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The Economic Transformation of Eastern Europe

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The countries of Eastern Europe, and particularly the more developed ones—Czechoslovakia, Hungary and Poland—are undergoing three distinct but interrelated processes. The first is the process of transition, whereby the system of central planning and the ideologically-based primacy of social ownership of capital is replaced by a system where markets and market-based allocations of resources play a primary role and where private ownership of the means of production assumes a significant, if not at first predominant, role. In the long run, the success of this transition is the critical economic issue for the region. Short-term changes in output or economic welfare cannot mask either the shortcomings of the old economic system or the potential inherent in the market system. Nevertheless, the potential that markets and private property hold for the economic future of Eastern Europe will not be realized quickly or easily. A measure of economic knowledge, wise governance, and policymaking and a political system that can maintain a balance between responsiveness to the popular will and political expediency are the least that will be needed.

The second economic process going on in Eastern Europe involves managing the short-term macroeconomic shocks to which the region is subject. Framing the proper responses to these shocks is first, for the

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rejection of Communism had much to do with its economic failures. Thus today’s governments in Eastern Europe face a legacy of deteriorating economic conditions.

In Czechoslovakia and Hungary the past decade has yielded stagnant or deteriorating incomes, while in Poland the worsening of economic performance has been, as Table 1 shows, more precipitous. Less easy to quantify but equally serious has been the worsening environmental degradation of the region, the extent of which is evident even to the casual visitor and the effects of which have resulted in a dramatic decline in health for the region’s populations. To these long-term trends are now added inflation and unemployment. Having put up with the empty economic promises of the Communist regimes for over 40 years, and having experienced declining living standards for the past 10 to 15 years people in these countries are impatient for palpable signs of economic progress. It is unlikely that they are willing to accept long-term solutions that call for greater sacrifice today in return for promises of a better, but distant, future. Thus, governments in the region have only a limited amount of political capital and limited room to maneuver. Policymakers must seek to produce concrete and visible gains in the short run without adopting policies that are expedient or simply benefit politically powerful groups at the expense of appropriate long-run policies.

The third process is one of rejoining the world economy. The pattern of trade that emerged in the Communist era, emphasizing the role of the Soviet Union as the major trade partner of the Eastern European countries and, perhaps more perniciously, limiting economic competition from and with market economies, was a major source of the economic shortcomings of the Eastern European economies. Thus, a redirection of trade toward the West offers both an injection of modern technology and know-how, as well as of competition and economic rationality that should benefit the countries of Eastern Europe. Unfortunately, the potential benefits of this turn toward the West are being outweighed by the negative consequences of its abrupt and partly involuntary nature, which is the result of the collapse of the Soviet economy and of the Council for Mutual Economic Assistance
The Economic Transformation of Eastern Europe

(CMEA), the organization that facilitated trade among these countries. This collapse of trade has led both to a more drastic shift in trade patterns and to a greater decline in the volume of trade of these countries than was desired. Moreover, the shift toward the West has occurred at a time when western economic growth has slowed, thus diminishing the short-term capacity of world markets to absorb the exports of Eastern Europe.

Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Czechoslovakia</th>
<th>Hungary</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>3.1</td>
<td>1.2</td>
<td>-2.3</td>
</tr>
<tr>
<td>1980</td>
<td>2.9</td>
<td>-0.9</td>
<td>-6.0</td>
</tr>
<tr>
<td>1981</td>
<td>-0.1</td>
<td>2.5</td>
<td>-12.0</td>
</tr>
<tr>
<td>1982</td>
<td>0.2</td>
<td>2.6</td>
<td>-5.5</td>
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<tr>
<td>1983</td>
<td>2.3</td>
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<td>3.5</td>
<td>2.5</td>
<td>5.6</td>
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<tr>
<td>1985</td>
<td>3.0</td>
<td>-1.4</td>
<td>3.4</td>
</tr>
<tr>
<td>1986</td>
<td>2.6</td>
<td>0.9</td>
<td>4.9</td>
</tr>
<tr>
<td>1987</td>
<td>2.1</td>
<td>4.1</td>
<td>1.9</td>
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<tr>
<td>1988</td>
<td>2.4</td>
<td>0.3</td>
<td>4.9</td>
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<tr>
<td>1989</td>
<td>1.3</td>
<td>-2.0</td>
<td>0.3</td>
</tr>
</tbody>
</table>


These three processes interact with each other, often in ways that seem unpredictable to policymakers and that are not clearly understood by the population. Thus, if we are to have a clear view of Eastern Europe's current economic situation and a realistic appraisal of its future prospects, we need to disentangle the processes in order to understand how they are likely to influence Eastern Europe's economic future.
The Economics and Politics of Transition

A transition from a socialist, centrally planned economy to a capitalist, market-oriented one requires the creation of markets and of the institutions that support and facilitate market processes; the privatization or at least "de-etatization" of productive capital; and the creation of a set of mechanisms that will allow the government to maintain control over macroeconomic aggregates and to provide an appropriate level of public services without interfering excessively with microeconomic processes in the economy.

The Conceptual Issues of Creating Markets

One difficulty with creating markets is that freeing prices tends to create inflation, which may cause social backlash against reform or unleash an inflationary spiral that would destroy markets. In some countries, such as pre-1989 Poland, there was a severe macroeconomic disequilibrium, characterized by large cash holdings among the population, a shortage of goods at existing and artificially low prices, and a large government deficit that continued to fuel the growth of the money supply. Even in countries such as Czechoslovakia and Hungary where there was less of an imbalance between the demand for and the supply of goods, the existing pattern of prices was badly distorted. Prices of food, housing, and energy were too low, largely the result of consumption and production subsidies.

Thus, the liberalization of prices would have two effects. The first would be to increase the general price level so as to reflect the existing monetary overhang. While such an increase, if matched by equal increases in real wages, acts largely to reduce the value of cash hoards, it nevertheless has important implications for the distribution of income because older or wealthier individuals, who have a greater stock of savings, lose at the expense of younger or poorer individuals. At the same time, it is not possible to tie all incomes to the price level, and thus pensioners and public servants, whose incomes are relatively inflexible in nominal terms, tend to be obvious victims of such a gen-
eral price increase. The latter groups, along with other low-income individuals, are also especially vulnerable to the second effect of price liberalization, the change in relative prices that operates largely to raise the price of highly subsidized necessities such as food, clothing, and shelter. Since such goods make up a very large share of the budget of low-income consumers, price reform is seen as causing large and, from the standpoint of social justice, unacceptable changes in the distribution of income. Indeed, to the extent that the former low prices of consumer goods were maintained by a combination of shortages, subsidies, and low wages, raising prices to unsubsidized market levels can be seen as replacing an invisible system of taxes with one that is visible and thus more unpopular.

Changes in prices will also alter the financial fortunes of many firms and of the workers employed by them. However, there are as yet no clear provisions for bankruptcy. It is true that laws on bankruptcy have been enacted in most Eastern European countries, but there have been few or no bankruptcies. In part, this is due to a misunderstanding of managerial incentives for declaring bankruptcy. Specifically, the Eastern European bankruptcy legislation implicitly assumes that it will be the managers of loss-making firms who will declare their firms bankrupt. However, both to retain their jobs and because of unfailing human optimism, it is not the managers of loss-making firms who opt for bankruptcy, either in western market economies or in Eastern Europe. Instead, it is the creditors of the failing firm who force the bankruptcy, largely in an effort to obtain some part of the equity in the failing firm, so as to secure the loans they have made to the firm. Unfortunately, Eastern European enterprises, like the majority of state-owned firms in other countries, lack equity; they are financed largely by debt, and consequently bankruptcy provides little prospect to creditors of obtaining assets that can cover any significant portion of their loans to the failing firm. Thus, like the managers of the failing firms, banks and other creditors are forced to rely on optimism and to hope that debtor firms can return to profitability. As a consequence, the structure of production fails to adjust to price signals as rapidly as it should while, at the same
time, the financial system is increasingly undermined by the accumulated debt of unprofitable firms.

Finally, the creation of markets requires the creation of institutions such as commodities and stock exchanges and the enactment of business and commercial laws. The complex task of creating this institutional and legal infrastructure entails both conceptual and practical difficulties. On the one hand, it is argued that the most modern institutional arrangements available in the West, and particularly in the European Community (EC), with which many Eastern European countries wish to align themselves, should be introduced as quickly as possible. The argument for this strategy is that it will provide institutions which, because of their modernity, will last a long time and provide a stable institutional framework for the development of the market. Moreover, institutions will facilitate trade and investment with the West due to their similarity to western laws and institutions. The pursuit of this strategy has led to some seemingly bizarre results. For example, the organization and high level of computerization envisioned in the legal framework creating a stock exchange in Poland ensure that it can handle a volume of transactions comparable to the United States stock exchanges; yet the number of shareholders and the volume of stock currently bought and sold in Poland are such that they could be quite adequately transacted and recorded by means of the bookkeeping technology of the Victorian era.

This dichotomy between the most up-to-date laws and institutions and the primitive state of the market has led some economists to argue for a more evolutionary approach. They point out that institutions arise and disappear in response to the specific needs of their environment. Under a given set of economic conditions, a given institution will arise if it can provide a useful service at minimal resource cost, and the same institution will be cast aside when its services either are no longer needed or are provided more cheaply by some other institution. Thus, for example, at some volume of stock trades, an informal system of curb brokers, such as the precursor of the New York Stock Exchange, may be most efficient, while only with a higher volume of trades do a formal stock exchange and computerization make economic sense. In a
more general sense, since the Eastern European economies differ from those of the West in more fundamental ways, such as the level of development, the degree of privatization, the size distribution of firms, and the extent of foreign ownership, it is argued that a more evolutionary approach permitting institutions appropriate to this environment to arise and compete for survival would make greater sense than would the wholesale importing of western institutions.

The drafting of laws has been characterized by a similar debate. Some argue that foreign laws, often those of EC countries, should simply be translated and enacted *tout court*. The difficulty is that there are insufficient legal scholars to translate the necessary laws so that lawmakers are forced to draft their own instead. In any case, most laws are rather simple frameworks that must be filled in through the accumulation of precedents that arise as the courts apply the laws to concrete situations. This fact has led to efforts to revive the business codes existing in these countries during the inter-War period. The problem with this approach is that such codes are often outdated and thus do not apply to modern-day business practices or to modern technologies. Moreover, they differ from EC law and thus tend to create obstacles to trade between Eastern and Western Europe.

**The Conceptual Issues of Privatization**

Even more difficult from a conceptual point of view than the creation of markets is the privatization of state-owned property, which includes not only virtually all industrial enterprises, but also agricultural and urban land, as well as commercial and residential buildings.

Privatizing this property involves difficult tradeoffs between three desiderata: equity, efficiency, and practicality. An equitable distribution of property would be one that was fair to the residents of the country. One element of fairness is that owners of property seized by the Communist regime should be entitled to some form of restitution. While the notion of restitution seems quite reasonable, its implementation has been something of a political football. Thus, different types of property, e.g., large vs. small firms, agricultural vs. urban land, as well as different property owners, e.g., those who emigrated vs. those who did
not, foreign vs. domestic, those whose property was seized after the Communist takeover vs. those whose property was seized beforehand, most notably Jews whose property was seized during the Nazi occupation, have been treated differently by the legislation on restitution. There is also the problem that simply returning specific pieces of property to owners after 40 years may either undercompensate them if, for example, their property has been run down, or overcompensate them if the state has made significant investments in the property over the past 40 years. In general, small shops and houses have been the easiest to return to former owners. Industrial property is more problematic and agricultural land is likely to be the thorniest issue of all.

Once restitution has been carried out, it then remains to put the rest of the assets to be privatized into the hands of the public in a way that is equitable. It is generally agreed that distributional equity in this case means allocation that gives each citizen a relatively equal share of the value of assets to be privatized. One immediate obstacle to this is that it is impossible to value the assets being privatized with any degree of accuracy. Each firm, of course, has a book value, but in the distorted economic systems of Eastern Europe, even more than in market economies, the book value has little to do with the economic value of an asset. Thus, any privatization scheme, other than the cumbersome one giving each citizen an identical portfolio of assets being privatized, stands the chance of being rejected on grounds of \textit{ex ante} inequality. Worse, once markets are introduced, the economic, rather than bookkeeping, values of the privatized firms will reveal themselves as share prices of profit-making firms rise and those of unprofitable firms sink. The result may be an exceptionally rapid, and therefore socially and politically unacceptable, redistribution of wealth from one that was \textit{ex ante} relatively egalitarian to one that has become, \textit{ex post}, quite unequal.

A major objective of privatization is to improve the efficiency of the firms. Under state ownership, firms were neither subject to the threat of bankruptcy nor induced to maximize profits. Rather, their managers pursued policies that sought to extract financial resources from the owner, the state, in return for fostering social objectives, such as high
levels of employment or exports or the production of desired products, all of which tended to interfere with profit maximization. Since private owners, unlike the state, do not have "deep pockets," privatized firms will face the threat of bankruptcy. Moreover, private owners can be expected to exercise greater control over managerial objectives and performance. The difficulty with this theory of corporate governance, as the extensive literature on the separation of ownership and management in the modern corporation teaches us, is that many owners, each with a relatively small stake in a corporation, have little incentive to monitor the behavior of managers and little possibility for mobilizing their fellow stockholders to take action to replace ineffective managers. Thus, what is required is some concentration of shares in the hands of one or more large shareholders to whom the benefits of monitoring managerial behavior exceed the costs and who can influence the selection of managers. Such a concentration of shares, however beneficial it may be from the standpoint of efficiency, of course is inconsistent with the broad and relatively egalitarian distribution of assets required by equity considerations. Moreover, large owners are also likely to attempt to utilize political pressure to protect their assets against the difficulties many firms will face during the transition process.

Finally, there are problems of timing. Privatization can come about partly from the bottom up, as small private businesses emerge and expand, but their ability to do so will surely depend on the existence of a "level playing field" between them and the large state-owned firms. Moreover, it will be a long time before such small businesses can grow to a size where they can take over large state-owned firms. Thus, it is the de-etatization of the existing industrial stock that will largely determine the pace of privatization. Therefore, putting the state-owned firms into private hands has to be done quickly, forcing a certain measure of arbitrariness and pragmatism into competition with the objectives of equity and efficiency.

Given these competing objectives, it is not surprising that a rather disparate set of alternative proposals for privatization has appeared. Among the most radical privatization proposals to come forward is the so-called voucher scheme, in which every citizen would be given
vouchers with some nominal value attached to them to be used to bid for shares of the firms being privatized. The scheme could be modified so that risk-averse voucher holders could obtain either fixed-interest securities or shares of mutual funds that would use the vouchers of the participants to purchase shares of the firms. Moreover, foreign investors could be accommodated, either by allowing them to buy stock at some premium over the price paid by residents, or by allowing them to bid for vouchers offered either by the state or by the citizens of the country.

The voucher scheme is attractive primarily because it provides for a quick and extensive privatization of state property while simultaneously establishing at least the relative values of firms, an excellent starting point for the creation of a viable stock market. The proposal is also appealing in terms of *ex ante* equity, since everyone starts off with the same number of vouchers. *Ex post* equity is less of a problem since it depends largely on the choices made by each individual regarding the allocation of his or her vouchers. Nevertheless, given the lack of any useful information about the economic performance or prospects of the firms being privatized, it can be argued that citizens are being forced to determine their future wealth on the basis of little more than an arbitrary game of chance. Finally, the voucher scheme is appealing because it creates a broadly based “people’s capitalism,” so that, with everyone a shareholder, there should be strong political and social support for an economic system based on markets and private property.

The shortcomings of the voucher scheme are equally clear. First, the broad shareholding that it implies means that shareholder monitoring of managerial performance will be weak, and managers will tend to be unresponsive to the objectives of the owners. Second, the distribution of wealth to the population is seen by critics of the voucher scheme as being inflationary since, with greater wealth, people will wish to consume more.

A possible solution to the efficiency defects of the voucher scheme is to give the stock of the firms being privatized to holding companies, which would then be able to exercise effective oversight of managers. The public would receive shares in the holding companies. The use of
holding companies also has serious shortcomings. It is possible that holding companies would collude with management of the firms they own, preferring to keep poorly performing firms afloat rather than making the difficult decision to close them down. Moreover, the power wielded by holding companies would be enormous and, in the end, the holding companies might well reproduce many of the shortcomings of the old Communist system, with state control practiced through the holding companies.

The alternative to the voucher scheme is a program of selling state-owned enterprises to the public. A state agency, possibly aided by foreign consultants and bankers, would establish a fair market value for state-owned firms and then sell its shares to the public, including possibly to foreigners. The principal advantages are that the scheme is non-inflationary and, indeed, raises revenue for the government, and that large stockholders are likely to emerge, promoting enterprise efficiency.

This approach has shortcomings in equity and practicality. If the shares are to be sold, then the wealthier members of society will emerge with the majority of the shares. Not only is this rather unegalitarian, it also favors those who had high incomes under the former Communist regime. Since these individuals were often part of the old political and economic power structure, the sale of state-owned firms is often referred to as the "embourgeoisment" of the "nomenklatura" (those appointed to high positions by the Communist party). Thus, the system not only fails to provide much equity, but appears to reward those who, to most people in Eastern Europe, least deserve it. A further problem is the role of foreigners who, because of the undervalued currencies of the Eastern European countries, and because of their access to international credit markets, can easily outspend the residents of these countries in bidding for firms being sold.

The scheme is also short on practicality. Firms put up for sale will be difficult to value, and the process of selling them will necessarily be time-consuming, meaning that privatization will be slow. In Hungary, the valuation of firms, especially those sold to foreigners, has become the object of bitter controversy, further slowing the process. The popu-
lation of the Eastern European countries lack the liquid assets to buy shares in firms being privatized and, given the uncertain economic future of these countries, they seem disinclined to trade cash for risky shares.

**The Conceptual Issues of Macroeconomic Management**

The change from plan to market also means that both the sources of government revenue and the size and nature of government expenditures must change. Under the old system, the principal sources of revenue were the turnover tax, a highly variegated set of levies on sales of consumer goods, and a set of levies on the assets and profits of enterprises. To move to a system of uniform sales or value-added taxes and of taxes on enterprise profits will, in a market environment, involve a good deal of uncertainty, not the least because neither consumption nor profits is likely to be predictable in a period of chaotic transformation. At the same time, a new system of income taxes must be introduced to equitably spread the tax burden to individuals who engage in private enterprise or who own large amounts of stock. What rates to set for these taxes, and what government revenues will be are difficult questions to answer given the lack of experience with a market economy.

There will be equal uncertainty on the expenditure side. While the state budget should no longer have to subsidize inefficient industries and the consumption of food and other consumer goods, new and more volatile claims on the government will appear. The creation and financing of a social safety net is critical, both to provide for those suffering from the new phenomenon of unemployment and to keep the incomes of pensioners and the poor from being overtaken by inflation.

In addition to uncertainties about the government's revenues and expenditures, policymakers will face uncertainty about the efficacy and impact of traditional tools of macroeconomic policy. Although changes in the money supply, interest rates, government expenditure and taxes, and the exchange rate will have some effect on aggregate economic activity, the magnitude of these effects cannot be predicted *ex ante*. In western economies, economists have had a long period of experience
with these policy tools, which enables them to make some estimate of the impact of changes of policy on economic activity, although there is still considerable uncertainty and controversy about macroeconomic policy. This uncertainty will be considerably greater for Eastern European policymakers who must deal with much larger macroeconomic shocks using tools at whose precise effects they can only guess.

As these complex problems of transition and integration into the world economy are being worked out in the reforming countries, they have an impact on short-term economic developments and, simultaneously, the success of the transition measures is strongly affected by short-term economic developments. Thus, it is to the analysis of these short-term trends and their interaction with the transition measures that we now turn.

Macroeconomic Developments in Eastern Europe

In each of the three Eastern European countries undergoing the transition to capitalism, the transition measures have been to some extent limited by, but also have themselves strongly influenced, the macroeconomic environment.

Czechoslovakia

Of the three Eastern European countries undergoing transition, Czechoslovakia was the least prepared intellectually to undertake such a step. Few people within or outside the country anticipated the rapid collapse of the government that occurred in the winter of 1989. The economy, while lacking dynamism, at least was not in the state of crisis that characterized neighboring Poland, and the Communist party showed few signs of concern. Moreover, Czechoslovak economists had been unable to openly discuss measures for even modest reform, much less for the transition from communism to capitalism. The regime installed in the wake of the 1968 Warsaw Pact invasion of the country had purged many of the leading reform economists, consign-
ing some of them to manual labor, and those who remained in the profession clearly understood that economic reform was a politically sensitive subject best avoided by economists.

It is thus understandable that 1990 was a year of slow groping toward an acceptable reform package. Early in the year, two competing packages were put forward, one popularly associated with Valtr Komarek, the popular head of the Forecasting Institute of the Academy of Sciences and Deputy Prime Minister in the government that took power in the wake of the “Velvet Revolution,” the other with Vaclav Klaus, the articulate if acerbic Finance Minister and self-proclaimed disciple of Milton Friedman. The conservatives who sided with Komarek preferred a slow transition process where a period of some eight to ten years would be required to implement structural changes that would eventually permit the freeing of prices. In these proposals, there also was some searching for a “third way,” some means of combining the social equity and egalitarianism of socialism with the efficiency of the market, in part reflecting the slogan of the reformers of 1968 who had sought to create “socialism with a human face.” Privatization was also to proceed relatively slowly, with state-owned enterprises gradually being sold off to domestic or foreign buyers.

The more radical proposals called for a more rapid elimination of price subsidies and the freeing of prices within four to five years, a much more rapid privatization accelerated by the use of a voucher scheme and a sharp devaluation of the Czechoslovak koruna in order to set the stage for its convertibility.

During the first half of 1990, progress on resolving the conflict between the conservatives and the radical reformers moved slowly, in large part because the political situation was dominated by the Civic Forum, an umbrella organization for all the groups who had opposed the Communists. In such a heterodox amalgam of views, compromise rather than choice was preferable, and thus hard decisions were often difficult to reach. Moreover, until the June 1990 elections, the rump Parliament was loath to take any important policy measures. Since the parliamentary elections and the split of the Civic Forum, with a group headed by President Havel favoring more gradual and measured
reform and the remainder siding with Vaclav Klaus, the reform has begun to move forward along the agenda set out by the radicals.

In the summer of 1990, food and energy subsidies were eliminated, leading to a sharp jump of more than 25 percent in prices for these items. This tended to squeeze the profits of firms dependent on energy inputs, since their output prices remained frozen. A further price liberalization was introduced in January 1991, leading to another surge of inflation, with food prices increasing by 30 percent in three weeks. Because the government is pursuing a strongly anti-inflationary policy, it is hoped that these are one-time price jumps rather than the precursors of an inflationary spiral.

Privatization has also begun. Parliament passed a restitution law, which cleared the way for the so-called small privatization to begin. Under this program, retail and service establishments were auctioned off to the public. The auctions attracted a good deal of public interest and appear to have had the hoped-for result of improving the assortment and quality of service in these establishments. Large privatization, meaning privatization of large state-owned enterprises, will be carried out with the aid of a voucher scheme to promote a rapid and broad diffusion of ownership.

Finally, in 1991, the Czechoslovak koruna was made internally convertible at a rate of 28 koruna/$. The convertibility is somewhat limited in that Czechoslovak firms are required to turn their foreign exchange earnings in to the state bank, but it is a step toward the liberalization of the foreign trade regime.

The macroeconomic policy of the reforms has been as conservative as their transition program has been radical. This policy stance was dictated in part by the economic situation that the new regime inherited from the Communists: a relatively small overhang of money in the hands of the public, little external debt, and stable prices. These positive inheritances the reformers could not afford to squander, since public opinion was clearly resistant to the outbreak of inflation at a level such as in neighboring Poland, or to a level of foreign debt that existed in both Poland and Hungary. Thus, the government ran in 1990, and is hoping to run in 1991, a budget surplus. The money supply has also
remained stagnant, resulting in the lackluster macroeconomic performance shown in Table 2.

**Table 2**  
**Macroeconomic Indicators for Czechoslovakia, 1989-1991**

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Net Material Product</td>
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<td>-3.3</td>
<td>n.a.</td>
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<tr>
<td>Consumer Price Index</td>
<td>1.4</td>
<td>17.0</td>
<td>53.1</td>
</tr>
<tr>
<td>Employment</td>
<td>0.4</td>
<td>-2.7</td>
<td>n.a.</td>
</tr>
<tr>
<td>Nominal Wages</td>
<td>2.5</td>
<td>3.8</td>
<td>n.a.</td>
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</table>


With the government's economic policy locked into an anti-inflationary posture, the level of output and employment in Czechoslovakia has been determined largely by the effects of the transition and by exogenous events. One outcome of the price reforms has been to create large fluctuations in consumer demand. In 1990, consumer demand was strong, as people sought to stock up on goods in anticipation of the price increases scheduled for January 1991. Then in January, consumer demand collapsed, because of both higher prices and consumer satiation. With the government unable to intervene to stimulate demand, output, which had held relatively steady in 1990 thanks to the purchases of consumers, plunged and industrial production fell sharply, as Table 3 clearly shows. Moreover, inflation has increased and unemployment has started to become a serious problem, with the level of unemployment increasing from month to month as may be seen from Table 4.

**Table 3**  
**Monthly Industrial Production in Czechoslovakia, 1989-1991**  
*(1989=100)*

<table>
<thead>
<tr>
<th>J</th>
<th>F</th>
<th>M</th>
<th>A</th>
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<th>J</th>
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</table>

In addition to the collapse of consumer demand, the collapse of exports to the Soviet Union and the other Eastern European countries could not be offset completely by strong consumer demand in 1990 and not at all in 1991. The decline in Soviet demand for Czechoslovak exports was particularly serious in Slovakia, whose industries were heavily oriented toward the production of goods, including armaments, for the Soviet Union. The collapse of this trade has had a particularly severe impact on unemployment in Slovakia, exacerbating tense relations between Czechs and Slovaks.

Table 4
Monthly Increases in Unemployment in Czechoslovakia, 1990-1991
(In thousands)

<table>
<thead>
<tr>
<th></th>
<th>J</th>
<th>F</th>
<th>M</th>
<th>A</th>
<th>M</th>
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<th>S</th>
<th>O</th>
<th>N</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>7.4</td>
<td>8.8</td>
<td>12.6</td>
<td>19.4</td>
<td>27.4</td>
<td>43.9</td>
<td>57.3</td>
<td>67.2</td>
<td>77.0</td>
</tr>
<tr>
<td>1991</td>
<td>119.0</td>
<td>152.3</td>
<td>184.6</td>
<td>223.2</td>
<td>-</td>
<td>-</td>
<td>-</td>
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</tbody>
</table>


It is, of course, too early to tell whether the economy can recover from the decline in output and the rapid increase in prices. Public opinion polls and government statements both suggest that the country is bracing for difficult times ahead. With macroeconomic policy locked into a deflationary stance, there are few ways in which output growth can be generated through increased demand.

Hungary

Unlike Czechoslovakia, which had much to do to catch up with thinking about transformation and reform, Hungary was the leader of Eastern Europe both in the theory and application of the market to a socialist economy. However, hampered by both the caution of domestic politicians and the limits to reform implicitly imposed by the Soviet Union, Hungary’s road to the market, begun in 1968 with the introduction of the New Economic Mechanism (NEM), has been a slow and tortuous one.
On the positive side, relative prices were less distorted than in other Eastern European countries, the role of small-scale private enterprise in services and in industry was quite large, and the Hungarian economics profession was made up of a large number of well-trained individuals who were familiar with western economic theory and who had regular contacts with western economists.

On the other side of the ledger, the greater sophistication of Hungarian bankers and economists did not help them to avoid incurring a foreign debt of over $20 billion, larger on a per capita basis than that of Poland. As a result, for the past 10 years, Hungary has had to follow a deflationary policy of limiting investment and output growth so as to restrain the demand for hard-currency imports. This led to a long-term stagnation of living standards and the servicing of Hungary's foreign debt has thus assumed such overwhelming importance that it virtually dictates macroeconomic policy.

Hungary has been following a policy of gradual and slow price adjustments and liberalizations since the introduction of the NEM in 1968. Since price liberalizations generally mean price increases, the government has sought to offset the effects of inflation on poor people and pensioners by simultaneously raising minimum wages and pensions, although this policy is constrained by the need to keep aggregate demand in check. Moreover, despite the long record of price liberalization, the reformers have faced seriously distorted energy and raw materials prices as well as distortions in rents, some food prices, and a patchwork of firm-specific taxes and subsidies that hamper rational economic calculation. The Antal government has not had great success in attacking these distortions, its most humiliating setback occurring when a protest by Budapest taxi drivers forced the cancellation of a 60 percent increase in gasoline prices.

Small privatization is well-advanced in Hungary, with private restaurants and retail outlets having been permitted for many years. More recently, private small-scale provision of services and even the manufacture of goods was permitted. Big privatization, the de-etatization of Hungary's large state-owned enterprises, is proceeding more slowly, reflecting the philosophy of the ruling Democratic Forum party. Privat-
tization of large state-owned enterprises was allowed by the Transformation and Corporation Laws, which set out the terms under which a state-owned enterprise could be converted to a corporation whose stock would then be sold to domestic or foreign investors. This proved to be a most controversial measure leading to public outcry and scandal. In some cases, managers and workers were alleged to have sold enterprises to themselves at artificially low prices; in other cases, managers allegedly sold their firms to foreigners at low prices in order to ensure their, and their workers', job security. A State Property Agency was organized in early 1990 to regulate privatization and to eliminate abuses of the Transformation Act. However, its head resigned shortly after taking office as the result of controversy over the privatization of Ibusz, the state travel agency, whose shares were quoted on the Vienna stock exchange at a premium of 200 percent over their original offer price. The Property Agency plans an orderly sale of enterprises, but the pace envisioned is so slow that, for the next 10 years or so, the bulk of large enterprises will remain in state hands. Since the more viable firms will be sold first, the state will increasingly come to hold Hungary's industrial cripples, and whether the government budget can stand the fiscal drain and the political system the pressure that workers in these industries will exert remains to be seen.

The macroeconomic performance of the Hungarian economy reflects the dilemmas and vacillation of the government. The level of output continues to decline, especially in industry, and so does industrial employment, as the figures in Table 5 indicate. To some extent in Hungary, as in the other two countries, these figures must be interpreted with some care. The existing statistical systems were conceived for a Communist economy where virtually all industrial activity took place in a relatively small number of large enterprises, and the reporting and compiling of production data for new, small private and cooperative businesses are in their infancy. Some estimate of the magnitude of this reporting gap in the case of Hungary can be gleaned from Note a in Table 5, which indicates how industrial production would have looked in 1990 had small businesses been more fully included in the measure of industrial output.
While industrial output is falling, inflation continues apace, creating a dilemma for the government. In 1990, the Antal government introduced a strict monetarist policy, which reduced bank lending to enterprises and slowed money growth. Nevertheless, inflation in 1990 was nearly 30 percent and the further elimination of subsidies planned for 1991 led most Hungarian economists to predict a rate of inflation between 30 and 40 percent for that year. The government, however, abandoned its tight monetary policy in early 1991 in an effort to stimulate production, particularly in the export sector and among the more profitable firms. Despite this reversal of tight money policies, inflation in 1991 appears to be abating. At the same time, neither unemployment nor industrial production are showing signs of recovery. Thus, the government, because of an inability to gauge the impact of policy measures and the lag with which they affect the economy, is forced to choose between two options. One is to assume that tight monetary policy is ineffective and to opt for easy money with the potential danger of inflation and the potential gain of higher employment and output. Alternatively, current developments can be interpreted as showing that monetary policy can, with a certain lag, fight inflation and that some monetary restraint ought therefore to be retained while waiting for the positive effects of the relaxation of the ultra-tight money policy of 1990 on production in the second half of 1991.
How much of the fall in industrial production in Hungary is due to domestic policies and how much to external events is difficult to judge, although it would seem reasonable to assign much of the blame to the collapse of trade with the USSR and with the other socialist countries. This decline in trade has been particularly large and difficult to adjust to for Hungarian heavy industry. The curtailment of credit by Hungarian banks, on the other hand, as in Czechoslovakia, has been a source of worry for managers. To a large extent, however, the worst effects of this policy on production have been mitigated by the expedience of firms delaying payments to their suppliers. While the long-term effects of such an expansion of interfirm credit can be catastrophic, such credits do not appear to be the source of the current problems of Hungarian industry.

There are also some bright signs in the Hungarian economy. The private sector has been relatively dynamic, with a rapid growth of output and employment that has as yet eluded official statistics. Moreover, unless Hungarian agriculture suffers either from excessive organizational change or a lack of industrial inputs, it too is capable of making a positive contribution to the growth of output and exports. Finally, Hungary has been especially successful in attracting major foreign investors: General Electric has purchased Tungsram, Hungary’s light bulb manufacturer; General Motors has invested in the huge Raba factory; and other western investors are participating in Hungarian banking, electronics, and telecommunications. Nevertheless, the slide in domestic output must be arrested and, since the economy is likely to suffer shocks to aggregate demand as trade with the USSR continues to decline, the only means of reflating the economy appears to be a rapid reorientation of trade toward the West or a domestic reflation spearheaded by foreign investment and consumer demand.

Poland

Poland is unique among the Eastern European countries in two ways. First, it entered upon its reform with a government that was perceived to be in a strong position to bring about a radical reform because it had a mandate from the population to bring about order out
of economic chaos. This mandate was based on the face that, prior to 1990, the economy had been operating on a self-sustaining inflationary spiral. Due to low consumer prices, the government had to subsidize production, which led to a large government deficit. This deficit was covered by printing money, leading to higher wages and costs, necessitating higher subsidies for producers, and setting off another round of the spiral. As Table 6 indicates, in 1989, inflation was high by any standard, but sales, and therefore production, increased very little, with most of the increase in sales coming in anticipation of the freeing of prices in 1990.

Table 6

Macroeconomic Indicators for Poland, 1988-1991
(Previous year or corresponding period in previous year = 100)

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Average employment</td>
<td>98.0</td>
<td>91.1</td>
<td>90.6 (J-M)</td>
</tr>
<tr>
<td>Average monthly wage</td>
<td>391.8</td>
<td>498.0</td>
<td>113.4a (J-M)</td>
</tr>
<tr>
<td>Consumer Price Index</td>
<td>351.1</td>
<td>684.7</td>
<td>112.7b 106.7b 104.5b 102.7b 102.7b</td>
</tr>
<tr>
<td>Real retail trade</td>
<td>109.0</td>
<td>74.9</td>
<td>70.3b 102.1b 106.0b 120.0b</td>
</tr>
</tbody>
</table>

a. Previous quarter = 100.
b. Previous month = 100.

This strong mandate and a perilous economic situation enabled the government to introduce a unique and radical freeing of prices in January 1990 that is popularly called the "big bang." Developed by the Deputy Prime Minister, L. Balcerowicz, the program freed prices while introducing strict controls over nominal wages. In view of the artificially low prices that had existed and of the huge overhang of unspent money in the hands of the population, prices of consumer goods almost doubled in January, but then inflation subsided to a rate of 5-10 percent per month, thus ending the hyperinflationary spiral.

This increase in prices, coupled with wage restraint, reduced both real incomes and private wealth held in the form of cash. As a result, consumer demand declined by over 20 percent. Polish firms responded to this decline in demand first by continuing production, some of
which was used to rebuild stocks that had been exhausted by the buy-
ing splurge that occurred just prior to the freeing of prices. However,
production for inventories could not continue forever and, with sales
remaining at low levels, firms began to reduce production and to lay
off workers. Table 7 shows the monthly evolution of unemployment in
Poland, which continues to increase. Like Hungary, Poland has
reached a point in the decline of output where some domestic or for-

Table 7
Evolution of Unemployment in Poland, 1990-1991
(Percent of economically active population unemployed)

<table>
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<tr>
<th></th>
<th>J</th>
<th>F</th>
<th>M</th>
<th>A</th>
<th>J</th>
<th>M</th>
<th>A</th>
<th>S</th>
<th>O</th>
<th>N</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>0.3</td>
<td>0.8</td>
<td>1.5</td>
<td>1.9</td>
<td>2.4</td>
<td>3.1</td>
<td>3.8</td>
<td>4.5</td>
<td>5.0</td>
<td>5.5</td>
<td>5.9</td>
</tr>
<tr>
<td>1991</td>
<td>6.5</td>
<td>6.8</td>
<td>7.1</td>
<td>7.3</td>
<td>7.7</td>
<td>8.5</td>
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</tbody>
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Among these positive results is the ending of high rates of inflation;
indeed, as Table 6 indicated, the rate of inflation appears to be abating
significantly in 1991. The creation of a rational price system in Poland
is a further benefit, although it has not yet been fully utilized to guide a
restructuring of Polish industry. Finally, the Polish zloty was made
convertible at 9,500 zloty/$, and it has depreciated only slightly since
January 1990. The cost of these gains in terms of lower living stan-
dards, unemployment and foregone production are, of course, quite
high, and the defeat of the Mazowiecky government at the polls by
Lech Walesa may reflect society’s evaluation of these gains and losses,
although Balcerowicz, the architect of the “big bang,” has retained
control over economic policy.

While the Polish government has acted to create markets in a radical
and seemingly quite effective way, there has been much less progress
on privatization. The broad outlines of the process are clear, but the
final enabling legislation is not as yet in place. The Polish procedure is
to mix equity with efficiency by combining sales of shares for cash
with a voucher scheme. When a firm is privatized, the bulk of the
shares will be sold, some to the public and a "core owner" who will own a large enough bloc to induce efficient monitoring of managers. Another bloc of shares, about 20 percent of the total, will be offered to the workers at preferential rates, and the remainder of the shares will be divided between the government and the Polish population, who will be given vouchers with which to obtain such shares. The strength of the procedure is that it provides for a broad and relatively egalitarian distribution of some of the stock of privatized firms with the concentration of shareholding needed for efficiency. The disadvantages are, first, the complexity of the scheme, which means that privatization will be a drawn-out process, and second, the coexistence of a variety of shareholders who acquire their shares under different conditions and with possibly quite different objectives.

Conclusions

In all three countries, the principal objective factors leading to the decline in economic activity are the collapse of trade with the USSR and the effects of anticipated price changes on consumption. While there is little that governments in the region could do to avoid these shocks, the decline in production in the region has somewhat mistakenly been attributed to the process of economic reform. The major economic danger facing Eastern Europe is that this mistake will lead policymakers to behave as if such declines are an inevitable aspect of reform and to delay the reflation of their economies, thus drawing out the hardships faced by the populations of the region and undermining popular support for the transformation to capitalism.

Integrating Eastern Europe into the World Economy

Sources of Pressure for Greater East-West Trade

The countries of Eastern Europe are being pushed and pulled into integrating themselves more closely into the international system of trade and finance. This is good news since, in the long run, such inte-
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Integration will stimulate investment, rationalize these countries' economies, and foster technological progress. However, in the short run, the forced pace of integration is likely to prove costly as many painful readjustments will have to be made.

The push for increasing economic relations with the West comes largely from the disappearance of the Council for Mutual Economic Assistance (CMEA), which promoted trade among the socialist countries, and from the collapse of the Soviet Union, above all, and of the other economies of the region. The CMEA mechanism had maintained a high level of trade among the Eastern European economies and between them and the USSR. It maintained this high level of trade by means of mechanisms that facilitated trade among nonmarket economies, including a system of trade agreements that enabled CMEA members to negotiate exchanges of goods among themselves and an international payment system based on the transferable ruble. While this system had its shortcomings, and was quite cumbersome when compared to western trading arrangements such as the EC, it did facilitate trade among these countries, even if its promotion of intermember trade was based in part on the diversion of Eastern European trade away from the West.

The CMEA mechanism no longer exists, in part due to the abolition of planning in the reforming Eastern European countries, which makes the government-negotiated trade agreements irrelevant. Moreover, in 1990, the members of CMEA agreed that, from 1991 on, intra-CMEA trade would take place at world market prices rather than at prices negotiated bilaterally among members, and that trade transactions would be paid for in dollars and not by means of the CMEA's transferable ruble. Thus, the two integrating mechanisms that bound the region's economies together, trade agreements and the transferable ruble system of clearing trade, were eliminated, and no new measures to maintain the level of intraregional trade have been brought forward to replace them.

In addition to the collapse of the CMEA, economic problems within the CMEA member countries have acted to reduce the volume of intraregional trade. The most important factor has been the economic
collapse of the USSR. The Soviet Union is the largest trading partner for each of the Eastern European countries, exporting fuels and raw materials to them in return for machinery and consumer manufactures. Due to declining Soviet oil production and the Soviet need to divert oil exports to the West to repay debts and to pay for western goods, Soviet oil deliveries to Eastern Europe fell by some 20 percent in 1990 and will fall again, possibly by even more, in 1991. Moreover, the Soviet Union reformed its trading system, decentralizing foreign trade decisions to individual firms, but these firms have no means of obtaining the currency needed to import from Eastern Europe. Thus, many large enterprises in Eastern Europe found themselves in a very difficult situation. Their supplies of energy and raw materials from the USSR were disappearing and Soviet customers, who had accounted for the bulk if not all of the output of these firms, were unable to purchase any goods.

In 1990, trade with other CMEA countries and with the USSR was further hampered by the realization that outstanding debts in transferable rubles would have to be repaid, after 1990, in convertible currencies. Thus, some countries were eager to export, but not to import, in order to build transferable ruble claims against their neighbors, and subsequently to convert these into claims payable in hard currencies. Of course, with all the Eastern European countries seeking to increase exports to each other and simultaneously to decrease imports from each other, the result was a decline in intra-Eastern European trade. The Soviet Union continued to be willing to import for transferable rubles, but its Eastern European partners did not want to accumulate large ruble claims against the USSR, fearing that both the difficulties faced by the USSR in paying western exporters and the political instability of the country would make eventual repayment of these claims highly uncertain. Thus, they unilaterally acted to reduce their exports to the USSR. Finally, the unification of Germany eliminated the German Democratic Republic from intra-CMEA trade, a process that began well before unification took place as East German firms canceled trade contracts for imports, realizing that they needed to husband their money for the difficult period they would face after unification.
The net effect of these forces is amply revealed by Table 8, which shows Polish trade cleared in transferable rubles and in dollars. The decline in ruble trade reflects both the physical decline in the volume of intraregional trade and its conversion from ruble to dollar clearing. Similarly, the expansion of dollar trade reflects both the increased volume of trade with the West and the greater use of hard currencies in intraregional trade. Despite the redirection of trade toward the West, the total trade of each of the countries of Eastern Europe has declined sharply in the past two years, with obvious effects on production and employment in the traditional export countries.

<table>
<thead>
<tr>
<th>Exports settled in:</th>
<th>Imports settled in:</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Transferable rubles</td>
<td>Convertible currencies</td>
<td>Transferable rubles</td>
</tr>
<tr>
<td>1989</td>
<td>102.3</td>
<td>102.7</td>
</tr>
<tr>
<td>1990</td>
<td>90.1</td>
<td>140.9</td>
</tr>
<tr>
<td>1991-J</td>
<td>29.1</td>
<td>168.7</td>
</tr>
<tr>
<td>-F</td>
<td>27.9</td>
<td>130.2</td>
</tr>
<tr>
<td>-M</td>
<td>11.7</td>
<td>108.2</td>
</tr>
<tr>
<td>-A</td>
<td>23.0</td>
<td>122.3</td>
</tr>
<tr>
<td>-M</td>
<td>19.6</td>
<td>135.5</td>
</tr>
<tr>
<td>-J</td>
<td>11.6</td>
<td>125.7</td>
</tr>
</tbody>
</table>


While the collapse of intraregional trade has sent Czechoslovakia, Hungary, and Poland searching for new markets in the West, such a westward turn has other, more positive motivation as well. The Eastern Europeans realize that much of their industrial technology and equipment is obsolete. Thus, they view trade with the West as indispensable to raising the productivity and competitiveness of their economies and ultimately to improving their living standards. Moreover, the Eastern Europeans believe that they must act quickly to become an integral element of the western economic system or they may lose their chance, if
not forever, then for a long time. The closer integration of the European Community, scheduled for 1992, has had a powerful impact on Eastern Europe because Eastern Europeans want to become part of the EC. They see themselves as sharing a common cultural heritage with the peoples of the EC, and they are caught up with the "Euro-optimism" that the 1992 program has engendered. At the same time, they believe that, as the forces let loose by EC-92 begin to integrate Western Europe more closely, it will become increasingly difficult for other countries to join. Thus, they believe that there is a narrow window of opportunity in which they must forge the economic links to the EC that will be the precursors to admission to full membership.

The Magnitude of the Restructuring of Eastern Europe’s Trade

To understand what the difficulties of redirecting Eastern Europe’s trade toward the West will be, we first must obtain a rough estimate of the volume and composition of the trade that is likely to be directed toward western markets. The CMEA accounted for about 8 percent of world trade. However, some 55 percent of the trade of the CMEA countries, or some 4 percent of world trade, was with each other. Due to the effects of CMEA integration, intraregional trade was some two to three times as high as it would have been had these countries not belonged to CMEA. Thus, the demise of the CMEA should reduce intraregional trade by about one-half, a volume of trade equal to slightly more than 2 percent of world trade. While the CMEA promoted intraregional trade, the total trade of its members was not excessively high, and it may be assumed that economic rationality would dictate that, rather than having their trade volume fall by 25 percent as the result of the demise of the CMEA, Eastern European countries would prefer to retain their present level of trade by redirecting transactions to the world market.

Thus, the first question is whether the redirection of goods equal to 2 percent of the world’s international trade toward the world market would be feasible. Since world trade grew by 6-8 percent per year in the 1980s, it would seem that a further increase of 2 percent, especially
if phased in over three to four years, would present few problems for international markets. However, once one moves beyond the aggregate and examines the commodity composition of the trade likely to be redirected, the problem appears to be more serious. Eastern Europe's exports to the USSR consisted largely of machinery and equipment. It is these export capacities in heavy industry that will have to seek new outlets in the West. At the same time, Eastern European imports from the USSR consisted to a large extent of fuels and raw materials, often at artificially low prices. When one examines the existing exports of Eastern Europe to the West, it quickly becomes evident that they consist largely of semi-fabricates and partially processed goods, not the machinery and equipment whose quality and technological levels, while suitable for the Soviet market, are unacceptable in the West. At the same time, imports of fuels and raw materials at world market prices will present a major inflationary shock for Eastern Europe.

The lack of competitiveness of Eastern European heavy industry on world markets means that policymakers in these countries face two choices. One of these is to attempt to make their heavy industry competitive on world markets by importing western technology, equipment and technical and business know-how. This, however, would be a vast undertaking, could proceed only slowly, and, most likely, could be achieved only by granting a good deal of influence to foreign firms and expanding foreign direct investment. Such a strategy may face political resistance from populations unused to foreign owners and to being buffeted by the impersonal workings of the world markets.

The other way of expanding exports to the West would be to expand those industries whose products Eastern Europe has been able to sell on world markets. The difficulty with this strategy is that such products come primarily from low-wage, low-skill, and low-technology industries. To expand such industries would be costly in terms of the costs of moving labor and capital from other sectors, and it would be unpopular because it neither accords with people's expectations regarding progress nor provides for the type of high-wage employment that is available in heavy industry. Moreover, it is precisely agricultural and
low-wage industrial products that face the greatest protectionist barriers on western markets.

Thus, the redirection of trade is likely to entail significant short-term costs in terms of unemployment, the shutting down of uncompetitive industries, and the need to devalue currencies to make Eastern European products competitive on western markets. The investment climate in the region will be a major determinant of how much western investment will be willing to undertake the rehabilitation of the region's industrial structure.

Conclusions

This essay has stressed the interaction of short- and long-term forces on the economic performance of Eastern Europe. While the catalog of problems and challenges facing the region seems, and indeed is, daunting, there are also positive elements at work. The populations of these countries are reasonably well educated and cultural levels are relatively high. People are hopeful of a better future, suggesting that they will respond to economic incentives. The most important issue for economic policymaking is that policymakers are able to understand the disparate forces acting on the region and frame the correct policy responses. Without a sound policy framework, the challenges facing the region surely cannot be overcome.