The Second
RAND/DIW/IFO Conference
and the Implications of the
Evolving German-American
Economic Relationship

Robert Levine (Editor), Lutz Hoffman,
Heiner Flassbeck, Kazimierz Laski,
Frederich Levcik, Charles Cooper
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German Marshall Fund
PREFACE

This report presents a summary of proceedings, and four key papers, from the second RAND/Deutsches Institut für Wirtschaftsforschung (DIW)/Ifo-Institut für Wirtschaftsforschung workshop/conference, entitled "The Implications of the Evolving German-American Economic Relationship." RAND is an American non-profit research corporation; DIW and Ifo are two of the five economics research institutes sponsored by the German government.

The first conference took place in Duesseldorf, 23-24 November 1992. This one was held in the RAND Washington offices, 10-11 June 1993. It was supported in part by the German Marshall Fund. Participants included approximately thirty American, German, and other European economists, political scientists, and public officials. A list of participants is appended to the summary, which attributes no views to individuals or institutions.

The four papers included here are:

- Lutz Hoffmann (DIW), "Adjustment Processes in East Germany: Current Position and Outlook"
- Heiner Flassbeck (DIW), "The Implications of Different Labor Market Regimes in Europe and the Lessons from German Unification for the EMS and EMU"
- Frederich Levcik (Wiener Institut für Internationale Wirtschaftsgleiche), "Die Transformation der Wirtschaft im Osten" (An oral summary of the English-language version was presented at the conference by the Director of the Study Group that originated it, Kazimierz Laski. The written English-language version, "Transition from the Command to the Market System: What Went Wrong and What to Do Now?" was too long for this publication, but the introductory and concluding portions are also included here.)
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- Charles Cooper (RAND), "Western Assistance to Eastern Transition"

Substantial thanks are due to the skilled rapporteur for both conferences, Denise Quigley of the RAND Graduate School.
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SUMMARY OF PROCEEDINGS

OVERVIEW

This overview summarises the proceedings of two days of sessions of the second RAND/DIW/Ifo conference, entitled "The Implications of the Evolving German-American Economic Relationship." The first conference took place in Duesseldorf in November 1992. The central objective of both has to be to explore economic developments in the two nations that are central to Atlantic and European prosperity, and the implications of these developments for world stability and security.

The overview of the November Duesseldorf meeting began with the following paragraph.

The purpose of the original RAND project and of the two conferences is to understand, and explore certain policy implications of, the vast changes that have been brought about by the collapse of the Soviet empire, the unification of Germany, and the consequent rearrangement of Europe and of the world economy. In particular, the relationship between the United States and (then-West) Germany had long centered on their roles as the two strongest pillars in what was primarily a military structure designed to deter/defend against Soviet aggression on West Europe. The new focus remains on Germany and the U.S., but now as two of the major pillars of a world economy under strain. Germany and the U.S. must take particular responsibility for Europe, including the collapsing economies of the former Soviet Union (FSU) and East Europe; and Germany remains the keystone of European integration. Even the security and political stability of Europe, once dependent on defense, now depend much more on creating and maintaining economic stability in the eastern as well as the western portions of that continent.

The conclusion of the overview was that:

For the conversion to market economies of Russia and the rest of the East, for the consequent political and economic stability of Europe as a whole, and for the restoration of the world trading and monetary systems, leadership is needed. Economic leadership must come from the G-7, and the leaders of the G-7 continue to be the United States and Germany. But the
United States is turning inward to confront its own problems; Germany is faced with the unsolved and enormous problem of rebuilding its own neue Bundesländer. The most hopeful notes come from the vigor of the new American administration, from the long-run opportunities that several German participants saw in central Europe, and perhaps from the observation by one that these things are always cyclical anyhow.

By the time of the second conference, in Washington in June 1993, very little had changed in either the description of the job to be done or the qualified pessimism about the possibility of doing it. If anything, pessimism had extended to the capability of the Clinton administration to turn the United States around, as seen five months after the inauguration of the new president. This degree of pessimism affected the tone of the second conference as compared to the first in one ironic way—less disagreement was manifest between the German and the American participants.

The second conference took place before three crucial events in the summer of 1993: in the United States, the passage of the administration's changed budget by the Congress; in West Europe, the partial breakdown of the Exchange Rate Mechanism (ERM); and in Russia, the failed revolt against Yeltsin. The fact of the budget passage, if not necessarily the contents, may qualify the June doubts with regard to the U.S., but the happenings in Europe, East and West, are likely to deepen even further the general pessimism.

The Washington conference covered five major topics. The remainder of this overview summarizes briefly the discussions of each of these. To characterize them initially, they were:

- **Germany.** Pessimism continued about the speed of reconstruction in the east, and partially in consequence, about turnaround in the all-German economy.
- **West Europe.** Even before the ERM events, great doubt was expressed about not only the timing of the European Monetary Union (EMU) and the political aspects of EC's Maastricht agreement, but even about their possibility.
- 3 -

- Russia and East Europe. Although the discussion on this topic was marginally more optimistic than it had been in November, the overriding note was realism, particularly about the small assistance that might be available from the western world.

- The United States. Less hope was expressed than in November concerning U.S. capabilities to turn around world economies.

- The World. Substantial discussion took place concerning the differences between "zones of peace" and "zones of turmoil." Little doubt was manifest about the ability of the zones of peace to maintain their own stability (before the ERM break), but also little confidence in their ability to help stabilize the zones of turmoil.

GERMANY¹

Several of the American participants noted that the Germans tended to treat "Germany" and "East Germany" as separate and almost mutually exclusive categories. The central economic reason for this was clear. In spite of the downturn, the economy of the old Federal Republic remains sound; for example, unemployment is substantially below that of the rest of EC and the United States. Unemployment is still so high in the east, however, even without counting various sorts of subsidized employment, that the overall national rate is high.

For western Germany, the theme was pessimism but not black pessimism. None of the Germans felt that the downturn would last a long time, although predictions about when the economy would turn up varied and nobody looked for a clean reversal in 1993. One cloud for the future rises from the fact that the German economy is largely export-driven, and worldwide recession and increased international competition do not bode well for German exports. Some hope was expressed--more than at the November meeting--that wage agreements were coming into line. The hope was rather less that the fiscal balance would improve to the

¹The paper by Lutz Hoffman, included in this report, is primarily concerned with the issues in this category. The paper by Heiner Flasbeck also touches on them.
point where the Bundesbank would significantly cut interest rates, or, to make the point more clearcut, that the Bundesbank would realize the need of the German and European economies for a rate cut in any case. (The mid-summer refusal of the bank to make major cuts, predicted by a German participant, and the subsequent crumbling of ERM, justified that pessimism.)

In east Germany, the turnaround has begun in the sense that growth is positive rather than negative as it has been in recent years. And, according to the German participants, the Treuhandanstalt has done well in its choice of firms to sell off or to liquidate, with not too much emphasis on trying by itself to restructure them. Nonetheless, a plausible rate of investment in the east will lead to equality between the two sections only in twenty years. And the easiest sales and conversions of eastern firms have already taken place. Best off have been the industries whose demand stems primarily from consumption in the region or from the construction sector. The heavy industries and those that must now compete internationally lag; they are the ones that dominated the economy of the former German Democratic Republic. The wage structure of the east makes it non-competitive with other states of the former Soviet bloc, so the outlook remains mixed.

What is most clear is that the need for investment and social subsidies from the German government will continue for many years, and therefore so will the drag on the West German economy. So long as the financing of reconstruction continues its current relative dependence on monetary as compared to fiscal policy, the drag on the economies of the rest of West Europe will continue too.

WEST EUROPE

Since changes in the needs of eastern Germany, the balance between German fiscal and monetary policy, or the discipline of the Bundesbank, seemed unlikely in June and seem even less likely after the cracking of

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2The paper by Heiner Flassbeck focuses on some of the issues discussed here, particularly those concerning the relationship of wage rates and exchange rates.
the ERM, the short-run outlook for West European economic turnaround is not bright. Given general agreement that politics follows economics and that the economic aspects of Maastricht were the more real (or at least the more immediate) ones, even the Danish turnaround on ratification did not change the picture of at best slow progress toward political as well as economic integration.

More fundamentally, however, a number of the Germans expressed substantial doubt that the economic convergence conditions for initiating the EMU would be met on schedule, or perhaps ever, or even that they should be met. Those conditions, having to do with inflation, stable exchange rates, long-term interest rates, and public deficits and debts, depend centrally on wage levels and labor-market structures, and these show no signs of adjusting among the members of EC. Lacking such adjustment, it was suggested that all that remains to achieve economic adjustment among the members is the play among exchange rates—permitted to be 2.5 percent in June, 15 percent after the break in the ERM, but zero under a true EMU. One German objected to that, however, on the grounds that the monetary illusion had departed from Europe, and thus real wages would have to adjust. On the other hand, an American contended that the problem is less wages as such than the costs of the European social net, well established in all EC member nations including (or particularly) Germany, which makes all of Europe non-competitive with much of the rest of the world.

The complete consensus, in any case, is that it's a long way to EMU and even longer to the rest of Maastricht. "Deepening" of EC will be very difficult. As the discussion of the next topic indicates, so will "widening."

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**EAST EUROPE**

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3 The papers by Lutz Hoffman and Heiner Flassbeck touch on these issues. Those by Kazimierz Laski and Charles Cooper focus primarily on them.
The first conference spent a substantial amount of time discussing whether microeconomic restructuring of former communist economies has to precede the imposition of effective macroeconomic constraints or vice versa. The Washington meeting touched on this again, again reaching no consensus on the chicken-or-egg question, although several of the papers threw more theoretical and experiential light on the issues. The conclusion of one paper, that the need is for both macroeconomic control of general wage levels and microeconomic adjustment of relative wages, may have summed it up. One new and strong argument presented in another paper, however, was that, whatever the conceptual validity of the need for macroeconomic control, the stringent regimes imposed by the International Monetary Fund were failing, imposing far too many constraints on real economic activity in their quest to control inflation.

More of the discussion focused on the role of the West in assisting transitions in the East. Here it was generally agreed that although the West had major contributions to make, much the greatest part of the job must be internal to the East, particularly in Russia. The analogy to the Marshall Plan, presented in one paper, was discussed. The conclusion was that although the Marshall Plan can bring useful insights to matters such as planning and cooperation, the task of reconstructing command economies in the 1990s is too different from that of reconstructing ruined market economies in the 1940s, and the resources available too much smaller relative to needs, for any useful direct analogies. One clear point is that trade is more powerful than aid, but in the light of the prognosis for West Europe, little optimism was available in this regard.

Thus, if deepening of the EC will be very difficult, widening will be a long time in coming, at least if it is conditioned on real transition of eastern economies to western standards and levels.

Substantial dialog was devoted to the question of whether Western aid was sufficient (agreed not), or necessary (consensus although not full agreement that it was) to Eastern reconstruction. Perhaps the minimal agreement was that it can be helpful and important, if done
right. What is "right," however, remains a difficult question, going back into the micro-versus-macro issue and that of conditionality, including conditionality on security steps in addition to economic ones.

Issues, policies, and prognoses must all be expressed in shades of gray. In looking at the future, the lightest grays remain in Poland, the Czech Republic, and Hungary, with Russia darker, and Ukraine—too frequently ignored—the darkest among major states.

THE UNITED STATES

The prognosis for the U.S. economy continued to be for slow growth. The Clinton budget (in June, two months before final passage) was assessed as neither impeding nor assisting that; partisan and other debates about the budget were over sums of money too small to make a difference. What happens to health care will determine a lot, for the budget and for the economy, and the prognosis is quite unclear. Major, if somewhat hidden, issues concern income distribution, particularly the perceived substitution of low-paying relatively unskilled jobs for higher-paying blue-collar jobs.

It is the distributional issues that have caused many Democrats to become protectionists, while the Republicans are now free traders. This is particularly true with regard to the North American Free Trade Area (NAFTA). Outside of the Western Hemisphere, most of the U.S. pressure toward protection is directed at Japan, not Europe.

Too much attention is devoted to the merchandise balance of trade, which is in greater deficit than the overall balance. This goes back to the feeling that goods, included in the merchandise balance, are more "real" than services which are outside that balance; the U.S. exports much more relatively in the service category. There was general agreement that services should count as heavily as goods, although this goes back to the issue of distribution of jobs and income, and loss of manufacturing jobs in particular.

In general, the United States was portrayed as presenting fewer problems internally than the major European economies, but far from being available as a major support for either West or East Europe. The
political scientists present confirmed this for the sphere of political and security support as well as economics.

THE WORLD

The concept of "zones of peace" and "zones of turmoil" was debated with no conclusion even as to whether the concept itself is meaningful. One key point that was agreed to was that it is extremely unlikely that the rich nations of the world will go to war against each other in the foreseeable future. Since conflicts among these nations caused the two world wars of the twentieth century, this is important, but it does not solve today's problems.

In spite of this major difference, analogies were drawn between the world of the 1990s and that of the 1920s-1930s. The current worldwide economic malaise, although it has different roots from that of the 1920s, seems as difficult to solve and is causing some of the same worldwide tensions; but nobody predicted descent into a great depression of the 1990s. In addition, however, the virulence of local nationalisms, and the consequent border-transcending tensions can hark back to the earlier period. The question was asked: But if we are not going to go to war with one another, why should we care? There was general agreement that at least part of the answer lies in the existence of nuclear weapons in the hands of unstable states in the zones of turmoil.

The conference did not end on a high note of optimism. The consensus was that the world, Europe, and the Atlantic have many current problems--the focus of this conference was on economics and the majority of the participants economists, so that economic problems were given primacy--and not many current solutions. The horizons for the solutions hoped for a few years ago--economic and monetary integration of Europe, GATT, restoration of newly freed eastern economies with western assistance--seem further away now than they did then.

If there was a division over degrees of pessimism, it was not between Europeans and Americans, but between political scientists and government officials on the one hand, who had an open view on the
ultimate possibilities for Maastricht and the freeing up of world trade, and the economists on the other, who viewed the future more darkly and dourly.
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Jed Johnson (Association of Former Members of Congress)
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Wolfgang Gerstenberger (Ifo)
Lutz Hoffmann (DIW)
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James Currie (EC Commission to the United States)
Kazimierz Laski (Wiener Institut fur Internationale Wirtschaftsgleiche)
Adjustment processes in East Germany

Current position and outlook

Viewed economically, the monetary union which was completed on 2nd July 1990 was an exogenous shock for the economy of the former GDR. It took the form of a sudden complete liberalization of foreign trade in an economy which had been almost totally cut off from international competition for decades, and costs and the prices of inputs increased by 400%. From a sober economic angle it was an historically unique experiment which provides interesting information on the effects of exogenous shocks. A full assessment will take years. Nevertheless, a number of consequences can already be well documented.

I. A supply or demand shock?

Gross domestic product in East Germany fell by over 16% in the first year after unification, and by over 30% in the second (figure 1). This is often put down to a demand shock, which is explained firstly by the loss of markets in East Europe and secondly by the fact that last year the Treuhandanstalt especially complained of a lack of markets for the products of East German firms. In fact, in macroeconomic terms, there was never a lack of demand in East Germany. During the whole of the adjustment period so far East German domestic and also total demand (which includes that for exports) has exceeded domestic supply.

The East German supply deficit, which grew rapidly after the monetary union, clearly shows that the shock of the monetary union primarily affected domestic supply. The loss of orders from East Europe certainly led to considerable difficulties in the export-orientated branches of East German industry. If these firms had been competitive, however, they would have been able to compensate for this by increasing supplies
within Germany or to other countries in West Europe, as happened in the cases of the Czech Republic and Hungary.

In comparison with these two countries and Poland, however, the price competitiveness of East German industry was many times worse. This was partly because of the revaluation effect of the monetary union and partly because of the explosion of wage costs as a consequence of the rapid adjustment of East German standard wages to the West German level. As figure 2 shows, macroeconomic unit labour costs have increased rapidly in the last three years. Maintaining a hold on the domestic market and increasing market share on Western export markets was and remains out of the question under these conditions.

The wage costs explosion in East Germany did not only undermine competitiveness, but eliminated almost all profits. Figure 3 shows the difference between productivity and labour costs on an hourly basis for both West and East Germany. Whereas there is a relatively stable difference for West Germany which allows scope for firms’ profits after capital costs, the difference was small in East Germany from the beginning, but it reached zero in the first quarter of 1991 and has been negative ever since.

The effect on foreign trade of the low competitiveness of East Germany was a massive increase in imports and lower exports, which led to an ever more quickly increasing current account deficit with West Germany and other countries (figure 4). East German imports exceeded gross domestic product by 5% in 1992, and the current account deficit was over four fifths of GDP.

Figure 4 also clearly shows that the West German current account balance further improved through German unification, albeit on a smaller scale, whilst the East German current account deficit increased. This means that West German producers diverted supplies from exports to East Germany and that Germany’s trading partners also profited considerably from the increase in East German demand for imports through increasing German imports.
II. Structural distortions

The transformation process is bringing longer term structural changes and temporary structural distortion in all former socialist countries. At the current time the latter dominate. In East Germany these take a different form which is linked with German unification.

On the demand side the main impact comes from transfer payments, but also investment on the part of West German firms. In 1989, the first year, the propensities to consume and invest in the former GDR were comparable with those in West Germany (figure 5). In the East the propensity to consume was slightly higher and the propensity to invest slightly lower than in the West. The rapid rise in the propensity to consume in 1990 and 1991 is because of the massive decline in gross domestic product. Real consumption remained relatively stable because of the income transfers.

With a sharp decline in domestic output the propensity to invest would normally also be expected to fall. This is overwhelmingly the case for the Central and East European countries in the transformation process, but exactly the opposite happened in East Germany. The reasons for this are the rapid acceleration of public investment (after an initial delay) and the investment of West German firms. The macroeconomic propensity to invest in East Germany is currently 54%, which is a world record. A further increase is expected next year.

On the supply side the structural distortions caused by the monetary union are even more marked than those on the demand side. As figure 6 shows, the share of manufacturing in East German gross domestic product in 1989 was only slightly lower than in West Germany. In the first two years after German unification this share fell to a half, which roughly corresponds to the structure of a middle-income developing country such as Sri Lanka or Honduras. The much complained deindustrialization in East Germany has therefore already taken place. Countering it was a rapid increase in the construction industry and in consumption- and firm-related services outside the traditional service branches of commerce, transport and the state.
The sharp decline in manufacturing is basically a consequence of the factors influencing competitiveness mentioned above. Particularly sharp declines were suffered by the industries competing interregionally and internationally, such as mechanical and electrical engineering, office machines, footwear and leather processing and textiles and clothing (table 1). Industries producing goods closer to consumption and for regional markets (foodstuffs, printing) and suppliers to the construction industry (minerals, steel and light metals), which profited considerably from public orders and private investment, were able to expand, however. Industries in which the Treuhandanstalt is still very active, e.g. iron and steel and chemicals, show a certain, if fragile stability.

III. Investment and Privatization

Investment is the decisive motivating force behind economic recovery in East Germany. Table 2 provides an estimate of total investment in East Germany by industry. From this it can be seen that from 1991 to 1993 around a third of investment was in so-called producing industries and almost two thirds was in services. It is not possible to subdivide investment within an industry into private and public sources.

The privatization carried out by the Treuhandanstalt has been subject to much controversy. Objections were raised at an early stage to a forced privatization process, because this would bring such a large number of firms onto the market that the attainable prices would be very low. Furthermore, those people entrusted with the privatization must have expert knowledge and therefore often come from areas close to the West German business sector, so that conflicts of interests are unavoidable. Corruption and shady deals always appear when the state moves large sums between the public and private sectors and there is no control system.

In spite of all these reservations, which are certainly justified, the basic idea to carry out the privatization quickly was correct, as without it there would not have been so much private investment. In view of the rapidly improving conditions for investment in Central Europe many investors who a year or two ago would still have chosen East
Germany would certainly now rather invest in the Czech Republic, Hungary, Slovenia or Poland, where labour costs are many times lower and the difference in labour costs with West Germany will continue to exist in the longer term.

The dynamics of privatization are shown in figure 7. The increase in the total number of former Treuhand firms from 8,000 at the beginning of the year to around 13,000 now is a result of the splitting-up of the combines and the nationally-owned firms. Around 5,300 firms have been privatized so far and over 1,300 firms were completely reprivatized, that is given back to their former owners. Together these represent more than half of the total. Of the remainder around 2,700 are in liquidation, which is a lengthy process, and liquidation has only been completed for 50 firms. The Treuhand is also involved in a further almost 1,900 firms which it still fully owns, 500 firms which are not to be completely privatized, and there are around 230 cases which involve property (e.g. forestry firms).

It has been observed that changes in structure and renewal of capital stock are very difficult to carry out under the aegis of the Treuhand, because the Treuhand employees responsible for the firms neither possess the knowledge nor the willingness to take risks required to grant and accept the responsibility for the corresponding investment. When there is doubt investment was postponed, often justified with the claim that a future privatization should not be prevented through bad investment.

As Table 3 shows, the amount of investment per employee in Treuhand firms was only half as much as in private firms in 1991, and in 1992 it was under a third. Investment in private firms has also increased far more rapidly than investment in Treuhand firms. Investment per employee was particularly high in West German-owned firms. This clearly shows that the rapid privatization made a considerable contribution to the stimulation of private investment in East Germany. A policy geared firstly towards the renovation of firms by the Treuhandanstalt and only then towards privatization would certainly have produced less investment, and in many cases firms would have lost the race against time because their capital stock was rapidly becoming out of date.
IV. Lasting unemployment

The adjustment process in East Germany differed most from that in the Central European countries on the labour market. There were considerably more job losses in East Germany. In the coming year employment in East Germany will probably fall below 6 million and thereby lie 40% lower than before the monetary union (figure 8). This sharp decline in employment is certainly only partly a result of falls in output. In all the socialist countries there were a substantial number of workers in the business sector who would not have been kept on under competitive conditions and sometimes had little to do with the production process. Nevertheless, the decline in employment in East German manufacturing industry is extraordinarily high. Compared with this unemployment is moderate, at around 1.1 million in the second quarter of 1993. A number of factors have contributed to this.

Between the first quarter of 1990 and the first quarter of 1993 the East German population fell by 750,000 through emigration to West Germany. Of these people at least half a million may have been of working age. Almost 900,000 people of working age are receiving benefits until they are old enough to retire or have taken early retirement. All the 250,000 people of pensionable age previously in employment have stopped working. Almost 140,000 workers are employed in employment creation schemes and 380,000 are in full-time further education. Around 400,000 regularly commute to West Germany, compared with 60,000 commuters to East Germany. The number of foreign workers has fallen by over 100,000, and there are 230,000 short-time workers.

The expectation of a stabilization of unemployment at the current level is based on the assumption that the phase in which productivity gains are achieved through redundancies and not increases in output is at an end. Furthermore, those sectors which have lost the most workers, manufacturing industry and agriculture, may now be at a level of employment which cannot plausibly be reduced with moderate macroeconomic growth. Employment still needs to be reduced to a certain extent in
the public sector, although this may be more than compensated by further increases in employment in other branches of services.

V. The outlook for East Germany and conclusions for economic policy

After two years of sharp reductions in output East Germany achieved positive growth of 6.8% last year. Growth of 4.8% is expected for this year, which is lower than the previous year partly because of the recession in West Germany, and next year stronger growth of around 7% is again expected.

In purely mathematical terms the growth rate of a country is identical to the product of the propensity to invest and the reciprocal of the marginal capital coefficient. If we take this value as an approximation for the marginal productivity of capital then, in simplified terms, the growth rate is equal to the product of the propensity to invest and the marginal productivity of capital.

Figure 9 shows that the East German propensity to invest has risen constantly since 1989 and has now reached an extraordinarily high level. The marginal productivity of capital has also been positive since 1992. In 1992 it was 13% and it will be almost 9% in 1993. It is therefore around the average of the values achieved by West Germany since the beginning of the 1970s.

Assuming that in East Germany a propensity to invest of 50% can be maintained for some years, then a growth rate of 10% would mean that the marginal productivity of capital would have to be around 20%. This does not seem very plausible in view of the fact that much of the newly emerging industrial activity in East Germany is more capital-intensive than in West Germany. If a marginal productivity of capital of 14% could be reached and maintained in the medium term, a growth rate of 7% could be expected. Growth rates of 10% and more, which appear in the forecasts of many firms providing professional advice and are also occasionally mentioned in public, seem most implausible. With growth of 7% it would take around 20 years for the performance of the East Germany economy, measured in terms of labour productivity,
to be brought into line with West Germany.
Figure 1

Trends in GDP-growth in East and West Germany
- % change on previous year, in constant prices -

DIW '93
Unit Labor Cost in East and West Germany

Source: DIW National Accounts Statistics.

DIW '93
Figure 3

Labor Cost and Productivity per Hour

- West Germany
- East Germany


Labor Cost  Productivity

DIW '93
Figure 4

External balance
- DM Billion, constant prices -


DIW '93
Propensity to consume (C/Y) and to invest (I/Y) in East and West Germany, - constant prices, share in % -
Figure 6

Share of Manufacturing (1), Services (2) and Construction (3) in GDP in East and West Germany - constant prices, share in % -
Table 1

Structure of Manufacturing Industry in East Germany
- share in % -

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<td>II</td>
<td>I</td>
<td>II</td>
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<tr>
<td>Total Manufacturing Industry</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>- Oil refining</td>
<td>2.2</td>
<td>4.0</td>
<td>4.2</td>
</tr>
<tr>
<td>- Quarrying</td>
<td>4.8</td>
<td>3.9</td>
<td>5.1</td>
</tr>
<tr>
<td>- Iron production</td>
<td>2.6</td>
<td>3.0</td>
<td>2.3</td>
</tr>
<tr>
<td>- Non-ferrous metal production</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
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<tr>
<td>- Foundries</td>
<td>1.6</td>
<td>1.5</td>
<td>1.2</td>
</tr>
<tr>
<td>- Steel and light-metal construction</td>
<td>5.2</td>
<td>7.5</td>
<td>9.6</td>
</tr>
<tr>
<td>- Engineering industry</td>
<td>23.6</td>
<td>18.3</td>
<td>18.5</td>
</tr>
<tr>
<td>- Automobiles</td>
<td>3.3</td>
<td>2.9</td>
<td>2.1</td>
</tr>
<tr>
<td>- Electrical engineering</td>
<td>15.7</td>
<td>11.5</td>
<td>11.1</td>
</tr>
<tr>
<td>- Precision mechanics, optics, watchmaking</td>
<td>2.4</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>- Sheet metal</td>
<td>1.1</td>
<td>1.9</td>
<td>1.8</td>
</tr>
<tr>
<td>- Chemical industry</td>
<td>8.3</td>
<td>9.4</td>
<td>10.1</td>
</tr>
<tr>
<td>- Production of office and data processing machinery</td>
<td>1.3</td>
<td>0.9</td>
<td>0.5</td>
</tr>
<tr>
<td>- Woodindustry</td>
<td>2.3</td>
<td>2.8</td>
<td>2.5</td>
</tr>
<tr>
<td>- Paper and cardboard processing</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>- Printing and copying</td>
<td>1.6</td>
<td>2.5</td>
<td>3.1</td>
</tr>
<tr>
<td>- Plastic-goods production</td>
<td>0.9</td>
<td>0.8</td>
<td>0.9</td>
</tr>
<tr>
<td>- Leather processing</td>
<td>1.2</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>- Textiles</td>
<td>3.0</td>
<td>2.1</td>
<td>1.8</td>
</tr>
<tr>
<td>- Clothing industry</td>
<td>1.1</td>
<td>0.7</td>
<td>0.6</td>
</tr>
<tr>
<td>- Food, drink and tobacco</td>
<td>12.6</td>
<td>17.6</td>
<td>16.9</td>
</tr>
</tbody>
</table>

Sources: Federal Statistical Office. Wiesbaden; DIW.
Table 2

Investment in East Germany by Industry

- in billion DM\(^a\) -

(April 1993)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Investment in billion DM(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture/Forestry/Fishing</td>
<td>1.5</td>
</tr>
<tr>
<td>Producing industries</td>
<td></td>
</tr>
<tr>
<td>- Energy/water, mining</td>
<td>8.3</td>
</tr>
<tr>
<td>- Manufacturing</td>
<td>16.5</td>
</tr>
<tr>
<td>- Construction</td>
<td>3.6</td>
</tr>
<tr>
<td>Trade</td>
<td>4.5</td>
</tr>
<tr>
<td>Transport and telecommunications</td>
<td>15.7</td>
</tr>
<tr>
<td>Other services</td>
<td></td>
</tr>
<tr>
<td>- Residential housing</td>
<td>20.4</td>
</tr>
<tr>
<td></td>
<td>12.5</td>
</tr>
<tr>
<td>Total industry</td>
<td>70.5</td>
</tr>
<tr>
<td>Government and non-profit organisations</td>
<td>14.0</td>
</tr>
<tr>
<td>Total</td>
<td>84.5</td>
</tr>
</tbody>
</table>

\(^a\) Estimates of ifo Institut, Munich.

Sources: ifo Schnelldienst 11-12/93; Federal Statistical Office, Wiesbaden.
Table 3

Investment per Employee
in East German Manufacturing Industry,
1991 and 1992\textsuperscript{1)}

- DM -

<table>
<thead>
<tr>
<th>Ownership types</th>
<th>1991</th>
<th>1992\textsuperscript{1)}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms owned by the Treuhandanstalt</td>
<td>11,070</td>
<td>12,860</td>
</tr>
<tr>
<td>Privately owned</td>
<td>25,330</td>
<td>40,040</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Autonomous firms</td>
<td>20,590</td>
<td>27,530</td>
</tr>
<tr>
<td>- Firms owned by west German firms</td>
<td>29,570</td>
<td>54,100</td>
</tr>
<tr>
<td>- Firms owned by foreign firms</td>
<td>28,570</td>
<td>39,100</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Firms founded since 1989</td>
<td>47,360</td>
<td>132,400</td>
</tr>
</tbody>
</table>

\textsuperscript{1)} Planned

Development of East German Labour Force
- in 000s -

- Employment

- Employment, 000s -

- Job-creation
- Adult Training
- Early Retirement
- Unemployment
- Commuting (net)

DIW '93
Marginal productivity of capital (MPK), ratio of gross investment to GDP (IQ), Rate of growth (GDP % p.a.) in East Germany
The Implications of Different Labour Market Regimes in Europe and the Lessons from German Unification for the EMS and EMU

by

Heiner Flassbeck

Berlin, July 1993
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and the Lessons from German Unification for the EMS and EMU

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I. Introduction

The implications of different labour market regimes for the future of the EMS and the creation of EMU are only mentioned in passing. The main points of the discussion are the questions of central bank autonomy in matters of monetary policy, the technical form of a rigid EMS, and fiscal policy convergence. This is astonishingly similar to the preparations for the currency union in Germany: at that time official announcements and scientific publications hardly touched on the problem of wage determination in Eastern Germany. In the meantime this has changed. There is now barely a single observer who does not emphasize the massive role of wage developments in the lasting weakness of the Eastern German economy. There are well-founded fears that in moves towards currency union the same mistake will be made in Europe. Although details about the form of a reformed EMS are being discussed, the central question, whether and for how long the wage policy regimes in the countries concerned will permit stable exchange rates, is being ignored.

In reality it was the divergent wage policy developments which finally played a large part in the breaking up of the EMS. Great Britain and Italy especially were not successful in their attempts to maintain their competitiveness at fixed exchange rates through wage discipline. France, far more successful in this respect, was, in spite of considerable speculation, finally able to defend her exchange rate. Every reform of the monetary system and every currency realignment will be judged in terms of whether it supports or even forces the required degree of wage discipline. Technical details of the currency regime therefore play a small role, and the fact that the currency regime of the western world is nothing more than a wage standard is crucial. The paper money currencies can only fulfil their purpose if price stability is guaranteed through a wage policy based on the trend in productivity. This may not sound too
displeasing, since it is already well-known that a monetary policy geared towards stability, if possible with the help of an independent central bank, is responsible for price stability. Stable prices alone, however, are not sufficient.

The significance of price stability continually has to prove itself as a necessary condition for achieving an acceptable level of growth and employment in order to retain its acceptance in society. If these aims cannot be fulfilled to a sufficient extent, price stability and the autonomy of the central bank become a chimera. What made countries such as the Federal Republic of Germany and Japan so successful and stable in the past was not a permanent restrictive monetary policy to force price stability, but an expansion of the money supply in line with the potential for growth, which was guaranteed stability by the basic consensus of tariff partners and society to stand by the requirements (without inflation). Only this kind of policy guarantees good supply conditions from the monetary side because it keeps interest rates sufficiently low to allow a high level of investment.

But even this kind of policy is not sufficient to guarantee the stability of a system of fixed exchange rates or of a currency union. A situation could arise whereby member countries of a fixed exchange rate system or a currency union permanently show fundamentally different real growth rates despite the same levels of prices and interest rates. The level of investment in the partner countries would therefore vary and real incomes would grow at different rates. This would be acceptable if such a society did not aim to bring standards of living into line with each other. If a currency union is considered as a preliminary step towards a political union, as in the case of Germany, political tension without a system of income redistribution between regions is unavoidable. As the German experience again shows, comprehensive systems for income redistribution themselves can, however, only be implemented with far-reaching political consensus on the part of the regions and the political parties involved. As EMU is considered explicitly as a preliminary step towards a "European Union", the effects of divergent rates of growth and their causes must be analysed.

Different rates of growth are, as will be shown here, predominantly the result of the wage policy regime at the microeconomic level and not merely a consequence of exogenous influences or political decisions. The wage policy regime determines what kind of effects the behaviour of entrepreneurs will have on capital returns and how much pressure there is for other firms to follow suit.
Two central questions will be examined below: firstly, what kind of wage policy regime at the microeconomic level is suitable for promoting dynamic management and therefore investment, and secondly, what kind of wage policy regime is required at the macroeconomic level to maintain the competition between economies and to guarantee price stability.

II. Decentralized Versus Centralized Wage Negotiations

Given different exchange rate and wage policy conditions, how are changes in competitiveness at the level of the individual firm translated into changes in competitiveness for the whole economy? Looking through the theoretical literature on foreign trade shows that such a question is neither dealt with in "real" nor in "monetary" theory, in such a way as to really help us in our task. The link between the firm level and the macro level is hardly to be found in modern literature, although older studies provided some preliminary work.

Economic theory’s lack of interest in finding out about questions of the efficiency of adjustment processes still stems from the one-sided orientation towards equilibrium as the beginning and end of every analysis. Equilibrium is only abandoned as a result of the overcoming of individual shocks, and the restoration of equilibrium through a change in price or quantity fulfils the aim of an insight into theoretical economics. Only a few authors, whose theories have for the most part not yet found an important place in economics, still interpret the world as a series of disequilibria at the micro and macro levels from which they develop a dynamic reference model. Only a dynamic model, based on the microeconomy, enables relevant economic policy conclusions to be drawn, because this is the only way in which the core of what makes up the dynamics of market economies can be captured. It is far more than a methodical difference as to whether it is a question of how flexible prices or flexible exchange rates can restore a certain initial equilibrium after a shock, or whether it is

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1 Chapters II to IV are based on an analysis carried out by the DIW for the Federal Minister for the Economy. cf. Heiner Flassbeck (1992).

2 See for example Angell (1922), p. 116 onwards, and the works of Taussig (1927) and Ohlin (1967).

3 For an analysis of shocks and a critical appraisal of the theory of flexible prices see Flassbeck, Horn and Zwiener (1989).

a question of how flexible prices or flexible exchange rates influence the ability of the system to adapt in view of the incentive mechanisms for the "creation" of dynamic development. The dynamics of the market system and its superior efficiency in overcoming exogenous shocks are based on the permanent existence of temporary disequilibria and not on the quickest possible restoration of a general equilibrium. Flexible prices, wages, interest rates and exchange rates must always permit temporary rigidity if the correct signals for the evolution of the system are to be given.

The economics of general equilibrium is just not capable of analysing such a system, because the time requirement of rigidity tends systematically towards zero. Comparative statics can only show that there are equilibrium solutions if prices are sufficiently flexible. It can, however, be shown how large a change in output is possible if prices are sufficiently rigid for the dynamic evolution of the system. Nonetheless, attempts have been made at more detailed analyses of partial rigidities and the significance of wage rigidity especially is being discussed more and more. The question is, however, almost always whether and how wage rigidity can be compensated by the flexibility of other prices, especially by exchange rate flexibility at the macroeconomic level. This is the classical analysis of overcoming shocks which in principle characterized the discussion in the 1960s about the "assignment problem". At the level of the individual firm and the adjustment processes which take place independently of price flexibility, however, this does not happen.

Strictly speaking, economic theory offers concepts for analysing competitiveness at only two levels:

- At the level of the individual firm competing in a clearly-defined market segment with rivals who, in terms of the availability of resources and technology, are all in a similar position. This is the area of business management market share analysis.

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5 cf. especially Flassbeck, Horn and Zwiener (1989).

At the level of regionally separable conglomerates of firms from various branches of industry which are characterized by interregional immobility of the factors of production (land, labour and capital). This is the area of the classical theory of international trade.

With mobility of labour, capital and raw materials, deviating profit levels are generally not possible for the firms in individual regions. Migration takes place, which leads to a quick equalization of prices. In a very simple model of equal international and factor mobility, competition problems at the firm level arise in the course of the evolutionary process. These are solved by offensive cost reductions or defensive adjustment (bankruptcy), but the average competitiveness of a regionally-diversified conglomerate is never threatened. All regions (nations) would progress at exactly the same rate, since the migration of labour and capital allow neither typical regional preferences nor the identification of an individual with the region in which he already lives. This also implies that the share of the state and the structure of state-produced goods and services fully conform to the preferences of the mobile suppliers of labour and capital. Any deviation from the level and structure of the desired state share would cause emigration and force the state to reverse such exogenous intervention. The level of state intervention in all regions would converge.

Even these simple observations show that interregional or international comparisons of competitiveness, that is the attempt to analyse the relative adaptability of conglomerates in one area, is only useful if a large proportion of the factors of production is immobile. Immobility is, however, not the only necessary requirement. For measurable and noticeable changes in the competitiveness of conglomerates of firms within an area a non-market (disequilibrium) adjustment of prices to changes in threshold productivity is required as well.

The real or "pure" theory of international trade explains - for a given quantity of resources - the exchange of goods and services between regions whose economic relations are characterized by immobility of the most important factors of production (labour, capital and land). The rates of exchange (relative prices, terms of trade) are determined by production costs and then lead to welfare gains for all regions concerned, compared with no trade if the absolute production

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7 As a rule, this effect is not, in reality, achieved by existing states through migration, but through an "equalization of living conditions", as it is referred to in Germany, with the help of state measures and general compulsory regulations.
advantages of particular goods were divided equally between sectors and regions. But even a one-sided allocation of absolute cost advantages can allow welfare-increasing trade, because the division of labour allows better use of the available resources (the principle of comparative cost advantages). Despite immobility of the most important factors of production there is a (long-run) tendency towards equalization of factor prices, as the prices of goods which are produced using abundant factors fall and through additional demand increase the scarcity of these factors and vice versa (Heckscher Ohlin theorem).

As the theory of international trade was illustrated by the classical authors in quantities, it was often interpreted as if prices and costs expressed in money terms have nothing to do with the evolution of international trade. This is a misconception\(^8\). The classical theory of international trade has only been built up and interpreted in this way because the classical authors wanted to prove the advantages of free trade between economies with different allocations of immobile factors. The emphasis of the theory of comparative costs clearly shows this aim. As a rule the classicalists believe that international trade is steered by absolute costs of production, expressed in money terms. Although the differences between prices are in the end determined by the differences in the (real) allocation of immobile factors, it does not matter a priori whether absolute or comparative real advantages determine the absolute difference between prices. The theory of comparative advantage shows simply that examining the absolute advantages of a firm or a country alone does not show whether an expansion of trade would still lead to welfare gains.

If, however, the absolute money costs actually do determine the evolution of trade flows and one takes into account that labour, as a factor that is being used directly, just as labour that was used in other periods (stored-up labour), called tangible capital, is by far the most important immobile factor of production, an analysis of the evolution of advantages and disadvantages in international trade which is not merely a welfare analysis cannot avoid recognizing the significance of changes in the cost of labour in its current form (nominal

wage) or in the form of lower efficiency of the capital inputs as a result of a change in labour productivity.\(^9\)

From these observations comes the very central conclusion often overlooked in "modern" real analyses of developments in foreign trade (investigations of the rate of technical progress, patent registrations, factor productivity, etc.). The monetary regime selected in an economy for domestic and international matters also determines the (dynamic) evolution of an economy's foreign trade. The (real) allocation of factors determines the rate of increase of labour productivity, but it does not dominate the process which leads to the determination of prices (and the price level) and which finally fixes the level of employment and the balance of payments.

In principle there are two methods for converting an improvement in the production process (which is normal for western economies and involves a shift of the supply curve for the whole economy to the right) to a higher real income:

- At constant nominal wages and constant nominal demand (money supply) the price level falls, corresponding to increases in productivity growth.

- With anticipation of growth in productivity through pay negotiations the price level remains constant at increasing nominal wages and a money supply increasing in line with growth in production.

The type of exchange rate system then determines the exact adjustment requirements for open economies and the emergence, as well as the duration and extent of (temporary) deviations from equilibrium. With absolutely fixed exchange rates the following possibilities exist:

1. Price levels falling at different rates depending on the average increase in productivity in the individual countries indicate the need for a forced adjustment of the country's development with the most dynamic competitor. Disequilibria at the macroeconomic level may be barely visible since adaptation vis-à-vis competitors must take place at

\(^9\) In this respect the now accepted international standard for measuring changes in price competitiveness, the so-called real exchange rate on the basis of individual wage rates, has a thorough theoretical legitimacy.
the level of the individual firm and in the very short term in order to be able to remain in the market. This is the principle of interregional adaptation applied at the international level and it implies a classical analysis on the basis of mobility of all factors and atomistic determination of prices and wages.

This case will not be pursued further, as it is only of theoretical interest. In practice no wage or monetary policy regime of this kind - independent of the degree of mobility of factors and therefore the degree of competition in the factor markets - has ever been successful, although it comes closest to the ideal of the intervention-free economy\textsuperscript{10}. The same arguments exist against permanent deflation as against permanent inflation\textsuperscript{11}.

2. In principle, anticipation of the rate of productivity growth through nominal wage increases in competing countries (with immobile labour) prevents such a national requirement for adjustment, since the national price levels only differ in terms of the share of services in national output and export prices are the same. Such a statement is, like the classical theory, based on a mark-up hypothesis for the explanation of the national price levels. The adjustment requirements derived from such a hypothesis only affect the macroeconomic level (wage negotiations) without excluding the pioneering profits of individual firms (or sectors) and the corresponding losses elsewhere. The differential profits of the pioneer are smaller than in the first case, as he must bear the average wage increase and therefore cannot reduce his prices or realize profits to the full extent of the increase in productivity.

Macroeconomically measurable differences in competition can only be explained under such a regime through deviations from productivity changes from the principle of totally fixed exchange rates and/or from the principle of adjustment of changes in the nominal wage, because "unavoidable" differing national rates of inflation are included in pay negotiations or integrated institutionally (indexation). In this way problems of competition arose in systems with "fixed but adjustable" exchange rates.


\textsuperscript{11} cf. J.M. Keynes (1936).
In order to reduce the complexity of reality in the centre of the adjustment process, the most simple dynamic model for analysis of changes in competitiveness will be used here. The starting point of all considerations is the improvement of a production process for a certain ("pioneer") firm's tradeable product in the observed country. The productivity of the immobile factor labour rises. At the same wage rate and the same level of output, the firm's costs fall. For the sake of simplicity, let us assume that the pioneer firm's productivity increases from the average for the whole economy to twice this rate. If the firm uses the reduction in costs to reduce prices immediately and to the full extent, it can increase its market share, even if this process results in an increase in the size of the total market.

The following assumptions will also be made, which merely simplify things without affecting the centre of the argument:

- Wage negotiations take place - either centrally or decentrally - at the end of a certain period. Wage increases can, however, be passed on in full in the form of higher prices.
- The price level abroad remains unchanged.
- The price elasticity of demand for the pioneer firm's products is normal in both domestic and foreign markets. This assumption may be risky for individual firms, but for the "average" pioneer firm it is fair and realistic.

With fixed exchange rates and annually, centrally-agreed wage rates on the basis of an anticipation of the increase in productivity for the whole economy at constant prices, conditions result such as those which were characteristic of the whole world in the 1960s or of the EMS for most of the 1980s. In very centralized pay negotiations, rates of wage increase are set at the beginning of each year according to the expected increase in labour productivity. If such a rule for finding wages is valid for all the countries participating in international trade, the average price competitiveness for the whole economy does not change, the real exchange rate remains constant and, as long as non-price changes are excluded, market shares remain the same. But what happens at the level of the individual firm?

But can pioneer firms, which enter the market with more efficient production processes, be successful? With a strategy of the highest possible market penetration, as has been assumed here, the pioneer firm can reduce the price of its product to the extent of its productivity increase, which is above the average for the whole economy. With normal price elasticities
of demand this price reduction would lead to a corresponding increase in quantity demanded and a larger market share. For the duration of the pay agreement (normally one year) the domestic price level will fall in line with the weight of the pioneer firm’s goods in the representative household’s basket of goods. The same is true for the price level in foreign trade. With fixed exchange rates the real exchange rate (on a price and cost basis) falls, and the country’s total market share increases.

Both change as soon as the new pay round at the start of the next period is completed. The average productivity increase for the whole economy causes the negotiating parties to agree on higher pay increases so that the price level for the whole economy returns to its previous level, and therefore remains constant from year to year. This increase in wages, which in the case described here is caused by higher productivity in just one firm signifies an increase in costs of the immobile factor (increase in labour costs per unit) for all other firms, which is reflected in lower profits or higher prices there. In contrast, the pioneer firm retains much of its original advantage, since its wages only increase in relation to the weight of its product in the basket of goods, and its labour costs per unit therefore remain lower than before. If increased costs are passed on in the form of higher prices, other firms’ market shares in foreign markets fall if the competitive situation there remains the same. The country’s real exchange rate then returns to its previous level.

The wage increase corresponding to the average productivity increase for the whole economy obviously has the function in this regime of equalizing differences in productivity growth between trading partners without eliminating the success and the incentives for the pioneering firm. In such a regime trading partners with very different rates of growth or very different structures of preferences and shares in foreign trade can keep the borders for goods open as long as the mobility of the other factors is not restricted.

In the case of decentralized pay agreements changes in wages are a function of the changes in productivity and profits in the individual firm. Whether and to what extent a price reduction will lead to an increased market share in this case depends on the speed and extent of the adjustment of wages to changes in productivity and/or profits. It is inevitable that the pioneer firm will at the time of the adjustment of wages lose most or even all of its advantage gained through innovation, so that the other firms at home and abroad - unlike with centralized pay negotiations - are only forced to adjust for a short time. Under the regime of a full adjustment
of wages the profit level and the individual market shares may remain unchanged, leaving the pioneer firm successful neither at home nor abroad.

With "normal" exchange rate policy conditions as have been assumed so far, the effect on the whole economy of an adjustment process in the wake of the "disturbance" of equilibrium by a pioneer firm is absolutely identical in all imaginable cases. The market share of the whole regional conglomerate of firms investigated remains the same over a time span long enough to allow for equilibrium. This is trivial, as such a result consistent with the theory is a priori preconditioned by the inclusion of market ("equilibrium") factor price adjustments into the model.

The result of the adjustment below the average for the whole economy is by no means trivial. With decentralized pay negotiations the market share of the pioneer firm may also remain constant. The pioneer firm cannot maintain its advantage beyond the period of the pay agreement. With centralized pay negotiations, however, the gain in market share of the pioneer is final, the other firms must accept losses (in profits and/or in market share) and have the chance to regain the lost ground only through their own creativity. This is a central point: the explanation of market economic dynamics can only be based microeconomic foundations if equilibrium at the level of the firm does not mean always returning to the old production level. Reaching a new equilibrium point (production level) requires that - at least for a sufficiently long period of time and for a sufficiently small economic unit - an adjustment of factor prices to the changes in profit does not happen.

On the other hand, a system of decentralized wage negotiations means that structures are conserved and the ability of firms to adjust is weakened, since they are to a large extent released from the pressure of adjusting to new conditions and they do not have the full incentive for "creative destruction". In this way such a regime reduces the competitiveness of the economy in the longer term. Moreover, a system of decentralized pay deals is only conceivable if the interregional and intersectoral mobility of labour is very low and/or the degree of organization of employees in trade unions is very low. Intersectoral mobility or pay deals for a whole sector create, however, the innovative incentives and the sanctions which are essential for dynamic economic development.

III. The role of the state and public intervention if labour is immobile
The content of the preceding analysis can be summarized in a single sentence: competition problems always occur when a society does not recognize the limits of the production and sales opportunities which it itself has determined and so tries to force through income demands which are not justified in reality. In a closed economy this manifests itself in rising prices and finally, if there is money illusion, in low real income again. In an open economy it manifests itself firstly in rising prices (loss of competitiveness) and then in the loss of market shares on the world market and falling employment. With fixed exchange rates these undesirable trends can only be corrected through withdrawal of the excessive nominal demands. The only function of flexible exchange rates is to facilitate this withdrawal by (unconsciously) exploiting money illusion. This also provides a direct solution to the "problem of the state", much discussed in the preamble to Maastricht. Any change in the level and structure of state involvement which is not accepted by society and entails competing private demands will lead sooner or later to rising prices, which in turn will disrupt external development. It is not the increase in state involvement which causes an external problem, but only ever its non-acceptance by the population.

This also deals straight away with the "tax burden problem" mentioned in Germany in connection with the location debate: in a country which - compared with the average of her trading partners - is characterized by stable price development without having to follow a permanent restrictive monetary policy, there is no reason to reduce state involvement or the tax burden on businesses for external reasons.

This can easily be illustrated. Let us assume that a state has an extremely high tax ratio and extremely high defence expenditure compared with its trading partners. This may lead to important public areas such as infrastructure, education or environmental protection having to be neglected. This means that the real purchasing power of private households will rise less sharply than in other countries, while businesses will have less investment funds and a worse complementary public infrastructure at their disposal. In turn this will indirectly reduce the chances of an increase in the purchasing power of households. Overall, growth and productivity in this country will be lower than in other countries, as defence expenditure is "unproductive" both in the eyes of private households and in the eyes of the world market. There will, however, be no external problems in this country if the necessity of such defence

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12 Incidentally also stated explicitly by Keynes in his critique of neoclassical wage theory. cf. J. M. Keynes (1936), p 262 onwards.
expenditure is accepted by everybody for overriding reasons. If the overall political situation changes and defence expenditure and taxes can therefore also be lowered, it will undoubtedly not lead to an improvement in the external situation, but to an earnings trend which adapts itself to the new, "more productive" circumstances.

The same applies to two countries which have the same level of state involvement but a completely different structure of public expenditure. Let us take one country with high "unproductive" defence expenditure and one with high "productive" expenditure on infrastructure and a small defence burden. If both countries have stable prices, i.e. they have adapted to the production opportunities in each case, there is no competition problem. The same rules as those for high defence expenditure apply for - what is in terms of international competition - "unproductive" expenditure on environmental protection. Here too it is always a matter of societal adaptation to the resulting lower productivity in international terms, not a ceteris paribus comparison of expenditure on environmental protection in two different countries.

In this respect discussion of comparative tax burdens or state involvement is generally not very relevant. Because there is the "compensation mechanism" of wage development, the tax burden is no criterion for assessing the international competitiveness of a national economy. In the last forty years this mechanism has worked better in Germany than in any other economically comparable country of the world. The relatively low inflation since 1950 is direct proof of this. This is the key to economic policy. The internal and external value of money cannot be separated. If internal stability is achieved, external stability cannot be lost; and only in times of an unsuitable currency system, e.g. the 1970s, could this realization be temporarily forgotten.

IV. The Macroeconomic Regime

Contrary to what is asserted time and again, the preservation of international competitiveness for a national economy overall is in no way a task of economic policy which requires a large number of different activities and the subordination of internal goals to external adaptation. The maintenance of competitiveness in the sense of retaining adaptability to new and what are in principle unforeseeable events is far more a problem of the currency and wage regime, which is applied to real developments and adapts to them in each case. If this regime or even
only parts of it are unsuitable for promoting the adaptability, all other measures for preserving a country's competitive position are condemned to failure in the long run. Conversely it is true that, with a suitable currency and wage regime which reacts flexibly, there are practically no limits to the freedom of a country to set and achieve its own goals in terms of social, environmental or defence policy.

This largely reduces the problem of preserving international competitiveness to the question of creating sufficient wage and/or exchange rate flexibility. The question as to which of these two variables should/can be made to bear the main burden of adaptation was a central feature of the debate on flexible versus fixed exchange rates in the 1950s and 1960s. For the most important advocates of flexible exchange rates it was purely and simply the assumed rigidity of wage rates that justified flexible exchange rates. The assumption of rigid wages, however, was a theoretical "device" of the Keynesian revolution, making it more than surprising that otherwise neoclassical and/or monetarist authors used this assumption to defend flexible exchange rates. This paradox must be reflected on briefly to be able to show how a consistent conception of economic policy can be backed up today, i.e. in light of the events and theoretical upheavals of the 1980s.

The rigidity of nominal wages by no means only affects the external situation of a country. As the Keynesian revolution showed with great clarity, if nominal wages are rigid, there is also no endogenous mechanism internally for creating full employment. Fiscal policy is then required time and again to stabilize effective demand and employment by means of an accommodating monetary policy. It is precisely with this constellation of economic policy that resorting to changes in exchange rates becomes unavoidable in order to make wages flexible enough externally - by exploiting money illusion. Competitiveness is permanently at risk because, as the Phillips curve logic of such a policy dictates, internal price stability is permanently at risk.

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\[42\] cf. Sohmen (1973) among others.


\[14\] Cf. Flassbeck/Vesper (1986), p 143.
It is completely different in the case of a conception of economic policy which also concentrates on wage flexibility in achieving its internal goals. The overcoming of Keynesianism by the monetarist counterrevolution undoubtedly produced such a conception. As emphasized at the start, a constant increase in the money supply can in principle only be successful in terms of price stability and employment, i.e. in the realization of a Phillips curve which is vertical in the long term, if nominal wages are flexible enough.\textsuperscript{15} It is precisely then that external problems in the sense of the preservation of competitiveness can generally be solved, as there is sufficient price stability. In this conception flexible exchange rates are expendable in order to preserve external equilibrium.

In the case of a monetarist conception of economic policy there is only one class of phenomenon that demands flexible exchange rates. If two countries pursue constant expansion of the money supply with different target concepts with regard to the "right" long-term (neutral) inflation rate (i.e. approx. two and four per cent), the exchange rate has to be changed by precisely this difference per period to preserve competitive neutrality.

It follows from these considerations that two types of international policy coordination are necessary in order to exclude changes in exchange rate for ever ("currency union"). In the first instance all the countries involved would have to agree on an internal assignment which imposes the main responsibility for the preservation of full employment on either wages policy or monetary/fiscal policy. This is clearly a very difficult form of policy coordination to handle, requiring as it does the ability to agree on how, at what times and in what economic situations money illusion is present and can be exploited.

If, however, all the governments involved are of the opinion that money illusion is not in any case large enough to base a conception of policy on, only coordination of the "correct" long-term (neutral) inflation rate is necessary. This problem does not really exist, however, as it is possible to agree on an arbitrary inflation rate, and such agreement is in any case preferable to a permanent change in the exchange rate or even flexible (market-determined) rates.

These considerations show just how close the interdependence of the goals of "external equilibrium, a high level of employment and stable prices", is. The simple assignment of goals and means which came out of the monetarist counterrevolution is:

\textsuperscript{15} Cf W. Koll (1988) and H. Flassbeck (1987) on the logic of these correlations.
Monetary policy - price stability
Wages policy - employment
Exchange rates - external balance

and is only tenable under very restrictive assumptions. It is inconsistent in terms of external security if it is not assumed that different degrees of neutral inflation in different countries are unavoidable.

The assignment of monetary policy to price stability and wages policy to employment, which in terms of internal economics is expedient, must in any case be modified externally. Money supply policy is the attempt to "objectify the money supply", that is to say the attempt to remove money supply policy from day to day politics and to assign responsibility for employment to nominal wages policy. With increasing internationalization of the money and goods markets more and more limits are being put on such a policy in a narrow national framework. The shifting of demand for domestic currency beyond frontiers (expansion of currency area) cannot be met with national money supply control, for example. Nor can monetary policy ignore changes in exchange rates which go far beyond the path of competitive neutrality marked out by purchasing power parity.

A system of fixed exchange rates has a very similar function when it comes to the assignment of responsibility for wages policy. Even with fixed exchange rates nominal wages policy is directly relevant to employment through the decline in competitiveness\textsuperscript{16}.

V. The German lesson

Such a system works if any misconduct by the actors at national level is sanctioned directly. Excessive wage increases will entail negative labour market effects, bringing about a correction of wage development. Unemployment is generally cushioned socially by means of insurance in order to involve employees in the costs of their misconduct and to limit the shifting of this burden onto the anonymous "state". That is to say the area from which misconduct comes in the case of immobile labour is punished for the misconduct in a way that makes it seem worthwhile for those involved to obey the rules of the system.

\textsuperscript{16} This too is evident in J. M. Keynes (1936), p 262 onwards. cf. also the fundamental work of Bosch/Veit (1966).
If labour were mobile, such problems would not exist from the outset, as wages would quickly rise in the low-wage country and fall in the high-wage country without more unemployment arising anywhere than in the case of immobility. Mobility of labour is frequently misunderstood, however, and its effects were politically misused time and again in the course of the German currency union to justify rapid harmonization of wage levels in East and West. The argument that the market has forced the rapid harmonization of the wage level in Eastern Germany with that in Western Germany though the migration of labour is not tenable, however.

If the borders are opened between two countries with different capital resources and different wage levels at an exchange rate which just stabilizes production in both countries, i.e. is competitively neutral, migration from the low-wage country to the high-wage country will start if labour is perfectly mobile. Labour will become short in the low-wage country, and a labour surplus will arise in the high-wage country. This will put pressure on wages to level out - they will rise in the low-wage country and fall in the high-wage country. It is vital that unemployment does not occur in either of the two countries. In the low-wage country the labour market is characterized by a labour shortage, not by high and rising unemployment. The fact that wage development there has detached itself from productivity development is purely a market result under the conditions of the labour shortage.

In the case of Eastern and Western Germany this illustration of a market process does not get to the bottom of the matter. Falling unemployment in Western Germany despite massive immigration, and rising unemployment in Eastern Germany despite emigration would, according to the laws of the market, have demanded rising wages in Western Germany and falling wages in Eastern Germany. Migration could not be prevented even then. It is plainly untrue to say that migration can be stopped by rapid wage harmonization if the low-wage country is far inferior to the high-wage country in competition on the goods markets. In this case the difference in income is only replaced by a difference in demand for labour. This is at least as important in terms of migration as a difference in income. The fact that there is not greater migration despite the extreme differences in the labour market situation between Western and Eastern Germany shows just how little mobility there is even in Germany.

Currency union in the case of immobile labour can function easily enough if only the responsibility for the currency itself is centralized, with all other sanction mechanisms
remaining at the level (in the area) which is characterized by mobility of labour or centralized wage negotiations. Under these conditions at least the same goal combination is achieved as at present and the readiness of the richer countries to pay is not overstrained. In other words it is not currency union as such that is a problem. The currency of a united Europe can be just as stable as a national currency if all the parties involved share the basic conviction that inflation does not solve real problems, but creates new ones. Vital factors are the design and decision-making mechanisms of the central bank, together with the framework in which the other decision makers operate.

The point is, however, that European currency union is not planned as purely a currency union. European currency union is seen by virtually all those responsible as a step in the direction of political union, at least in the sense of a confederation of states. The logical outcome of this is the shifting of additional responsibilities to the joint institutions of the European Commission and European Council, with cohesion funds, regional funds and structural funds being instruments for, in addition to standardizing currency conditions, providing harmonization aid for poorer regions with the aim of accelerating and facilitating the catching-up process.

It is precisely here that the real problems of the Maastricht Treaty begin. The national sanction in the wake of wage misconduct is weakened without their being a provision which would permit the other members of the currency union to assess why this undesirable trend is occurring and allow them to react as they saw fit - even with sanctions. This is possible in the case of budgetary policy misconduct, but in the case of wage policy misconduct the partner countries can only make reference to general obligations to consult.

It might be argued that the barrier to entry into a currency union is so high with regard to inflation rate that only countries with the necessary social consent will be able to participate in any case. However, this fails to take account of the fact that the design of the currency union and the shifting of further responsibilities to the Council and Commission change conditions decisively. Even countries which demonstrated good conduct when there were strict national sanction mechanisms will adapt their behaviour to the new conditions. There will be a temptation for low-wage countries to maximize their share of the central funds available through selfish conduct.
There is in any case a tendency for all those involved to unload the responsibility for undesirable trends on the state. This is given a new dimension in the case of the European Community. Poorer countries will try to move richer ones to share more than would otherwise be possible. Their means of doing this is to bid up national wage negotiations, that is to say misconduct in the sense of the union. Even if this means high regional unemployment, it may be worthwhile. The employed have higher real wages and unemployment is either kept directly lower by joint interventions or its social consequences are alleviated more than would be the case without European transfer mechanisms. The quantitative effects of such conduct can only be speculated about, but its occurrence is inevitable.

It is certain, therefore, that a currency union on these terms will produce poorer results with regard to inflation and/or employment levels than a currency union which retains the sanctions for misconduct in the region in question. This means that even if some measure of price stability would be preserved in Europe as is the case in the most stable countries, the European Phillips curve would move to the right, i.e. unemployment would be higher at any inflation rate than it is now. The readiness of richer countries to pay transfers can also be overstrained.

The differences in wage levels in Europe will be large for a long time to come. At present Portugal has the lowest wage level with approx. 4 ECU an hour and Germany the highest with approx. 20 ECU (including incidental wage costs). Announcement of a political union must lead to a response at European level from trade unions and employers’ associations as well. If, as in the united Germany, the trade unions and employers were to join forces quickly on a Europe-wide basis in order to harmonize wage-setting systems and to avoid direct competition in collective bargaining, it would represent a great threat to the European economy. The trade unions would have to try to achieve rapid harmonization of wages to avoid pressure on the high-wage countries to reduce wages. The employers would have a similar interest so as to keep competition from the low-wage countries to a minimum. If, trusting to the harmonization mechanisms of the community, the low-wage countries were to accept this, all would be united in an attempt to assign a maximum of responsibility for the undesirable trends to the joint central institution. This institution too would be interested in the first instance in accepting such responsibility in order to prove its importance to the whole. In this way the need of not overstraining the readiness of the prosperous states to pay transfers could actually be violated so badly that European union as a whole would be endangered.
If there is anything to be learnt from German unification and the rapid currency union, then it is this: as soon as the social forces of the area within whose borders centralized wage negotiations take place or within whose borders labour is mobile no longer bear the social and financial responsibility for undesirable developments, wages are no longer exclusively the outcome of the negotiations of a bilateral monopoly, but are marked by all those concerned attempting to involve a third party, the "state", in the responsibility. Owing to a power vacuum on the employers' side the results in Eastern Germany may deviate particularly markedly from the market result in open national economies where there is immobility of labour, i.e. the productivity orientation of wages, but in the European treaty the aspiration of the poorer countries "to reduce the differences in the level of development of the various regions" (Art. 130a) basically shows that currency union is to be accompanied by effective measures on the part of the joint authorities.

In principle there are two ways of designing a currency union. Firstly as a pure currency union, in which, with the exception of monetary policy, all important functions of economic policy and therefore all sanctions for misconduct remain at a national level. The immediate advantage of such a currency union compared with the system of largely fixed exchange rates practised today is hardly worth mentioning. The transaction advantage barely shows favourably in the books if the system of fixed exchange rates also succeeds in keeping the markets for goods and capital open. Such a pure currency union is open to all countries which want to submit to the constraints of its policy of stability, irrespective of their level of affluence.

Secondly, one can see European currency union as the preliminary stage of political union and, as in the Maastricht Treaty, soften the character of a pure stability community accordingly, i.e. sanction misconduct not only in the national framework. In this case rules have to be drawn up to prevent the readiness of the richer countries to pay from being overstrained. The Maastricht Treaty has tried to do this consistently in the area of fiscal policy. Wages policy, by far the more important factor in overall economic terms, is not even mentioned.

Politically this form of currency union can also be achieved if the richer countries' readiness to pay in accordance with the terms of the contract can be relied upon. It is questionable whether this is the case. Experiences in the united Germany show that policy tends to overestimate the readiness of the population to pay in principle and not call upon the readiness to pay which exists to a great enough extent.
Unlike a pure currency union, however, this type of currency union is not open to any number of countries with very different levels of affluence. Each admission of a country with below-average income threatens compliance with the aforementioned secondary consideration. The option of "deepening and broadening" the community only exists if the countries to be admitted already have above-average income. This is true in the case of Austria, Norway and Sweden, currently the most important candidates for admission.

It is, however, fatal to have an income threshold like this as an admission criterion. If the community does not remain open to the poorest countries as well, redistribution within the existing community loses its legitimacy. In that case it is only historical chance (the Iron Curtain opening "too late", for example) that decides whether a country will be able to enjoy redistribution from the richer countries to the poorer or not. In a changing Europe such a policy is bound to come to grief sooner or later.

VI. Conclusion

The analysis presented here focuses on two arguments:

1. The wage regime (decentralized or centralized) at the micro level largely determines the ability of a country to increase its affluence in dynamic competition.

2. The wage regime at the macro level (adaptation to productivity and international price level) is vital to the stability of the currency system.

This produces one central conclusion: fixed exchange rate systems or currency unions which are not a direct preliminary step towards political union only function if they contain no precautions to cushion undesirable national trends with measures at the supranational level.

This can easily be explained using the above two arguments. Different wage regimes at the micro level can easily be maintained if different levels of income in the countries are not regarded as a problem in political terms. If harmonization of differences in affluence by means of joint measures is planned, however, the results are paradoxical. In this case the countries which have exposed themselves to greater pressure to conform in the structural change through
centralized wage negotiations must pay for other countries choosing a slower rate of structural change. This cannot be wise in principle.

Different wage regimes at the macro level can only be maintained from the outset if there is no national sanction for misconduct, but supranational cushioning. This is not wise, as it provokes morally hazardous behaviour which is condemned to political failure in many respects.
References


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

(Introduction and Conclusion)

Vienna, March 1993
Transition from the Command to the Market System: what went wrong and what to do now?

1. 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.  

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" 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.

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.

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 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.\(^\text{28}\) 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.

\(^{28}\) 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.
Die Transformation der Wirtschaft im Osten

Eine kritische Einschätzung des bisherigen Verlaufs und Vorschläge für den Weg aus der Transformationskrise

Bei Interesse kann die englische Originalstudie im WIIW angefordert werden.

Wien, im Juni 1993
Friedrich Levcik

Die Transformation der Wirtschaft im Osten

Eine kritische Einschätzung des bisherigen Verlaufs und Vorschläge für den Weg aus der Transformationskrise


Die ursprüngliche Euphorie, daß der Transformationsprozeß in Kürze bewältigt werden könne, wenn nur genügend radikal vorgegangen würde, ist inzwischen der Einsicht gewichen, daß wir es mit einem langwierigen Prozeß zu tun haben, dessen positiver Ausgang noch fraglich ist. Die Erklärung hiefür liegt in den wirtschaftlichen Ergebnissen, die neben einigen positiven Aspekten doch überwiegend enttäuschend sind und negative soziale, aber auch politische Konsequenzen mit sich gebracht haben.

Die empirischen Ergebnisse der Studie beziehen sich vorwiegend auf die Transformationswirtschaften (TW) Ost-Mitteleuropas (Länder der Visegrad-Gruppe), doch können die Schlußfolgerungen sinngemäß auch auf andere TW, die in der Transformation noch nicht soweit fortgeschritten sind, angewandt werden.

Das Kernstück der Studie ist eine kritische Analyse des allgemein empfohlenen, konventionellen Musters der Transformationspolitik. Zugleich wird versucht, zu erklären, warum diese Politik nicht die gewünschten Resultate gebracht hat und was geändert werden müßte, um die Wirtschaftskrise in den TW zu überwinden und einen selbsttragenden Wirtschaftsaufschwung einzuleiten.
Die Ausgangsbasis


Positive und negative Resultate der Transformation

Eine Reihe positiver Ergebnisse der Umwandlung der Wirtschaft können registriert werden.


b) Die relativen Preise gleichen sich internationalen Preisstrukturen an. In einigen der TW gehen die Inflationsraten zurück, obwohl sie noch immer zweistellige Zahlen erreichen.

c) Der Außenhandel, von stark abgewerteten Wechselkursen gestützt, ist zum Großteil liberalisiert. Die früher stark defizitären Leistungsbilanzen, überwacht und gestützt durch Zahlungsbilanzkredite (stand-by credits) des IWF, scheinen unter Kontrolle zu kommen und in einigen Transformationsländern kommt es sogar zu Leistungsbilanzüberschüssen, die meist zur Aufstockung der Devisenbestände verwendet werden.

d) In einigen der Länder hat sich auch die Haushaltsdisziplin festgesetzt.

Auf der Negativseite steht die Entwicklung der realen Sphäre der Wirtschaft. In den drei Jahren der Transformation ist die Wirtschaft der TW in einem Ausmaß geschrumpft, das nur mit dem wirtschaftlichen Niedergang während der großen Wirtschaftskrise der Dreißigerjahre vergleichbar ist. Das aggregierte Brutto-Inlandsprodukt (BIP) der drei(nun

Vom Niedergang am stärksten betroffen waren die Industrieproduktion, das Bauwesen und die Landwirtschaft. Lediglich der Anteil des früher unterentwickelten Handels und des Dienstleistungssektors ist gestiegen.

Was die Verwendung des BIP betrifft, so sind alle Aggregate, insbesondere aber die Unternehmensinvestitionen rückläufig. Dabei wären neue Investitionen für die erhoffte Beendigung der Talfahrt und den notwendigen Strukturwandel entscheidend. Aber auch Konsum und Realeinkommen liegen noch tief unter dem Ausgangswert. Selbstverständlich sinkt auch die Beschäftigung (wenn auch ein Teil der Arbeitslosen durch den expandierenden privaten Sektor absorbiert wird) und die Arbeitslosigkeit ist in den meisten TW noch im Ansteigen begriffen. Aber im allgemeinen ist der Beschäftigungsrückgang geringer als der Produktionsausfall. Daher ist die Arbeitsproduktivität, die bereits vor Beginn der Transformation weit hinter der der westlichen Marktwirtschaften zurückgeblieben war, noch weiter beträchtlich gesunken. Der vom Staatssozialismus ererbte Beschäftigungsüberhang in den Staatsbetrieben ist weiter angestiegen. (Part A.III)\textsuperscript{1}

\textbf{Häufig gebrauchte Gegenargumente}


\textsuperscript{1) Die Verweise in Klammern beziehen sich jeweils auf Teile des englischen Originalmanuskripts.

Stabilisierung
eine Notwendigkeit


Die Quantitätstheorie des Geldes, die die Basis des financial programming bildet, geht davon aus, daß die Umlaufgeschwindigkeit des Geldes konstant ist und die Gesamtproduktion (aggregate output) exogen von der Angebotsseite bestimmt wird. Unter diesen Annahmen

Verwechslung von Ziel und Mittel zum Zweck

Unsere Kritik des konventionellen Stabilisierungskonzeptes zielt u.a. auf die Radikalität der Maßnahmen, sowie auf den Versuch, alles auf einmal lösen zu wollen und auf die Verwechslung von Zielen der Transformation mit den erforderlichen Mitteln, um diese Ziel zu erreichen. (Diese Diskussion läuft meistens unter dem vereinfachten Schema "Schocktherapie" versus "Gradualismus"). Wichtiger ist jedoch, daß die negativen Folgen der rücksichtslosen Restriktionspolitik auf die Realeinkommen, die Inlandsnachfrage und folglich auf die gesamte Wirtschaftsentwicklung bei weitem unterschätzt oder gar ignoriert wurden. Dadurch wird auch der in den TW ursprünglich in weiten Kreisen vorhandene Konsens über die gesamte Transformation und die noch fragile Demokratie ernstlich in Frage gestellt. Sozialer Unfriede und der zerstörerische Nationalismus, der bis zur staatlichen Desintegration führen kann, muß in Zusammenhang mit den negativen sozialen Folgen der eingeschlagenen Transformationsstrategie gesehen werden.

Die zentrale Rolle der Gesamtnachfrage

Dies führt zur Schlußfolgerung, daß die Stabilisierungsphase nur im Rahmen der volkswirtschaftlichen Gesamtrechnung beurteilt werden kann, wobei der Gesamtnachfrage die zentrale Rolle bei der Bestimmung des Niveaus des Sozialproduktes zukommt. Nur bei einer solchen Betrachtungsweise können die wirtschaftlichen und sozialen Folgen des

Die Inflationsbekämpfung steht bei der Stabilisierung mit Recht im Mittelpunkt des Interesses. Es ist jedoch fraglich, ob Methoden, die bei einer unkontrollierten Hyperinflation anzuwenden wären, auch bei einer "normalen" Inflation unter den Bedingungen einer stark geschrumpften Gesamtnachfrage mit Erfolg eingesetzt werden können.

Restriktive Stabilisierungsmaßnahmen, die zu Beginn der Transformation den Nachfrageüberhang beseitigen, werden bei einem weitgehenden Wirtschaftsrückgang – falls fortgesetzt – nicht nur die Rezession unnötig vertiefen, sondern werden beginnen, die Angebotsseite der Wirtschaft derart ungünstig zu beeinflussen, daß die Inflationseindämmung immer schwieriger wird. Wenn bei bereits erfolgtem starken Produktionsrückbruch weiterhin öffentliche Ausgaben gekürzt und die Geldmenge durch Kreditbeschränkungen und hohe Zinssätze auf niedrigem Niveau gehalten werden, so kann das nur zu weiteren Produktionseinbrüchen führen. Investitionen werden dann auch für private Firmen unrentabel. Insbesondere die staatlichen Unternehmen verschulden sich gegenseitig und werden zunehmend illiquid und zum Teil zahlungsunfähig.


Fiskalpolitik und Budgetdefizit

mit weitverbreiteter Steuerschonung und -hinterziehung, sowie sinkende Beschäftigung und sinkende Reallöhne wirkten sich negativ auf die Budgeteinnahmen aus.


Ähnliches gilt für die Geldpolitik, die gemäß dem konventionellen monetaristischen Ansatz eher restriktiv (durch Kreditbeschränkungen und positive reale Zinsraten) sein sollte, um die auch während der Depression anhaltende Inflation einzudämmen. Wenn jedoch die Depressionsphase durch eine Erholung und Expansion der Wirtschaft mit begleitenden strukturellen Anpassungen auf der Angebotssseite abgelöst werden soll, dann wird eine Weiterführung der restriktiven Geldpolitik durch die unvermeidliche Restriktion der effektiven Nachfrage die Depressionsphase nur verlängern. Darüber hinaus wird sie auch die für ein kontinuierliches Wachstum notwendigen Anpassungen auf der Angebotssseite erschweren, weil mittel- oder langfristige produktive Investitionen bei hohen Zinssätzen zu teuer und daher zu unattraktiv sind (Part A VII).

Die Transformation von einer zentralgeplanten Wirtschaft zu einer dezentralen Marktwirtschaft kann sich selbstverständlich nicht in der Anwendung einer flexibleren, von rigidem Paradigmen befreiten makroökonomischen Politik erschöpfen. Eine Reihe von institutionellen und systemverändernden Maßnahmen muß gesetzt werden, damit die makro-
ökonomischen Rahmenbedingungen überhaupt greifen können. Die vorliegende Studie setzt sich nicht das Ziel, eine umfassende Darstellung und Analyse aller dieser institutionellen Veränderungen zu bieten. Sie beschränkt sich auf die Diskussion nur einiger systemverändernder Schritte, die für die Transformation unerläßlich sind und zugleich in engem Zusammenhang mit den untersuchten makroökonomischen Rahmenbedingungen stehen (Part B).


**Empfehlungen des Westens:**

- **einsigete Außenhandelsliberalisierung**
  
  Außenhandelsliberalisierung wird allgemein als ein essentielles Ziel der Transformation angesehen, um die Disziplin internationaler Preise auf das inländische Preisgefüge zu übertragen, den ungenügenden internen Wettbewerb zu ergänzen und Zutritt zu Know-how und zu Investitionen aus dem Westen zu erlangen. Gemäß dem konventionellen Weg wird zusammen mit der inländischen Preisliberalisierung auch die Liberalisierung des Außenhandels, verbunden mit einer zumindest be- 
  

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kale und monetäre Restriktionen engegengewirkt werden mußte. Die restriktiven Maßnahmen resultierten nicht nur in vermeidbaren Produktions- und Beschäftigungsverlusten (siehe Part A III und IV), sondern sie erwiesen sich letztendlich in den meisten TW als außerstande, die entstehende Kosteneinflations einzuüben. Auch war die Verhandlungsposition jener TW, die mit der EG die sogenannten Europaverträge abgeschlossen haben, durch die vorzeitige und einseitige Liberalisierungspolitik geschwächt.

Erst heute, wo sich der Westen in Hinblick auf die gegenwärtige Rezession gegen die Billigimporte aus Osteuropäische Maßnahmen zu schützen beginnt, wird die einseitige und zu umfassende Liberalisierung des Außenhandels in den TW vielleicht als Fehler angesehen. Wie zum Hohn werden westliche Schutzmaßnahmen gegen Importe aus den TW u.a. auch mit den zu niedrigen Löhnen (Lohndumping) begründet, die eine direkte Folge der westlichen Empfehlung zur vorzeitigen Einführung der Konvertibilität bei stark abgewerteten Wechselkursen sind. Zumindest in den TW, die noch eine Transformationsstrategie zu formulieren haben, könnte daraus die Lehre gezogen werden, daß der graduell Weg, den die westeuropäischen Länder nach dem 2. Weltkrieg, aber auch Ungarn im Zuge der Reformen der achtziger Jahre zur Liberalisierung des Außenhandels und zur Erlangung der Konvertibilität eingeschlagen haben, zielführender sein könnte (Part B VIII).

Konventionelle Privatisierung und unkonventionelle Schnellverfahren

Die Privatisierung ist eine entscheidende, systemverändernde Maßnahme, die unumgänglich notwendig ist, um zu einer funktionierenden Marktwirtschaft zu gelangen. Gerade hier begegnen wir häufig einer Verwechslung zwischen Zielen der Transformation und den Mitteln, sie zu erreichen. Im Hinblick auf das sozial-politische Ziel ist der Wunsch der verantwortlichen Entscheidungsträger in den TW verständlich, womöglich das gesamte Staatseigentum so rasch wie möglich mit unkonventionellen Methoden zu privatisieren. Es zeigt sich jedoch, daß trotz aller Bemühungen auch die unkonventionellen Schnellverfahren ihre Zeit brauchen und daß die Unterlassung, die staatseigenen Unternehmen vorher zu halbwegs funktionierenden Marktsubjekten (und Verkaufsobjekten) zu machen, der Wirtschaft schwere, oft nicht wiedergutzumachende Schäden zufügt. Während die Privatisierung der kleinen und mittleren Betriebe, sowie auch die Gründung neuer, kleinerer und mittlerer Betriebe meist keine sonderlichen konzeptionellen Schwierigkeiten bereitet, wird zuwenig unternommen, um diese Unternehmen auch lebensfähig zu erhalten. Insbesondere ist die strikte Kreditpolitik eine schwere Belastung für diese Unter-
nehmen, die häufig ohne genügende eigene Kapitalausstattung arbeiten und deren Zugang zu neuen Krediten schwierig ist.

Bei den überrepräsentierten Großbetrieben wird die Privatisierung dadurch erschwert, daß es an inländischem Kapital mangelt und ausländische Firmen am Erwerb von Unternehmen, die erst gründlich technisch, organisatorisch und finanziell restrukturiert werden müßten, nur mäßig interessiert sind, sodaß die Privatisierung nur schrittweise im Laufe einiger Jahre zu bewerkstelligen wäre. Ungeduldige Reformer setzen daher auf unkonventionelle Schnellverfahren, wo das Staatsereignis unentgeltlich oder gegen einen unbedeutenden, nominellen Beitrag unter den Staatsbürgern verteilt wird. Die so verteilten Vouchers werden dann in einem mehrere Runden währenden Auktionsverfahren gegen Aktien bestimmter Unternehmen, für die sich die einzelnen Staatsbürger oder in ihrem Namen als Zwischenglied eingeschaltete Investitionsfonds entschieden haben, ausgetauscht. Der Marktwert dieser Aktien wird nicht in den Zuge des Wertpapierhandels auf den meist erst entstehenden Börsen festgesetzt werden. In der Zwischenzeit, die ein bis zwei Jahre dauern kann, sind die für diese Art der Privatisierung ausgewählten Betriebe praktisch ohne jegliche Kontrolle und befinden sich in der sogenannten Vorpriivatisierungssagonie (ein Terminus, der von den Erfreunden der Vouchermethode geprägt wurde). In dieser Zwischenzeit kann es zu nicht wiedergutzumachenden Schäden und zu unzulässigen Bereicherungen interessierter Gruppen kommen. Der Ausgang dieser Methode ist selbst in Tschechien, wo sie am entwickeltsten ist, noch vollkommen offen. Es ist anzunehmen, daß ein beträchtlicher Teil der neuen Aktionäre versuchen wird, den Aktienbesitz so schnell wie möglich gegen Bargeld umzutauschen, was bei einer Verkaufswelle selbstverständlich den Wert der Aktien stark unter Druck setzen und manche Investitionsfonds in Liquiditätsschwierigkeiten bringen kann. Es handelt sich hier um eine lediglich oberflächliche Privatisierung, welche die von ihr erwarteten Realeffekte, wie z.B. eine entscheidende Verbesserung der Effizienz der Betriebe, nur ungenügend wahrnimmt. Darüber hinaus kann sie aber auch zur Vernichtung bedeutender Teile der Vermögenswerte und zu einer unzulässigen Bereicherung von Insidern führen, welche die Privatisierung in den Augen der Öffentlichkeit diskreditieren können.

(Par B IX)

Konventionelle Privatisierungsmethoden werden hingegen offenkundig mehrere Jahre in Anspruch nehmen. Das führt zu dem Schluß, daß vor der Privatisierung auch diese vorderhand noch staatlichen Großbetriebe kommerzialisiert, d.h. vom direkten Einfluß des staatlichen Eigentümers befreit werden müssen. Durch "harte Budgetbedingungen", aber auch durch eine positive Motivierung des Managements muß versucht werden,

**Löst der Markt alles?**


**Struktur und Industriepolitik ist unerläßlich**

Dabei ist eine aktive Struktur- und Industriepolitik wegen der noch unentwickelten Märkte und Marktreaktionen der Wirtschaftssubjekte in den TW bedeutend wichtiger als in den entwickelten Markturschaften. Die TW stehen überdies vor gewaltigen Strukturveränderungen und unerläßlichen Modernisierungen, die ohne eine aktive Industriepolitik nicht zu bewältigen sind. Eine solche Politik kann selbstverständlich nicht gegen die sich entwickelnden Marktkräfte gerichtet sein, sondern sollte sie eindeutig stärken und unterstützen. Neue indirekte Methoden der staatlichen Beeinflussung müssen erarbeitet werden, wie steuerliche oder
kreditfördernde Maßnahmen zugunsten kleinerer und mittlerer Unternehmen, regionalpolitisiche Eingriffe in durch Arbeitslosigkeit bedrohten Gebieten und exportfördernde Maßnahmen für Firmen, die die Möglichkeit haben, in Zukunft anhaltend Exporterlöse zu erwirtschaften.


Gegenwärtig wird in den mitteleuropäischen Staaten diskutiert, ob der Wirtschaftsrückgang bereits überwunden ist und man schon mit einer

Die Rolle des Westens

Wichtiger sind die mittel- und langfristigen Erwartungen, die die Wirtschaftspolitik der einzelnen Staaten dieser Region stark beeinflussen werden, ebenso wie Einstellung, Empfehlungen und Hilfestellungen des Westens diesen Staaten gegenüber. Die Hilfestellungen müßten verstärkt werden und insbesondere müßte eine weitere Öffnung der westlichen Märkte für Waren aus dem Osten erfolgen. Man kann sich des Eindrucks nicht erwehren, daß sich der Westen und insbesondere Westeuropa noch nicht bewußt sind, welche Gefahr die ungelösten Probleme Mittel- und Osteuropas auch für sie selbst birgt. Noch wichtiger als technische und finanzielle Hilfe, Marktzugang und Direktinvestitionen (deren Bedeutung keineswegs geschmäht werden soll) erscheint uns eine Neueinschätzung der vom Westen empfohlenen makroökonomischen Wirtschaftsstrategien, sofern sie als Bedingung für die notwendige Unterstützung formuliert werden.

unterstützen. Auf jeden Fall müßten die heute mit westlicher Finanzhilfe verbundenen Bedingungen, wie das Bestehen auf Verringerung der Budgetdefizite auch in der gegenwärtigen Depressionsphase wesentlich gelockert werden. Der von uns vorgeschlagene Weg hat aber u.E. auch deshalb eine größere Chance auf Erfolg als die bisher verfolgte konventionelle Stabilisierungspolitik, weil sie den verloren gegangenen Konsens der Bevölkerung, der für den langen Transformationsweg unumgänglich ist, in Kürze wiederherstellen könnte.

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Im Rahmen des hier zusammengefaßten Forschungsprojekts wurden bisher folgende Teilstudien durchgeführt, die zum überwiegenden Teil auch als Forschungsberichte des WIIW veröffentlicht wurden:

* Avramović, Dragoslav: International Experience with Adjustment Programmes and with Lending for Adjustment

* Bhaduri, Amit: Conventional Stabilization and the East European Transition

* Fath, Janos: Industrial Policies for Countries in Transition

* Hunya, Gábor: Speed and Level of Privatization of Big Enterprises in Central and Eastern Europe – General Concepts and Hungarian Practice

* Landesmann, Michael A.: Industrial Policy and the Transition in East-Central Europe

* Laski, Kazimierz: Transition from Command to Market Economies in Central and Eastern Europe: First Experiences and Questions

* Laski, Kazimierz: Fiscal Policy and Effective Demand During Transformation

* Levčik, Friedrich: The Place of Convertibility in the Transformation Process

* Levčik, Friedrich: The Thorny Path of Transition from Command to Market Economy

* Levčik, Friedrich: Privatization and Restructuring of State Enterprises

* Rosati, Dariusz K.: Foreign Trade Liberalization in the Transition to the Market Economy
WESTERN ASSISTANCE TO EASTERN TRANSITION
CHARLES COOPER

This paper is designed to raise an issue rather than to settle one. The issue raised is whether Western assistance to the economic, social and political transition underway in a vast territory of Central Eurasia as a result of the collapse of the Soviet Empire has been given adequate priority in view of the importance and diversity of Western interests involved.

Introduction
The liberation of Eastern Europe from Soviet control in 1989 followed by the end of Communist rule in the Soviet Union itself in August 1991 opened up the dramatic possibility of extending the realm of stable democracies respectful of human rights from the Atlantic into Central Eurasia, of establishing market economies in the former Soviet empire capable of providing growing prosperity on an equitable basis, and of revamping costly international security arrangements adapted to the needs of a post-Cold War world. Countries with some 400 million people seemed to be ready for assimilation into the ranks of the world's industrial democracies, to the great benefit not only of their inhabitants but of the world generally. To a limited degree all this is happening. However, the conditions of formerly Communist economies and societies were far weaker and internally contentious than generally realized, and the industrial democracies, themselves under economic pressure, have by and large failed to imagine and implement a coherent strategy for taking advantage of the new opportunities that presented themselves.

As a result, in mid-1993 in the many lands and countries of the former Soviet empire democracy is generally ascendant but fragile, ethnic and religious tensions and conflict are somewhere manageable and elsewhere bloodily out of control, economic reform and progress is spotty and its future course uncertain almost everywhere. Preoccupied with understandable domestic concerns and with ongoing foreign policy challenges elsewhere in the world we in the West have had trouble
rousing ourselves to this new challenge, even though it has enabled dramatic savings in the resources that would otherwise have been devoted to defense needs with the prospect of more to come in the years ahead. A difficult and challenging task has not so much proved unachievable as it has daunting and discouraging.

Today when we try to assess the post-Communist scene in East Europe and central Eurasia we aren't sure whether to be pleased or frightened. We are generally impressed at how quickly democracy has taken hold and Communism has lost its appeal even as we are concerned about the absence of strong political parties almost everywhere. Again we look with satisfaction at the growth of a dynamic private sector and the spread of market activities even as we note the growth in crime, ethnic tensions, social injustice and joblessness that has also taken place. We look again at actual and potential violence in a region where many borders seem to be only lines drawn in sand, living conditions for many are even worse than they were a few years ago, and old rivalries have reemerged. The ugly events taking place in Bosnia make us wonder whether History isn't in the saddle again leading us back into an era we thought we'd left behind.

An Uncertain Look

Change and progress have occurred, of course, most notably in Poland, Hungary, and the Czech Republic. In these countries, democratic governments have been able to carry out effective economic reforms which promise in a reasonable period of time to bring about fundamental improvements in productivity and living standards. Still, even where reforms have worked best the resultant social and political strains have been sharp and persistent. In Poland economic recovery after three years of slump was not enough to prevent the government from falling as a result of a series of strikes and budgetary stringencies which led to the government's refusal to accede to pay increases for striking health workers and teachers. In Hungary a projected fourth year of slump together with government plans to increase the value added tax and cut public sector pay has split the factions in the ruling Democratic Forum. Nevertheless, reform itself seems not to be the issue in either
case. A reasonable risk-taker might well take an even-money bet that the year 2000 would see the countries of Eastern Europe commercially bustling and politically democratic. That same gambler probably wouldn't touch such a bet for the Balkans, and he certainly wouldn't for Russia, Ukraine or most of the other successor states that emerged from the wreckage of the former Soviet Union.

In many of these countries, significant economic reforms are also occurring, notably price liberalization and the emergence of a significant private sector, but the outlook for deeper economic transformation remains highly uncertain. Undoing 70 years of Communism is proving no easy task. As yet neither prosperous market economies nor stable democracies can be safely projected.

In Russia, where the stakes are highest, price liberalization and substantial privatization have in the last eighteen months had a visible and important impact on the economic scene, goods are back in the stores and for the most part queues have disappeared. Employment in private sector activities has increased at a rapid rate and the beginnings of a modern market economy have become clearly visible. New market oriented institutions are developing and a post-Soviet man is increasingly noticeable.

Nevertheless much remains to be done before reform efforts can be said to be successful. Licensing requirements remain pervasive, property rights remain vague, minimal progress has been made in establishing adequate financial sector and capital market institutions. There has been little effective agricultural reform, and private ownership has been slow to emerge. Energy price controls remain in place and subsidies to large public enterprises continue to contribute to monetary disequilibrium. Government revenues have fallen sharply and inflation is running 20 to 30 percent a month. Energy price controls and export taxes and licensing requirements have even contributed to very substantial black market oil and gas exports. Large-scale capital flight is taking place, in part due to negative real rates of interest, and the currency market has seen the ruble decline to over 1000 R to the dollar. The continued labyrinth of controls and licenses has spawned an astounding variety of easy money schemes, some
legal, many not. Corruption and criminality is rampant. Social hardships are severe as the younger, more energetic, and the less scrupulous have been able to take advantage of new opportunities, while the older and less nimble have seen their standard of living deteriorate markedly.

Still to come in Russia are the effects of rationalizing overblown and inefficient large state enterprises, a process that is the inevitable counterpart of successful monetary stabilization efforts. Experience in East Europe, and in East Germany, has shown that as such enterprises are rationalized and marketized the economic disruption will be severe even though the real output decline of non-defense goods may be moderate. In particular, this essential next stage of economic reform in the FSU will result in sharp increases in unemployment, which is greatly feared by the public, but which up until now has been minimal.

In the second largest republic of the FSU, Ukraine, economic prospects are noticeably less encouraging since reform efforts have been stifled in their cribs. Ukraine is virtually the only country where the ruble is considered a strong currency. Inflation and slump today, unemployment and a worse slump tomorrow is all Ukraine can look forward to. Ukraine's ill-fated attempt to issue its own currency is also indicative of a failure to establish a working follow-on to the Soviet economic union among FSU republics. A de facto ruble zone has functioned poorly as a result of the inability to bring Russia's central bank credits under control and has been abandoned as a policy objective. In addition to stopping credits to the republics, a Russian decision to switch to world market prices for its energy exports to the rest of the FSU, together with its continuing hard-nosed position on sharing the debt burden, will make the coming months very difficult ones throughout the FSU.

Reform in principle retains public support and there is no apparent danger of a return of Communism to the region. even though several of the successor republics are currently run by former Communists. Given time, free market economic reforms will work if effective stabilisation efforts can be mounted. The longer-term future is not bleak but the
short-term outlook is anything but rosy. The potential political and security consequences of continued economic stagnation, currency inflation, increased social hardships and inequities, widespread criminal violence and corruption should not be taken lightly. The current constitutional discussions are not likely to end the uncertainties about governance within and among FSU republics. Today's borders may not be tomorrow's. Moreover democracy is lightly perched in most places, not deeply embedded. And while democratic governments look to be able to maintain their balance in the major political arenas, Keynes' famous warning suggests prudence in how long economic stringencies should be expected to be acceptable.

Western policies in support of eastern transition are becoming somewhat more effective, particularly as regards Russia. 1992 was marked by grand promises and little action. This year a new Administration in Washington has focused more attention on the problem, the IFI's have found how to reconcile their traditional ways of doing things with the novel requirements of transition, and the EC has recently begun to liberalize its trade policies towards the region, particularly for Eastern Europe.

If 1993 is likely to see more effective Western support for eastern transition, this support will be modest relative both to the needs and the opportunities presented. A sea change in the world's geostrategic structure is being managed as if it were just another foreign aid obligation. In the United States, President Clinton's welcome championing of increased aid to Russia is pushing water up hill in view of his Administration's concentration on domestic economic issues. As a result, modest proposals are presented as adequate to the task at hand. Only a very optimistic reading of the outlook suggests this is the case.

**Lessons From The Marshall Plan**

Sooner or later, discussions of how to facilitate economic transition in the successor states turn to the Marshall Plan as an example of how large-scale external assistance can at the right moment make a critical difference in turning around problem economies. Economists being a quarrelsome lot, there is an extensive literature on
the relevance, and for some the irrelevance, of the Marshall Plan both to postwar reconstruction and the current struggle for transition in the East. Moreover different countries benefited in different ways and in different degrees. This literature is well exemplified in the publication earlier this year of the papers and proceedings of an LSE conference on the relevance of the Marshall Plan to eastern transition. 1

Drawing in part on the excellent summary chapter by Delong and Eichengreen in this volume the following broad conclusions emerge:

- The amount of Marshall Plan aid was not a decisive factor in any mechanical sense, as aid levels were just too small in and of themselves to provide the capital and materials needed to fuel postwar growth. Mobilizing domestic savings was key, but Marshall Plan aid at 2.0-3.0% of recipients' GNP helped in closing the financial gap between the demands of various social claimants for resources and their availability. (If pre-Marshall plan aid is taken into account, a case can be made that needed raw materials and equipment were provided when they were critically needed to break bottlenecks in the early postwar period.)

- The bilateral pacts entered into between the United States and individual countries as conditions for Marshall Plan assistance promoted balanced budgets, internal financial stability, realistic exchange rates, European financial integration, and tipped the balance decisively towards market forces rather than the extensive government controls which many of the recipients were likely to have chosen left to their own devices. To help achieve this, counterpart funds were used to influence marginal expenditures in accord with US

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wishes and were also "frozen" as a means of limiting government spending.

- While there was no quantitative precision in the distribution of aid, there was a rough and ready parity among the aid provided to the various recipients enforced by the requirement that recipients play a key role in determining relative needs.

- US policies in the Marshall Plan encouraged trading off current consumption for longer term growth through wage discipline and high rates of investment and capital formation.

- Marshall Plan conditionality was effected by the early provision of funds to facilitate policy reforms to come, with the long-term assurance of additional funds as they were needed (provided the basic policy lines continued to be appropriate). Such assurance was provided by the fact that the full multi-year program was appropriated by the US Congress. (The new IMF systematic transformation facility created this year breaks through the austere IMF practice, born of later experience in developing countries, of only rewarding reforms after the fact. It does not offer assurance of multi-year funding.)

- Marshall Plan conditionality was pragmatic rather than theological. For example, while liberal trading practices were encouraged, temporarily high levels of protection were accepted. Similarly, pragmatic accommodations were permitted in financial markets and full convertibility was not achieved in Europe until 1958.

- The US accepted European exports freely and even tolerated a degree of discrimination against its own exports. Together with US insistence that there be no barriers to internal European trade, this contributed to export growth as a leading sector in European recovery.

- US financial assistance was provided on a grant basis. Debt burdens did not complicate the recovery process, while European recovery stimulated and supported US growth and prosperity.

The aid scene in Eastern Europe and the transitional states is very different from the picture drawn from these somewhat idealized observations. Some of the differences are inherent in the differing
circumstances. But the most significant reflect the much lower degree of political commitment to the program on the part of both donors and recipients. Not just the amount of assistance is relatively smaller, but the terms are less generous, the element of multiyear commitment is missing, the close political understandings regarding what is politically feasible in trade and financial matters is much less apparent, and the trade environment is far less congenial.

One reason for these differences is that the Marshall Plan was fresh, the first trial run of 'economic aid' as a foreign policy tool while experience since then has bureaucratized foreign aid and made publics more skeptical and less trusting about aid matters generally. One consequence is the virtual abandonment of grant aid except for humanitarian programs and the continued drying up of long-term concessional assistance. Another reason is that the strains of the current worldwide economic slump are such as to occasion public resentment of government programs that are not focused directly on improving domestic living conditions. Such resentment is intense in the United States.

The strategic setting is also very different. The Marshall Plan drew broad support among both donors and recipients in part because of the bipolarization of the world, symbolized by Soviet refusal to permit participation in it by bloc countries. Its integration in a broad strategy of economic recovery and reform, democratic nation-building, and security cooperation was part of its durable appeal. As contrasted with technocratic assistance provided by multilateral agencies, Marshall Plan aid was clearly perceived by the public as an expression of nonpartisan political partnership among like-minded democratic countries. International assistance to eastern transition, however, has already come to be generally viewed as just another foreign aid program.

This development is particularly unfortunate since at the heart of the transition process is the objective of building new democratic governments almost from scratch, whereas Marshall Plan recipients all had many years of relatively recent experience with democratic forms of government. Even in Germany which had to start from scratch politically as well as economically, the experience of democratic rule was
relatively recent and a strong democratic tradition existed to draw on. In East Europe democracy had been absent for some 45 years and in the FSU for some 75 years. What is truly remarkable is how rapidly democracy and market-oriented economic policies have been able to command public support in the face of difficult economic conditions and social upheaval.

Finally, the economic problem being dealt with in the transition process is itself very different to the economic challenges addressed by the Marshall Plan. Nothing comparable to the "privatization" problem at the heart of the Eastern transition process existed in postwar Western Europe. War-ravaged though Europe was the institutions and mechanisms of a market economy were in place in all countries. Marshall Plan experience thus provides no guidance on how to manage the microeconomic effects of stabilization policies in countries where large, inefficient, and outmoded state sector enterprises dominate the economic scene, and where market adjustments are dampened or even nonexistent as a result of the lack of effective market institutions and experienced entrepreneurs and managers. and where many workers lack market-relevant skills and experience.

Rethinking Western Support For Eastern Transition.

1. Establishing a credible partnership: the need for integrating economic assistance and security interests. A salient feature of the Marshall Plan period was the integration of economic, political and security objectives facilitated by Soviet rejection for itself and its clients of participation in the Marshall Plan. If Western support for the transition process is to become more effective, the goals of establishing stable democracies, productive market-based economies, and appropriate security arrangements must be seen as mutually dependent and mutually reinforcing. The evil events today in what was formerly Yugoslavia illustrate the fragility of a status quo where none of these goals had been satisfactorily met, even after many years of independence and quasi-integration into the Western world. But such systemic failure can easily arise from the dynamic consequences of failure in any one of these areas. Persistent poverty and perceived
social injustice may jeopardize nascent democracies, unmet national security concerns may lead to reliance on a domestic military establishment uninterested either in democracy or a stable international scene, uncertainty about another country's security policies may preclude supporting its efforts to strengthen itself economically, etc.

Support by the West for economic transition can be sustained only if there is common understandings of security interests. Indeed, the successful negotiation of STARTS I and II and of agreed limits on conventional arms is the basic underpinning of US and Western support for Russian economic reform. A tacit alliance with Russian and the Gulf War seemed to confirm a growing communality among Russian and Western security interests. The Nunn-Lugar aid for nuclear dismantling initiatives, a bright spot in last years moribund economic aid scene, shows how closely connected economic support and security cooperation are in the mind of the U.S. public.

Little has been done, however, to institutionalize common security interests. Meanwhile, under domestic pressures to reassert its interests as a great power, Russian foreign policy has begun to reassert its independence from the West. Not only has Russia begun to reinterest itself in former areas of interest such as India and China, but it has played an active diplomatic role in the Bosnian crisis. Initially concerned to avoid the threat of military actions against Serbia, Russian policy has evolved to where today it is reported to be willing to send troops to defend the designated safe-havens. The diplomatic shuffle in Bosnia has been a serious and awkward affair and Western policy has been constrained at various times by evolving Russian interests.

The lack of an articulated European security structure capable of identifying and seeking to defuse potential trouble spots in advance is worrisome. It takes little imagination to conceive of a new crisis, in the Balkans or elsewhere, where deference to Russian interests is hard to explain publicly, and a next one after that when it is clear that no commonality of interest exists. Russia needs to have a reasonable understanding regarding what roles and missions for its armed forces
are acceptable to the West, and to what degree Russian interests can be taken into account and accommodated. Moreover, if the West is going to provide significant economic support to Russia, Russian military strategy as well as its force structure must be seen to be politically acceptable.

The greatest security challenge for Russia as well as for the West is likely to lie within the former Soviet Union, possibly with the Russian Federation itself. Active conflicts we, Georgia Tadjikistan bear witness to the challenge. The possibility of armed conflict between Russia and Ukraine is often cited as a realistic worst-case scenario. Unfortunately, while unlikely in the extreme, it can't be entirely ruled out in part because the whole structure of the FSU is so unstable. Great Russian sentiment on a collision course with local ethnicity and or religious zealotry is easy to imagine in many places in the FSU. At the same time it is hard to imagine stability in Central Eurasia without a strong Russia.

An effectively governed democratic Russia respectful of human rights, mindful of the interests of other countries as well as of local areas within Russia, adhering to internationally agreed norms regarding border changes is the sine qua non of stability across a wide region of Central Eurasia. A common understanding among the Western industrial democracies, East Europe, Russia, Ukraine and other countries of the FSU regarding the responsibilities and authorities of such a Russia, including its military capabilities and the purposes to which they are put, is of extraordinary importance. The current crisis in Tadjikistan is only the most recent case in point.

A necessary precondition for this to be achieved is that Russia remains democratic. This in turn is likely to require a degree of economic success that so far has proved elusive. Russian governance both within the Federation as well as in the "near abroad" is far more likely to turn harsh and repressive if economic and social conditions remain harsh than if burgeoning prosperity channels individual hopes and aspirations into the innocent pastimes of becoming better off. Any such turn could greatly complicate prospects for international support for Russian economic progress.
The close link between security issues and economic support is shown in a different way by the diplomatic impasse which developed last year between the US and Ukraine. Ukrainian unwillingness to promptly turn over strategic nuclear weapons to Russia has blocked implementation of the START treaties. It is understandable that concerns about being bullied by a nuclear Russia have made it politically expedient to many Ukrainian political leaders to support holding on to such weapons, particularly when a chorus of Russian voices asserting Russia's special rights in the FSU can be heard with little Western demurral. US policy up until recently of refusing to discuss economic and other issues with Ukraine until it had complied with its previous agreements simply aggravated the concerns and paranoia underlying this stance. With little being offered in the way of either credible security assurances or economic support, Ukrainian incentives for compliance were minimal. Up close and personal the great Russian Bear doesn't look warm and cuddly to a country with a long memory and a large ethnic Russian minority. The recent change in US tactics on this issue offers a better chance for a way out of this tangle.

Strains between Russia and Ukraine are particularly worrisome, but they are hardly unique. The Russian Federation that emerged from the wreckage of the Soviet Union is a vast and diverse territory containing an amalgamation of peoples of many different ethnic, religious and historical backgrounds whose interests frequently diverge. (The same might be said for Ukraine!) It is also an incomplete nation, 25 million of whose people are now precariously trying to adjust to living in somebody else's country. Under present economic and social conditions, in the light of pent up rivalries of one kind or another suppressed during Communist rule, and bearing in mind the vast quantities of military equipment and large numbers of trained soldiers, it is easy to see why several conflicts have already broken out - in Georgia, Armenia and Azerbaijan, Moldova, Tadzhikstan, as well as inside the Russian Federation itself. Unfortunately it takes little imagination to conjure up the possibility of further and bloodier conflicts still to come should deteriorating economic conditions make effective governance ever harder to achieve.
2. Increasing the financial contribution of economic assistance by multi-year funding and debt policy easements. As noted above, Marshall Plan aid was funded by a single donor on a multi-year basis and could therefore be continue over several years. This stands in contrast to present arrangements where aid is provided through numerous different donor spigots all of which require different conditionality code words and stay on for differing periods of time. The result is that officials trying to put together reform programs can never know where they really stand with respect to the availability of external resources.

At the same time, in one way or another all of the recipients are compelled to participate in complicated negotiations regarding the servicing of foreign debt, most of which was contracted by previous Communist regimes and put to dubious use. In addition, much of the assistance that had been provided has taken the form of relatively short-term supplier credits for both industrial and agricultural goods. The result is that the debt servicing burden remains a constant source of concern that requires substantial high-level negotiations and attention. Time could be better spent by both donors and recipients on other matters.

Few informed analysts believe that substantial additional external aid by itself is critical to the success of the transition processes. However, most would argue that the aid that is provided should be made more predictable and longer-term, and that historical debt should be generously written off or deferred. The plain fact is that the concessional value of aid that is being provided is quite a bit smaller than the impression given by its budgetary numbers.

Additional aid is no substitute for self-help efforts and can be counter productive if it inhibits them. But there is now abundant evidence that the political fallout occasioned by the social and economic strains of transition to a market economy makes the establishment of durable democratic processes very difficult. More generous aid in support of sound reforms could, if wisely used, help ease this problem. If public support for Marshall Plan levels of aid cannot be achieved, all the more reason that those funds that are provided be made fully effective by liberalizing debt policy and multi-
year commitments. Removing the weight of the past debt overhang would also have the benefit of encouraging foreign investment - and in the process could very well result in increasing the value of eventual paybacks.

3. Conditionality is essential, but should include undertakings regarding microeconomic policies as well as macro stabilization efforts, and at a high policy level should be negotiable with a single donor interlocutor. The unique feature of the transition process is the degree of entanglement between macroeconomic liberalization and stabilization measures, and microeconomic reforms, particularly in the state sector.

Large state enterprises formed by bureaucratic rather than market processes cannot survive in competitive markets without substantial structural modification, if then. Typically they employ too many people in their production activities and still more in their capacity as purveyors of social services; have large amounts of inappropriate capital; are too highly integrated vertically have monopoly positions in their particular economy; operate inefficiently because of unduly cheap energy and raw materials; are enabled by low interest rates to maintain grossly excessive inventories of raw materials, goods in process, and final products; have weak and inexperienced senior management; lack adequate financial and marketing personnel have little knowledge of their foreign competition; and have a financial balance sheet that makes no sense in market terms.

When such enterprises are brought to heel by the enforcement of reform-induced hard-budget constraints and import competition, a series of demanding management challenges immediately arises that cannot easily or quickly be dealt with. In Communist economies many of these management issues would have properly been dealt with, if at all, at Ministerial level. But transition requires strategic decisions about layoffs, shutdowns, downsizing, spinning off services, extricating enterprises from social responsibilities, asset selloffs and write offs, product line specialization, process adjustments, drastic inventory reductions and a host of other perplexing issues. These management challenges arise whether or not the enterprise is privatized, placed in
some sort of public trust a la the Treuhand, or allowed to go bankrupt and then taken over by some new "owner" in what has been termed "slingshot privatization". Experience has shown, not surprisingly, that the initial consequences of reforms are substantial cutbacks in enterprise employment and output. For the economy generally, this results both in reduced output and disproportionate increases in unemployment.

Of course, the aggregate effects are mitigated somewhat by the increased economic efficiency that results even initially and more so over time. But the shock effect of the therapy is still real. Moreover, the social consequences are severe since not only has aggregate output gone down, but the increased incomes of the new class of service sector entrepreneurs and other beneficiaries of reform comes in part at the expense of the newly unemployed, retirees, and workers in traditional industries. Moreover, the adjustment process will not be speedy: a decade or more will be required.

A successful reform strategy accordingly requires both microeconomic reforms and macroeconomic discipline. The key conditionality negotiations have focused primarily on macroeconomic stabilisation. At the same, different donors or programs may require funds to be used in support of particular microeconomic reforms. The result is a multiplicity of negotiations and the lack of an integrated reform program.

A variety of internationally negotiated programs, some negotiated at regional and local levels, is all to the good. Western donors only imperfectly understand what is required for a successful transition and an experimental "back what seems to work" approach is desirable. Competition among donors and programs should be encouraged. Conditionality with regard to large transfusions of aid financing, however is best centralized as much as possible since recipient Government administrative capabilities are overtaxed in the base case. The prospective establishment of a G-7 liaison in Moscow should be used to consolidate donor strategies and reduce the variety and frequency of program negotiations required. This should be done in other capitals as well.
Conditionality discussions should incorporate major microeconomic reforms as well as stabilization targets. For example, it is scandalous that the oil sector in Russia is in the state it is in part because of Russian reluctance to liberalize oil prices. The diversion of industrial oil supplies to an export black market with the proceeds deposited in Swiss banks is as much a reform failure as the headlong growth of the money supply. Similarly progress in establishing a more effective private housing market is needed to encourage labor mobility and is appropriately a subject for negotiations with donors. Also critical is the need to reform agricultural practices and stimulate increased food production. This is an area where current aid efforts are, if anything, counterproductive since the ready availability of imported food discourages entrepreneurial activity and reduces the urgency of needed microeconomic reforms.

Finally, in Russia in particular, some understanding regarding military production and exports is essential for political as well as economic reasons. While some limits on high-tech exports to rogue states is a reasonable request, blanket limitations on conventional arms exports generally would not be and any attempt along these lines would rightly be viewed as protectionist rather than security related.

4. Liberal trade policies on the part of donors are essential. This is an area where the temptation to provide assurances today about tomorrow's policy are apparently as irresistible as they are unsatisfactory. Neither enterprise managers nor potential investors will take such assurances seriously. Until they can and do, economic transition will continue to be adversely affected. As noted above the EC has addressed this issue more directly than before, but the current association agreements still stop far short of what is needed. Some 40% of East Europe's exports consist of agricultural products, textiles, steel, and chemicals. Some sort of temporary protection in such so-called "hardship" sectors may be needed, preferably from tariffs, but should be limited and phased out as quickly as possible. Moreover, the successor states of the FSU remain in a sort of trade policy limbo subject to state-trader restrictions by the EC, and still subject to Jackson-Vanick in the United States. Russian complaints about this
matter, and the prospect of prolonged negotiations regarding its membership in the GATT, have gotten nowhere.

5. Reasonable even-handedness among recipients - a rough comparability taking into account need, readiness for reform and equity is essential. In practical terms this means resisting the temptation to focus too heavily on Russia and taking into account the distributional effect of reforms. An obvious example among the various transition states is the need for compensating other republics when Russia switches to world market prices for its oil and gas exports. It is important not to convey the impression that only Russia counts - which is not true as the imbroglio with Ukraine over nuclear policy shows. Russian relations with East Europe as well as with other successor states are going to remain complicated and unsettled for some time to come. Aid policies ought to remain politically neutral unless there are strong reasons to the contrary. The Marshall Plan practice of requiring recipient agreement on the distribution of assistance in some modified form could be helpful here.

6. Substantial investments in environmental clean-up must be part of Eastern transition. Turnaround requirements greatly exceed the domestic resources available than anywhere in the world. "Sustainable development" may be further from realization in EE and the successor states and it won't be achieved quickly or cheaply. Concerns over nuclear safety are only one problem in a vast geographic area where air and water pollution are endemic, and land use management virtually non-existent.
CONCLUSION

More than their publics, Western statesmen realize that the stakes are high in the struggle for a successful transition to democracy and market economies in Western Europe and the successor states of the former Soviet Union:

- The present opportunity for adding new members to the community of practicing democracies respectful of human rights if all too likely to prove temporary if the strains of transition overwhelm its promise.
- Violent conflicts in Bosnia, the Caucasus, and Central Asia underscore the threat of instability in a region where both conventional and nuclear arms are plentiful. If a renewed geostrategic challenge appears a fanciful danger for the foreseeable future, the spillover of regional turbulence does not.
- In addition to the potential for spreading conflict, growing numbers of refugees and would-be immigrants reveal the potential for an irresistible movement of peoples across old Cold War borders.
- At the same time, hopes for a decisive worldwide move in the direction of sustainable development appear delusory in light of the spreading stain of environmental degradation throughout the region.
- Finally, the potential for a relatively near-term increase in world economic productivity as new productive market-oriented economies emerge could, if realized, provide a badly needed stimulus to a sagging global economy.

The magnitude of the opportunities at issue is not unlike that existed in the early postwar period. However, compared to the response of the Marshall Plan and its attendant initiatives, the Western response this time has been tepid, bureaucratic and inadequate. Quantitatively, economic assistance has been stunted, while procedurally it has been administered with a heavy technocratic hand rather than a sensitive political touch. Paradoxically, the result has in many cases been too little incentive for "reform" as Russia, and other recipients, have felt pressured to adapt to somebody else's idea of sound policies rather than to devise their own. Since the problems of transition are historically
novel and there is no agreed "right" approach this is doubly unfortunate. The evidence of Polish success to date is persuasive for Poland, but certainly no more so than the evidence of Chinese success with a very different approach.

Certainly just throwing money at the problem is not the answer as the disastrous example of German loans to Gorbachev’s failing regime shows. The extent of corruption and capital flight in Russia today is a salutary example of the need for sound policies, but just what such policies are remains a matter of debate. What is not legitimate is the argument that foreign assistance necessarily undercuts reform efforts, and that only private investment can be counted on to be productive. Foreign assistance appropriately administered can meet two urgent economic needs: first, the political and social need to shore up living standards for the many who are hurt by the inevitable disruption of the transition process; and second, the need to provide new capital to accelerate the adaptation of transitional economies to their new circumstances as participants in an international competitive economy.

It might be argued that neither of these needs is really "necessary" for a successful transition which can be brought about solely by disciplined self-help reform efforts. However, what is really at issue is whether the likelihood of a successful transition can be enhanced by foreign assistance. Even though a substantial proportion of the declines in production that stabilisation efforts cause in transitional economies is simply eliminating waste, the sharp increases in unemployment and the drastic redistribution of incomes that result makes it hard to sustain political support of the reform process. Given the degree of disruption that transition involves, as opposed to that entailed by more standard economic development scenarios, helping to cushion the blow to the many who are hurt by providing financial support via the sale of aid-financed imports can make a decisive difference in the degree of political support that economic reforms can enduringly command.

At the same time, waiting for private capital inflows means waiting for investor confidence in the legal framework and financial institutions that only time can bring about. Private investors are not
comfortable with non-market risks. It is precisely such risks that are attendant on early investment that public financial institutions and programs are called upon to take and that private investors will for the most part shun.

International financial institutions cannot be expected to behave with the same sensitivity to political constraints as governments. A more effective and comprehensive political relationship must be build between Western industrial democracies on the one hand and Eastern Europe and the successor states of the former Soviet Union on the other. In light of the many other issues now clamoring for attention on the international agenda, it may be quixotic to suggest that a new international political initiative is needed to establish an appropriate organizational framework for such a relationship. What then is the alternative?