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## Credible Transitions in Eastern Europe: a Perspective from the Theory of Traverse and Systemic Change

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**CREDIBLE TRANSITIONS IN EASTERN EUROPE:  
A PERSPECTIVE FROM THE THEORY  
OF TRAVERSE AND SYSTEMIC CHANGE**

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*Abstract*

The best way to think of the transition from a centrally planned to a market economy is as a traverse from one growth path to another. However, questions of traverse are as yet relatively understudied as are issues of disequilibrium dynamics of a market or a planned system. The economics of the transition currently in process cuts across issues of traverse and of disequilibrium. Thus what is needed is to model the transition from a planned economy in disequilibrium (as evidenced by excess demand, repressed inflation, excess liquid balances) to a market economy characterised by an eventual equilibrium.

The paper suggests how economic theory can tentatively cope with the formidable difficulty of this task. Moreover, the paper defends the thesis that it is a major mistake to start a transition process before knowing where a country wants to go. This mistake is the main source of considerable human costs and unnecessary hardship which Eastern European Countries are currently experiencing.

## 1. Introduction

The abandonment of the Soviet model of centralised planning and the historic decision by the formerly planned economies of Central and Eastern Europe to make a transition towards a market economy pose novel and challenging questions to economists. Economics has in the past provided theories for the working of a planned or a market economy. Within each of these categories we have ample work on the comparative statics or the equilibrium dynamics of the systems. It is well-known that the largest part of economic theory is better at analysing equilibrium positions than transitions. Unfortunately, the collapse of communism in Europe thrusts the analysis of transitions into the limelight, thereby exposing economics' weak flank. The best way to think of the transition from a centrally planned to a market economy is as a traverse from one growth path to another. However, questions of traverse are as yet relatively understudied as are issues of disequilibrium dynamics of a market or a planned system. The economics of the transition currently in process cuts across issues of traverse and of disequilibrium. Thus what is needed is to model the transition from a planned economy in disequilibrium (as evidenced by excess demand, repressed inflation, excess liquid balances) to a market economy characterised by an eventual equilibrium.

Given the formidable difficulty of this task, all I hope to do in this paper is to pose some key questions and suggest how economic theory can tentatively cope with them. Transformation is one of the most complex forms of institutional change. It prompts three questions: which forces destroy the old equilibrium; which new institutional order corresponds to the changed constellation of external factors; how is the new equilibrium reached. What would be needed is a general theory of institutional change and transformation, which do not have yet. So we have to contend ourselves with loosely interconnected ideas and pieces of theories.

Before trying that, in the next two sections I outline the context in which the transition in Central and Eastern Europe is taking place, a context characterized by considerable instability not only in this area but also in the capitalist world order.

## 2. Emerging tendencies in the world economy

The transformation of Central-East European economies into capitalist economies requires both the liberation of market forces and their restriction. For they must be articulated to specific ways of organizing production, specific mechanisms for matching production and consumption so that expanded economic reproduction can occur. If the emerging market forces are not embedded in appropriate non-market relations, they will produce catastrophic disequilibrium and reinforce the systemic vacuum in Central-Eastern Europe.

The context in which this simultaneous liberation and restriction of market forces must occur is one marked by considerable instability not only in Eastern Europe but also in the capitalist world order and its constituent economies. To appreciate the point, let's consider the most important emerging global economic tendencies affecting the post-socialist transformation:

a) new core technologies are becoming the motive and carrier forces of economic expansion. They include: microelectronics, telecommunications, data processing, optical technologies, robotics, new materials, renewable energy sources, and biotechnology. Their mastery is critical to economic expansion and structural competitiveness yet few firms are likely to have the skills, capital, and knowledge to master them completely. Many are so knowledge - as well as capital - intensive that their development depends on extensive collaboration among many economic, scientific, and political interests. This is associated with increasing international technological competition as well as increased state concern to encourage technological innovation and transfer - especially in the advanced industrial economies.

For, given the competitive pressures from low-waged NICs in low-tech products, this could be a source of continuing competitive advantage, permitting both innovation rents and high wages. Among the post-socialist societies the former Soviet union may be able to compete in some of these new technologies, especially if it can convert its military-industrial complex to peaceful purposes; the other post-socialist economies will be disadvantaged in this technological race. They will need to encourage technology transfer from abroad and its rapid diffusion within the domestic economy at the same time as competing with the third-tier NICs (e.g. Thailand, Indonesia, Philippines, China) in the low waged, low-tech sector.

b) the internationalization of financial and industrial flows involves ever more firms, more markets, and more countries. This tendentially homogenizes economic space as leading edge technologies are diffused, product and capital markets become international, foreign direct investment is undertaken by all metropolitan powers, a small but increasing number of NICs develop their own multinational companies and banks, and post-socialist economies are also drawn into the process. This does not mean that the operations of global firms are identical from country to country nor that they will ever become equally dispersed across the globe; it does mean that they are subject to an overall strategic plan which is formulated on a global scale.

In turn this has major implications for the role of nation states and for the concept of the 'national' economy as a natural unit of the world economic order. One crucial effect is that national economic space is no longer the most obvious starting point for promoting economic growth, technological innovation, or structural competitiveness. This is more and more reflected in the transnational strategies of firms and states alike. This tendency is evident not only in advanced capitalist economies but also established and more recent NICs. It must also be reflected in post-socialist societies.

c) there has been, a paradigmatic shift from a Fordist growth model focused on mass production, scale economies, and mass consumption to one concerned with flexible production, scope economies, and more differentiated patterns of consumption. This shift provides an important framework for making sense of the current crisis and imposing some coherence on the search for routes out of the crisis. It is accompanied by a crisis of US economic hegemony (with which the Fordist paradigm is especially identified) and an emerging struggle between the USA, Germany, and Japan to define a hegemonic post-Fordist paradigm.

At stake today in international competition is the competitive struggle to switch quickly and smoothly among innovative products and processes with each new product offering better functional qualities and improved efficiency in production. East European and Soviet economies were also strongly influenced by Taylorist and Fordist assumptions about the organization of production but proved far less effective in securing mass production and mass consumption. In at least some East European economies there is growing interest in alternatives to Fordism, such as flexible specialization à la Third Italy.

d) the macro-economic global hierarchy is being reshaped as concepts such as the European Economic Area and the Asian Pacific Economic Community are promoted to challenge the economic dominance of the US sphere of economic influence. For our purposes the most important of these new regional concepts is the accelerated economic integration of the EC which was begun as a deliberate move to overcome 'euro-sclerosis' and to build Western Europe up as a 'triad power'. The recent agreement to set up a European Economic Area is even more significant for the future - especially as it holds the promise of associate membership for the former COMECON economies.

But one should note that this is likely to deepen existing trends toward centre-periphery relations within Europe: in addition to a solid core of strong economies we can expect to see a Southern European semi-periphery, a North African and Eastern Mediterranean periphery, a Baltic periphery, and loose ties to an East European periphery. Within this context there will also be a significant re-emergence of regional economies organized around specific countries or growth poles (e.g., a Baltic region encompassing Scandinavia, Poland, north eastern Germany, and the Baltic republics) as well as growing interpenetration of the so-called triad powers themselves (USA, Germany, and Japan). From the viewpoint of Eastern Europe the optimum strategy would be to seek integration into a regional growth pole tied to a strong West European economy, to attract investment from the two other triad regions, and to stimulate their own internal regional and local economies.

### 3. Changes in the World Economy and the State's Economic Functions

These four trends have clear implications for the economic functions of the state in the current restructuring of the world economy. For ease of presentation we will deal with them in the same order as they were introduced above. But this implies neither that each trend is associated with a specific set of economic functions of the state nor that these trends will somehow call forth the appropriate state capacities to perform such functions. Indeed this is especially problematic in post-socialist societies where the state itself has weak steering capacities and is in deep crisis - issues which we address in a later section.

Firstly, given the growing competitive pressures from NICs on low cost, low tech production and, indeed, in simple high tech products, advanced capitalist economies are trying to move up the technological hierarchy and specialize in the new core technologies. States have a key role here in promoting innovative capacities, technical competence, and technology transfer

so that as many firms and sectors as possible benefit from the new technological opportunities created by R&D activities undertaken elsewhere in the economy. Moreover, given the budgetary and fiscal pressures on states as national economies become more open, states must shift their industrial support away from efforts to maintain declining sectors as they are presently structured and towards their technological renewal and/or replacement by 'sunrise sectors'.

Secondly, as internationalization proceeds apace, states can no longer act as if national economies were effectively closed and their growth dynamic were autocentric. Small open economies had long faced this problem; now even large, relatively closed economies must confront it. In particular the macro-economic policy instruments favoured by the Keynesian welfare state become less effective with growing internationalization and must be buttressed or replaced by other measures if traditional postwar policy objectives (such as full employment, economic growth, stable prices, and sound balance of payments) are still to be secured. In almost all cases states have become more involved in managing the process of internationalization itself in the hope of minimizing its harmful domestic repercussions and/or of securing maximum benefit to its own home-based transnational firms and banks.

They must get involved in managing the process of internationalization and creating the most appropriate frameworks for it to proceed. This is especially true, of course, of post-socialist economies faced for the first time with inserting themselves fully into this new global economy. Key issues affecting them will be agreement on measures to regulate labour migration; the rights of workers in foreign-owned or jointly-managed firms; intellectual property right (especially in relation to technology transfer); the legal forms for foreign direct investment, cross-national cooperation and strategic alliances; international taxation; protectionism; and, perhaps, environmental controls.

Thirdly, as the dominant techno-economic paradigm shifts from Fordism to post-Fordism, the primary economic functions of states are redefined. Fordism was typically associated with a primary concern with demand management within national economies and with the generalization of mass consumption norms. This reflected the belief that Fordist mass production was supply-driven and could only be profitable when high levels of demand were maintained and markets for mass consumer durables expanded. The class compromise supporting the Fordist Keynesian welfare state also encouraged this pattern of economic intervention. But the transition to post-Fordism is prompting a reorientation of the state's primary economic functions.

Indeed, the combination of the late Fordist trend towards internationalization and the post-Fordist emphasis on flexible production has encouraged many states to focus on the supply-side problem of international competitiveness and to attempt to subordinate welfare policy to the demands of flexibility. Thus we can speak of a shift from the Keynesian welfare state to the Schumpeterian 'workfare' state. This does not mean that all the states will become alike with the transition to post-Fordism: the emerging political regime is already assuming various neo-liberal, neo-corporatist, and neo-statist forms shaped by institutional legacies and the prevailing balance of political forces. The East European and Soviet economies will be especially subject to pressures to become Schumpeterian workfare states since measures to

enhance their structural competitiveness are absolutely crucial and they lack the resources to finance a welfare state which does not also serve the purpose of promoting full employment and economic growth.

Fourthly, as the forms of internationalization become more contentious and conflictual and competing strategies evolve around the triad powers, states must address the political as well as economic repercussions of the changing international order. There is a complex dialectic at work here. For, besides globalization and the formation of supra-regional triad economies, there are also trends towards the re-emergence of regional and local economies within the nation-state. In certain respects this is associated with a 'hollowing out' of the nation-state as powers are delegated upwards to supra-regional or international bodies, downwards to regional or local states, or outwards to relatively autonomous cross-national alliances among local states with complementary interests.

Even so the nation-state retains a key role in managing the changing balance of political forces consequent upon the complex and contradictory process of globalization. For it is still the most important site of struggle among competing global, triadic, supra-national, national, regional, and local forces; and social cohesion still depends on the state's capacities to manage these conflicts. It is precisely the capacity of the central state to undertake such activities which is at issue, of course, in the post-socialist societies.

There is more to capitalist economies than the free play of market forces. Market forces must be embedded in supportive (but constraining) social, organizational, institutional, and normative frameworks. Moreover, as the dynamic of capital accumulation changes, so will the type of framework which is appropriate. In this sense the state's economic functions can never be confined to maintaining the appropriate legal and monetary framework in which economic actors can pursue their own interests in the free play of market forces. Nor can its further interventions be limited to compensating for market failures - real and inevitable as these are. For the state is also involved in (but not solely responsible for) managing the mode of social regulation of capitalist economies. This comprises the social norms, typical modes of calculation, organizational and institutional forms, social networks, etc., which bring about the conformity of private economic actions with the overall requirements of continued economic growth despite the inevitable dilemmas, conflicts, and contradictions within any economy.

#### 4. Path-dependence in economic processes: implications for policy analysis

In order to understand the transformation process in its functional and sequential interdependencies, the theory of traverse (in the sense of Lowe 1976; and Hicks 1973) and of disequilibrium dynamics on the one hand and the theory of institutional change on the other hand seem to be relevant starting points.

In the centrally planned socialist economy, behavioural and motivational patterns often result in chronic shortages of consumer and producer goods and lengthened construction periods of plant and equipment. Bottlenecks, sectoral labour shortages and underemployment of labour and capacity exist simultaneously. Because the shortage economy is a sellers market,

there is little information about the real quantities demanded, the quality of products, quality of services, which in turn creates little incentive for product and process innovation.

The traverse from a centrally planned economy to a market-oriented one, therefore, starts from a particular kind of disequilibrium state and its corresponding behaviours. Moreover, because these behavioural and motivational patterns were not goal-adequate in the actually existing socialist economies of 1989, they are not goal-adequate for the economies in transition. Because the centrally planned economy is characterized by chronic shortages, excess demand and repressed inflation, different motivations and social relationships between enterprises, the state and the manager, the state and worker and buyer and seller, have become institutionalized and have engendered particular behavioural patterns which are not easy to change. The results are sluggish growth, a lack of incentive to innovate, and widespread product deterioration.

Until recently, the implicit assumption in economic analysis was that institutional change is reversible and, hence, perceived optima should be attainable. In turn, this presupposed an assumption of malleability: the elements of economic order can be changed should it be desired. For any transformation strategy, this has the nice consequence that errors can be repaid and costs of errors will remain within limits. Only very recently has the phenomenon of irreversibility been recognized and studied (Cfr. Boyer, Chavance, Godard, 1991). Sociologists have, of course, always stressed the inability of actors to change a situation or the course of process. The individual actor is constrained by the system and, acting in conformity with the established norms, s/he reconfirms the system. This can indeed be subsumed under irreversibility. But there are also straightforward economic explanations: even if the individual realizes suboptimality, transaction costs and transformation costs may bar the transition to the optimal situation. This leads to the tenacity of suboptimal states of order.

A transformation may be called irreversible if a symmetric change does not lead back to the initial state. In other words, a change is irreversible if it cannot be made undone by an act symmetric to the initial one even if there exists an appropriate sequence of acts to do the job. This is the well-known phenomenon of hysteresis. More generally, a change is irreversible if it does not allow the return to the starting point. This, of course, is always the case with historical time. In situations of uncertainty about the future, irreversibility becomes especially relevant. It describes the fact that a certain decision, once taken, changes the perception of the decision-maker which he will have in similar situations in the future.

Thus a dilemma arises: the later a decision is taken the better may be the information about it and hence decision-making can get delayed. In sequential decision processes, the individual steps are irreversible and the final outcome is not known and may be unintended at the beginning. Given momentary information, each step is the result of a rational choice, but one may end up in a situation which nobody intended and, moreover, is inefficient.

Inability to change, hysteretic asymmetries and changes of perception introduce initial conditions and historical time into the analysis of institutional change. If we add non-linearities, externalities and increasing returns, it becomes clear why transformation is a highly complex process. It diverges from rather similar initial conditions, is path-dependent and self-enforcing.

More specifically, we know nowadays that path-dependent processes can settle into "basins of attraction" that are suboptimal; but also that perturbations and shifts in the



underlying parameters can push such systems into the neighborhood of other, quite different attractors. Several considerations may be briefly mentioned in this connection.

First, there has been a great weakening in the reinforcement that economists who pay attention to the natural sciences can derive for persisting in focusing on the investigation of linear, or linearized systems - in which equilibria, when they exist, typically will be unique. During the past decade natural scientists have been turning increasingly to problems in the analysis of complex dynamical systems of the "self-reinforcing" or "auto-catalytic" type. (For surveys, see for example, H. Haken (1978) and D.L. Stein (1989)).

As fascinating as these phenomena are, economists should not expect to find paradigms ready-made for their use. Indeed, the positive feedback systems of interest to the economist, unlike these physical systems, contain volitional agents whose actions reflect intentions based upon expectations. All this is according new significance to details of historical sequence - a development associated with the growth of interest in nonlinear dynamics.

Second, because transient situations leave a persisting influence (hysteresis), the details of timing and circumstance cannot be ignored, or treated simply as rhetorical devices. Economic models that failed to specify what happens away from the equilibrium position(s) would not be taken seriously. Consequently, a lot more empirical attention would have to be devoted to characterizing the reactions of agents to unpredicted changes in their environment.

Third, at certain junctures individual human actors of unheroic stature can indeed affect the long run course of history, and so, under conditions of positive feedback, the personality of inner-directed entrepreneurs and the ideological convictions of policy makers turn out to possess far stronger potential leverage affecting ultimate outcomes than they otherwise might be presumed to hold. Greater attention would therefore be paid to the heterogeneity of beliefs, and the degree to which agents were "inner-directed", rather than "other-directed" in their expressed preferences. In systems where positive feedback dominates, it is the inner-directed agents who exercise a disproportionate influence upon the motion of the system, because those who are other-directed tend eventually to adopt to the views of those around them. (See Haltiwanger and Waldman, 1988).

Fourth, sudden shifts in structure, corresponding to the notion of "punctuated equilibria" as used by biologists can be explained analytically in nonlinear, positive feedback systems. This may open a way for the formulation of dynamic models that are compatible with "stage theories" of development, whereas stage theories formerly have had a bad name in economics because they merely offered a choice between simple taxonomies and tautologies. (See Day and Walter, 1989).

Moreover, analysis of stochastic processes that are non-ergodic and display the property of converging to one out of a multiplicity of stable attractors, shows that comparatively weak "shocks" occurring early in the dynamic path can effectively "select" the final outcome. Later on, however, when the system has slipped into one or another basin of attraction, it acquires sufficient momentum that economically costly actions are required to redirect its motion. This implies that effective public intervention in economic affairs is more a matter of achieving optimal timing than has been admitted by modern welfare economics. In other words, it is not so much a question of level of intervention, rather of timing and sequencing.

## 5. Three transformation dilemmas

There are two major sources of barriers to transformation: the legacy of the past and the uncertainty about the future. As to the former, all which does not conform with or is not adopted to the market order and which cannot be changed by the stroke of a pen will make its importance felt. Major structural and behavioural idiosyncracies of the old system have to be enumerated here:

i) the product and capital structures of the economy which were based on a distorted price system or on voluntaristic and ad hoc decision. This fact raises a major problem for partial reform, for inputs are the most valuable on the margin where they are the most underpriced. As Murphy, Shleifer and Vishny (1992) write, if timber is cheap, it is in short supply and has a high shadow value. The short supply makes entry attractive to the private firms, which enter and divert some of that supply of timber to their own use. The incremental producer surplus to the private firms is directly proportional to underpricing. The implication of this result is that private firms are likely to enter precisely where they can do the most damage in terms of diverting inputs from competing state sectors. Private firms are likely to enter sectors where the inputs are most scarce and so create the largest resource misallocation as a result of their entry;

ii) capital shortage and the lack of financial markets due to unsound accounting practices and the complete reliance on bureaucratic coordination;

iii) the lack of an entrepreneurial "class" and the pushing away of all animal spirits into secondary and illegal activities. As it has been remarked by Baumol (1990), how the entrepreneur acts at a given time and place depends heavily on the rules of the game - the reward structure in the economy - that happen to prevail. Therefore, it is the set of rules and not the supply of entrepreneurs or the nature of their objectives that undergoes significant changes from one period to another and helps to dictate the ultimate effect on the economy via the allocation of entrepreneurial resources between productive activities and largely unproductive activities such as rent seeking or organized crime;

iv) the lack of civil society by which I mean an objective set of rules to which all citizens including the rulers are subjected and a reasonably predictable interpretation of these rules. The fundamental difference between monopolistic structures such as those of nomenklatura socialism and liberal structures is that a plurality of autonomous associations are on offer which are not all geared to one common purpose. Civil society at its best is a creative chaos of associations. It protects us against the inconveniences of the state of nature, but also against those arising from monopolistic claims by self-appointed minorities and indeed majorities;

v) the lack of competition and of competitiveness due to high concentration of the firm structure and to the sellers' market situation in which the firms operated.

Let's now consider the main implication of these five idiosyncracies of the old system upon the viability of the transition path.

It is by now a well-known fact that modern technology can only be effective if a part of the population forms a social infrastructure upon which the use of the given technology depends. Such an infrastructure mediates the human energy devoted to coordinating production and exchange, to providing social cohesion for effective cooperation, for training and inculturating the work force and for producing the public goods, such as waste disposal and public safety required for the well-being of the work force. Call the part of the population that makes up this infrastructure the infrastructural force.

To take account of the infrastructural requirements, divide the total population into infrastructure forces and work forces. And, correspondingly, divide the capital stock into that devoted to the infrastructure and that devoted to the production of market goods. For simplicity, assume that the size of the capital stock required for the infrastructure is directly related to the population by a fixed proportion. Likewise, assume the size of the infrastructural force is directly related to the size of the capital stock by a fixed proportion. Then, Day and Zou (1993) have shown that the effect on the production function is to compress the possibilities for capital/labor substitutions into a cone within the positive orthant. Day and Zou call this the "Restricted Factor Substitution" (RFS) production function.

A significant property of the RFS production function is that for any given output level, the efficient capital/labor combinations lie in a cone, say  $\underline{C}^*$ , within the feasibility cone  $\underline{C}$  but the isoquant on which these combinations lie approaches the boundaries of  $\underline{C}$  asymptotically and extend outside  $\underline{C}^*$ . In practice, this means that if the political and economic decision makers, administrators and managers could perceive and understand society's production structure as a whole, more production and a higher standard of living could be achieved for any given combination outside of  $\underline{C}^*$  by rearranging capital and labor so as to obtain a combination within  $\underline{C}^*$ . It seems unrealistic to suppose that they always manage to do this. Viable trajectories of capital and labour must unfold within the viability cone, but now the growth paths need not be monotonic or convergent to balanced growth. At a given savings rate, over-investment can take place with a corresponding inefficiency in the use of capital and labor. Capital/labour ratios can fluctuate and the paths of capital accumulation can follow a zig-zag path in the capital-labor space.

The reason for this is that for any given population level, a sufficient capital stock must be allocated to infrastructure before production can occur and, for the same reason, for any given capital stock, a sufficient part of the population must be allocated to infrastructure. Capital/labor ratios are therefore constrained to lie in an interval. If the capital/labor ratio becomes too small, or too large, there must be a rapid decline in productivity. Consequently, it is possible to overshoot the balanced growth path and oscillation around it may follow. Turbulence is therefore a possibility with continued growth occurring only after a series of jumps and reversions.

Consider the current situation in the former Soviet bloc. Here we see something like the kind of occurrences the above considerations predict. The process surely looks turbulent,

the prospects highly uncertain. In the terms spelled out here the causes are clear. The system outgrew the infrastructure required to continue growing in an effective manner. A population of such great size cannot persist within that kind of a regime. A new one is required and that is what the attempted transition is about.

The legacy of the past in Eastern Europe are institutional and behavioural structures which drag the transition to a market economy. Compare with it the initial conditions of West-Germany or Italy or Japan after the war or of Spain after the fall of the Franco regime and the differences become quite apparent: the market system had been temporarily and never completely suspended in these countries. They were able to return to it. Markets are the result of a very complex evolution in which well-defined property rights, credibility, expectations, reliable administration and the like play an important role.

So we arrive at the first transformation dilemma: markets seem to function only within a well-established market environment which evolves on the way to a market order. But since it does not exist ex-ante and cannot be created ex-ante, nascent market orders cannot immediately compete with fully developed ones. The solution of the conundrum is time and a very careful policy of protection. Moreover, it is highly unlikely that we can derive from historical experience a proper sequencing for institutional reforms.

As to the latter, i.e. uncertainty about the future, it prevents the emergence of entrepreneurial activity. If we look once more at the just-mentioned examples, we see that political stability and, hence, long-term credibility of policy measures form one of the outstanding features of their post-transformation economic history. It is the stable state and not the minimal state which seems to create favourable conditions for the evolution of a self-sustained market process.

Stability and certainty in a process of transforming economic structures and institutions, this seems to be a contradiction in terms. And indeed, it is the second transformation dilemma: what is needed is stability and flexibility at the same time. Path-dependency of the transformation process calls for sequential decision-making. Far-reaching structural changes will be implemented only in a rather stable environment. The solution of this second conundrum could be confidence: the objective uncertainty about the future cannot be reduced, the subjective uncertainty about it however can by a stable socio-economic framework which leaves room for institutional adaptations.

Confidence is a network element of the economic system: it has strong self-enforcing effects. An economy in whose success the business community trusts will, for instance, attract foreign capital thus improving the chances of this success. The problem, of course, is how the build-up of confidence can get started, a well-known question from business cycle theory. Evaluating the successful post-war return to capitalist market economies in Western Europe and Japan, we may point to two outstanding features: i) national industrialization and recovery programs which in most cases were supported by coordinated government policies; ii) concertation and the rise of the welfare state, i.e. the propagation and implementation of a sense of fairness and the forming of a national consensus which included the working class.

This lead us to a third transformation dilemma which is closely related to the second one, but has also its ramification into the political system. The market's, as well as democracy's, resilience are rooted in the flexibility-creating pluralism of a multitude of decentralized decision-makers with own ideas and interests. The market system, certainly in

its building phase, needs a stability-creating consensus to support it. It is difficult to imagine how societies which have just escaped from a political system that prohibited all forms of pluralism and imposed consensus by force, can solve this conundrum.

## 6. The political economy of change and transformation

As Blinder (1992) has splendidly clarified, the so-called transition problem is usefully divided into two questions: i) where do we want to go?; ii) how do we get from here to there? Standard economic analysis is supposed to be good at answering the first question but bad at answering the second one. Moreover, while it is well-known that the answer to the second question depends on initial conditions, the answer to the first question is supposed not to.

The developments in the theory of path-dependent processes hinted at in section 4, allow us to understand why the answer to the first question may also depend on initial conditions. The reason is briefly the following. If there is more than one viable equilibrium, as it is the case when in the economy operate positive feedback mechanisms, the one a society selects may depend on its history, its culture, or even on random events. Where you end up may depend on where you start. That much is well known. But I want to suggest that even where you want to end up may depend on where you start.

Briefly, the argument is this. There are a variety of models of market capitalism: the Anglo-American, the German, the Japanese and their many variants. Each model shares some common elements and has certain distinctive features; each has its strengths and weaknesses. In practice, the choice of a model instead of another will certainly depend on a country's inherited stocks of physical and human capital, broadly construed (including history, culture and the like). The question is whether that choice should also depend on these things in principle. I think there are reasons to believe that it should. Part of the explanation lies in transition costs which depend on the time horizon of the transition process. But part of the reason pertains to the likelihood of making the transition successfully. Surely nothing is more important than that.

If this is correct, a major implication follows. Given where they are coming from, the formerly socialist countries of Europe might do better by emulating the German or the Japanese models than by emulating the Anglo-American one. In the heady early days of the Eastern European transformation, many Western economists viewed the formerly socialist countries as tabulae rasae. They were, it was thought, starting new economic systems "from scratch". This view is absolutely wrong. Each of these countries began its transition with a heritage of both human and physical capital, a preexisting economic structure, a culture, a government and a memory. The thesis here defended is that these initial conditions will and should influence which of the several models of market capitalism each country finds most suitable.

In particular, in their rush to emulate the West, and especially the United States, these countries seem to have all but forgotten that there are appropriate economic models developed in Japan and in Continental Europe, models which not only work well but requires a less gut-wrenching transition from socialism. In many important respects - such as the nature of the banking system; the role of stock market; the characteristics of the labor markets; the

functioning of the firm; the role of government policies - Japan and Germany differ sharply from America. And in most of them, it is clear that the formerly socialist economies start out closer to the Japanese or the German than to the American norm.

When an economic system is closer to your starting point, and at least as successful as another which is more distant, a country looking for a new model should study it carefully. It is this logic that leads me to state that Eastern Europe should have paid more attention than they did to Japan and Continental Europe.

Some may object that Russian and Poles are not Japanese nor Germans. Economic institutions that are suitable for one nation may not be suitable for another. That is surely true. But neither are Russian and Poles Americans. What is here claimed is that the transition from European Socialism to a Japanese-style or to a German-style system may be easier than the transition to the American way. Nor must a reforming country adopt the Japanese or German system in its entirety. Americans are certainly not Japanese. Yet certain aspects of the Japanese system, especially their industrial relations practices and management structures, have been brought to the United States by Japanese transplant operations with great success, using American workers and surrounded by American economic institutions. It would be a nonsense if this same sort of thinking were not going on in the formerly communist countries.

The role of change in the social structure and the establishment of new institutions cannot be considered as an end in itself since it does not define the desired terminal state or goal that is to be achieved; it is purely instrumental. Institutional change has to serve as a suitable means to the achievement of certain goals. An analysis of the transition, therefore, requires that the desired terminal state of the economy must be specified and that institutional changes be viewed as instrumental to the achievement of specified goals.

The need for specifying the envisioned terminal state of the transition economies comes into sharp contrast with some prevailing views. Lipton and Sachs (1990 a, p. 75) argue that these transition economies do not need to choose their desired social structure, but only certain institutions: "Western Europe offers a wide array of alternative economic models from which to choose, but in practical terms there is little reason yet for the Eastern European countries to choose among the variants of Western European political economy. Before such choices have to be made, Eastern Europe should work hard to create the common core of market institutions found in all of Western Europe".

It is true that the alternative models of market economies share a number of common institutional features, such as the existence of financial intermediaries, property rights etc. Yet - as it was noted above - there are important differences not mentioned by Lipton and Sachs. A policy of transition that sees the main goal as the rapid creation of certain market institutions is neither neutral in answering the question of what kind of market economy is ultimately to be adopted, nor is it conclusive. In such a policy proposal institutional changes appear not as the means to the realization of economic ends, but as desirable goals in themselves.

Once it is realized that the crucial difference between alternative market-economic models lies in the significance placed upon certain features such as macro-controls, the role of stock market, the nature of industrial relations and the like, the non-neutrality of the Lipton and Sachs proposal, strongly favoured by the IMF, becomes immediately apparent. For if the desired form of market economy is one closer to the German or to the Japanese one than to

the Anglo-American one, then steps towards establishing the necessary institutional arrangements should be made at an early stage of the transformation process.

Also Blanchard et al. (1991) give priority to stabilization and privatization at the start of the transformation programme. However, while it is acknowledged that a totally free economy is "neither socially acceptable nor economically desirable" (p. XVI), placing priority on stabilization and privatization over restructuring the economy implicitly neglects the need to specify the desired terminal state. By neglecting the technical and social structures of the economy, their proposals create institutions which may lead to a socially undesirable end state. Establishing these institutions before knowing where the traverse is heading is a tragic methodological mistake.

## 7. Conclusion

The early years of transition from plan to market have been associated with the dramatic declines in output and, with a lag, employment, at a rate not initially envisaged by policy-makers. Explanations normally highlight the sharp fall in intra-CMEA trade at the time of reform, structural imbalances and price-cost squeeze associated with price liberalisations. These features are certainly true, but in this paper stress is placed on a more fundamental reason.

The transformation of centrally planned economies into capitalist market economies is a good example of a disequilibrium traverse between socio-economic systems. A traverse from one growth path to another necessarily requires an analysis of speed, sequencing and restructuring - all crucial issues for the transition economies. However, unlike the analysis by Lipton and Sachs (1991), specification of the future structure of the economy required that institutional changes be viewed as instrumental to the achievement of clearly specified macro-goals. This is not simply a matter of setting a goal of increasing the living standards of all Eastern Europeans, but a matter of determining what types of public controls and institutions are necessary to achieve this goal. In other words, what kind of economy do Eastern Europeans want?

At the beginning of the reform process in Eastern Europe, market socialism was seen by many reformers as a possible alternative (Brus 1972; Kowalik 1989). However, after the collapse of the centrally planned economies in 1989, the target shifted towards the adoption of a Western-type market economy. Yet, the question of what particular kind of non-socialist economy is finally to be adopted as the desired one was considered as being of minor importance. This has been a great mistake and the main source of considerable human costs and unnecessary hardship on many groups of the population.