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Paper presented by

CARLO BOFFITO

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1. This paper investigates the internal and external effects that abandonment of the Soviet-type centrally-planned economic system amd dissolution of traditional economic relations among Comecon countries has had and will have on Eastern European countries and the USSR.

Transition from the old system of management of the national economy and international economic relations to a new system is still in its initial stages. The process was set into motion by the approval of the resolution on economic reform by the Central Committee of the CPSU in June 1987 and the preparatory work on political reform which led to the election of the Congress of Popular Deputies in the Soviet Union in spring of 1989. These events were followed up in all Eastern European countries by the political revolutions of 1989 - which started in Poland in the summer - and free elections in 1990.

In order to determine the direction the current transition process is taking, its origins must be retraced and the salient aspects of the changes that have taken place up to now examined.

2. The key to understanding the reasons for and the direction of the changes in the Soviet-type economic system is its war economy nature. Lenin first took the idea for this kind of organization of the economic system from the sorting system of the Raw Materials Office organized by Rathenau for the German Ministry of War at the outbreak of the First World War (this model provided the budgeting, the planning in physical terms, the ministerial hierarchy, etc.). Later, Soviet leaders gave absolute priority to military production, convinced that that was the only way to ensure the survival and consolidation of the USSR and its internal stability.

It became evident at some point that this system created economic and social conditions that were backward with respect to those achieved by market economies. It could not maintain the same rate of technological progress (this aspect is particularly evident in the role played in Western countries and the Asian NICs by the widespread use of electronics) and did not satisfy the needs of the population to the same extent as market economies. Even the military industry - in spite of the availability of almost unlimited resources - was barely competitive with the military production of the United States and its allies.

But in order to undertake reform of the Soviet-type economic and social system, the causes for conflict with Western countries underlying the traditional economic system (war economy) had to be eliminated, making preservation of that system groundless.

Soviet reformers (Gorbachev and his group) envisaged the replacement of centralized management of the war economy by a "socialist market" on which independent and competing state companies would respond freely to the stimulus of technological progress and consumer demand. The socialist firms would have benefitted from direct cooperation and competition with Western enterprise in a world without military and political confrontation and, therefore, open to the spontaneous economic integration brought about by business (the foundations of the "common house").

3. Gorbachev's scheme was marked by another distinctive feature based on previous experiences with reform in other socialist countries: the awareness that economic reform is not possible without political reform. Only if the Communist Party's monopoly of both the public adminstration and economic management were abolished, could enterprise be freed from state control and guided by real socialist entrepreneurs.

But political reform produced unexpected effects that proved to be totally incompatible with the establishment of a socialist market. As soon as they were able to freely express their opinions, the populations of Eastern Europe and the Soviet Union recovered their national traditions and re-established the continuity with the past that had been interrupted by the institution of the Soviet-type political and economic system. Political pluralism and a program of transition to a market economy centered on the return to private property was rapidly introduced in Eastern Europe. In the Soviet Union, the only significant political movements are those that appeal to nationalist sentiments and values and are aimed principally at the total sovereignty of the republics.

In the current political situation, three groups of countries with important internal analogies can be distinguished:

a) The Central-East European countries (Czechoslovakia, Poland, Hungary) which have achieved relative political stability although their governments still have to prove that they are able to manage the transition to a market economy.

b) The Soviet Union or, rather, the fifteen Soviet republics, which are plagued by political uncertainty and could take quite different paths.

c) The Balkan countries.

In the following paragraphs, only the first two groups of countries will be taken into consideration. The economic and political situation in Yugoslavia is very specific and would call for a separate analysis. In Bulgaria and Romania, the political situation seems to show greater continuity with the communist period than in other Eastern countries and still has to be clarified: the population has been slow to awaken to democracy and the Communist Party, which has maintained its organization and its control of the media, has managed to impede renewal; the opposition does not consider the government - supported by a puppet majority - legitimate and tries to assert its rights through street demonstrations that are often violently repressed.

4. The three Central-East European countries have already determinedly undertaken transition to a market economy. Their past and recent experience with reform provides elements for examination of the economic problems to be solved. Classified into groups, the major problems concern market organization, foreign

investment, economic policy for stabilization of the internal market, foreign trade and currency convertability.

The general objective in market organization is to move towards rapid development of the private sector: the initial privatization programs presented by political parties during the election campaigns and by governments upon taking office call for the transfer to private hands of significant portions of industry in only a few months.

Privatization is taking a similar course in the three Central-East European countries. State real estate is made available to a public body that exercises the rights to state property and is charged with selling shares of the firms transformed into joint-stock companies to private parties. Sale of shares can be direct or through the stock market.

The privatization of large state companies is called the "large privatization", as compared to the "small privatization" (sale of stores, restaurants, workshops, as well as small and medium-sized firms). While small privatization should proceed quite quickly, large privatization is coming up against a number of obstacles that hinder application of the criterion that state property should be sold to those who can use it profitably.

Some practices tend to discredit privatization and have induced authorities to proceed with caution. These practices include excessively low sale prices, often demanded by employees (who have obtained job and salary assurances) or by managers who intend to buy the firm they are managing; purchase of the firms by representatives of the old state bureaucracy, who can use their position to obtain credit; crossed share-holding between companies, etc.

Employees often oppose privatization and demand the right to take over ownership themselves. In Hungary, "factory councils" which were given the management of some firms in the mid-eighties are opposed to their transformation into joint-stock companies. In Poland, it took three months of parliamentary debate and continuous legislative amendments to set the maximum quota (20%) of shares that employees can acquire on easy terms. On the other hand, the decision originally taken in Czechoslovakia and imitated in Poland to give all families in the country (who, with their forced savings contributed to financing the development of state industry) stock rights which can be granted or exercised to buy shares should encourage the habit of investing in securities.

The availability of capital is relatively low, except among speculators and representatives of the hidden economy who have carried out illegal activity until now. The accumulated savings of the population, which have been and will be eroded by inflation, would not be able to buy more than 20-30 per cent of the capital of state companies.

The owners expropriated by the Communist government are demanding the return of their property. While re-privatization seems possible for land, it is not for industry. In Hungary, compensation in the form of government securities to former owners is being discussed.

Furthermore, state companies would have to be restructured and made more efficient in order to be sold at a competitive price. And for the patrimony of a company to be evaluated correctly through the emission of shares, a securities market has to be set up. The capital market is more developed in Hungary than in the other two Central-East European countries: government and firms started emitting stocks and bonds in 1983; every other day since 1988 Hungarian banks sell Treasury bonds, other bonds and a limited number of reactivated shares of those companies which formally survived the nationalizations of the Communist government as joint-stock companies. In June of this year, the reopening of the Budapest stock market (as scheduled by the previous government) allowed the Agency for State Property to offer the public 40 per cent of the stock of the travel agency Ibusz. Numerous investment funds and financial trusts have already been set up in Hungary - partly with foreign capital - and are waiting to go into operation.

However, even in Hungary the law regulating privatization must still be approved. Aside from a few exceptions and numerous cases of indiscriminate privatization which could still be declared illegal, the process of privatization has not yet begun in any of the three countries.

5. Foreign investment can be carried out in three ways: setting up a joint venture; direct investment in a company entirely owned (in some cases this calls for government authorization); and acquisition of an existing company (which thereby becomes a joint venture, also fiscally). While the number of visits by foreign entrepreneurs to Hungary, the amount of information gathered, and the negotiations on projects underway are innumerable, the transactions completed are relatively few and foreign investment is generally low. Foreigners cannot buy real estate unless they enter into a joint venture. Rather than set up new companies, many foreign firms are waiting to buy existing companies, but there will probably be severe restrictions on purchase (Polish law limits the share of capital that can be acquired without government authorization by non-residents to 10 per cent).

Hungary holds the record not only for the amount of foreign capital invested (over 700 million dollars), but also for the number of joint ventures (over 1000) and of dealings with foreign investors (direct sale of stock, or sale of securities on the Budapest and Vienna stock markets). However, widespread criticism that the Hungarian government is selling out the country's patrimony to foreigners could cause a slowdown in the flow of capital.

6. The factors listed in points 4 and 5 suggest that the economies of the Central-East European countries will be mixed in the next five years, with a significant state-owned sector. On the basis of very rough, but indicative estimates, it can be claimed that, if the three Central-East European countries receive 3-4 billion dollars in foreign

investment per year in the next three years (an extremely optimistic hypothesis), foreign capital would acquire approximately 10 per cent of the non-agricultural sector of the economy, 90 per cent of which is state-owned today. Furthermore, if private residents and independent national organizations were to buy 30 per cent of non-agricultural capital, the state sector (considering the closing of some unproductive companies) would still account for approximately 50 per cent of non-agricultural activities.

Therefore, it follows that the governments of the Central-East European countries will have to renounce their projects of rapid and widespread privatization and deal with the problem of the organization and management of the state sector - a problem substantially ignored until now. Experiments carried out for a number of years in Yugoslavia, Poland, Hungary and the Soviet Union have shown that the autonomy of socialist companies (that is, companies operating in a decentralized Soviet-type system) destroys the macroeconomic equilibria of the traditional centralized system, but does not create new equilibria; their monopolistic position and the habit of operating according to indicators generally expressed in physical terms and of not being bound by financial constraints drive socialist companies to raise prices, profits and wages, thereby generating a strong inflationary spiral (see section 7). At the same time, they do not have the flexibility in management needed to respond efficiently to restrictive monetary policy and react to contractions in money supply and in demand by cutting back production and employment.

Thus, the state-owned sector will have to be totally restructured and reorganized into companies that are government-controlled, but that are nevertheless forced to maximize profit in competition with the private sector and the international market. At the same time, the authorities in charge of economic policy will probably be forced to use temporary support of state-owned enterprise while giving alternate priority to criteria defending employment to ease social tensions and criteria maximizing efficiency.

7. The internal disequilibria in a Soviet-type economy that must be eliminated by a stabilizing policy are generated by government subsidies to keep down the prices of consumer, above all, food products, and the population's accumulated surplus of savings, representing unsatisfied demand of consumer goods and distortions in supply which does not correspond to demand.

In the initial phase of reform of a Soviet-type economic system, these disequilibria cause inflationary strain that can be manifested in two forms. As long as the prices of consumer goods are held constant by subsidies, the inefficient behaviour of the companies described in the previous section (wage hikes linked to increases in prices rather than in production) generate a constant increase in demand that is not satisfied by supply and therefore generates shortages on the market. This causes real inflation, a typical example of which is the Soviet economy. If, on the other hand, the prices of consumer goods are not subsidized, the pressure of demand and the distortions of supply cause a jump in prices (as occurred in Poland in the summer of

1989 when Radowski - before leaving the government - abolished controls on the prices of consumer goods). This may lead to a combination of real and monetary inflation, with shortages (in goods that still have subsidized prices) and price increases, as occurred in Poland in 1987-89.

In Poland, the problem was tackled through the introduction of a very restrictive money supply and wage policy, which brought inflation down from over 50 per cent in January to less than 4 per cent in July. However, the urgency of the inflation problem kept the Polish government from restructuring and reorganizing the state-owned sector, which continued to function in the traditional way (section 6) and, faced with the restrictions in credit and demand, caused a deep recession. At the same time, the high interest rates did not allow the vast private sector (three-quarters of agriculture) to awaken from its traditional sleep. It is likely that the production paralysis will lead to a political crisis which could, if it does not degenerate into authoritarian alternatives, lead to the substitution of the single party (Solidarnosc) by a multi-party system that would allow the social forces to express their interests and the government to adopt a selective policy to stimulate supply to promote recovery of production.

In Czechoslovakia, a gradual two-step transition towards a market economy has been undertaken. In July, the majority of government subsidies were abolished and the prices of consumer goods increased accordingly and fixed at a higher level; compensatory wage increases were granted. The average rate of inflation for 1990 should work out to 10 per cent. At the beginning of 1991, prices should be liberalized on the basis of the new market equilibria that have been established during the last months of 1990. In any case, the internal market will probably be protected by a system of tariffs and export restrictions that will only gradually be eliminated with the progressive liberalization of foreign trade.

In Hungary, the government has substantially continued to gradually eliminate subsidies and liberalize foreign trade, while maintaining a restrictive monetary policy and trying to minimize the devaluation of the forint in order to contain inflation (the 1990 average will be around 40 per cent).

Yet, the gradual transition policies worked out in Czechoslovakia and inertially pursued in Hungary will come up against the additional difficulties of the new external conditions in which Central-East European countries have to operate. The price increases in imported energy and the fall in trade with Comecon countries will cause further inflationary pressure and, by limiting productive activity through both supply and demand, will worsen the recession and exacerbate social tensions.

8. Taking up a Hungarian proposal, in October 1989 the Soviet government suggested substituting the transferable ruble inside the Comecon with payments in convertible currencies and barter prices with internationally competitive prices as of 1991.

No precise accords regulating trade and payments between the Soviet Union -

the supplier of energy sources and raw materials - and individual Central-East European countries have yet been entered into. On the basis of the ongoing negotiations, trade should be carried out directly by the companies at contract prices (considerably lower than former barter prices) and with payment in convertible currencies; if the Soviet companies are not able to pay in convertible currencies, clearing systems (inside which prices would probably be higher than contract prices) must be set up with annual clearance of trade imbalances in convertible currencies.

In any case, the drop in Comecon trade, which started this year as a result of the will of the Central-East European countries to eliminate their inflationary trade surpluses accumulated in transferable rubles in 1989 and of the cuts in oil supply by the Soviet Union, will continue in 1991.

Assuming that the USSR will be able to maintain its exports of oil and gas at 1989 levels (even if this were possible, the USSR is interested in shifting exports to Western countries) and that non-energy trade drops by 30-40 per cent with respect to 1989, the total trade deficit of the three Central-East European countries would amount to 8-9 billion dollars. The contraction in trade with the Comecon and the fall in internal production will favour exports towards market economies; nevertheless, the resulting trade surplus with the latter (already recorded in 1990 in Poland and Hungary, but not in Czechoslovakia) will only allow for partial compensation of the deficit with Comecon countries. If possible increases in international interest rates are considered, significant difficulties in financing the balance of payments of the most heavily indebted countries (Poland and Hungary) can be predicted.

9. The economic and social difficulties caused by transition, the threat of a significant reduction in the standard of living and consequently of social tension, and the deterioration of the terms of trade are all reasons urging the West to provide generous financial support to Eastern European countries. Western Europe has shown its willingness to help Eastern European countries, and even the Soviet Union, to some extent. However, given the absence of imminent international conflicts (such as the one that led to the Marshall Plan), the only concrete aid programs that have been formulated and put into practice are those worked out by individual countries (above all the FRG for urgent political reasons). Rather than unconditional funding (like the kind the Marshall Plan granted the Western European economies - already in operation and requiring only the elimination of the bottlenecks caused by wartime production to regain momentum), timely coordinated aid aimed at promoting the transition to a market economy is needed.

In order for the aid to favour the transition to a market economy, the semi-paralyzed production system (sections 6-7) must be revitalized through action directed at supply as well as demand. To that end, mixed government-owned companies could be set up to develop infrastructure (build roads, modernize the transport and telecommunications, etc.). Western governments could provide these companies with funds in convertible currencies (in the form of grants, as the foreign debt of Poland and Hungary cannot be aggravated any further) for the acquisition abroad of the technologically advanced component of infrastructure. Local governments could provide them with funds in local currencies for immediate expenses for construction of infrastructure. These investments would absorb employment and sustain demand. At the same time, the Western governments should work out schemes for the promotion of direct investments that would sustain supply.

While this aid program would be formulated in the medium term, the Central-East European countries also need immediate help to finance their balance of payments (section 8). To that end, Western governments should finance the Central-East European countries' oil exports through long-term loans, possibly made available by the EBRD. This would preserve and expand the European energy network.

Fearing a break in energy supply owing to social and production problems in the Soviet Union, the Central-East European countries could prefer giving priority to geographic re-orientation of their exports. This would call for (Western) financing of oil imports from the Middle East and export of industrial products currently destined for the USSR, the developing countries and, to a lesser extent, Western markets.

10. Within the framework of the stabilization program adopted at the beginning of the year, the Polish government introduced internal convertibility of the zloty, setting the exchange rate - after a substantial devaluation - at 9500 zloty per dollar. This rate has remained almost unvaried to date.

In Hungary, the forint was made internally convertible some time ago (the forint can be converted into Western currencies for importation of liberalized or authorized goods), although the rigid anti-inflation control (section 7) of the exchange rate by the central bank has kept an exchange market from being formed. Part of the restrictions on foreign trade were abolished this year and most of the rest (up to 90 per cent of total imports) will be eliminated in the next three years.

In Czechoslovakia, the second stage of reform, which should start at the beginning of 1991 (section 7), calls for calculation of a realistic exchange rate, which should bring internal prices into keeping with international prices.

Complete transition to convertibility (internal and external) will require the balancing of the internal market (eliminating money surpluses and price subsidies on consumer goods) and the full functioning of the market, allowing prices and internal costs to be adjusted continually to external ones and putting the exchange rate in an active position. Finally, the industrial production of Central-East European countries will have to become competitive internationally in order for convertibility to be maintained.

An optimistic scenario would be the achievement of these conditions by the second half of the nineties, as a prelude to negotiation of the entry of these countries into the European Community.

11. The economic situation in the Soviet Union is very serious and continues to worsen. The central government has lost control of the economic system and the independent activity of the companies in non-competitive conditions is generating strong inflationary pressure (section 7).

The country's economic prospects are linked to the solution of a political dilemma that is no longer limited to the modality of the transition to a market economy, but involves the constitutional configuration of the country itself. In order to outline some scenarios that may emerge from the political conflict presently underway, the forces being fielded must briefly be reviewed.

* Quite apart from whether Rizhkov retains the position of Prime Minister or not, **the government**, while waiting for a new economic system to come into operation, will have to regain at least partial control of the instruments for centralized management to reactivate the production system.

* After the emergence of Democratic Platform in Russia and the breaking away of the other republics, **the party** is dominated by conservatives and upheld by the conservative bureaucracy that is still prevalent in the central state administration and the state-owned sector of the economy.

* **The republics**, now all dominated by national independence movements.

* **President Gorbachev**, whose main attribute is the support he receives from the West: the process of independence of the republics weakens the central institutions and, therefore, also the position of the president of the Supreme Soviet of the Soviet Union.

The interaction of these forces could lead to three scenarios which are listed below in order of the probability that can be attributed them today.

* Scenario a) in conformity with the Gorbachev-Yeltsin program for transition to a market economy; the republics delegate to a new centre - already defined by Gorbachev as a Union of Sovereign States (<u>Sojuz suverennych gosudarstv</u>) - certain functions: defence (unified command of national armies), foreign policy (not wholly), monetary policy (conducted by a federal reserve system), management of the energy, telecommunications and transportation networks; development of a single market through direct dealings among companies.

* Scenario b) the republics do not come to an agreement on the institution of an "economic union" (<u>ekonomiceskij soyuz</u>) because of contrasts on transfers to the central budget, on the division of currency revenues or on monetary policy (in particular, if an anti-inflationary policy is not implemented with sufficient rigour, the republics with surpluses of consumer goods, especially food, will be forced to contain the influx of devalued rubles through the introduction of their own currency and tariff barriers, thus splitting the unity of the market); a process of fragmentation is set off, ending with the complete disintegration of the central authorities.

* Scenario c) the centre re-establishes its authority over the country, by force, if need be.

Of course, combinations of these scenarios would be possible. While Scenarios b) and c) are not compatible, Scenario a) could combine with b) in a tormented and anarchic path towards a new Union or with c), calling in the army in the name of law and order to supervise a diluted transition.

In any case, each republic will have its own pace of transition to a market economy. It is likely that the more backward republics and Russia will maintain the state sector and government intervention (subsidies) longer to compensate for the liberalization of prices, which should advance parallelly to ensure the formation of the single market (Scenario a)).

12. In this political framework, the problem of Western aid takes on special importance. It seems obvious that aid to buy consumer goods and finance the balance of payments' deficit would only contribute to prolonging the current situation. On the other hand, the Soviet government must be forced to take the measures needed to fight inflation and stabilize the internal market, as well as increase the competitiveness of companies and rebalance the balance of payments.

Aid must be conditional and targetted; it must be granted only is specific programs forming part of a coherent plan for transition to a market economy are approved and undertaken. For example, a fund for the stabilization of the convertibility of the ruble can be set up with Western aid only when certain conditions in the transition to convertibility are fulfilled and, above all, if the monetary surplus representing unsatisfied demand is eliminated.

Furthermore, aid must be granted for financial support and consultancy for specific programs such as the development of joint ventures and the promotion of direct investment, reform of the banking system, extension of the private sector in agriculture and in the food-processing sector.

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