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"BIG BANG" VERSUS EVOLUTION:

EAST EUROPEAN ECONOMIC REFORMS IN THE LIGHT OF RECENT ECONOMIC HISTORY

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I. INTRODUCTION

The climate for private business in Eastern Europe and the Soviet Union over the next few years will be immensely dependent upon the actions of the governments undertaking economic reforms. Although there is great interest in investing in the region at present, it is perhaps true to say that there is more uncertainty induced by the nature of government policies and their effects on the economy than in any other area of the world, at any time in the last few decades. The economies of that region are entering into uncharted waters in attempting the transition from central planning to capitalism. Businesses searching for investment opportunities are very much reliant upon the success of the governments' attempts to navigate safely. Hence, a crucial element of information presently needed is the likely future outcomes of the different policy options open to the East European governments over the next few years. (For the sake of brevity, the Soviet Union is taken to be included when referring to Eastern Europe in the forthcoming paragraphs.)

It has almost become a cliche in the last few months that economists are working in the dark in the present situation in Eastern Europe. Since no country has ever before made the transition from planned economy to market capitalism, it is said that we must freshly build our understanding of the reform process. But that is not quite true. There is an accumulation of historical information that can be drawn upon, especially from the experience of the few East European countries that made tentative stabs at reform in the twenty years before the revolutions of 1989. In what follows, I use that historical information to provide a few clues about the likely outcomes from the different reform scenarios that could be implemented over the coming months and years.

Because of their dramatic nature, the present Polish policies -- the so-called "big-

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bang" or shock-tactics -- have grabbed center-stage in current discussions on the optimal locus of reforms in Eastern Europe. For now, the agenda of debate has been set by that Polish option of complete and immediate decentralization of the state sector accompanied by draconian stabilization policy. Thus, it is natural, when considering policy options for Eastern Europe, to reflect upon the advisability of implementing those shock-tactic policies in the rest of the region. The following, therefore, presents those facts that seem most relevant in judging the likely outcome of the Polish experiment. In presenting these facts, I implicitly argue that, as far as can be judged in the light of history, a more measured approach is advisable. Moreover, such an approach will be much more beneficial for the private businesses, including foreign corporations, that will be operating in those countries in the near future.

In the following, I omit discussion of what should certainly be the first, and easiest, step in any viable reform plan -- letting the private sector function without let or hindrance, including giving multinational companies the opportunity to undertake direct investment with 100% ownership. Hence, I focus on what is really the central issue of debate -- how to handle the state sector in the immediate future. I hope to show that the policies undertaken for the state sector will crucially affect the development of the private sector. Indeed, a major argument for going slow in the state sector is to encourage the faster growth of the private sector.

When discussing recent East European economic history, it is important to keep clearly in mind three distinct types of economic systems: the traditional centrally-planned economy, the capitalist market economy, (presumably the goal of reforms) and the hybrid system, the market-socialist or reformed socialist economy, in which free markets play a large role, but in which there is a dominant presence of state enterprises and therefore rather limited capitalism. The most immediate issue in the reform debate is whether implementation of this decentralized hybrid system is a productive step in the initial phases of the reform process. Until this issue is resolved, all other policy questions are secondary. I begin addressing this issue by first considering the economic performance of the state sector in the unreformed East European economies.

II. An Imminent Crisis of Central Planning or Simply Stagnation?

The performance of the traditional centrally-planned economies in the 1980s was not such that we should characterize the situation as one of imminent economic crisis, in the sense that production or consumption was declining or that macroeconomic disaster was lurking. To be sure productivity increase had declined, probably to zero, and one could characterize the situation as one of stagnation. But for these economies, there was no economic disaster threatening that would demand sudden radical change. Indeed, with plans using the principle of "from the achieved level", the immense stability of central planning, was exactly the long-run problem, rather than the threat of crisis.

In down-playing the possibility of economic crisis, one should not forget the growing long-term problem -- the lack of dynamism, as evidenced in the fact that these countries palpably lagged behind their peers (East versus West Germany, Czechoslovakia versus Austria, etc.). Moreover, this difference in dynamism seemed to be increasing with the resurgence of capitalist Europe in the mid- to late-1980s and the continuing stagnation in Eastern Europe. But, still, that failure of the centrally-planned economies certainly is not the same as imminent threatening economic crisis.

Since this point is bound to meet objections, it is useful to be very explicit about what is being said. First, I am referring only to the centrally-planned economies in their traditional, unreformed versions, not the reformed socialist economies. Second, the differentiation between stagnation and crisis is most important in its implications once there is a general acceptance that epoch-making economic reforms will occur. Crisis implies that something drastic has to be done immediately and its absence means that there is some breathing space to prepare reforms adequately and to ensure that there is no precipitate move in unwise directions. Third, I emphasize that I am only talking about the economic dimension of the situation. The Eastern Europe regimes in the 1980s certainly did face political crises, associated with the growing recognition of economic stagnation. But the short-term effects of that crisis have been largely solved by the installation of new governments that are ready to begin preparations to introduce sweeping changes.

While these views might seem somewhat dissonant with the current tenor of popular discussion, I believe that they are not so controversial to those scholars who have studied these systems over an extended period. For example, Richard Ericson's views on the performance of the pre-reform Soviet economy in the middle of the 1980s are typical: "Despite all [its] problems the Soviet economy is in no imminent danger of collapse. The predicament is not one of potential collapse but of slowly increasing obsolescence of the economic foundations of Soviet power. The highly centralized system can easily maintain current levels of output; enforce the achievement of major, measurable priorities; and probably produce some expansion in the level of economic activity."

The conclusion from the foregoing is that the economies that still have the rudiments of the central controls in place in the state sector have a certain amount of time to prepare for and to make changes. This is especially the case when one realizes that, with appropriate policies, there will be a burgeoning private sector that can be expected to provide large increases in economic welfare almost immediately. Hence, on purely economic grounds, the case for risky economic emergency surgery is weak. Of course, the case for movement to a different system is assumed, as is the case for the removal of all restrictions on the private sector. But that is different from immediate and perilous reform of the state sector.

III. The Macroeconomic Stability of Central Planning

The centrally-planned systems have demonstrated the capacity in the past to keep monetary imbalances under control and to reverse macroeconomic imbalances that showed the possibility of becoming threatening. During the period of classical central planning, large imbalances were not prevalent phenomena. The reverse was indeed the case. As Gur Ofer has stated on reviewing discussions of the classical Soviet monetary and financial system: "...most of the sources...indicate a high degree of Soviet budgetary (and presumably credit) discipline during the entire post-war period." It is important to remember this point at the present juncture in view of the fact that "monetary overhangs" and budget imbalances are on the minds of many because of current developments in the Soviet Union. But these phenomena are not a product of central planning but rather a characteristic of a country that is already decentralizing its state sector. (As Mr. Gorbachev has said, "We have dismantled the old system, but we have not yet put in place a working system, a new system...")

The centrally-planned economies have also shown the ability to reverse quickly the macroeconomic effects of past policy decisions that have become ill-advised in the light of new circumstance. Perhaps, the best example of this phenomenon occurred in the first half of the 1980s. In response to the world debt crisis, all East European countries were forced to reconsider their stance on the accumulation of foreign debt. Over a period of four years, Bulgaria, Czechoslovakia and East Germany all reduced their convertible-currency debts to a remarkable extent without reductions in per capita consumption, while maintaining respectable growth rates of GNP and while keeping internal monetary balances in check. It is true, of course, that there was an unfortunate side to these adjustments -- the deterioration of the capital stock and the environment that continued throughout the 1980s. This deterioration was, of course, a sign of the inability of the centrally-planned economies to undertake the necessary adjustments on the microeconomic level that corresponded to their very effective macroeconomic adjustments.

Hence, one can conclude that it might be particularly productive to use some of the traditional instruments of central government control of the state sector during the transition period. It should be emphasized that the major reason for taking such control would be to keep the macroeconomic environment as healthy as possible for the nascent private sector during the process of transition. Hence, central controls would be expected to provide some level of stability (or perhaps a little growth) in levels of state-sector production, while ensuring that macro balances were in order in the transition to a private-enterprise economy. Of course, the degree of central control need not be as complete as in the past. The most important feature would be to produce ex ante plans for such important elements as the wage bill, credit, and the use of foreign exchange, with the possibility of ex post intervention, if events were to take an unexpected and threatening turn.

IV. The Macroeconomic Instability of Decentralized Socialist Economies

In contrast to the experience of the traditional centrally-planned economies, major examples of macroeconomic imbalance have been primarily associated with reformed socialist economies and with the process of decentralization itself. For example, the <u>PlanEcon Report</u> of May 7, 1987 clearly identified the beginning of the set of circumstances that have led to Bulgaria's current payments difficulties: "...the sharp deterioration in hard-currency trade balance and consequent dramatic increase in Bulgaria's indebtedness in 1986, and to some degree also in 1985, reflect some of the changes in the Bulgarian economic mechanism." Similarly, the largest per capita foreign debts in Eastern Europe are in the three economies with the most decentralization -- Hungary, Yugoslavia, and Poland. Moreover, it is surely no coincidence that Poland and Yugoslavia were the two countries in which recently there was complete loss of macroeconomic control, resulting in near hyperinflation. Such evidence is consistent with the detailed study of a Polish economist, Grzegorz Kolodko, who calculated the monetary imbalances across the East European economies during the period from 1977 to 1984. He found that the two decentralized economies, Poland and Hungary, exercised the least monetary control and performed worse in this respect than the five centralized economies. (Yugoslavia was not included in his study, but there is no doubt that it behaved as a typical decentralized economy in this respect.)

Additionally, once the decentralized socialist economies are in macroeconomic imbalance, corrective measures seem to be inordinately difficult. During the 1980s both Yugoslavia and Hungary made austerity a feature of policy in order to reduce their hard-currency debts. Despite the implementation of austerity, these policies have been completely unsuccessful in Hungary to date and had no effect in Yugoslavia from 1980 to 1987. Hungarian debt declined by less than 20% from its peak level after four years of austerity and then began climbing again, despite the fact that per capita consumption was hardly increasing. Yugoslav debt continued to increase until 1987, even though per capita consumption expenditures were continually decreasing.

Had one been writing in 1988, the conclusion would be simple -- decentralized socialist economies are simply incapable of correcting macroeconomic imbalances. However, there are now two counter examples, which nevertheless cause only a slight modification in the conclusion. In 1988 and 1989, Yugoslav debt was reduced rapidly, but only in the face of massive decreases in real incomes (16% in two years). Similarly, in 1990, Poland has generated a large trade surplus, but only by imposing wage controls of a most extreme kind and entering into a huge recession. Hence, the conclusion must be revised to say that the only cases of reformed socialized countries getting themselves back into balance are those that have been willing to use draconian macroeconomic policy measures.

The foregoing reveals the central dilemma of decentralizing reforms, which leave the private and state sector to compete equally within the same set of free-market arrangements during the process of transition. Because of the state sector's tendency toward lack of financial discipline, there has to be draconian macroeconomic policy. Without such policy, there is a large risk of foreign indebtedness and hyperinflation. While such policy is in place, however, the growth of the private sector is likely to be retarded. (There is much evidence that the private sector has suffered enormously in the last six months in Poland. Moreover, since the austerity policy was introduced, the Polish economy is reported to offer a less attractive environment to foreign investors.) Thus, decentralization of the state sector might in fact be detrimental to the single most important element in the whole reform package -- the encouragement of the private sector.

Although reform discussions up to a few months ago almost unanimously emphasized immediate decentralization of the state sector, there is now a growing recognition that such emphasis might be misplaced. It is widely assumed that, if managers in the state sector are allowed to act independently, they will not act responsibly in husbanding the state's resources. To avoid these excesses, the state must either impose central controls or draconian macroeconomic policy. Viewed from this perspective, then, central control is a means of avoiding the extremes of free-market macro-stabilizing measures, while preserving the access of the private sector to credit and foreign exchange. Thus, for example, Janos Kornai writes in his recent book about protecting the private sector and, to that end, advocates the use of credit, wage, and foreign exchange controls in the state sector. This is also why Vaclav Klaus, the Finance Minister of Czechoslovakia, warns against the "trap of decentralization".

V. Are There Large Benefits in Decentralizing the State Sector?

The macroeconomic problems introduced by decentralizing the state sector would be worth enduring, if such reforms were able to deliver large real gains in efficiency and dynamism. These gains might offset any threat of loss of macroeconomic control. But, in fact, past attempts at decentralizing reforms in the state sector have produced few significant benefits in terms of improvements in economic performance.

There are many theories explaining why decentralizing reforms have failed to produce significant increases in efficiency, growth, and innovation. Here, I would like to mention one such theory, which has some significant support in the academic economics literature. This particular theory is worth considering because it contains perhaps the most profound implications for understanding appropriate paths of transition and for predicting what is likely to happen under various reform scenarios.

There is a tendency to regard centrally planned systems as rather irrational beasts whose economic decisions are not driven by any fundamental logic. It is natural to assume that it is simply impossible to introduce rationality into such a complex task as the centralized planning of a modern economy. Therefore, the purpose of market-socialist reforms was to decentralize both decision-making and responsibility to those with the best information, that is the managers or the workers in the enterprises.

Nevertheless, the view of fundamental irrationality of the centrally-planned systems can be challenged. Instead, one might argue that there is a fundamental internal logic to these systems and that their major problems arise from certain systemic constraints that leaders have imposed, such as the banning of private enterprise, the absence of enterprise closures, etc. For example, without the disciplining force of competitive private enterprise, there is a logic to central coordination; with central coordination, there is reason to have large production units; once there are large production units, it is rational to concentrate on heavy industry and have a small service sector, and so on. Following this logic, and recognizing that these economic systems survived for many years and in earlier decades prospered, one might conclude that centrally-planned systems work as efficiently as any system could within the bounds of these systemic constraints. Hence, decentralization of the state sector within these same systemic constraints might do little for the performance of a socialist economy. This conclusion certainly seems to be reflected in the experience of the East European countries that adopted market-socialist reforms. For these countries, casual inspection of the aggregate statistics and detailed econometric studies of resource allocation both indicate that decentralization of the state sector produced few improvements in economic performance.

Hence, one must conclude that no great gains are to be expected from a decentralized state sector during the transition process. It is not the issue of decentralization or centralization of the state sector that seems to matter in terms of dynamism and efficiency. It is the systemic constraints that have remained under both centralization and decentralization that seem all important.

VI. What Have Socialist Economies Lacked?

In understanding which changes are most necessary in reforming the East European economies, one must appreciate the systemic constraints that have impeded performance over the last forty years. The almost total absence of private enterprise is of course the most distinctive feature of these economies, but of more importance for the period of transition are the following (which are closely related, in fact, to the lack of private enterprise):

- there has been very little foreign direct investment and until recently no majority-owned affiliates of foreign corporations were permitted.

- in order to maintain employment security, there was virtually no closing of existing enterprises.

- very few new enterprises were created.

Put most starkly these economies simply lacked the entry and exit behavior of capitalism -- the process of creative destruction.

Of course, once these features are listed, they come as no surprise. It is, however, when one examines the differences vis-a-vis these features between capitalist and East European economies that one really understands the full extent of the changes that must be wrought by reforms. When such comparisons are made, there remains no mystery as to why the state sector in Eastern Europe, whether centralized or decentralized, performed very poorly. For example, in Bulgaria, it seems that virtually no plant closed its doors between 1965 and 1985. (And in this respect, there are no reasons to believe that Bulgaria is different from any of its neighbors.) In contrast, 50% of large older plants in the U.S. would have closed during the same time period. (This is a conservative comparison. Large older plants are the ones that have the most stable existence.) Similarly, every year in the U.S. manufacturing sector, 11% of existing employment positions are lost (and replaced with others), while the corresponding figure for the Soviet Union is only 0.5%.

To see how sluggish has been the entry of new firms in socialist countries, one can examine time periods when the creation of new firms was a high priority. In Hungary during the early 1980s, there were "organizational changes of epoch-making importance", according to one Hungarian scholar. At that time, the rate of entry of new plants reached one thirteenth of the U.S. rate. During the 1980s, Bulgaria introduced new procedures for the establishment of enterprises in order to encourage enterprise formation. But after eight years, truly new enterprises employed only one-half of one percent of the labor force. In contrast, in U.S. manufacturing, over two percent of the manufacturing labor force every year takes up employment in new plants. Hence, in a normal year in the U.S., entry behavior affects thirty-two times as many workers as in an extraordinary time in Bulgaria.

It is not surprising to learn that the amount of foreign capital in the socialist countries has been small, but in this respect what most needs emphasizing is the importance of multinational corporations in the affairs of the capitalist counterparts of the socialist countries. For example, in the early 1980s, 26% of all Austrian manufacturing employment was in the affiliates of foreign corporations, over 50% of sales of Spanish manufacturing industry emanated from domestic branches of foreign corporations, and 70% of Irish exports were by foreign-owned affiliates. These figures are repeated in different patterns, but in much the same magnitudes, across Western Europe. The multinational presence in Eastern Europe is derisory in contrast. For example, in the first two years in which foreign capital was allowed to participate in the Soviet economy, less foreign capital was committed than was placed in the new European Disneyland by the minority American partners in that venture.

Hence, what really distinguishes the East European economies from their capitalist counterparts is the lack of a spontaneous process of destruction and creation of economic institutions that is so typical of capitalist market economies. Moreover, they have missed that specific piece of institutional creation that is becoming ever more important -- the setting up of affiliates of foreign-owned corporations. Until this process of creative destruction occurs, one might conclude, with some exaggeration, that no amount of increase in incentives or decentralization of decision-making will significantly improve the performance of the East European economies.

If this conclusion is correct, then it has profound implications for the workability of the different types of reform schemes. The major benefits of reforms will come from the entry of new firms -- which, of course, will be in the private sector of the economy -- and from exit of old ones -- which means the closing down of inefficient state enterprises. Reform schemes must concentrate on how to accelerate this process of entry and exit. Any scheme that relies upon increases in efficiency from a stable existing stock of institutions by simply decentralizing the state sector will be doomed to failure.

VII. On the Speed of Privatization

The leading candidate to establish the process of entry and exit on an economy-wide scale has been the privatization of the state sector. Of course, such privatization is to be hoped for. But it now seems likely that both the possible scale and the possible speed of privatization of state sector enterprises have been exaggerated. Innumerable difficulties in rapid privatization are now being emphasized. The fundamental existence of these difficulties is, of course, underscored by the slow pace of privatization in those countries that place speed of reform as the highest goal. For example, in Poland it seems that only about 50 enterprises will be privatized in 1990, out of a total of 8,000.

Apart from the sheer complexity of the task of privatization, which implies slowness, the difficulties arise from a number of sources. First, there are the inherent problems in the rapid redistribution of wealth that will occur when assets are sold in a rapidly changing environment or simply given away. These problems, which would be difficult in any society, are compounded by the fact that Eastern Europe has had a long history of egalitarian promises by politicians. Moreover, there is the belief, probably justified, that private wealth is disproportionately held either by the old nomenklatura or by black market dealers, neither of which should be given easy title to the new private sector. Second, there is the inherent ignorance (uncertainty is too weak a term here) of the value of firms in circumstances that are likely to be economically and politically volatile for a number of years. (Consider just one small detail -- the shape of environmental legislation that will appear in the coming decade.)

Hence one must conclude that state enterprises are likely to be a feature of the East European landscape for many years to come. Any policy for transition that does not deal squarely with this fact is sure to fail. Indeed, that might be the central problem in the present Polish strategy. Polish reformers assumed that structural changes -- including rapid privatization -- would follow decentralization very quickly. Now we see that this is not a good assumption on which to hang the central elements of a reform policy.

VII. On the Scope of Privatization

There are many reasons to believe that, in the final analysis, the scope of privatization will be rather less significant than is being assumed at present. Consider the following simple facts:

First, because there has been little closure of enterprises in the past, many of the East European enterprises would be due for closure anyway in the normal process of the aging of technologies and organizations, at least if one takes the experience of capitalist countries as a guide.

Second, the capital stock in centrally-planned enterprises has been retired after much longer periods of service than in capitalist countries. Hence, a larger proportion of enterprises have obsolete capital equipment than would be appropriate for a private sector economy.

Third, judging by comparisons with capitalist countries at an analogous level of development, there is a huge structural shift to be made from industry to services. Such a shift will require the closing of capacity. If one compares the size of industry in an average East European economy to that in even the poorer West European countries, then the over-production of industrial goods is probably between 25% and 33%.

Fourth, within the industrial sector there are specific industries that will have to shrink a great deal -- industries such as metallurgy and machinery. Many of these will need to close in the movement to an industrial structure that is consistent with the level of development of these countries.

Fifth, there are the factories that produce low-quality products unsalable on all but CMEA markets.

Sixth, there are the factories whose environmental pollution is so great that they will need to be closed for health reasons.

Seventh, there are the factories that are just too large for the type of activity for which they have been designated. On the basis of very rudimentary calculations, I estimate that fully one-half of the enterprises in manufacturing might have to close because of inefficient scale. In individual industries, such as textiles, the figure could be as large as 70%.

Of course, all of these are overlapping categories. Moreover, there might be some factors that mute some of these effects (for example, the ability to keep on exporting the products of the bloated industrial sector, or the ability to use new technology to control pollution in existing factories.) But in contrast to the case of Western companies with old capital, there are few profitable trademarks to be bought, and organizational structure and labor relations are likely to be poor. Thus, it is hard to believe that in the next decade even a majority of existing organizations will be privatized, rather then simply go out of existence. To subscribe to the myth that the whole economy can be privatized is to invite disaster by tying up new capital formation in the wasteful undertaking of saving the old rather than creating the new. (It might seem to some that the policy of gradually shutting down many plants is a very extreme one. But, in fact, implementing that policy is simply part of the process of creating a market economy. In the United States in any ten-year period, over 50% of plants close through the normal operation of market processes.)

IX. Encouraging the Growth of the Private Sector

Given the above discussion, it is obvious that successful reforms will be those that are able to ensure that an adequate supply of capital flows to the private sector. Hence, it will be crucial for the government to extract a large surplus from the state productive sector and channel it through the banking system to the private sector. Decentralization of the state productive sector will be totally inconsistent with such an objective. The managers of state enterprises have in the past proved themselves to be investment hungry. They are not likely to pass surplus funds into the banking system. Hence, yet again, one sees a conflict between the growth of the private sector and the decentralization of the state sector. If the goal is to speed the growth of the private sector, then a government would be best advised to keep control of the state enterprises in order to ensure that these enterprises do not use their profits to undertake profligate investments, as they have done under previous market socialist regimes.

X. The Response of Enterprises to Change and Austerity

As argued above, the immediate creation of free markets in the state sector requires the simultaneous imposition of macroeconomic austerity. State productive enterprises, therefore, face two radical changes in their operating environment if the "shock-tactic" policies are implemented. First, there is the drastic shift in the way in which they interact with other economic agents -- from a bureaucratic shortage economy to an excess-supply market economy. Second, there is the extremely adverse change in their financial status, which means that previous behavior is untenable. It is a cardinal assumption of the shock-tactic policies, and perhaps of mainstream economics in general, that organizations will be able to adjust costlessly to the new environment. It is assumed that, There is an enormous leap of faith within this standard assumption concerning the response of organizations to change and adversity. Using the image of the rational well-informed individual economic agent, postulates are made concerning the behavior of large complex organizations. While the image of the rational calculating individual might be acceptable at an approximation, the extension to large organizations is inconsistent with all that we know about bureaucratic behavior. Organizations are complexes of inter-linked agreements, which are contingent on some semblance of environmental stability. Organizational structure and the division of labor are tuned to specific environments. Specialized languages develop, whose meaning is contingent on stable modes of operation. When the environment changes radically and old modes of operation are rendered infeasible, all these things must be created anew. The complicated truce between groups of workers and management will need to be renegotiated -- a process that is likely to be very traumatic when each group must face large declines in welfare. One just cannot assume that these changes will happen easily, quickly, or costlessly. In fact, we cannot assume that these changes will happen at all. The productivity of existing organizations might drop enormously in the intervening period when the environment is new and the behavior is still conditioned to the old. And this might be exactly what is happening in Poland at the present, where labor productivity in industry has fallen by over 25% within the last year and by much more in some branches of industry.

The factors noted in the previous paragraph are not considerations that economists usually take into account. But these would be standard fare for scholars conversant with the behavior of organizations. Failure and rigidity ganizational routines is ruled out, the standard assumption should be that the competence of the organization goes down dramatically in the face of radical changes in the environment. Those advocating such changes for the enterprises of the state sector must therefore take into account the fact that productivity in the state sector might decline radically in the transition. The implications for the level of national welfare during transition are transparent. This might be what we are observing in Poland at the moment.

The conclusion here is that slowness of transition might be a virtue. Even if an old environment (central intervention and control) is not the best from the point of view of the long run, it might be the best one for the existing organizations that have adapted themselves to that environment over the last forty years. Giving those organizations time to change or even allowing them to function as usual until they can be replaced by private sector equivalents, might be the transition policy that maximizes the flow of national income over the transition period.

XI. The Risks of Designing Macroeconomic Policy In a Brave New World

Economists and policy-makers have had no experience observing societies that have transformed themselves overnight from central-planning to free markets and have simultaneously implemented macroeconomic austerity. As the above makes clear, there is little knowledge of the lineaments of the behavior of organizations that are under enormous pressure to adapt to new environments. Our knowledge of supply and demand responses is sparse, at best. Those designing macroeconomic policy for such a transition are taking great leaps into the dark, where they might find the abyss of dysfunctional and perverse responses by enterprises that can hardly be relied upon to act like the rational profit maximizers of economic theory. Hence, there are greater than normal risks in imposing draconian macroeconomic measures in Eastern Europe than in corresponding capitalist economies. The necessary knowledge for the choice of those measures is missing -- not uncertain, missing. Hence, there is value in a period of learning in which changes occur slowly and in which perverse responses are likely to be less common. Perhaps, the need is for a sector-by-sector move from central planning to the market. Or maybe, there is simply a need for slowness. But what is certain is that the risks of the big-bang approach are enormous.

The discussion above can be summarized rather simply. Any immediate decentralization of the state sector will, of necessity, have to be combined with draconian macroeconomic policy. Such decentralization therefore contains two problems for the private sector. First, the austerity measures will directly inhibit private sector growth. (And given the likely slow speed of structural reform, the austerity policy might be necessary for a number of years.) Second, there is large risk from the possibility that policies will go awry, because they are being implemented in a totally new environment. Moreover, while these costs of decentralization are very evident, economic history tells us that we should not expect any large benefits from decentralization of the state sector. Indeed, if the decentralization rapidly changes the environment, then the productivity of state enterprises might fall a great deal. Hence, in the forthcoming years of the East European economic transition, the most secure environment for business investment will be in those economies that take a more measured approach to economic reform of the state sector, especially in those economies in which state enterprises are kept firmly under central control, pending either closure or privatization. In observing future government policies vis-a-vis the state enterprise sector in Eastern Europe, caution should not be interpreted as timidity. Nor should speed be equated with progress.