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A Marshall Plan for Middle and Eastern Europe?

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Eastern Europe?**

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I. Introduction

The rapid pace of economic change in Middle and Eastern Europe poses an almost unprecedented challenge not only for the reform countries themselves. The industrialized countries of the Organization for Economic Co-operation and Development (OECD) have to come up with a clear-cut and sensible concept on how to respond to the economic reforms east of the river Elbe soon. While it is widely acknowledged that the West should lend a helping hand to those Middle and East European countries who need a close collaboration with the West to enhance the prospects of their market-oriented reforms, the major conceptual issues are still unresolved. Many of the demands for Western assistance invoke the precedence of the "Marshall Plan", some observers point towards the example of foreign aid to developing countries. Therefore, we shall try to contribute to the debate by addressing three questions: (1) What was the substance and significance of the U.S. recovery program for Western Europe in 1948-1952; (2) what has foreign aid accomplished in developing countries; and (3) given the lessons from past experience, what could the West do today to promote economic reforms in Middle and Eastern Europe?

The purpose of this essay is neither to comment on any of the specific proposals advanced so far nor to present detailed aid packages for particular countries of Middle or Eastern Europe. Instead, we intend to elaborate the general principles to which economic assistance for the previously centrally administered economies should conform and to sketch the ways in which this aid could ease the transition to genuine market economies without distorting the incentive structure in the meantime.

II. The Example of the Marshall Plan 1948-1952

Hardly any transfer of resources has acquired as much fame as the European Recovery Program (ERP), commonly known as the Marshall Plan. That this flow of US dollars across the

Atlantic in the late 1940s and early 1950s "revitalized postwar Western Europe, contained Soviet expansion, stopped the spread of communism, helped preserve the European capitalist tradition (and) powered tremendous economic growth ... has become a modern myth" (Cowen, 1985, p. 61). From April 1948 to June 1952, Western Europe received 12 billion dollars of ERP aid from the US (Table 1), a sum that was tantamount to 2.1 per cent of their GNP or roughly 21 per cent of their gross capital formation in this period; between 1948 and 1953, the economies of the recipient countries grew by 5.3 per cent on average in real terms (OEEC 1955, p. 322). The coincidence of aid flows and rapid growth in Europe has led many academic observers¹ and - more importantly - politicians and the general public to believe in a causal link. Whenever massive external assistance is demanded, the example of the Marshall Plan is invoked as an outstandingly successful precedence. However, this apparent success story merits closer attention.

At the end of World War II, liberated Western Europe had to cope with a partially destructed capital stock. Although wartime damage could not but impair living standards considerably in the short run, the growth prospects looked quite favourable. The very fact that parts of the capital stock had been destroyed while complementary factors of production, i.e. skilled and unskilled labour, were readily available, should have made private investments highly profitable and should thus have turned Europe into a magnet on the international capital market. However, the reverse happened. From the very beginning, private capital inflows from the US were negligible (BIS 1948/49, p. 7). In fact, given a chance to convert their European assets into US dollars, investors even withdrew capital from Europe and invested these resources in the comparatively capital-abundant United States, i.e. in a country without the

¹ For a typical assessment see Price (1955).

opportunity for and the need of reconstruction. Western Europe came to rely on foreign aid.

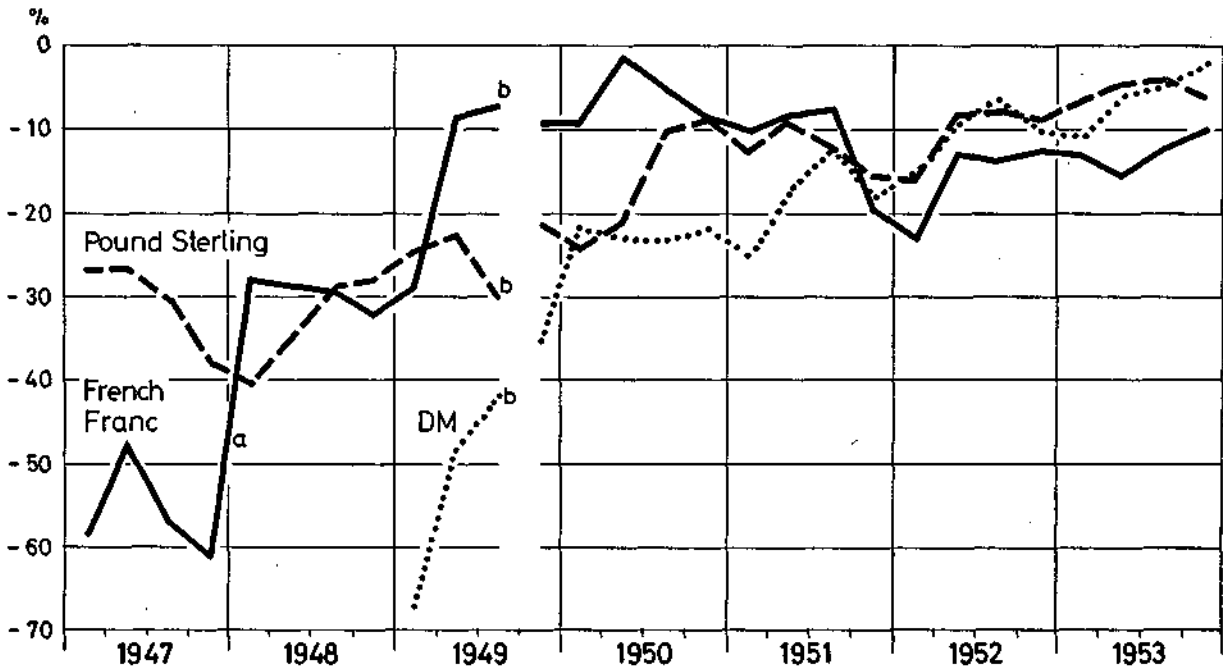
The economic policies of Western European countries after the war provide the explanation for this development. Internally, these policies rested on three pillars: (1) The continuation of war-time controls over production and prices of major goods²; (2) the overriding importance attached to investment for reconstruction and - at the same time - to policies of redistribution; and (3) the financing of expansionary demand policies by money creation. Externally, these policies were complemented by a severe overvaluation of European exchange rates vis-a-vis the US dollar (Figure 1). This overvaluation served to make imports of capital goods and food that were considered as "essential" cheaper in terms of the domestic currency. In addition, the European states were reluctant to openly admit the consequences of their internal inflation and of the relative strength of the US economy by abandoning the prewar parities. The resulting severe shortage of foreign exchange forced European governments to keep their currencies inconvertible. The "dollar gap" not only limited the growth of cross-Atlantic trade by discouraging European exports, it impeded intra-European exchanges of goods and services as well. At the going exchange rate, no other major currency but the dollar (and, less importantly, the Swiss franc) looked sound enough to be trustworthy. Consequently, every European country had an incentive to accept no currency but dollars in exchange for its goods and to keep its own dollar obligations to a minimum. Due to the severe shortage of money that could be used as a store of value and medium of exchange in transactions between currency areas, the world outside the dollar area

² Belgium and Italy are the most notable exceptions (de Cecco, 1986, p. 109).

Figure 1

Overvaluation of Major West European Currencies 1947 - 1953

Deviation of Market Exchange Rate from Official Dollar Parity



^a Devaluation; ^b Currency realignment of September 1949.
Market exchange rate: Zürich rate for banknotes.

Source: BIS, various issues; own calculations.

turned to barter trade, i.e. to an extensive network of bilateral agreements specifying in detail the quantities and values of goods to be exchanged.

All in all, the economic policies in postwar Western Europe were quite similar to those which most countries of Eastern Europe still pursue today. The consequences were a grossly inefficient allocation of available resources within the countries, an inherent bias against a productive division of labour between countries and the failure to attract private resources for reconstruction and growth from outside.

The most visible direct result of these policies was the European balance of payments crisis of 1947. Regulated relative prices and the lack of a trustworthy money had

inhibited an efficient allocation of resources between different uses and locations according to relative scarcities. The monetary expansion at overvalued exchange rates, the ill-fated British attempt to make the pound Sterling convertible at the by now untenable prewar-parity³ and the virtual absence of Europe's traditional supplier of capital goods, Germany, from European trade circuits caused a high level of dollar imports and discouraged exports and inflows of private capital at the same time. In 1947, Western Europe lost one third of its gold or dollar reserves (Milward 1984).

Politically, the crisis of 1947 was seen as playing into the hands of communist parties in Western Europe which were anyway strong in the initial postwar period. This threat induced a shift in US policy. In a famous speech at Harvard University on June 5, 1947, the US foreign minister George Marshall announced a sizeable program of American aid for Western Europe. His speech signalled the readiness of the US (i) to get more directly and lastingly involved in European affairs, (ii) to replace the previous short-run relief efforts by medium-term aid for reconstruction and (iii) to abandon, for the time being, the efforts to create a global international economic order (to be supervised by the "Bretton Woods" institutions) in favour of vigorously promoting regional political and economic co-operation within Western Europe.

Until April 1948, the details of the European Recovery Program were elaborated in negotiations between the US and Western European countries.⁴ Marshall Plan expenditures

³ Britain spent almost the entire special assistance credit which she had received from the US in the six weeks of Sterling convertibility (Haberler 1954).

⁴ On the part of the US, the Paris-based Economic Co-operation Agency (ECA) was to supervise the aid disbursements, contin. footnote

started in April 1948 and reached their peak already in the US fiscal year 1949 (July 1948 - June 1949). In mid 1952, when expenditures were less than half of what they had been three years ago, the Marshall Plan was replaced by the much less ambitious Mutual Security Assistance scheme for most of the recipient countries.⁵ 88.2 per cent of the aid disbursements were outright grants, 11.8 per cent were in the form of long term credits at favourable terms (AID 1971, own calculations).

The Marshall Plan dollars served mainly to finance imports of agricultural products (food, feed, fertilizer: 32.1 per cent of all ERP shipments) and raw materials plus semi-finished products (48.3 per cent, of which 15.5 per cent were fuel and 14.0 per cent cotton). Only 14.3 per cent of the entire amount were used for machinery and vehicles, i.e. genuine investment goods. For West Germany, the latter share stood at a mere 3.3 per cent (including iron and steel as well as iron and steel products, Milward 1984, p. 101f).⁶

In the importing countries, the national currency equivalent of the import values financed by Marshall Plan aid was

contin. footnote

on the European side, the Organisation for European Economic Co-operation (OEEC) was founded for the purpose of coordinating aid requests and promoting the liberalization of trade and payments within Europe. Although the US had invited all European countries besides Spain to participate, Eastern Europe had to abstain because of a veto by Stalin. To compensate his satellite states in Eastern Europe, Stalin founded the Council for Mutual Economic Assistance COMECON in 1949.

⁵ The European Recovery Program was formally replaced by Mutual Security Assistance as of December 30, 1951 already. Because of the US appropriations practice, the entire US fiscal year 1952 (July 1951-June 1952) should be included in the Marshall Plan period though (see, i.a. AID 1971).

⁶ As the actual aid financed shipments may have released funds for other imports, these figures may not give a correct impression of the structure of the additional European imports made possible by the ERP.

deposited in special accounts. These counterpart funds were at the disposal of national governments (although under the supervision of the US Economic Co-operation Agency (ECA)). They were usually made available as credits for specific investment projects at concessional terms. On the one hand, these funds supplemented domestic sources of capital; on the other hand, they made it easier for governments to direct resources into the politically desired uses and thus strengthened state control over Western Europe's economies.

The economic impact of the Marshall Plan has recently been the subject of a lively academic debate. The traditional view that this massive transfer of resources made a considerable contribution to the economic recovery of Western Europe has come under heavy attack (see i.a. Abelshauser 1989, Cowen 1985, Milward 1984). A comparison of the aid receipts of individual countries (in per cent of their GNP) and their economic performance as measured by the growth of GNP and exports reveals no clear picture. While for instance Austria obtained comparatively large amounts of aid and achieved high rates of growth, it was by far outperformed by West Germany which received considerably less funds. A statistical analysis (Spearman rank correlation) shows only a weak and insignificant positive correlation between aid receipts in per cent of GNP and the growth of exports and especially GNP⁷ in the 1948-1953⁸ period (Table 1).

The basis for the allocation of Marshall Plan funds among the recipients was a country's balance of payments situation vis-a-vis the dollar area, not an evaluation of investment

⁷ The correlation between the growth of industrial production and aid disbursements is higher and more significant. Because of a lack of data, this correlation is, however, based on a smaller sample of countries.

⁸ This period which includes the 18 months after the end of the Marshall Plan aid was chosen because the impact of aid on growth may not be immediate as investments typically take time to mature.

Table 1: Marshall Plan Aid and Economic Performance

	Aid Receipts ¹ in mio. \$	GNP 1950 in bn. \$	Annual Real Growth Rates of ²			
			GNP	Industrial Production	Exports	Gross Capital Formation
Austria	703.5	2.430	8.66	12.82	22.30	16.87
Belgium-Luxemburg	324.8	7.052	3.87	2.92	8.71	3.66
Denmark	271.2	3.348	3.79	3.96	15.46	7.46
France	2862.6	29.090	4.26	4.47	17.08	-0.56
West Germany	1317.2	23.310	13.32	20.37	50.09	20.12
Greece	773.7	2.185	9.01	14.69	17.76	4.55
Italy	1253.5	15.165	6.05	9.96	8.68	11.79
Netherlands	980.6	4.976	5.18	7.63	23.89	2.96
Norway	263.6	2.720	3.34	7.26	7.54	3.61
Portugal	41.6	1.398	3.71	-	4.87	1.98
Sweden	82.1	6.520	3.59	2.48	7.54	2.11
Turkey	213.1	2.300	7.39	8.36	12.81	-
United Kingdom	2690.7	37.337	2.71	4.03	4.40	2.92
Ireland	146.5	1.086	3.07	7.78	12.92	6.00
Iceland	29.3	(0.110)	1.63	-	0.71	-

All recipients ³	11954.0	139.027	5.27	7.71	13.3	-

¹Total expenditures, adjusted for the reallocation of aid via bilateral drawing rights 1948/49.

²1948-1953 average (gross capital formation: 1948-1952 average), in per cent.

³Excluding the working capital of the European Payments Union which amounted to 350 mio. dollars.

Spearman rank correlation coefficients between aid receipts in per cent of GNP and (i) GNP growth: 0.179 (26.2); (ii) export growth: 0.358 (9.5), (iii) growth of industrial production: 0.544 (2.7), growth rate of gross capital formation: 0.275 (18.2); in brackets: probability of non-correlation (in per cent).

Source: AID (1971), BIS (various issues), Donovan (1987), Millward (1984), OEEC (a,b; various issues); own calculations.

needs or of how the resources could be employed most productively (Abelshauser 1989, p. 94). The major recipients of Marshall Plan aid in absolute terms, namely Britain and France, were exactly the two countries which went through recurrent balance-of-payments crises in the 1950s. On the other hand, West Germany - which had suffered a net outflow of resources in the post-war period if war reparations and the costs of military occupation are deducted from the Marshall Plan payments and the further assistance which the country had received until 1952 - experienced an unprecedented export boom, outstandingly high rates of economic growth and a rapid accumulation of foreign reserves. Although it had started from a much lower base, the West German standard of living eventually surpassed that one of both Britain and France.

The actual improvement in the European payments position which took place while the Marshall Plan operated can be largely attributed to two factors: the reemergence of (West) Germany as a major trading nation and the devaluations of European currencies against the dollar in September 1949 (Milward 1984). Throughout this period, German exports grew rapidly. This was due to (i) the final decision by the Western allies to let (West) Germany rebuild itself, (ii) the abolition of central planning and most price controls in conjunction with a drastic currency reform to eliminate the monetary overhang ("repressed inflation") in June 1948, and (iii) the stepwise relaxation of restrictions on Germany's foreign trade. West Germany's share in world exports rose more than eightfold between 1947 and 1952 (from 0.66 to 5.6 per cent). This reduced the need for Western Europe to import from the US (Schmieding 1987). Impressive as these figures are, the reemergence of West Germany was still hampered by the fact that firms had to rely predominantly on their own earnings to finance investments. The internal capital market was underdeveloped, and - apart from the reasons listed above - investors from abroad were deterred by the unresolved question of the external debt of the German Reich. This debt problem was finally settled in the

London debt agreement of September 1953 which cut Germany's external indebtedness by half (from 29.3 to 14.5 billion DM, Erhard 1954, p.268). The devaluation of European currencies against the dollar which took finally place in September 1949 helped to correct the overvaluation of these currencies and paved the way for higher European exports. Still, they were insufficient to eliminate the gap between the official parities and the valuation on the residual free market (Figure 1).

Nevertheless, the European Recovery Program had two important and positive political consequences: (1) The American payments to France and the UK made it easier for these countries to accept the politically contentious reintroduction of (West) Germany into the politics and the trade circuits of Western Europe; (2) the shift of US emphasis from short-term relief efforts to medium-term aid for reconstruction was interpreted by investors as a lasting US commitment to stay in Western Europe and thus enhanced their confidence in the political stability of this part of the continent. Furthermore, the anticipation of the first Marshall Plan deliveries in late 1948 contributed slightly to keeping the rise in prices in check which West Germany experienced after the currency reform and the decontrolling of the economy in June 1948 (Borchardt and Buchheim 1987). This helped the German authorities to stick to their free market policies in the turbulent adjustment period immediately after the reforms when - because the velocity of the newly issued Deutsche Mark had been underestimated - monetary demand expanded even ahead of the rapidly increasing volume of production.

In spite of these positive effects, the Marshall Plan cannot be counted as an unqualified economic success. Most fundamentally, the aid payments relieved European governments of the need to correct their economic policies in a way which would have made their countries attractive for private capital inflows. Instead, it encouraged the majority of European governments to continue with their internal policies of "planification", demand expansion and premature

redistribution. Externally, Western Europe could thus afford to take the long road to trade liberalization and currency convertibility.⁹ Due to the reluctance on both sides of the Atlantic to devalue European currencies sufficiently, the "dollar gap" retarded the removal of barriers to international trade and payments for more than a decade. The US as the hegemonial power and most governments of Western Europe simply opted to wait for Europe's postwar needs to import from the US to abate over the course of time and to fill the "dollar gap" with aid financed imports of food and capital goods in the meantime. Although, under the prevailing economic policy condition, the Marshall Plan was indeed helpful for many countries, the example of West Germany demonstrates that a shift in economic policies along the lines of the West German reforms of June 1948 would have been much more beneficial. In the case of such a change, a short-term infusion of public funds might have been a good thing to ease the period of transition. Longer-term aid would, however, have been unwarranted.

III. The Example of Foreign Aid to Developing Countries

A. Why Development Aid Has Not Lived up to Expectations

Similar to the Marshall Plan for Western Europe, external financial assistance granted by industrialized countries to the Third World was frequently considered as a panacea to

⁹ A minor part of the Marshall Plan aid was indeed used to facilitate the removal of quantitative restrictions on trade within Western Europe at the existing exchange rates directly. Most importantly in this respect, the US supplied the European Payments Union (EPU) with a working capital of 350 mio. dollars. From mid-1950 to late 1958, the EPU settled payments for current account transactions between the currency areas of the OEEC members on a multi-lateral basis. The EPU mechanism made a balancing of all bilateral intra-OEEC trade flows unnecessary and thus helped to remove one major cause of quantitative restrictions on trade within Western Europe (Schmieding 1987).

solve a multitude of problems. Development aid was expected to improve the endowment of low-income countries with infrastructure facilities and human skills, to encourage the industrialization of highly commodity-dependent economies, to provide better employment and income opportunities for landless labourers, and to meet the basic needs of the poor. Notwithstanding changing priorities in development aid policies, it was maintained that external assistance is crucially important to narrow the gap between the level of economic development in rich and poor countries. Development aid was justified on the grounds that the chief obstacle to economic progress is the lack of real capital: "The assumption is made that if public funds are made available in the shape of grants and concessional loans it will be possible to enlarge upon inadequate domestic savings in the recipient countries and hence raise their investment levels. Higher investment, the assumption continues, will then accelerate overall economic growth in the Third World, thus contributing to a reduction in the pronounced international differences in income" (Hiemenz 1986, p. 176).

Only since the early 1980s the idea that the Third World's economic situation could be substantially improved through financial aid from the industrialized countries has been disputed increasingly (for an overview, see Agarwal et al. 1984). Some observers even consider development aid as one of the roots of deteriorating economic conditions in the recipient countries (e.g. Bauer 1982). Several disincentive problems may arise in aid dependent economies. Most notably, unconditional aid tends to reinforce misguided economic policies in the Third World rather than to ameliorate them. Foreign aid is liable to add to distortions in relative prices and hence in production patterns:

- Aid in the form of monetary transfers renders it easier for the recipients to maintain overvalued domestic currencies. Unfavourable exchange-rate effects of aid inflows add to frequently observed discriminations against the production of tradables, i.e. exports and import substitutes. Moreover, subsidized capital transfers encourage

capital intensive modes of production that conflict with the comparative advantages of low-income economies.

- If aid is given in the form of goods, a crowding out of domestic production of the same or similar goods is likely to occur. This is especially true for permanent food aid (Fischer, Mayer, 1981). Domestic market prices are suppressed by free or heavily subsidized supplies of agricultural products from abroad. Domestic production is discouraged so that the recipients become more and more dependent upon foreign aid.

Typically the ruling elites in recipient countries exert strict control over the usage of the bulk of aid inflows. This leverage allows them to carry on with policies that are damaging in macroeconomic terms. They may block comprehensive and consistent policy reforms (e.g. land reforms) that could help to overcome economic backwardness. In addition, excessive leverage of public authorities may induce unfavourable reactions by the private sector (Bauer 1982; Myrdal 1981). Rent seeking is encouraged, while making productive efforts of one's own may be regarded as no longer worthwhile or dispensable.¹⁰

Stagnating or even declining per capita incomes indicate that aid has in fact failed to promote a sustained growth process in low-income countries. This is confirmed by a simple correlation exercise for 70 developing countries. The Pearson correlation coefficient between the per capita

¹⁰ From a study on the effects of external aid in India, the Birla Institute of Scientific Research (1981, p. 102) in New Delhi concluded: "One tends to agree more with Bauer in so far as his position on institutions and attitudes is concerned. For example, we have seen the damaging effect of foreign aid on our economy through budgetary support We have also noticed the other ill-effects of aid which manifest themselves through the sapping of our initiative, the importation of inappropriate technology, distortions in resource allocation, and a lot of other things".

amount of official development assistance (loans and grants) received in 1976-1987 and the average per capita GDP growth during this period is completely insignificant (-0.06). It is of course true that the cross-country correlation for this very heterogeneous set of economies may lead to distorted results. It has been argued, for example, that a negative relationship between aid and economic growth may be due to the concentration of aid payments on low-income countries where growth is most difficult to be achieved, while more advanced economies with a favourable growth performance receive relatively small amounts of aid. However, the Pearson correlation coefficients remain insignificant if the sample heterogeneity is reduced considerably. For the 30 African countries in our sample a coefficient of 0.12 is calculated. The correlation between aid and growth is also extremely weak for different income groups¹¹.

A glance at econometric investigations conducted on the economic performance effects of development aid also shows that aid has not achieved its intended objectives.¹² As far as the relationship between aid and domestic savings in the recipient countries is concerned, a number of macroeconomic studies demonstrated a quite obvious negative influence. Empirical tests of the relation between aid and overall economic growth in the recipient countries came up with differing results according to the observation period and the country sample chosen. Positive growth stimuli were mainly generated or amplified in those developing countries which already made considerable progress, especially middle-income countries in Asia (Dowling, Hiemenz, 1983). On

¹¹ The Pearson correlation coefficient amounts to -0.009 for 26 countries with per capita income of less than US\$ 500 in 1981; 15 countries with income of US\$ 500-999: -0.13; 18 countries with income of US\$ 1000-1999: -0.004; 11 countries with income of US\$ 2000 and more: -0.17.

¹² The following summary on the effects generated by development aid is based on material contained in Agarwal et al. (1984).

the other hand, growth effects of development aid largely failed to materialize in those places where they were most urgently needed, i.e., in the poorest Third World countries, the African countries, and those economies with a strong dependence on raw materials.¹³

B. How to Improve the Effectiveness of Aid

The failure of external aid to induce a sustained growth process in most low-income countries is no longer disputed by those who are generally in favour of traditional aid policies.¹⁴ But some observers maintain that aid has at least prevented poverty from turning into catastrophe (Cassen et al., 1986; Burki, Ayres, 1986; Levy, 1988). Even if the latter were true "such a 'success' does not offer any medium-term perspective for development aid policies of industrialized countries" (Hiemenz 1989, p. 12). The dismal

¹³ In a recent study, Levy (1988) found aid to be positively correlated with economic growth in Africa. However, the aid variable proved to be insignificant once a more extensively specified growth function was estimated. Moreover, the argument that the growth effect of aid was channeled through the investment rate was largely invalidated in the cross country regressions. In the 1973-1982 period, the coefficient of the investment ratio remained insignificant.

¹⁴ In a review of the major findings of an OECD task force on concessional flows, the authors agree that aid has been legitimately criticized for not achieving fully its intended objectives in Sub-Saharan Africa: "Despite the commitment of large amounts of aid to African agriculture, food output per capita declined in 23 out of 33 countries in the region between 1975 and 1982 (...). This was a major reason for the stagnation (and even decline in some countries) in overall growth of per capita income" (Burki, Ayres, 1986, p. 7). Cassen (1986, p. 11) concludes: "Unfortunately - though perhaps not surprisingly - the record of almost all aid is least satisfactory where good performance is most urgently needed: in the poorest countries, particularly in Sub-Saharan Africa The record of aid for rural development, ..., is much better in South Asia than in Africa".

experience with aid in the most needy countries rather suggests to draw some important lessons on how to improve the effectiveness of aid. Most importantly, both donors and recipients have to accept that aid flows of whatever magnitude cannot be a substitute for sound macroeconomic management and appropriate policy incentives. Neither a substantial increase of aid payments nor a stronger focus of donors on low-income countries will help unless the political and economic conditions for a productive use of foreign and domestic resources are created within the recipient countries.

Empirical evidence of the past three decades has clearly highlighted the importance of a stable macroeconomic environment, i.e. stable monetary and fiscal policies, and the critical role of prices for economic development (World Bank 1988, Par. 2.10). Aid recipients "need to devote greater attention to domestic resource mobilization so that aid resources complement local efforts rather than substitute for them" (Burki, Ayres, 1986, p. 8). Official pricing policies that act as disincentives to private producers must be revised, and artificially overvalued currencies that discourage exports must be avoided. For many countries, the design of macroeconomic policies that support long-term development requires considerable reform efforts. Policy reforms can ultimately not be decreed by external aid donors.¹⁵ Aid recipients must be committed to reducing poverty and willing to implement the adequate policy changes towards encouraging economic progress with external donors mainly playing a catalytic role.

Even assuming a strong and reform-minded government, adjustment programs may fail due to a highly deficient institutional and administrative framework (Cassen 1986). Moreover,

¹⁵ Frequently aborted IMF and World Bank adjustment programs have proven that an appropriate macro and sector policy management cannot be imposed externally.

the period of transition until the benefits of policy reform can be reaped may be quite long. This is especially true in low-income and commodity dependent economies that are typically characterized by segmented and distorted markets and uncertainty about property rights. The effectiveness of external aid could thus be enhanced if the focus were on supporting the stabilization of fragile institutions, human resource development, and the implementation and sustainability of policy reforms (Hiemenz 1989, pp. 17ff.). For example, donors may

- support the establishment of courts and other independent executive bodies so that property rights could be defined, protected and enforced;
- assist the emergence of well-functioning private capital markets;
- grant assistance for tax reform and for improvements of the customs and tax administration;
- help to improve primary education, vocational training, and the transfer of management and marketing know-how;
- improve compensatory financing schemes so that adjustment programs have not to be aborted because of temporary shortfalls in export earnings;
- limit debt service to those obligations that had existed under historical exchange rates so that devaluation (which increases debt service obligations in local currency) is no longer discouraged;¹⁶

¹⁶ In low-income developing countries debt problems of the public sector are mainly connected with official development loans granted by bilateral and multilateral creditors. Devaluations cause an additional drain on the public budget since devaluations increase the debt-service obligations on foreign loans in national currency. The current strategy of donors to forgive debt-service payments for official loans (i.e., an ex-post conversion of loans into grants) does not solve debt problems persistently unless forgiveness is made conditional on domestic policy reforms. Debt relief may be used as an instrument to strengthen the incentives for policy reforms, however. In this context, it is most important to counter contractionary effects of widening budget deficits following a devaluation.
contin. footnote

- alleviate the foreign debt burden by reschedulings and debt-for-nature swaps;¹⁷
- provide compensation payments for the poorest population segments that may suffer from the policy changes (e.g. reduced food subsidies) in the transition period.

The example of development aid underlines the crucial role of appropriate incentive systems in promoting the economic and social development of the recipient countries. Aid does not make much of a difference if the ruling elites in developing countries are notoriously unwilling to put their economic house in order. Moreover, experience with IMF and World Bank lending suggests that letters of intent should no longer be accepted as sufficient proof of reform-mindedness. But donors should be prepared to increase external support if policy reform is initiated by Third World governments. A recent study suggests that it was at least partly due to lacking aid response that policy reforms were abandoned or stagnated in several African countries (Gulhati, Nallari, 1988). Consequently, selectivity and greater flexibility in aid allocations among low-income countries is required.

In summary, development aid may be used to bridge the difficult transition period once low-income countries implement urgently required policy reforms. However, aid should not be

contin. footnote

uation. To this end, governments of developing countries may be allowed to transfer debt-service payments by applying historical exchange rates, e.g. the rate prevailing prior to the devaluation. Consequently, debt relief would be restricted to the devaluation-induced increase in debt obligations in national currency.

¹⁷ In the case of debt-for-nature swaps, debt relief is granted in exchange for property rights on natural resources as well as in exchange for a successful and controllable reversal of past trends in environmental damage. Additional aid payments may be required since debt-for-nature swaps frequently involve the substitution of domestic for external debt.

mistaken as a substitute for free access of developing countries' exports to all markets of industrialized countries. An open trading environment is best suited to defeat the widespread export pessimism of aid dependent economies and thereby to overcome the resistance within these countries against internal economic reform.

IV. The Way Forward for Eastern Europe

A. The Need for Thorough Internal and External Reforms

Eastern Europe's disappointing economic performance in the post-war decades resembles those of many developing countries. Crippled by foreign debt (Tables 2, A1) and the inability of the central planners to restructure the distorted economies, all East European countries have seen their growth rates slowing down, and most of them have recorded falling living standards. Under the new freedom of information flows - in the age of "Glasnost" - even East European officials frequently confirm pessimistic Western assessments of the bad condition of the centrally-planned economies (CPEs). The relative position of Eastern Europe in the world economy is today weaker than ever (Kostrzewa, 1988, 1989b): the market share of European socialist countries in trade with the industrialised countries of the OECD is far lower than it was 20 years ago (Table 3).

The decline of competitiveness is reflected in the dramatic reduction in the ability to earn "hard" currency. This process has been reinforced by the negative side-effects of Western European economic integration in the 1970s and 1980s. The Southern enlargement of the EC to include Greece, Spain, and Portugal has led to the removal of barriers of a type which still prevail in trade between Eastern and Western Europe (ECE 1989). Recent estimates by the United Nations' Economic Commission for Europe suggest that EC imports from Eastern Europe have been diverted in favour of Southern Europe. Unlike the inflexible centrally-planned

Table 2: Eastern Europe's Net Debt in Convertible Currencies
1970 - 1988 (bn. US-\$)

	1970	1975	1980	1988
Bulgaria	0.6	2.3	2.9	6.6
Czechoslovakia	n.v.	0.7	3.3	3.4
GDR	0.9	3.6	11.6	10.2
Hungary	0.9	2.2	7.7	16.1
Poland	0.9	7.7	23.5	35.3
Romania	1.0	1.4	9.3	1.3
Soviet Union	0.6	12.2	16.6	25.6

Source: ECE 1989.

Table 3: East European Market Shares in Trade with the
OECD 1965-1989 (in %)

	1965	OECD imports from		1989 ^a
		1975	1985	
Bulgaria	0.12	0.07	0.05	0.04
Czechoslovakia	0.34	0.28	0.19	0.18
GDR ^b	0.45	0.45	0.36	0.32
Hungary	0.22	0.21	0.19	0.21
Poland	0.51	0.54	0.28	0.28
Romania	0.22	0.28	0.26	0.17
Comecon (6)	1.87	1.82	1.34	1.20
USSR	1.37	1.44	1.54	1.16
Comecon (7)	3.24	3.27	2.87	2.36
	1965	OECD exports to		1989 ^a
		1975	1985	
Bulgaria	0.18	0.19	0.15	0.09
Czechoslovakia	0.37	0.33	0.17	0.10
GDR ^b	0.50	0.44	0.32	0.28
Hungary	0.24	0.32	0.22	0.16
Poland	0.43	0.97	0.25	0.24
Romania	0.26	0.35	0.11	0.04
Comecon (6)	1.98	2.60	1.23	0.91
USSR	1.15	2.20	1.67	1.44
Comecon (7)	3.13	4.80	2.90	2.35

Notes: ^a estimated; ^b including trade with West Germany

Source: OECD a,b various issues; own calculations

economies of Eastern Europe, the newly industrializing countries of East Asia have quickly learned to cope with the trade diversion that went along with regional economic integration in Western Europe.

As in the case of the Third World, the prospects of Eastern Europe to catch up with the developed world depend on their readiness to rid themselves of interventionist policies which severely distort relative prices and the incentive system and to adapt their economic and political systems to the needs of an outward-oriented development approach. While the reform fatigue continues in many developing countries, various East European countries - in particular Hungary and Poland - seem to be willing and able to opt for comprehensive political and economic reforms. The changes in the political power structure and the weakening of the old pressure groups of the nomenklatura create a situation which Olson (1982) described as being very favourable to economic growth. The second crucial difference between the developing countries and Eastern Europe lies in the factor endowment. The outdated and often damaged capital stock in most East European countries is still, in per capita terms, higher than in the low income developing countries. Furthermore, human capital is not a bottleneck in Eastern Europe. The factor endowment of Eastern Europe is more similar to that of Western Europe after World War II or to that of some NICs in East Asia today.

Because of mounting economic problems, it has become increasingly difficult for Eastern Europe during the past few years not to reform. Under the pressure to adjust, Poland and Hungary are far ahead in the implementation of various market elements. Furthermore, the Soviet Union's economic and political elite has been showing a growing awareness of the need to reform. The Soviet Union has already introduced some remarkable changes in its economic system, but the

economic and political conditions in 1985 were far less favourable than those of Hungary or Poland.¹⁸

There is a broad consensus among Western experts and their counterparts at least in Hungary and Poland that the necessary reform program has to contain internal and external components. The internal components are (i) the implementation of a price reform, (ii) a revival of the private sector, and (iii) the establishment of a money and capital market. The goals of the external reform are (i) the liberalization of foreign trade and capital flows, and (ii) the convertibility of the domestic currency.

The importance of linking foreign assistance to these economic reforms has to be emphasized. Unconditional financial aid may encourage the various entrenched interest groups to resist the necessary reforms. The past experiences with unconditional financial aid to the developing countries clearly support this view. As a matter of fact, the generous and sometimes concessional Western credits to Eastern Europe had a similar effect during the 70s. Because domestically initiated internal and external liberalization has a great importance for devising the most effective form of foreign

¹⁸ Because of the very fast changes in Eastern Europe, a clear distinction among the other countries is nearly impossible. Romania's leadership is strongly opposed to all forms of economic and political reforms and sometimes even tries to stop the development in neighbouring countries (see e.g. the proposal of a military intervention in Poland by the Romanian dictator). Other countries have until now been very reluctant in the implementation of reforms. The political leadership in Bulgaria for instance seems to wait for a clear success or failure of the reform fraction in Moscow. But the preparation of outlines for "a transition program" is going ahead, at least among the researchers and some economic advisers. Actually, the October-November events in the GDR and in the CSSR have proved the possibility of a political break-through taking place within a few weeks only. Today, one may expect some kind of market oriented economic reform in all European COMECON countries save Romania.

aid, all main elements of the necessary economic reforms will be briefly discussed.

A revision of the price setting principles and of the price structure is the cornerstone of internal reforms. This means that in principle prices ought to be determined by the market and to correspond with the world market prices. If the economic bureaucrats in the East European countries continued to fix a substantial number of prices, the other elements of economic reforms would not make much sense. The bad experiences of Hungary and Poland with a neither-plan-nor-market system support this thesis. The link between price distortions and a dismal growth performance, significantly observed for the developing countries (Agarwala 1983), exists obviously in centrally-planned economies as well. Hence, the price liberalization, covering most prices on both the producer and consumer markets, is crucially important. In order to avoid a damaging burst of inflation, the freeing of fixed and controlled prices and a removal of the producer subsidies has to be complemented by monetary discipline and a sharp cut in the government's budget deficit, the establishment of a new market-conformable tax system and better incentives to save, i.e. a positive real interest rate.¹⁹

The supply responses to price reforms might remain weak unless the restrictions on private property rights of means of production are relaxed. Not only the law has to be changed to make private ownership economically viable. No

¹⁹ The experience from the liberalization program implemented in Germany 40 years ago suggests, that a link between price reform and currency reform would make the first reform easier. Partial annihilation of money assets (= currency reform) would reduce the need of a high "corrective inflation". The political feasibility of the reform would be enhanced. A currency reform is almost more important, given the high degree of price distortion, the high level of forced savings ("repressed inflation") and the low supply elasticity in Eastern Europe.

less important is the practical guarantee of equal treatment of private and state-owned companies. This implies free access to the labour, the capital and the goods market for the private sector. The rigid limits concerning market entry, technology or choice of branches of activity have to be abolished.

One of the important problems is the future shape and extent of the public sector. The optimal means of avoiding a dominating position of this sector might be a radical reprivatization and deregulation program²⁰, connected to radical changes in the structure of financial services. The privatization may be slowed down or even fail because of some unresolved issues such as the question of property rights (the state enterprises have to change their legal construction and to become corporations listed on the stock market) or the non-functioning of capital markets. Given the underdeveloped state of financial and banking services in East European countries, the number of native investors who would be ready to buy a company with their own capital resources only is rather limited. Without external financing - raised for instance by venture capital funds, investment banks or mortgage banks - the private sector could only play a rôle similar to the one it has today: an enclave in the inefficient cartel of public enterprises.

The necessity of privatization thus makes the introduction of the third element of internal liberalization inevitable: The establishment of a well functioning capital and money market to improve the allocation (and reallocation) of

²⁰ At present, only the Polish government is preparing a comprehensive privatization of state enterprises (Rzeczpospolita 1989). It will guide the process of privatization of state enterprises as quickly as technically possible. The basic design of the privatization program is likely to be a "Western" one: auctions of enterprise shares with free access for all buyers, management buy-out and worker buy-out programs and the like.

capital within and among sectors is probably the most difficult task for the reform-minded countries in Eastern Europe. Such markets have never existed in a centrally-planned economy. This means that there is a lack of experienced native specialists who would be able to introduce an efficient banking system, to establish stock markets and to introduce modern financial services. In addition, the contemporary network of bank branches in Eastern Europe countries is extremely poorly developed.

The three main elements of internal liberalization have to be complemented by the external liberalization aiming at an outward-looking development approach. A removal or a significant decrease in the tariff and non-tariff barriers, most notably the abolition of export and import quotas and an end to the state monopoly over foreign trade, should help the reformers to undermine the domestic monopoly of some state-owned companies and to introduce more competition in the internal market. The integration of East European countries into the international division of labour according to their comparative advantages also requires a convertible currency, i.e. the companies should be allowed to buy and sell their hard currency assets on the exchange market. For most East European countries, the first step has to be the introduction of a uniform foreign exchange rate. In some countries such as Poland or Hungary this merely requires the unification of a few different commercial exchange rates. Others like Bulgaria, the GDR or the USSR have to replace hundreds or even thousands "valuta coefficients" by a single exchange rate and deal with the corresponding adjustment problems.

The most important form of currency convertibility in the first (contemporary) stage of economic reforms in Eastern

Europe is the internal convertibility²¹ (Lavigny 1989; Kostrzewa 1989a). The implementation of a free exchange market with a floating rate would probably lead to a significant depreciation of the domestic currency vis-à-vis Western currencies. However, this is the only way to ensure that the most competitive and efficient enterprises would get free access to foreign exchange and thus to the world market. Furthermore, this would provide them with an additional and important incentive to export.

This program is to be understood as one package. This means that a simultaneous implementation of the major elements of the described market-transition approach is required. A "Big-Bang" strategy is indeed recommendable as the most promising way to destroy the influence of the old conservative pressure groups which would otherwise get the chance to reorganize the resistance in the case of step-wise reforms.

B. Western Aid to Reform-minded East European Countries

For the success of the economic reforms, the long-term and profit-oriented inflow of capital from abroad in the form of private direct investments and voluntary bank loans from private sources is of utmost importance. But at present, Western governments are facing urgent demands for short-term assistance, which should support East European reform countries in the process of establishing a market economy and of removing the obstacles to private capital flows.

Actually, in the period of transition from a centrally-planned economy to a market economy, temporary and well targeted Western economic assistance could play a beneficial

²¹ All domestic residents have the right to exchange their domestic or foreign assets at one market at a single exchange rate. This must apply to all current account transactions, including short-term trade loans.

rôle. Even assuming a reform-minded government with strong political support, a radical reform program like the one discussed above may fail because of a deficient institutional framework, a lack of private capital and a missing system of social safeguards in the transition period.²² The effectiveness of external aid could be high if it supported the concrete reform steps, encouraged a faster speed and higher degree of liberalization and made it easier to manage the social tensions during the transition period. Foreign aid would be very likely to fail, though, if it took the form of a permanent financial support without preconditions.

Lessons from the past, both from Europe after World War II and from the developing countries during the last three decades, are helpful in setting up a catalogue of necessary measures. It is important to emphasize that not a new Marshall Plan (i.e. large scale public - or at least publicly directed - investment) is required. The focus must rather be on short-term emergency measures and on setting up the institutional framework that is necessary to encourage the private capital investment.

Starting with the technical measures, the following elements of public economic assistance from the West are to be recommended under the precondition that a reform program along the lines described above is already being implemented:

(i) The establishment of an adequate framework in the fields of public finance, banking, stock market and social security system should be supported. The East European countries need blueprint proposals for a legal framework, prepared for

²² An adjustment program would lead to large-scale reallocation of workers. It might thus be necessary to establish an efficient security system that has never existed in a centrally-planned economy. Thus, those economies lack experience, specialists, and the appropriate institutional framework.

instance by Western advisers upon request.²³ The centrally-planned economies do not have sufficient specialists in such typical "capitalistic" branches as capital markets or financial services.

(ii) Technical economic assistance should also help to establish and improve a management and administrative education program, both in East European countries and abroad.

The short-term financial assistance may include the following measures:

(i) The establishment of a "convertibility fund" is to support a rapid introduction of currency convertibility by East European countries. Such funds, as a loan or a grant linked to the convertibility declaration, could be provided to the central bank authorities. The willingness of the Western countries to finance a convertibility fund should be linked to two preconditions, namely that a floating exchange rate system²⁴ will be established and that any future central government budget deficit will be financed exclusively on the capital market and not by the central bank.

(ii) Debt service payments of East European countries may be limited to the obligations which existed under the old exchange rates, so that a devaluation and thus the in-

²³ Some Soviet economists have recently proposed to form a joint international adviser group, which should help to draw up a detailed reform blueprint for the Soviet Union (see Maximova, 1989).

²⁴ The change to currency convertibility after a longer period of price controls would be facilitated by a floating exchange rate. If a fixed new exchange rate were wrong, all foreign exchange reserves could be used up in a very short time. An example of a similar situation was Great Britain in 1947 (Haberler, 1954).

roduction of currency convertibility will no longer be discouraged.

(iii) The foreign debt burden may be further alleviated by reschedulings, debt-for-equity and debt-for-nature swaps. The debt relief should be granted only step-by-step, as a direct Western response to concrete reform measures. Debt relief negotiations should be combined with an announcement that there will be no further public guarantees for private loans. In this case, the private banks would no longer have an incentive to delay their engagement in the reform-minded countries until such guarantees were given.

(iv) Branches of Western banks in public ownership may be established for a limited period of time (say 10 years) to supply small and medium-sized private enterprises with loans at market rates of interest. An "EER"-Bank with a full range of banking activities, including deposits, would encourage private banks to invest in Eastern Europe as well. Furthermore, such a "East European Recovery Bank" may help to transfer management know-how and to improve the development of financial services.

Technical and financial assistance should not be considered as a substitute for a trade liberalization. The West should guarantee free market access for manufactured and agricultural products and thus help to overcome the export pessimism of the reform-minded East European countries. The most important rôle has to be played by the European Community as the largest Western trade partner. A feasible solution would be the creation of a great European free trade zone and the inclusion of reform-minded countries in the European Free Trade Association (see Kostrzewa, Schmieding, 1989). The EC would have to extend the existing free trade agreements for manufactures between EFTA and EC to factor movements and trade in services. The EC should also commit itself to allow all new (East European) members of the EFTA to join the extended free trade agreements. The EFTA on its part should clearly define the minimum conditions as to how far the

economic reforms must have progressed in a COMECON country before it can be admitted to join the EFTA. The old and new EFTA members would constitute a European free trade zone with the EC; and East European reform-minded countries would get free access to the whole West European market.

V. Summary

The current discussion in the OECD countries as to how to support political liberalization and the implementation of economic reforms in Eastern Europe is strongly focussed on public funding of huge external aid packages. The multitude of proposals on how to raise and orchestrate financial assistance largely abstracts from historical experiences indicating that public capital transfers are of little help unless the conditions for a productive use of those resources are created in the capital recipient countries:

- The Marshall Plan for Western Europe after World War II provides an example that external financing may even retard rather than promote economic reforms. It relieved European governments of the need to correct misguided policies in a way which would have made their countries attractive for private capital inflows.
- The example of development aid granted to Third World economies shows that the lack of capital is typically not the critical bottleneck towards economic progress. Both donors and recipients have to accept that aid flows of whatever magnitude cannot substitute for sound macroeconomic management, undistorted policy incentives, and an adequate institutional framework.

Also in Eastern Europe the main focus of external financial and technical assistance must be on encouraging the implementation of reform packages. Most importantly, comprehensive price deregulation is needed to stimulate production, improve the allocation of factors of production, and prevent the waste of scarce resources. The example of West Germany after World War II suggests that inflation may be contained

if price reforms were supplemented by a currency reform. Moreover, the full benefits from market-determined price signals cannot be reaped unless property rights are clearly defined, private ownership of the means of production is encouraged and public-sector dominance reduced, efficient capital and money markets are established, the tax system is restructured, and sovereign risks for joint ventures with foreign investors are reduced. Internal liberalization should be complemented by an outward-looking development approach. To this end, trade barriers must be removed, the monopoly of the state in foreign trade abolished, flexible and less arbitrary exchange-rate policies implemented, and internal convertibility of the domestic currency introduced.

Under such internal policy conditions, the attractiveness of Eastern Europe for private foreign capital can be expected to increase significantly. OECD governments should help to overcome the export pessimism in Eastern Europe by providing free access to all markets of industrialized countries and by securing an uninterrupted availability of imports. Western support for reform programs in terms of technical and financial assistance by Western governments can serve two purposes:

- It may support institution building and human resource development in the medium and longer run.
- It can help to bridge the difficult transition period.

Even assuming a reform-minded government with strong political support, the comprehensive and consistent adjustment program suggested above may fail due to a highly deficient institutional framework. Technical assistance is thus required with regard to the formation of internal capital markets and efficient tax and social security systems. Administrative and management training programs may help in these respects. Technical help should also be granted to establish a legal framework that defines, protects and enforces property rights.

Moreover, the period of transition until the benefits of policy reform can be reaped may be quite long. Hence, short-term financial support is needed for reform-minded governments to prevent that promising adjustment programs have to be abandoned because of lacking aid response. Temporary relief may include public funding of a convertibility fund, foreign debt renegotiation, debt swaps, and limiting debt-service payments to those obligations that existed under historical exchange rates. Furthermore, public funding at market terms may be provided on a temporary basis to supply small and medium-sized private enterprises with loans, possibly through an "East European Recovery Bank". Such an approach is better suited to encourage productive investments and to foster internal financial intermediation than the current preference on public guarantees for private bank loans. The demand for further guarantees and public subsidies should be unambiguously rejected. Subsidized loans may once again encourage an inefficient use of the transferred resources. Moreover, the ongoing debate on the role of Western governments in private lending rather adds to the reluctance of creditors to engage in Eastern Europe.

Table A1: Eastern Europe's Debt Burden 1981-1988 (in %)

	1981		1985		1988	
	net interest service ratio ^a	net debt ratio ^b	net interest service ratio ^a	net debt ratio ^b	net interest service ratio ^a	net debt ratio ^b
Bulgaria	10.1	68	4.3	44	14.1	205
Czechoslovakia	8.6	61	4.5	50	4.6	59
GDR	23.2	168	7.5	78	8.0	98
Hungary	28.0	197	19.0	249	18.8	310
	(19.4)	(137)	(13.2)	(173)	(13.0)	(217)
Poland	51.0	446	43.7	503	38.5	427
	(38.2)	(335)	(29.5)	(366)	(29.3)	(320)
Romania	14.5	136	10.0	97	5.2	19
USSR	5.0	4.2	3.6	40	9.1	48

Notes: ^a Ratio of net interest payments to exports to the market economies

^b Ratio of net debt to exports to the market economies

In brackets: in per cent of all receipts in convertible currency

Source: ECE 1987, 1989

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