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The possibility of a soft revolution

by

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The paper takes up the most important current issues of the transforming post–communist economies, such as inflation vs. recession and unemployment, on the example of Czecho–Slovakia. Against the background of current literature of the subject and the experiences of the transforming economies the reasoning is deployed indicating the need for a soft path towards the market system with an important role of the state, as opposed to shock therapy head on towards radical liberalism.

1. Introduction

This paper had been written before the "Scenario for Economic Reform" was published by the ČSFR[1] government. That scenario contains a number of the suggestions made here, yet emphasizes zero money supply growth and restrictive incomes policies as instruments to control inflation. If these policies cause a recession, their goal of budget limitation will be hard to meet.

The government may not be concentrating enough on improving the terms of trade. Trade deficits spiraling with undervaluation of the currency will defeat

[1] this paper describes the situation in the yet existing federal Czecho–Slovak state; it can be assumed that in terms of perspective it applies equally to the future separate Czech and Slovak Republics (eds.)

the anti–inflation policy. Inflationary pressure will come from costs and scarcity, not from demand. But cutting subsidies is not inflation: the price is the same, only its incidence is moved. Wage increases by the amount saved on subsidies should not cause an inflationary spiral; this occurred in other countries due to price–wage anarchy and foreign debt.

My recent reading (Michael Porter: The Competitive Advantage of Nations; Abegglen and Stark: Kaisha, the Japanese Corporation; and W.E.Deming: Out of the Crisis) confirms the importance of job security and healthy domestic demand growth. The authors all emphasize the need to upgrade products, something even the planners did try to accomplish.

They point particularly to the intense rivalry in competitive industries. Some things are known about creating the conditions for such competitive spirit: high growth markets, but also forcing firms to cope with pressures and disadvantages. Allowing firms to raise prices, devaluate the currency, freeze wages and lay off workers will only make them weaker, as Porter shows in the case of Britain. Subjecting them to pressure forces the strongest to devise aggressive strategies to gain market share.

Abegglen and Porter agree on the role of government: to provide education and infrastructure, a steady economic policy without shocks or stop–go moves, to insist on better terms for companies who are negotiating foreign licencing agreements, and creating a favourable credit and fiscal climate for investment.

But governments have shown a poor record in identifying key industries and in regulating monopolies. In light of these findings the optimism in this paper about a central commission for economic reform may be excessive.

The strong industries of a country seem to develop organically in "clusters" of suppliers, competitors and sophisticated consumers around a certain national strength, according to Porter. Most of the successful competitive nations he cites have, like the ČSFR, poor natural resources but excellent human capital. But the other three bases required: strategy, structure and rivalry of firms, sophisticated consumer demand, and related and supporting industries, are weak. Such a constellation can take years to build. In most countries, strong industries first saturated their own markets before exporting.

All three authors emphasize the need for energies to be focussed on consumer satisfaction and production technology. The loss of competitive position by the United States is unanimously laid to short–term policies by firms, financial institutions and government. Such an error appears to be hidden in the arguably populist scenario proposal to sell shares in state companies at nominal prices to the public ("velky privatizace").

Aside from the false emphasis on speculative wealth, the simple fact that no economy has the cash on hand to buy its total capital stock, acquired over decades, means the issues will be grossly undervalued, leading to severe risks: insider trading by managers and politicians, followed by a sell-out to foreign capital in the secondary market. Thus my proposal:

Sell only 10% per year of the state firms in this way, giving people time to learn and to invest a realistic amount. The state share could be non-voting to facilitate replacement of incompetent managers, and the first shareholders and workers could be given first choice to buy shares in succeeding years in order to increase the incentive to build a successful business.

Macroeconomic policy has generally concentrated either on expansion by stimulating demand or on restricting growth to control inflation. Expansive policies aim to increase demand to absorb free labour capacity, to create jobs; restrictive policies "cool off" an "over-heated" economy by moderating increases in output and prices.

Such policies do not apply well to post communist economies. Planned economies have been characterized by 1) excess demand, 2) full employment, 3) an inelastic labour market, 4) insufficient output and 5) prices below world levels, a combination of conditions that would be illogical in a market economy. Because of these factors, expansive macro economic policies such as foreign borrowing could not be used without creating galloping inflation and devaluation. Restrictive policies cause social dislocation and a further slump in production. They do not apply since output and prices are already too low.

The planned economies are re-entering the world scene in a phase of accelerating integration and competition, which makes the promise of export-led recovery more challenging. Profit margins on low-quality goods are under pressure from automation and competition from emerging economies. The inelasticity of demand for some products and the need to pay for raw materials in hard currency cancel out the classical advantages of an undervalued currency and low wages. However, the world economy is healthy and demand for quality goods is strong.

Nations that have concentrated on aggregate demand and supply management but neglected microeconomic policies, such as the USA and the UK, are being outperformed by countries that have not experimented with doctrines such as free trade or tax cuts, but have used a corporatist or dirigiste approach to organizing a growth strategy. An example is Austria, with its accord between representatives of labour, industry and the political parties.

In view of these limitations, what policies should Central European countries now adopt? There may be a tendency on one hand to opt for outdated purist liberal laissez–faire positions that are too simple to work well in practice, and on the other to unconsciously try to carry out socialist ideals in naïve ways that could conceal unpredictable risks.

At the risk of being labeled an armchair economist, I would like to ask the Reader to entertain the hypothesis that there could be a way to adjust from the planned to market economy without severe dislocations in the economy. I am not talking about a simple formula, but a comprehensive approach based on understanding the interaction of numerous parameters. But I think it should be evident, that if policy–makers do not look for such a solution, it will not be found; and even the search for a smooth transition policy is likely to contribute to our understanding of the costs and benefits of policy alternatives.

The basic condition that could make such transition possible, is that these countries are characterized by both pent–up demand and underutilized capacity *pent–up supply* so that the right policy recipe could result in rapid growth.

One of the difficulties confronting us in attempting to find this way is the scarcity of minds containing expert knowledge of both systems. This means it is up to us to share knowledge to complete our picture of the actual workings of the two existing systems. For the reform countries this means learning about institutions such as anti–monopoly commissions, stock exchanges, and modern central banks. For westerners wanting to offer advice it means more detailed knowledge of the specific workings and parameters of the individual economies.

The main point made in this presentation is the need to create structures capable of channeling the forces released by liberalisation: agencies to limit monopoly and foster increased productivity and competition, in order to control inflation; deregulation and aid to small enterprise to increase the supply of services and demand for labour; capital markets to mobilize resources for investment; and an institution to coordinate the diversification of large firms, to foster optimal results from joint ventures; and radically mobilize export capacity.

Further the thesis is defended that since the planned economies are characterized by insufficient infrastructure and production capacity, recessionary macroeconomic policies are not what is needed. Rather new investment and growth should be goals.

If we compare the planned economies to a type of protected organism lacking in certain immunities or resistance to outside environmental factors, we have a graphic presentation of the difficulties caused by East–West encounters up to now. The heavy debt burdens of Hungary and Poland are a result of this type of encounter, where the foreign material — loans and capital equipment — could not be beneficially digested by the host economy. The early liberalization of foreign exchange in Yugoslavia probably fueled that country's disastrous inflation. These examples, if not the current near–collapse of the DDR economy, should give us pause. Returning to our medical image, we can see that a period of convalescence or as it were physical rehabilitation is needed before pushing the patient into a hostile environment.

Another consideration is that the slogan, things have to get worse before they get better, is not a law of nature, but rather an exception to the rule. If I want to start a car going forward, I don't shift into reverse — or into fourth gear, as the shock theorists would. Furthermore, a smooth transition is the only one governments have any chance of controlling.

2. The WIIW forecast – can the ČSFR catch up in ten years?

The following recommendations for a transition policy were cited in an interview with Prof. Levcik of the Vienna Institute for Comparative Economics (Wiener Institut für Internationale Wirtschaftsvergleiche, WIIW; in "Die Presse", 4.12.1989):

Large monopolies must be split up into smaller units; price subsidies to be abolished, as well as subsidies to firms, some of which must be closed; gradual introduction of market prices, especially where monopoly power has been broken; restrictive monetary and currency policy; commercial banks to be created, with reserve requirements preventing them from uncontrolled lending to firms; more foreign investment, and easier transfer of dividends. "Western firms want to sell their production from the East in the East, not in the West". Due to the inexperience of ČSFR management, some large firms might need to give free access to foreign capital to make them ready for the market.

I agree except to the points about closing firms and selling only in the East. Multinational companies are in principle indifferent to where they sell, they seek comparative advantage through international integration of their operations.

3. How much unemployment is unhealthy

Hastiness to close firms in an unfortunate symptom of our modern throw-away mentality. This was all too true of planned economies that were often unable to organize the logistics of repair, finding it simpler to tear old things down and replace them.

I can muster several arguments for a policy of turning companies around rather than closing them:

To foster competition we need to increase the number of firms, not decrease it.

We also need to radically increase the range and variety of products. Thus for every troubled firm there are theoretically unlimited alternatives: becoming a second supplier in a market dominated by another monopoly; introducing some of the many presently lacking goods or services onto the market; increasing the efficiency of its production and marketing in its existing product range.

Not to attempt this now, when the political conditions for it exist for the first time, and after investing subsidies for decades, would seem to be most inopportune. Not only the social-psychological costs of plant closings, but also the loss of institutional memory and specific experience would be great. Plant closings as a rule ought only start after competitive market conditions appear, as a weeding-out process. Before a plant is closed, changes in management should be tried. Current managers do not always owe their position to their qualifications; their entire work-force should not be held accountable for this.

Two institutions are lacking which would enforce management accountability — unions and shareholders. Is it letting companies off too easily to just lay off personnel? Even in the USA this would increase a company's contributions to the unemployment insurance fund.

Furthermore it is not possible to absorb many laid-off workers until the economy's structure is more flexible. We can't simply imitate monetary policies used in mature market economies in the 1980's. These economies were characterized by a high potential for job creation through innovation, particularly in the service sector. This is the prerequisite to aim for.

To put it bluntly, so long as the state is still the only employer, it really has no right to carry out mass lay-offs, according to its social contract. An economic revolution, too, can have a human face.

Yet we are faced with dilemma: to avoid mass unemployment yet increase productivity and reduce subsidies to state firms. Productivity can be increased by competition and the price discipline of the market place – the economic equivalent of pluralism. But we should distinguish lay–offs, causing downward–spiraling demand, from normal, frictional unemployment, which is necessary to the extent that more flexibility rationalizes the allocation of labour.

Before workers are laid off, they and their managers could present proposals for widening their companies activities using current staff. Perhaps cutting pay across the board rather than laying off a select few would stimulate the flow of ideas! But it is also time to start giving wage increases as an incentive to performance and to re–create a middle class with sufficient income to become investors.

4. The supply side and prices policy

The big difference compared to employment policy in a market economy is the inadequate capacity in the consumer sector.

Thus deregulation is just as necessary as privatization. Firms should be allowed to choose their own products and markets. A certain amount of co–ordination is desirable to rationalize outlays on these ventures, but on a voluntary basis: a clean break must be made with the planning straightjacket.

This is a microeconomic problem requiring institutional innovation. Although some companies will want to keep their plans secret for competitive reasons, I imagine most will be only too glad to consult with a central information office. More on this proposed co–ordinating institution below.

A commonly heard comment in the ČSFR is that there are too many people sitting behind desks. I do not have the statistics but I find it hard to believe the ratio of workers to white–collar employees is higher in the West. As much as the infrastructure needs improvement, not many of these people are likely to become construction workers, but it is from this pool that the market researchers, financial analysts, sales representatives and stock brokers will be drawn. Unused is not the same as useless.

In an interview in Die Presse (27.8.1990), Prof. Levcik warns against overly rash removal of subsidies and liberalization of prices. Recent experience in Poland shows how difficult it is to enforce fair prices under monopoly conditions, even with an anti–monopoly commission. (The Polish commission, however, lacks certain powers.) Price discipline from imports could function in particular product markets, but not if the domestic price level as a whole is too high: this would lead to balance of trade problems and an inflation–devaluation spiral. Looking at it the other way round, firms need to practice price discipline so they can compete abroad.

During the transition phase, low prices are beneficial because they ensure competitiveness in foreign markets and also soften the blow of unemployment. The "discomfort index" is measured by adding together the inflation rate and the unemployment rate in percent.

5. Diversifying the economy

Levcik also levels a serious criticism: Prague is planning to liberalize price–setting by the large monopolies, while small businesses, even hairdressers, cannot set prices or enter the market freely. If this is true, it is an upside–down approach. Consumers can go without haircuts but not without food; unemployed persons can start a bed–and–breakfast or a repair service, but not a steel mill.

The ČSFR has been slow in responding to the opportunities offered by the wave of interest in tourism; "Room for rent" signs have been a common sight along the roads of Yugoslavia for years, yet Čedok holds onto its monopoly, while tourists in Prague desperately look for a place to spend the night — or to eat, with restaurants half–empty, "reserved" — just as before the revolution. In this sector, incentives and private enterprise are desperately needed — and these are the services which do not require a lot of start–up capital.

Another area individuals cannot start a legitimate business in is exports, exactly the sector which should be encouraged. The foreign trade law allows only producers to be involved. This seems to be the old Marxist contempt for marketing. Of course, the larger companies could hire marketing consultants, but small companies do not have the means to explore foreign markets alone. If we look at Japan, we see that some of the largest firms are exactly trading companies. Deregulation — more competition between the state trading companies and debureaucratization of export rules — would pave the way for such firms to develop.

The greatest growth in job creation in recent times has been provided by the expansion of new services in the United States. The diversification of services also increases consumers' standard of living, or "Pareto–optimal welfare".

Long decades of mis–rule have fostered a mentality of scarcity in Eastern Europe[2]. This year, too, there is an echo in some countries of Stalin's rule, when industrialization was forced regardless of the human cost. The result was a huge investment in heavy industry without the secondary and tertiary skills to bring this capacity to market. The result of economic policy without regard to human beings is unavoidably a dehumanization of society.

It is sometimes said that layoffs are needed to scare people into working harder and stimulating new enterprises. Unfortunately, the new economic activities brought forth by a recession are often of a criminal nature.

Economists up until Marx and on to the 20th century worked with static models and ignored the dynamics of innovation. And up until Keynes there was no appreciation for the dynamics of employment. I wonder if the difficulties encountered by transitional governments could partly be due to classical economic training — Marx depended on the classical framework — combined with the current neo–classical thinking. Though I was never a Keynesian, we were all drilled in Keynes' emphasis on aggregate demand and employment to the point where it is natural to us to think in these terms, too.

Unemployment programs in the West often involve training for under–staffed occupations, or assistance in setting up small businesses. But the most remarkable example is Japan. Traditionally, employees' great loyalty to the firm was rewarded with a policy of keeping employees and retraining them to suit changed requirements. My favourite is the story of the Pentel company, manufacturers of mechanical pencils, who developed a robot to assemble them. Rather than laying off the assembly workers, they put them to building the robots for sale.

The company is now a market leader in robotics. How many managers are this far–sighted?

6. International competitiveness: restrictive or investment policy?

On the macroeconomic level, conflicting viewpoints are possible concerning maintenance of aggregate demand: reducing demand through recessionary policies can improve a country's competitive position. Recent figures indicate that

[2] I refer here to the Central European reform countries as Eastern because this is a convenient and neutral term for the whole region.

the factor of relative demand can be more important than exchange rates in determining the balance of payments (The Economist, 25.8.90).

A recession would do a lot to curb imports (although that is not desired by Prof. Levcik's investors). But this is a high price to pay, especially when a major goal is to replace autarchy with integration. Imports do increase our standard of living. Through import–substitution policies, i.e. product diversification as mentioned above, some previously imported items could even become exports.

In view of the low wage levels, the real problem with competitiveness is not demand, but the short supply of exportables.

Without a healthy internal market, both domestic and foreign investors will be discouraged. Yet investment is needed to raise productivity. The ratio of investment to income increases with rising income; the investment multiplier is the most powerful engine of economic growth, and in a phase of sustained and foreseeable growth, the investment accelerator (demand for capital goods) begins to work, as a result of investors' confidence in future prospects. Killing off the domestic propensity to invest means depending entirely on foreign investment, which is an unworkable solution.

To any Western tourist, the competitiveness of Eastern products is not a problem of price; in fact, at the tourist rate of exchange, some prices are ridiculously low. For months it has been impossible to buy a refrigerator in Bratislava; I am told that they have all been bought up by foreign speculators. I cannot believe that the quality of refrigerators from the ČSFR is inadequate for all Western consumers.

Yet people will tell you time and again that "we have no products with sufficient quality to meet Western standards". This is a most pessimistic generalization. In many cases all that is required is brighter packaging, which of course accounts for only a tiny fraction of the production cost.

Granted, over the long term there is a need to improve quality, and the ČSFR is not destined to be a cheap exporter in the class of Taiwan or Thailand. There is no much future in supplying cheap labour, which is not scarce in the world. But the location in Europe is favourable to a competitive medium price strategy.

7. Exchange rate policy and investment

The official trade rate of exchange is another matter. Anyone working for a foreign trade company will tell you that they cannot sell at these rates.

Progress has been made in this area. The official rates are being devalued while the street rate of the crown has increased. The obstacles to convertibility at free–floating rates might be less than thought at first.

In purchasing–power parity terms, the Czecho–Slovak crown is often worth as much as the old official rate before it was devalued. This gives grounds to believe that in a free float the crown would actually be quite strong, as long as exports are healthy. Its value is presently depressed by its lack of convertibility.

A hard currency policy (that is, a rising market value of the currency) has numerous advantages. It would ease the transition to world prices by checking inflation, not counting removal of subsidies as true inflation. Adjusting the price level by means of inflation usually destroys the currency, wiping out savings and pensions.

Controlling inflation avoids so many problems. There is the administrative confusion in constant indexing of prices; as a trivial example, take the costs of refitting automatic bus ticket dispensers and pay telephones. A falling currency encourages hoarding, with consequent pressure on prices, supply problems and distortion of resource allocation.

Just as important are the salutary effects of faith in the currency, which works as an incentive to saving, which is necessary to investment. A strong currency also encourages foreign investment, facilitates convertibility, and reduces pressure to repatriate profits.

Add to this an improvement in the terms of trade. Imports become cheaper. Exports (e.g., tourism) are currently so cheap at the market exchange rate that price elasticity is unfavourable: that is, receipts from exports would be higher with higher prices. All the more so since the volume effect hardly counts, as we are still in a supply scarcity situation.

A strong, convertible currency would also facilitate investment by Czecho–Slovak firms abroad. This will be necessary to compete in the world market, dominated as it is by the integrated operations of multinational companies.

The current account balance includes not only trade but also capital funds flows. I think we can agree that an influx of foreign funds is ceteris paribus a desirable thing. It will certainly increase the supply of capital for the above–mentioned investments by ČSFR firms abroad.

The influx of capital is sensitive to expected return on investment — whether on capital projects or on stocks, bonds or money–market instruments – and to the expected change in the value of the currency. Thus a higher interest–rate policy and expected appreciation of the currency are the macroeconomic variables stimulating funds inflows, while the outlook for capital projects depends on specific factors, but also on the overall expected growth in the economy.

8. The need for modern capital markets

So we come to a key area that has not been much discussed: the need for capital markets. We can concentrate on three main types: government bonds, small–saver accounts and stocks.

Government bonds can be issued to finance necessary infrastructure projects, and also to create a local investment market — not merely floating debt abroad, which is the lazy way of getting foreign currency. Such investment offerings are an alternative to consumption, and the projects financed are a stimulus to employment and economic growth. This is better than restraining consumption by restrictive measures.

Similarly there should be more than a symbolic return on savings accounts; 2 or 3 percent real return (net of inflation) on passbooks, with more attractive rates on small certificates of deposits, of course, the norm. New savings will increase the lending power of banks to business.

(According to my sources, the differential between interest rates on funds taken in and loaned out by ČSFR banks is a multiple of the norm; if this is so, these banks are not supporting economic development as much as hindering it. Here again, competition would be the cure.)

The creation of stock companies from the state monopolies has been widely discussed. Two proposed variants have been to distribute the stock to the workers, and to distribute coupons to everyone in the population. These ideas seem rather like naïve Marxist nostalgia.

Giving ownership of monopolies to the workers has serious drawbacks. One, the lack of accountability to the public due to monopoly power would be aggravated, since the shareholders will never vote themselves out of a job. They are more likely to vote for increases in wages and prices; multiplied throughout the economy, this would be anarchy. A second drawback is that this policy violates portfolio theory. Stocks are, after all, called securities because they can be used to provide for one's old age and so on. The portfolio management rule of risk diversification is, never put all one's eggs in one basket, but that is exactly what a worker does by holding stocks where he works.

The idea of distributing shares to the entire population might seem to have the merit of popularizing stock ownership. The big drawback is that shares are also meant to be a way for companies to raise funds for capital investment. Simply giving away undercapitalized companies creates no "value added". Perhaps a quarter of total equity could be given out like this to start a market in coupons going, creating a market value for companies, which they could later draw on when issuing shares of the remaining equity.

Privatization schemes such as in Britain have first concentrated on making companies profitable before selling them. The receipts from sales can go towards fixing up other state companies for market. This approach can add a great deal of value, not least by setting a specific rationalization goal.

Issuing gratuitous stocks might have effects similar to printing money, that is, it could stimulate inflation. Selling shares, on the other hand, stimulates investment and diverts resources from consumption.

The two proposals also seemed to be unclear about the creation of a stock exchange. Yet another aspect of stocks is that they are supposed to pay a dividend. Without a dividend or a stock exchange they have no much value. With a dividend, give–away stocks would represent an off–balance sheet liability taken on by firms without receiving any assets in return, something most of them can likely ill afford just now.

9. A new institution is needed

The Marshall plan or a similar domestic plan for revolving credit could be used to stimulate the founding of small businesses. For the large firms, Japan's Ministry of Industry and Trade (MITI) could be an appropriate model.

The co–ordinating office would have members and information from domestic and foreign trading organizations, banks, universities, industry associations and chambers of commerce, commercial attachés and governmental economic bodies. The national institution could be affiliated with the East–West Bank.

Incidentally, the Bank really ought to be located in Central Europe, to give its experts first–hand knowledge of the local bureaucratic problems, and a chance to militate against these limitations directly, as well as giving a certain economic stimulus to the host country.

A smooth transition cannot be achieved by unguided private enterprise. With all respect to Adam Smith, the order of complexity of the mission to be accomplished is far greater than during the first industrial revolution. England had the advantage of being first and having decades to develop. The reform economies have very little time to adapt before market pressures become unbearable.

Any complex modern industrial welfare society requires optimal solutions, not hit-or-miss ones. If only because the Far Eastern competition is firmly based on a precise approach to identifying and resolving opportunities and problems, the time for trial and error is a luxury none of us have. The slogan from Japan these days is marching separately, but striking in unison, and for this, an institution like MITI is needed. One meaning of this saying is that the intense domestic competition among Japanese firms make Japan Inc. more formidable in the world market.

So the concept of a planned economy should only be 90% thrown out – the 10% should be a flexible, sophisticated, market-driven and internationally integrated plan, not an old one limited by ideology, autarchy and party politics. The Japanese plans involve setting National Priorities, which are usually concrete technological and market goals.

A study of GNP growth in the USA estimated that over 60% of growth in output per worker was attributable to know-how and under 40% to capital inputs[3]. This could be a reason why the investments cited above in Poland were not effective. The co-ordinating organization could promote the acquisition of know-how, serving as a clearing house to help allocate Western expertise, aid and investment to Eastern European enterprises. It would also give assistance to joint ventures, most of which now do not get off the ground, or when they do, they do not always have the desired macroeconomic results. This would be the same office mentioned above as an information center for firms investigating new product markets.

A sign that Prague senses the need for such an institution is the recent decision to centralize applications for joint ventures in one ministry. Too much management time goes into following up unrealistic joint venture inquiries. With better organization, there is a better chance of attracting really worthwhile investors.

[3] Samuelson and Nordhaus, Economics, 13th ed., p. 864.

Gear up for export

The process would work something like a wartime task force. As such it would have a specific goal. **Priority one** should be: to **Increase capacity in exportable goods**. This capacity increase would be achieved by productivity increases, imports of know–how, capital equipment, marketing agreements.

Exports will pay for the needed modern equipment and make it possible to free the economy from the stranglehold of foreign exchange controls. A study of developing countries showed that "Outward orientation is the keystone of the strategies of virtually all the success stories"[4].

The existing planning structures could conceivably be used to convey a modified type of information stream. Large firms would identify the most critical bottle–necks, suggested domestic and foreign suppliers for the necessary investment, and their most promising areas for expansion. The co–ordinating office would rank the projects by profitability, giving priority to modest investments with a quick pay–back. A domestic bidding system would economize on hard currency outlays. The need for certain equipment could be turned to advantage by negotiating to produce it domestically under licence. In fact, the "textbook" was written by the Japanese in the 1950's and '60's, and it can be studied — as it has been by the NIC's.

One of the coordinators' tasks would be to actively promote contacts with foreign suppliers and buyers. By conveying an effective, organized image and uniting the competence to make rapid decisions within one body, it could do a lot to stimulate interest in serious investments.

10. How free should free trade be?

Some temporary guidelines are needed to limit the damage from such phenomena as sell–outs, predatory competition and unfavourable terms of trade. In the long run, international trade theory tends to discount such priorities as national self–sufficiency and protection of infant industries. At any rate, we are dealing here not with infant but mature industries, which have the potential to become competitive, but need a minimum realistic time–span to switch to state–of–the–art production and marketing methods.

To bankrupt the existing industrial infrastructure by suddenly exposing it to overpowering competition, such as is now the danger in the DDR, is an

[4]Samuelson, ibid, p.892.

unnecessarily destructive means of transition and would jeopardize the chances of achieving the status of future parity as a trading partner.

It is simply not true that all the countries which are success stories of the 20th century have practiced free trade. Restricting our economic perceptions to a simplifying ideology, whether it be the ideology of free trade or of communism, reduces our perceptual effectiveness in formulating competitive strategies.

It appears that the ČSFR leadership intuitively sense this and are looking for a pragmatic, gradual and non-dogmatic approach. A small example: imports of computers are duty-free, while consumer electronics remain subject to tariffs. Similar logic should be applied to investments: they should be especially encouraged when they improve productivity or the balance of trade. Ownership should be allowed in exchange for value added, rather than simply selling off under-valued assets.

Here we need to factor in such basic economic concepts as marginal utility and opportunity cost. We cannot just say, is that not nice that we can now have more modish Western goods, without figuring in the social and fiscal costs of not defending our domestic markets whilst bringing up our own products up to this standard, or comparing the utility of the various investment and trade proposals, not all of which one can afford.

Such guidelines would tend to increase the civic awareness of Western investors. At the same time there is the danger of excessive bureaucratic delays, dampening of competitive drive, perhaps even of graft, if there are restrictions on foreign ventures. A better solution could be tax incentives for investments meeting criteria such as transfer of technology and know-how, earning foreign currency or creating jobs[5]. But as the matter now stands, the problem is to attract investment. So what's in it for the West? Bringing eastern countries up to the level where they can afford ecological and energy-saving investments. A larger European market makes Europe competitive with the USA and Japan – economies of scale are still too limited in western Europe's national economies. In many ways Eastern Europe is a perfect match for Western Europe which has a skilled labour shortage and needs new markets for its high technology.

[5]There is a good deal of wisdom in Adam Smith's observation that men do more for the common good when pursuing their own interest than when they actually proclaim to be doing good. However, Smith was talking about enlightened self-interest. This has been somewhat in short supply this year: the euphoria about the Eastern market has been far greater than interest in making capital investments.

The international economy is now so integrated that a recession in Eastern Europe will certainly cost Western Europe in many ways and many billions. Fortunately, we are no longer playing zero–sum games, but looking for a win–win solution.

But the practical problem remains, that the pluralistic economies are made up of atomistic firms interested only in the winnings on their balance sheet. At the end of the day, it is up to the buyer to identify his most pressing priorities and to organize the means of paying for them.

11. Conclusion

A few macroeconomic policies and goals could be identified that would facilitate the transition from plan to market:

1. A general policy of avoiding extreme or sudden intervention.

2. Maintain aggregate demand and employment at healthy levels.

3. Cut subsidies, but inhibit further increases in the general price level (inflationary spiral).

4. Strong growth in aggregate supply.

5. A hard currency and a climate of investor confidence.

6. A favourable balance of trade and a net capital influx.

7. Issue Government bonds to finance investment in infrastructure.

8. Raise nominal interest rates to provide real returns.

9. Establish capital markets in bonds, stocks and money–market instruments.

10. Privatization after firms are profitable and with shares sold at market value to the public.

To support these objectives, a great deal of microeconomic work needs to be done. The major tasks identified were to:

1. Prepare firms to compete without subsidies, without excessive price increases, and without mass layoffs.

2. Encourage large firms to diversify and compete with new or better products and services. Achieve this by means of deregulation and coordination by a national–international institution like Japan's Ministry of Trade and Industry.

3. Create institutional mechanisms to check monopoly power.

4. Deregulate small business, services, tourism and foreign trade.

5. Actively exploit the potential for earnings from tourism.

6. Obtain the maximum in know–how and technology transfer from foreign investment by fiscal incentives, and by co–ordinating foreign activity with the domestic efforts of companies to diversify and increase productivity.

7. Set national priorities such as productivity goals for key sectors.

A successful transition is theoretically feasible. Investments in improving productivity and diversifying services should be interesting enough to attract financing. Investment, deregulation, and competition should mobilize employment and buoy aggregate demand.

Most important, a critical factor was identified which holds the key to economic recovery: **increasing export capacity**. It was recommended to take a cue from the Japanese experience and organize the achievement of this goal as a national priority.

A side benefit of this finding was to demystify the uniqueness of the transition problem. The recovery task can be compared to problems of developing countries or post–war reconstruction.

Eventually there may be more guidance to be gained from the experience of other nations in that period. Ask an Englishman why his country lags behind Germany, and you will learn that the Germans' advantage was that they had to build everything new!

We can count our blessings ...

12. Afterwords

The problem in Eastern Europe is 90% in the mind. You need self–confidence, pragmatism, decisiveness. The objective obstacles are relatively mild.

The Pessimisms.

1. "Our quality is no good." If not, why do smugglers carry it off by the carload? The packaging needs improvement, but that is a minor expense.

2. "We need high–tech production equipment." James Brown: "You've got to use what you got to get what you want." Japan started off in the 1950's selling poor–quality toys. Turn shortcomings into virtues. Build the machines — and export some.

3. "Our problems are unlike anything ever seen before." Excess capacity of the wrong products, shortages of the things you need, excess labour: same situation as after the war, or during the Depression. Your luck — you do not have to wait for Keynes to write his book.

4. "Our people don't work hard enough." They do very well under the conditions. With a bit of incentive they will do wonders.

5. "We are left with an investment ruin, it will have to be scrapped." Looked at another way: the economy is like a box of assemble–it–yourself furniture. It does not look like much until you put it together.

Look at the Plus–Side. Compare to the situation in the Third World: high birth rate, low education or non–technical diplomas, terrible debt burden, dependence on a few raw materials exports. Your cards: industrial capacity to spare, well–educated technicians.

Tribute to Lord Keynes.

1936 – in the depths of the Great Depression Keynes postulates the theory of aggregate demand. The government must invest in something to get the economy going again. F.D. Roosevelt is trying to apply such policies.

1940 – Roosevelt finds something Congress is willing to invest in and in a big way. The war effort will have housewives in the factories – "Rosie the Riveter." Not only does the effort unleash a stupendous war machine, but it finally pulls the US economy out of a decade–long depression. Keynes certainly wrote for his time.

How many people realize that Keynes "versus" Friedman is not a matter of ideology, but of context? **when** ?

1990 – Poland, Hungary, GDR, USSR. Eastern Europe is sinking into a recession. Monetarist ideas, the antidote to the overdose of 30 or 40 years of Keynesian demand management in the West, are popular. Like President Hoover after the crash of '29, governments are applying restrictive policies. Output, income, employment are dropping, there are no funds for necessary investments. The people are tired of political slogans and centralized planning's investment projects.

Will the politicians see they need Keynesian policies and find a way to implement them? Or do things have to get truly desperate first?