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THINKING ABOUT A "MARSHALL PLAN" FOR EASTERN EUROPE

SUMMARY OF A CONFERENCE*

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ABSTRACT

In February 1990, a conference was called at the Harvard Institute for International Development to bring together specialists on Central and Eastern Europe to investigate ways official U.S. aid could be used currently in these regions. The one-day program was divided into two sessions: a morning session, during which area specialists assessed the possibility, pace, and success criteria for economic reform in five Eastern European countries and in Central Europe as a region; and an afternoon session, during which various implications for foreign aid to this area were explored, along with the relevance of the Marshall Plan to the region today. The primary presenters for the conference were Stanislaw Gomulka and Keith Crane on Poland; Paul Marer on Hungary; Josef Brada and Jan Svejnar on Czechoslovakia; John M. Montias on Bulgaria and Romania; James F. Brown on political aspects of reform in Central Europe; and Thomas Schelling on the Marshall Plan and its relevance to this region today.

**THINKING ABOUT A "MARSHALL PLAN" FOR CENTRAL EUROPE
SUMMARY OF A WORKSHOP**

February 10, 1990

The purpose of the conference was to bring together specialists on Central and Eastern Europe to discuss the need for official US aid to that part of the world and how it might be provided.

The conference was organized in two sessions. In the morning, area specialists assessed the prospects for economic reform in five countries and offered their judgments about the sequencing and pace of reform in each country.[1] The specialists also identified the principal obstacles faced by reformers and evaluated the prospects for "success." The morning session ended with a discussion of the political prospects for reform in Central Europe.

The afternoon session addressed the implications for foreign aid, which were discussed during the morning session on economic reform. Topics discussed included the economic role of foreign aid, the "appropriate" amount and form of foreign aid, the linkages between aid and policy reform on the one hand, and the relation of aid to other capital flows on the other hand. The relevance of the Marshall Plan experience was discussed at some length, and the similarities and dissimilarities between the period 1948 to 1951 and the present were brought to light.

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[1] Poland, Hungary, and Czechoslovakia were individually discussed; Bulgaria and Romania were discussed jointly.

The morning session was chaired by **Dwight Perkins**, Director, HIID, and the afternoon session was chaired by **Lester E. Gordon**, Fellow, HIID.

Session (Morning): Country-Specific Opening Statements and Discussion

Poland: Stanislaw Gomulka began by focusing on the sequencing of reform. Poland joined the IMF in 1986 and had already prepared various programs of fairly radical reform. The IMF and the World Bank also proposed programs of their own. Although the program was not implemented at that time, a body of ideas and policy suggestions was thenceforth available to policymakers. The emergence of hyperinflation, however, presented a new problem: its existence made stabilization a key policy objective. Unfortunately, stabilization conflicted with price liberalization and presented a sequencing problem.

The following principles of reform were adopted:

1. Price liberalization, stabilization, and zloty convertibility were to be the primary policy reforms. An argument was made by some policymakers to the effect that the high degree of monopoly in the Polish economy could make price liberalization more difficult unless the economic structure was first reformed; however, this argument was rejected because the time available for liberalization was judged to be very short, while the implementation of structural reforms can take a considerable amount of time.

2. A stabilization program, such as Dornbusch's and Fischer's, including a balanced budget and wage restraint, was to be introduced on January 1, 1990.
3. Large firms were to be broken up and ownership reform undertaken. The objective was to have a capitalist, Western European-style economy.
4. It was recognized that balance of payments considerations would be of secondary importance for the next one or two years. The IMF recognizes this and the Polish agreement with the IMF is based on this principle. This recognition implies a need for large amounts of aid.

Radical economists promoted to ministerial posts agreed to the four principles, but raised many questions.

1. On the timing of the "big bang": Should it occur on the day after the new government was in place? In three weeks? Later? Some wanted immediate sacrifices, some urged caution. Eventually the reform package was put into effect on January 1, 1990, about three months after the new government assumed its duties.
2. Poland has a uniform exchange rate now: Was there to be one rate for households and another for the industrial sector? The arguments for a uniform rate were eventually rejected.
3. On exchange rate policy: Was there to be a fixed or a managed float? IMF advisers argued in favor of a fixed rate, which the government would be under a legal

obligation to defend. This position was rejected, since the economy was judged to be too uncertain to allow an accurate judgement in advance of the correct rate of exchange. The government is currently under some obligation to defend the exchange rate for as long as possible, but this is not a legal obligation.

4. On the speed and the levels of price increases: For instance, coal prices had been raised six times before January 1, yet they still stood at one-third of world levels.

5. On how radical incomes policy should be after the big bang: An outright wage freeze was rejected, but tough restraints were imposed.

6. On the toughness of the negotiating stance that Poland should adopt toward foreign private banks (creditors): An open confrontation was rejected, but Poland hopes for leniency on its international loans.

7. On privatization: It is unclear how rapidly it can be achieved, given the huge socio-political implications.

8. On how deep would the output contraction be as a result of the price shocks: Events since January 1 have provided some early, albeit provisional, answers. The initial reaction of the suppliers was to increase prices on a cost-plus basis, even if they could not sell at these prices. Given low wages, enterprises could not find enough buyers for their products and output fell by 20%

relative to January of last year. Statistical wages fell by 25-30% compared to November 1989, a fall that perhaps was too large (the planned reduction was lower, but price increases were also larger than planned).

The interesting question is whether enterprises will reduce costs in the future. If the drop in GDP is 5-10%, then the situation is fine; if 10-15%, worrisome; if 20% or more, dangerous, since among other things, the budget deficit is likely to re-emerge. The government is now assuming a 5% output contraction and a resulting unemployment of 400,000 (unemployment is currently increasing fast and there are virtually no new jobs being created).

Aggregate demand has not been as low as it might have been because the program included a conversion of a significant fraction of dollar deposits to zlotys. Liquid dollar savings have been estimated at $2.5 billion for enterprise and $6 billion for households, of which $4 billion is on dollar bank accounts. The government, which at the time had low levels of official foreign reserves, successfully induced the private sector to convert dollars to zlotys ($1.2 billion in the month of January).

The interest rates were in the range of 40-50% in January, still lower than the inflation rate. By early February, inflation had fallen very substantially and the incomes policy had not been compromised. No serious attempt by workers to challenge the policy has been made, although several strikes have occurred, four or five by coal miners.

The change in relative prices and the fall in real incomes have induced people to shift demand rapidly away from consumer goods that are considered less basic. As a consequence, stocks of industrial goods and many food products are rapidly increasing. The exchange rate was substantially devalued and the hope is that enterprises will now be induced to increase exports. Poland wants to use a structural adjustment loan from the World Bank to help enterprises divert output currently exported to the Soviet Union toward the West.

Keith Crane focused on the various economic policymaking groups in Poland and their advisors. He noted that the reform program was chiefly designed by Balcerowicz, Poland's finance minister. Jeffrey Sachs, who has been advising Solidarity, provided input on the sequencing of reform; however, the reform program was mostly Balcerowicz's creation, in collaboration with key aides and advisors in the Ministry of Finance.

Given the relative size of the budget as a percent of GNP, price reform made slashing the budget initially simple -- only milk subsidies survived. In addition, a 1% GNP decline in military expenses resulted. Some interest rate and transportation subsidies still remain, but further cuts will not prove to be easy. In addition, certain factors point in the other direction. Tax collection was easy while industries were state controlled. Now, some enterprises have almost stopped paying taxes; and given the long history of tax evasion in Poland's private sector and the squeeze on enterprises profits, tax revenues are likely to fall.

After 1991, the government will try to impose a value-added tax. Also, the turnover tax has been increased.

On price policy: The government is beginning an administrative breakup of the wholesale and retail sectors. This reform is especially important, since the government was able to determine who got what through the wholesale sector.

The reforms are providing mixed incentives for managers. Given the squeeze on the public sector, enterprise managers have tried to enter the private sector; the process has been much like an LBO, in which the managers are not paying a fair amount for their enterprises. Other incentive problems have persisted: last year managers had little incentive to try and keep wages low (this continues to be a problem).

On unemployment: Last year the labor market was very tight. This is now changing rapidly, although unemployment is still low in percentage terms. Labor mobility is a problem, especially given the housing market rigidities. Of Poland's population, 33% is engaged in farm-related employment, but most are also employed in the cities. In this respect, Poland is more similar to Western Europe than to the Third World.

Implementation of reform has been affected by personalities and politics. The main economic policymakers have been Balcerowicz as the finance minister, Baka as the central banker, Kuron as the labor and wages minister, and Swiecicki as the trade minister. Swiecicki supported the program, but he is too weak politically to be a major policymaker. The role of Kuron was and is important, both within the government and within the country. Baka wants a tight monetary policy and Balcerowicz wants austerity -- it would be a sign of backsliding if he were to leave. Thus far, Mazowiecki (the Prime Minister) has backed Balcerowicz. The public has shown an approval rating of 85% for the government, whereas the former Communist government had a less than 15% approval rating.

Implementing an austerity package was made easier by the lack of credible alternative economic policies. The Communists gave support to the reform package, albeit in a qualified way, by calling for price control. However, they enjoy limited public support. The old official union has been active in coal strikes and has called for high unemployment benefits and price controls. The Confederation for an Independent Poland has taken a more nationalistic stance and has wanted to break away from the Soviet Union. Exports to the Soviet Union are still important, however. The Peasant party wants favorable relative prices for agricultural goods. The Socialist party wants self-management (something that Balcerowicz no longer supports).

The 1982 reform gave workers various rights, such as the right to hire and fire managers and the right to decide on investment. These reforms were never really implemented, but workers' councils did retain an important advisory role. As a result, privatization legally requires that you ask permission from the workers' councils. Gdansk shipyards are still not privatized, for example, after a year and a half of trying.

Perkins asked, although the first stages of reform seem clearly defined, is there a clear strategy vis-a-vis final ownership?

Gomulka responded that there is a proposed office of privatization, whose primary aim is to clarify who owns the assets. In December, legislation was proposed to convert all enterprises into stock companies whose shares would be owned by government, and where workers would be dropped from the board of directors. Pressure from the workers' councils killed this legislation. Now "softer" legislation is being introduced; the idea is to extend to workers a large quantity of credit to be used only to buy shares in enterprises. Another idea has been to allow foreign capital to enter, which has begun on a minor scale. A topic that has been hotly debated is the limits to be placed on foreign ownership (a limit of 15-20% of the total capital stock seems likely). The government wants in particular to attract foreign capital in the exportables sector.

Abram Bergson asked, given the lag in compensatory adjustment to wages, is not the drop in real wages larger than described? With regard to burden sharing, will not the low-paid workers and the pensioners be more adversely affected? Will not inequality be increased as a result of the reforms?

Crane responded that the opposite may, in fact, happen. The active secondary market and queuing created large rents with the result that wage statistics are badly distorted. A better measure of welfare is to use per capita consumption. In addition, eliminating the queues benefits the elderly.

Gomulka responded that all segments of the population fear that they will bear the sacrifice. Statistical real wages increased by between 30-40% in the last quarter of 1988 and had remained at these unsustainable levels for most of 1989. These increases were completely out of line with productivity. These wages declined already in the last quarter of 1989. The price shock reduced them further, so the overall drop has been about 15% compared to levels in 1987-88.

On the distributional issue, Gomulka agreed with Bergson, since the removal of food subsidies meant that food prices increased more than the general price increase. However, the overall level of consumption fell less, since exports absorbed some of the fall in output. Exports fell by $1 billion, which eliminated the balance of payments surplus. In 1990, the trade deficit is expected to will be $800 million. In 1989, Poland had a surplus of 2 billion rubles with the Soviet Union, a surplus that the Soviet Union wants to preserve.

Paul Marer asked, what is Poland's strategy toward the IMF?

Gomulka replied that the overall purpose has been to obtain stabilization, an aim common to both parties. There was almost no debate on the balance of trade problem, and the IMF has set no performance criteria in that area except indirectly, through the position of international reserves. There was considerable discussion of incomes policy. The IMF accepted the view that the brunt of the stabilization programs should fall on fiscal and incomes policies with monetary policy playing a supplementary role. Jeffrey Sachs wanted a wage freeze during the first three months, but his view was rejected. Also rejected were most of the other specific advice that he offered, with the important exception of his views on the general direction and sequencing of reform. These views on content and sequencing were, however, shared from the beginning by the inner reform group working with or under Balcerowicz.

The government felt that shortening the period of suffering was desirable; it wanted to give the public some results quickly. The IMF offered two policy options: the option of a wage freeze, and the ".5 option." [0.5 * inflation rate = wage increases free of taxes]. The latter was considered to be the "soft" option by the IMF. There was considerable negotiation on this point, since initially the government budget had a ".7" scenario. Eventually, a ".3" scenario was adopted for the first month, followed by a ".2" scenario for the next three months.

The key IMF negotiators suggested a fixed exchange rate policy, meaning a legal commitment to defend a specific rate. The Polish negotiators argued that the overall economic uncertainty could justify nothing more than a managed float with a policy objective to defend a specific rate. This Polish position was accepted by the IMF. In the end, the rate was defendable and the difference in approach proved to have no practical significance. On monetary and credit policy, IMF was very cooperative and understanding. They agreed that the program should not strive for a positive interest rate in January.

Hungary: Paul Marer noted that Hungary faces many of the same problems as Poland, but there are some major differences.

1. Unlike Poland, Hungary (at the time of the conference) has not yet gone through an election (scheduled for March 25). Politically it is at a different stage of its development. Hungary has 55 parties (four to five major ones) which implies future coalition governments.
2. The economic situation is different. Inflation is at 20%, shortages are not pervasive, the monetary overhang is small, and Hungary has not had to reschedule its foreign debt.
3. No agreement has been reached on the "system transformation" policies and insufficient attention has been paid to what the next government will do; the current government is on the way out and is preoccupied with the problems of the present.

A blue-ribbon commission of Hungarians and foreigners has been established to recommend a comprehensive program for Hungary's new government. It is a private effort, though it is supported by the Hungarian government and key persons affiliated with some of the opposition parties. But for now, Hungary has no political actor, such as Solidarity in Poland, that the public trusts.

Differences aside, Hungary does face some really severe problems. There have been ten years of economic stagnation, and the balance of payments is nearly in crisis. Hungary is running a huge surplus with the CMEA countries, but other Eastern European countries, especially the USSR, cannot come up with goods in return.

Marer then discussed some individual aspects of reform.

1. **Fiscal and monetary stabilization:** All agree that subsidies should be reduced, but the fiscal balance is threatened by the CMEA situation. If Hungary were to switch to dollar trade with the Soviet Union, it would encounter new budget and balance of payments problems. Taxes on imports from the CMEA that come in at below world market prices provide large revenues. Also, Hungary's terms of trade vis-a-vis the USSR will deteriorate, increasing both problems.

   Monetary policy is tight, in agreement with the IMF, but there is a problem with its effectiveness, due in part to the laxness of the bankruptcy laws (they are not enforced, while enterprises give each other credits). Thus enterprises and even banks seem able to get around budget constraints in various ways; also, they retain the old mentality and do not try to minimize costs or maximize rate of return on investment. The upshot of these arguments is that Hungary cannot rely on monetary policy to fine tune the economy. Fiscal policy remains important, but fiscal discipline has also been hard to enforce; the budget deficit has been large, although recently declining, at the IMF's insistence.

2. **Pricing reform:** Some possibility of easy price raising exists because money sellers have monopoly power and because price controls are selective. Enterprises tend to raise those prices that they find administratively easy, not necessarily to equate supply with demand.

3. **Industrial reform:** Oligopoly is a problem, but breaking up the high concentration of production by making the smaller plants independent does not force them to compete vigorously. Many of the products reformed under the import liberalization program do not compete with domestic production.

4. **Labor markets:** There is an incomes policy in effect, via the high marginal taxation of wage increases that are higher than productivity increases.

5. **Exchange rate policy:** There has been little difference between official and unofficial rates. During the last few months, the divergence has increased, but government economists still claim that the exchange rate is about right (they want to use the exchange rate to keep inflationary pressures low).

6. **Privatization:** A major problem, as in the case of Poland, is defining who owns what. Enterprise councils play an important role in controlling about two-thirds of state-owned enterprises. In some cases they have undertaken

spontaneous privatization (often with golden handshakes for management); and these have sometimes been attacked in the press as unfair. Foreign sales of enterprises have occurred at favorable terms for the foreign investor (cases have been reported where a 20% down-payment, which goes into the enterprise itself, was enough to get control of an enterprise). Public outcry followed the reporting of these cases, and the laws regulating such transactions were recently toughened. A consensus seems to be emerging saying that different avenues of privatization should be pursued; at the same time, the interest of the state in the national patrimony should be preserved and strengthened so that the proceeds from selling existing firms should be available to reduce the governments large domestic debt and the National Bank's huge foreign debt.

7. **Financial problems:** These have been very severe. Commercial banks do not operate as they should, and the legal-regulatory system needs to be overhauled. The basic problem is that commercial banks, when they were established in 1987, were saddled with a great deal of non-performing assets (loans).

The general conclusion is that up to now there has been no big push for reform, but problems are mounting. The process of privatization will prove to be very important. The most pressing of these problems can be summarized as follows:

1. The probability of a weak government emerging from the next election is the major problem facing Hungary. Able people are leaving the government for the private sector.
2. People do not realize the sacrifices needed and the time it will take to really solve the country's economic problems. It is common to think that just throwing the "rascals" out at the next election will suffice.
3. The balance of payments is in a precarious state, leaving little room for Hungary's new government. During the early years of the transformation, a large net inflow of resources (current account deficit) is needed, but servicing the huge debt that Hungary owes implies a large net outflow of resources.
4. The great uncertainties in CMEA trade, on which Hungary has been very dependent, also pose a major problem.

Clifford Lewis asked how deep seated is ill-will toward privatization? How good was the deal for GE in Hungary?

Marer felt the problem had not yet hit public consciousness, nor is the evidence on the GE case clear at this time. It is hard to determine the value of an asset that is badly managed now, but that has good potential profitability. Hungary must concentrate on ensuring a fair, transparent process of privatization (which has not been the case so far).

Josef Brada thought that there does not seem to be much backlash against foreign investors; people see such investment as necessary. They are more upset at the behavior of domestic managers in arranging deals with foreigners.

Crane recalled that many Hungarian enterprises were foreign-owned in the past. It is necessary to distinguish the small enterprise sector, where anybody can open a business (extending credit to small enterprises will be popular), from the large, professionally-managed firms.

Perkins asked how much of total output is produced by small firms?

Crane responded that 10% of the workforce in Poland was employed by private enterprises in 1988. More are employed now.

Gomulka said that "small firms" in Poland are mostly very small, less than five workers each, with little opposition present to privatization. The fear in Poland is a possible invasion of German capital.

Marer responded to Perkins' question by noting that more than two-thirds of labor is employed in large state enterprise in Hungary. There is a phenomenon sometimes described as a "black hole," to indicate the lack of small- and medium-sized suppliers. The result is an inflexible response to supply shocks and excessive dependence on foreign imports.

Czechoslovakia: Josef Brada began by noting that there is widespread sentiment for creating a free market economy that will generate high growth rates, sectoral shifts to high value-added sectors and tourism and will result in greater integration into the world economy (quantitatively and qualitatively) within eight to ten years. Opinion leaders want Czechoslovakia to become a player in world markets as an exporter of capital.

Will these aspirations be achieved? It is hard to say definitively; it will depend on economic and political issues. The major weakness of reform is that politicians underestimate the population's expectations concerning the results of radical reform. Moreover, they overestimate the amount of time they have to produce tangible results.

A brief analysis of major issues follows.

1. **Macroeconomic policy:** No pressing macroeconomic problems face the country because there has not been much inflation.

2. **Budget:** The government wants to create a budgetary surplus by reducing subsidies, even though it recognizes the political danger inherent in this policy. Moreover, it wants to reduce the size of government per se: social security will increase, but subsidies will decrease.

3. **Monetary policy:** Sharp arguments exist about whether there should be rules-based management of the economy by the central bank (e.g., monetary supply should grow more slowly than GNP -- a deflationary monetary policy) or whether there should be discretionary management of the economy (this last option is advocated by the central bank, which argues that nobody knows what will happen to velocity). As of now, the central bank seems to be winning the argument. Commercial banks also have

problems; they own the loans of the enterprises, many of which are non-performing, with the result that commercial banks are captives of their borrowers.

4. **Price reform** (a key issue): Some economic policymakers are arguing for slow price reform. Services might see some price liberalization first, but it will go slowly. The Czechs are very cautious about inflation.

5. **Enterprise reform:** De-monopolization and privatization are the two threads here. Monopolies, however, are viewed mechanically: the monopoly is seen as a function of the number of firms in an industry. This attitude ignores the behavioral aspect of management. As for privatization, a new law is being instituted; small businesses can be created and owned by individuals, but a large chunk of the industrial sector will remain in government hands (transport and utilities included). Other enterprises will be turned into joint holding companies, with the state being the largest holder. Some proposals for quasi-ESOPs also exist. Enterprises that produce for the CMEA (especially the Soviet Union) will probably retain planned, mandated production targets. Other unresolved questions include who will manage, what objectives they will be given, and how managers will be chosen and evaluated.

6. **Labor markets:** Private firms are unregulated. Wages in

and an incomes policy may be lurking for the state sector. To facilitate greater labor mobility, retraining and making the housing market more efficient to increase labor mobility has been discussed. Subsidies to housing will be eliminated, and there is a wish to privatize state housing. The fact that food price increases will lead to a worsening income distribution has been recognized; a third of the people might be pushed below some officially-accepted poverty level.

7. **Convertibility of the currency:** A stabilization loan is being envisioned for this purpose.

8. **Foreign direct investment:** The Czechs want to increase it, and they want to renegotiate their agreement with the EEC, hoping for associate status. In addition, they want to join the World Bank and most other multilateral organizations.

9. **Legal reform:** Much help is needed. The main question seems to be whether it is faster to write their own laws from scratch or whether to translate and import foreign ones.

The conclusion is that people have experienced a political revolution, but their economists do not seem to realize that an economic revolution will now be expected as well.

Czechoslovakia: Jan Svejnar emphasized how new the changes are in Czechoslovakia and how the population's expectations are running ahead of events. Ministers do not have much time to reflect, as they are spending all of their time meeting delegations. One group pushes for slow, gradual transition, another (which includes the central bank) pushes for faster, more incisive reform. The worry is that a stalemate may ensue.

The macroeconomic situation is stable. The enterprise situation is more worrisome and unraveling. Workers in some cases have ousted management, often putting inexperienced personnel in charge. Strikes have also occurred. The primary task is to create a financial system. The government is thinking about a stock market, but it has not drawn any concrete plans yet.

Agriculture is another problem. If the Czechs imported all the food they are currently consuming they would be better off, considering the subsidies they are currently giving to agricultural products. However, the agrarian party is strong and likely to be a single issue voting block. Of the population, 17% is agrarian, although many whose primary employment is listed as being in agriculture hold a second job in the city.

Obstacles to reform come from false know-how (the Czechs assume that they know the right answer to their problems, even if they do not), a run down infrastructure and the political issue (see above). As for the prospects for success, the struggle is now at the initial stages, and it is hard to predict. The process does seem susceptible to ideas from outside, however.

Crane observed that other countries have faced new macroeconomic problems almost overnight, especially following an opening of borders. Were the Czechs aware of these potential problems?

Brada responded that they are aware of them. If they try to deal with them they will face the dilemma of a need to either decrease or increase control.

Svejnar noted that planning more or less works now, but the Czechs do not realize that if they go half-way with a market system they will lose what control they have without attaining the coordination of the market.

Kyn asked who is involved in planning?

Brada named Komarek, who thinks that he can take control and guide the system. Dlouhy and Klaus are differentiating their positions, trying to determine how to either bypass him or bring him around to reform.

Svejnar commented that Klaus' deputies appeared receptive to reformist ideas at the recent meeting in Prague that he and Brada attended. Klaus himself may be looking forward to an Austrian model. Komarek is not a "details" person.

Bulgaria and Romania: John M. Montias emphasized the paucity of knowledge about recent events in both of these countries. Romania, for instance, curtailed its statistical output years ago. One piece of evidence on agricultural yields has cast doubt on what statistics we did have from the Ceaucescu era. Given the degree of political upheaval in Romania, it is surprising to see how mild the reformist proposals are that recently appeared in the press.

Bulgaria and Romania were essentially agrarian countries until the 1930s; they have been industrializing for half a century under authoritarian regimes. Now they are industrialized, urbanized nations, with 80% of the workforce employed in non-agricultural employment. There is little intra-industry specialization, and there is heavy emphasis on the need to export at all costs (in Romania this policy has been pursued to an unprecedented degree -- it has run the economy to the ground). Bulgaria has become a specialized supplier to the Soviet Union. Romania had tried to bank on its oil industry and expand its chemicals industry but achieved mixed results.

Bulgaria has done fairly well with respect to rates of growth (it has enjoyed the highest rates of growth in the Eastern bloc). It has managed to increase the rates of consumption per capita at a steady, if slow, pace. Romania, on the other hand, has become an "empty economy" under a policy of repaying all of its foreign debt. In the 1988-89 period, exports were running at 50% more than imports. One consequence was that foodstuffs were scarce. The regime then announced that there would be no respite from austerity even after all the debt had been repaid; instead, a further increase in investment was contemplated. These policies may be attributed to Ceaucescu's delusions of grandeur; he wanted to surpass the size of Poland's population while industrializing, with the aim of becoming a Balkan power.

The new regime (called the Council of National Salvation) has released foodstuffs that were earmarked for export in an effort to relieve internal pressures, but this can only be a short-run measure. No serious long-run reform seems to be contemplated either by the elites running the economy or by the people right now; perhaps something will happen after the election. In Bulgaria, some attention has been paid to reforms, but, perhaps because of the relative success of industrialization, reforms have not had much impetus there (the Bulgarians have managed to cultivate a comparative advantage with respect to the Soviet Union). Bulgaria has yet to show any great dissatisfaction with the system.

In the field of commercial policy, if these countries decide to open up to foreign trade, they will have to position and specialize themselves with respect to Czechoslovakia and Germany. In the 1920s-30s, they had run deficits with both Czechoslovakia and Germany, which they paid for by accumulating surpluses with the West; this pattern may recur. If they open their economies, will they allow the creation of "industrial-cemeteries"? Will they scrap much of the obsolete equipment currently in operation?

The conclusion is that no real discussion of reform has taken place in these countries until now. In the future, agreements with neighbors will become important.

James F. Brown observed that in the past, there had been special historical ties between France and Eastern Europe. It is quite possible that France, if only to compete with West Germany, may return to Romania with the purpose of using it as an entry point to the rest of Eastern Europe because France has virtually no economic ties with it now.

Oldrych Kyn recalled that Bulgaria has had three waves of reform in recent years. During one wave, workers' councils were implemented. During another, economists gained favor. By decree (though not by law) some state enterprises were converted into stock companies. It was declared that all forms of ownership were equal and that there would be no restrictions in the size of an enterprise that can be held privately. All of this was happening a year ago, but it has disappeared from public debate since then (apparently the political winds have changed).

Montias responded that **Kyn** was describing the third reform, but the Bulgarians have a habit of putting reforms on paper that seem radical but are later diluted. No such reforms have been put into place.

Perkins wondered, addressing to **Bergson**, how the Soviet Union is likely to be affected by all of these processes. What will be the impact on the CMEA?

Bergson observed that, although major economic reforms were adopted in the Soviet Union in 1987 and supposedly implemented in 1988, nothing has really taken root. The reforms were supposed to give more autonomy to the enterprises, but the government gave instructions to enterprises, and these instructions served the same role that the plan served previously. Up to 90% of material production is now being directed this way. Wholesale and retail prices had been completely out of line and food product subsidies amounted to about 10% of GNP in 1989. Partly because of the subsidies, the government incurred a large budget deficit, which it funded by printing money; this has led to a breakdown in the consumer goods market. The government has felt that this is not an opportune time to move toward a freer price system. Partly for political reasons, the government has been hesitant in taking what economists would consider rather obvious reform measures. Instead, the government has been temporizing. Rhyzkov's report to the Council of Deputies said that measures concerning retail prices "should be investigated" in 1990, "measures should be prepared" in 1991, and action will be contemplated only after 1992. This shows that reform is not really being vigorously pursued now. Gorbachev has not succeeded thus far in producing any improvement in the economy. In fact, deterioration has occurred.

Eastern Europe is dependent on the Soviet Union for its oil supplies. The price that the Soviets get for their oil is now comparable to world prices, but the goods that the Eastern Europeans send back to the Soviet Union in exchange are probably overpriced for the quality. The Soviet Union has recently said that it would favor the use of world prices when computing the terms of exchange within Comecon.

Marer noted that Hungary has been told by the Soviet Union that it will continue to need consumer goods from abroad, but it would like to price "hard goods" such as oil, which are easily sold on the world market, at world levels. The Soviet Union has a large surplus with Comecon where hard goods are concerned. Eastern

Europeans are concerned that they might not be able to sustain energy imports given their hard currency payment capacity and economic disruptions in the Soviet Union, which might reduce that nation's import demand.

Crane reminded the conference that the Comecon countries agreed to revamp the protocols of CMEA at the Sofia summit, and they have said that they will move to convertible trade within five years. The problem so far has been the transition. Eastern Europeans want compensation for the predicted terms of trade losses, but the Soviet Union is reluctant to provide them.

Much the same is happening with regard to Poland, **Gomulka** observed. A substantial shift will occur in trade patterns away from CMEA and toward Western Europe.

Thoughts on the Political Process of Reform: James Brown has characterized current events as "living between two ages" -- the Soviet Union internally and the Soviet Union, Eastern, and even Western Europe (which is facing the prospect of living with German reunification) -- all of these have been changing. A profound psychological effect has occurred upsetting mind-sets. The mood in Eastern Europe is the opposite of rationalism. Expectations certainly have outpaced reality and there will be a backlash ahead.

A number of problems face Eastern Europe. If 1989 could be called the year of exultation, 1990 will be the year of problems.

1. The most important problem is what kind of value system, or political culture, will develop in Eastern Europe. Will it develop toward civil society, or will it revert

to traditional ethnic divisiveness and nationalistic divisions? Will North Eastern Europe end up in an adversarial position with South Eastern Europe? Even in Czechoslovakia, which now seems to be the one bright hope, problems might surface.

2. Another problem might be called, "the pollution of the mind," borrowing a phrase from Vaclav Havel. Will the effects of 40 years of Communist rule on the minds of the people of Eastern Europe take generations to overcome? This raises the question of corruption, which has become almost a way of life.

3. Then, there are the problems of politics, power, government reform, and stability, and then the attendant problems of establishing democratic institutions, an independent judiciary, and so on. These are long-run problems, but they do have a short-run aspect: how much and what kind of old Communist bureaucracy will be retained? What will be the criteria for selection of public servants? What about public anger and resentment toward the old bureaucracies? This will also be an enormous problem because it is an emotional one.

4. In judging how severe economic problems will be, the Polish economic experiment is the one to watch. What happens in Warsaw will be crucial for the rest of Eastern Europe. If Poland can get away with its reforms, others will follow; if not, there will be gloom ahead, since

Solidarity confers more legitimacy on the Polish government than that enjoyed by any other government in Eastern Europe.

5. Environmental problems, surprisingly neglected in the discussion so far, loom ahead. If the environmental disaster is not checked sometime in the next ten years, a lot of what has been discussed will be irrelevant. This is an important aspect of what the West can do for the East, and it is perhaps simpler to address this issue than to effect any one of the other forms of aid currently being considered.

6. Emigration from Eastern Europe (even from Poland and Hungary) represents an important societal net loss. It is usually the young, the "best and brightest" that leave. They say that they will return within three to five years, but the vast majority do not return.

7. Then, there is the cluster of problems with regard to Eastern Europe-Soviet Union relations. The Eastern Europeans are now becoming politically independent while remaining economically dependent. Many attendant problems exist with respect to multilateral organizations (such as the Warsaw Pact, Comecon, and any new European security arrangements). Will there be a withdrawal of Soviet troops? The answer seems easy in the cases of Czechoslovakia and Hungary, but harder to find elsewhere. What is going to happen to NATO? How does that affect

the Soviet troops in East Germany? How does that affect Poland?

8. With regard to the West, the East will be faced with psychological problems, specifically that a rejection of the Soviet Union and Communism has resulted in them wanting to be part of and to be accepted by the West. Great disappointment lies ahead, since their expectations and aspirations are totally unrealistic. Again, a threat of backlash appears. Economically, can an associated status in the EEC be worked out even for three Eastern European countries (Hungary, Poland, Czechoslovakia)? And, of course, there looms the gigantic problem of coming to grips with German reunification.

Bergson offered a footnote to the theme of Eastern Europe rejecting Russia and gravitating toward the West. Gorbachev can also be said to be rejecting the Soviet Union and gravitating toward the West. His theme of a "common European home" is recurrent; it was elaborated in his last speech to the party plenum.

Brown agreed that the theme of a "common European home" might have been just a propaganda slogan in the past, but it now appears to be much more real, especially in young people's minds. If Eastern Europe does not become part of a common European home, it will be a very lopsided one. The future role of CSCE (Helsinki agreements) might be to bring Eastern Europe closer to Western Europe.

According to a recent study by the Economic Commission for Europe, said **Montias**, trade diversion after 1992 might dominate trade creation, so industrial exports by Eastern Europe might be problematic. Trade barriers might well increase.

Marer thought that possible domination of the EEC by Germany could make the rest of the EEC more receptive to Eastern European membership in an effort to counterbalance German influence. Delors has said, for example, that associate status for the Eastern Europeans might be quite acceptable. **Brown** hoped that such would be the case.

Kyn thought that time will obviously be needed before integration is complete, but that discussion so far has been too pessimistic. Ideologically and ethnically, Czechoslovakia has always been considered a part of Central Europe and has only temporarily been under Soviet control. Sometimes there has been more understanding between Western and Eastern Europe than between Western Europe and the US, if Europe could absorb Greece, Portugal, and Turkey, why not Czechoslovakia?

Brown countered that Turkey has not been absorbed in Europe, and, at least as far as the eye can see, will not be accepted as a part of the European community. When this is realized, Turkey will be faced with serious internal ruptures.

Many Hungarians may be hoping for an open arms reception. But Hungary may be faced with bitter disappointment even from a country as sympathetic as Austria. Such a disappointment may bring a return of that introspective aspect of the Hungarian character that has always been present and that is already present in the parliamentary representation of the Hungarian Democratic Forum.

Svejnar pointed out that Eastern Europeans have shown a strong desire to approach the US as well as Western Europe. An economic argument to diversify should be considered here, by approaching both Europe and the US.

Brown responded that this is very true. As one piece of evidence, he noted that much of Eastern European emigration is directed toward the US.

Gomulka agreed that there is a desire to change on the part of Eastern Europe and a desire to become like the West but many (especially in Poland) do not expect that they will be permitted to join the EEC very soon. There is more realism in this respect than previous comments have indicated. Poland, for example, does not expect as much economic help as some have suggested. German unification is likely to help maintain some closeness of relations within the Eastern bloc, especially between Poland and the Soviet Union, particularly while Gorbachev or other reform-minded leaders are in charge in the Soviet Union. There are warm feelings toward Gorbachev and many have feelings of solidarity toward a Soviet Union that is also attempting to reform its system and rejoin the West.

With respect to the EEC, there is a move toward an intermediate position of the EFTA type, with some tariff reduction. Brussels realizes and expects some applications from Eastern Europe, viewing some of them favorably. They are interested in enlarging the common market to envelop Germany from the Eastern side as well.

Brown concluded that German reunification will not prove as serious as is currently feared; nevertheless, there is tremendous concern.

Session II (Afternoon): The Implications of Economic Reform for Foreign Aid

Lewis began the afternoon discussion by explaining that AID called the conference because the issue of aid to Eastern Europe will be an important foreign policy question in the months to come. As such, AID is seeking input on how a future US aid package to the region should be structured. Recent US aid has consisted primarily of $60 million in enterprise funds for Hungary and Poland and $10 million for the National Endowment for Democracy. A number of other smaller programs are being offered directly through various departments of the government.

In addition, other nations and multilateral organizations are also coming to the aid of the region. A European Bank for Reconstruction and Development is being formed, primarily at the initiative of the French. The Germans and others are offering significant amounts of non-concessional tied aid. Several nations are offering technical assistance. Much of that aid may be in the form of goods rather than cash. The IMF and World Bank have been providing various types of assistance with the World Bank focusing on supporting enterprises and the financial sector. The IMF is primarily involved in stabilization programs.

Gordon asked **Thomas Schelling** to describe the relevant features of the Marshall Plan and to indicate how he thinks the Marshall Plan might be relevant to aid discussions for Eastern Europe.

Schelling explained that the Marshall Plan was designed to operate for only four years and three months beginning in 1947. As a closed-ended plan for a war ravaged Europe, it had a number of features that may differentiate it from any aid program today for Eastern Europe:

1. During the Marshall Plan, aid was the dominant dimension of American foreign policy toward Europe.
2. The Marshall Plan was organized, institutionally, on an identical basis for all countries. This emphasized that it was a plan for all of Europe administered through the Organization for European Economic Cooperation, the single most important institutional feature of the plan. Marshall did not propose a specific plan, but said that aid would be available to support any plan the Europeans proposed. This made it clear that there was a single pot of funds to be divided among all of Europe, not separate aid amounts for each nation. Requiring a European solution meant that all of the individual country requests were scrutinized by other European governments. The US created a facade that pressed the European nations to decide on the division of the funds even though the US made the ultimate decision. These procedures had the

effect of making each country understand that an increase in its aid came at the expense of aid to another European nation.

3. The primary goal of the plan was trade liberalization in Europe. Prior to the Marshall Plan, all trade within Europe was bilateral and the US wanted to move toward a system where there would be free trade with convertible currencies. OEEC was charged with examining bilateral trade relations and encouraging liberalized trade. Ultimately, the US set aside funds to create a European Payments Union to facilitate currency transferability. Along these lines, a plan for Eastern Europe might include a component for Eastern European countries to critique their commercial policies.
4. While the Marshall Plan was administered on a joint basis, there were few projects involving more than one nation. Any projects for Eastern Europe would presumably be similar, but environmental concerns might have to be met on a multilateral basis.
5. The Marshall Plan was founded on a strong ideological desire to promote a united Europe.

The most important difference between then and now is that in 1947 the US was the only aid-granting country in the world. Today our most difficult problem probably will be trying to figure out how to set common procedures for aid givers. Alternatively, each aid granting country could adopt a protege (e.g. West Germany being responsible for aid to East Germany.)

Thought must be given about whether the European arrangements regarding 1992 create an opportunity to decide how to integrate Eastern Europe with Western Europe.

The type of aid can make a difference. The process from 1948 to 1951 was for the US and OEEC to agree on a total balance of payments deficit for each of the countries. Dollar vouchers would be issued by the US for various imports and deposited to the account of central banks which would then sell them to importers. The US decided which types of goods would be available via vouchers. No money was directed toward specific projects.

The local funds generated by the sale of the vouchers were sequestered and could only be used with the acquiescence of the US. However, given the existing debts of countries, no way could be found to keep the central banks from effectively spending the funds by disbursing other assets and maintaining the sequestered funds as part of their reserves. Ultimately, little of the sequestered funds were actually spent. Most were used to offset short-term debt.

Despite this, the US was able to use its authority over the sequestered funds to examine and discuss the monetary and fiscal policies of the recipient nations. It was also possible to support certain activities within a nation by suggesting that the sequestered funds could be used to support those activities.

Under the Marshall Plan, all aid was government-to-government, so the issue of whether aid should flow to the public or the private sector was never raised.

It may make a difference if a donor pretends to target their aid. This allows the donor to take credit for certain activities, but it usually does not really matter. It may also be important to support certain ministries in the recipient country that are weak relative to other ministries by providing targeted aid.

During the years of the plan, there was considerable discussion about attaching conditions to aid. In Schelling's experience, most conditions were welcomed by recipient governments since the conditions forced them to do what they wanted to do while making the US the scapegoat.

Those involved in the administration of the plan discovered that it was very hard to cut off aid to a country. It is probably easier to cut off aid to a group of countries. If aid is discontinued to a country, it looks like political abandonment. Moreover, eliminating aid reduces diplomatic intimacy when much of the relationship between donor and recipient has revolved around aid.

Gordon observed that the US and other donors employ a wide array of instruments to transfer foreign assistance, much wider than in the 1940s. Aid is frequently provided in the form of projects, but it can also be in the form of specific imports, unspecified imports for broad program purposes, general balance of payments support, or even cash. Counterpart aid, or "sequestered" proceeds from imports sales or government deposits of equivalents amounts in local currency, is now a highly developed tool. With respect to counterpart, one of today's problems is that many central banks in the less developed nations of the world are not sufficiently competent or sophisticated to offset through overall monetary management the inflationary effect that can occur from counterpart releases. India in the 1960s and 1970s was a notable exception. Its Reserve Bank was able to minimize the inflationary aspects of mountains of counterpart deposits by sterilizing it for many years.

Schelling was asked how much of Marshall Plan was loans? One-quarter of the first year's disbursements were in the form of loans with a nominal or zero interest rate, he responded. None of the later funds were in the form of loans.

Another questioner asked when US foreign direct investment in Europe took off, and did the Marshall Plan facilitate it?

The Marshall Plan may have created a more optimistic environment for investment, **Schelling** recalled, but it did not directly support American investment abroad. Some negotiations also may have happened to ensure that European countries provided access to their markets to US investors.

Gordon asked the assemblage the following question: If the US interest is to support economic reform, how can the US be confident that its aid will advance this goal? It seemed to him that aid can be employed in two different, non-exclusive ways:

(1) Aid can be a resource used to finance a specific need, such as balance of payments gap or a specific project; or

(2) Aid can support institutional changes such as enterprise reform.

Which of the countries of Eastern Europe need which kind of aid?

Perkins continued by recalling that in the morning's discussion at least two countries, Poland and Hungary, were said to be facing serious balance of payments problems and might need aid to offset that crisis. But as the CMEA is modified and current problems are exacerbated, structural changes might be required.

Gomulka noted that this was especially true for Poland. Its need for aid is much larger than the aid levels currently being contemplated by the US and Western European nations. These high levels of aid are needed because the restructuring program that has been put into place contemplates a two-year contraction of the economy.

Poland faces an immediate problem, he said, created by its $40 billion in foreign debt. Interest alone this year equals some 40-50% of all dollar export earnings. Such a level of foreign exchange usage for debt service is out of the question for the next five to ten years. The best assistance for Poland, and perhaps Hungary, would be to remove the threat to economic reform caused by outstanding debt. Thus, the West would be well-advised to support debt relief rather than provide new resources. Both debt reduction and interest rate relief should be contemplated. Poland will be offering to its bank creditors a restructuring much like Mexico's. It may even demand that the debt be reduced to its current market value, which is now about 15 cents on the dollar.

Poland's communist government resolved a previous debt crisis by continuing to service private debt. To do this it paid about $900 million a year in interest. The serviced private debts constituted approximately one quarter of all foreign debt and the Paris club received little payment. Now that Poland is less dependent on private banks it has been able to demand better terms on that debt, leading to a decline in its value. It is clear that Poland will have to demand a major reduction in both private- and public-sourced debt. At the same time, Poland will fully service all newly acquired debt.

Gomulka was asked to summarize the scope of Poland's present debt obligations. If the debt were fully serviced, he said, interest would run between $3-5 billion each year during the next several years. Actual debt service payments over the past few years have only run to $1.6 billion annually. Presently, $8.9 billion in commercial debts exists, of which about $1 billion is short-term. Poland will service its short-term debt, but does not intend to service fully any debt extending over 12 months or more. The letter of intent assumes that Poland will pay only 15% of its interest obligations on both commercial and public debt. This will lead to savings of approximately $800 million per year.

The need for debt relief is underscored by the fact that the restructuring of the economy will cause a significant growth in new debt over the next several years. This is due to contraction in the economy that may lead to a reduction in exports and an expected increase in imports. One can see an upcoming crisis.

Two questions were asked of **Gomulka**: Why is there an assumption that there will be a reduction in exports? Should the opposite not be expected as a result of devaluation and improved efficiency? Is it not more likely that exports will rise as inefficient enterprises are closed down and the currency devalued?

Gomulka explained that a contraction in output is expected as enterprises are closed down for restructuring. As for the stimulation of exports by a devalued currency, price increases have already more than offset that change. Furthermore, there will be many dislocations due to restructuring. Exports of coal are declining, in part because of a fall in output. Finally, the Soviet Union has a problem in that some debts to it will have to be paid in hard currencies if the CMEA moves to such a settlement system. This will lead to a balance of payments crisis in three years unless the CMEA arrangement is modified.

Although the most important need of Poland today is debt relief, an infusion of new resources is required. Presently, the World Bank and the IMF are providing approximately $1 billion in aid to support the stabilization program and to finance imports. Aid programs from the US and others are providing approximately $1 billion this year. Including enterprise-directed aid, a total of $2.5 billion in aid seems assured. But some of that aid may not be used, and some may be needed to service the debt.

Investment is needed in two key infrastructure areas: telephones and banking. The telephone system is crude. Up to $10 billion may be justified over the next 10 to 15 years to bring it up to western standards. A $500 million crash program to improve telecommunications is now being worked out with the World Bank. The current state of the telephone system is impeding improvements in the banking system and is slowing down foreign investment. An injection of $1 to $2 billion over the next three years would fund minimal improvements.

As for the banking system, it does not need funds as much as it needs technical assistance. Western banks could also help by opening branches in Poland.

Crane expressed the view that there are two bases for aid to Eastern Europe: to address resource needs and to promote institutional change. Looking at the data, the countries of Eastern Europe invest a higher share of GNP than most other nations. The problem is that the investments have extremely low rates of return. But this may change. As reform moves forward, there will be a transfer of the savings function to the private sector. We cannot say today in what direction savings will move. Whatever occurs, it is important that investments of future savings and foreign aid be directed toward worthy projects. Under the present system, any resources made available to these nations will be wasted. Thus, a major focus of any Western aid package must be institutional change to promote sound investment strategies.

Without such change, aid will just help to maintain the current system.

The investment problem aside, **Crane** continued, it is clear that Poland is bankrupt today. Hungary is only quasi-creditworthy and has a balance of payments problem. Bulgaria is in the same situation as Hungary. The other countries of Eastern Europe do not face a balance of payments crisis. Crane suggested separating debt issues from aid issues because they are distinct.

The Marshall Plan is not a good policy model for the current situation in Eastern Europe, **Crane** argued. Unlike Europe after the war, capital stock is in place and investment levels are currently high. The focus should be on institutional change to get reasonable rates of return from existing and new investments.

Bergson expressed the view that aid cannot be completely divorced from the debt problem because any funds offered may be used, in effect, for debt relief. It cannot be ensured that aid will be used for the purpose it is offered. Thus, any plan that is developed must address the debt problem.

Gordon commented that it is difficult to get multilateral donors and some nations to accept debt relief. Their way of avoiding the problem in the short run is to use additional aid as a way of funding debt service, although sub-Saharan Africa's annual debt service now exceeds the flow of new public funds.

Perkins expressed the view that any real resource gap in Poland, Hungary, and Bulgaria appears to be a foreign exchange, rather than an investment, gap. If it is not filled, real hardship will ensue in terms of lowered consumption. Whether such a gap can best be filled with further lending or debt relief is currently being debated in the Latin American context. In Latin America, the question arises whether debt relief might relieve the political pressure for reform. If that were the case, then the debt should be left high to encourage reform with assistance provided to service the debt. If the commitment to reform is high in Eastern Europe, then there may be less to worry about regarding commitment to reform than in Latin America.

In Poland, it was asked, is there an incentive for enterprises to export (e.g. the devaluation of zloty)? **Gomulka** responded that six months ago there was excess demand in the economy. Today, supply is in surplus. Enterprises will be trying to sell some of this excess abroad. Although the devaluation was designed to encourage exports, the elimination of export subsidies (20% of existing exports are unprofitable) discouraged them. It is difficult to judge what the net effect will be, but **Gomulka** believes that exports may fall this year, although they should begin increasing fairly fast next year. Poland's recovery, if it is to be sustained, must be export-led.

Crane noted that empirical research on Hungary indicates that when there was a decline in domestic demand, exports increased. Today domestic demand in Poland, demand from the Soviet Union, and demand from the rest of the CMEA are declining. This should lead to more exports. Devaluation can also be a powerful incentive. Some earlier partial devaluations in Poland have occurred, and these actions were greeted with positive export responses. But a lot depends on the currency policies followed by Poland after the devaluation. If true devaluation occurs, strong export growth may follow.

Gordon asked **Marer** his opinion of Hungary's resource needs and requirements for institutional change. **Marer** said it is clear that Hungary's resource situation differs significantly from Poland's. First, Hungary's debt is not sold at a discount, and it has made no plan to reschedule its debt. Hungary has maintained its creditworthiness; moreover, two-thirds of the debt is owed to commercial creditors, so the availability of new credit is heavily dependent on servicing the existing obligations. This is one reason why Hungary has been avoiding disturbing the credit markets with talk of restructuring debt.

Hungary does resemble Poland, however, in the share of GDP (3-4%) that must be devoted to debt service. This is equivalent to 50% of export earnings, an amount sufficient to jeopardize the political acceptability of the reform process, particularly in the short run. At a minimum, Hungary would like guaranteed access to international credit and some kind of bridge loan as well to soften the transition. It should be noted, **Marer** observed, that a minority view in Hungary exists that calls for repudiation of prior debt incurred by the old government, especially if the judgment is that rescheduling will not be possible to expect.

In response to a query about the amount of financing Hungary will need over the next few years, **Marer** responded that there is too much uncertainty to make macroeconomic predictions of that sort. Not enough is known about the transformation process, the amount or terms of foreign investment that will flow into the country, what will happen in the CMEA, or what will happen to Hungary's creditworthiness with the commercial banks. However, something is known about the balance of payments (current account) deficit for last year (1989), which was approximately $1.3 billion. This year it is expected to fall to $600 million. For next year, the IMF target is to reduce it further.

Marer was asked whether his inability to estimate resource needs stems from the fact that Hungary has not advanced as far as Poland in its restructuring program. Not so, **Marer** responded. The problem is that the uncertainties are too great. It is difficult to predict the impact of restructuring on the balance of payments. Also, Hungary is very dependent on CMEA trade. Therefore, changes in the CMEA are very important. In fact it is currently estimated that the cost of moving to a hard currency basis for trade with the Soviet Union could lead to an increase in the trade deficit of between $500 million and $1.5 billion per year, depending on the prices used and the responses of the exporters and importers in Hungary and the USSR. Thus, the uncertainties are too great for predicting resource needs accurately.

Gordon observed that this interchange raises the fundamental problem of how to estimate the level of funds needed by Eastern Europe. It has been suggested that real reform in the direction of a market economy will lead to such substantial and unpredictable changes in relative prices that such outcomes as the impact on the balance of payments are impossible to estimate with any confidence. The situation under the Marshall Plan was substantially different.

Devarajan interjected that **Marer** had in mind a different kind of uncertainty. He was concentrating on the external environment. The suggestion now being made, **Devarajan** said, is that we cannot even make estimates about the internal response to external events.

Marer commented that the history of reform in Eastern Europe is a history of mistaken assumptions about the responses of households and enterprises to changes in the "regulators" that are manipulated by the reform measures. Today, a great deal of uncertainty prevails regarding the ways actors will respond. If they respond quickly, predictions might be able to be made. But history has shown that they do not respond as would be expected and hoped, which creates problems for economists in trying to make predictions.

Gordon asked **Marer** the following question: If a fund were created to cushion the transition from CMEA trade, on what basis could the amount of relief each country receives be decided?

Marer acknowledged that there is no consensus on the answer within Hungary. However, if the group of 24 were to establish a fund to provide Eastern Europe with relief, then there would be enough leverage to force through the tough reforms that would make Hungary a competitive economy within two to four years. Otherwise, the political acceptability of the transition may be impaired. It should be in the economic, as well as political, interest of the

West to see Hungary and other Eastern European countries move intra-CMEA trade onto a dollar basis, with trade determined by enterprises on the basis of profitability. Such trade within the CMEA group should be maintained and somehow financed, otherwise the economic collapse would be too sudden and too great, which is not in US or Western interest.

Do the Hungarian's see two years of economic decline under restructuring as is expected in Poland, **Marer** was asked? He responded that because there no plan exists yet for restructuring the Hungarian economy, the question has not been discussed.

Kyn observed that internal behavior is easier to predict under a market economy. Assuming that reforms take place, it may become easier to predict the impact of policies using CGE models over the next two to three years.

A question was asked about the size of the manufactured exports from Hungary to non-CMEA countries. If it is large, the questioner said, it may be hoped that Hungary's response to market forces will be quick. **Marer** responded that very few finished goods that are sophisticated are sold outside of the CMEA. Intermediate or semi-manufactured goods are significant. In response to **Crane's** observation that there are large sales of textiles and shoes as well, **Marer** felt there is little short-term possibility for increasing capacity in these sectors.

Marer then turned to what he regarded as a major problem that Hungary must address: whether state-owned enterprises can be made to respond to market forces. Some believe that they can; others believe they cannot. The blue ribbon commission will suggest that a massive effort should be undertaken to privatize state-owned firms, including some that currently export mainly to the CMEA.

Gomulka expressed the view that major restructuring of state enterprises is a need throughout Eastern Europe. In the case of Poland, an agency has been created to finance the restructuring. It is envisaged that financial discipline will be imposed but that behavior of managers may not be appropriate. Thus, there will be losses, and it may be necessary to close or restructure some enterprises. A need exists for funds to support enterprises that should be assisted.

Enterprises should be encouraged to try to sell to Western, rather than CMEA markets, but such restructuring will be an expensive process, requiring more investment. How should this process be managed? Bureaucratic allocation of resources should be avoided, but if it is left entirely to the markets, there is the danger that the contraction will be much greater if there is no intervention.

Perhaps the solution, **Marer** reflected, is to rely on the IMF or some other international agency to impose conditions on the use of aid to support restructuring of industry. Some international agency should probably oversee the process to ensure that goals are met, but the IMF and the World Bank do not have the billions of dollars needed to address these problems.

Marer reminded the conference that the governments of Eastern Europe have failed in past efforts to decide which industries should be phased out. Alternative mechanisms must be found. To address the institutional problem, he suggested that limited-life task forces be created to address the following concerns, among others:

1) How to overhaul the bureaucracy?

2) How to privatize the economy?

3) How to create capital and labor markets?

4) How to build a commercial, investment, and savings banking system?

5) What should be the foreign direct investment strategy, and what agencies can best attract and direct such investment?

6) What should be done about infrastructure?

7) What should be done about the accounting system?

8) What about the legal system?

9) How should labor relations be handled?

10) How do you create small businesses?

The role of governments, Hungarian and others, **Marer** continued, would be to bring together two or three highly regarded Hungarian experts and other experts from the rest of the world to address each of these problems. The task forces would then establish terms of reference, calling for tenders to address each problem in light of Hungarian reality and world experience. In evaluating the responses to the terms of reference, special consideration would be given to tenders from groups that include both Hungarian and outside experts. This would encourage the transfer of knowledge on these issues from foreign experts to Hungarian citizens. The final result of the work would be recommendations to the government of Hungary. Eastern European countries are now overwhelmed by ideas proposed by foreign experts, and they do not know how to choose among them.

Svejnar was then asked to comment on Czechoslovakia's aid requirements. He began by reporting that the official Czechoslovakia position is that no aid is needed. **Svejnar** believes, however, that assistance in institutional change and information provision is needed. For instance, a need exists to learn English, a need that the US could address through the Peace Corps. A need also prevails to acquire managerial know-how. Managers need training to evaluate potential business suitors. Another problem, the low level of computerization, could be addressed by outside assistance.

Svejnar also contended that there is a need to develop certain institutions, particularly in the financial sector. Commercial banks have to be developed and loan officers trained; stock markets, auctions, and boards of directors will have to be established and run; and both management training and some form of insurance to protect small businesses, in particular, against uncertainty will be required. All will require some help and training based on experience in the market economies.

Transitional assistance may be needed, **Svejnar** observed, to move the Czech economy away from its orientation toward the Soviet Union, particularly if the CMEA deteriorates rapidly. In particular, foreign governments could promote access to their markets for Czech goods. Finally, assistance is needed to address the ecological disasters in the country, but this will likely come from European sources.

Svejnar also noted that it is important that US businesses come to Czechoslovakia. Currently, this area is being dominated by the Germans and the Austrians.

Brada agreed that Czechoslovakia does not need resource aid now. Sufficient resources are available for investment. The problem is to ensure that good investments are made.

Regarding the idea of a Marshall Plan for these nations, **Brada** observed that one of the outgrowths of such an approach is the development of a planning bureaucracy within the government of the recipient. What these countries need now, however, is de-bureaucratization, not new agencies. However, as a practical issue, if there is a program to aid the other Eastern European nations, Czechoslovakia will want its fair share.

Institutional aid can be very useful. For instance, the country would benefit from the teaching of basic economics at a grassroots level. Tremendous lack of knowledge exists about what is an acceptable economic system.

Brada was asked whether there are economics faculties competent to handle the teaching of market economics. He responded that there are some economics teachers, but they cannot recognize market outcomes on the street. They often confuse problems created by bureaucratic interference in markets with market outcomes.

Their response to a problem in a market is that there should be a law to fix it.

Gomulka interjected the observation that, in Poland, the 1970s were disastrous for the teaching of economics; the quality of courses declined precipitously. All of the Eastern European countries suffer from the lack of micro and macroeconomics courses at any level. Macroeconomics is somewhat better taught.

Marer added that Hungary needs business education more than it does economics education. Accounting and marketing are a high priority, and few faculty can teach these topics.

Kyn asserted that business education is non-existent in Czechoslovakia, nor is modern economics being taught. The best potential teachers are now in the government.

Schelling agreed that government officials may need to know some economics, but the more crucial problem is increasing the level of understanding about economics and markets among the general population. The interesting point, he observed, is that this may not be too difficult to do and could be done quickly. For instance, Vietnamese peasants move to Saigon and learn to operate in the market economy in three months. How quickly people learn to operate when the government lets them is often underestimated. Another good example of this may be the black market entrepreneur in Moscow. Looking at examples of this kind of learning, various types of enterprises can be identified and initiated by this kind of entrepreneur. His comments also applied to smaller scale efforts, but different and more difficult problems within larger organizations may exist.

The question, he asked, is whether the population will quickly learn to be entrepreneurs. They probably would if they migrated to New York. The question remains if they do so at home.

Brada agreed, but he felt that the problem in Eastern Europe is that so much capital is tied up in large state enterprises. The managers of those enterprises know how to work within the bureaucratic environment. They may not be capable of adapting to new forces and ideas such as commercial finance, marketing, and international business. They have not had to deal with these issues before.

Svejnar added that the education of the populace in economics will be important in order to protect the political reform process. If the people do not understand why certain steps are being taken, there could be a backlash against reforms. This is particularly true with respect to current concerns over persons making easy fortunes.

Along these lines, **Perkins** noted that in 1981, when HIID started a training program in China, officials there could not understand that anything could be taught about marketing.

Marer expressed the belief that small scale entrepreneurs will be able to learn the market quickly. He agreed with **Brada** that the problem is that the managers of large enterprises may find the market economy difficult.

Nevertheless, **Bergson** observed, the need for qualified economists might be quite large. Governments will need to absorb many economists. Economists outside the government will be needed to generate independent assessments of government policies. A country like Czechoslovakia may need a significant investment in economics training to meet its needs.

Montias was asked to comment on the need of Romania and Bulgaria for external aid. Looking at the process of moving to an industrialized market economy, Czechoslovakia starts this learning process with an advantage: they remember capitalism. Bulgaria and Romania are at a severe disadvantage. Their industrial economies were created while under communism; they have no memory of how to operate industries in markets. They are afraid of the market system. This is probably why there is no public pressure for reform in these countries. If there is not a strong will to create markets, then market reforms attached as conditions of aid will not work. Conditionality will work if the bureaucrats want it.

To understand the need for assistance in Romania and Bulgaria, it must be remembered that Romania has now paid back its foreign debt. Unfortunately, this does not mean that the economy is in good shape; it is in disequilibrium. Debt was retired by ignoring the need for investment and demand for consumption. As a result, the infrastructure of the nation has deteriorated severely.

Also, the relative isolation of the country, **Montias** reminded the conference, has cut it off from the stream of technical progress, but this may be an advantage. Many fruitful opportunities may be available in the country where investments in current Western technologies could yield high returns. This is a situation where a country should want to become a debtor.

Montias does not believe that Westerners should try to guess the kinds of projects Romania needs. Instead, balance of payments aid should exist along with humanitarian aid such as foodstuffs, medicine, and school books. The country's attempts to obtain commercial and other unsubsidized loans should be supported. Any direct aid should be humanitarian.

As for Bulgaria, **Montias** continued, the political climate that emerges there will be as a result of the elections. In particular, it should be determined if a real demand for market reform exists. If there is, then the reform should be supported.

Montias pointed out that the promotion of Balkan unity is important. In particular, the West should consider promoting trade agreements among these countries in order to encourage multilateral trade throughout Eastern Europe.

Marer observed that a particular problem affecting political receptivity to reform is that the workers, intellectuals, and professionals are worried that their accumulated skills under communism will not be of any use under the new regime. If any reform is to succeed, these people must feel they have a vested interest in the new system. This will not be accomplished by offering courses, but by working with them on a problem affecting their own country. That is why **Marer** likes the idea of creating a number of task forces to deal with the changes that will be occurring in their society. This will train them to work with foreigners and to learn the skills that are needed in the new system. Retraining will be needed to help them deal with the new economic and political situation.

Schelling expressed discouragement with the idea of trying to attach conditions to aid. The political process by which aid is requested and appropriated in the US seems to result in a heavy-handed approach to such conditions even though a lighter touch is required. This leads **Schelling** to believe that the only basis for giving large amounts of aid is that it might be possible some of these nations can succeed in moving to a market economy, and the biggest impediment to a country achieving that success is a short-term economic crisis. If balance of payments aid to hold down inflation and maintain standards of living is provided, that may be the best that can be done.

In addition, a limited number of projects directly in the areas of health, pollution control, and infrastructure development might be supported.

Gordon observed that the discussion to that point seemed to have established that two of the five countries, Poland and Hungary, require balance of payments aid. In addition, Romania may need some humanitarian assistance. Resource inflows seem not yet to be needed to support economic reform in Romania or Bulgaria. Even in Hungary, the external payments problem seems to be confined to debt service and possible problems of CMEA clearing payments.

Clearly, he continued, these countries differ in their interest in undertaking reform. Thus, it appears that aid to these countries must be differentiated, lest the US winds up helping some countries to avoid or delay reform. Does all of this suggest that a multilateral approach such as a new Marshall Plan is inappropriate?

Gomulka noted that the G-24 countries decided some time ago with respect to Poland, that they would offer assistance only if the IMF and Poland agreed on a plan. Now Poland and the IMF have reached an agreement. This triggered other aid, which was useful to both sides. The reform-minded government, including Balcerowicz and others, are able to use this agreement to support reform.

Gordon observed that a pattern has emerged in aid to the Third World: being in the good graces of the IMF has become a qualification for assistance from the World Bank and most bilateral donors. Once some measure of economic stability has been achieved, or at least promising stabilization measures, such as the IMF requires, are in place, the World Bank tends to take the lead in the amount of aid provided and in coordinating other donors. But this leads to a country-by-country basis for decision-making.

Perkins agreed that the international agencies can be an important part of a program of aid. However, the IMF is too rigid, and the World Bank comes in with too much clout. The critical thing is that there be an aid agency that can be supportive of persons within the country. If you do not have people in the country that will promote reform, the international agencies cannot accomplish anything. In Poland, a group, with which to work, has been identified. In Hungary, it is hoped that a group will be identified after the elections. If this does not happen, reform will fail.

Brown expressed his view that in order to achieve a civil society in Eastern Europe it is important to establish a market economy. But the difficulties that will be faced in creating a market economy are greater than people infer. In the short run, he believes that the main difficulty will come from the hardships that the introduction of a capitalistic economy will entail. In view of the opposition and delays that will occur, the lower classes will bear the burden of reform and thus may oppose it. Some way must be found for the majority to make transitions in these countries until the long-term benefits of reform are felt. **Brown** said that he could envision Congress agreeing to aid for unemployment benefits to Gdansk workers.

Gordon recalled that some conferees suggested that balance of payments aid to maintain consumption in the short-run is necessary to support a stringent stabilization program. The question then arises, does such aid serve as a disincentive to reform? In the case of Poland, the recipient has taken the initiative. If reliance is placed on the IMF to induce reform, is reliance being placed on an institution that only enters the picture when the patient is seriously ill? This may be a good time to start reform, but it is not necessarily a good way to induce countries to take up and sustain long-term, fundamental market reform.

Schelling responded that if Poland is an important bellwether of reform and they are trying to implement reform, then maybe assistance should be focused there. This might encourage others to take risks since they see that the US is helping out.

Gomulka commented that in Poland no perception exists that reform was induced by the West. It was local in origin and came as a response to internal crisis. A commitment was made by the new leaders to make changes. Western aid is to be used to reduce the risk of failure. The IMF was not seen as imposing unacceptably harsh conditions. The agreement contained a common purpose. You need a crisis in the other countries to create a need for reform.

Devarajan observed that this is very different from the situation in most developing countries where the IMF provides the impetus for reform.

Most of the Eastern European nations are seeking market access in the West, said **Crane**. This should be used to promote trade liberalization.

It was **Marer's** view that the US can only exercise a leadership role in coordinating aid because it will not be the largest donor. One possible approach would be to adopt a division of labor among countries in the provision of aid.

Batchelder reminded the conference of **Lewis'** earlier observation that US aid is taking shape on a bilateral basis. This is in contrast with the Marshall Plan. In that case, aid was given to Europe as a group, and they worked together to divide the aid. Is that not possible for Eastern Europe? **Gomulka's** view was that multilateralism will not work for Eastern Europe. **Marer** felt that our aid should be designed to support two goals. First, we should encourage economic liberalization. Second, we should encourage countries to give bills of rights to minorities to prevent explosive political situations.

Brada observed that the governments of Eastern Europe are at very different stages of reform. Different policies are needed for each. Moreover, an offer of aid cannot wait until late reformers catch up. **Marer** agreed, but he also stressed the need for a commitment to reform and to reduce ethnic tensions before aid is provided. Those countries that move in these ways should be aided immediately. **Crane** seemed to express the consensus when he said that a country-by-country approach would be best.