out to be wrong as well.

The tendency to confuse policy objectives with instant instruments has probably been most marked in the privatization issue. The socio-political objective of transforming these economies with prevailing state ownership into market economies with dominant private property and an energetic entrepreneurial class created in several EITs an understandable impulse immediately to privatize all or most of the state property with short-cut or wholesale methods of privatization. And yet (like trade liberalization discussed earlier), the ultimate socio-political objective of privatization might be jeopardized or discredited if it is introduced in a premature manner with the desire to encompass into privatization at an early stage a vast scope of state property with the aim to. complete the process as soon as possible. From this point of view, the longer-term efficacy of a privatization programme depends critically on its macro- and microeconomic consequences.

There are, of course, some measures which can and should be undertaken right at the outset of the transformation process. They comprise the abolition of the previous denial of private property rights or their limitation to petty activities – as was, almost everywhere, the rule under state socialism even in its end-phase – as well as establishing new laws on free entry to the market, on the acquisition of land and real estate and on company status. These measures have already been introduced in most EITs.

But more ought to be done at an early stage for creating a new entrepreneurial class, an indispensable element for the functioning of a market economy. In the first place the spread of small-scale firms should be encouraged *int. al.* by enabling the acquisition of assets, mainly in retail trade and catering, previously held in state (municipal) property.

Therefore, small-scale privatization is next to the founding of new private firms a measure which should be undertaken fairly early together with the freeing of most of the prices. Auctions, public tenders, but also management or employees' buy-outs are appropriate forms of acquiring this type of public property. If the private sector established in such a way is to spread also to industry, manufacture and construction, either by founding genuine small- and medium-sized enterprises or by further privatization, active industrial policies have to be developed for overcoming the many obstacles encountered by the new entrepreneurs. Technical obstacles include insufficient knowledge and competence of the owners of new firms, especially in the field of accounting, costing and marketing. Technical assistance from abroad, but in the first instance from chambers of commerce or similar entrepreneurs' associations (to be set up at an early stage), can overcome these shortcomings in time.

More difficulties are encountered by the new entrepreneurs on account of economic obstacles. The most pressing is the macroeconomic environment prevailing in most of the EITs. The restrictive monetary and fiscal policy with its recessional impact on economic activity is not conducive to new economic undertakings. Indigenous savings are restricted to the beneficiaries of the previous regime or to speculators who have gained great riches overnight. The others are in need of credits for starting a business. However, raising of credits through commercial banks is hampered by high interest rates and by the reluctance of banks to grant credits to newcomers without, or with insufficient, collateral. The government ought to encourage the setting up of specialized banks for financing small- and medium-sized enterprises funded at least in parts from privatization proceeds, and of insurance institutions for providing against the risk of failure. Other measures in favour of small and new firms, also in use in many developed market economies, are fiscal alleviations, speedier depreciation possibilities and export promotion, necessary to compensate for the natural disadvantages of the small newcomers. Far more effort should be devoted and support given to this type of entrepreneurship instead of favouring the early emergence of broad groups of passive share-holders devoting their efforts to dividend clipping and to speculation on the stock market.

The privatization debate becomes far more controversial concerning the crucial issue of how to privatize the many large-scale state-owned enterprises (SOEs). Any known conventional method – with the help of foreign capital or relying mainly on domestic capital resources – is a lengthy, drawn-out process.[23] Foreign capital is by far not so keen on investing in the existing enterprises in the EITs as had been hoped for initially, and it takes time for accumulating sufficient domestic capital.[24] Last but not least, many of the largest enterprises are in acute need of technical, organizational and financial

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[23] For details of privatization see: United Nations Economic Commission for Europe (1992), chapter VI, Hunya (1991) and Levcik (1993).

[24] It is true, more than US$ 7 billion of Western capital has so far been invested in the five (now six) Central and East European countries. Compared with the size of assets to be privatized, this is, however, a negligible amount (see Grosser, 1993, pp. 29-30).

restructuring for becoming viable economic market subjects. All these facts persuade many impatient radical reformers to resort to short-cut or wholesale methods for getting privatization over in the shortest possible time.

It may be useful in this context to distinguish between **real privatization** and what might be called **nominal** or **surface privatization**. In case of real privatization, private physical or legal persons obtain a dominant position in state-owned assets which enables them to impose the owners' objectives on the management, including the right to replace it, restructure the firm, sell off some units or merge it with other firms. Surface privatization covers several possibilities, such as reciprocal cross-ownership of companies, all owned by the state in the final instance, or the transfer of state assets into holdings or property management funds established by the state with the aim either to sell off or distribute (almost) free of charge shares of the holding company or fund. In all such cases only a transitional new owner has been created with the shareholders not being able to exercise effective control.

Similarly, despite their apparent appeal to the principle of social justice and equity, all schemes of **free distribution** (or at a nominal price) of **vouchers** to citizens suffer from the adverse consequences of surface privatization. Even at a later stage, when voucher holders exchange the vouchers for shares in specific firms of their own choice, they will not be able to exercise effective control over the privatized assets considering the broad dispersion of shares among the public. As a consequence, enterprises privatized by this method will be without any effective control for a longer period. This is also one of the reasons why managers of state-owned firms confronted with privatization requirements often favour this specific method. The time of absence of any control by the owner, public or private, will last as long as, through the working of a secondary capital market (so far hardly in existence), some physical or legal persons accumulate a sufficient share of capital stock of a particular firm for obtaining a dominant position and being able to exercise control as owners.

Even if private investment funds step in as intermediaries, administering the vouchers of private citizens (often promising them a return in cash, after a year, of ten to fifteen times the initial cost to the voucher holder, as happened in the former CSFR) the ensuing situation will not be very different. It will take considerable time and there can be unpredictable developments on the stock market (once one is set up and stock trading starts) before the investment funds will have sorted out their share preferences and have got rid of shares of unwanted companies. So far it is also not quite clear whether the investment funds will limit their activities to pure asset management or if they intend to exert proper owners' rights, controlling the managers of the privatized firms, restructuring the companies, selling off or liquidating some units or the firm altogether, or raising new capital for reconstruction.

It may also happen that many individual voucher holders having entrusted their vouchers to an investment fund, would like to cash in the value of the shares as soon as possible,

with many adverse consequences. The massive sale of shares at the outset of stock trading could have a "bearish" effect on the overall trend on the stock exchange. Many investment funds may encounter liquidity problems or even go bankrupt under the pressure of their clients wanting to sell their assets. A high tax on capital gains is being considered in some countries (for instance in the former CSFR) to dissuade share holders from premature sale of their assets. However, having obtained the initial capital (almost) free of charge, they may be satisfied with any after-tax gains. In any case, there is the possibility of insider trading with a few well-informed "winners" and many uninformed "losers".

The method of voucher privatization, though untried on a large scale and therefore unpredictable in its many possible consequences, is gaining support in this or other form in most EITs (the exception being – apart from the former GDR – first of all Hungary and seemingly also Bulgaria). In our opinion it would have been more prudent to try out the method in a limited way, and broaden the scope of the scheme only after evaluation of the results, of their possible advantages (e.g. relative speed, solving the valuation problem of different firms) and their likely dangers and risks. Among these, an important place has the ill-defined structure of responsibility and control at the enterprise level implied in superficial privatization. The latter would tend to decrease the expected flow of profit from the enterprise, which in turn would result in the weakening of the private incentive to invest. The managers left for the time being without any control, but also without any guidance or support and in complete uncertainty about their future position, have no incentive to improve the performance of the enterprise. On the contrary, by shifting the development of the enterprise nearer to bankruptcy they may have the chance for a later cheap buy-out of the firm or part of it when the new owners will be faced with a run-down and heavily indebted firm. Characteristically the inventors of the voucher privatization coined also the term of the "pre-privatization agony" which – as they hope – would vanish once the new owners are going to assert their owners' rights.

Privatization, no matter what methods will be favoured, is a lengthy and highly political process and therefore under no circumstances an easily controlled one. Conflicting aims are bound to come to the fore and the decision makers will have carefully to weigh the advantages and disadvantages of moves considered. Often compromises between contending claims of different groups will have to be made for getting the necessary consent of the law-makers for keeping the privatization process on the move. Commitment to one form of privatization as the preferred or dominant method should be avoided, and rather a diversified, pragmatic strategy adopted. Obviously the state cannot abstain from aiming at transparent control regulations of the entire process to avoid excessive abuse and unjustified enrichment which could bring privatization as such in discredit.

X. State-Owned Enterprises and Restructuring

Privatization in the leading reform countries has made some, though limited, progress.[25] In the former CSFR, by the end of 1992 about one third of the capital book value of state firms had been privatized, mostly by the voucher method (estimation of WIIW); at the same time, the share of the private sector in GDP reached, according to data from statistical offices in Prague and Bratislava, about 20 per cent (see *Narodna Obroda*, 1993, p. 1, and *Hospodářské Noviny*, 1993, p. 3). In Hungary, at the end of 1992, about 10 per cent of capital book value of state firms had been privatized (see HVG, 1992, p. 7); at the same time about 28 per cent of GDP was produced by the private sector, broadly defined (WIIW estimate). In Poland, up to June 1992, only 15 to 17 per cent of state firms had been privatized (J.M. Dabrowski, 1992, p. 6); at the end of 1992, employment in the private sector constituted 58.5 per cent of total employment (estimate, based on Statystyka Polski, 1993, p. iv).[26] Hence, the problem arises what to do with the state-owned enterprises (SOEs) before they can be privatized. Those who believe in the automatic beneficial working of the market show in the first instance a detached attitude towards this issue. They are inclined to wait until the privatization schemes start to bear fruit and to set aside constructive steps for enabling state-owned firms to adjust to the new situation without central planning and state orders, and with changed relative prices as a result of price and trade liberalization.

The obviously required answer, however, is rapid corporatization and commercialization of state-owned firms with the state ceasing to be engaged in the management though remaining the ultimate owner. The legal change involves the transformation of the SOEs into joint-stock or limited liability companies. Concurrently with changing the legal status, the management – which may have to be changed too – will gain much independence in running the firm in a changed economic environment, subject to adequate monitoring by a supervisory board of directors set up initially by the supervising state authority. The new corporations are to operate under "hard budget" constraints, implying their being profitable or otherwise going out of business. In the real world of the EITs, when the uncompromising application of this rule would lead to mass bankruptcies, the authorities usually shy away from such treatment dreading the social consequences, without, however, designing positive policies for improving the performance of the SOEs. Such policies would consist in providing positive market-oriented incentives to managements by **management contracts**, linking rewards to performance and granting them job security till privatization if performance criteria are met.

Restructuring during transition is a term used for manifold operations by changing existing enterprises into viable companies capable of working in a market environment. Often monopolies have to be broken up, conglomerates have to be deconcentrated, firms may have to fall back on core activities, selling off peripheral units or liquidating inefficient

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[25] See Grosser (1993), pp. 31-33.

[26] It should be stressed, however, that this share, in comparable terms, reached already in 1989 (i.e. before the stabilization programme had started) 47.2 per cent (see *Rocznik Statystyczny 1991*, 1991, p. xv).

ones, and improving thereby their financial position. Technical reconstruction with new equipment and new technologies will frequently be required – an aim achievable as a rule only in cooperation with a foreign partner. Many SOEs are heavily indebted. In this case restructuring involves also **financial rescue operations**.

A lively discussion pertains to the question as to whether restructuring of SOEs should be undertaken before or after privatization. The opponents of restructuring before privatization point out that in the past the state failed to fulfil its entrepreneurial duties, and that restructuring is a typical entrepreneurs' responsibility which can be carried out only by those having a clear enterprise concept and being prepared to take the appropriate risks. Restructuring involves in most cases the loss of a substantial number of jobs and the state is as a rule less firm in carrying out the necessary operations, being under political pressure from regional authorities and the trade unions.

By deferring the unpopular move to the future private owner, some political and social troubles can be avoided or at least postponed. On the other hand, restructuring after privatization also raises serious problems. Which private investor is prepared to buy an inefficient state enterprise which needs restructuring or even costly financial rescue operations? If state assets are to be sold then there is the real danger that would-be investors are going to "skim the cream" buying only economically sound companies, leaving the state with the inefficient ones and with the thankless task to dismiss employees, liquidate the firms or engage in some restructuring, now probably much more costly because of the delay. The alternative is giving away the assets free of charge – then all the dangers and possible negative consequences listed above will come into play.

The real issue is that with the large amount of SOEs in need of restructuring it is beyond the strength of the authorities to engage in restructuring before privatization on the whole front. However, for some important companies where the chance of survival is given – if possible with the cooperation of potent foreign investors – the state as the owner cannot abstain from its responsibility to initiate at an early stage restructuring including financial rescue operations.

Every delay of the public authorities hoping that the future private owners will take over the entire burden of restructuring will be far more costly, the chances of survival of the constituent parts of the enterprise will deteriorate, and the requirements of a possible foreign partner will be more exacting. A case in point are the drawn-out negotiations for the marriage of the prestigious Czech Skoda works, Pilsen, to the German Siemens A.G., where the Czech authorities for a long time maintained that the settlement of the financial situation of the enterprise was largely outside the domain of the government. In the end the government had to step in relieving the enterprise of some of its liabilities incurred by irretrievable loans granted earlier to foreign or domestic trade partners. But according to Siemens Chief von Pierer, "the bride is now not quite so beautiful as two years ago" and a successful conclusion of the negotiations with the German partner will now depend on

the success of restructuring measures which the enterprise will have to undertake with government support.

With the bulk of other SOEs in need of restructuring, direct involvement of the authorities will hardly be possible. But the managers of corporatized state-owned firms should be encouraged by specific management contracts, and the work force by suitable incentives (including requalification and severance schemes), to engage in restructuring measures under clear rules, e.g. that restructuring assistance and/or protective measures designed to facilitate adjustment will be available for a limited period only.

Such restructuring measures can be realized only in cooperation and with the help of commercial banks. In selected cases the authorities may have to give the commercial banks direct guarantees for restructuring credits granted, in other cases credit insurance institutions will have to be established. But in all cases necessary adjustment credits will have to be tied to stringent restructuring measures within forward-looking enterprise concepts and with constant monitoring of the measures effected. The financial commitment of the commercial banks does not have to be bigger than it is up to now anyway. But the fundamental difference would be that credits would no longer be granted *nolens volens* in the last moment, after strong pressure, just to assure a further "muddling through" of the ailing enterprises, but would be tied to concrete restructuring proposals. Not everywhere will such rescue operations be successful. Some bankruptcies and market exits of nonviable firms will be unavoidable. But a larger part of SOEs could be saved by a constructive policy on the part of the government and the overall political environment. Also the chances of later successful privatization would thereby be enhanced.

XI. Industrial Policies

In order to tackle and solve the problems discussed in chapters VIII, IX and X they should be viewed within the framework of an overall programme of adjustment and structural change. Unlike the conventional stabilization measures which are being applied according to more or less the same pattern in most EITs, structural programmes have to be tailor-made according to the specific situations prevailing in the individual countries. The only feature these programmes have in common is the need of consistency of the individual elements of the programmes instead of the now practised piece-meal and *ex post* reactions to the ensuing adverse situations.

Industrial policies are especially important in the face of the current deep recession in the EITs. This recession, resulting in severe reduction in the degree of capacity utilization, may mean two different things. Low capacity utilization may mean that reserve capacity exists, which in response to suitable market incentives, e.g. higher prices or higher demand, would be used for rapid and upward adjustment of output. This is the usual economic meaning of upward (or downward) movement along a "supply curve". However, especially as a result of stabilization in the EITs, an alternative meaning of downward movement along the supply curve must also be considered. It may mean, as already

mentioned, not capacity kept in reserve, but capacity more or less permanently destroyed, e.g. firms may close down due to liberalized import or "credit crunch" and may not spring back to life in response to higher prices or growing demand. This irreversible downward movement along a supply curve results in a phenomenon often described as "hysteresis", i.e. the crucial influence of "history" or past policies on the future course of economic policy. Thus, if demand restriction and import liberalization during conventional stabilization result in a large number of enterprises being destroyed, and labour de-skilled permanently, then a new initial condition comes into existence, characterized by reduced productive capacity in the economy. This new initial condition would make any demand expansion in the next round more problematic because a kind of downward "ratchet effect" is set in operation on the supply side.

It is unlikely that such an irreversible downward adjustment in supply in the EITs can be overcome "in the long run" by blindly relying on the "market forces". There is no such automatic transition from stabilization to growth on the supply side, and the problem may become even insurmountable if free import of products is allowed to simply compensate, as long as feasible, the falling supply. Unless a consistent domestic industrial policy is formulated, coordinated, and implemented by the government to encourage and initially protect domestic private investors and attract suitable foreign investors, the market forces will only exhibit their destructive, and not their creative side. An exclusively defensive industrial policy will basically be directed at moderating the downward adjustment on the supply side (e.g. through some import restriction, subsidies, and protection to selected domestic enterprises) and is not even intended to achieve spectacular success on the path towards a market economy. To the contrary, an aggressive industrial policy emphasizing the determination to face international competition within a specified time horizon, as well as the promotion of exports and the penetration of foreign markets (including those lost after the demise of the CMEA) could at least in some cases yield spectacular results.

Industrial policies have been successfully practised by several countries in the Pacific region. They are, however, not limited to this region or to developing countries only. Also developed countries have been involved in industrial policies, and Austria can serve as a good example in case. A member of the Austrian government lines out in a recently published paper the directions of modern industrial policy in his country and comments on Bill Clinton's victory in the US presidential elections as a benevolent signal for the reorientation of the role of the state in the economy. He considers it to be a trend away from the much-applauded (but seldom pursued) "laissez-faire" strategy, which, in its official reading, concedes the state no possibility, or even necessity, of intervention. (Klima, 1992, p. 5) The Economy Minister of Saxonia, Mr. K. Schommer, is of the opinion that Ludwig Erhard, his model, would have handled Germany's economic unification differently. As early as 1953, in an article on reunification, Erhard wrote, "the productivity of the East German economy is to be improved at such speed and so dynamically that the process of performance adjustment will be as short as possible, also in terms of time. Private and public capital must be mobilized to a sufficient extent. In this respect the

economy of the East must be backed up by the state." Schommer, under present conditions, interprets Erhard's statement to mean that a market economy is not created simply by proclaiming its introduction. During the transition from a command- to a market economy the state must support entrepreneurs financially for a longer period of time in order to enable them to take part in free competition at all. Schommer calls, in the framework of industrial policy, for the creation of a federal holding into which enterprises in need of restructuring which cannot be privatized should be absorbed. The financial means needed for restructuring should be raised by the Federal Government and the banks. Managers from the private economy should guarantee the necessary distance from the state. (Schwenn, 1993, p. 13)

It is obvious that industrial policies are far more essential in EITs than in the case of developed market economies (where they are usually based on market failures) because of the only rudimentary existence of markets and market responses evolving only gradually. The EITs face, as was shown, difficult structural problems on their way to developed market economies. The share of services in total employment and output has to increase, that of agriculture must be diminished. The industrial sector must be basically restructured and modernized in order to reduce its high material- and energy intensity. It goes without saying that the elaboration and implementation of a programme of institutional and structural changes, implied by the transition towards a market economy, require substantial (although not exclusive) state involvement. It is just this necessity of state intervention which the post-communist governments dislike most, being aware of the misallocation of resources in the past due to the state planning system. For this reason the new governments are often shying away from their economic responsibilities associated with structural or industrial policies. Tadeusz Syryjczyk, Minister of Industry in Poland's first non-communist government, is famous for having declared, "the best industrial policy is not to have an industrial policy". The same opinion was voiced by Vladimír Dlouhý, Minister of Industry in the Czech government.

In such conditions, the vital question is, what type of state intervention can increase the response rate of firms, workers or households to a newly emerging market environment so that they will react more flexibly to market signals? At the same time the state-administrative machinery, by establishing (in cooperation with the managerial-entre-preneurial sector and various interest groups) and administering the programme, will become more sensitive towards the needs of an evolving market environment.

What are the main principles on which structural and industrial policies during transition will have to be based?

The main aim of such policies is to speed up proper market responses of economic subjects, of existing and new enterprises. The state and other public authorities will have to use new methods designed to interact with firms which are increasingly guided by market forces. This means that mainly indirect policy instruments will have to be applied, such as tax incentives, credit availability and support, trade promotion and infrastructural

support e.g. in science and technology, in training and manpower policies, and in marketing.

In addition, the government will have to take on responsibility for some unavoidable restructuring measures for a few most important enterprises (national flagships). For such enterprises where – because of their importance for the national and regional economy and the many workers tied for their livelihood to their existence – a policy of governmental abstinence is not feasible anyway, a policy of structural assistance will have to be developed in cooperation with the management, workers' representatives and with interested foreign partners. This policy aims at helping the enterprises to shift their lines of business and to diversify into new promising fields. Also investments in the under-developed and neglected infrastructure and in environment should be encouraged with various financial schemes. However, enterprises (irrespective of ownership structure) and governmental policies will be judged not by setting targets but by performance on both domestic and international markets.

Capacities available in the early stages of transition are the result of past allocation; once prices and foreign trade have been liberalized, and wages cannot be depressed any further, a considerable part of these capacities can no longer be utilized. A process of overall structural change has to set in, during which some of the old capacities will have to be abandoned, and others adapted to the new conditions; but most important is the building of new capacities. One of the principles of a constructive structural and industrial policy is to find a consensus among all economic agents (political parties, enterprises, entrepreneurial and trade union groupings) about the timing of phasing out the old capacities, adapting some of them through restructuring, and supporting the emergence of new capacities capable of coping successfully with a competitive environment.

An important feature of structural change during transition is the shift of the enterprise structure in favour of small- and medium-sized enterprises (SMEs). The past state planning system favoured large and comprehensive enterprises. SMEs existed only at the fringes of the economy. As has been argued before (see p. 44) a set of policies in favour of small- and medium-sized enterprises applied already at an early stage of transition can help in building up, with relatively modest means, the new capacities essential for the emergence of a competitive enterprise structure. Once the SMEs have spread sufficiently by these policies, and a new entrepreneurial class has thereby established itself, the latter should be able to take up (often in cooperation with foreign capital) the process of cumulative new investment flows to be used both for creating larger new capacities and for transforming old ones into competitive firms.

The required link between trade and industrial policies was already referred to (see pp. 40-43). Here it should be pointed out that a certain protection of national markets and industries during transition – for declining industries to give them time to adjust, and for the newly emerging and as yet weak industries alike – by appropriate trade policies is still possible even if the countries in question have opted for full integration into the EC, the

most developed regional system in Europe. In this case the policies have to be shaped in a way which is acceptable both to trading partners and the world community. While it may be difficult to raise the general level of tariffs in view of GATT rules, EC association agreements and EFTA accords, specific tariff positions related to branches of industry, various phases of production or even to certain types of products could well be changed in the interest of industrial-policy considerations. It is interesting to note that strong foreign partners (e.g. in the automotive branches) in the EITs seem to be successful in obtaining such specific tariff protection from governments otherwise committed to liberal trade policies. Non-tariff protection may provide a wider scope for implementing industrial policies. To safeguard so-called "fair trade", "codes of good behaviour" are being applied to non-tariff barriers and to trade promotion policies. The general impression is that the EITs so far do not dispose of sufficient knowledge and experience in applying various industrial policy measures to safeguard national interests within the adopted international trading system. Even more important are trade promotion policies in line with the accepted trade regimes when instruments used in the developed market economies are still underdeveloped in the EITs (for specific measures see Fath, 1992, pp. 39-45).

Throughout the transition there will be a dilemma between the need of defensive and active industrial policies. The policy of export promotion and import substitution involves in the case of EITs a problem of paramount importance, namely that of already existing firms. Which firms should be protected - and for a limited time even supported - and which ones left alone, is a question which must be answered in the framework of this general policy in the first place. The state support required for the survival of existing and promising firms, as well as for the development of new ones, must be strong, but not so strong as to let survive firms which cannot become, even after a while, self-supporting. This is easier said than done. There exists, however, no other solution. Since the development of new firms and the changes in the branch and size structure of industries are a time-consuming process, most of public spending will go into a mix of support for loss-making firms (before restructuring) and dealing with the social consequences of structural change. At the same time there will also be a pressing need for an active industrial policy (business start-up schemes, infrastructural investment, retraining, R&D support).

No easy solutions can be put forth and the appropriate mix of defensive and active industrial policy measures will depend on the specific situations in the individual countries. Perhaps one could accommodate industrial policy measures of an investment nature outside the normal budget, expecting normal financial returns from them in the medium or long term.

In any case, the absolute level of funds available will be closely linked to the macro-economic climate combined with the degree of foreign aid support. Budgetary constraints in some of the EITs are not so much the result of too much spending as rather of insufficient revenue. In so far the deep recession in which the EITs are locked because of continued conventional stabilization policies seems to be the essential stumbling block for

applying an active industrial policy. Stabilization with economic expansion is the only viable alternative.

PART C: FROM STABILIZATION TO GROWTH

XII. Stabilization with Economic Expansion

Economic policy making during transition has to proceed on the twin understanding regarding both the **scope** of reform and its **basis**. It needs to be recognized that the scope of the reform is defined broadly by three distinct but interlinked elements, namely, systemic or institutional changes, liberalization of prices and trade needed in the market economy and finally a set of commensurate macroeconomic policy measures. A common fallacy here is the confusion between the **aims** of reform or what we called the policy objectives and the **means** of reform or what we called the policy instruments (see chapter IX). The fallacy arises from assuming that the aims of reform or the policy objectives, e.g. a liberalized trade regime or extensive private ownership of property, can be achieved simply by treating them as instruments of policy that are to be applied at the early stages of reform. This confusion between policy objectives and instruments could result in an unviable or self-defeating reform programme, e.g. sweeping trade liberalization or privatization may fail to be sustainable, precisely because they were introduced too early without the necessary prerequisites being satisfied. In judging the **scope** for reform it is therefore essential to identify the prerequisites which constitute the **basis** of the reform.

During the difficult process of transition, a minimum degree of social and political consensus should be seen as the essential **basis** of the reform. Without this, the process of transition through reforms is unlikely to be sustainable. Our main objection to conventional stabilization policies and the massive recession they almost deliberately induced, arises precisely from this fact. Instead of attempting to develop a consensus among the main economic actors, the reform policies envisaged by the conventional stabilization programmes tended to undermine systematically the initial optimism and consensus which existed in the EITs right after the collapse of the command system. In its design and application, conventional stabilization has failed largely because its economic consequences were socially divisive and not directed towards building social consensus during the hard times of transition.

Fortunately, from an economic point of view, consensus-building is not only essential, but also quite naturally attainable through a set of economic policies in the present circumstances of deep economic recession in the EITs. The first step in this direction is to recognize the central role of aggregate demand management in present recessionary circumstances (chapter IV). In the first place, conventional stabilization erred because it did not take into account adequately in its theoretical framework the influence exerted by the reduction in aggregate demand on the level of economic activity. As a result, it

systematically underestimated the recessionary impact of stabilization on output and employment and its divisive impact on the society (chapter III).

However, once the importance of aggregate demand management is recognized in the present circumstances of the EITs, two policy implications follow more or less directly. **First**, aggregate demand expansion could have a considerably faster speed of adjustment compared to supply expansion. Therefore, the positive impact of the policies we recommend should be visible within a short time span which is of crucial practical importance in a democracy. This is because the enterprises and other micro-units or the agents in the economy respond relatively slowly to changed incentives. At the same time, restructuring and other similar measures are time-consuming. In contrast, at least one of the important elements governing aggregate demand, namely expansionary fiscal policy through government budget deficit (chapter IV), can be adjusted relatively fast, once we reject intellectually the mistaken idea that the government should try to reduce its budget deficit under **all** circumstances. Indeed, the very attempt to reduce the budget deficit in a deep recession becomes self-defeating by deepening the recession even further (chapter VI). Moreover, by accepting the mistaken notion that a balanced budget is the basis of "sound" fiscal policy under **all** circumstances, governments in the EITs are surrendering their most crucial policy instrument for relatively fast upward demand adjustment which they badly need to get out of the present deep recession.

This is also related to a **second** policy implication of demand management in EITs. There is no disagreement that, for various reasons, government budget deficit should not be used indiscriminately over a long time for stimulating demand. It would be decidedly preferable from the policy point of view over the longer run to stimulate other major components of aggregate demand, namely, business investment and trade surplus (chapter V). Nevertheless, these components of aggregate demand are far less under the immediate direct control of the government (compared to budget deficit) and can be influenced only indirectly and relatively slowly. For this reason, we also accept the logic of an initial devaluation in the EITs for improving the trade balance, and a substantial degree of liberalization of prices – because, given the legacy of the command economy, some initial steps in the direction of more realistic exchange rate and prices were essential, not only for introducing competition, but also for improving the trade and investment climate in these economies. It is also from the same policy perspective that we point to the need to improve the profitability of private investment in long-term capital formation by following a monetary policy which reduces the exorbitantly high nominal interest rates (chapter VII). However, the central point is to realize that, as the economic climate for business investment and export promotion (i.e. the other main components of aggregate demand, see chapter IV) can improve only slowly, and indirectly, an initial stimulation of demand through government budget deficit would play a complementary role in improving the longer-run economic climate for growth.

It deserves emphasis that business investment plays an absolutely crucial role for transition and growth, and government fiscal and monetary policies can play only a

supportive role. In this respect, our perspective is not so different from that of conventional stabilization. But on the critical issue of **how** to improve the profitability of and stimulate private investment, conventional stabilization policies have clearly failed so far. This is amply evidenced by the fact that the presumed automatic transition from stabilization to economic growth is not in sight. The main reason for this failure is to be found again in the inadequacy of the theoretical framework of conventional stabilization, in so far as it fails to see the influence of aggregate demand management on the profitability of private investment.

One could perhaps identify here three central propositions in the conventional view of stabilization which are supposed to help in rapid transition from stabilization to growth, mostly through the dynamics of the private sector. First, there should be not only expenditure reduction by the government, but also expenditure switching in favour of the private sector, e.g. cuts of subsidies to the general public (in the form of higher prices for public utilities, food etc.), while providing various price and tax incentives (e.g. accelerated depreciation, lower corporate tax rate etc.) to private business.

Second, greater reliance on the price mechanism to deal with balance-of-payments problems by shifting relative prices in favour of tradables against non-tradables: devaluation of the home currency is an instrument specifically favoured for this purpose; but liberalization of the trade regime is also expected to help in achieving the same target perhaps in the long run.

Third, greater flexibility of the labour market: in essence, this means allowing the real wage rate to fall in order to improve the profitability of private business. It would also mean liberal exit policies for inefficient firms, i.e. allowing inefficient domestic (especially public sector) firms to go out of business, usually as a consequence of trade liberalization, which would also create unemployment in the short term. But this unemployment is to be tolerated in the hope that the economic dynamics of an efficient and competitive private sector would create enough jobs to overcompensate the employment loss in the longer run. The Schumpeterian view of the process of "creative destruction" under capitalism is often invoked in this context to justify such a liberal exit policy for existing enterprises.

The general idea underlying these apparently diverse policies like government expenditure switching, shift of relative prices in favour of the tradable sector through devaluation, and labour market flexibility, is that they would promote also the profitability of business, especially private investment, for economic restructuring and growth. For instance, various tax concession measures in favour of private business that may be encouraged by expenditure switching would increase post-tax profitability directly. Similarly, at constant labour productivity lower real wages would increase the profit margin per unit of sale, while devaluation of the home currency would also tend to push up that margin of profit in domestic currency for domestic exporters.

Nevertheless, most of these measures increase profit margin per unit of sale, while total profit depends not only on that margin **per unit** of sale, but also on the **volume** of sales. In other words, the rate of profit, i.e. profit per unit of invested capital (in accountants' book value), depends both on the profit margin and on the degree of capacity utilization (which may be assumed equal to the volume of sales, assuming no change in inventories).

Thus, the rate of profit realized may even go down if the improvement in the margin of profit per unit of output is quantitatively outweighed by a decline in the degree of capacity utilization. The problem with the conventional stabilization package – its insistence on government expenditure reduction as well as government expenditure switching, lower real wage through wage restraint etc. – intending mostly to increase the profit margin per unit of sale, may now become obvious. It may increase the profit margin, but decrease capacity utilization and the volume of sales disproportionately more through demand restriction, so that the rate of profit realized, as well as that expected, may decline in the process. The result would be a worsening, not an improvement in the climate for private investment due to stabilization, as indeed is being evidenced in several EITs.

The way out of this dilemma in the short run is to rely on expansionary fiscal and monetary policies, especially government budget deficit, greater availability of credits and lower nominal interest rates as the borrowing cost of finance for business. By expanding demand, these policies will raise the degree of capacity utilization and simultaneously increase the expected rate of profit to encourage private investment. Therefore, in the present recessionary circumstances of EITs there is no justification for the belief that government budget deficit would "crowd out" private investment; instead, in all probability, it would "crowd in" more private investment by playing a complementary role.

The mutually reinforcing or symbiotic relation between government policy and private investment needed during transition also directs attention to the central **social** advantage of suitably targeting expansionary demand management policies in deep recession. By expanding private profitability through higher capacity utilization brought about by larger government expenditure on essential welfare measures and socio-economic infrastructure, a strong economic basis for social consensus during transition may be created. The point may be illustrated by a telling example.

The situation with respect to housing construction has deteriorated at an alarming rate in the EITs. Compared to the average of the years 1980-1988 the number of dwelling construction per 1000 inhabitants declined dramatically in 1990-1992 (see Table 11). Expansionary government fiscal and monetary policies targeted partly at improving the desperate housing situation would create some economic hope and thus a basis for consensus among the population at large. Even more importantly, it would indirectly

improve the climate for private investment by raising total profit through higher sales.[27] It has been one of the tragic errors of economic policy making in the EITs recently to sacrifice these sensible options for consensus building in the mistaken belief that even in a deep recession the budget must be balanced and contractionary policies continued. As a result, some policy makers have taken recourse to ideological measures for building consensus, such as privatization through distribution of vouchers. However, even though this may be appealing to the public for a short while, it can hardly be sustained over a longer period. In all probability it has been counter-productive even in the short run by worsening the climate for private investment, by creating ambiguities in property rights and in the structure of control at the enterprise level.

Table 11

Annual housing construction, flats per 1000 inhabitants

Year	Bulgaria	CSFR	Hungary	Poland	Romania
1980-1988[1]	7.5	6.4	6.6	5.2	6.0
1989	4.5	5.9	5.0	3.9	2.6
1990	2.9	4.7	4.2	3.5	2.1
1991	2.1	4.2[2]	3.2	3.5	1.2
1992[3]	1.3	3.3[2]	2.5	3.2	0.9[2]

1) Average per year. - 2) Estimate. - 3) Preliminary.

Sources: National statistics.

In normal conditions, there are two major barriers to expansionary government policies for creating such social consensus which are also emphasized frequently in the policy debates in the EITs. These two barriers are inflation and trade deficit. While under normal conditions inflation is propelled largely by excess demand, we pointed out that the current inflationary process in most EITs is not rooted primarily in excess demand (chapter V). The sharp recession causing a disproportionate drop in output in relation to employment reduced labour productivity and increased labour cost per unit of output. Combined with increases in the administered prices of basic services and inputs (like energy and transport) and higher prices of imported inputs under the liberalized price and trade regime, the declining labour productivity has generated strong cost-push inflationary

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[27] It goes without saying that apart from social housing schemes for the lower-income strata financed from public sources, co-operative housing programmes with some public support, and housing ownership schemes financed by building saving institutions (offering attractive mortgage conditions) ought to be encouraged.

Housing construction is an important example of expansionary demand management in the EITs but not the only one. The same role can be played by investment in infrastructure, by financing of different measures foreseen in the industrial policy framework or by direct support of the developing private sector, especially small firms.

pressures. The way out of this inflation is not further demand compression or further wage restraint, but raising short-term labour productivity through higher capacity utilization, which in turn requires expansionary policies (chapter V). Almost paradoxically, therefore, the immediate inflationary barrier in the EITs can be overcome not by further demand contraction but rather by demand expansion.

The real barrier to expansionary demand policies in the EITs might be created by an unsustainable position regarding the trade deficit. Recognition of this barrier calls for a more controlled pace of trade liberalization, especially concerning import, in the near future and also for specifically designed industrial policies for export promotion in the longer run (chapter XI). The pressure on the balance of payments could also be eased partly by undertaking primarily expansionary investment programmes which are not directly import-intensive (like housing construction mentioned earlier). A judiciously controlled pace of import liberalization combined with a government capital expenditure pattern which has relatively low import content, could provide the needed direction for combining expansionary policies with a tolerable balance-of-payments position. The situation could be eased tremendously through a substantially higher inflow of foreign capital and granting alleviations in debt servicing. Such international cooperation and assistance could no doubt help in the path of transition. But even without sufficient international support, which the EITs are hoping for, the alternative path to transition we are proposing has a considerably higher chance of success.[28] The fundamental reason for this is our emphasis on the need for social cooperation as the basis for any politically sustainable strategy. In our view, economic policies must be designed to build social consensus during the most difficult years of transition. Without this essential basis for economic policy, the fragile democratic system may not survive a drawn-out economic crisis in some of these countries.

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[28] However, a substantially softer frame of conditionality (like dropping the insistence on lowering the budget deficit under conditions of economic recession) for credits to be granted by international institutions or the G-24 would be indispensable.

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ANNEXES

ANNEX 1

Table A1

CSFR: velocity of circulation of money, basis data

	M1	M2	GDP	V1=GDP/M1	V2=GDP/M2
	absolute data in Kcs billion				
1Q1988	261.4	467.1			
2Q1988	270.9	478.7			
3Q1988	279.1	490.1			
4Q1988	309.5	529.4			
1Q1989	272.7	497.2			
2Q1989	286.6	513.4			
3Q1989	295.8	525.0			
4Q1989	317.7	554.4	189.9	0.598	0.343
1Q1990	287.7	534.7	184.8	0.642	0.346
2Q1990	303.3	546.7	199.0	0.656	0.364
3Q1990	292.9	537.7	202.9	0.693	0.377
4Q1990	291.1	550.6	232.2	0.798	0.422
1Q1991	278.9	550.0	254.7	0.913	0.463
2Q1991	285.6	579.1	243.2	0.852	0.420
3Q1991	317.1	616.5	229.0	0.722	0.371
4Q1991	371.4	697.7	250.9	0.676	0.360
1Q1992	356.7	712.2	223.2	0.626	0.313
2Q1992	378.2	746.4	224.1	0.593	0.300
3Q1992	397.4	786.8	235.7	0.593	0.300
4Q1992					

Sources: For M1 and M2, *International Financial Statistics*, IMF; GDP quarterly, *Bulletin*, Statistical Office, Prague; industrial production quarterly, information of the Institute for Forecasting, Prague.

For Czechoslovakia all data for calculation of velocity of circulation are available. With the help of these data we test the reliability of our method of estimating the quarterly GDP data which do not exist in Hungary and Poland (see Table A1 continued).

Table A1 continued

CSFR: velocity of circulation of money, estimated data.

	M1	M2	industrial production quarterly as % of year		GDP estimated[1] Kcs bn	V1	V2
	Kcs billion						
1Q1988	261.4	467.1					
2Q1988	270.9	478.7					
3Q1988	279.1	490.1					
4Q1988	309.5	529.4					
1Q1989	272.7	497.2	226.8	25.3	191.7	0.703	0.385
2Q1989	286.6	513.4	225.4	25.1	190.5	0.665	0.371
3Q1989	295.8	525.0	212.1	23.6	179.2	0.606	0.341
4Q1989	317.7	554.4	233.5	26.0	197.3	0.621	0.356
1Q1990	287.7	534.7	222.8	24.5	200.5	0.697	0.375
2Q1990	303.3	546.7	221.1	24.3	199.0	0.656	0.364
3Q1990	292.9	537.7	210.7	23.2	189.6	0.647	0.353
4Q1990	291.1	550.6	255.3	28.1	229.8	0.789	0.417
1Q1991	278.9	550.0	324.7	28.0	273.7	0.981	0.498
2Q1991	285.6	579.1	299.0	25.8	252.0	0.882	0.435
3Q1991	317.1	616.5	256.6	22.1	216.3	0.682	0.351
4Q1991	371.4	697.7	279.8	24.1	235.8	0.635	0.338
1Q1992	356.7	712.2					
2Q1992	378.2	746.4					
3Q1992	397.4	786.8					
4Q1992							

1) GDP data estimated with the help of quarterly data for industrial production and yearly data of GDP.

We assume that: $GDP_i/GDP = I_i/I$ where:

i= 1,2,3,4 – denotes the quarter of the year

GDP and GDP_i – denote yearly gross domestic product and quarterly gross domestic product, respectively

I and I_i – denote yearly industrial production and quarterly industrial production, respectively.

Table A2

Hungary: velocity of circulation of money, estimated data

| | M1 | M2 | industrial sales as % of yearly sale | GDP yearly | | ESTIMATED | |
	forint billion				GDP (1)	V1=GDP/M11	V2=GDP/M2
1Q1988	286.3	586.3	388.3	22.7		325.8	1.138	0.556
2Q1988	285.1	583.4	424.2	24.8		356.0	1.249	0.610
3Q1988	284.4	587.3	414.4	24.2		347.7	1.223	0.592
4Q1988	302.0	612.8	483.4	28.3	1435.2	405.7	1.343	0.662
1Q1989	307.4	631.3	377.5	23.5		402.3	1.309	0.637
2Q1989	317.0	646.3	409.2	25.5		436.1	1.376	0.675
3Q1989	323.6	650.4	382.9	23.9		408.1	1.261	0.627
4Q1989	355.0	706.2	435.6	27.1	1710.8	464.3	1.308	0.657
1Q1990	361.1	732.3	383.8	22.2		461.9	1.279	0.631
2Q1990	382.8	764.7	431.3	25.0		519.0	1.356	0.679
3Q1990	389.0	794.9	401.7	23.2		483.4	1.243	0.608
4Q1990	449.1	912.9	511.3	29.6	2079.5	615.2	1.370	0.674
1Q1991	421.5	909.4	468.9	26.3		604.5	1.434	0.665
2Q1991	442.4	953.6	449.5	25.2		579.5	1.310	0.608
3Q1991		995.2	406.7	22.8		524.3		
4Q1991		1162.0	459.0	25.7	2300.0	591.7		
1Q1992		1164.0	390.6					
2Q1992		1242.0	405.8					
3Q1992		1331.2	400.8					
4Q1992								

1) GDP yearly data on quarterly industrial sales developments, see Table A1.

Sources: For M1 and M2, *International Financial Statistics* and Monthly Reports of the Hungarian National Bank; industrial sales from *Statisztikai Havi Közlemenyek*.

Table A3

Poland: velocity of circulation of money, estimated data

	M1	M2	industrial sales	GDP		ESTIMATED	
			as % of	yearly			
	zloty billion		yearly sale		GDP (1)	V1=GDP/M1	V2=GDP/M2
1Q1988	4145	8390	6592	21.3		6323	1.525	0.754
2Q1988	4694	9213	7526	24.4		7219	1.538	0.784
3Q1988	5493	10885	7638	24.7		7326	1.334	0.673
4Q1988	5748	12110	9133	29.6	29629	8760	1.524	0.723
1Q1989	6275	13977	11500	12.1		14307	2.280	1.024
2Q1989	8505	19168	13481	14.2		16771	1.972	0.875
3Q1989	11584	30241	18160	19.1		22592	1.950	0.747
4Q1989	19975	74433	51967	54.6	118319	64649	3.237	0.869
1Q1990	41800	114184	115685	21.3		125863	3.011	1.102
2Q1990	64509	140918	123914	22.8		134816	2.090	0.957
3Q1990	91872	178547	136186	25.0		148168	1.613	0.830
4Q1990	99896	196230	167898	30.9	591518	182670	1.829	0.931
1Q1991	108222	205069	166219	22.5		185453	1.714	0.904
2Q1991	115636	234927	156152	21.1		174221	1.507	0.742
3Q1991	129225	258988	166303	22.5		185546	1.436	0.716
4Q1991	133016	272743	250163	33.9	824330	279110	2.098	1.023
1Q1992	146932	297082	190368					
2Q1992	163618	324953	206638					
3Q1992	181356	361095	229738					
4Q1992								

Sources: For M1 and M2 until 4Q1990, *International Financial Statistics*; 4Q1990 from *Finanse 1985-1990*, Statistical Office, Warsaw; from 1Q1991, *Biuletyn Statystyczny*, Statistical Office, Warsaw; for industral sales, *Biuletyn Statystyczny*.

1) GDP yearly data on quarterly industrial sales developments, see Table A1.

ANNEX 2

Savings and savings ratios: Statistical and methodological remarks

1. We have a function GDP represented as GDP = (1/s)S, where GDP is output and S savings. The savings ratio may be expressed as s = S/GDP.

2. We define the index for S and GDP as

$$\Delta S = S_2/S_1 \text{ and } \Delta GDP = GDP_2/GDP_1.$$

The savings ratio index Δs is defined as

$$\Delta s = \Delta S/\Delta GDP.$$

3. The real index for savings $\Delta S_r = \Delta S_n/P_S$ where ΔS_n is the nominal index and P_S the price index for savings. ΔS_n is given, P_S will be estimated. With the help of P_S we find the real savings ratio.

4. The price deflator for savings is estimated as a linear combination of the price indices for government deficit, investments and foreign trade balances, weighted by corresponding components of savings at current prices.

$$S = D + I + E$$

where: D – general government deficit

  I – investments (of the business sector)

  E – export surplus;

hence
$$P_S = (D/S)P_D + (I/S)P_I + (E/S)P_E$$

where: P_D – price index for D

  P_I – price index for I

  P_E – price index for E.

5. Components of savings and price indices for these components are defined as follows:

General government deficit – expenditures less revenues, comprising deficits of central and local governments. Revenues exclude the value of state bonds and surpluses of local governments from previous years.

As price index for the government deficit we use the domestic price index.

Investment – gross capital formation less government expenditures for investments and repairs.

The two components are separately deflated with price indices for gross capital formation and for investment outlays.

Export surplus – balance of goods and non-factor services. Data from balance-of-payments statistics, for CSFR in national currency, for Hungary and Poland in US dollar and transferable rouble, are converted into forint and zloty with the help of official exchange rates.

Export surpluses and deficits are deflated by export or import price indices, respectively.

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