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The Strategy of Reform in the Previously Centrally-Planned Economies of Eastern Europe: Lessons and Challenges *

by

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Abstract

This paper analyzes some of the lessons that can be drawn from the experience of Eastern Europe in the process of transition to a market economy that is under way, and examines some key challenges currently facing policymakers in these economies. The paper studies the constraints affecting the general strategy of reform--rapid versus gradual--that was adopted, and the output decline initially experienced and its effect on medium-term growth perspectives. The paper also discusses the implementation of mass privatization schemes, and the type and extent of government intervention in the restructuring process.

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Contents

I. Introduction

This paper analyzes some of the lessons that can be drawn from the experience of Eastern Europe in the process of transition to a market economy that is under way, and examines some key policy challenges that are currently facing these economies. After some three years since the initiation of the reform process in the previously centrally-planned economies (PCPEs) of Eastern Europe 1/, a number of lessons can be extracted from their collective experience. Although the transition process raises myriad policy issues, this paper selectively concentrates on two fundamental ones. The first issue concerns the relative merit and feasibility of slow and rapid reform strategies. The Eastern European economies have generally followed a strategy of rapid implementation of market liberalization; this may be contrasted with the partial or gradual market liberalization followed, for example, in China. The second issue relates to the output decline observed at the outset of the reform programs in the PCPEs; a better understanding of this output decline may clarify the tradeoffs involved in the application of different macroeconomic and structural policies, and help in evaluating the medium-term growth prospects for these economies.

Looking ahead, despite the depth of the reforms already implemented in Eastern Europe, some of the most difficult tasks of building a market economy remain unfulfilled. The most important of these is privatization. It is doubtful that a market economy could function effectively when

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1/ The set of PCPEs of Eastern Europe whose reforms are discussed in this paper comprises: Bulgaria, the former Czech and Slovak Federal Republic, Hungary, Poland, and Romania.

privately-owned enterprises comprise only a minor share of domestic markets. Moreover, state enterprises, having developed under the nonmarket conditions of a centrally-planned economic system, are still generally operating at low levels of efficiency. These enterprises would require deep restructuring to achieve competitive standards comparable to those of public, let alone those of private, enterprises in market economies. As the feasibility of such restructuring under state ownership is questionable, the transfer to private ownership becomes imperative.

Another challenge of the transition process is to determine the extent of government involvement in the reallocation of resources and in the restructuring of enterprises. This type of government intervention could apply to a very broad range of problems. Areas in which government intervention is probably well justified include dealing with the enterprise debt problem and the weakness of the financial system, and taking a more active role in closing down nonviable enterprises. More controversial interventions include the granting of temporary subsidies, or providing protection from international competition to firms that require more time to become competitive, and assuming a more active role in directing investment to certain economic sectors.

II. Big Bang versus Gradualism. Was there a Choice?

The main component of what has been termed a big bang reform package is the rapid liberalization of the goods and foreign exchange markets. Typically, this liberalization has not been complete, as prices for energy, some consumer goods and services, such as food and rents, etc., have remained administratively set, and foreign exchange markets have been decontrolled only for current account transactions. These market liberalization measures have been accompanied by a tightening of financial policies to prevent the onset of protracted inflation after the initial price jump. Financial and labor markets were liberalized to a lesser extent. In the case of labor markets, limits on wage increases were typically imposed to serve a twofold purpose: (1) as an incomes policy designed to support the stabilization efforts based on aggregate demand restraint, and (2) as a device to prevent the possibility of enterprise decapitalization through excessive wage payments. In the case of financial markets, liberalization is also limited by the fact that a few state banks with weak balance sheets virtually control the whole market.

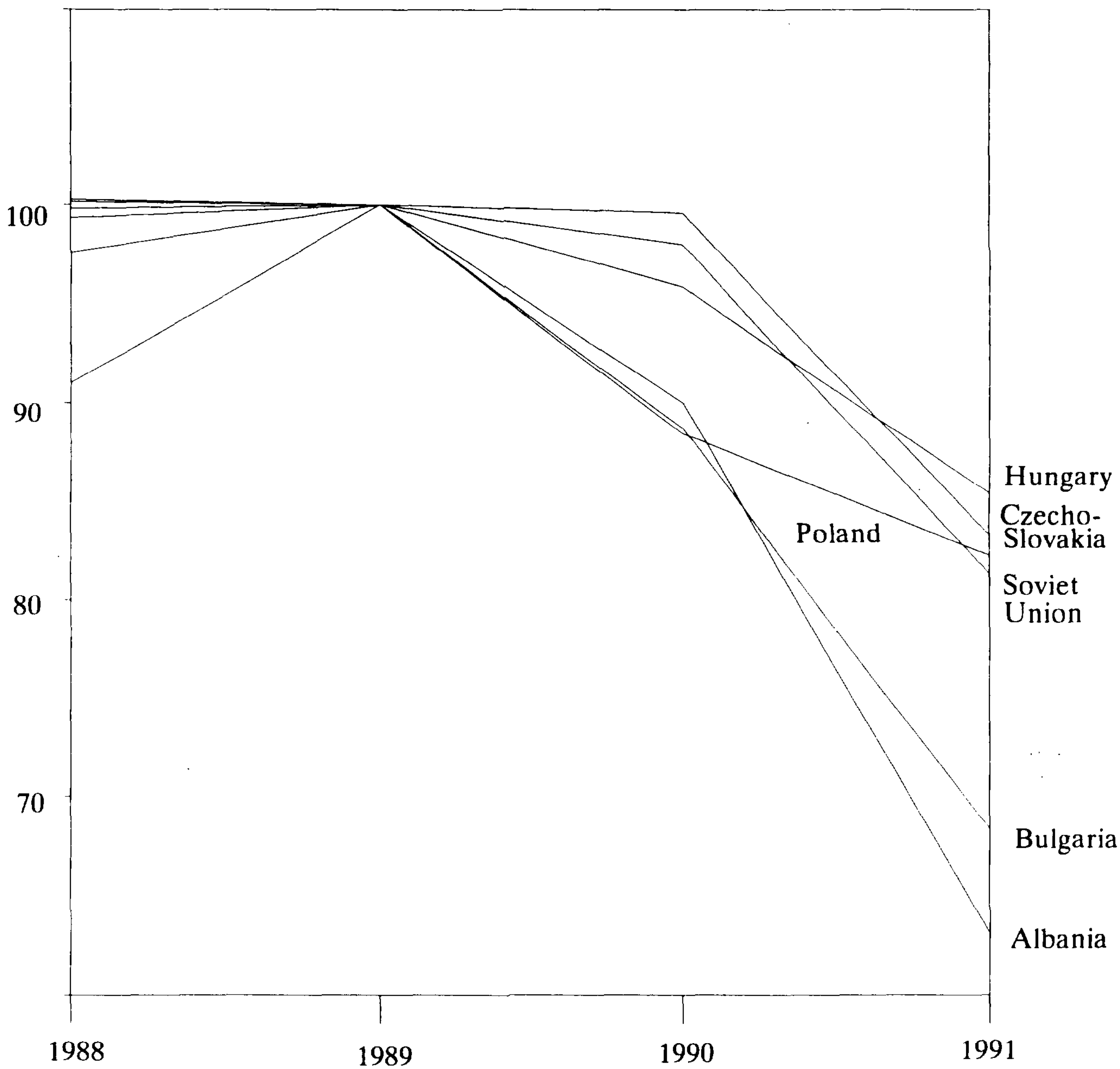
To a major extent, however, attempting more gradual economic policy changes was precluded by economic and political developments in Eastern Europe, particularly with respect to price and trade liberalization. This was the case because following radical political changes many PCPEs found themselves in a state of limbo: the centrally-planned system did not function anymore but there was still no trace of a market system to organize and motivate economic production. In this situation, it was no longer possible for the government to order enterprises to produce or to deliver goods at arbitrarily set prices, or to coerce exporters into surrendering hard currency earnings at the official exchange rate. In such circumstances, productive relations start to break down, shortages multiply, and the expectation of price liberalization only compounds the problem by increasing incentives to build up inventories. The breakdown of the economic system tends to be more serious when the extent of previously existing shortages or of market disequilibria are relatively larger. 1/ This state of limbo may explain developments in countries like Albania, Bulgaria, and the former Soviet Union, where output fell sharply well before any serious economic reform got under way (see Chart 1).

Therefore, the Eastern European economies had no choice but to move quickly to free prices, and to impose "current account convertibility". Current account convertibility, which basically involved trade liberalization, provided some limit to the monopolistic power exercised by state enterprises in many domestic markets, which amounts to a big bang reform. Although Hungary is sometimes mentioned as an example of gradualism, its policies were not very different from the other Eastern European countries. For example, while some countries (such as Poland) liberalized prices at once, others (such as Czechoslovakia) kept prices under control for one year and then liberalized them in one shot. Hungary liberalized prices in stages over an 18-month period. These differences cannot be of a first-order magnitude.

A more important difference between Hungary and the rest of the PCPEs, is that Hungary had begun to liberalize and decentralize its economy considerably since the 1960s (prior to 1990, about 50 percent of prices were already market determined and enterprises enjoyed a fair degree of autonomy). During those decades Hungary did pursue a gradual reform, with at best mixed results. But for the Eastern European economies, however,

1/ Moreover, in countries with larger disequilibria, financial discipline in government agencies tended to break down to a greater extent.

Chart 1. Evolution of Output in PCPEs 1/



1/ Hungary and Poland started substantive reform programs in 1990, and Bulgaria and Czechoslovakia did in 1991.

following the sudden collapse of communism in 1989, there was no possibility to implement price and trade liberalization gradually over the following 20 years because the political authority to impose such a plan had completely eroded.

But what about the contrast between the sharp declines in output experienced in Eastern Europe and the remarkable performance of countries (such as China and Vietnam) that, not having recently undergone revolutionary political changes, were in a position to attempt a gradual and partial liberalization of their economies? Is that performance evidence of a superiority of a gradual approach? In fact, the contrast between the two groups of countries is less revealing than it appears. The engine of growth in the "slow" reformers is small businesses, often family or community establishments in agriculture and services (but also in manufacturing in the case of China), that have taken advantage of the new opportunity to produce for more or less free markets. Reforming this sector of the economy is the easy part of the transition. Once legalized, small private businesses provide a substantial supply response quite quickly. The same response was also evident in Eastern Europe where, even in the midst of very unfavorable macroeconomic conditions, this segment of the economy (small private businesses, largely in the service sector) has done remarkably well. In Poland, for instance, the private sector may have grown some 15-20 percent in 1990-91. In the region of Prague, the unemployment rate *fell* to about 1 percent in 1991 (while it was reaching nearly 15 percent in industrial areas) thanks in large part to the expansion of small private businesses. Moreover, the more difficult part of the transition, namely removing the market disequilibria and price distortions--for example in exchange rates, energy prices, and so forth--will still have to be faced sooner or later by the "gradualist" economies of Asia (see Gelb (1992)).

III. Output Decline and Growth Expectations

It was plainly evident in the countries of Eastern Europe that the quality of life delivered by the centrally-planned system compared poorly to what had been achieved by their neighbors to the West that had historically attained similar levels of economic development and well-being. However, the initial effect in the aftermath of the reform in Eastern Europe was a large decline in GDP. While it was clearly anticipated that output in certain sectors or enterprises was bound to contract, the pervasiveness of the output decline was not anticipated. Despite this surprise, there is no shortage of explanations for the output decline. In fact, the difficulty is in apportioning responsibility between the different explanations, which include both endogenous and exogenous factors. Among the endogenous factors, there are two main categories: macroeconomic factors and structural change. The main exogenous factor is the collapse of the Council for Mutual Economic Assistance (CMEA).

At the outset of the reform programs in Eastern Europe, the general stance of macroeconomic policies was certainly not expansionary. In fact, a substantial stabilization effort was needed to prevent an inflationary spiral from emerging following the adjustment of some highly undervalued administrative prices and the removal of price controls. In the case of Poland, moreover, the economy was bordering on hyperinflation before the reform program started. It is not surprising that, as the PCPEs of Eastern Europe underwent a real increase in domestic energy prices of some 200 or 300 percent and a substantial real devaluation, while yet attempting to maintain some degree of price stability, the impact on output was not stimulative. However, especially when compared to the experience of other developing countries, output declines on the order of 20 percent appear to be too large to be explained by macroeconomic forces alone.

The massive resource reallocation--structural change in production--implied by moving from a centrally-planned system to a market economy is likely to initially result in an output decline. There is a fundamental asymmetry in the speed of response of activities that are affected in positive and negative ways. Productive sectors that are not viable under market conditions very quickly become financially strapped or face nonexistent demand, while productive sectors that should expand are slow to invest and grow because of adjustment costs and uncertainty. While some evidence of structural change is present, for instance, in the boom of the services sector and of other private activities, it does not appear that structural change is the principal explanation of the output decline. For example, some recent econometric work on the industrial branches of several Eastern European countries reveals that macroeconomic factors account for an overwhelming proportion of the output decline while factors that are specific to the different industrial branches have had little impact. 1/

1/ See Borensztein, Demekas and Ostry (1992). The main thrust of the econometric work is a decomposition of the changes in the output of 14 industrial sectors between common macroeconomic factors and industry-specific factors.

The dismantling of the CMEA trading arrangements in 1991 ushered in a large decline in international trade between the former member countries, with negative effects on the level of output of the affected exporting activities. Despite the large role generally attributed to the collapse of CMEA trade (Rodrik (1992)), it is far from obvious that this was the main determinant of the output decline. First, sharp declines were observed in 1990 while the CMEA was still operational. Poland is a case in point, where in 1990 GDP fell by some 12 percent while exports to the CMEA area <u>increased</u>. Second, part of the decline in CMEA exports was simply a manifestation of the poor competitiveness of some sectors of industry. Gelb (1992) points out that import demand by Russia from non-CMEA countries did not decrease; therefore, in part, the observed decline in CMEA trade is just a sign of the process of resource reallocation that was under way. This implies that while the maintenance of some preferential trading arrangements would have supported output in a few productive sectors, a significant decline in CMEA trade would have taken place in any event.

Despite the initial decline in output, the medium-term growth prospects continue to be favorable for the PCPEs of Eastern Europe. The main reason is that the stock of *usable* or *correctly allocated* productive capital (both fixed and human capital) in Eastern Europe may actually be very small, despite the high rates of fixed investment achieved historically. The distortions in the investment and hiring decisions in the centrally-planned system imply that a substantial fraction of fixed and human capital would effectively be useless in a market economy, and would need to be reallocated if possible. 1/ An attempt has been made to calculate the degree of inefficiency in the utilization of capital and labor in some Eastern European economies by comparing their economic performance to that of the broad sample of 75 countries included in a growth study by Mankiw, Romer and Weil (1992). 2/ Using estimates of the current levels of per capita GDP (in PPP terms) one can calculate--on the basis of the growth regression--the level of investment in fixed and human capital that would have been necessary to achieve the current position. This calculation thus provides a measure of the degree of "overinvestment" or redundant productive resources currently employed. The estimates of the amount of redundant resources range from 17 percent in the case of Czechoslovakia to nearly 30 percent in the cases of Hungary and Poland. It is notable that this inefficiency is measured relative to the "average" performance of a broad sample of countries, not to just a few success stories.

There is, however, an optimistic conclusion to be drawn from the above measures of inefficiency. If the stock of useful capital is actually very small, its productivity should be very large in Eastern Europe. 3/ Conventional Solow-type growth models indicate that high transitional growth rates take place in this situation when the productivity of capital is high. Moreover, as human capital is reallocated it also adds to productive

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1/ But, as the literature on "irreversible investment" has emphasized, reallocation of fixed capital to alternative activities may not be possible in most cases. The same would apply to specific knowledge that is embedded in the stock of human capital.

2/ Borensztein and Montiel (1992).

3/ Note that this is equivalent to saying that the PCPEs of Eastern Europe are endowed with abundant and cheap labor, which is a statement often shared by observers.

resources. The empirical study mentioned above estimated that per capita growth rates of the order of 4-7 1/2 percent per annum could be obtained with fairly modest investment rates (22 percent of GDP in the simulations). 1/ This means that, to some degree, the observed output decline should not be perceived as worsening growth prospects. To the extent that the output decline reflects (or even induces) the shedding of redundant or inefficient resources, it actually helps to create the conditions for high transitional growth rates in the near future.

IV. Privatization

Privatization is the most difficult and the most critical of the reforms that PCPEs face. The task is to sell enterprises representing between 50 and 90 percent of the economy when the private sector has scarce savings, capital markets are basically nonexistent, and it is not possible to obtain a reliable valuation of most of the state enterprises. These conditions make it almost impossible to attempt a conventional, case-by-case sale of the enterprises, except by resorting to "spontaneous" privatizations in which managers of the state enterprises are free to negotiate and close privatization deals themselves, a method that has aroused strong complaints of impropriety and insider trading, and also of leading to an excessive foreign control of the domestic economy.

Under these circumstances, the real need of PCPEs to privatize their state enterprises could be questioned. Could they not instead choose a

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1/ These rates of growth are based on the assumption that the PCPEs achieve a level of economic efficiency similar to the average of non-centrally planned economies.

brand of capitalism that does not require a substantial transfer of state enterprises to the private sector? In the first place, as Milanovic (1989) and Lipton and Sachs (1990) have pointed out, there is currently no functioning market economy with such a massive state enterprise sector. Independently of how interventionist the predominant economic philosophy has been, the size of the state enterprise sector in market economies is several orders of magnitude smaller than was the case in centrally-planned economies. In the second place, for cultural and political reasons, public enterprises in Eastern Europe are particularly ill-suited to compete under market conditions. The experience with the excess wage tax in Poland serves as an example. This excess wage tax penalizes wage increases in excess of a national norm with rates up to 500 percent; it was devised as a deterrent, with essentially zero expected revenue. However, the actual accrued revenue soared to about 5 percent of GDP in 1991, even in a very soft labor market.

Responding to the particular conditions of Eastern Europe, an alternative method of privatization has been conceived--mass privatization--that distributes ownership basically for free to the citizens at large. These "voucher schemes", despite their appealing features in terms of speed and equity considerations, may present some problems regarding the makeup of corporate governance that would emerge in the newly-privatized enterprises, a problem that may have delayed its implementation in Poland. But considering that economics does not (yet) offer decisive results on the issue of optimal structure of corporate governance, at either a theoretical or empirical level, there is little justification to delay the privatization process in an attempt to refine the ownership structure.

Given the technical and political difficulties in implementing any mass privatization scheme, the one scheme that is actually in the process of implementation, that of Czechoslovakia, deserves special attention. 1/ The scheme surely does not address all the capital market imperfections and principal/agent problems but it is very simple and is proving to be workable. Under this scheme, all citizens can purchase vouchers that can be used for direct acquisition of enterprise stock or for deposit with investment privatization funds (IPFs) in exchange for shares in the funds.

Some concerns have been voiced regarding a presumably insufficient regulation of IPFs. One reason is the possibility that some IPFs become the vehicle for highly-leveraged acquisitions that could jeopardize the already fragile financial system. Concern has also been aroused by advertising claims made by a number of IPFs, which offered a "guaranteed return" to voucher holders, such as the option to sell their IPF shares for a price ten times the original cost of the vouchers after one year. The first problem--the potential conflict of interests arising from IPF/banks cross ownership--appears to be very serious and should prompt a policy response; to the extent that this problem is taken care of, however, the issue of promises of a guaranteed return is of no consequence.

If an IPF acquires a large equity position in a bank, it could gain almost unlimited access to financing for "empire building" (including buying out original voucher holders). Although deposit insurance does not exist formally, the large size of existing banks and the remaining state

1/ The impending breakup of the country did not interfere with the first "wave" of mass privatization. After the breakup, however, only the Czech Republic will continue the execution of the mass privatization program.

participation in their ownership would certainly reassure depositors. This situation could lead to a repetition of the experience of Chile following its first wave of privatization in the 1970s. After privatization, a highly-leveraged capital structure emerged, with a few consortiums controlling all major banks and enterprises. When the business cycle turned down, banks were logically reluctant to force enterprises into bankruptcy and, in the end, a major financial crisis developed in the aftermath of which most banks and enterprises had to be renationalized. 1/ The already weak financial position of the banking system in Czechoslovakia--as elsewhere in Eastern Europe--makes this scenario all the more likely. Regulatory steps to avoid conflicts of interest in the banking industry should become a priority in any Czechoslovak-type of mass privatization scheme.

The potential problems with promises of guaranteed return are more apparent than real. In the first place, given that vouchers were sold at a nominal value, a tenfold return on the vouchers is in fact in the right ballpark for a well-diversified portfolio of shares. The book value of the enterprises included in the first wave of voucher privatization is more than *thirty* times the total value of the sold vouchers. In the second place, the "option" offered to voucher-holders guaranteeing a sale price for their IPF shares is a completely empty one. If after one year, the IPF shares trade in stock markets for a price that is higher than ten times the original cost of vouchers, no shareholder would exercise the sale option. If, on the

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1/ See Luders (1990). Later, a second wave of privatization took place that provided a much more solid financial footing for enterprises and which is now considered a prime example of successful privatization.

other hand, shares trade at a lower price, all shareholders would, in principle, want to sell. However, management would not be able to secure financing for such an operation (except if, as in the case discussed above, the IPF controls a bank) and it would have to forfeit its promise. 1/ This means that the return obtained by depositing the vouchers with a particular IPF will always be equal to the market value of the IPF, and will never be affected by the "guarantee" of a tenfold return. The "put option" on IPF shares will not be exercised under any circumstances and thus has no value.

Even under a more sophisticated view of financial markets, in which the managers of the IPF have some informational advantage over the average shareholder in assessing the value of the IPF, this sale option still has no value, essentially for the same reason demonstrated by Grossman and Hart (1980) in the context of takeovers. Because the IPF management would want to purchase shares only if their "true" value is higher than ten times the voucher value, no shareholder should want to sell his or her shares if management has actually secured financing and is willing to maintain its promise. Of course, if management does not appear prepared to follow through with the share repurchase offer, shareholders cannot exercise the sale option even if they try to. Again, in no event would the actual return on IPF shares be affected by the promised returns.

1/ One could speculate that this could trigger a removal of managers by shareholders, but such an option is always available to dissatisfied shareholders.

But then, why did investors flock to those IPFs offering the guaranteed return. It is possible that some investors perceived the offer as a valuable option or those IPFs that offered guarantees as the most worthy ones. In fact, contriving the guaranteed return idea speaks well of management's abilities. In any event, in a year's time, if share prices exceed the guaranteed price, it should be clear enough, even to the least sophisticated investor, that it is more convenient to sell the shares in the stock market than to the IPF management.

V. An Industrial Policy for PCPEs?

The massive resource reallocation that is in prospect, together with the insufficient development of markets and institutions, suggests a case for an active role of government in monitoring the productive restructuring process. First, it would be important to mention some arguments that are *not* valid to justify government involvement in this process. For example, the presence of large adjustment costs associated with the reallocation of economic activities is not a valid justification for government involvement for the purpose of trying to lengthen (or shorten) the transition process. This is because, in the absence of economic distortions, there is no difference between the private and the social adjustment cost, and the speed of adjustment resulting from private investment decisions should be the optimal one. 1/ There are, however, some reasons that may carry more weight on the basis of macroeconomic or institutional deficiency arguments.

1/ Mussa (1984) makes this point.

One line of reasoning would be to suggest a slowdown in the restructuring process to take into account a macroeconomic externality, that is the risk of triggering a deep recession if a large number of enterprises collapse simultaneously. One appealing way to slow down the decline of less competitive industries would be the imposition of a uniform, temporary tariff on imports. The case for the tariff is, in fact, twofold: (1) to provide fiscal revenue in view of the time required for tax reforms to be introduced, and (2) to offer a longer time period to adjust (or to phase out) for industries that cannot easily compete with imported products. However, to some extent, all subsidization policy is distortionary and other sectors of the economy must necessarily bear the brunt of the policy. It should be noted that even in the case of a "no-exceptions" uniform tariff the degree of protection granted to different sectors would vary according to the incidence of imported inputs in each activity. Moreover, since the real exchange rate consistent with a given trade balance would be more appreciated, the introduction of the tariff would directly affect the export sector, which is probably among the most efficient and dynamic sectors of the economy. While slowing down the decline of noncompetitive industries may be desirable, the case for retarding the takeoff of the competitive industries is less clear.

Another line of reasoning would argue that, owing to the underdevelopment of markets and legal institutions and because of particularly serious information deficiencies, private markets would not do a very effective job of resource reallocation and some government stewardship would be required. The problem with this argument is that the ability of government to select the most profitable investments ("picking winners") is also highly suspect. After all, the countries of Eastern Europe, particularly those with more rigid central planning systems, have had complete state control over all investment and resource allocation decisions for decades, with dismal results. Moreover, despite the noted shortcomings in financial markets and legal institutions, the potential returns to picking winners are so high that, under appropriate regulation, the private sector should not take too long in creating sufficient investment banks, market analysts, and so forth, to provide these services.

In fact, the state could have a greater role in "picking losers", namely, enterprises that are not viable but which continue to operate because bankruptcy proceedings do not get started. Considering the prevailing macroeconomic conditions and the expected high level of resource reallocation activity, the observed number of bankruptcies has been very low. 1/ The reasons for the small incidence of bankruptcies include the fact that most enterprises are still state enterprises which may assume that "hard budget constraints" are not totally applicable yet, the lack of appropriate laws or legal institutions, and an insufficient expertise on the part of banks and enterprises to take the initiative. A more active role by government in this area may be necessary, including reinforcing "safety net" provisions where necessary to facilitate proceedings.

But there is also the risk that too many bankruptcies may take place. This risk emerges from the high level of indebtedness with which enterprises

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1/ Under a new law, the number of bankruptcy proceedings initiated in Hungary has risen considerably in 1992.

were saddled at the time of market liberalization. Because bankruptcies are economically costly, it seems desirable to protect enterprises that are otherwise profitable. Also, large inter-enterprise debts may worsen information problems and uncertainty. The enterprise debt problem, however, is not easy to deal with. While some large, across-the-board cancellation of debt would have made sense at the outset of the reform program, the same measure does not seem appropriate after three years during which monetary authorities have maintained the position that budget constraints had definitely hardened for enterprises. A debt write-off would be effective only if it is absolutely believed that such write-offs would not be repeated in the future; otherwise, moral hazard problems would be exacerbated, and debts will quickly grow again after cancellation. The experience with multiple debt cancellations in Romania is relevant in this respect. 1/

Privatization may offer, however, an appropriate opportunity to deal with the enterprise debt problem in as clean a way as possible. In the case of standard privatization, reducing debt would simply increase the value of the enterprise one-for-one and should pose no major problem; the advantage of reducing debts, in a non-Modigliani-Miller context, should come from preventing unnecessary and socially costly bankruptcies and strengthening the financial markets. In the case of nonstandard or "voucher" privatizations, a one-time-only debt write-down could be effected at the time of privatization; since privatization will not be repeated, this should not affect the credibility of the monetary authorities for the

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1/ See Khan and Clifton (1992) for an analysis of the enterprise debt problem in Romania.

future. 1/ It would also be possible to use debt write-down as an inducement for enterprises where management and/or workers are resisting privatization. While even voucher privatization generates some revenues that could partly offset debt reduction costs, it is clear that the write-down would have a fiscal impact. However, it must be taken into account that the contingent obligations of the monetary authority arising from its "lender of last resort" function would be greatly reduced by a write-down of enterprise debts, and thus the net effect may not represent a large additional burden on government finances.

1/ There is a moral hazard problem, however, in the intervening period between the announcement of the debt write-downs and the consummation of privatization, but it should not be hard to find ways to counteract this effect.

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