

Policy Dilemmas of Eastern European Reforms: Notes of an Insider

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It is becoming more and more clear to all East Europeans, and to Czechs and Slovaks in particular, that the only practical and realistic way to improve their living standards is the total abolition of institutions of central planning, the dismantling of price and wage, exchange rate and foreign trade controls, and the radical transformation of existing property rights. This approach represents the "hard core" of the reform project of Czechoslovak economists and politicians which is currently under discussion and preparation.

We have to face, however, many obstacles (see for more detail, Klaus, 1990b) while trying to realize such an ambitious reform goal in a very short period of time. There are many serious technical issues which must be solved, but the most pressing obstacle is the ideological prejudice against the market and its side effects, the dreams of "muddling through" based on minor improvements of the existing system, and rational or irrational fears of crossing the tolerance limits of the population or, better to say, of some powerful organized groups with their well-defined vested interests.

We have to argue with 1968's reformers who believed then, and still believe now, it is possible to improve the performance of our inefficient economy by introducing some minor elements of the market into it, and who explicitly or implicitly consider the market to be an overcome, obsolete, and inefficient economic coordination

mechanism. They are supported by Western intellectuals who visit our countries nowadays and who preach obsolete, long forgotten ideologies they are not able to sell at home.

We have to fight quasi-radical antibureaucratism whose adherents do not criticize the system of central planning as such, but particular people in it. It unfortunately becomes an extremely unproductive and nihilistic approach which blocks any far-reaching and deeply rooted social change.

At the same time we have to oppose the arguments of very loud and very self-confident technocrats who stress the superiority of technical knowledge, who do not understand the systemic explanation of social events, and who believe in social engineering and in "rationalistic constructivism."

We have, therefore, an enormous task to explain the advantages of the "invisible hand of the market" as well as its accompanying effects and to sell these ideas to the public and to the newly-born politicians. It takes time which is necessary for the search for difficult solutions of pressing economic issues of the reform and its sequencing.

Historic events are unfolding before our eyes and with all necessary fears and risks, we have to move forward very quickly. In Czechoslovakia in the first eight months of 1990, we proceeded in a parallel fashion with institutional restructuring, with legislative measures, and with changes in economic policy:

- (1) the **monobank** was dismantled and the two-tier banking system was introduced;
- (2) several institutions, so characteristic for the traditional command economy, like the State Planning Commission and the State Price Board, were abolished;
- (3) new legislation, supporting the private sector and defining the rules of the game, was initiated;

- (4) restrictive monetary policy was implemented with the target for the rate of growth of the money supply in 1990 around zero;
- (5) fiscal policy goes together with monetary policy and the state budget was transformed from deficit to surplus;
- (6) the Czechoslovak crown was significantly devalued (not to the equilibrium level, but the change was in the right direction);
- (7) subsidies both to consumers and producers were cut, and especially food prices were increased when the "negative turnover tax" was abolished;
- (8) foreign trade was to some degree liberalized.

On the other hand, the parliament has not yet discussed the so-called "Transformation Act" which provides an original scheme for rapid and widespread privatization. The prices (and foreign trade and exchange rate) have not yet been liberalized. We know that we have to act rapidly because gradual reform provides a convenient excuse to the vested interests, to monopolists of all kinds, to all beneficiaries of paternalistic socialism, to change nothing at all. We are well aware of the fact that losing time means losing everything. Losing time means falling into the "reform trap" of high inflation and economic, social, and political disintegration we see in some other countries. We feel that history will not forgive us if we miss our unique chance. We plan to implement all crucial reform measures at the beginning of 1991.

The microeconomic restructuring (privatization and price liberalization) has its macroeconomic aspect, which is—at least in **Czechoslovakia—fiercely** debated under the title "restrictive versus expansionary macroeconomic policy." The reformers stress the need for restrictive policy (see Klaus, 1990a) because

- they are afraid of inflation and its debilitating impacts upon economic decision **making** and resource allocation;

- they are very pessimistic about the short-term growth potential of the unreformed economy as well as about the rapidity of the supply response in a reforming economy;
- they want to squeeze out the most inefficient parts of the economy as soon as possible, which is not possible to achieve with excess demand and easy sales of any products;
- they want to start the real restructuring without being tied up with a burden of repayment of a "reform neutral" foreign debt.

The anti-reformers, on the contrary, criticize the restrictive policy and call for expansionary policy because

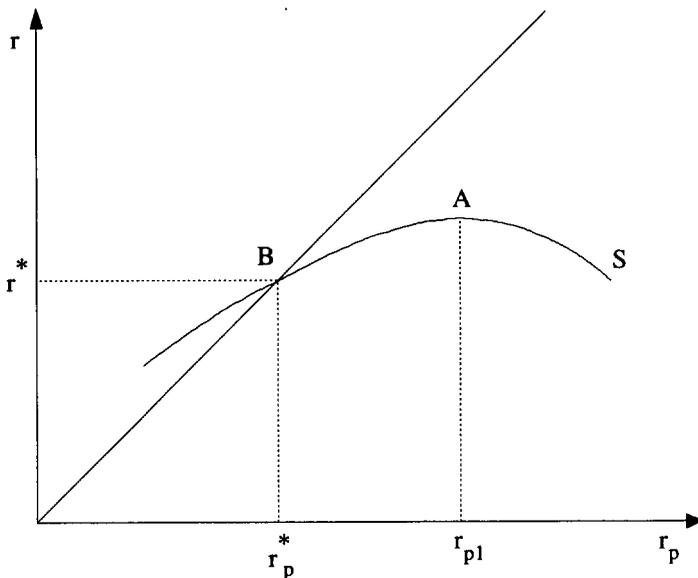
- either they are principally against the reform or they do not believe the reform can bring about an improvement of the situation in the foreseeable future;
- they believe in the efficiency of interventionistic industrial policy, in the ability of the government to orchestrate science and large-scale innovation, to organize foreign assistance, and to coordinate all **kinds** of "progressive solutions;"
- they are more optimistic about the blocking effects of various structural constraints on economic growth because they underestimate how structurally deficient the economy really is and will be when the oil crises will be felt;
- they do not want, in principle, to stop unprofitable business activities because they want to give everybody another chance.

We can demonstrate this issue with the help of the following diagram, depicting the so-called S-curve which is a locus of feasible combinations of planned, intended rate (r_p) of economic growth and of real rate (r) of growth. (See Ickes, 1990.)

The position and the shape of the S-curve depend on

- the growth potential of the economy at the aggregate level;
- structural defects, non-homogeneity of the economy, and bottlenecks.

The critical point is that the second factor is closely related to the quality of the economic systems, to the type of its coordinating mechanism, to its incentive structure, and so forth.



The diagram suggests that only at point B, both rates equal, is the economy in macroeconomic equilibrium. Slightly higher r_p than r_p^* still accelerates growth (with accelerating inflation), but after reaching point A, the real rate of growth goes down and inflation accelerates even further. The economic strategy, therefore, depends crucially on the assumptions about the position and shape of the S-curve, especially about the location of point A.

The implicit assumptions of the Czechoslovak government economists can be summarized as follows:

- (1) the prevailing long-run tendency in our economy was and still is $r_p > r_p^*$ with the secular open, hidden, and repressed inflation as a result;

(2) r_p^* is permanently—because of deep structural defects, price rigidities, and low supply response—lower than the natural rate of growth based on aggregate input data. This is documented by declining total productivity (according to standard growth accounting methodology) in the past two decades;

(3) short-run effects—both from abroad (collapse of Comecon and current oil crises) and from inside (uncertainties connected with systemic transformation)—shift the S-curve lower than it used to be in past years.

We do not possess sufficient data for drawing the S-curve, but our analysis shows that the short-run r_p^* is probably very close to zero if not below. We are aware of the fact that macroeconomic mistakes would be extremely costly. Even if the major challenges for the reform process are microeconomic in nature, sound macroeconomic policy is essential if the reform process is to succeed. We are, therefore, convinced that restrictive, and not expansionary, monetary and fiscal policies are the precondition for any successful economic reform. In a structurally rigid and deficient economy, expansionary policy cannot provoke a positive supply response.

The pursuit of our monetary and fiscal targets is difficult now and will prove to be even more difficult in the near future, but we cannot afford the risks of entering the forthcoming intricate reform phase with a large monetary latitude and excessive aggregate demand. The initial transitory costs of such a policy will be nontrivial, but the benefits to be gained will be well worth the effort.

References

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