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REGIONAL COOPERATION IN THE ECONOMIC, SOCIAL AND RELATED FIELDS

Summary of the economic survey of Europe in 1994-1995

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I. RECENT DEVELOPMENTS AND THE SHORT-TERM OUTLOOK

A. Western Europe and North America

1. The current cyclical upswing has been under way in the United States of America since 1992 and in western Europe since 1993, but it was only in 1994 that output growth spread to virtually all the market economies and the average level of output finally reached the level of its previous cyclical peak in 1990. Although activity in the market economies has become more synchronized in the last year, there are still significant differences among the leading economies: Canada, the United Kingdom of Great Britain and Northern Ireland and the United States are now close to their cyclical peak, as indicated by standard measures of capacity utilization, while a number of continental European economies, France and Italy for example, still appear to have plenty of spare capacity. Thus, growth in western Europe, which averaged 2.5 per cent in 1994, is expected to be maintained at about 3 per cent in 1995. In North America, growth of gross domestic product (GDP) should slow down to about 3¼ per cent from just over 4 per cent in 1994. Thus, for the western market economies as a whole the average growth rate in 1995 should remain about the same as the 1994 rate - about 3 per cent.

2. In both western Europe and North America, growth in 1994 was actually much stronger than was forecast a year ago. In western Europe, the out-turn averaged some 2.5 per cent, compared with forecasts of about 1.5 per cent; in the United States, where the annual rate of output growth had been rising since 1992, GDP had been expected to rise about 3.5 per cent but actually increased by 4 per cent. Thus, forecasters still appear to be finding it very difficult to adjust their models to the structural changes that have occurred in the world economy over the last decade.

3. One reason why the performance of the western European economies in 1994 was better than expected was the unexpectedly strong growth of exports that led the recovery. Western European exports of goods and services rose by about 8.5 per cent in volume, but countries that had devalued their currencies in late 1991 or late 1992 generally achieved much higher rates of growth. The initial stimulus to exports came from the United States and the developing countries, especially those in Asia, and it appears, on the basis of still incomplete statistics, that extraregional demand continued to be strong in 1994. The stimulus from foreign demand has given rise to an improvement in domestic demand which, given the very high degree of integration of the west European economies, has in turn led to a strong recovery of intra-European trade. The recovery of domestic demand has of course led to a rise in imports albeit smaller than the rise in exports. Consequently, net trade added nearly one percentage point to the western European growth rate in 1994. As domestic demand strengthens, that stimulus to growth can be expected to diminish in 1995.

4. Another reason why the original forecasts for 1994 were relatively subdued was the expectation that the recovery of consumer expenditure would be relatively weak compared with previous cyclical upturns, reflecting not only the continuing high rates of unemployment in most of western Europe but also the perception that job security was much weaker than it had been in the past, especially for middle-income groups which had hitherto been relatively immune

from the threat of unemployment. Other factors restraining consumption were the still high levels of household debt in a number of countries - a legacy of the 1980s boom - and higher taxes and administrative charges. Thus, private consumption was fairly sluggish, rising by about 1.5 per cent. Most of the rise was due not to an increase in real disposable income but to a fall in savings ratios, reflecting an improvement in consumer confidence in the course of the year. Nor did domestic demand get much support from government spending, which barely increased (0.9 per cent on average) as most Governments sought to cut spending (especially on defence) and generally reduce public-sector deficits, with varying degrees of commitment to the Maastricht convergence criteria.

5. An encouraging development in western Europe has been the general improvement in the investment climate. Demand and profits have increased and business confidence has been rising, along with higher rates of capacity utilization. However, there is some concern that the rise in long-term interest rates in 1994 may have a negative effect on investment, but this is not apparent so far. Investment intentions, for the moment at least, appear to be more influenced by a significant increase in real rates of return - relative to both previous rates and the returns on financial assets - and by the expansion in enterprises' own resources, which will provide a major part of the finance for new investment. Although the actual rise in fixed investment in 1994 was only 1.5 per cent, it was gaining momentum through the year and in 1995 is likely to be the most dynamic component of domestic demand, increasing on average by some 6.5 per cent.

6. The more advanced stage of the economic upturn in the United States in 1994 was marked by the strong growth of both private consumption (3.5 per cent), supported by rising employment, and fixed investment (12 per cent), especially concentrated in machinery and equipment and in new housing. Public spending actually fell because of the falling defence budget, and rising net imports were also an increasing constraint on the growth of domestic output. Nevertheless, the increase in GDP (4 per cent) was the largest since 1984.

7. With the recovery in output, the decline in employment finally came to an end in most of western Europe during 1994 and there were small increases in employment figures in the four largest economies over the second and third quarters. The improvement so far seems to have been largely located in the service sector, but employment is still in the early stages of recovery from a recession in which over five and a half million jobs were lost.

8. In North America, the number of new jobs has been increasing steadily in the United States since the end of 1991 and there was another large increase (3 per cent) in 1994. The rise in employment has spread to the manufacturing and construction industries, but four fifths of the overall gains were made in the service sector. A significant proportion of the latter were part-time or temporary jobs; it is a matter of some controversy whether this reflects a flexible labour market accommodating the preferences of job-seekers or the negative effects of insider discrimination against outsiders. Migrant labour, including a significant proportion of illegal immigrants, also contributes to the flexibility of the United States labour market.

9. Nearly 7 and a half million people in western Europe have lost their jobs since 1989, and the total out of work averaged nearly 30 million in 1994. However, unemployment rates now appear to have stabilized during the course of the year and the level of unemployment has begun to fall in Germany, in some of the smaller countries and especially in the United Kingdom, where the cyclical upturn is further ahead than it is in the rest of Europe.

10. A great deal of the public discussion of the unemployment problem has stressed the need for deregulating the labour market, improving levels of education and training, reducing non-labour cost burdens on enterprises and other supply-side initiatives. All those suggestions are relevant and useful, but educated workers will still fail to get a job if aggregate demand is inadequate. The secretariat of the Economic Commission for Europe (ECE) estimates that the minimum annual rate of output growth required to maintain current levels of employment is just under 2 per cent in western Europe. To prevent any further increase in unemployment it needs to be in the range of 2.5 to 3 per cent; for a significant reduction, a sustained rate of some 3.5 per cent is required.

11. The ECE secretariat has also estimated the current growth rate of potential output in western Europe to be in the region of 2 per cent. Currently, there are still sizeable margins of spare capacity in several countries in continental Europe but this slack will quickly disappear, with actual growth rates of 3 per cent forecast for 1995. At that point, actual growth will again be limited by the growth in capacity which, at about 2 per cent, is clearly insufficient to create the jobs required for a large reduction in unemployment. Calculations of potential output and capacity utilization are unavoidably surrounded by substantial margins of error, but the estimates provided in this survey suggest that the prospects for a large cut in unemployment are not very bright unless there is a significant rise in fixed investment.

12. Obviously, enterprises will only start to expand capacity when they begin to reach the limits of their existing plant and if at the same time they expect future demand to justify that expansion. But one legacy of the past two decades is that whenever output approaches full capacity, the incentive to invest for expansion is swamped by the fear of renewed inflation; given the dominance of monetary policy in macroeconomic policy, that usually means higher interest rates and thus a constraint on the search for investment-led growth.

13. Overall inflation rates are now lower than they have been for decades. In western Europe, the average increase in consumer prices in 1994 was just under 3 per cent, with no tendency to accelerate during the year. A similar tendency occurred in the United States, despite its being considerably more advanced in the cycle. This is a remarkable development, given the recovery of output and a sharp rise in commodity prices. Price rises are of course more likely at full capacity than when there is slack; but to assume that inflation will flare up again as full capacity is approached is to ignore the structural changes that have occurred since the 1980s in both the market economies and in the world economy at large. It is also to ignore the likelihood that the falling inflation rates of the last few years will lower inflationary expectations among wage-earners and price-setters.

14. At present, the economic outlook for sustained and balanced growth in western Europe is probably better than it has been at any time since the oil crises of the 1970s. Exports have led the recovery and fixed investment is poised to take over the running in 1995, with private consumption also increasing but only modestly. Such a growth pattern offers a real chance of eventually bringing about a significant cut in unemployment. The challenge for policy makers is to protect that opportunity from the effects of exchange-rate instability and the inflation pessimism of the players in the financial markets.

B. The transition economies of eastern Europe and the former Soviet Union

15. Economic performance also improved markedly in the transition economies of eastern Europe in 1994, although this reflected not a cyclical upturn, as in western Europe, but the start of recovery from a structural or transition slump in output on the scale of the slump experienced in the 1930s. The recovery began in Poland in 1992 and has since spread to virtually all the economies of eastern Europe. In 1994, output continued to fall only in the former Yugoslav Republic of Macedonia. 1/ Everywhere else it rose, marginally in Bulgaria and Croatia (0.2-0.8 per cent) but by as much as 5 per cent in Poland and Slovenia. Unofficial estimates suggest even larger increases in Albania and Yugoslavia, where output had fallen massively since 1990. Thus, for the first time since the transition process got under way five years ago, there was an increase in aggregate eastern European output of just under 4 per cent. The indications are that the pace of activity was getting stronger in most countries in the second half of 1994 and it seems reasonable to expect an average growth rate of 4 per cent in 1995. There is likely to be some deceleration in Hungary, perhaps to zero growth, as policies are brought to bear on the growing budget and current account deficit, as well as in Romania, if macroeconomic policy is tightened as part of the agreement with the International Monetary Fund (IMF). But in most other eastern European countries, 1994 rates of growth should be maintained or increased.

16. These developments in overall activity are most encouraging, not least for those who have suffered directly the considerable costs of transition to a market economy, but they need to be placed in perspective. After a decade of virtual stagnation, output in eastern Europe fell on average by more than 20 per cent between 1989 and 1993. If the expected growth rate 4 per cent in 1995 is sustained, it will still take until virtually the turn of the century before the activity level of 1989 is equalled again. This of course is no more than arithmetic but it illustrates the scale of the problem facing the Governments of the transition economies as they try to grapple with the still considerable problems of transition (discussed in more detail below) and at the same time try to maintain popular support for the entire process. Discontent with the economic and social costs of the transition is considerable and is reflected in the widespread electoral successes of post-communist parties. These high levels of dissatisfaction cannot be ignored by Governments: western and international suppliers of aid and assistance might usefully help in easing some of the sources of social discontent. And while popular discontent can diminish quickly when expectations of future growth are firmly established, according to a recent poll only in four countries (Albania, the Czech Republic,

Estonia and Slovenia) does there appear to be a majority of people convinced that their situation is improving. 2/ On the other hand, forecasts for the transition economies have been very unreliable throughout the period since 1989: not only was the transition recession grossly underestimated but so was last year's recovery. If growth proves stronger than expected, this will help to strengthen business expectations and encourage a take-off in fixed investment.

17. A recovery of fixed investment in a number of countries is in fact one of the most important developments of the last two years. On average, total fixed investment rose by some 5 per cent in 1994, but the signs that a modernization programme is under way may be detected in the rapid growth of investment in machinery and of investment in the leading group of reforming countries. In Poland, investment in machinery and equipment has been growing annually at 15-17 per cent over the last three years; in Slovenia, it grew at 11-12 per cent in 1993 and 1994; and in the Czech Republic it grew at 17 per cent in 1992 and probably grew at similar rates in 1993 and 1994. In Hungary, such investment has also risen but at more variable rates than in the other three countries.

18. The recovery of fixed investment in eastern Europe calls for two comments here. First, that recovery has been largely financed by the resources of the enterprises themselves and not by the intermediation of domestic savings or by foreign investors. The growth of enterprises' own resources has in turn been a function of large productivity gains, a moderate growth of wages and largely moderate increases in producer prices. Thus, increased profit margins have been an important source of funds for enterprises wishing to invest. In the short run, this can be seen as a form of forced saving in countries where financial institutions are still underdeveloped, but it cannot be maintained for very long without creating a significant upward pressure on the price level.

19. Second, much current investment activity is likely to be focused on rationalization and modernization. This will lead to job creation in new, private enterprises but is unlikely to be sufficient to absorb both the increase in unemployment due to the restructuring of agriculture and State-owned enterprises in industry and the increase in the working-age population. As a result, current unemployment rates are unlikely to fall significantly for some time.

20. In fact, despite the recovery of output, employment continued to decline in eastern Europe last year, although the rate of decline moderated somewhat in those countries where the recovery had started in 1992 or 1993. Within this aggregate, however, private-sector employment is increasing rapidly, especially in the service sectors, but not yet by enough to absorb the losses in State sectors.

21. Consequently, unemployment rates have remained high and ranged between 10 and 18 per cent at the end of 1994, with the notable exception of the Czech Republic. And although the level of unemployment in eastern Europe as a whole appeared to peak at about 7.5 million people in early 1994, the fall in numbers over the rest of the year (about 4 per cent) probably reflected a reduction in the labour force due to early retirements and the so-called discouraged worker effect. With both the numbers of young people unemployed and levels of

long-term unemployment large and on the rise, unemployment is one of the most pressing problems currently facing the Governments of the transition economies.

22. There was progress last year in regard to the other main components of macroeconomic balance, namely, the domestic price level and the balance of payments.

23. On the inflation front, there was a significant slow-down in the countries where prices had been rising most rapidly in 1993. In Croatia and Yugoslavia, the stabilization programmes of late 1993 and early 1994 cut inflation rates dramatically, although the sustainability of the lower rate was in doubt in the last quarter of 1994 in Yugoslavia. On the other hand, in the leading group of reforming countries it is proving much more difficult to get inflation rates down to single digits.

24. The external position of the transition economies generally improved quite markedly in 1994. Eastern European exports of goods and services rose by some 18 per cent (in dollar value), nearly double the rate of increase of imports, which was the principal factor behind the large reduction in the aggregate current-account deficit of eastern Europe: from $8.3 billion to $3.4 billion. The improvement occurred in all the individual countries except Hungary, where the large deficit continued to rise. This considerable improvement in external accounts, in particular in the growth of exports, was not expected at the start of 1994 and is one of the main reasons why growth was much stronger than forecast.

25. The Baltic States have generally made much better progress in stabilizing and reforming their economies than other members of the former Soviet Union. Output was still falling last year in Latvia and Lithuania, although by much smaller amounts than in 1993, while Estonia appears to have reached the bottom of the recession (with zero growth). Progress has been made in stabilizing the three economies: public deficits are largely under control and inflation rates fell sharply in the course of 1994. Nevertheless, inflation still remains high (between 30 and nearly 50 per cent, year-on-year, in the last quarter) and current account balances swung into deficit, mainly because of a rapid expansion of imports. Employment in all the Baltic States continued to fall in the wake of declining industrial production and enterprise restructuring, but unemployment rates are still surprisingly low (2-6 per cent) given the collapse of output. It is not easy to assess the prospects for the Baltic States: tracking the current condition of their economies is difficult because of incompleteness and large revisions to their national accounts. All three countries are expected to attract relatively large amounts of foreign-direct investment and the prospective signing of association agreements with the European Union should help to boost their exports to western Europe. There thus appears to be a reasonable prospect for export-led growth, supported by foreign investment.

26. In contrast with eastern Europe, economic developments in the Russian Federation and the other members of the Commonwealth of Independent States (CIS) have remained fairly depressing. In the Russian Federation, GDP continued to fall in 1994, by 15 per cent, much more than was expected at the start of the year. Even larger cuts in output occurred in most of the other CIS countries

but especially in those Caucasian and central Asian republics where armed conflict is destroying productive assets.

27. At the same time as output continued to fall, inflation accelerated sharply in many CIS States where there was a general lack of effective monetary and fiscal policies. In the Russian Federation and Ukraine, although rates of inflation initially fell rapidly as a result of tight monetary and fiscal policies introduced in late 1993, that performance was not sustained and inflation began to accelerate again in the autumn.

28. Despite large falls in output, unemployment rates are still very low in the Russian Federation and the other CIS States, although they are beginning to rise. Registered unemployment at the end of 1994 was between 0.3 and 2.1 per cent of the labour force (except in Armenia, where the rate is much higher). But the unrealistic nature of these numbers is indicated by the official estimates for the Russian Federation which give a rate of 2.1 per cent on the basis of registered unemployment but 7.1 per cent on the basis of the standard definition of the International Labour Organization. Nevertheless, low unemployment in the CIS is not just a statistical artifact: it reflects, inter alia, the stance of macroeconomic policy and the lack of coherent restructuring programmes, which have resulted in a large amount of overemployment (or hidden unemployment) in large State-owned enterprises.

29. In contrast to eastern Europe, the Russian Federation experienced a sharp deterioration in its current account, which swung from a surplus in 1993 to a deficit of the same order of magnitude in 1994 (nearly $3 billion). The trade surplus remained virtually unchanged, so that the deterioration in the current account was mainly due to a greatly increased deficit on services (especially for tourism, the deficit for which increased by $2.6 billion) and net interest paid abroad.

30. Assessing the short-term outlook for the Russian Federation is still extremely difficult. A further but smaller decline in output in 1995 seems likely. But the outlook depends crucially on whether stabilization policies can be maintained consistently without being thrown off course by the demands of the agricultural and industrial lobbies. After three years of unsuccessful attempts to stabilize the Russian economy, policy makers now have a credibility problem to overcome as well. Whether the recent IMF agreement can tilt the balance in favour of an effective set of stabilization and restructuring policies is one of the major uncertainties. But as soon as there is a sign of policies moving in the right direction, that would be the moment for a well-coordinated programme of international assistance to move in and bolster the reform effort.

II. FIVE YEARS OF REFORM: A BRIEF RETROSPECTIVE

31. Looking back at the hard road to reform in eastern Europe and the former Soviet Union since 1989, it is not easy to draw up a balance sheet. It is clear that important progress has been achieved in creating democratic institutions and transforming the centrally planned economies into market systems, but the economic and social cost of transition has been much higher than anticipated. A prolonged economic downturn, high levels of unemployment, sharply reduced social

security, widening income and wealth differences, falling health standards and the rise of organized crime have all contributed to frustration, disillusion and mounting political tensions. As a result, the current mood among the eastern European populations is very different from the enthusiasm and hope that were raised by the fall of the Berlin Wall in late 1989. It is a curious irony that in all but one of the east European countries, Governments are now in the hands of political forces with direct roots in the communist past.

32. The dramatic divergence between expectations and reality has probably been the single most important factor behind the recent turnaround in the political and social climate in the region. Whether the transition could have been less costly in terms of economic losses and social welfare and whether different policies could and should have been used to minimize such costs remains a hotly debated issue among economists and policy makers, and will probably remain so for some time. Nevertheless, there is an almost universal consensus that the recession has been much deeper and longer than initially expected and that the transformation has not yet delivered on many of its explicit and implicit promises.

A. Building capitalism: the rise and fall of expectations in central Europe

33. It is instructive to recall what those expectations were in 1989-1990. What was the early vision of transition from plan to market and from totalitarian socialism to democracy? What was the hoped for outcome of the transformation? In answering these questions, it is important to remember the gap that existed between popular expectations, shaped mainly by the dismal performance of the central planning system *vis-à-vis* the western economies, and the expectations of political elites.

34. The initial reform programmes consisted of varying combinations of stabilization measures, institutional reforms and structural policies, including privatization. Monetary and fiscal restraint was aimed at reducing inflation, restoring financial equilibrium and setting the stage for a stable macroeconomic environment. Liberalization of the external sector would help to establish correct relative prices and impose a desired measure of competition on the domestic market. Resources were expected to flow from loss-making firms into new, profitable activities that would be undertaken and managed chiefly by newly emerging private entrepreneurs. The overall level of social welfare would rise, even though there would also be some losers, especially in the sectors that had enjoyed exceptional privileges under central planning: heavy engineering, metallurgy, mining and the bureaucracy. However, the adjustment costs were expected to remain relatively limited, partly because of the substantial foreign-direct investments that were expected to flow into transition economies attracted by low manpower costs and virgin markets.

35. The transformation was not expected to be completed quickly; it was clear, at least for a majority of policy makers, that the creation of an efficient market system would take a number of years. But it was also assumed that at least some of the benefits would materialize quickly, especially the elimination of shortages, improved access to goods and services, and the liberalization of

business activities. Although most reformist Governments did not set precise dates, indirect evidence suggests that they all expected economic growth to resume after a relatively short adjustment period, perhaps within one to two years. 3/

36. Popular expectations, on the other hand, were much more unrealistic. The massive critique of the inefficiencies and failures of central planning seemed to be perfectly consistent with the demonstration effect stemming from the affluent markets of western economies: the result was a widely held popular assumption that the substitution of capitalism for communism would be a rather simple exercise and that the shift would bring about a substantial and rapid improvement in the long depressed standards of living of eastern European populations.

37. The reality proved to be much harsher than the predictions derived from such rosy scenarios. Recession and unemployment hit all the countries in the region very hard. When the expected improvement was not quickly forthcoming, reformist Governments were accused of incompetence, wrongdoing and corruption; quite frequently, conspiracy theories were invoked to explain the lack of success. For many people, it was impossible to understand why the divorce from communism should be such a painful experience. This reform fatigue spread, manifesting itself in frequent changes of government and in a shift of political support in favour of opposition, sometimes populist, parties.

B. Infant capitalism?

38. It cannot be denied that the eastern European countries have come a long way since they started their transition to capitalism five years ago. Democratic and pluralistic political systems have been established in all of them and there is little question of reversing the trend towards the market economy. The straight-jacket of central planning and State controls has been dismantled: prices have been liberalized, domestic currencies are convertible, and consumers and producers are essentially free to make decisions according to their preferences. Inflation has been greatly reduced and endemic shortages have been eliminated. A large part of output is now produced by a dynamic private sector and domestic markets offer a large variety of goods and services, comparable to that available in western European countries. According to official national statistics, the non-State sector share in GDP already exceeds 50 per cent in most countries, an indicator of the enormous distance covered since 1989, when that share was generally less than 5 per cent (except in Poland, where it was about 30 per cent because of largely private agriculture). Although these statistics must be treated with some caution because the rules of statistical reporting and sectoral classification are not always clear and consistent, the radical change in the ownership structure is unmistakable.

39. The Governments of transition countries have also made considerable progress in integrating their economies into the global market economy: most of their foreign trade is now conducted with developed market economies at international prices and in convertible currencies, and their international links have been further strengthened by inflows of foreign-direct and portfolio investment. Many new market institutions have been established and developed,

such as stock exchanges, monetary and credit instruments, anti-monopolistic regulations, bankruptcy legislation etc. By the end of 1994, most eastern European economies had passed the low point of the economic recession: the long-awaited recovery appears to be under way.

40. The results of transformation thus far lend credibility to recent claims that the transition economies have put the essential foundations of a market economy securely in place. 4/ They also show that those countries' strategic decision to dismantle central planning and organize their economies according to market rules and principles was justified. Yet, all the achievements notwithstanding there have been failures and disappointments as well. In fact, after five years capitalism in the transition economies is still in its infancy: growing fast but still immature and turbulent.

C. Transitional recession: too deep, too long

41. Perhaps the most disturbing and unexpected outcome of the 1989 revolutions was the so-called transitional recession that depressed output and employment well below pre-transition levels. The official statistics show that the cumulative contraction of output between 1989 and 1993 in the transition economies was on a massive scale and unprecedented since the Great Depression of 1929-1933. The recession was particularly dramatic in Bulgaria and Romania, the two eastern European countries commonly considered the least prepared for market reforms, as well as in nearly all the countries of the former Soviet Union. Another common feature is that the cumulative fall of (gross) industrial output was larger, generally by more than a half, than the fall of GDP; by the end of 1993, it had exceeded 50 per cent in the worst cases (Bulgaria, Romania, the Russian Federation, Ukraine and the Baltic States).

42. What was surprising about the recession was not the fall of output itself - because some degree of recession had indeed been anticipated - but rather that the recession was so deep, so widespread and so persistent and that the subsequent adjustment on the supply side has been so weak. Official forecasts, which accompanied the launching of the stabilization-cum-reform programmes, typically predicted a temporary and relatively mild contraction of output, followed by a strong recovery fuelled by efficiency gains, the expansion of private business activities, and inflows of foreign investment. 5/ In reality, however, the behaviour of output followed an L-shaped pattern, instead of a U-shaped one.

43. The unexpected depth and persistence of the recession is still a puzzle to be explained. Attempts to explain it have in most cases focused on the structural and institutional characteristics of centrally planned economies. Specifically, it has been argued that under the new, market-based regime a large part of the previously produced output has become unsustainable for various reasons, 6/ but at the same time the necessary restructuring has been inherently slow. 7/

44. However, the deep fall of output is still intriguing because the very collapse of communist regimes was supposed to bring about a substantial and rapid improvement in economic performance and standards of living, precisely

because the traditional communist system was commonly regarded as so wasteful and inefficient. Removal of the command system and transition to a market economy was thus seen as an efficiency- and welfare-improving socio-economic innovation. It is therefore somewhat surprising that most experts now tend to regard the registered fall of output in the transition economies as something quite natural and largely inevitable.

45. A number of possible explanations of the transitional recession have been suggested over the last few years. They range from Keynesian demand-deficiency to Schumpeterian institutional interpretations, from concepts of structural rigidities and distortions typical of Soviet-type economies to views regarding the recession as a statistical artifact. None of them is fully convincing, but considered jointly they allow for some conclusions.

46. First, it should be noted that the recession was real and not imaginary: while there seems to be no doubt that the official statistics do tend to overestimate the extent of the actual fall in output, it may also be argued that the margin of error is probably smaller than is commonly believed. 8/ Second, the recession was the joint outcome of a combination of factors working from both the demand and supply sides; but the adverse impact of stabilization programmes on domestic demand appears to be quite substantial. With the benefit of hindsight, it can be argued that the stabilization policies were probably too restrictive, as they were guided by a mistaken judgement of the initial degree of macroeconomic disequilibrium. Third, it might have been expected that the shift away from communism would release large X-efficiency gains, which would generally work in favour of output expansion rather than contraction; 9/ that these gains have not materialized underlines the excessive optimism that prevailed in 1989 as to the responsiveness of the supply side of the transition economies. Whether micro-supply responses could have been stronger with a different set of policies is an open question.

D. Structural unemployment

47. It is a well-established proposition of traditional comparative economics that the nearly full employment levels observed under central planning were artificially achieved because of low work discipline, an ideological commitment to full employment, and low wages. Large-scale lay-offs during the transition were therefore predicted, but it was also assumed that rapidly increasing demand for labour in the expanding service and private business sectors would absorb most of the excess manpower in industry, and that unemployment would remain moderate. In reality, the jobless rate in most east European countries is well over 10 per cent of the labour force and has remained high, despite the emerging recovery of output.

48. An important message from labour market statistics is that not only are unemployment rates high in the transition economies, but also that there was only a small reduction in excess employment (as indicated by the difference between the cumulative change in GDP and the cumulative change in employment) between 1989 and 1994. Only in Bulgaria and Poland have employment levels fallen broadly in line with the fall of output, thus leaving the initial level of overemployment practically unchanged; in all the other countries, but

especially in the former Soviet republics, the level of overemployment has increased, with obviously negative implications for labour productivity and wages.

49. Since the major reason for high unemployment has been the transitional recession, the recovery might in principle have been expected to at least alleviate the problem. Unfortunately, the emerging recovery cannot be counted on to radically improve the labour market situation because the flow of new jobs is likely to be broadly offset by new entrants to the pool of unemployed, coming from schools, an overmanned agricultural sector and shrinking State enterprises. As a result, the transition countries are likely to have to live with double-digit unemployment rates for several years to come.

50. Long-term and high rates of unemployment, however, involve serious risks. First, as more and more persons remain without a job for a long time they will tend to drop out of the active labour force permanently because of a loss of skills. This hysteresis effect will thus reduce the potential output of the transition economies in the future and put additional burdens on their fiscal expenditures on extensive social safety nets. The share of the long-term unemployed (more than 12 months without a job) in total unemployment has been gradually increasing in eastern Europe, and is now more than 40 per cent on average and close to 60 per cent in countries such as Bulgaria and Slovenia. Another worrying fact is that there are more and more young people and school leavers among the unemployed - a tendency which carries a high risk of their remaining more or less permanently without a job. The implications of this are daunting: not only is the economy likely to suffer from the waste of manpower resources, but social and political stability may be endangered if too many people are unemployed for too long. There are no simple solutions to this problem, but structural policies aimed at improving the workings of the labour markets and active labour market policies, including training and retraining programmes, would appear to be priority areas for action. But, there must also be a recovery to sustained, employment-creating rates of output growth if the inflow to the pool of unemployed is to be reduced significantly.

E. Persistent inflation

51. High rates of inflation and widespread shortages were characteristic of the final days of the central planning system. Liberalization of prices and the initial devaluation of domestic currencies further added to inflationary pressures; in fact, the corrective inflation in most countries strongly overshot the levels envisaged in the stabilization programmes. To restore fundamental price stability was thus one of the central objectives of the reformist Governments. Experience has shown that reducing inflation from near hyper-inflation levels to manageable proportions is a relatively easy task and can be done quickly with standard measures of financial restraint implemented within a credible and consistent programme. However, most of the eastern European countries that have succeeded in lowering inflation to 20-40 per cent per annum seem to be finding it very difficult to reduce it further to one-digit rates.

52. The persistence of inflation at so-called moderate levels cannot be easily explained with standard theories. 10/ The growth of money supply does not seem to have been a primary inflationary factor, because it has generally lagged behind the consumer price index in all central European countries (except in the Czech Republic, where, however, inflation is the lowest in the region), and even more so in the Russian Federation and the other members of the Commonwealth of Independent States. Also, there is no uniform pattern in the impact of budget deficits: although there seems to be a clear link between fiscal deficits and inflation in the Russian Federation and Ukraine, the evidence is less clear for eastern European countries (Hungary and Slovakia have had lower inflation rates and higher deficits than Poland or Romania). Wages have been kept under control throughout the region, generally increasing less than consumer prices (again, the exceptions include countries with the lowest inflation rates in the region).

53. Even where inflation is considered moderate, it nevertheless varied in 1994 from 10-13 per cent in the Czech Republic and Slovakia to some 33 per cent in Poland, and such rates are likely to have an adverse impact on economic activity. Interest rates, both nominal and real, are kept high, thus hampering economic recovery; uncertainty is maintained in the business sector and investment horizons are shortened; and social unrest may be provoked because of the undesired effects of inflation on income redistribution.

54. The nature of the current inflation appears to be different from that observed in the initial stages of the transition when the liberalization shocks, excess demand and the monetization of fiscal deficits played the most important roles. Moderate inflation seems to be caused chiefly by inertial mechanisms, such as various indexation schemes for wages and pensions, frequent foreign exchange rate adjustments, periodic increases of key commodity prices (mostly energy and food) and inflationary expectations. Attempts to stop such inflation with the standard instruments of tight monetary policy tend not to be very effective, especially when inflows of short-term capital boost the domestic money supply under pegged exchange rates (as in the Czech Republic and Poland). A conservative monetary policy is still needed, but it should be combined with other measures that would dampen inflationary expectations through the breaking up of inertial mechanisms.

F. Enterprise reform and privatization

55. Policy makers in the transition economies were clearly aware of the systemic weaknesses of traditional State enterprises and seem to have recognized that, unreformed, they were likely to behave in a perverse way in a market environment because of the distorted structure of incentives facing not only managers but also banks, workers and government agencies. In the initial stage, these dangers were to be avoided through rigid tax-based incomes policies, and thereafter through privatization. And yet the composition of the stabilization packages in most countries suggests that they were based on an implicit assumption that the reaction pattern of State enterprises to stabilization measures would be broadly similar to that observed in developed market economies. This may help to explain the lack of early reforms of State enterprises and banks and the slow pace of privatization. Indeed, instead of discontinuing inefficient production, laying off excessive manpower and

responding to market signals in a standard, profit-maximizing way, State enterprises preferred to raise prices, protect employment and lobby heavily for government support and assistance.

56. Incomes policies, although instrumental in reducing inflationary expectations, proved to be only partly effective in imposing wage discipline and keeping unemployment low; in many cases they proved to be an impediment to restructuring, and were often considered to be socially unfair and politically unacceptable. On the other hand, privatization proved to be much more difficult and time-consuming than initially envisaged.

57. From the economic perspective, the role of privatization was to introduce efficient corporate governance and additional sources of funding for enterprises; 11/ in addition, and in many cases primarily, it was also seen as an important underpinning of the political transformation. Very broadly, two different privatization strategies were followed: one based on the free distribution of State assets to the public at large; the other following a case-by-case, commercial approach. In the first case, the transfer of ownership rights can be carried out relatively fast, and the share of the non-State sector in the economy is expanded "at the stroke of a pen". However, the main advantage of the latter method is essentially its speed. As for the economic objectives of privatization, it takes much longer for effective corporate governance to be established, since give-away schemes create dispersed ownership with the dominance of passive owners. As a result, while managers are liberated from government supervision, they are not put under the control of new owners. Effective controls can be imposed only gradually, no matter how fast the formal ownership rights are distributed. A good illustration of the problem is provided by the results of privatization in the Czech Republic, widely regarded as the most successful in eastern Europe. Even though the State managed to divest itself of more than half its industrial property within less than three years, the behaviour of enterprises has in fact changed very little, if at all, because the new owners are either dispersed or, if they hold strategic stakes, are unable to exert the desired influence on managers because of a lack of information, conflict of interest or general passivity. The privatized enterprises are thus non-state, but they are not yet fully private in the western sense of that term. Moreover, only limited funds have been channelled to enterprises as a result of this method of privatization. Voucher privatization in the Russian Federation is another example of the rapid formal transfer of ownership away from the State that is followed neither by effective governance nor by an inflow of new capital.

58. Under the first strategy, when a State enterprise is sold to a new owner(s), corporate governance is immediately established, additional financing is often forthcoming and the necessary adjustments begin to follow; but since the strategy proceeds case by case, it takes a long time to privatize effectively a majority of State enterprises. The dilemma is therefore to choose between a wide and shallow privatization or a deep and narrow one. Whatever alternative is selected, the process of economic restructuring will take years to complete.

59. One important lesson that can be drawn from the experience of the last five years is that a mixed strategy may be desirable, combining elements of free distribution and commercial sales. Another is that the rate at which corporate governance can effectively be established in newly privatized enterprises should be an important consideration determining the speed of the privatization process. As proper governance cannot be achieved overnight, a large number of enterprises will have to stay and operate under non-private ownership for some time. However, to minimize losses from possible mismanagement, several steps can be taken. First, State enterprises should be legally remoulded in order to create an economically desirable structure of incentives available to managers. This can be done through corporatization and commercialization, which would precede privatization proper. Second, both the managers and members of the board should be offered a stake in their enterprise’s future market value (e.g. a call option for shares to be issued in a future privatization) to prevent asset squandering and dissipation.

G. Banking reform

60. The need to overhaul the whole financial sector in the transition economies was fully recognized only when the banks and other financial institutions emerged as a major obstacle to the process of reform. The main weaknesses of the financial sector include the absence of many important institutions of financial intermediation (such as pension funds, mutual funds, specialized savings and loans organizations, security firms, equity and bond markets, etc.), the small capital base of the existing commercial banks, the excessive dependence of banks on a limited number of clients (mainly large State enterprises), lack of experience in credit operations, and either absent or inadequate prudential regulations and bank supervision. However, policy makers did not seem to fully realize that not only was the reform of the financial system an integral component in the creation of a market economy, but that it should have been initiated at the very beginning of the transformation process.

61. The failure to reform the financial sector at the start of the transition has had a number of important implications. The most important is probably the rapid accumulation of bad loans in the commercial banks, a phenomenon common to all the transition countries. 12/ Some of the bad loans are an inheritance from the regime of central planning, when State enterprises were largely unconstrained in their investment activities, but much more significant are those accumulated during the transition period. The latter resulted from a lack of appropriate adjustment by enterprises and banks to the sudden change in the macroeconomic environment. Protracted recession and the collapse of traditional export markets in the former Council for Mutual Economic Assistance (CMEA) countries also led to many technical and actual insolvencies in the enterprise sector.

62. The problem of bad loans is now at the centre of economic discussions in all the transition economies. Any efficient and lasting solution to the problem should combine two types of initiative. First, the existing stock of bad loans has to be dealt with through a comprehensive financial restructuring programme. Second, the recurrence of bad loans (the flow problem) has to be forestalled, which implies a fundamental change in the behaviour of economic organizations,

which in turn requires a radical change in the structure of incentives available to the managers of banks and enterprises.

H. Foreign investments

63. From the very beginning of the transition process, the Governments of both western countries and eastern European countries regarded foreign-direct investment (FDI) as playing a key role in the restructuring and transformation of the former centrally planned economies. The initial optimism surrounding the role of FDI was based essentially on a number of perceived characteristics of the transition economies: an abundance of cheap skilled labour, geographical proximity to western markets, the anticipation of a rapid growth of internal demand, and liberal commercial legislation.

64. The balance after five years of transition looks rather modest. The actual volume of FDI in transition economies has been much lower than expected and, in addition, has been very unevenly distributed across countries. Moreover, FDI declined in 1994, mainly because of declines in Hungary, which had attracted the bulk of the region's FDI since 1990, but it was weak in most other countries as well. Apart from a few large investments in the early 1990s, such as Fiat's $1.8 billion investment in Poland, Volkswagen's purchase of a stake in Skoda car manufacturing in the Czech Republic, or General Electric's acquisition of Hungary's Tungsram, foreign investment has tended to be hesitant and on a small scale.

65. One possible explanation of this outcome is that foreign investors picked up the best companies in eastern Europe, in terms of their market potential, expected profits and the risks involved, and are not in a hurry to invest in other, typically more debt-ridden and overstaffed, companies. But a more general explanation for the reticence of foreign investors is probably linked to more general, systemic factors, such as the uncertain legal, political and institutional environment. In a few countries the high level of unionization and a tradition of frequent industrial disputes may also be a factor. The delays, frequent changes and sometimes reversals of earlier government decisions on privatization have also created uncertainty by sending confusing signals to foreign investors. 13/

66. Apart from limited inflows of FDI, its distribution may also be sometimes questionable. Casual observation and case studies suggest that FDI often tends to concentrate in sectors and branches with a relatively high potential for rent-seeking that may arise from quasi-monopolistic positions or from special arrangements with the host Governments of transition countries. Thus, foreign investment in eastern European car manufacturing was typically made conditional on the granting of special privileges to investors in the form of high customs tariffs (in Poland, for example). Similar motives may be behind the attempts by large multinational companies to establish control over east European markets for tobacco products. 14/

67. The weakness, and recent decline, in FDI in the transition economies has not been offset by official assistance. Project lending by the development institutions corresponds broadly to the types of investments made by FDI

enterprises, although that of the former is concentrated in the infrastructure and energy sector. Project-related disbursements to the transition economies by these institutions show a rapid increase in 1994, but not enough to compensate for the fall in FDI, although the prospects for further growth in project disbursements appear to be good, given the accumulation of new commitments in the past five years.

I. Conclusions

68. In 1989-1990, the countries of eastern Europe enthusiastically embraced the capitalist model of economic organization. But since then, reservations have emerged and grown large, mainly because of the unexpected social and economic costs of transition and the slow improvement in living standards. These reservations pose important challenges to policy makers: they call for imaginative domestic policies aimed at sustaining economic growth, checking and reversing the rising trend in unemployment, and speeding up the necessary structural change, while maintaining financial discipline and macroeconomic stability. For political leaders, the current mood of disillusion creates a strong temptation to resort to populist measures, which could have disastrous economic consequences. Finally, popular reservations about the market reforms also pose a serious challenge to the international community, which should read them not simply as symptoms of impatience and naiveté on the part of eastern European populations but as the reflection of real social distress and, often, disorientation, conditions which call for more, not less, cooperation and solidarity with the transition economies. The ways in which the main political and economic actors respond to these challenges will have a considerable influence on the sustainability of the market reforms in the transition countries in the next few years.

III. THE MEXICAN CRISIS AND THE TRANSITION ECONOMIES

69. When the Mexican peso was suddenly devalued by 15 per cent on 20 December 1994, there was an immediate collapse of confidence on the part of foreign investors who withdrew capital on a massive scale, thus leading to a further drop of 18 per cent in the exchange rate in just a few days. Since then, an international assistance package of over $50 billion has been put together and the Mexican Government has announced a programme of adjustment measures that will probably lead to a severe recession in 1995. The external ramifications of this crisis are complex and are still working their way through the international system: not only are other Latin American countries facing severe problems as a result of the loss of confidence of foreign investors, but the nature of the rescue package itself has focused attention on the fiscal and current account deficits of the United States, raising concern about the country’s exposure to the highly uncertain outlook in Mexico. Given the relatively high degree of integration of world financial markets, this concern has led to increased turbulence in the foreign exchange markets in the first quarter of 1995. There is now a risk that, if the recent rise in the trade-weighted value of the deutsche mark is not quickly reversed, western European growth will be less than is currently expected for 1995.

70. However, although slower growth in western Europe is likely to have a negative effect on the prospects for continued export growth from the transition economies, the immediate concern in the aftermath of the Mexican crisis was whether they might be vulnerable to a similar collapse of foreign confidence and withdrawal of capital. In this context, Hungary was frequently mentioned by commentators in the financial press, and the Hungarian Finance Minister, Mr. Laszlo Bekesi, expressed similar fears when he resigned at the end of January.

71. The short-term situation in the eastern European transition economies differs in many crucial respects from that in Mexico last December. In the first place, the vulnerability of eastern Europe to a sudden withdrawal of foreign capital is fairly limited, for the simple reason that private capital inflows since 1989 have not been large and, indeed, have been considerably smaller than expected or hoped for. Altogether, the total gross inflow of private capital into eastern Europe in the five years prior to 1994 was about $42 billion, less than United States private investments in Mexico alone, and a small fraction of the total private flow to developing countries. Moreover, the share of short-term debt and of portfolio investment in the eastern European total is very small. This is also true of Hungary, which has succeeded in attracting the largest share of private investment in eastern Europe.

72. Eastern Europe also differs from Mexico in a number of other respects. Apart from Hungary, there has been a general improvement in current account positions over the last year or so, to some extent a reflection of the limited ability of the eastern European countries to finance deficits. Half the these economies were actually in current account surplus in 1994. Foreign debt levels (gross and net) have fallen in the past year (except in Hungary), and with regard to exports, which have risen strongly, debt burdens are relatively low. Foreign currency reserves have risen considerably and in most countries now exceed the conventional safety margin of having reserves equivalent to three months of imports (Hungary’s reserves are currently equivalent to nearly five months). Also, most of the transition economies have not committed themselves to fixed exchange rates and have therefore avoided the persistent currency overvaluation that was an important feature of the Mexican situation. It should also be noted that no transition economy has yet introduced convertibility on the capital account and all retain capital controls, albeit of varying degrees of effectiveness. These, of course, effectively segment the local from the global capital markets.

73. Thus, there appears to be little ground for expecting a Mexican-type crisis to develop in eastern Europe at the present time. The possibilities for a sudden and massive withdrawal of short-term foreign capital do not exist, and in any case the expectational environment had already changed in eastern Europe before last December: equity markets in the Czech Republic, Hungary and Poland have been falling for over a year and some small amounts of foreign portfolio investment had been repatriated before the Mexican crisis; nor are expectations focused on fixed and overvalued exchange rates - indeed, Hungary has devalued eight times in the last year and foreign investors cannot be surprised by anything approaching the Mexican devaluation of 20 December. Fears that eastern Europe would suffer contagion from the Mexican crisis have therefore proved unfounded and, given what has been said above, were unjustified in the first

place. Indeed, both Hungary and the Czech Republic were able to raise medium- and long-term funds on the international capital markets in early 1995, the former more expensively but the latter more cheaply than in 1994. By contrast, many Latin American borrowers have been unable to raise new funds at all. This is not to assert that eastern Europe is completely sheltered from all fallout from the Mexican crash. In a more uncertain global environment, foreign investors may well be more cautious in investing funds in the transition economies, although this is by no means certain. But foreign investment was already falling last year, not because of Mexico but because of domestic factors such as the slowdown in privatization in a number of transition economies and uncertainty about the commitment to or effectiveness of reforms in others.

Lessons from the Mexican experience

74. Although the contagion and systemic consequences of the Mexican crisis appear to have been exaggerated, as far as the transition economies are concerned, there are nevertheless important lessons to be drawn from it for transition strategies. One is the obvious danger of relying on an overvalued exchange rate for too long. This can help to lower high rates of inflation but it also encourages imports of consumer goods, undermines export competitiveness and discourages domestic savings - precisely the opposite of what is required to bring about a transformation of economic structures. These shortcomings can be overcome for a while by raising interest rates and attracting foreign capital to support the current account. This was relatively easy to do in the early 1990s when interest rates in the United States had fallen to very low levels and when, as a result of financial deregulation in the 1980s - which greatly reduced liquidity constraints - small changes in rates could induce large movements in capital. But there comes a point when the deterioration in the trade balance becomes so large that a sudden collapse in confidence and an outflow of capital can be triggered by comparatively minor events.

75. The orthodox response to this situation is to insist that the outflow of capital represents the verdict of the market on unsound monetary and fiscal policies. There is some truth in this, of course, but the argument assumes that foreign capital responds to economic fundamentals, supporting sound policies and growth prospects and shunning the bad. But the evidence suggests that speculative bubbles and bandwagon effects play an important role in international capital movements. 15/ In Latin America, in the early 1990s, foreign capital flowed into almost every country irrespective of their fiscal, exchange rate or trade policies, or whether or not they had serious economic imbalances. 16/ Such capital movements can seriously complicate macroeconomic management by increasing the volatility of exchange and interest rates, and undermining a country's competitiveness both as exporter and as a location for foreign direct investment. They may also produce, for a short while, an illusion of economic success which may lead to the postponement of the reforms required to encourage long-term investment and economic growth. 17/ (In Mexico there was a boom in consumption and real estate speculation but little growth in fixed investment.) The collapse of speculative bubbles, apart from threatening the stability of financial systems, which is a familiar issue, can often impose very large costs on indebted households and enterprises, and lead to economic austerity programmes that can threaten social stability especially in countries where political and economic institutions are not very robust.

IV. A CHANGE IN THE EMPHASIS OF TRANSITION STRATEGIES?

76. A major reason why the contagion effects of the Mexican crisis on the transition economies was negligible, as argued above, is that they are still poorly integrated into the world capital markets. Their weakness thus proved to be their main defence. The barriers to full integration reflect, in effect, the condition of being an economy in transition rather than a full-fledged market economy; they include the lack of a fully articulated infrastructure of market economy institutions, including an appropriate framework of law and law enforcement, exchange controls, the absence of internationally acceptable regulatory and accounting systems, a lack of sufficient national funds, and the limited size of existing equity and other capital markets. Poor international credit ratings also reflect the more general uncertainty arising from incomplete - and untried - institutions, as well as from continued problems of macroeconomic imbalance, such as large fiscal deficits or high and variable inflation rates.

77. Obviously these are all problems that need to be dealt with in their own right, but the standard advice to transition and developing countries is to remove or lessen the impact of barriers to capital market integration as quickly as possible, since such integration, together with appropriate fiscal and monetary policies, will provide a boost to development by reducing the costs of capital, strengthening incentives for investment and enhancing the mobilization of domestic resources. 18/ But this advice ignores the fact that international financial markets, as a result of technological and regulatory changes, provide a highly efficient environment where speculative behaviour can impose significant costs on the real economy. 19/ Private-sector portfolio shifts can have interest rate and exchange rate consequences that may prolong or even cause current account imbalances rather than simply finance them. 20/ The problems created by speculative activity are difficult enough for the western market economies to handle and are likely to prove even more intractable for transition economies, where the institutional infrastructure is still incomplete and fragile. It would therefore seem unwise for the transition economies to move towards full integration with the international capital markets until the transition is complete, market institutions firmly established, and a process of sustained growth under way. As the structural barriers to integration are removed as part of the reform process it may thus be necessary to strengthen controls against destabilizing capital movements. 21/

78. One of the recognized dangers of large inflows of foreign short-term capital into countries such as Mexico is that they may not only reduce domestic savings but actually become a substitute for efforts to mobilize domestic resources for investment, with damaging effects when foreign investors withdraw their funds. Flows of foreign direct investment (FDI), however, are not only usually exempted from this criticism but have been allocated, by both western and eastern Governments, a crucial role in the transition process. FDI would not only help to finance the current account but would play a catalytic role in introducing new technologies and a new culture of management and entrepreneurship. In fact flows of FDI into the transition economies have been very much less than expected at the start of the transition and have been largely concentrated in Hungary and the Czech Republic. The disappointment with the levels of FDI was not only due to unrealistic expectations 22/ but also to a

misunderstanding about the possible motives for foreign investment. The mainstream view sees FDI as a generally benign influence diffusing new technology and management techniques wherever it goes and securing a more optimal allocation of global resources. As with most economic theories, there are grounds to support this view. But there is an alternative approach, associated with the Austrian and Schumpeterian traditions, but with roots going back at least to Adam Smith, which sees enterprise behaviour as rivalrous and driven by rent-seeking and the urge to dominate markets. 23/ It is in countries where economic and social institutions are relatively weak - where the structures of the State are weak - that this more predatory behaviour by the enterprise is both more apparent and least restrained. The transition economies are, by definition, characterized by still imperfectly functioning markets, embryonic institutions, and, to say the least, ambiguous attitudes towards the role of the State. These are the conditions that encourage rent-seeking and even the capture of domestic policies by foreign enterprises. Comprehensive data on market structure and FDI are not yet available, but there is a lot of anecdotal evidence to suggest that much of the foreign investment that has flowed into eastern Europe has been targeted at obtaining dominant market shares. 24/ Such developments, together with attempts to protect the domestic market from other outsiders, may have as much to do with the growing hostility towards foreign investors in a number of transition economies as alleged nationalism or a failure to understand the workings of the market economy. Where markets are not competitive or the State lacks effective regulatory powers, there can be no presumption that the activities of foreign companies will automatically contribute to a more efficient use of resources or that the pattern of growth will be the one desired by the local population. 25/

79. One reason for doubting whether the emphasis on FDI as having a leading role in the early stages of transition is appropriate or necessary is that the current rates of recovery of output and investment in eastern Europe do not suggest that it is crucial. Poland has received very little FDI to date "only $43 per capita compared with $688 in Hungary and $303 in the Czech Republic - and yet it is showing the most sustained recovery of output and a strong upturn of investment in new machinery and equipment. A sample survey of 200 Polish enterprises at the end of 1993 revealed that nearly two thirds of their capital stock was more than 10 years old, so the scope for catch-up is considerable. In fact, over 61 per cent of the sampled firms had introduced new technology since 1991, most of it bought outright from OECD sources and not acquired through joint ventures or outside investors. The proportion of total output based on foreign designs or produced with foreign production technologies was 30 per cent for the whole sample but 58 per cent for privately owned companies. 26/

80. The Polish experience demonstrates not that FDI is necessarily ineffective or irrelevant to restructuring and re-starting growth but that it is not a necessary condition for getting the process under way. FDI is not the only transmission belt for obtaining new technology, and therefore the Governments of transition economies should not be inhibited from assessing more carefully the costs of premature inflows of foreign investment. Moreover, the tendency to regard foreign investment as the litmus test of successful entry into the community of market economies can be very misleading if it is used as a substitute rather than a complement to the mobilization of domestic resources. In Mexico short-term capital flows were used to support consumption rather than

fixed investment; but FDI in the absence of domestic resource mobilization may either prove fragile if foreign investors see they are the only ones with major stakes at risk or provoke social and political problems if it occupies too dominant a role in the host economy. 27/ In fact, as noted above, the strategy of giving a leading role to FDI has not been very successful and has managed to generate a lot of disappointment and some resentment.

81. An alternative approach is therefore to pursue a strategy of much greater self-reliance, especially in the early stages of economic modernization and in restarting the process of sustained growth. This will require (a) an increase in the ratio of domestic savings in relation to GDP and (b) if dependence on foreign investment or current account deficits is to be kept low or avoided, a rise in the share of exports in national output in excess of the growth in the import share. In addition to establishing a reasonable degree of macroeconomic stability, in particular maintaining control over inflation and fiscal deficits, this strategy suggests that high priority should be given to reform of the financial sector, in order to mobilize and protect domestic savings, 28/ and to broad-based export promotion programmes. 29/

The need for structural reforms

82. Despite marked differences in the history and rates of advance of market reform and in current macroeconomic performance, the transition countries of eastern Europe display many similarities. Most of them have made considerable progress towards stabilizing their economies, strengthening their domestic currencies and developing a strong and dynamic private sector. They have also managed to reorient much of their trade from the depressed eastern markets to the more competitive markets of western Europe. But these successes notwithstanding, the eastern European countries also face some common problems, which - if not addressed in an appropriate way - may hamper the economic recovery and even lead to political instability in the region. In particular, they are all confronted with essentially the same task of a massive reconstruction of their productive capacities, a task that includes a substantial reallocation of resources and probably the closing down of many inefficient enterprises. In this context, the slow pace of structural reforms raises serious concern. Political obstacles to the restructuring of State enterprises, the lack of funds for new investment and the rehabilitation of the existing plants, and the problems involved in the large-scale reallocation of resources all conspire to hold back the reforms and contribute to high interest rates and inflation. The implications, actual or anticipated, of restructuring for the distribution of income and wealth are also a cause of bitter political in-fighting in most transition countries, which is also a factor slowing the progress of reforms. Improving the working of an inefficient and underdeveloped financial sector is also taking a great deal of time and effort, and the burden of bad debts has negative repercussions on the ability of the commercial banks to finance the enterprise sector. The reform of public finances has not yet been completed, and the rapid increase of budgetary expenditures on social security threatens to ruin the fragile stability of state budgets in the near future. Domestic public debt has been increasing in all countries, and in some of them it may soon reach alarming proportions.

83. As argued above, the economic performance of the eastern European transition countries will also depend heavily on continued export expansion if overdependence on foreign capital is to be avoided or, since such capital seems unlikely to be available in significant amounts anyway, if the balance of payments is not to be a constraint on growth. Given the need for imports of new technology to support the restructuring process, an expanding capacity to import will therefore largely depend on the growth of exports. The recovery of output in 1994 was chiefly driven by the expansion of exports to western markets; but the cyclical upswing in western import demand can be expected to stabilize in 1995 and to weaken gradually in the course of 1996; unless domestic sources of growth emerge, the current rates of growth in the transition economies may slow down considerably. The positive impact of exports on growth may, however, be extended and strengthened if better access to western European markets is granted for the transition countries, and this in turn may encourage an outward-looking FDI that can play a useful role in expanding exports over the longer term. But export growth can also be supported by export promotion efforts directed not only at western Europe but also at the more dynamic economies in Asia and other parts of the developing world. This in turn will require improvements in the trading infrastructure of the transition economies, along the lines discussed in the trade promotion programme quoted above.

84. The other major constraint on growth, which is likely to be increasingly encountered by all transition countries in 1995 and beyond, is the relatively low rate of domestic savings, which limits the potential for domestically financed investment. This is due only in part to the currently low level of per capita incomes in these countries. (It is worth noting that a considerable part of the household savings accumulated in the pre-transition period were wiped out by inflation and exchange rate changes.) Policies to encourage more savings are urgently needed in the transition countries. In this context, real positive interest rates on bank deposits are an important but not sufficient incentive. A variety of attractive and secure savings instruments need to be developed, such as mutual funds, pension funds, bonds and equity shares. Also, accessibility of more expensive goods (consumer durables, housing) could be increased through the development of financial instruments, allowing people to save a larger proportion of their incomes in order to finance long-term purchases and investments (mortgages, consumer credits and so on).

85. Economic prospects will also depend on the political developments in the transition economies. In this context, an important question is whether the almost universal shift of political support in the last two years away from economic liberalism and political conservatism, which had dominated the early years of transition, has implications for the direction and pace of economic reform. The shift of political power to the social democratic left, which started in Lithuania and Poland in 1993, was followed by similar political changes in Hungary, Slovakia and Bulgaria in 1994 and, in early 1995, in Estonia. The immediate concerns and uncertainty about the sustainability of market reforms in the wake of these political changes have so far proved unfounded. While most of the new Governments display somewhat less enthusiasm for rapid, or spontaneous, privatization - and, indeed, the pace of ownership transfers has slowed down in some countries - there seems to be little question about their genuine commitment to continue with the process of market transformation and democratic reform. But it is important to underline the

problems facing these Governments. After five years of reform considerable progress has been made in transforming economies and political institutions, and in many of them the first signs of a recovery in output have appeared. Many people in eastern Europe are benefiting considerably from this progress, especially the educated young, the skilled and those with entrepreneurial drive. But there are also many losers, especially the old, the unskilled, those employed by the State and many of those in the professions. Their growing discontent is now a factor that no Government in eastern Europe can ignore, and if their numbers continue to increase, then both social stability and the commitment to continued reform are likely to be undermined. Foreign private investors are less likely to be interested in solving such problems than in whether these problems will increase the risks of investment. But this is where more generous and well targeted levels of official assistance from western Governments and international institutions can play a vital role in helping to ease some of the social costs of adjustment while helping transition economy Governments to keep the reforms on track. It is frequently claimed by western Governments that they cannot afford such assistance, but such claims abstract from the questions of political will and the calculation of longer-term self-interest. The costs of a stalling or failure of the transition processes in eastern Europe and the former Soviet Union are likely to be far greater than the costs of supporting them in advance.

Notes

1/ No data are available for Bosnia and Herzegovina.

2/ See Commission of the European Communities, Central and Eastern Eurobarometer (Brussels, March 1995).

3/ For a comparison of the targets and results of early stabilization programmes, see Economic Commission for Europe, Economic Survey of Europe in 1991-1992 (United Nations publication, Sales No. E.92.II.E.1). See also D. M. Nuti and R. Portes, "Central Europe: the way forward", in R. Portes, ed., Economic Transformation in Central Europe: A Progress Report (London, CEPR-EUROP, 1993), pp. 1-20.

4/ See "Camdessus discusses progress in transition economies in central and eastern Europe", IMF Survey, 23 January 1995, p. 21.

5/ In 1990, the Government of Poland assumed that the fall of GDP would be restricted to between 3 and 5 per cent and would be followed by recovery in the second half of 1990. Even in early 1991, when the Polish economy was in a downward spiral, the Government was still predicting 3.5 per cent GDP growth for 1991. Actually, the economy contracted by another 7 per cent. The same errors of underestimation were made in other countries. The Hungarian Government predicted 2-3 per cent growth for each year, 1991 to 1993, but GDP actually fell by 12 per cent, 5 per cent and 2 per cent, respectively. At the outset of the reforms in Czechoslovakia in 1991, the Government cautiously reckoned with a possible decline of output of 5-10 per cent; the actual result was a 14 per cent fall in 1991 alone, followed by another drop of 7 per cent in 1992. During the first two years of stabilization and reform in Bulgaria (1991-1992), GDP fell by 17 per cent much more than the initial forecast of 11 per cent. See Economic Commission For Europe, Economic Survey of Europe in 1991-1992 (United Nations publication, Sales No. E.92.II.E.2).

6/ See, for example, P. Hare and G. H. Hughes, "Competitiveness and industrial restructuring in Czechoslovakia, Hungary and Poland", CEPR Discussion Paper series, No. 543 (London, 1991); I. Sujan, "On the unavoidability of output reductions", in J. Pöschl, ed., Czech Economists on transformation, The Vienna Institute of Comparative Economic Studies, Research Report No. 206 (May 1994); J. Winiecki, "The inevitability of a fall in output in the early stages of transition to the market: theoretical underpinnings", Soviet Studies, vol. 43, No. 4 (1991), pp. 676-699.

7/ See, for example, B. Chadha, F. Coricelli and K. Krajnyak, "Economic restructuring, unemployment and growth in a transition economy", in IMF, Staff Papers, vol. 40, No. 4 (December 1993). In this context, J. Kornai coined the term "transformational recession" as something fundamentally different from a regular recession associated with a normal, western-type business cycle. See J. Kornai, Transformational Recession: A General Phenomenon Examined through the Example of Hungary's Development, Collegium Budapest, Institute for Advanced Studies, Discussion Papers No. 1 (June 1993). Similar views are also expressed by many other authors (see, e.g., O. Blanchard, R. Dornbusch, P. Krugman, R. Layard and L. Summers, Reform in Eastern Europe (Cambridge, Massachusetts, The MIT Press, 1991).

8/ D. K. Rosati, "Output decline during transition from plan to market: a reconsideration", The Economics of Transition, vol. 2, No. 4 (1994), pp. 419-441.

9/ In the most general terms, the X-efficiency idea refers to the closing of the difference between actual and maximum output, the gains arising from better use of inputs for a given output, varying degree of work effort and discipline by individuals, varying degree of diverging interests in agent-principal relationship, inertial costs and some other factors. For a more detailed exposition of the X-efficiency idea, see H. Leibenstein, General X-Efficiency Theory and Economic Development (New York and Oxford, Oxford University Press, 1978), pp. 17-38.

10/ R. Dornbusch and S. Fisher, "Moderate inflation", The World Bank Economic Review, No. 7 (1993), pp. 1-44.

11/ P. Aghion and N. Stern, eds., "Obstacles to enterprise restructuring in transition", European Bank for Reconstruction and Development, Working Paper No. 16 (London, December 1994).

12/ Bad loans include non-performing assets on banks' balance sheets, mostly in the form of overdue credits, extended to enterprises which - for various reasons - were unable or unwilling to service them.

13/ The recent decision by the Government of the Russian Federation to restore partial State controls over already privatized enterprises, or the withdrawal of the offer by the Government of Hungary to sell a State-owned hotel chain to an American consortium provide examples of "stop-go" policies vis-à-vis foreign investors.

14/ There appears to be little or no discussion of the welfare implications of allowing foreign companies to introduce modern advertising and distribution methods in the cigarette industry. Male mortality rates from smoking-related diseases in eastern Europe and the former Soviet Union are the highest in the world, while those for females are among the lowest. See R. Peto and others, Mortality from Smoking in Developed Countries, 1950-2000 (New York and Oxford, Oxford University Press, 1994).

15/ A. R. Ghosh, "International capital mobility amongst the major industrialized countries: too little or too much?", The Economic Journal, vol. 105, No. 428 (January 1995), pp. 107-128.

16/ UNCTAD, Trade and Development Report, 1993 (United Nations publication, Sales No. E.93.II.D.10).

17/ The illusion of success in Mexico was hardly questioned by foreign Governments, the international financial institutions or private banks and securities firms. See H. Kaufman, "Why alarm bells didn't ring over Mexico", The Wall Street Journal, Europe, 27-28 January 1995. But it should be acknowledged, on grounds of intellectual honesty and professional etiquette, no less, that UNCTAD economists gave clear and repeated warnings, in the body of their texts and not hidden in precautionary footnotes, of the dangers Latin American countries were running in relying so heavily on short-run capital movements to finance their current account deficits. UNCTAD, Trade and Development Reports, 1991, pp. 95-97; 1993, pp. 113-125; 1994, pp. 95-115 (United Nations publications, Sales Nos. E.91.II.D.15, E.93.II.D.10, E.94.II.D.26).

18/ S. Claessens, "The emergence of equity investment in developing countries: an overview", The World Bank Economic Review, vol. 9, No. 1 (January 1995), pp. 1-17.

19/ B. Eichengreen, J. Tobin and C. Wyplosz, "Two cases for sand in the wheels of international finance", The Economic Journal, vol. 105, No. 428 (January 1995), pp. 162-172.

20/ Bank for International Settlements, International Capital Flows, Exchange Rate Determination and Persistent Current Account Balances (Basel, 1990).

21/ For an extensive survey of capital controls and the international regimes that regulate their use by members of the Organisation for Economic Cooperation and Development (OECD) and the European Union, see UNCTAD, Trade and Development Report, 1994 ..., pp. 95-115. On proposals to restrain speculative flows, see also Eichengreen, Tobin and Wyplosz, loc. cit., and for sceptical reactions, see the articles by P. Garber and M. P. Taylor, and by P. B. Kenen, in the same issue of The Economic Journal.

22/ Economic Commission for Europe, Economic Bulletin for Europe, vol. 46 (1994), pp. 4-5.

23/ For an extended discussion of these issues, see R. Kozul-Wright, "Transnational corporations and the nation state", in J. Michie and J. Gireve-Smith, eds., Managing the Global Economy (New York and Oxford, Oxford University Press, 1995), pp. 135-171.

24/ Economic Commission for Europe, Economic Survey of Europe in 1993-1994, (United Nations publication, Sales No. E.94.II.E.1), chap. 5.

25/ Economic Commission for Europe, Economic Survey of Europe in 1989-1990 (United Nations publication, Sales No. E.90.II.E.1).

26/ M. Belka, S. Estrin, M. E. Shaffer and I. J. Singh, "Enterprise adjustment in Poland: evidence from a survey of 200 private, privatized, and state-owned firms", CEPR Working Paper, No. 658 (London, September 1994).

27/ FDI is generally seen as a more stable component of foreign investment flows. There are grounds for believing this to be so in many cases, but FDI can be made with a relatively short time horizon and there is some evidence that there is little difference in the relative stability of different types of foreign investment. See S. Claessens, M. P. Dooley and A. Warner, "Portfolio capital flows: hot or cold?", The World Bank Economic Review, vol. 9, No. 1 (January 1995), pp. 153-174.

28/ For a discussion of the strategic importance of financial reform, see Economic Commission for Europe, Economic Bulletin for Europe, vol. 46 (1994).

29/ For the outlines of such a programme on a regional basis, see "Ways and means of promoting the expansion of trade in transition economies", Parts I-III (E/ECE/1311, 17 February 1995), a report presented to the Economic Commission for Europe at its fiftieth session.
