"Countries in Transition: Where do we stand now?"

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The year 1989, with its sweeping though unexpected events was welcomed globally as an annus mirabilis. The collapse of Soviet totalitarianism, the abolition of the system of command economies and the emergence of democratically elected governments in Eastern Europe were seen as symbols of glorious times to come. People were talking about "the end of history" and those who voiced scepticism were belittled to be pessimists and faultfinders.

Since then almost four years have passed and the mood has changed drastically. Hope has been replaced by despair, optimism by disappointment and disillusionment. What has happened? What went wrong? In a nutshell, people had failed to realize that never in modern history had there been a successful, simultaneous change of the political <u>and</u> economic nature of a system! Thus it should be no surprise that there is no simple recipe, or magic formula, for changing a system both politically and economically. The path from Marx to the market has been and still is very much terra incognita where every step, even with the best of intentions, may have unexpected and often undesired consequences.

It is not a question of choosing between shock therapy or gradual approach. The collapse of the former CMA system already was a shock because traditional markets disappeared almost overnight. Instead of talking about shock therapy it seems to be more appropriate to talk about therapy shocks. The dramatic change of oil prices in Russia serves as a case in point: In three years the state oil price was increased from 120 rubles per metric ton to 38.000 rubles, where it stands now, the equivalent of one liter of gasoline going from $ 1 to $ 316 in the West.

Does this mean we should close the books, look at our own problems and let these countries deal with their own by themselves? At least there seems to exist a broad consensus that this would be foolish and very much against our own interests.

Instead, what is required is less euphoria or despair, less sentiments flowing between optimism and pessimism. Nothing but a hard look at the facts, a sound analysis of the problems and far-sighted actions, free of any ideological burdens, are needed.

The Problems

Why has the economic development in the countries in transition been slower than expected? It appears that it makes sense to distinguish between problems stemming from the past and "new" problems.

The principal problems resulting from the **past**, which still haunt these countries, can be summarized as follows:

1. There still are **large parts of the economies**, frequently conglomerates, which are totally **inefficient.** One has the choice to either close them down, at probably unacceptable social costs, or modernize them. To modernize them, however, requires means very often not available from the public or private sectors for a whole range of reasons. Thus, these inefficient industries just muddle through and continue to be a drain on already scarce resources.

2. Important industries, such as the **arms industry**, have become partly **obsolete** and have lost their former customers due to changed geopolitical realities. Unfortunately, the arms industry used to be of overwhelming importance in some of the former CMA countries. According to CIA estimates, armament expenditure of the USSR, for example, amounted between 15 and 17 per cent of GDP. Of course there are examples of companies which have been able to switch from military to non-military production. This, however, requires capital, know-how and market knowledge.

3. The above mentioned problems, while remaining largely unresolved, have led to further strains on already **over-stretched state budgets** since the economic deficits of these industries continue to be covered by the state to avoid, among other things, public unrest. This, in turn, has undesirable macro-economic consequences which one is able to watch in many of the countries in transition.

4. Many sectors of the economies in transition still suffer from an **over-indebtedness** stemming from the previous system. In the old days corporations were either not allowed to make profits or had to turn them over to the state. Thus, companies were unable to generate funds from within and had to raise loans from banks to move along. Consequently, local banks today carry assets and corporations face liabilities which cannot be repaid from the companies' operations.

   It is somewhat puzzling that this problem which constitutes a huge burden for the parties involved, has not yet been tackled decisively. A solution should be found which would take these huge non-performing assets off the banks' balance sheets and would enable the companies to have a fresh start with manageable liabilities. This could be reached by the state taking over the loans and thereby improving the quality of the banks' books. Alternatively, the state could repay the loans immediately through issuance of long-term bond issues. Such a strategy or a similar one seems to be imperative to create the necessary breathing-space.

5. The **external debt situation** of the countries in transition, too, calls for a speedy and generous reconciliation. The countries used to be excellent borrowers with a pristine pay-back record. The high interest rates of the past and declining export revenues, however, have led to a situation where refinancings have become necessary. In the light of current needs in these countries it seems to be quite absurd that many of them have faced and some - as for example Poland - still face net foreign currency outflows.

   There has not been the generous, comprehensive rescheduling of foreign debts which, for example, Germany and Austria have enjoyed after World War II.

   This, of course, has had crippling effects on the disbursement of new funds, be it on a multilateral or national, on a public or private level.

Turning to "**new" problems**, the most important seem to be the following:

1. The **state budgets** are unable to cover the needs of the countries in question. Budgets can only be fed by taxing, borrowing and printing money. The tax collectors face the problem that either there are too few profits to be taxed or that profits go untaxed because of inefficient tax collection procedures. Borrowing and printing money - particularly in stagnant or shrinking economies - may have highly undesirable macro-economic effects.

2. The countries **lack** positive **trade surpluses** which could be used for investments at home. This, of course, has been caused not only by a shortfall of marketable goods, but mainly by the closed or nearly-closed western markets. The governments in the West, faced with a recession themselves, in panic fear of further unemployment caused by cheap imports from the East, have shut the doors while publicly advocating the advantages of free trade.

3. Although the West has nominally encouraged market reform, its tangible **support** has been **inadequate.** The willingness and desire of the former CMA countries to introduce market economies has not been matched by a corresponding conduct by western institutions, be it on a multilateral or national, on a public or private level. Foreign investments since 1989 in Eastern Europe have amounted to roughly $ 10 billion. In contrast, the Marshall Plan carried out in post-World War II Europe involved $ 13 billion over four years, or roughly 1.14 % of the GDP of the United States in these days. Translated into today, the equivalent amount would be $ 70-80 billion. This short-sightedness is even more puzzling since the countries constitute huge markets and therefore great potential for the western economies.

4. The **financial system** of the countries in transition very often is not in a position to cater for the requirements of a market-economy. Money is the blood of commerce, there has to be a

functioning circulation of money between providers and users of funds through an effective banking system and through efficient capital markets. Currently, however, corporations very often suffer from a lack of working capital resources, there is a general lack of liquidity and inter-company debts cripple economic activities.

5. Very often **legal structures** are incomplete. In view of lacking or insufficient regulations with regard to the ownership of land, taxation, tariffs, insolvency, execution of legal titles, patents and licenses, a less than enthusiastic attitude by foreign investors and lenders should not be surprising. This, very often, is accompanied by overloaded, inefficient public administrations which lack the experience to carry out their responsibilities. There are many reported cases of otherwise highly promising projects which have been frustrated by legal obstacles. Problems arise especially where acquisition of land by foreigners is restricted or, as in some countries, even prohibited. The political discussion and the occasional instrumentilization of this topic in internal politics do not serve to encourage investments, especially since real estate very often is the only asset local partners are able to contribute.

6. **Infrastructural problems** of transportation and telecommunication present another serious challenge for these nations. A lot of progress has been made in some countries, while in others even local telephone calls can be a nerve-racking exercise. Also, transportation is hampered by an inadequate network of highways and poor railway- and airline connections.

7. The need for **political stability** should not be underestimated. Although no one expects a return to the pre-1989 days, there exists irritation in the West over recent events where elections have brought some of the old guards back to power. This has clearly been less an expression of the wish for a return to the previous system and more an outburst of a sense of frustration. Nevertheless the

West prefers to see stable majorities able to lead the countries for sustained periods and carry through necessary reforms.

Rising nationalist and xenophobic attitudes born out of an equal sense of frustration over slow progress in some of the countries have also contributed to a lot of concern.

8. The **lack of adequate management skills** prevailing in some countries should not come as a surprise after 70 years of central planning. This problem, while a serious one, is only to be mastered over time through intense training, exchange programs and the like.

Action required

In the light of these facts, what is to be done to accelerate the economic transformation of the countries in transition? To be sure, success will not happen over night. The World Bank has calculated that a real rate of growth of 8 % per capita is needed, if the countries in transition were to catch up with Western Europe within 15 years. For this, an investment ratio of well over 30 % of GDP is required. This is not impossible. For many years Austria enjoyed a rate of almost 30 %, second only to Japan, but of course under different circumstances.

The argument how long the transformation of these countries will take has rested between two extremes. Some wanted to achieve it within 500 days. They have not really been taken seriously. Helmut Schmidt, on the other hand, once said it would take one night, nine months and 40 years, or 500 months, for a new generation of leaders with the required mentality and qualifications to emerge. 500 weeks seem to be an acceptable compromise, although a rather ambitious one.

It seems to be most important for the West to realize and to take account of the fact that any reluctance to act and be supportive now will only lead to much higher costs later on. The apparent disappointment and disillusionment is constantly adding fuel to a strange cocktail of nationalist and anti-social tendencies already brewing in some of these countries. It has to be repeated again and again that, if one does not want these people to move here, one has to let their goods move here.

Besides, it is obviously cheaper to pay the costs for peace than to pay for war.

Incidentally, there live about 400 million people in the western parts of Europe and roughly an equal number in Eastern Europe. The former enjoy very high standards of living and generous welfare benefits. However, the West is confronted with a growing number of unemployed, already close to 40 million, and under-utilized production capacities. In the other part of Europe people suffer from conditions of scarcity, low and even further decreasing living standards and from insufficient social security umbrellas. They do not have the necessary purchasing power and, so far, even not the possibility to generate it.

Given these circumstances, would it not be in the common interest and of mutual benefit to bridge the gap between the haves and the have-nots and to tear down the welfare wall dividing Europe at present? An idea would be for western governments, instead of paying unemployment subsidies, to order the production of goods which would entail better use of public funds, production capacities and higher employment. These goods should then be given to the governments of the countries in transition which in turn would sell them to the local population at reasonable prices in local currency. The receipts would be deposited into counterpart accounts and should be used, under strict conditionality, to finance private and infrastructure investments, which would fuel the economic engine of growth. The resulting improvement in purchasing power would then partly be reflected in increased demand for western goods. In order to realize this proposition the OECD should be drawn in, because of its experience from the reorganization of the war economies in the post-war years.

Needless to say that a strongly developing Eastern Europe will directly benefit Western Europe, which, in the light of record unemployment there, would be highly desirable.

Thus the West is called upon to strengthen its efforts considerably, on government- as well as on supra-national levels. The European Bank for Reconstruction and Development may serve as a case in point: Founded with lots of trumpets blowing a couple of years ago it quite dramatically failed to be a decisive factor and its impact upon the economies in transition has been negligible.

The EBRD could of course be a very attractive source of funds from a foreign investor's point of view. However, expectations have been higher than results. The Agreement establishing the EBRD contains severe and unnecessary operational restrictions. Mistakes were made in setting up the Bank's initial operational policies. Management problems have culminated in the retirement of the Bank's Chairman.

Jacques de Larosière, the new head of the EBRD, has just announced a radical reorganisation of the Bank. It involves the abolition of the merchant and development banking departments which previously handled seperately private and state sector projects. Their functions are being absorbed by two new "banking" departments, one covering southern-based countries and the other for the more northerly countries. I am convinced that these changes will make the Bank more effective in helping the economic regeneration of Eastern Europe and the former Soviet Union.

The EBRD was set up as a purely project financing institution with neither a facility for the financing of technical assistance, nor a soft loan window. The EBRD is required to provide at least 60 % of its financing to the private sector, both on an aggregate as well as on a country basis - after a given period of time.

A project financing institution has a slow disbursement profile by necessity in the light of the fact that disbursements follow the actual implementation of the projects. If the Bank is supposed to disburse quickly and have a maximum impact on Eastern Europe economies, then policy-based lending - fast disbursing structural adjustment loans or sector loans with a strong economic and political condition - would be an ideal instrument. Such an instrument however is expressis verbis excluded from the Bank's operations.

More flexibility is needed in the context of the 60/40 ratio, especially on a country basis. Without such a flexibility a slow-down of infrastructure financing as well as a slow-down of the Bank's overall operations is the logical consequence.

The Bank's lending terms are purely commercial, both for its private sector - as well as its state sector operations. At the same time operational member countries are highly diverse in terms of stage of development, per capita income and indebtedness. A facility which would allow an appropriate softening of lending terms, depending on the status of the operational country and/or the project, would considerably enlarge the scope for useful bank financing.

There is no grant financing foreseen for technical assistance activities in the Bank's Agreement (financing technical assistance activities are of course questionable since no income stream is created through activities which would form the basis for the repayment of the loan). Therefore the Bank depends on additional voluntary financing by its member countries/institutions for the funding of its activities. Normally the use of such additional funds is restricted in various ways and therefore limits its rapid and effective use.

The major argument against changes in the Agreement along the above mentioned lines ist that such changes would lead to a new mini-World Bank. This is not an impressing argument, since a considerable enlargement of the Bank's instruments and more flexibility in their use does not mean that the Bank's primary focus on support for private sector development has to be lost.

Supporting to a greater extent small and medium sized enterprises in member countries should be another important policy objective for the future. It is the new class of entrepreneurs which is supposed to ensure the irreversibility of the transition towards democracy and market economy. These small and medium sized enterprises can only be reached through intermediaries in various forms. Use of the guarantee instrument should play an important role in this context.

A new start under the new management should make the EBRD a decisive instrument in supporting the economies in transition in their difficult endeavor and give the private investor improved opportunities of financing projects in Eastern Europe.

Of course the nations must make every possible effort and take every conceivable initiative to pull themselves out of their current predicament. Apart from actions mentioned above, governments of countries in transition have to demonstrate a distinct willingness and determination towards principles of market economies and have to exercise fiscal and monetary discipline to the largest degree possible. Otherwise confidence in the internal and external values of the respective currencies will further weaken.

In conclusion it appears to be appropriate to quote Germany's former Foreign Minister, Hans-Dietrich Genscher, who said that "in the long run Western Europe will not prosper unless Eastern Europe does." I would like to add that the solution of the economic challenges form part and parcel of an urgently required new security system to ensure a lasting peace in Europe.