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PRESENT STAGES OF ECONOMIC REFORMS AND PRIVATIZATION PROGRAMS IN EASTERN EUROPE: THE CASES OF EAST GERMANY, CZECHOSLOVAKIA, POLAND AND HUNGARY

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ABSTRACT

East European economies are in the process of experiencing an unprecedented transition from a central planning to a market system, parallel to the democratization of the political sphere. The main purpose of this paper is to show a sequencing of the economic deregulation and expectations at each stage of economic transformation. The author presents a critique of central planning and advocates a free market as a desirable direction for reform programs. Selected components of these programs are critically examined. Among them, far reaching and unrestricted privatization, discretionary monetary policy, full convertibility of domestic currencies and large-scale deregulation of businesses are favored. The author emphasizes the dangers for successful reform of excessive taxation, protectionism, and exaggerated regulatory involvement of governments. He advocates a comprehensive, gradually sequenced approach to reform programs somewhat different from the “shock therapy” proposed by several academic economists and government policymakers. The suggested transition to market structures is subdivided into three stages: 1. the period of decentralization of major pricing categories; 2. decomposition of monopolies and activation of competitive markets; 3. accelerated economic growth and capital accumulation. Anticipated patterns of inflation, exchange rates, interest rates, and national income are derived for each of these periods. The final section examines current problems of integrating the East German provinces and implementing reform programs in Czechoslovakia, Poland, and Hungary. Concluding remarks focus on aspects of East European restructuring that may affect multinational firms’ strategic plans for their involvement in this region.

RESUMEN

Las economías de Europa Oriental están en el proceso de experimentar una transición sin precedentes de un sistema central planificado a un sistema de mercado, paralelo a una democratización de la esfera política. El propósito principal del trabajo presentado es el de mostrar una secuencia de deregulación económica y de expectaciones a cada etapa de la transformación económica. El autor presenta una crítica al sistema central planificado y aboga por el sistema de mercado libre como una dirección deseada de los programas de reforma. Componentes selectos de estos programas son examinados críticamente. Entre éstos son favorecidas una privatización de gran alcance y sin restricciones, una política monetaria discrecional, la convertibilidad total de las monedas nacionales y una deregulación a gran escala de empresas. Son recalcados los peligros de impuestos excesivos, del proteccionismo y de las políticas regulatorias exageradas por parte de los gobiernos para asegurar el éxito de las reformas. El autor persigue un análisis comprensivo, de secuencia gradual de los programas de reforma, algo diferente a las “terapias de choque” propuestas por varios economistas académicos y políticos gubernamentales. La transición a estructuras de mercado sugerida se subdivide en tres etapas: 1. el período de decentralización de las categorías de precios principales, 2. decomposición de monopolios y activación de mercados competitivos, 3. una acumulación de crecimiento económico acelerado y de capital. Patrones de inflación anticipados, tasas de cambio, tasas de interés y de ingreso nacional son derivadas para cada uno de estos períodos. La sección final examina los problemas actuales para integrar las provincias de Alemania Oriental y los programas de reforms en Checoslovaquia, Polonia y Hungría. Las observaciones finales enfocan aspectos sobre la reestructuración de Europa Oriental que pudiesen afectar los planes estratégicos de empresas multinaciones relacionados a su involucramiento en esta región.

I. General Goals of Economics Transformation

Since the mechanism of central planning has essentially ruined East European economies, the ultimate goals for their reform are constructed as an antithesis to the command system. There is neither a comprehensive theory nor sufficient practical experience of a full transition from centrally planned to a decentralized market economy. Therefore, nations like Hungary, Poland, Czechoslovakia, and East Germany are in the process of undertaking a truly pioneering experience.

Formulation of ultimate goals for their economic reconstruction is a fairly easy task, although a full understanding of these goals is more complicated since these societies are not accustomed to the functioning of a market-based system. The discussion presented here on these common goals attempts to emphasize their interpretation and economic impact.

Superiority of a market system as a goal for East European economic reforms arises by antithesis to the major reasons for the failure of the command economy mechanism. At least three broad causes of the collapse of socialist central planning can be noted here. Firstly, there was a separation between an exclusive decisionmaker (the government) and decision executors (firms and society) which led to a passiveness in social economic initiatives. Reformers wish to rebuild the entrepreneurship and innovation of people and firms under conditions of market competitiveness. Secondly, both the quantitative and the value-based central planning led to a substantial technological retrogression of state-owned, monopolistic firms. They were only interested in producing the assigned quantity or value of simplified products, not having the technological incentives to win a market share that normally occur under competitive structures. Thirdly, the same planning mechanism caused a lack of cost saving efforts, since companies were accountable only for the final output at whatever costs they incurred. It was sometimes in their interest to maximize costs in order to drain more easily obtained state subsidies. This situation led inevitably to a high land and capital intensity of production and consequently to overstated material costs and low value added. It is believed that a market system will correct these deficiencies.

The targeted system is consistent with general messages of free market capitalism, where economic decisions depend upon supply and demand conditions and equilibrium prices. Deregulated prices of goods and services, interest rates, exchange rates, and wage rates are expected to fulfill an informational function, which they could not satisfy under the centralized system. As they are able to do so, the society's knowledge and productivity will be better utilized. This assumption reinforces a statement by F. A. von Hayek that "no centralized system is capable of gathering and processing the requisite information coordinating activities as efficiently as a decentralized free market economy."[1] Previously, the economic information system was based on massive amounts of data exchanged through bureaucratic channels between the government and economic agents, where fixed prices and production quotas reflected the authority's preferences rather than the society's. The new system is expected to release forces of the "invisible hand" where the price system transmits buyers' preferences, production, and allocation messages among different economic agents. Consequently, the reform programs are to be built on deregulated prices, market interest rates, and flexible exchange rates, not distorted by any type of central interference.

The second commonly acceptable goal is competition and freedom of choice. For this purpose demonopolization of existing structures and a shift of responsibility for economic decisions from governments to consumers and businesses are required. It is no longer society's role to await and then to execute economic decisions that were often based on limited and distorted information. A new type of social creativity and initiative is expected from workers, consumers, and business leaders, who are now empowered, but not quite ready, to make such decisions. Today, the problem is especially evident in the case of East Germany, where Western firms are signalizing difficulties with finding a proper degree of entrepreneurial ability in a society still hibernating as a result of central planning. Under new conditions of competition, societies are motivated to generate profit-seeking businesses. At the same time, they will have to accept many business failures. Many of today's unprofitable companies still function under "hothouse" conditions consistent with what Janos Kornai calls a "soft budget constraint"—a weak financial discipline of state-owned firms always kept afloat by heavy government subsidies.[2]

[1] See Hayek, 1948.

[2] For an extended discussion see Kornai, 1990, pp. 57-79.

The third general goal for Eastern Europe is privatization, understood in the sense of contemporary capitalism. No longer will the means of production belong to the state, thus no longer can they be misused, neglected, or inefficiently employed. Moreover, the main purpose of public stock emission of today’s large state companies may be to create an opportunity to access new sources of external capital for their future expansion. The capital stock cannot just be given away to employees, who have a limited excess liquidity anyway, but should be open to anybody who is willing to invest funds in the company. On many occasions East European authorities have expressed fears about excessive selling of national companies to Western, particularly West German, investors or speculators. Their position is understandable from a perspective of a prewar capitalism, but today these reservations ought to be largely discounted, since most of the contemporary corporations are managed effectively by top executives facing numerous dispersed shareholders rather than a few exclusive owners. It is imperative, that reforms of property rights and financial and accounting systems are instituted concurrently with privatization.

The main feature of structural reforms is a departure from central planning and directing economic activity on the microeconomic level to a macroeconomic stabilization policy. Governments are expected to use fiscal and monetary policy tools identical to those presently available to industrial market economies. Direct price controls and allocative priorities to heavy industries will very likely be ended. Agriculture, consumer goods, housing, and service sectors will gradually regain preferences that were suppressed by socialist central planning.

A strong managerial role played by governments is expected in the transition period to the macro-oriented policy. It is a paradoxical phenomenon, since the ultimate goal of the economic reform is a market-based system with limited interference from policymakers. Economic leaders will face a need to end the proactive regulation of business operations, granting them more freedom. Central management of fiscal and monetary policies is essentially unknown to government leaders in Eastern Europe, so long accustomed to planning directives.

Governments are expected to apply an expansionary fiscal policy in the transitional period. Progressive tax rate based income policy is designed to repress inflation. Strong government funding for economic restructuring is desirable as well. On the other hand, subsidies and tax breaks supporting noncompetitive businesses will be phased out.

Plans for currency convertibility and deregulation of commodity and capital markets will confront weak, comparatively disadvantaged Eastern economies with leading Western manufacturers and financial institutions. Consequently, fiscal policy will be aimed at strengthening desirable firms that can be expected to gain a competitive position in world markets. As a result of fiscal expansion budget deficits will arise. The easiest, yet the most dangerous, way to offset these is heavy taxation. It is essential that governments reject this in order not to spoil business initiatives, savings rates, and the entire program of restructuring. A prefered way of financing budget deficits is a creation of public debt, so far not applied by these economies. If excessive debt to GNP ratios occur in the remote future, accommodative, proinflationary monetary policy will likely take place to reduce them. It is imperative that the postsocialist policymakers observe the nature, dimensions, and dangers of contemporary fiscal policies in developed market economies to ensure their skillful management. A fiscal burden, unavoidable in the transitonal period, can be eased by a further expansion of Western credits supporting programs of economic restructuring.

A crucial part of the macroeconomic refocusing is the construction of commercial and investment banking systems, central banking, and an active monetary policy. Experienced personnel in this area are scarce and training needs are substantial. No longer will these countries have a monobank serving exclusively as a channel of collection and distribution of funds. A multiple and competitive banking system will have to be instituted in order to generate an active monetary policy and money markets with equilibrium interest rates serving as the most important measure of investment efficiency, forcing companies and individuals to the most profitable portfolio structures. The rates will also reflect information about inflation expectations and liquidity shortages or surpluses and will ultimately provide a ground for currency stabilization. Until such markets are effectively in place, all East European currencies will substantially depreciate. It is essential for economic reforms today that priority be given to a construction of a solid central banking system. The groundwork for such a system was presented recently at a conference on East European central banking, which took place in a “noneconomic wilderness” of Wyoming, with creative presentations offered by New York Federal Reserve Bank President G. Corrigan and several economists from the IMF, World Bank, and academic institutions.[3] Successful establishing of profitable business firms was stated as a necessary condition for an efficient financial system. It is imperative that the newly emerging financial institutions in Eastern Europe are viewed as safe and convenient outlets for public deposits, where a large fraction of savings will be highly liquid and used to make payments and generate credits. Inexperienced bankers in that region need a fair amount of guidance through sizeable regulation and oversight, primarily in the area of management of the desirable level of reserves and prudent credit allocations. The correctly working system will direct credit to the most efficient, most competitive, and most profitable recipients who will become the most capable of producing the stream of goods and services that will permit the economy to grow. East European bankers face the task of assessing the size and the composition of banks' capital account as a source of permanent funding and as a cushion for eventually occurring losses. The capital base is expected to serve a function of creating a constituent group of individuals and institutions who will have a direct interest in the profitability of the banking system. For this reason private ownership of financial institutions should be the most desirable solution. It is not easy to achieve these banking system foundations. It will take time to educate managers of financial institutions, to create public confidence in the financial system much damaged today under galloping inflation, especially in Poland, and also to generate sufficient domestic capital accumulation. Conditions of low inflation and positive real interest rates are absolutely essential for this purpose. In addition, an excessive outflow of domestic capital to satisfy external debt payments must be prevented through rescheduling and through foreign actions foregoing large portions of obligations. This will help the domestic financial system to accumulate capital. The desirable time for a sound financial system reform is perhaps the most important obstacle to the Polish concept of a "leap to the market economy" advanced by Deputy Prime Minister Leszek Balcerowicz and by Harvard economist J. Sachs.[4]

[3] See Corrigan, 1990.

[4] An extensive description is provided by Lipton and Sachs, 1990, and by Sachs and Lipton, 1990.

Almost all East European markets, commodity, capital, labor etc., are too weak to face a competitive confrontation with the developed Western economies. So far they have been isolated by centrally planned systems serving a function of extreme protection. Prevention of excessive injuries can be expected to emerge as an argument for a sizeable protectionism based on nontariff barriers, sophisticated subsidies, and capital flight controls contrary to GATT arrangements. It is questionable whether Poland, Czechoslovakia, and to a lesser extent Hungary will be able to avoid a similar phenomenon to the East German experience, where the economic merger with the West completely redirected domestic aggregate demand on Western goods, literally crushing the inadequate local economy. The expected protectionist tendencies may delay the much desired collusion of Eastern Europe with the European Community and may impede its smooth cooperation with other members of GATT.

Discussion of the role of a central bank in the new economic system should not bypass the issue of how to manage monetary policy. It seems more appropriate that a central bank, as a single monetary authority, will initially pursue a discretionary policy, rather than rigid rules of money supply growth. This advice is contrary to the calls of monetarists in the process of construction of the East European system.[5] The rationale for a discretionary approach is that the initial formation of money markets and the commercial banking system, combined with a decomposition of monopolies in the production sector of the economy, will very likely be accompanied by severe monetary shocks. For instance, price decentralization usually happening before demonopolization of industrial structures may cause excessive inflation resulting in a sudden increase in the demand for money. A central bank will have to react with a strong liquidity injection to the monetary system. In addition, we may expect some mistakes from inexperienced commercial bankers in the transitional period in management of a desirable level of bank's reserves. Again, offsetting liquidity reactions will have to take place. Furthermore, reaction lags between different monetary aggregates may be more severe under newly constructed economic systems than those known to monetary systems in industrial market economies. All these conditions will

[5] Such a call was presented, for instance, at the Conference on East European Central Banking in Wyoming in August 1990 by Prof. Alan Meltzer.

require skillful discretionary liquidity reactions by new monetary authorities in Eastern Europe.

There will also be a profound role to be played by investment banks in the process of privatization and securitization of firms. This subject is much neglected in the present discussion on economic reforms. There can be no rational program of stock emission and future trading without involvement of skillful investment bankers. In the present program of privatization in Poland it is the government that assumes responsibility for these issues in the absence of investment banks. Establishing a solid foundation for an investment banking system should be a prerequisite for the privatization program.

A separate, much debated issue in the description of the transitional period from a planned to a market economy is a problem of a proper speed and sequencing of reforms.[6] The overall discussion seems to favor "shock therapy" of the Polish type. It claims that the advantages of fast adjustments outweigh predictable transitional costs, or disadvantages. The fast speed is believed to diminish transitional costs and to make the reform program more credible and comprehensive. Condensed solutions will make the issue of proper sequencing less relevant. Many reservations to these arguments can be raised. First of all, rapid pace of reforms does not mean that they are automatically comprehensive. On the contrary, the leap to free market structures can be faced by unprepared entrepreneurial ability and by unadjusted financial system, "patched" by heavy government interference. Such loopholes may undermine the comprehensive character of the reform program.

However, favoring fast speed is also based on some legitimate arguments. Past attempts at partial reforms, particularly in Hungary and Poland, sometimes produced perverse and unintended results. It seems, however, that improper sequencing can be blamed for their incomplete success, since these reforms have been usually limited to decentralization of prices without a true decomposition of monopolies and formation of a competitive financial sector. For instance, the Polish wholesale price reform of 1971 was accompanied by the formation of even more monopolized structures called "Large Economic Organizations," and in response to the

[6] See both papers of T.A. Wolf, 1990, for an extensive analysis.

danger of emerging price increases the government instituted a policy of suppressed inflation fixing almost all retail prices at a low “ceiling” level and consequently yielding painful shortages. The most convincing political argument for a faster speed is that rapid changes will prevent eventual obstruction of the reform program by bureaucrats of the former system fearful of losing jobs and influences. Fast changes will also take advantage of the momentum of an enthusiastic public support for a transition to democracy.

Some social concerns about speedy adjustments can be also added. The process of familiarization with the market system by workers, managers of new, independent firms, and the financial sector will have to be accompanied by training programs that cannot produce results overnight. Some optimism about this process may arise from experiences of Eastern immigrants to the West who have frequently become entrepreneurial and competitive in a relatively short period of time, being previously equipped with a high level of general education. Yet again, their success stories did not happen overnight. More importantly, a fast speed of marketization requires a very detailed government interference with business, since inexperienced institutions need great deal of guidance and regulation. Such inherently inefficient, sizeable intervention is inconsistent with the ultimate goal of the reforms, which is a deregulated free market system. It is hard to predict whether governments accustomed to and comfortable with interventionist economic policy will be ready to give up excessive regulation as quickly as possible once competitive market structures are in place.

Since there is such limited theoretical guidance for the reform programs in Eastern Europe, an outline of their sequencing is a speculative task. For this reason, forecasts of major economic indicators can only be intuitive, based on available macroeconomic models. Data extrapolation from past trends would be erroneous, owing to a complete change in economic structures.

It can be also noted that there is a change in the importance of production factors for East European economic systems, which will have an impact on the determination of values of goods and services. Socialist economies led by the Marxist labor theory of value gave a strong priority to the quantity of labor employed, neglecting capital formation and land utilization, and causing careless and inefficient exploitation of natural resources resulting in high energy intensity and pollution and undermining the importance of developing entrepreneurial ability. The new system will have to be designed to ensure efficient utilization of all factors of production. Needless to say, it must be consistent with the capitalist theory of value and profit maximization as a leading criterion of economic activity.

II. Stages of Transition and Expected Economic Effects

Based on currently available reform programs, the transition from central planning to a market based system can be subdivided into three stages:

A. The period of decentralization of major pricing categories, such as prices of goods and services, interest rates, exchange rates, and wages.

B. The period of decomposition of monopolies, activation of competitive market structures, privatization, and currency convertibility.

C. The period of accelerated economic growth and capital accumulation under new market conditions.

This classification has been intuitively constructed, based on corresponding relationships among major economic indicators illustrating a stabilization policy, such as inflation, unemployment, interest rates, flexible exchange rate, and real GNP trends. The distinctions among periods A, B, and C are based on outlines of reforms proposed in Hungary and Poland. The assumption that stabilization policy is not countercyclical is made here, in order to investigate changes in economic variables induced solely by market interactions.

The trend of anticipated inflation can be drafted as follows (Figure 1):

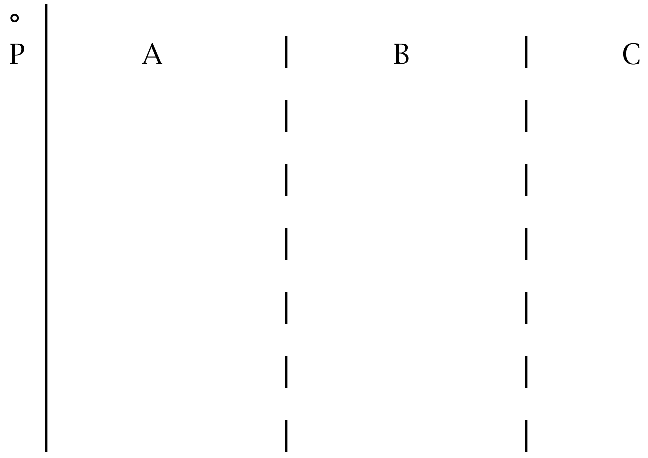

Figure 1

Initially in stage A, deregulation of prices under monopoly conditions should result in adjustments to world market prices in a monopoly price setting. Inflationary effect will therefore be very significant. Poland has already experienced this wave of inflation reaching 700% in 1989 followed by the 78% monthly rate in January 1990 gradually slowing to 3% monthly rate in June 1990. Czechoslovakia deregulated prices of agricultural products, which are presently sharply accelerating. East Germany's inflation effect was avoided by a drastic increase in the purchasing power of the Eastern Mark as a result of the July 1, 1990 one-to-one currency conversion to Deutschmarks. In the second stage, decomposition of monopolies and activation of competitive markets should substantially diminish inflationary pressures. There will be also a much lower purchasing power of consumer incomes left after stage A, therefore real consumer spending will be also lower and demand induced inflation will fade away. Currency convertibility may occur very late in this stage, and if not restricted it may cause a stronger demand for foreign currency selling out domestic money and absorbing some inflationary impulses. The privatization program will also lower the inflation overhang, redirecting any available excess liquidity to investment in equity shares. Promptly introduced securitization of capital assets, fully and openly available to domestic investors, may substantially reduce inflation. The remote stage C should be able to bring about capital accumulation generating the economic growth. Nevertheless, labor costs are and will remain at least four times lower in the region compared to the European Community and investment opportunities in infrastructure, services, modern technologies, etc., will be enormous. The new growing economy will likely increase aggregate demand and will add to inflationary pressures in a long, rather undetermined time. The described "normal" trend of inflation assumes that monetary policy will not counteract with it and a fiscal deficit will not be financed by creation of new money.

Corresponding changes in real interest rates *r* will be eminent in stage B, when an active money market emerges (Figure 2). This stage will create a stronger demand for credit for the purpose of establishing new businesses. A skillful monetary policy response will be required. A consideration for central banks will be to inject enough liquidity to meet the increasing demand for money. At the same time, they will have to keep interest rates somewhat stronger to induce society's savings in order to create a potential for the intended expansion in period C.

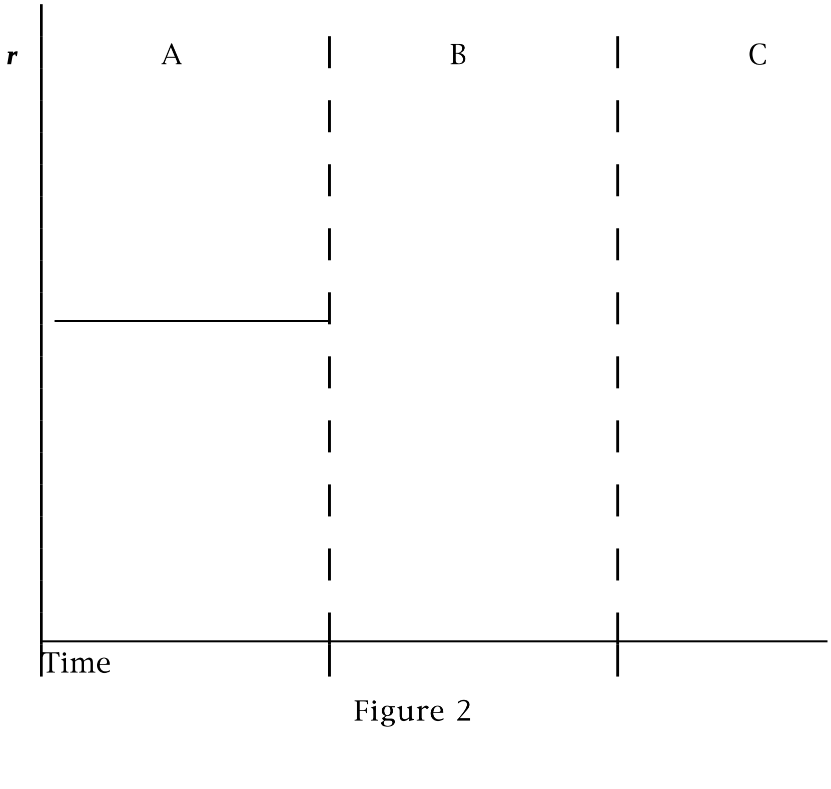

Figure 2

The effective exchange rate *e* will very likely experience depreciation in phase B, assuming that it will be flexible, or market determined, with some stability reached in stage C (Figure 3). Appreciation of domestic currencies seems to be extremely unlikely throughout the entire transitory period.

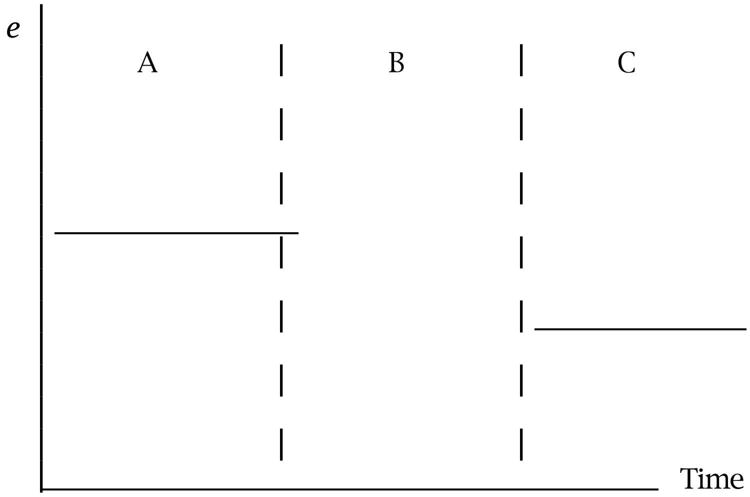

Figure 3

It can be noted that at the end of phase B domestic capital will be very inexpensive to foreigners. It is also necessary that debtor nations, such as Poland or Hungary, will generate trade surpluses to ensure a relative stability of their exchange rates. Consequently, the program of full currency convertibility will become more feasible. Figures 2 and 3 also imply that the currency rate sensitivity to changes in interest rates will be very small, because it is hard to anticipate that East European economies will become attractive to allocations of international financial capital investment in the transitory period. Adversely, stimuli for foreign direct investment and proexport activities may very likely occur. In addition, any possible import incentives will be directed toward high-tech goods, transferring modern technologies to the depressed economies and also toward capital and intermediate materials alleviating shortages and bottlenecks in the transition period. There will be almost no effect of import competition stimulating domestic producers of consumer goods in the near future, since the quality and technology gaps are too drastic. For this reason, the total value of imports may outweigh the growth of their volume if domestic consumers tend to buy mainly foreign goods as a result of full currency convertibility. Demand for imports will become highly inelastic and the trade deficit may expand. These effects may occur under the absence of protectionism.

A combination of the conditions discussed provides a ground for the anticipated trend in real gross national product Y (Figure 4) and the corresponding rate of unemployment υ (Figure 5).

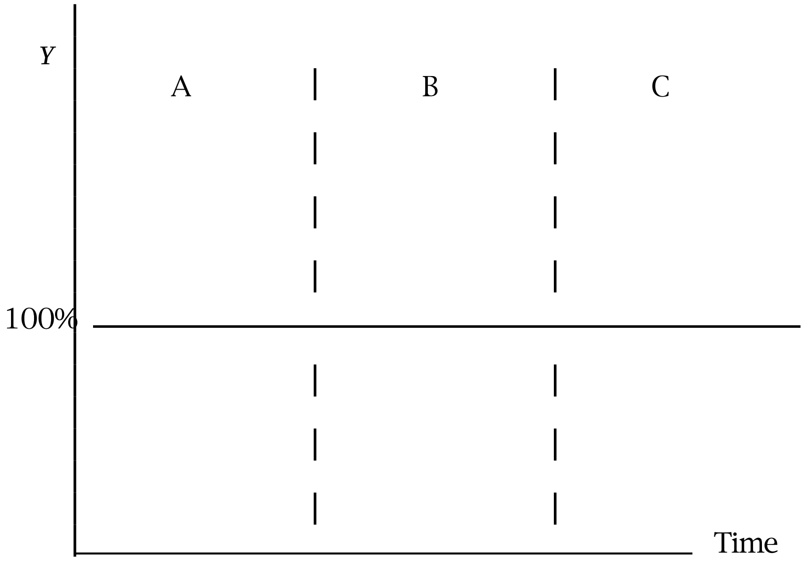

Figure 4

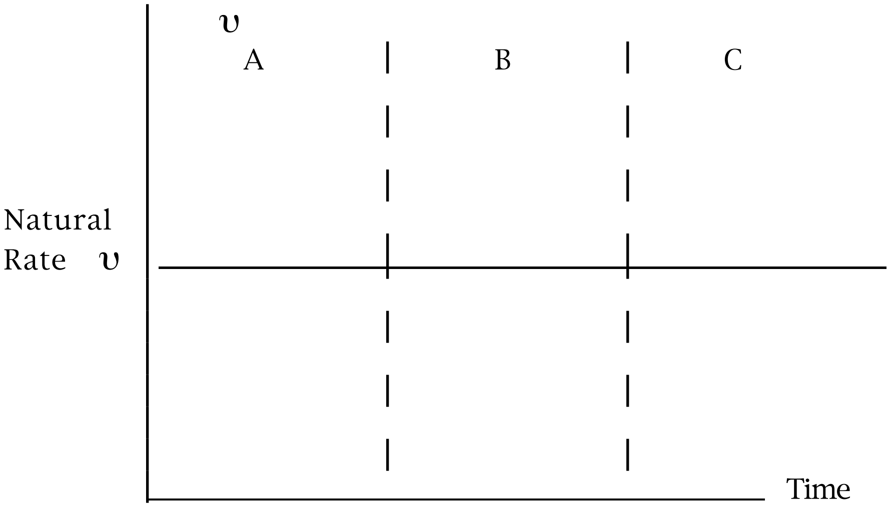

Figure 5

Stage A has an unavoidable recessionary impact with unemployment rates rising well above the natural level for these economies. This shock may be quite significant, considering for instance the jump in the unemployment rate in East Germany at the beginning of September 1990. New business opportunities enforced by training of workers and managers primarily in the field of organizing small businesses should lower the unemployment rate to a stable level in the long run. Since monetary policy will still be inactive in phase A and only gradually developed in B, no evident tradeoff between unemployment and inflation is expected to occur. Among the factors contributing to an accelerated economic prosperity in stage C are higher domestic investment and growing incomes, followed by a stronger real value of consumer spending. Investment attractiveness will be ensured by preferential labor costs in the region and in some cases by abundant natural resources.

In conclusion, it can be argued that no evident incentives for foreign direct investment and/or export by economies of industrial nations can be found in stage A. Only periods B and C will generate such stimuli. It is therefore advisable from a purely economic standpoint for U.S.-based and other multinationals to delay their involvement plans in Eastern Europe (with the exception of East Germany) until reform programs are consistent with the described nature of these two stages.

III. Individual Cases: East Germany, Czechoslovakia, Poland, and Hungary

There is no standardized program of economic reform in Eastern Europe. Long-term consequent realization of principles of marketization applied by Hungary, a more cautious approach to transformation in Czechoslovakia, a "leap to a free market" in Poland, and the East German inclusion in the all-German economic system are entirely different ways to accomplish similar goals of a market-based economy discussed before. These four nations will be more specifically analyzed below. Interesting proposals advanced recently in the remaining countries of the former Soviet Bloc, such as Bulgaria, Romania, and the Soviet Union itself, will not be covered since the conditions of political reforms and stability needed as a threshold for economic reforms have not been accomplished there yet.

East German Territory

On July 1,1990 the former German Democratic Republic merged its economic and monetary system with West Germany. On October 3, 1990 both countries became politically unified, ruled by the interim government until the December 2, 1990 all-German election. The East German territory is still a local district which has inherited tremendous economic problems left behind by the Soviet-backed rulers.

Throughout the year of 1990 the Eastern noncommunist government had to prepare thirty major legislative acts reforming everything from property rights, trade laws, banking, privatization, and the accounting system to reorganization of state companies. The most centralized and rigorous economy of Central Europe was forced into a free competition with one of the most effective and advanced economic systems and the largest exporter of goods and services in the world. Even in June 1990, right before the monetary unification, almost nobody realized the degree of the economic retrogression of the East German system, previously viewed as the most advanced in the Soviet Bloc. Government economists predicted at that time only about 30% unavoidable business closings owing to obsolete capital, trusting that the remaining 70% could be subject to modernization. However, Eastern consumers reacted with unwillingness buy locally produced goods after the currency swap, because of their low marginal utility. Current predictions claim that approximately 70 to 80% of Eastern capital is completely useless.

The productivity gap is equally shocking. Although Eastern wage rates are still about four times lower than Western, the number of workers for the same comparable market value of output is about four to five times higher. Managerial skills are significantly depressed. Thus it is no wonder that the current unemployment rate has jumped to 27%. Massive training of the workforce is the most needed solution to this problem. Easterners need to acquire entrepreneurial skills for future establishment of small businesses. Considering the much depressed service economy, the risks in opening small businesses are enormous. Today the region has many scattered gas stations, shops, banks, restaurants, etc. The need for training is supported by an example from the Hannover Chamber of Commerce, which in fall 1989 offered a training program for 200 Eastern managers. Six thousand people signed up for it.

The key objective of reforming the East German territory is to narrow the gap in living standards with the West. Prompt action on this task will eventually prevent a continuous outpour of Easterners threatened by job insecurity and seeking opportunities in the booming West. To illustrate this gap we may compare the percentage of households with

automobiles:	52 in the East, 97 in the West
color TVs:	52 in the East, 94 in the West
telephones:	only 7 in the East, 98 in the West.[7]

The communications sector was very much depressed by the Communist rulers for the purpose of better information control in the society. To German policymakers reforming the East means unifying with the West. At this time the macroeconomic effects of the unification are more predictable.

The presently soaring unemployment, estimated to reach 27% in April 1991, is expected to rise somewhat higher next year before it will show any declining tendency. Long- term labor market perspectives are not gloomy at all for the following reasons:

1. Eastern workers are much less compensated, while their general level of education is very high.
2. The salary gap will eventually induce job-creating foreign direct investment despite several failures of premature ventures by West German firms presently recorded.
3. Potential employment needs in the service sector are very strong.

The initial threat of unemployment will also substantially improve workers' productivity much neglected by the 100% job security guaranteed by the socialist government.

Inflation expectations stemming from the monetary unification are much overstated. The overall implicit price deflator for the combined economy should remain relatively stable, with some internal realignments among values of individual types of goods. At the one-to-one swap of German currencies, overvalued and obsolete Eastern durables are already downward adjusted while food prices are somewhat increasing. Excess inventories of Eastern goods are emerging, which in combination with the strong German propensity to save will not result in any excess money supply that could yield inflationary consequences. The July 1,1990 currency unification enforced

[7] Source: *IMF: World Economic Outlook*, May 1990, p. 90.

conditions contrary to Gresham's Law—the economic phenomenon of an inferior currency replacing a wider use of the stronger one. It is the mighty Deutschmark that has replaced the weaker Eastern Mark in circulation.

The balance of payments effect of the economic unification should not pose a meaningful disturbance. The inherited external debt of East Germany, totalling $17.5 billion at the end of 1989, is only about 2% of the West German nominal GNP. It should be emphasized, that the largest commercial bank lender to East Germany was Japan (with $3.9 billion), not West Germany (with $2.9 billion). The free market value of $100 outstanding East German debt was recorded at a high level of $97 in April 1990 (comparing to only $14.50 for Poland's debt). This indebtedness is not significant and can be easily absorbed by the West German monetary system.

The long-term optimistic outlook should not overshadow serious structural problems of the East that the united economy will have to face. Perhaps the most severe impediment is an exceptionally high degree of capital concentration, even for an average scale of Eastern Europe. In the eighties the industrial sector was further reorganized into only 132 conglomerates. The second painful problem is the strong economic reliance of the Eastern economy on lignite coal for energy and the chemical industry. In combination with the high overall energy intensity, this has created unbearable pollution. East Germany has currently the highest per capita sulphur dioxide emission in the world. Finally, the areas of specialization in the manufacturing sector have much departed from desirable allocations from the standpoint of comparative advantages. Much of the investment stream went over the years into noncompetitive technology intensive projects, neglecting capital stock formation in other areas especially in consumer product industries.

The leading force in the economic restructuring of the Eastern land is expected to be West German commercial banks, on top of special funds designated for this purpose by chancellor Helmut Kohl's government and by the Bundesbank. A fierce territorial battle for influences in the East has just began among the three banking giants: Deutsche Bank, Dresdner Bank, and Commerzbank. All of them have formal plans to establish numerous branches in the East as soon as possible. Dresdner is considering moving its headquarters to Dresden, where it was founded in 1872, and the two others are discussing relocations to Berlin. Deutsche Bank wants to establish a network of about 300 branches; part of them will be acquired from Eastern Kreditbank (former Staatsbank) to set up as a joint venture universal bank.

The process of economic restructuring of the East involved in 1990 a substantial reduction (approximately 20%) of the manufacturing output, similar to conditions described here as stage A. This trend will be also continued next year, although it is premature to analyze how effectively the banks, Western corporations, all-German government, educational centers, and others will be able to act on a construction of the entirely new economy much oriented to a service sector and to competitive areas of industry.

Czechoslovakia

The country is perceived as the technically most advanced East European economy, having the lowest degree of external debt of only $5.4 billion. The indebtedness, in combination with $2.4 billion reserves of gold and convertible currencies at the end of 1989, is not a significant impediment to economic reforms. On the negative side, the industrial output is highly energy intensive, which causes pollution only marginally better than in East Germany. In addition, the energy sector relies strongly upon oil imports, primarily from the Soviet Union. The country is expected to be strongly affected by the rising trend in oil prices during the second half of 1990 and by the Soviet decision to accept only hard currency payments for its exports as of January 1, 1991.

The reform program in Czechoslovakia started relatively late; in 1987 the Communist government partially released market forces and decentralized prices, stating however that it was “essential not only to preserve, but even to enhance, the role of the centre.” The program created some incentives and autonomy for small businesses and for private initiative in general. A more serious change came with the June 1989 legislation abolishing traditional annual directive plans. Stronger reform actions began in spring of 1990. A series of laws was enacted, aimed at expanding self-financing of enterprises. The state monopoly in foreign trade was weakened and individual exporters could retain a certain share of their convertible export earnings. Also the role of the State Bank has been reduced to that of a central bank, leaving commercial activities to newly emerging independent financial institutions in the country. Substantial tax breaks for foreign direct investment and a new commercial code were introduced in the April 1990 legislation called “Act on

Enterprise and Foreign Property Participation." The Act allows joint ventures not only with state companies but also with private persons. It grants permission to fully owned foreign companies to operate in Czechoslovakia. Establishing a new company requires permission from the Ministry of Finance and applications could be presented either by a local or a foreign partner. It is no longer necessary to present a feasibility study. There is an obligatory reserve fund and 30% of foreign currency earnings must be sold to a Czechoslovak bank. This reserve fund is created for a purpose of introducing limited internal convertibility of the Czechoslovak Koruna to hard currencies. Joint ventures are permitted in all areas except national defense and their regulations are adopted directly from the Austrian legislation. The present tax on earning remittances is 40%, but the legislators want to cut it to 30% in the nearest future.

The Act on Commercial Banks and Savings Banks effective January 1, 1990 creates a favorable ground for demonopolization of the financial sector and for formation of competitive commercial banking structures. At the present time an increasing number of international banks are opening their branches in the country with the Japanese giants taking an unquestionable lead.

Approaches to the program of economic reforms are much diversified. Finance Minister Vaclav Klaus strongly favors the Polish-style "shock therapy"—a fast move to market conditions, while many others, including the most admired and respected President Vaclav Havel, advocate a cautious approach. Mr. Havel recently expressed worries about "selling off the family silver" if reform programs are too radical. Nevertheless, Mr. Klaus's team submitted in September 1990 a draft law on privatization and ownership transformation. This problem is particularly difficult for this country, where the right to use a property has been more important in legislation than true ownership. The plan is based on a voucher program, which would give each citizen the right to obtain a certain number of shares without payment. The government fears that a market distribution of shares in exchange for payment would result in snapping up the equity by foreigners, or by former communist officials who managed to accumulate large savings over the years. Some points of criticism can be raised to this program. Free distribution of shares is pro- rather than anti-inflationary, since monetary assets are created without a simultaneous reduction of excess liquidity. It is also doubtful whether such distribution will indeed give shareholders a true sense of ownership and, therefore, make them liable and responsible for company's capital. Finally, the program is not consistent with the main function of equity emission, which is to provide a source of external capital expansion.

As a part of the financial reform the Czechoslovak government also announced its withdrawal from Comecon's system of fixed exchange rates, and introduced the above described internal convertibility of the koruna in 1990. Firms will be able to buy unlimited amounts of hard currency from the banks.

Long-term prospects for Czechoslovak reforms are relatively good. Among positive aspects of the economy are: a good geographical position that can play an important role in facilitating East-West trade; fairly good infrastructure; strong international competitiveness in areas such as printing, medicine, and engineering; and a diversified, relatively modernized economy. A major obstacle in the transitional process is the limited skills of upper level economic management. Many of their most qualified people, including thousands of academic leaders, were ruthlessly transferred to manual jobs as a result of the 1968 Soviet invasion. This painful sacrifice has never been fully healed. There is also a growing antagonism between Bohemia and Slovakia which may result in competitiveness and separation of roles of regional governments in terms of their future fiscal and monetary policies. There are claims to establish two separate central banks for both major nations within the country.

Despite disagreements about the speed of reforms, policymakers are consequently granting more freedom to private enterprises and to foreign investments, dismissing state planning. The Ministry of Foreign Trade is particularly active in advancing changes designated to facilitate joint ventures and repatriation of profits in cooperation with several individual governments. Most importantly, the nation is determined to support any program leading to freedom of people, businesses, and markets.

Poland

Polish society has always taken a strong leadership in opposition to Communism and central planning. Consequently, the Poles have moved forward considerably in their programs of economic reform.

The present pattern of decentralization of the economic system started essentially in 1982, when the government adopted a series of measures loosening central controls over economic activity. At that time the number of branch ministries was reduced from 32 to 5 and allocation of material inputs and the foreign exchange system were much decentralized. Commercial and noncommercial exchange rates were unified and parts of export earnings could be retained by companies.

The next wave of reforms was enacted in 1988 and in 1989. It eliminated all restrictions on hiring practices of enterprises. It also made far-reaching deregulation efforts in the financial sector by establishing a two-tier banking system and by allowing independent exchange dealership. Limits on ownership shares of foreign investors were also phased out with expectations of attracting foreign capital investment in the country. Finally, a year ago the new government eliminated all administrative barriers on pricing and distribution of food products and the authorities decided for the first time not to prepare an annual central plan, simultaneously transforming the Planning Commission into a new Office of Central Planning.

But the most serious and comprehensive program of economic reform was launched on January 1, 1990 under auspices of Deputy Prime Minister Leszek Balcerowicz. The program has been labeled an attempt to "leap to a market economy" and is based on the following precepts:

1. Elimination of the budget deficit and easy credit policies in order to reduce shortages and to overcome the galloping inflation, at the 700% level in 1989.

2. Decentralization of prices and elimination of subsidies in order to accomplish undistorted price equilibria.

3. Massive reduction of import restrictions, aimed at introducing a free trade regime and incentives for the national economy.

4. Demonopolization and privatization at the fastest possible pace, involving most of the 7,800 enterprises in the country's industrial sector.

The government was largely able to accomplish these tasks using the following means:

— a restrictive tax-based income policy, that progressively taxes excessive nominal wage hikes over the rate of inflation;

— full unification of the exchange rate for all kinds of transactions with the rate devalued to 9,500 zlotys per $1 (from the level of 6,500 at the end of 1989);

— reduction of tax breaks and subsidies to the level that guarantees a balanced budget for fiscal 1990;

— a tight credit policy by setting the central bank's refinance rate at the level ensuring positive real market interest rates and by adopting measures prohibiting the National Bank of Poland from extending any long-term credit to the government;

— reduction of price controls to the present degree, where only about 5% of prices are centrally fixed.

These solutions could be introduced in a prompt manner, leaving however some major tasks for adjustment in a much longer period of time. Among these projects are a comprehensive reform of the accounting and taxation systems, and programs of demonopolization and privatization. Several areas will have to be addressed in the nearest future, such as more specific rules of profit repatriation to motivate foreign investment, a much greater degree of liberalization of private business activity, and systems of retraining the labor force and relocation of workers to more competitive and comparatively advantageous allocations.

Certainly, the process of privatization could only be advanced after the initial stage of stabilization and liberalization in order to ensure proper structural conditions for its full implementation.

The recently announced privatization program gives a strong responsibility for its implementation to the newly created Ministry for Privatization and to the Council of Property Transformation advisory to the Prime Minister Tadeusz Mazowiecki. Privatization of state enterprises will be conducted in two stages. Initially, the firms will be transformed into a "corporation of the Treasury Department." Within two years the capital of this corporation will have to be distributed to the public, either through a public offer, or through direct negotiations with potential buyers. Employees of the corporation will be eligible to elect one third of the Board of Directors and after the stock emission the board will be elected by an annual shareholders meeting. In the second stage of privatization employees will be able to purchase up to 20% of the stock at preferential prices and anything above it at market prices.

Initiation of a corporation will be based on a petition submitted to the Minister for Privatization either by the company president or by the "initiatory council." The minister him/herself will also be able to initiate formation of a corporation without any petition.

A large part of state property will be distributed without payment to Polish citizens residing in Poland. The size of emission of free equity shares will be decided by Parliament based on a request by the Prime Minister.

A questionable element in the whole program is a lack of efficiency control and emissary function normally played by investment banks. The process "gives away" capital to the domestic public without an access of potential wealthy foreign investors. Thus chances for external capital expansion for companies will be much dimmed. Also the initial privatization of a firm will be decided upon a recommendation by consulting firms, not by banks. Much doubtful is an effect of reduced inflation through equity investing owing to restrictions on amounts and persons eligible to invest.

Stabilization policy outlook for next two years is mixed. Owing to drastic measures of the reform of January 1, 1990, the rate of inflation has fallen from a monthly level of about 78% in January to only about 3% monthly in July. Since nominal wages lagged behind inflation the purchasing power of society's income has been declining, thus slowing domestic aggregate demand. Lower real incomes will not produce demand induced inflation in the nearest future. The unemployment rate was only about 1.5% in March 1990 but it is expected to be higher than in most of the European nations within next two years. Deregulation will force more efficient and productive allocations of labor leaving many unskilled workers out of jobs. Together with the rise in unemployment, productivity of labor has been much improved. The Polish government recently reported lower absenteeism and fewer sick leaves combined with a stronger motivation to work and to acquire better skills. A large number of unemployed workers will also force the government to promptly introduce new programs dealing with job security, unemployment benefits, pensions, and insurance. All of them are largely unresolved today.

The strongest impediment to the reform program is the $41 billion external debt. Excessive repayments may obstruct structural adjustments and may jeopardize public support for the government. It is imperative to renegotiate and to restructure this heavy indebtedness. Under the auspices of the Brady Plan, Poland should be able to reschedule only about $10 billion it owes to commercial banks. The remaining portion is owed to governments and the G7 ought to act more aggressively on rescheduling this part. The most effective reduction could be done through a comprehensive "buyback" action in the secondary market.[8] International agencies (IMF, BIS, World Bank) have already granted some of the necessary stabilization loans for this purpose. Considering a low value of the Polish debt in secondary markets (at about 15 cents per each $1 of debt in April 1990) the size of the bridge loan does not have to be insurmountable.

There also also additional positive factors in the long-term economic outlook for Poland. The country has a geographic advantage in neighboring unified Germany and the increasingly open Soviet Union. It is also well endowed with natural resources, except crude oil which under the long-term expensive trend will be burdensome to the Polish economy. In addition, the reform program has strong public support as proven by several opinion polls taken in spring 1990. These factors, combined with a high degree of determination and good skills of government leaders, will encourage the success of a prosperous future economic growth.

Hungary

Major market-based reforms were introduced in Hungary as early as in 1968 by the so-called New Economic Mechanism. There were two primary objectives of this program: 1) a sizeable reduction of central planning directives for enterprises; and 2) incentives for private firms and business initiatives. Underdeveloped markets could not provide a desirable degree of competition for decentralized firms, thus the intentions of the program could not be fully accomplished. In addition, the inflationary shocks of the seventies negatively affected price decentralization and profit maximization. The government had to continue providing heavy subsidies to the economy, despite its earlier plea to eliminate them.

The pace of economic reforms in the late eighties and in 1990 has been relatively slower, although significant attempts at solutions have been undertaken.

A more comprehensive program of economic stabilization was adopted by the government in 1987. Its main tasks were:

— reduction in the budget deficit;
— curtailment of excess liquidity;
— reduction of the current account deficit.

[8] See a detailed proposal by Sachs and Lipton, 1990, p. 65.

These contractionary macroeconomic solutions resulted in a drop in aggregate demand and a recession in 1988 with the real GNP decline by 2%. At the same time the rate of inflation rose to 15% in 1988 partially owing to the introduction of the value added tax in that year. Although the current account deficit was narrowed in the period 1986 to 1988 it later accelerated again to about 5% of GNP in 1989. During the past two years there were large debt service payments on the accumulated external debt of $20 billion—the highest per capita in Eastern Europe. The pressure on balance of payments came also from large travel spending abroad, as a result of relaxed travelling.

Recent reforms undertaken in Hungary are also ambitious.

A two-tier banking system was introduced in 1987 in order to encourage financial intermediation. A fair number of competing banks face flexible interest rates in all monetary markets. Credit rates for enterprises are also market based, as well as their deposit rates. As of January 1990 most barriers to a full integration of the banking sector were eliminated. Monetary policy has been traditionally tight in order to ensure positive real interest rates and highly desirable savings for the economy. The country also enacted laws setting a framework for the first stock market in the region.

Taxation laws have been also revised. The value added tax and the personal income tax were introduced in 1988. The most desirable accomplishment is a reduction of the marginal tax rate to 50% in 1990, from an excessive 60% in 1989. At the same time the corporate income tax was also lowered from 54 to 40%.

Deregulation of commodity prices is also moving forward. The share of consumer prices relieved from central control has gradually increased from 53% in 1988 to 77% in 1990. At the same time the structure of relative prices has been improved through reduction in consumer and producer subsidies and through the system of Value Added Taxation. Such system is highly desirable from the standpoint of matching taxation rules with those of the European Community, especially when all of the East European countries wish to establish proper structure allowing them to join the unified Europe.

The country has also achieved much success with trade liberalization by eliminating licensing requirements and quota restrictions for almost 65% of comparable hard currency imports in 1990.

Much of the emphasis of the Hungarian program is put on the reform of the process of wage determination. Pay differentials are presently more related to job performance. Since 1989 there has been also collective bargaining in state owned enterprises, safeguarded by taxation of excessive wage increases.

There are several main concerns for the Hungarian government in its future reform programs. About 90% of enterprises still remain in state hands, which is excessive from the standpoint of improving economic efficiency. Both inflation and unemployment are increasing at an unacceptable pace and the level of real wages in 1990 was back to what it used to be in 1970. The government also recently reported a 20% poverty rate measured by the Hungarian standard. Needless to say, the most serious impediment to the faster implementation of reforms is the excessive level of international debt.

The country may expect further assistance from the International Monetary Fund since it has been able to satisfy several targets set for the economy by this institution. Most importantly it was able to reduce the ratio of budget deficit to GNP below the targeted level. It also accomplished a favorable increase in export by 15% in 1989 compared to the previous year, which combined with the growth of imports of only 4% reduced the size of the current account deficit. The targeted deficit set by the IMF for 1990 is $550 million, down from $1.4 billion for 1989, and is expected to be accomplished.

The government has also issued a plan of reaching full convertibility of the Hungarian forint. As of 1991 all foreign trade, including East European partners, will be accounted in hard currency. Till 1994 Comecon quotas and fixed prices will be abolished, making the forint potentially fully convertible.

Considering the fact that the country has a well educated labor force and a large entrepreneurial and independent retail sector, its future chances for economic prosperity are very good. Again, future success will strongly depend upon international debt relief programs similar to those described in case of Poland.

III. Concluding Remarks

Several comments can be derived from the analysis of ongoing economic changes in the East European region that may be helpful for strategic plans of multinational firms:

1. Foreign direct investment in Eastern Europe will strongly depend the stage of economic transformation the recipient country has reached. There are no incentives for such involvement in stage A, but it becomes increasingly feasible in stages B and C. The East German rapid merge with the West and the fast progress of structural adjustment in Poland create favorable chances for such plans. Hungarian reforms are also far reaching, but the favorable results of the stabilization policy are are still remote. Major economic indicators are better for Czechoslovakia, although the reform progress is relatively slower.

2. The process of economic restructuring and capital formation will be long lasting. Therefore, there will be no accumulation of income that could stimulate demand for imports of goods and services. Poland and Hungary face the need of debt repayments and proexport efforts. Their import demand will be particularly limited.

3. Opportunities to participate in programs of privatization are extremely limited, since its programs effectively seal capital markets from foreign influences.

4. Excellent opportunities are emerging in the areas of joint ventures and infrastructural investment. Low labor costs and needs to construct a proper infrastructural base are evident.

5. There are exceptional needs and opportunities in the areas of management training and corporate and institutional advising.

6. Financial institutions should take advantage at the present moment of the need to establish competitive banking. Role of banks in trade financing (through letters of credit, bankers acceptances, forfeiting, etc.) should be significant.

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