THE EMERGING EUROPEAN COOPERATION IN THE 1990'S
Istituto affari internazionali (IAI)
Hungarian Institute of International Affairs (HIIA)
Budapest, 26-27/VI/1989

a. Programme / List of participants
1. "Italy and Hungary and the new relations between Eastern and Western Europe : the current economic and political situation"/ Cesare Merlini, Paolo Savona
2. "Between chaos and stagnation : towards an international strategy of managed change in Europe"/ Laszlo Lang
3. "The 1992 challenge: responses in East-West co-operation and in Hungary"/ Béla Kádár
4. "1992 and after: European Community and Eastern Europe"/ John Pinder
5. "East-West trade and financial relations: recent developments and prospects"/ Pietro Catte, Cristina Mastropasqua

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Istituto Affari Internazionali
Roma

Hungarian Institute of International Affairs
Budapest

The Emerging European Cooperation in the 1990's
International Seminar

June 26-27, 1989
Hotel Novotel
Budapest

Sponsors:
Banca Nazionale dell'Agricoltura, Italy
Hungarian Credit Bank, Budapest

Sunday, June 25

Participant arrival
(Accomodation at Hotel Novotel, Budapest, Alkotás St. 63/67, tel: 36-1-869-588, fax: 665-636)

18.00- Registration

19.00- Dinner at individual discretion at the hotel's restaurant

(All session will have simultaneous English/Italian/Hungarian translation.)

Monday, June 26

07.00- Breakfast at the hotel's restaurant

09.30- Opening of the seminar – Bartók Room, Novotel Convention Centre

Opening remarks:

Dr. Peter Hardi, Director, Hungarian Institute of International Affairs

Prof. Cesare Merlini, President, Istituto Affari Internazionali, Rome

Welcoming remarks:

Dr. Giovanni Auletta Armenise, Chairman, Banca Nazionale dell'Agricoltura

Sándor Demján, President and Chief Executive Officer, Hungarian Credit Bank

10.00-12.45 Panel I: „The rise and fall of international hegemonies – symptoms and implications"

Panelists:

Dr. Cesare Merlini, President, Istituto Affari Internazionali

Dr. László Láng, Deputy Director, Hungarian Institute of International Affairs

Discussants:

Dr. Jan Q. Th. Rood, Research Associate, The Netherlands Institute of International Affairs

Prof. Jadwiga Staniszkis, Institute of Sociology, Warsaw University

11.15-11.30 Coffee break

13.00 Lunch at Palma Room, Novotel Convention Centre

Address by State Secretary for Foreign Affairs, H.E. Ferenc Somogyi

15.00-17.00 Panel II: „Beyond Europe '92: challenges and chances for in– and outsiders, East and West"

Panelists:

Dr. Béla Kádár, Director, Institute of Planning, Budapest

Prof. John Pinder, President, Unione Europea dei Federalisti

17.00-17.15 Coffee break

17.15-19.00 Panel III: „Business responses to the emerging political economic frameworks in Europe"

Panelists:

Mr. Ádám Angyal, Chief Executive Officer, Ganz Danubius, Budapest

Dr. Péter Balázs, Director General, International Organizations and Tariff Policy Department, Ministry of Trade, Budapest

Dr. Carlo Boffito, Professor of Economics, Turin University, Economic Advisor to the Banca Commerciale Italiana, Milan

20.00 Cocktail, Palma Room, Novotel Convention Centre

20.30	Gala dinner hosted by the Director of the Hungarian Institute of International Affairs, Dr. Péter Hardi, Palma Room, Novotel Convention Centre Addresses by the former Prime Minister of Belgium H.E. Pierre Harmel and Minister of State, H.E. Rezső Nyers

Tuesday, June 27

07.00	Breakfast at the hotel's restaurant
09.30-11.15	Panel IV „The perspectives of banking and finance on the all-European economic cooperation" Panelists: Dr. Árpád Bartha, Vice President, Hungarian Credit Bank Dr. Pietro Catte, Researcher, Banca d'Italia Dr. Cristina Mastropasqua, Researcher, Banca d'Italia
11.15-11.30	Coffee break
11.30	Concluding remarks: Dr. Péter Hardi, Director, Hungarian Institute of International Affairs Prof. Cesare Merlini, President, Istituto Affari Internazionali
12.15	Departure for buffet lunch by bus

12.30	Buffet lunch hosted by H. E. Joseph Nitti, Ambassador of Italy to Hungary at his residence
15.00-18.00	Optional sight-seeing tour Bus leaves from Hotel Novotel
19.45	Departure for reception by bus from hotel
20:00	Reception hosted by sculptor Imre Varga Varga Exhibition House Address by Minister of State, H.E. Imre Pozsgay

Wednesday, June 28

07.00-	Breakfast at the hotel's restaurant
a.m.-	Participant departure

LIST OF PARTICIPANTS

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Italy-Hungary Project

"Italy and Hungary and the new relations

between Eastern and Western Europe"

Budapest, 26-27 June 1989

Presentation

of the topic

"The current economic and political situation"

by

Cesare Merlini and Paolo Savona

1 - The most advanced industrialized nations (the so-called G7) have enjoyed the longest cycle of post-war growth and there is reason to believe that this growth, despite uncertainties and slowdowns, may continue in the foreseeable future.

Growth has spread to the other industrialized countries (the so-called "OECD area") with some delays and specificities, but above all it has spread violently to the Asian area, bringing about the coining of a new acronym, the NICs (new industrialized countries). Of these, the "four dragons" (Singapore, Hong Kong, South Korea and Taiwan) are in the vanguard and important with respect to economic and perhaps political equilibria.

This prolonged and, in many cases, intense growth has not spread to the so-called LDCs (less developed countries) or the "centrally-managed economies", that is, socialist countries. The political reasons for this may vary, but the economic reasons seem to be similar: the more the country accepts free market rules the more rapid and/or intense the spread of growth.

The characteristics of this stage of industrial development can be summarized as follows:

- greater disequilibria in exchange and interest rates;
- minor monetary disequilibria (or inflation);
- more market and less government intervention (or less economic policy);
- globalization of economic strategies.

2 - The gradual loss of effectiveness of Keynesian policy in the post-war period, brought to a standstill by increasing deficits in state budgets and growing public debt and inflation, has led to a growing sentiment in public opinion against further public intervention in the economy and use of monetary instruments to stimulate development.

This was manifested politically by the election of Thatcher in Great Britain, Kohl in the Federal Republic of Germany and above all, Reagan in the United States (1980), but reached maturation in the nomination of Volcker to the

Federal Reserve in Washington.

It is important to point out that Volcker was nominated by the Democrats before their term ended, attesting to the fact that the "less government intervention more market" and "less money and more finance" movement is horizontal, transversing all parties and countries, including those with centrally planned economies.

Volcker proceeded to introduce a severe monetary stabilization as a basis for the fight against inflation. He, in fact, changed the domestic and international monetary regime: unlike the past, the creation of money was no longer aimed at maintaining moderate interest rates, that is, rates advantageous to development, but rather at a closer control of money supplies, in view of controlling predicted inflation. As a consequence, the market determined the interest rate.

Reagan, in turn, detaxed the economy and gave the market greater rein, re-establishing the rules of capitalism. In the face of the new real interest rates set by the market (which went from -2% to +4-5%) and lower public investments, private investments had to yield from 6 to 8 percentage points more than in the past. After the inevitable recession due to the two changes (less inflationary expansion and the need for greater profits), a virtuous circle was set off in the industrial system consisting of technological innovations, global development strategies and stock market dynamism.

3 - The vital characteristics of capitalism came to the fore, but so did the negative ones: the distribution of individual and social income (internally and internationally) deteriorated and development did not spread to areas where the market was not working, that is, it was not open to international competition.

The classic cyclical disorders in economic development also re-emerged: tensions in exchange and interest rates, renewed inflation. Upon closer examination, it can be seen that these disorders affected the price system more than the quantity of products produced and traded, in keeping with a principle known since the dawn of the study of economics. In order to maintain the rate of real economic growth substantially stable, prices must be allowed to adapt. In the case in point, adaptation of the international price of commodities (that is, the currency exchange rate), the international price of money (that is, the interest rate), and to a certain extent the international price of goods was accepted.

The reason why inflation has returned stably to less than 10% and is unlikely to remount to two digit numbers is still the subject of discussion among economists. It is certain, however, that besides the new monetary regime, the breakdown of the OPEC oil cartel played its part.

4 - The current deideologization taking place to varying degrees in all countries in the world makes it possible to criticize the functioning of neocapitalism with less likelihood of misunderstanding than in the past. As already mentioned, recent developments have resulted in serious problems of indebtedness by LDCs, profound disequilibria in the balance of payments of the three giants (United States, Japan and Germany) and a persistent link between inflation and the price of oil products.

The problem of the indebtedness of LDCs is an explosive political and economic issue. It is the consequence of the combined effect of mistaken decisions in financing in the past and the change in the monetary regime engendered by the United States. In fact, on the one hand, the financing of the development of the LDCs should have been entrusted to public institutions, which are the only ones capable of taking on the high risks of operations of the kind, and on the other, private institutions entered the business on the erroneous presumption that the monetary regime would remain stationery and that, therefore, interest rates would remain moderate, if not negative.

Some political progress has been made with the Baker-

Brady plan, presented in two stages, but the economic substance of the proposals is still rather limited and does not provide an adequate response to the question: who is going to finance the future needs, that is, the development of the less developed countries.

5 - The problem of the adjustment of the disequilibria in the balance of payments of the three giants is equally explosive politically and economically. The Omnibus Trade Bill of 1985 provided the United States with a legal instrument for negotiated adjustment of its balance of payments disequilibria. But it also legitimated retaliation or breaking away from free trade through the introduction of measures curbing development. Should the kind of adjustment of external accounts carried out by Carla Hills (US Trade Representative) take the upper hand, it would change one of the characteristics of the current political and economic situation which, according to the evaluations presented here, has led to the prolonged growth enjoyed: greater market freedom.

However, the development of the NICs, in particular the "four dragons", may attenuate the problem of the disequilibria of the three giants and the dangers connected with a turnaround in the trend described by providing a market outlet for greater exports from Japan and the US.

This might also reduce the tensions on prices, and as a consequence, on inflation, caused by the increase in the cost of money and the devaluation of the dollar (which makes the cost in national currency of raw materials more expensive everywhere). Inflation is still the most serious hazard to the continuation of the current phase of prolonged world development, because of interference in corporate strategies and reactions by monetary authorities.

While it is still possible to overcome tensions in exchange and interest rates, any solution would be hindered by the strengthening of a political tie among OPEC countries. The probability of this occurring is low. It should be pointed out, however, that market operators' predictions rule out a substantial increase in the real value of oil, but at the same time, operators consider the idea of guaranteeing the stability of oil prices solely in monetary, rather than in real terms, equally unfeasible. The intertwining of politics and economy is even closer in this sector than in others; thus, the matter is open for discussion and alternative scenarios may be suggested. If the growing political weight of environmental protection is added, the oil question becomes even more complex and decisive for development.

6 - The evolution of the economic situation described above shows that the Soviet Union and the other centrally managed economies find themselves at the periphery of the polycentric world economy (small share of the world trade, non convertibility of currencies, marginal role in international institutions).

In politico-strategic terms, however, the world today remains largely bipolar. The partial success of nuclear non-proliferation policies and institutions has preserved the near-bipolar nature of nuclear deterrence, on which the relative peace of the post-war period (prevention of global war and containment of local conflicts) has rested so far. Repeated calls for the dissolution of the "blocs" has failed to provide an indication of a possible alternative world order.

At the same time the buildup of military forces has reached levels that appear increasingly unjustified, if not altogether insane . Moreover, the economic burden for both the superpowers has become very high, indeed intolerable, at least for the Soviet Union. A number of marginal unilateral reductions and the agreement to zero the INF have not had any relevant economic effect, but the political "impact" has been important.

The strategic debate has increasingly centered on the issue of stability. While the prospects of arms reductions, either negotiated or through mutually responding unilateral steps, have substantially improved, the central problem is to make sure that every stage of the process is no less stable than the previous one.

Stability is more complex a concept than equilibrium. It includes reduced risks of war by accident, less mutual distrust, etc. This brings to the fore the central role of crisis management, verification and confidence building measures, with related mechanisms and institutions. This development offers the most promising prospects for a new world order.

7 - The trend in the last two decades has been a decline in the hegemonic role of the superpowers. The crisis of the Soviet Union has recently overshadowed the fact that the situation also applies, though in a different manner to the United States.

In the economic field, a "oligopoly" has been trying to operate in the Western world (which now comprises Japan) since the early '70s. In the strategic field, Washington has been constantly pressing the allies to do more for common security. The first Reagan administration, which associated a tough military posture and the economic policy described above, temporarily restored American hegemony. Reagan-2 turned out to be more arms control oriented than anyone would have predicted resulting in strengthened US leadership. But the dramatic emergence of the "twin deficits " proves that the trend has not basically changed.

Current differences in the alliance about defence priorities and arms control strategies have somehow been papered over more than really solved at the last summit, but they do not seem to be more important than in previous cases throughout the "troubled partnership" between Western Europe and the US. Most observers concur in considering George Bush's trip to Europe as a success, not only among the allies but also in American public opinion, which was becoming increasingly puzzled by the new president.

For the European members of the alliance, the event demonstrated that they are still too often unable to straighten divergencies without the help of "big brother". A certain entente between Paris and Bonn, however, has been confirmed despite the ambiguities that affect both national positions. Italy and other countries either marginally mediated or joined in, with the exception of Britain, whose agreement was clearly reluctant.

Assuming that the present process of change in East-West relations continues, will the declining US leadership in the West be affected? One scenario is that since the superpowers are still the backbone of the changing East-West dialogue, the political role of the United States will be reinforced and will continue to conpensate for its declining economic role. The opposite scenario is that because of the declining perception of threat among Western Europeans, the security umbrella provided by the US will lose importance and thus, its strategic role will also be reduced.

8. As the United States did in Vietnam, the Soviet Union has realized that huge military expenditure to keep up with (or even lead) the strategic arms race does not contribute to an effective policing role in local situations, even when its sphere of influence and/or prestige is felt to be at risk. The acknowledged "mistake" of invading Afghanistan is not central to the Soviet crisis of the eighties (as Vietnam was for the Americans in the sixties); it only adds to the long list of problems.

It has become increasingly evident that an entire socioeconomic and political concept has failed. Whether the reform has to start from the economic or political end, or both, and how gradual or radical it should be, is a question that is receiving different answers from country to country. Whether the bloc can survive such different patterns and paces of change is another question. Uncertainty is multifold. It is not really clear what the characteristic features of the system really are: remaining ideological solidarity? the military pact? the partly integrated economic area?

The present leader in the Kremlin has been the main impulse behind the reform so far. At the same time, the Soviet people appear to be the least perceptive, culturally perceptive, of the model -- political, social, and economic -- towards which such a reform has to be steered.

Three scenarios can be formulated:

i) The reform will be able to overcome all the obstacles in the Soviet Union and in a number of Eastern European countries. Western and Eastern models will get closer and cooperation will be easier. Moscow and other capitals will become more involved in international institutions.

ii) Mikhail Gorbachev will not make it and his destiny will somehow repeat that of Nikita Khrushchev. The Soviet domestic scene will cyclically return, as far as possible, to the previous situation. It is probable that the foreign system of alliances will have problems in simply returning to its former state. Some countries, like Poland and Hungary, may have undertaken an irreversible process of less alignment.

iii) Domestic tensions, either political or ethnic, and looser links with the allies will eventually bring about the collapse of the "empire".

Without entering into any exercise of rating the chances of this or that scenario it is useful to bear in mind that all three are possible.

9. There has been so much talk about European unification that we now have two European unities. West Europeans have been accustomed to identifying European unity with the process of integration in the Community framework. Now they have to be specific. The broader concept of European unity is, basically no more than a reduction of the dichotomy of the old continent. The European "common home" is a slogan. The most important framework of a broad European concept remains the CSCE and its appendices. Canada and the United States are now a part of this process.

A number of European areas or groups of countries are identifiable. The EEC inevitably comes first. The Community shows possible contradictions between external relations and internal cohesion (it is seen at once as a closed "fortress" and an open "magnet"). The fate of the Delors Report will be an important indication of the latter.

While the Twelve are linked by institutions that partly compensate for economic differences, the EFTA countries show more economic homogeneity. Their political positions, however, differ. As a consequence, while the magnetism they resent from the Community is predominantly economic, the way the issue of an eventual enlargement is perceived as being predominantly political.

Besides the differences that were mentioned before, the Eastern European countries show rather differentiated economic situations. Most of them seem to be in the process of strengthening their economic ties with the West, and the economic framework that binds them with the Soviet Union (the CMEA) receives less and less attention.

The Balkans countries are part of the above areas, in some cases in peripheral positions (like Greece with respect to Western Europe, or Romania with respect to a changing Eastern Europe. Moreover there are the two unique cases of Yugoslavia and Albania.

Before closing the list, it has to be borne in mind that there are non-European countries which are increasingly looking to the European Community: Turkey has applied for membership; North Africa and, particularly, the Maghreb are seeking special relations.

2

BETWEEN CHAOS AND STAGNATION

Towards an International Strategy of Managed Change in Europe

by

dr. Laszlo Lang
Hungarian Institute of International Affairs

June 1989

My commissioned topic if you look it up in your program is apparently the world at large which though a legitimate topic on its own seems to be somewhat oversized for a 15 minutes talk. Not much more focused than that is the decline of international hegemonies and the political economic implications their presumed withering away might imply. I said "presumed decline" because it perhaps would be as premature as were the news of Mark Twain's death, to bury the superpowers and the basically still bipolar set-up of the world structured around them. The political world we live in is, no doubt, very much transitional though this transition has no fixed outcomes. Nowadays, almost any scenario of the future finds proponents and even certain credibility. In what follows I will try to elaborate shortly on certain scenarios and considerations hegemonic declines and the changing East-West relationship might validate in terms of the East and Central European region.

The fundamental thesis to be shortly elaborated is that though politicians from various quarters of the world find good reasons for maintaining the status quo in Europe, the present status quo may turn out to be unsustainable. If so, an international strategy must be designed to manage change rather than let the post-hegemonic and post-bipolar political world work out its way through chaos and mutual destabilization. Within the frames of such a strategy, the problem of Eastern Europe must be addressed with particular care.

The surest way of getting provocative for illustration is to quote Henry Kissinger. He wrote recently: "Ironically, each of the alliances may be counting on the disintegration of the other. If both turn out to be wrong, there will be stagnation. If both turn out to be right, there will be chaos." [1] Unfortunately, Kissinger happens to be right. Stagnation, which would mean the reassertion of the bipolar divides could come for defensive reasons, namely if either of the superpowers wished to pre-emt that the waning cohesion within its own bloc becomes an inordinate power resource for the other, or for offensive reasons, when either of the superpowers overestimates the scale and speed of the disintegration of the bloc of the other and strives for unilateral advantages. Chaos, on the other hand, seems to be quite a natural state of affairs beyond bipolarism. A multiactor balance-of-power system, let alone the transitory phase to such a system, is inherently less stable than bipolarism based on mutual deterrence. Hegemonies on both poles do have their norms, rules and institutions, whether coercive or benevolent, which may be bound to decline in tandem with their respective hegemons, All this has a tedency to create anarchy. Stanley Hoffmann posits plainly that the biggest threat to order in the next decade is "not the confrontation of the superpowers but chaos", not a very reassuring prospect either. [2] It is only too evident to note that the perception of a nearly constant struggle between the two poles was essential to the cohesion of the two major blocs. Now that this political glue is weakening, the danger that chaos and conflicts arise from the deeds of the lesser nations may indeed grow.

This assessment fits Europe, Eastern Europe in particular. Chaos here might mean what Timothy Garton Ash calls the ottomanization of Eastern Europe. [3] As opposed to finlandization, this is "emancipation in decay". In this process, which would be protracted, stepwise and zig-zagged, the states of the region could indeed gain a greater room of independent maneouvre within their alliance, and the societies within their respective states. However, all this would proceed under the circumstances of social decay and mounting frustration rather than rapid modernization and systemic change. The greater rooms of maneouvre would then turn into the proliferation of conflicts between and within societies making the danger of open political explosions imminent. If, then, conflicts and upheavals would be responded by those in power, nationally or regionally, as they were most recently in China, Tbilisi or in 1968, 1956, etc. stagnation would set in with reborn hostility on both sides of a repolarized East-West divide.

Chaos, thus, clearly has a tendency to turn into stagnation. Action on one pole to restore bloc cohesion is sufficient; the still prevalent logic of bipolarism would provide for the other. The question is then whether stagnation, or more euphemistically, enhanced status quo in Europe is a panacea against chaos? Many answer this question affirmatively contending as Representative Steny Hoyer, Vice Chairman of the Democratic Caucus of the US House of Representative did recently with a view to Eastern Europe that "trying to reform an increasingly untenable status quo may be no more dangerous than leaving things as they are". [4] The opposition to change in European status quo finds support in two principal propositions. One argues with the wide-spread complacency in the general, mostly Western, public stemming from the hopefully legitimate conviction that the peak of superpower military confrontation is over. The other proposition is based on the belief that the international situation, and within that, the East European reform climate, will improve automatically. [5] This belief is fundamentally wrong. For one thing, a conflict as intense and long-standing as the cold war will not, as Michael Mandelbaum puts it [6], end without deliberate effort. For an another, however attractive would it be for both East and West, to achieve increased systemic legitimacy without change in Eastern Europe, that is impossible. It would be as wanting to cook the meal without having the water boil.

It certainly would be naive to fail to mention another consideration that might motivate the Western, and primarily the American proponents of the European status quo. This is that so long as the East-West relationship was concieved primarily in terms of military threat, it was only too natural that the West's response should be drafted under American leadership, ot to put it less euphemistically, under American hegemony. But if with a fading military threat, the axis of the East-West relationship starts to be defined in more political terms, then the inevitability of American leadership in an economically progressively multicenter Western world becomes questionable. It is not that I suspect some grand conspiracy theory at work which would discriminate against change in -among others- Eastern Europe so as to protect an American hegemony over the West and a Soviet one over the East if that were the price in exchange. However, even non-American experts would subscribe to the assumption that the unity of the Western alliance will be increasingly difficult to maintain under the new Soviet politics. As Bernard Nossiter aptly notes, "the [Western] alliance.. is evolving under the new Soviet politics. This is not a climate in which nations sacrifice jobs and profits to each other for the sake of unraveling common defense - let alone for a doctrine as abstract as comparative advantage". [7]

Nor should one shy away from mentioning another powerful argument of the status quo believers, namely that changes, of whatever kind, in the European theatre tend to stir apprehensions of a reemergence of the so-called "German issue". In fact, no pan-European process of change must decide now what the Germans themselves have not yet decided. One can only agree with Jeane Kirkpatrick positing that "the division of Germany will [have to] be the last part of the cold war in Europe to be liquidated" [8]. In this, it is implied, however, that a gradual process of European reapprochement, including the Ostpolitik and Deutschland-politik must be far advanced before time comes "when Germans will be in a position to make their own decision and the international community will be ready to accept that decision". [9]

The question is then what is in between enhanced status quo in Europe and chaos? Henry Kissinger's answer would probably be that what should come in between, is diplomacy, and certainly many would agree with him. In diplomacy, vision must be combined with pragmatism. The vision is a Europe where the spheres of influence are being gradually replaced by new cooperative institutions and patterns of interactions, based not on permanent alignments but on permanent bargaining between shifting coalitions. The reality is, however, that a world marked by unequal power distribution and bipolar concentration does produce and tends to reproduce spheres of influence whether one likes them or not, whether one recognizes them or not. In the process of bridging the gap between reality and vision, the superpowers must be convinced that it is by relinguishing some of their powers to lesser nations and new coalitions of states that they can best promote their legitimate national interests. Both superpowers fear a possible destabilization of Europe which would mount a costly challenge to the tasks they both face at home. However, it is managed change rather than reinforced status quo which can prevent large-scale destabilization. Managed change will require bilateral superpower diplomacy (which cannot be saved by simply denouncing it as a new Yalta) as well as multilateral efforts both in the frames of the CSCE process and others-to-be.

As for Eastern Europe, the baseline question is how nations in the region will be able to choose their domestic regimes while keeping their security commiments to the Soviet Union? So that this equation will have a solution, Soviet reforms must be continued. If so, the Soviet Union will be increasingly able to seperate security from ideology, and it will seem progressively less alien for the peoples of Eastern Europe. However, continued Soviet reforms are a necessary but not a sufficient condition. Not only because Soviet security concerns, even if dezideologized, cannot be properly adressed within the frames of a Soviet-East European dialogue. But also because, with or without continued Soviet reforms, some of Eastern Europe has a fair chance to go up in economic chaos and social frustration soon if no corrective, or rather pre-emptive international action is taken.

There is nothing paradoxical in that it is the radical reformers of Eastern Europe who face the most serious economic constraints. Systemic change will not be forged so long as the old domestic power structure seems to be sustainable. Therefore, for a systemic change time and conditions will always be largely inappropriate, and domestic efforts, left to their own. will prove insufficient. These efforts, however resolute and though irreplacable, are inherently doomed to failure and abandonment unless supported by a conditional international support which is embedded in a strategy which also takes account of the larger post-hegemonic and post-bipolar configuration.

There is much talk in these days about a new Marshall Plan for Eastern Europe. And although I denounce the idea if it is considered as a regional, i.e., undifferentiated and unconditional scheme, I tend to object to the arguments which are most often brought up against it. One such argument is positing that Poland, Hungary, Yugoslavia and others have already been granted a Marshall aid back in the 1970's in the form of large-scale untied Western credits and loans. Though this might sound convincing, one wonders whether it is fair to compare credits provided for the exclusive discretion of totalitarian party-states to those granted to governments under increasing popular control and firms under transparent profit motive? Another argument against some larger-scale action is that Poland, Hungary etc. are economically not yet in a position to take substantial advantage of a Western financial support package. The original Marshall Plan, Timothy Ash argues, was to oil the pumps; in Eastern Europe first the pumps need be constructed now. [10] He may be right but what if these pumps will not be built or they turn out to be shoddies with structural faults for which no lubricant is a help, simply because popular dissatisfaction, daily economic and payments pressures lead even the benevolent designers astray. A third argument, based on a legitimate concern, is that it is only under pressure that these economies and political structures can be reformed; the smaller the pressure, the more hesitant the reform drive. Again, though caution is prudent, one ought to note that reforms do need popular support; however, under ever-increasing pressure popular support goes to demagogic populism, left or right, the historical hotbed of acute conflicts in and beyond Central Europe.

The West should not delude itself by pretending that joint ventures, partially lifted Cocom controls or assistance to manager training and the like, however usuful, could on their own mount a solution. Nor should Western Europe cling to the old habit of expecting the United States to deliver the public good of peaceful change in Eastern Europe to the benefit of all. This is the beginning of a post-hegemonic era and the hegemons are not any more able or willing to provide the public goods all free-riders got used to in the recent decades. Of course, nor should Eastern Europe, or its reforming wing, fool itself by believing that economic support, if at all forthcoming, will not be strictly contingent on prior actions by East European governments. The illusion that the West would be in the possession of some magic key, be it the allowance for an accelerated accession to the European Community or some grand Marshall aid, which could open up the Catch 22 East European reformers face, is also misplaced. There is some painstaking enterprise ahead of us, designed to work out the country-specific details of how the long-range grand strategy for managed change in a post-hegemonic and post-bipolar European theatre could be reconciled with short-term assistance to the pioneers of change in Eastern Europe. There is a real danger that unless this short-term line of action will fail to be forged, the grand strategic thoughts will lose their relevance.

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BÉLA KÁDÁR:

THE 1992 CHALLENGE: RESPONSES IN EAST-WEST CO-OPERATION AND IN HUNGARY

1989

Béla Kádár:

The 1992 Challenge: Responses in East-West Co-operation and in Hungary

1. Dilemmas and Realities of the Challenge

A ghost has been haunting the European region in our decade: that of Europeanisation, the establishment of the unified European economic region. The various countries of the world, and particularly of Europe, have not yet seen a reliable image of this ghost but they are aware of the fact that the transformation of the European economic region will have an influence upon the conditions of their development and they are already trying to find their place in the newly-forming European system of economic relations.

The establishment of the Single European Market is an historic milestone in the development of not only Europe but also of the system of international relations. Vast economic regions usually come about through long-term, organic processes of history. The radical halt of the world economic loss of ground of Europe, which began after the turn of the century and was especially spectacular in the last two decades, and the laying of the foundations of a European "risorgimento" opening up new horizons, are changes of development phases of world-wide dimensions. The abolition of still existing trade, financial and legal obstacles braking economic flows, the approach of national technical, environmental and educational systems, the general harmonisation of the social and economic environment and economic policies, the large-scale replacement of earlier bureaucratic management techniques of regional integration by market forces will modify, according to estimates, the conditions of economic activity in altogether 41 per cent of the EC's combined GDP, and will undoubtedly speed up the pace of economic growth, structural transformation and technical-scientific progress.

It is not surprising that in the different political and intellectual trends more and more frequent references are made to the illusionary character of European co-operation, to the failure or traumatic historical experience of earlier efforts and to the dangers of the annihilation of small nations. Economists are well aware of the fact that the process of European integration is by no means exempt from contradictions and conflicts. There will obviously be disagreements among the members of the EC concerning the financing of costs stemming from the acceleration of the integration process,from the economic redeployment and from the sectoral and geographical reorientation of economic activities. It is possible that owing to implementation problems resulting from conflicting interests the establishment of the Single European Market will require longer time and will bear less favourable growth, employment, equilibrium, etc. effects than expected earlier. The formation of a "European Europe" will be not only an option but a constraint, and rational political interests and forces will also be mobilised in this spirit, in order to responding to the Asian challenge, to counterveiling the weakness of the century-old Atlantic system of relations as a consequence of the ever stronger and dominating Pacific external economic orientation of the US, and to curing once and for all the Euro-sclerosis of the 1970s. The establishment of the unified internal economic environment of the European Communities uniting a total of 320 million consumers and representing 50 per cent of world trade in services, 40 per cent of world merchandise trade, 25 per cent of world production, and the formation of the more pronounced market character of Western integration, will be, by all means, the basic reality of the 1990s and demands an immediate adjustment to the new realities from all foreign trade-sensitive countries in the world.

2. The Single European Market and the Outsider Countries

The establishment of the unified internal market and the more solid foundations of the joint actions of West European countries in themselves tend to increase the bargaining power of Western Europe in international relations. In the period of the decreasing trend o low level of dangers rising from military conflicts, international power relations are primarily influenced by the size of international economic, more precisely, financial, technical and foreign trading bargaining power. As a consequence of the more intensive interactions between the military, economic and social aspects of security, the security policy importance of the EC relying on greater bargaining power is indirectly upvalued even if the "European" character of directly assuming a military and security role is not yet developed in the 1990s.

a/ Of the main factors of the international system of relations the share of the EC in the foreign trade of the US has decreased to 25 per cent by the end of the 1980s. The accelerated dynamics of East Asia and the extension of North American regional integration absorbs the American co-operation capacities, falling behind in Western Europe, without any difficulties. Parallel with the continued existence of a great number of sectoral and functional partial conflicts, the interests of the US are reliably served in the medium run by the double bondage of Western Europe; the maintenance of military co-operation on an "Atlantic" basis beside a stronger "European Europe" and relatively weakening economic co-operation with the US. At present only 15 per cent of Japan's exports is sold in the EC. The possibly strengthening international activity and multiplied co-operation energies of Japan will be aimed at the Pacific region. From this point of view, the economic conditions for the establishment of a "European Europe" are much more favourable than earlier.

b/ In the group of the developing countries domestic markets amplify rather special re-orientation constraints. Based on the external priorities of the EC in the last three decades, one assumes that the dynamisation of the West European region will improve, above all, the development chances of the so-called Lomé Group and of the Mediterranean countries. In a given product structure the positions of OPEC countries are determined primarily by the international oil market and not by the developments within the EC. The growth and external economic energies of dynamic East Asian countries are absorbed by the Pacific region. Although they make certain efforts to find alternative markets to those in the US or Japan, their sensitivity to changes in the EC is relatively modest. In a bizarre way, the system of external relations of a "European Europe" has influenced most unfavourably, in the developing world, the Latin American countries which have, from the point of view of their development history, most intensively been attached to Europe, and thus they are compelled most powerfully to respond.

c/ The destiny of outsider European countries is of key importance from the point of view of the formation of a European Europe. In the case of EFTA countries which have historically been deeply embedded into the European division of labour remaining outside might be the source of grave dangers of decline. In the 1990s EFTA will not function as a real "counterveiling force", defensive zone vis-a-vis the European Communities any more, especially if certain important members like Austria or Norway leave EFTA. In the neutral countries the long-term solution could be, beyond the faster implementation of nation-level adjustment strategies, an all-European economic, political and security co-operation.

3. The EC Challenge and the CMEA countries

The EC challenge is a special part of the multiple "shock effects" influencing the CMEA countries. In the last decade in the Central and East European region an equilibrium, structural, growth, social and political crisis of differring depth, patterns, speed by countries has come about. This complex crisis is a multi-causal one. The driving forces nourishing the rapid quantitative growth in the three decades after World War Two have been exhausted. Such driving forces were, in the small East European countries, the survival after the war, the life-energy releasing effect of "zero-time", in the 1950s and 1960s the resources redeployed into the productive sphere through expropriations, income-nivellation and the negligence of agricultural and infrastructural development, in the 1970s growing indebtedness in some countries and the improvement of the terms of trade in some other countries. As far as the 1980s are concerned, a number of factors have already had a very powerful and negative effect: missing the opportunity to adjust to the new-type, technology-intensive world economic growth pattern and the new world economic value system, the handling of the consequences of indebtedness /and, in a wider sense, the debts accumulated towards foreign debtors, neglected domestic sectors like education, transports, telecommunications, housing, etc had to be serviced simultaneously/, the "Eastern challenge" resulting from the exhaustion of the driving forces in CMEA co-operation, the constraint of external economic re-orientation /for example, the share of CMEA countries in Hungary's foreign trade decreased from 71 per cent in 1960 to 45 per cent in 1988 and it will most probably be down to 40 per cent in 1990/.The model-functioning disorders, missing the world economic adjustment, structural obsolescence and loss of market positions could be perceived already prior to the 1992 challenge in East-West economic relations. For instance, the share of the European CMEA countries fell in the period 1985-88 from 4,6 per cent to 2,3 per cent in the exports and from 4 per cent to 2,7 per cent in the imports of the twelve EC members. Thus in the CMEA countries the difficulties resulting from the simultaneous economic and political modernisation, changing the growth pattern and the model, constraint of external economic reorientation and improvement of performances, are multiplied by the challenge of 1992.

a/ The external conditions of the social and economic progress in Central European countries are favourably influenced by the dynamisation and accelerated modernisation of neighbouring Western Europe, a region which has been playing a role in their historical development in the last one thousand years, by the curing of "Euro-sclerosis" being so apparent in the 1970s, by the deregulation and liberalisation of the economic environment and, finally, by the standardisation of adjustment requirements. It needs no further explanation that the adjustment of traditionally weakly adjusting enterprises in the CMEA countries to the national markets of 12 countries is, by all considerations, a bigger task than having to adjust to a unified market.

b/ At the same time, however, a new challenge for Central Europe involving a great, although not yet quantifyable, number of new schock effects will be an increased sales competition in Western Europe, the extended scope of competition mechanisms, stronger trade-diverting and capital-draining effects, the expected squeezing-out of non-competitive, outsider countries and enterprises from the West European big market creating a more and more unified economic, technical and administrative system. This danger is not hypothetical at all as it is also reflected in the development of East-West relations in the second half of the 1980s. It is even more instructive to realise that so far the geographical enlargement and the "articulation of depth" of the EC has influenced the industrial exports of less competitive CMEA countries more unfavourably. The 1988-89 Annual Report of ECE also underlines /Economic Survey of Europe, 1989, N.Y. pp. 64-82/ that even in the period 1980-86 the sources of supply in the industrial imports of EC countries shifted from Eastern Europe to South European countries. In greater perspective, Central and Eastern European countries are influenced even more unfavourably the geographical reorientation of West European economic dynamism. If West European economic dynamics are centred along the Hamburg-Sevilla axis instead of the Danube basin and the Alp-Adriatic zone, the external conditions of the development of Central European countries will further deteriorate.

c/ A special dimension of the challenge can be the appearance of West European unified defence and political efforts which can hinder the improvement of relations with outsider countries and, parallel with the unification of the economic environment, it can draw a new demarcation line between the countries separated from each other after Yalta. The risks stemming from the diverging priorities of a unified market and an all-European co-operation are yet far from being eliminated. It is difficult, also from the point of view of domestic politics, to prepare the individual Central European countries for the strategic re-integration without the anxieties around "Fortress Europe" being clearly dismantled. In the event of a possibly unfavourable form of Austria's entering the EC, the deterioration of the special relationship between Austria and Hungary might pose a problem, for the latter, of primary importance.

4. East European Options of Responses

Unlike in the 1950s, 1960s and 1970s, the individual CMEA countries have not been ignoring the development challenges coming from Western Europe in recent years.

a/ A certain group of countries, political power factors and economists wished to respond to the challenge of 1992 by an accelerated intensification, priorisation of co-operation among CMEA members, by the fundamental reform of CMEA. According to the supporters of this kind of response it would make the preservation of economic and power structures envolved in the past decades possible and would minimise the social and political tensions which could be dangerous for the given power. However, as a consequence of economic real processes, the exhaustion of the driving forces of CMEA co-operation and the resources of its individual members, the extensively parallel capacities and the appearing spheres of shortage economy, and of the import demands of the modernisation constraint, the economic conditions of more intensive co-operation are, right from the outset, missing. No Socialist "Common Market" can be established in a group of national economies where market mechanisms are, to varying degrees, either underdeveloped or missing. On top of that, the economic management techniques and the outlines formed about the future image of social, political and economic development are very different by countries - as it can be experienced even today between Hungary, Poland and the Soviet Union, on the one hand, and Romania, the GDR, Bulgaria, and Czechoslovakia, on the other hand. Thus, apart from differring economic interests and conditions, even the lack of political and economic policy interests and conditions make the realisation of the rehashed idea of an "East European fortification formed by chariots-countries" simply hopeless.

b/ A specific offshoot of a regional protection area is an all-European co-operation growing out of a CMEA-level response, that is, of the relations between the two regional organisations. These approaches lead into blind alleys partly as a consequence of the dishevelled system of CMEA co-operation, partly due to the differrent interest relations and counterveiling possibilities by countries vis-a-vis the European Communities, and therefore the scope of a possible regional co-operation is very limited from the beginning. For example, the Hungarian economy has distanced herself in the last two decades from the Soviet-type Stalinist model and is advancing, on the basis of her national characteristics, on the road of development termed as "market economy Hungarian style". Probably a similar pattern will be followed in Poland and, with different time-lags, in the various other Central and Eastern European countries, too. The responses to the EC challenge and the character of relations between the European Communities and the individual CMEA countries will also reflect national characteristics and thus will be selective. Even the pace, depth and complexity of the transformation taking place in the individual reform-countries shows considerable differences which makes either the modernisation of economic co-operation between CMEA countries or the joint response impossible.

c/ Rather special approaches can be experienced in the attitude towards the EC of certain liberal groups advocating the accelerated renewal process in Eastern Europe. This school of thought ignores the specific features, divergences, the size of distance from the Stalinist model, in the development of the individual Central and Eastern European countries and regards all CMEA economies as uniformly unreformable, Soviet-type models. According to this notion neither export-orientation, nor forcing foreign investments, joint ventures, structural reforms brings results. The co-operation with the EC can start only after the full marketisation, liberalisation, monetary management of the national economy and after the change of the system; the tasks of EC co-operation are then greatly eased by the established market automatisms.

Instead of going into the details of reform strategies and reform roads, perhaps it is sufficient to refer to that as a consequence of the wide gap in Eastern Europe between what is "desired" and what is "possible" - both terms interpreted in a rather individual way -, a longer /although the time requirement is different in the case each country involved/ and very special transitional period will finally lead to the target state of a market economy. In responding to the EC challenge, Central Europe must not wait until all system-specific problems are cured since it is obvious that the response is historically belated even today. Therefore the implementation of the co-operation strategy between the EC and the individual CMEA members, on the one hand, must suffer no further delay and, on the other hand, the response, reflecting the national characteristics, manoeuvring field of each country, most not be left to either non-existent or underdeveloped automatisms.

5. Hungary and the EC

Why is Hungary the "champion rider" of not only Central and Eastern European reforms but, at the same time, all-European co-operation, too? Based on her heritage of development history, continental situation, present growth endowments, Hungarian economic growth has been extremely deeply embedded into the European division of labour. Only one-sixth of her foreign trade is with non-European countries. Therefore the rational Hungarian external economic strategy is ambitious to widen her co-operation with overseas developed and outsider developing countries. Nevertheless, these overseas partners cannot counterbalance, if only for dimensional reasons, the consequences of a possible deterioration of the all-European division of labour. The "slimming diet" of Hungary's co-operation with the CMEA is a matter of fact in the medium run. Austria's joining the EC would greatly limit the expectations, from the point of view of Hungary, concerning a hypothetical co-operation with EFTA. One must not ignore, either, that EFTA as an organisation regards at the moment the institutionalisation of relations with Hungary as of disturbing effect, from the point of view of working out its own co-operation with the European Communities.

As a result of all these factors, the EC-connection is a matter of life and death from the point of view of Hungarian development. It is not a coincidence that among all the CMEA economies both the relative increase and the absolute share of the EC Twelve has been the highest in Hungary's trade in the two decades after the beginning of the Hungarian economic reform. Between 1970 and 1988 the share of the EC in Hungarian exports rose from 16 per cent both in 1970 and 1985 to 24 per cent in 1988, whereas in Hungarian imports from 17 per cent in 1970 to 21,8 per cent in 1985 and to 25,3 per cent in 1988 /source: Yearbooks of the Hungarian Statistical Office/. The relative importance of trade with the EC countries is almost twice as great as the average of the other CMEA economies which indicates, on the one hand, the high EC-sensitivity of the Hungarian economy and, on the other hand, the interrelation of Hungarian economic reforms and the Europeanisation of her national economy. Although from Hungary's point of view at present the constraining elements and shock effects of the 1992 challenge prevail over other factors, the basic task of Hungarian external economic strategy is not to take a defensive attitude but, instead, to exploit the possibilities of the bigger internal market by an active, offensive strategy of renewal.

Of the <u>external conditions</u> of intensifying Hungarian-EC relations I would like to call the attention to two aspects:

- Despite encouraging rhetoric on political levels, the <u>receptiveness of the EC</u> is not reassuring from the point of view of Hungarian co-operation efforts. For the renewal process of both Hungary and other Central European countries the formation of a West European judgement of the situation is of key importance, namely that the positions could be improved, her standind vis-a-vis both the Far Eastern and the North American region could be supported, her security interests are better defended by the intensification of East-West co-operation, by her support to the European re-integration, and the success of the European re-integration, of certain Central and Eastern European countries, by her participation in preventing the crisis situation jeopardising the whole European stability and by exploiting the human potential of the Central and Eastern European region. On the basis of the geographical elbow-room and traditions of co-operation, the European re-integration of the Hungarian economy cannot be indifferent especially for the Federal Republic and Italy. From this aspect it is in the interest of Western Europe to take responsibility in the transformation of Central Europe, to ease a non-violent Central European transformation by establishing receptiveness, by upvaluing the Central and Eastern European region in the EC's geographical priorisation hierarchy, by offering better market access possibilities, by encouraging the flow of technologies and direct capital, by a kind of structural co-operation reaching beyond transportation and environmental protection, by opening the "gates" of organisations in which West European countries do participate /OECD, Council of Europe, European Parliament/, and by establishing the European integration forms between enterprises, small communities and different groups of population.

In the case of Hungary it can be concretely formulated that the accelerated implementation and the further conceptual development of the Trade and Economic Agreement, reflecting an earlier stage of political situation, signed in the autumn of 1988, is justified by the accelerated dynamism of the transformation process and political development. From the professional point of view it is really difficult to justify the standpoint of the EC which, identifying the Hungarian economic model with that of Albania, Romania, etc. ranks Hungary among the group of state-trading countries. By objective measurements the Hungarian economic model is at least as much in conformity with GATT rules as the Yugoslav one. This is the reason why it would be desirable to develop the trade agreement between Hungary and the EC further into a more comprehensive co-operation in the fields of economic, technology, financial and tariff policies. This kind of co-operation is indispensable for the re-integration, since too big burdens of integration cannot be loaded on the yet underdeveloped commodity and capital market mecahnisms of the Hungarian economy.

- The other, equally important external "pillar" of Hungarian Europe-policy is the new Soviet strategic and foreign political thinking, the easing of tensions in the field of Soviet-American military confrontation, and the possibility of withdrawing foreign troops stationed in Europe. The new European policy of the Soviet Union, the higher flexibility in the CMEA system of relations, the tolerant attitude to Hungary's seeking for the way out of the crisis, all create external conditions never experienced before for the formation of new, more articulated ways of co-operation between Hungary and the West European countries. At the same time, a scientifically-based European policy of Hungary must not ignore the consequences of cyclical political processes and of a possible transitional Soviet restauration, either. Flowing from this, in the period of favourable external conditions the more rapid pace of institutionalising relations between Hungary and the European Communities is of key importance because this may offer contractual safeguards to the irreversibility of this process.

c/ The internal conditions of responding to the EC challenge do not significantly differ from the general requirements of the Hungarian renewal process. The requirements of adjustment to the Western Europe of the 1990s should become manifest in all segments of the new Hungarian development strategy to be worked out and to be implemented, ranging from external economic strategy to structural, educational policies, legislation, standardisation, environmental protection and the modernisation of the institutional structure.

- On governmental level, adjustment is expected from the implementation of a comprehensive integration package. As far as external relation-building is concerned, the fine blending of the European dimensions of the new Hungarian foreign policy, security policy, trade policy facilitating the market access of Hungarian agricultural products, decreasing the tariff burdens of Hungarian industrial goods, obtaining the full-scale treatment of most favoured nation, a complex co-operation policy reaching beyond the trade agreement and, finally, the combined scientific, educational and cultural policy must be highly priorised. As regards structural policy, it has been well-known by pursuers of science in the last 15-20 years that the material, energy, capital and muscle-intensive production and supply structure of CMEA countries generates no dynamics, no incomes and no stability, either in the domestic economy or in hard currency exports. The creation of more up-to-date forms of East-West co-operation and the acceleration of European re-integration requires a powerful redeployment of resources, incomes and economic activities.

It would be expedient to focus the initial stage of Central European commodity and capital import liberalisation on those sectors which bring the fastest and most remarkable results. Beyond the transitional protection of the scope of activities reaching competitiveness only after a certain transitional period, and those not yet importable in the medium run, the future of lastingly non-viable sectors and activities, and those not relying on specialisation advantages, must be determined /partly perhaps counterveiled in a possible, comprehensive EC co-operation/ by import competititon. The further structural development and new-type export-orientation of Hungarian agriculture and food industry, having, by European standards, exceptionally favourable growth endowments, could be linked to a significant increase of the share of some import products from the European Communities /e.g. fodder, butter, milk powder, tropical fruits, etc./. In order to prevent greater social, political, sectoral and regional tensions, the future of those Hungarian sectors and activities which will be phased out as an aftermath of co-operation with the EC must be determined in the frameworks of comprehensive cutback and restructuring plans.

- The main field of the Hungarian economy's re-integration into Europe is, in the end, the <u>sphere of activities of enterprises.</u> A fundamental task of government activities is to establish an economic environment and management technique which compels and makes Hungarian enterprises intersted in performing succesfully in West European markets, creates the preconditions of enterprise-level competitiveness by abolishing the barriers of capital, manpower and technology flows, by developing infrastructure, revising the present overtaxation practice, offering attractive conditions to foreign investors and other partners and by the adjustment to the West European measures of deregulation and standardisation. Perhaps it is worth emphasising here, in this context, too, that Hungary intends, after the necessary preparatory period, to move in the "European House" as one among the equal tenants and not as a night-lodger in the basement. Flowing from this, the European inter-enterprise relations based on the Hungarian human potential, expertise, technical development mobilisable through the present and the European forms of co-operation, the establishment of the network of Hungarian producing and service enterprises, banks should be greatly encouraged.

- The creation of New Europe demands, parallel with preserving national identities and cultures, the integration at the levels of the European population, the reinforcement of Europe-consciousness, the establishment of behavioural cultures in harmony with the historically well-proven values of Europeanism. This process can be accelerated by easing the mobility of the Hungarian population around Europe /tourism, education, jobs/, and, in the framework of an all-European co-operation, by the creation and rapid development of the network of Hungarian institutions affiliated and integrated into various kinds of European Academies, Europe Institutes and the whole European teaching and educating system. Of course, Hungary's re-integration into Europe cannot be realised without a larger-scale adjustment to historically well-proven West European values /democracy, parliamentarism, human rights, private ownership, moral value system/. It is of great importance both in the short and medium term to relatively reflect the European-level party political lines of force in the Hungarian domestic political development and to make use of inter-party relations in the new political field of force in the integration process.

The new European policy of Hungary and the accelerated adjustment to the challenge of 1992 involves, of course, a number of breaking points as regards the institutional frameworks and power structures which have come about in the last decades. Overcoming the various kinds of resistance and moments of inertia resulting from these factors requires very circumspect, creative solutions bearing always in mind the elbow-room of the country at the given time, and, as a result of elections in the not very distant future, a newly-formed, strong government.

The road leading back to Europe is not a multi-lane motor-way but a rather narrow, by no means easy and danger-free path. Hungary has set out again, being aware of the risks, for this path. Perhaps it is not exaggerated to wish what West European nations and the European Communities, having already found their Europeanism, guide, as modern "St. Christophers", the Hungarian wanderer on this long and winding path.

1992 AND AFTER: EUROPEAN COMMUNITY AND EASTERN EUROPE

by John Pinder

An age of the rule of law

1. The present period may be seen as the rise of an age of the rule of law. Politically, we can see the spread of constitutional and representative government based on fundamental rights ensured by the rule of law, and offering liberty to the citizens. Economically, the market within a framework of law is replacing the administrative or over-regulated economy, offering space for the initiative and creativity of individuals and enterprises.

2. Many states have, during the past half-century, moved in this direction. But in an increasingly interdependent world, the rule of law within each state is not enough; it must also extend to the dealings among citizens of different states and to the relations between the states themselves.

3. The international economy is still fragmented by states claiming full sovereignty, with barriers and distortions at the frontiers representing sharp breaks in the application of the rule of law. Yet the modern economy needs a wider market, providing room for the specialisation and scale that go with the development of new technology. In the postwar period the Gatt helped to serve this purpose; and within Western Europe the European Community, and to some extent the European Free Trade Association, were a framework for a deeper integration. This integration enabled Europeans to catch up with the Americans in the industries of the second industrial revolution: cars, consumer durables, standard machinery.

4. Less remarked, perhaps, but no less important, the European Community established the rule of law for many of the transactions among economic agents in its different member states. With the EC's Court of Justice as the ultimate judicial authority, disputes are settled under the law rather than by reference to the power relationships that so often underlie the resolution of disputes among fully sovereign states. While the EC Treaties themselves contain much of the law that is applied, they also provide for the enactment of further legislation. Thus the EC is a polity that enacts laws and applies them, not just to the member states but also to the individual citizens and legal persons who have rights that can be, and are, enforced through the courts.

5. This law-based character of the Community is the crux of the new phase of its development, associated with the 1992 programme. There was, by the early 1980s, widespread alarm in the Community that its industries were falling behind those of the United States and Japan in developing the new technologies: that is, in the third industrial revolution, with microelectronics and information technology at its heart. A wide consensus put much of the blame on the continued fragmentation of the EC market by non-tariff distortions among the member states, which denied to industry the size of home market available to Americans or Japanese. Public purchasing, subsidies, state enterprises and technical standards are very important in such sectors, and the EC market was fragmented by all of these. Such barriers were also weakening production based on more standard technologies, with each member state defending its own enterprises against the competition in these sectors, much of it from dynamic newly industrialising countries, by measures that fragmented the Community market itself. Hence the agreement to create the single market by the end of 1992, through a vast programme of legislation to remove the non-tariff distortions.

The 1992 programme

6. The founders of the German social market economy were among the first to explain that modern markets require a strong framework of law. So it should be no surprise that a single multinational market must be created, not just by laisser-faire, but by much common legislation. Formally, then, the completion of the single market comprises the enactment of some three hundred legislative measures for such things as the harmonisation of technical standards and regulations, the opening of public procurement to competition from suppliers in other member states, the removal of frontier controls. In order to fit the Community for this big legislative task, the Single European Act strengthened the EC's legislative process through greater scope for majority voting in the Council of ministers, and made it more democratic by enhancing the role of the European Parliament. The Act also enlarged the Community's competences in the fields of policy for technology, environment, employment, and social solidarity among the member states; formalised the cooperation of the member states in foreign policy; and adopted economic and monetary union as a Treaty-based objective.

7. The single market can be translated into reality only by business decisions. Not only must the laws be enacted, but business must have the confidence that the single market will exist and will be important for enterprises. Conscious of the need for such confidence, the Commission of the EC initiated a vast study of the likely effects of the single market, which was published as a book with many supporting documents and is usually known as the Cecchini report. The central estimate was that the rate of growth of the Community's gross domestic product will be boosted by some ½ per cent a year in the 1990s if the single market is successfully completed.

8. The Community has made remarkable progress in enacting the laws that concern mainly the operations of industry and finance. The liberalisation of capital movements by mid-1990 is a striking example. The majority voting together with a simpler procedure for harmonising standards has been an evident success. Gains such as those foreseen in the Cecchini report are a powerful moti

9. Where the operations of governments have to be controlled, success seems less certain. Subsidies, many of them supporting the less competitive production, still amount to some 3 per cent of gross domestic product in a numl of member states. There is resistance to the removal of frontier controls. The legislation for open public procurement is not yet complete; and, given the difficulty of proving discrimination in the courts, enforcement of the single market principle in this very important sector will be hard to achieve.

10. Success of the single market programme is, then, not yet assured. It could fail if legislation is impeded by a deterioration of political relations among the member governments; and much of what remains to be done, enforcement as well as enactment, is intrinsically hard to accomplish. But the expectation must nevertheless be that the programme will succeed. It has acquired a strong momentum in the EC institutions; and business support for it, which was seminal in its initial promotion, remains strong. There is also a fair prospect that the momentum will be maintained by a new phase of integration, centred on the project of economic and monetary union.

Economic and monetary union: a new phase of integration

11. With capital and financial markets fully integrated, there will be less macroeconomic autonomy for the member states and, at the same time, more pressure on the exchange rates with larger flows of money across the exchanges. Yet less stable exchange rates are not what business wants. Changes in the relative values of EC currencies are one of the outstanding remaining examples of fragmentation of the Community market, and business interests strongly support enhanced stability. Monetary integration would also help to place the EC on an equal footing with the United States in the field of currency policy, just as the EC's common tariff has done as regards trade policy, and would be a major step towards political union, or European Union as it has come to be called.

12. These were among the motives that led to the inclusion of economic and monetary union as an objective in the Single European Act and to the European Council's decision in June 1988, under German Presidency, to charge the Delors committee with proposing 'concrete stages leading towards this union'. The Delors report, published in April 1989, proposes a phased approach to economic and monetary union, starting with the extension of the exchange rate mechanism of the European Monetary System to include all member states, and ending with a common currency managed by a European System of Central Banks. In the final stage there would also be firm coordination of macroeconomic policies and new measures of solidarity to help the weaker regions to meet the challenge of competing without recourse to the possibility of devaluation. Further reform of the EC institutions is also implied.

13. Will the economic and monetary union really be established? Among the larger member states, France, Italy and Spain are in favour. The British government is against. The German authorities are for in principle, but cautious about locking in the Mark with more inflationary currencies. If the Germans side with Mrs Thatcher rather than with the Latin countries, there can be no effective union in this field. But Mrs Thatcher appears increasingly isolated in the Community: not just in her rejection of any cooperation with respect to exchange rates, but also in social policy, frontier controls, and attitude to sovereignty in general. Nor has her quarrel with Chancellor Kohl about security policy improved the climate for an Anglo-German alliance t prevent monetary integration. With the support of business interests for

such integration, and widespread support for further movement in the direction of European Union, it seems unlikely that the Delors report will result in a fiasco -- which would have the political consequence of placing the 1992 programme itself at risk.

14. Thus the Community is likely to make progress in monetary integration, with steps towards economic and monetary union, which may well be achieved in the 1990s. If Mrs Thatcher persists in standing aside from the process, this could result in a two-tier or a two-speed Community: two-speed if the British are later to climb on board; two-tier if Mrs Thatcher's revulsion against such further integration becomes entrenched in the British political system,

The mirage of fortress Europe

15. When the European Economic Community was established in 1958, the EC was accused of dividing Europe and of being an inward-looking, protectionist bloc. The accusations came in particular from Britain and from Eastern Europe. But they were quite misplaced. The customs union led instead to a series of liberalising trade negotiations in the Gatt and to the extension, by 1973, of a free trade system to the whole of Western Europe. The EC, in providing the framework for a dynamic economy, fostered industries that felt the need for wider free trading too. It was after 1973, with the onset of stagflation, that the Community became more protectionist, and the fears of East Europeans in particular were to some extent justified.

16. The linking of the slogan 'fortress Europe' with the 1992 programme is equally a mirage. If the programme succeeds, the EC economy will be dynamic; and this will be better for other countries, not only because the EC market will expand faster, but also because business interests in the EC will feel more confident of competing in an open world economy, and will see the need for the wider international market. But that is not to say that there will be no problems for the EC's trading partners: just that the context will be more favourable for such problems to be resolved.

The EC and other Europeans: Efta

17. Members of the European Free Trade Association have declined to accept the rule of law within the EC chiefly because they have wanted to keep their full state sovereignty. Switzerland and the Scandinavian members (Finland, Iceland, Norway and Sweden) have had this motive. The other member, Austria,

has been less insistent on sovereignty as such, but has been inhibited by its neutral status, as have also Finland, Sweden and Switzerland. The free trade agreement that each of the six has with the EC has given them a comfortable half-way house until now. But they fear that their markets may drift apart from that of the Community as the latter completes its body of single market law. Far-reaching compliance with EC law could reduce this danger; but the implications for sovereignty would be similar to those of membership -- without the share in the larger sovereignty that membership allows. Acceptance of the common currency of an economic and monetary union would likewise subordinate the Efta countries to the EC's macroeconomic policy without a say in its making.

18. The Efta countries seem to have three alternatives: full membership of the EC, which should be negotiable after 1992; membership of the second tier of a two-tier Community, if the EC's core group undertakes a form of security integration that countries such as Austria cannot contemplate, or offers a trading relationship based on the single market for states such as Switzerland or Britain which may refuse to join in further integration; or a continuation of the free trade agreements, with an attempt at more consultation about single market legislation and monetary policy. But the EC legislative process i complex enough already, and hence resistant to influence from outside. Unless a two-tier structure can be devised for the Community, the Efta countries may have to choose between the binding commitments of full membership, or an external status that would reduce business confidence and hence the dynamism of their economies.

The EC and other Europeans: Eastern Europe

19. The problems of trade between economies based on market and on administrati systems are well known. In formal trade negotiations, the market-economy partners find it hard to identify reciprocal benefits to seek. In the trade itself, the administrative systems seem resistant to a dynamic development of their external economic relations; and this reflects a general resistance of such systems to a dynamic development of the modern economy. It is often remarked that the EC's trade with Switzerland is of the same order of magnitude as its trade with the whole of CMEA.

20. Despite the reforms of the last two decades, Hungary retains many of the features of an administratively organised economy. The EC's agreement with Hungary, with the commitment to remove discriminatory quotas by 1995, shows that significant improvements can be negotiated. More importantly,

the EC could, as the reform of its agricultural policy progresses, reduce its protection against imports of Hungarian farm products. But without a fuller economic reform in Hungary, the scope for an expanding economic relationship with the Community will remain limited.

21. The reform of the Hungarian economy into a basically market system seems probable during the 1990s. The same may be said, if with less confidence, of Poland. The reform of Czechoslovakia and the GDR depends more on the success of Soviet reform, which is more problematic and may require a longer time-scale.

22. With a market economy, Hungary, Poland or other East European countries should be eligible for free trade agreements with the Community such as those of the Efta countries. Full membership of Efta, which may by then imply a somewhat deeper level of integration than now, could also require a solidly based system of constitutional and representative government. Association with CMEA should be possible to combine with free trade with the EC and even with membership of Efta, as the example of Finland shows.

23. If full membership of the Community is possible for Austria, it should also be acceptable to the Community for a Hungary that became as fully a market economy and a constitutional democracy as Austria is today. This political condition stems from the Community's need to enact laws by such constitutional means and to sustain the rule of law throughout its area by the authority of independent courts. For a Hungary so reformed, the question would not be its eligibility from the Community's point of view, but its relationship with the Soviet Union. If the Community develops its competence in security cooperation, the two relationships might not be reconcilable, unless the Community also create a second tier which can accommodate neutral states and Hungary can achieve such a status.

24. By the time that Hungary or other East European countries have market economies and constitutional democracies, Europe may have evolved a security system that makes such questions easier to answer. Meanwhile, we have to consider how the relationship with the Community could develop as East European reforms progress.

25. The baseline for trade relations is the present agreement, securing the removal of discriminatory quotas by 1995. A next step could be better terms of access for agricultural products. Beyond that, Hungarians may think of

preferential arrangements such as the Yugoslavs enjoy, although the EC may be reluctant to extend further its already extensive schemes of preferences. If Austria joins the Community, however, Hungary could seek the adoption by the EC as a whole of the preferences granted by Austria, as an alternative to keeping a special relationship with Austria such as the GDR has with the Federal Republic. More promising than preferences, perhaps, would be a ten-year transitional programme to achieve a free trade relationship, to start when there is convincing evidence that reform to secure a market system has begun, and to enter into the final phase only when the reform is complete.

26. When confidence in such reforms has been established, a debt settlement should become possible that would lighten this burden on the Hungarian economy. To create such confidence seems, for internal as well as external reasons, essential for the success of the reforms and hence of Hungarian economic development.

27. Nothing would do more to establish such confidence, externally at least, than a convincing programme to introduce convertibility by stages during the 1990s. Real, as distinct from purely financial, convertibility depends of course on a decisive shift from administered to market-based prices. Once the Community is convinced that this is being done, and that convertibility will definitely be achieved, it should be possible to provide finance to facilitate the process, as the US did for Western Europe with the European Payments Union.

28. This raises the question, since reforms in CMEA member states proceed at different speeds, whether a reform group would consider a special relationship within CMEA, moving towards convertibility together. It should be possible for the EC to support such a group, with an East European Payments Union, in moving to mutual convertibility among themselves as a first step towards general convertibility.

29. The 1990s offer great possibilities in Europe. The EC may move far towards a Union with federal institutions, which would promise an era of stability, prosperity and political renaissance. European countries that are not now members of the Community should at least benefit from this process, and their close association with it should be welcomed. If the Hungarians freely decide that they wish to associate themselves with the Community in one way or another, and if they meet the conditions for doing so, there should be no doubting what welcome partners they would be.

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East-West Trade and Financial Relations: Recent Developments and Prospects.

(Pietro Catte - Cristina Mastropasqua)

1. East European trade: an overview

The trade relations of East European countries[1] are characterised by a 'fundamental asymmetry'. Although trade with western industrialized countries is much smaller than that with CMEA partners, (less than 30 per cent of the total, as against more than 60 per cent), it plays a crucial role in fostering the accumulation process in eastern countries, through the import of manufactures with a high tecnological content.

Intra-CMEA and East-West trade are conducted under different 'rules of the game'. Integration in the CMEA is achieved through the joint planning of trade flows, while market rules govern trade relations with western countries. Currency inconvertibility and the virtual impossibility of

1. Bulgaria, Checoslovakia, German Democratic Republic (GDR), Hungary, Poland, Rumania, URSS.

transferring balances between member countries have caused a bilateral trade structure to develop within the CMEA, involving countries and categories of goods (primary products and manufactures, Colombatto, 1984).

Although it is often claimed in the literature that bilateralism has imparted a contractionary bias to intra-CMEA trade (Lavigne, 1985, Maciejewski and Nuti, 1985), its growth during the 1980s has been faster than that of East-West trade.

Intra-CMEA trade has benefited from the n-th country role played by the Soviet Union, which has been accumulating non-transferable trade surpluses (and irrecoverable credits) vis-à-vis Eastern countries. The pattern of CMEA trade has been dominated by flows to and from the Soviet Union. Between 1973 and 1985, the latter supplied its CMEA partners with 90 per cent of their energy imports at lower than world prices, in exchange for manufactures and primary products. In return for this 'implicit subsidy' the Soviet Union has increased its power to decide on the destination of the resources collected from CMEA members (Van Brabant, 1987).

Since the considerable drop in world oil prices (50 per cent between 1985 and 1988), the Soviet Union has been feeling the external constraint as more binding. The need to boost oil exports to western countries and the reduced availability of new sources will probably affect Soviet supply to CMEA countries and/or increase the settlements in convertible currency (now around 10-15 per cent), with negative repercussions on the growth of intra-CMEA trade.

East-West trade in the 1980s shrank both in value and in volume. The dependence of Eastern countries on imports of western manufactures has increased in relative terms. At the same time the weight of primary products and semi-manufactures in their exports has risen. This shift has resulted in the structure of exports having been more vulnerable to the weakness of the prices of primary products in the course of the 1980s.

The external constraint of the Soviet Union was concealed until 1985 by the windfall gains from the rise in oil and gold prices. However, these gains did not lead to the build up of an export industry, but rather led the Soviet Union to specialise in the export of energy products (Hewett, 1980).

In conclusion, the structure of East European trade with the industrialised countries has worsened both in quantitative and qualitative terms, becoming similar to that of LDCs, net exporters of primary and semi-finished products and net importers of manufactures. The orientation towards the less dynamic sectors and the unfavourable shift in the terms of trade between primary products and manufactures have caused a loss of world market shares for both the six East European countries and for the USSR. Moreover, the competition of LDCs and NICs has increased on western as well as on third world markets (Graziani, 1987).

2. The interplay of external and domestic factors.

The weakness of the terms-of-trade of the six smaller East European countries and their debt burden have heavily constrained their import possibilities. The dependence of accumulation and income growth on western technology has negatively affected the development of the export sector. External and domestic factors have mutually reinforced each other, leading to a 'vicious circle' of import contraction, slower growth and a more binding external constraint.

The domestic factors affecting the organization of production in a CPE can be summarized in:

(i) the state monopoly of foreign trade, i.e. the predominance of plan directives over market signals in determining the supply of exports and the demand for imports;

(ii) the price formation mechanism, leading to a relative price structure different from that prevailing on the international market, and the 'price equalisation mechanism' that insulates domestic prices from external influences;

(iii) external inconvertibility and currency shortages.

All these factors have combined to deprive domestic firms of the incentives to specialise in international trade. Moreover, their virtual monopoly on the domestic market has been a deterrent to production for the external market, where competition is fiercer and profits uncertain. The need to fulfill production targets and the equalisation of foreign and domestic prices have discouraged domestic firms from economising on imports. It has also been difficult for planners to direct production towards the most dynamic markets and profitable goods, due to the diversity between domestic and foreign relative prices (Daviddi, 1989).

3. The prospects for East European trade and the possible impact of economic reforms

The prospects for a recovery in the East-West trade of the six smaller Eastern countries are not encouraging. For Poland, Bulgaria and Hungary, which are highly indebted, the most likely outcome is a debt reduction strategy based on further import cuts, especially in view of the foreseeable weakness of primary product prices, which will keep their terms of trade unfavourable for some time.

As for the Soviet Union, which is still a credit-worthy country in the eyes of western banks, the need to comply with the five-year plan targets, which prescribe yearly growth of 4.1 per cent in net material product and of 4.3 per cent in the capital stock, will probably translate into higher imports of capital goods. At the same time imports of consumer goods are also likely to rise, to satisfy the growing excess demand of the population and strengthen the political consensus on perestroika. The 15 per cent increase in Soviet imports from the West in 1988 and the worsening of the Soviet trade balance in convertible currency (by 1 bn roubles between 1987 and 1988) lend support to this view. It is therefore not unreasonable to expect an increase in Soviet external debt in the next years.

The revival of the reform process in Eastern European countries has aroused expectations of a significant opening of their markets. In particular, western businessmen have strongly welcomed the reform of the external sector in the Soviet Union. On the other hand, the economic literature has widely recognised that the impact of the reform on the structure of Soviet trade will be negligible. Even if it aims at reducing the interference of Ministeries and bureaucracy, the reform does not eliminate the state monopoly of foreign trade. Moreover, the establishment of a system of subsidies and taxes is deemed insufficient to cover firms' entry-costs on the international market (Daviddi, 1989; Hanson, 1989). Hence, although the Soviet Union will intensify negotiations with western countries to participate in international organizations such as the GATT, the IMF and the World Bank, it will probably remain a minor actor on the international scene for a long time (Mc Intyre, 1987).

4. The present debt situation and the prospects for East-West financial relations.

Eastern European countries' external debt has grown significantly during the 1970s and '80s, as in different occasions several of them have undertaken large investment programs financed by foreign borrowing. In general, they have maintained good access to financial markets, and tend to be considered relatively low-risk borrowers. Their debt/export ratios present wide differences, from the very high ratios for Hungary and especially Poland (respectively, 274 and 431 according to OECD estimates) (OECD, 1989) to the relatively low ones for Czechoslovakia, the USSR and Romania.

Debt service absorbs about 70 per cent of Poland's export revenue, and 50 per cent of Hungary's. These countries will need a continuing access to international financial markets to be able to refinance their existing debt and face temporary current account difficulties while meeting their essential import needs, but further debt accumulation does not seem advisable at this stage.

The question of whether to increase indebtedness may arise for countries presently less indebted. However, caution should advise against embarking in substantial new borrowing and investment plans before the correction of the system of relative prices and the reorganization of the economy are allowed to determine the actual profitability of the different lines of production.

For those countries who have become members of the IMF and the World Bank, participation to these international institutions should prove extremely valuable in the coming years. They can provide crucial financial support and economic and technical advice in designing important aspects of the countries' strategies of economic reform, in particular those concerning trade liberalization, payments mechanisms, and economic stabilization policies.

5. CMEA currencies' transition to convertibility

For a Centrally Planned Economy, convertibility should be seen not as a brand new policy regime that can be introduced at some point in time but as a transition process from the present situation to one in which no restrictions exist to the currency's use in international transactions.

To a great extent, the pace at which the transition to convertibility can be allowed to take place will be dictated by the export and import-competing sectors' speed of adjustment and ability to improve their competitiveness. External convertibility therefore requires as preconditions a number of significant reforms in the way firms are managed and operate in the internal market. On the other hand, the move towards greater openness to the world market cannot wait for the completion of internal reforms. Facilitating the participation by domestic firms to the world market and allowing domestic producers to be more exposed to foreign competition can provide a powerful stimulus to increasing efficiency and to the correction of price distortions.

The crucial issue in the transition process concerns the order in which the various reforms should be introduced. In this respect, a general result of welfare economics should be kept in mind: when several distortions are present in an economy, removing only one or a few of them may reinforce the negative impact of the remaining ones on the country's output and overall welfare. That is, even if a reform is known to be aimed "in the right direction", its immediate effects may be perverse, and must be analyzed case by case.

Some aspects of convertibility concern the working of the internal market: the move from strictly centralized planning to decentralized decision-making, price liberalization, the removal of quantitative restrictions. They amount to creating a domestic market and allowing full "convertibility into goods".

Other aspects concern the rationalization of intra-CMEA trade. The stages of this process could include: the full implementation of multilateralism through transferability of rouble balances; the transformation of the transferable rouble into a fully convertible intra-CMEA currency; finally, the mutual convertibility of all CMEA currencies. The experience of the Western Europeans countries' post-war return to convertibility through the European Payments Union can be studied as a useful example of a gradual transition to multilateralism, although there are obvious differences that should not be overlooked (Daviddi and Espa, 1989).

Full convertibility for current account transactions with non-CMEA countries could be seen as the principal goal of the process. In its fullest realization, it would require the gradual elimination of all quantitative restrictions and limitations to the use of foreign currency through licencing of imports and exports. It is clearly an objective that will not be within the reach of most planned economies still for many years. Its achievement will require very significant gains in these economies' capacity to export, through improvements in efficiency and product quality.

Even though reaching full convertibility will take time, the development of East-West trade must remain an immediate priority. In fact, export growth is essential to finance imports of technology inputs and to service existing debts. Therefore, while the phasing out of trade restrictions is likely to proceed slowly, significant progress must be made already in the short run, by providing firms adequate incentives to orient their production toward exports.

In this context, exchange rate policy should be viewed as an instrument of the transition process. Exchange rate setting should tend to reflect the real cost of obtaining imports (Wolf, 1985). It remains unrealistic to allow the exchange rate to be market-determined until most of the price distortions and quantitative restrictions are eliminated and countries improve their productivity and capacity to export. However, consideration could be given to allowing firms to freely dispose of a fraction of their foreign currency earnings, using them for imports or selling them to other firms through an (initially limited) free market for convertible currencies.

6. Reforms in the area of banking and finance

The current process of reorganization and market-oriented reforms in the Centrally Planned Economies will require a complete reshaping of the current monetary and financial mechanisms. The reform plans that are being undertaken in Hungary, the Soviet Union and other countries already envisage the existence of a number of commercial banks, separate from the central bank, and the introduction of market criteria for lending decisions (Nuti, 1988).

The transition to decentralized decision making implies a shift to a dramatically different mechanism of resource allocation. This will require new policy tools, more similar to the fiscal and monetary instruments in use in market economies, through which the State can indirectly influence aggregate demand, the composition of output, and in particular the rate of saving and the orientation of investment.

In the reformed system, the determination of saving can no longer be the automatic outcome of planning decisions (through firms profits, and the excess of wage income over available consumption goods), but will have to be the result of firms' and households' decisions and of the State's fiscal policy. Two aspects are crucial:

1) the use of fiscal policy to a) generate sufficient revenue to cover the cost of current expenditures and public investment; b) promote efficiency and eliminate distortions.
2) The ability of the financial system to provide sufficiently diversified and attractive financial instruments to stimulate private savings and to ensure their efficient allocation to finance investment.

A particularly delicate phase of the reform process will be the initial one, when controls and subsidies on prices are gradually removed. The existence in some countries (including the Soviet Union) of a large overhang of liquid purchasing power threatens to fuel an outburst of inflation, with possibly disruptive social consequences. The transition calls for a combination of some degree of gradualism in price liberalization with adequate incentives to voluntary saving, and for prudent demand management policies.

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