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General Remarks on the Speed of Transformation in the Socialist Countries

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General Remarks on the Speed of Transformation in the Socialist Countries

Summary

This study examines the processes of transformation in the socialist countries (Hungary, Poland, China, the USSR).

The trust of the paper is to show that the speed of transformation in the socialist countries with orthodox centrally planned economies is largely determined by the coincidence of political and economic change and that the acceleration of just one side of the transformation leads to the surfacing of serious tensions in the transformational process in general.

According to the analysis, there are some general perspectives concerning transformation of the socialist system. So, partial transformation may not improve the quality of the socialist system; rather instead it leads to disequilibrium in the society. The serious delay or rapid acceleration of reform in one sphere of society provokes radicalization of transformation in general, but the resultant changes may as likely be in one direction as in the opposite direction. Persistence and permanency are needed in transformation policy, because the transformation of a socialist society is a long process.

¹ This paper was prepared during the stay at the Bank of Finland as a visiting researcher. I am indebted to Kari Pekonen, Terhi Kivilahti, Pekka Sutela, Jouko Rautava, Glenn Harma, and Kamil Janáček for very fruitful comments. I thank Päivi Pellikka for editorial advice. Any opinions expressed are of the author only. All remaining errors are mine.

1 Introduction

The ongoing process of radical change in the former socialist countries, which has attracted worldwide interest, is gaining speed.

The command economy – which seemed strong and competitive in the mid 1970s – encountered several complicated problems concerning generally its ability to satisfy the needs of society. Facing a severe crisis, it found itself unable to make the necessary improvements without abandoning the basic guidelines of socialist theory. The political and ideological system – previously based on a repressive apparatus found itself unable to resist the conscience of the people, which was developing under the influence of glasnost, without resorting to the old bloody tactics.

Of course, no specialist could have foreseen with certainty that the socialist block would disappear in such a short period in the span of history (1989-1991). But, as I see it, the transformation in different countries has actually been going on continuously since 1968 (Hungary and Czechoslovakia) or even since the 1950s (Yugoslavia). And it is now clear that this transformation is far from over, and that it will continue in the future. The final goals of the former socialist countries – a democratic society and a market economy – are still only dreams. Nevertheless, different countries have thus far achieved different results – positive and negative – and their experience in making the transformation can and must be given serious attention because of the light they cast on the spread of the transformation process and their usefulness in predicting the course of events in the transforming countries.

Certain consequences of economic reform – inflation, increasing income inequality, unemployment – are the most visible ones. Their negative character makes us wonder if we have chosen the wrong course. But it is naive to believe that all these things occur only during the transformation of command economies. It is only their form that is now changing – from repressed to open. All countries with command economies suffered from excess demand for both consumer and industrial goods, corruption and low quality goods and services. Inflation took place everywhere, but it was manifested not in price increases but in shortages and long queues. Low retail prices for food products as a result of budget subsidies forced the prices up in the free market, but had no impact on the behavior of producers and consumers. The increases of retail prices by government decision never led to an influx of goods onto the shelves, because producers did not receive those signals, or received them in a distorted form. Inequality in incomes was measured not by the level of money income, but by the access to goods, which distorted human relations and morality. Unemployment was hidden by the policy of guaranteeing everyone a job, which led to chronic overstaffing, with the result that the marginal product of labor is virtually zero and industrial discipline and the labor ethic are badly eroded.

The appearance of these problems as a result of partial and modest measures was always unexpected by the reformers, but the impossibility of restoring the old control methods, i.e. turning back, was even more unexpected. The only way out of the dilemma was forthright movement towards reform. Preserving macroeconomic equilibrium and holding inflation to a tolerable level have been the key aims of all communist governments during the period of economic reform. And the political viability of reformers and the accomplishment of their goals have depended on the achievement of those aims.

The thrust of this paper is to show that the speed of transformation in the socialist countries with orthodox centrally planned economies (CPE) is largely determined by the coincidence of political and economic change and that the acceleration of just one side of the transformation leads to the surfacing of serious tensions in the transformational process in general. I focus on the experience of the best known transforming countries (Hungary, Poland, China, USSR), though other countries' experiences are also cited from time to time.

2 Objectives of Transformation

The transformation of centrally planned economies (CPEs) can be divided into four parts: financial stabilization, liberalization of the economy, structural adjustment and opening of the economy .

Due to the poor efficiency of the mechanism which combined centralized price setting with the general accumulation and redistribution of financial resources, and to the underestimation of the role of money in the economy, macroeconomic disequilibrium was one of the characteristic features of the command economy. As soon as liberal changes – by socialist standards – begin taking place in this mechanism the disequilibrium worsens and threatens the overall success of the transformation. This is why the most urgent goal for CPE countries is that of financial stabilization – reconstruction of the monetary system which is necessary in a market economy, implementation of the hard budget constraint for all economic agents, and the achievement of dynamic macroeconomic equilibrium² through tight monetary and fiscal policy.

The market economy is based on the initiative of ordinary people and on private property. This necessarily requires freedom of decision making for all economic agents: what to produce, what price to charge, where to buy and where to sell are the responsibility of economic agents. The CPE was based on state property – which was not in fact institutionalized – and on the hierarchical process of decision making within the pyramid of state organs. The process of transition from all-encompassing state responsibility for economic activity to private initiative requires extensive liberalization of the economy. In this process the CPEs must abstain from planning the activities of enterprises and give them freedom to set prices and find their own suppliers and consumers. They must also attend to the most difficult task, i.e. the privatization of state-owned enterprises. The result of such a transformation will hopefully be a privatized economy with true owners, who make their own decisions and take complete responsibility for the results.

The next major objective for the transformation of CPEs is structural adjustment. Presently, these countries are characterized by a large share of intermediary and military production and a small share of private consumption. This was caused by, and at the same time fomented, technically underdeveloped industry, barbaric exploitation of natural resources, and inefficient economic activity in general. While the technological revolution, which took place in the 1980s in developed countries, was based on the growing importance of science and its application to industry and led to significant structural change in the economy, the CPE countries tried to compete economically using the old industrial capacity and lacking the resources to modernize it. Now the CPE countries are obliged to make huge efforts in this area: it is necessary to change the structure of final production, develop a service sector,

² By dynamic macroeconomic equilibrium I mean an inflation rate – though high according to western standards – not exceeding 40 % per year, i.e. a rate that remains under the control of the authorities. I argue that in economies undergoing transformation there are factors which make a long period of inflation inevitable – price distortions, low level of personal incomes and a huge social security scheme financed by the state - but this is the subject of another paper.

deal with monopolies which are all in fact state-owned enterprises, support the development of small businesses etc.

All this will lead to the elimination of the existing barriers between CPE countries and the world economy and will make possible the opening up of these economies, which may be considered the final objective of economic transformation. Having realized the idea of the socialist block, the CPE countries created an enclave which developed separately from the world economy and which did not participate in normal international economic relations. The result of this policy was bad for everyone: low quality of produced goods, non-competitiveness of goods in world markets, loss of opportunity to take advantage of international specialization and growing dependence on the import of consumer goods and industrial products in order to support economic development and living standards. One of the most visible results of the opening of the economy is participation in international economic organizations (IMF, World Bank, GATT) and convertibility of the national currency at reasonable exchange rates. It is more difficult to determine what it means to find one's own place in the world market and how much time will be needed to accomplish this.

All these processes of economic transformation are extensively interconnected and interdependent. Sometimes it is possible to say roughly in which direction the next step lies or what the aim was of a specific decision. Nevertheless, it is now quite clear that it is impossible to limit transformation to the achievement of just one objective and pay no attention to the other objectives. Successful comprehensive economic reform means that all these objectives are faced by decision makers and that politicians observe this fact in their planning.

The problems of political change, which have to be resolved during the overall transformation, are not at all less important. I shall only outline briefly the desired political reforms. The most essential step is the dissolution of the party monopoly on power and free general elections of legislative bodies. Typically, the communist party is unable to win free elections, and its defeat leads to the creation of a new government by the Parliament. Sometimes the formation of a 'coalition government' under a one-party system can be the first step to an eventual multi-party system. The next stage is the strict legal separating of the legislative, executive and judicial powers and the formation of a constitutional court. Comprehensive reform of the legislative and judicial system is an essential requisite of a democratic society. A final step may be projected: the drafting and adoption of a new constitution which summarizes the most important changes to be effected and spells out the basic guidelines for the construction of a new society.

3 Case Studies of Transformation

3.1 Hungary

The reform of the economic system in Hungary – as in other Eastern European countries – may be divided into two stages: in the first stage, communist leaders tried to improve the existent economic system by implementing some elements of competition, loosening the state's grip on the operative management of enterprises and by attempting to use quasi-market instruments to regulate economic activity. As a result of internal political factors and personal features of the Hungarian leader, this country is the only one in Eastern Europe to this stage of transformation without any serious social conflicts. At the end of this stage and as a logical result thereof, a package of laws on the reform of the economic system was adopted. This became the foundation for the second stage of reform, which coincided with radical democratic transformation, and meant the breaking away of Hungarian society from the socialist idea. This is why the Hungarian experience is extremely important to analyze, and I, in contrast to some of my colleagues (e.g. Aven (1991)) as the Hungarian economic transformation as the most rational and successful one, possibly even being the optimal way of making the transition to a new economic system. In any case, the social costs of the Hungarian transformation are lower than those of her neighbour countries.

Hungary began its long process of transformation of the CPE in 1968 by introducing, as a result of a decision of Central Committee of the Hungarian Socialist Workers' Party (HSWP), the so-called "new economic mechanism", which was a significant break from the basic elements of the CPE (Kornai (1986), Czaba (1989)).

The first and most radical step during this stage of reform was the change in the role of the state plan. Instead of the comprehensive planning of all aspects of economic and social development, Hungary started to use its national plan as a set of targets, primarily macroeconomic in nature. State enterprises – as private companies practically did not exist that time – became free in their decision making as to what to produce, where to sell, and how to develop themselves. The centralized system of allocation of physical resources was abolished, and though some planning coordination was retained it was no longer a part of a comprehensive system. Plan fulfilment was no longer used as an indicator of an enterprise's economic success (Bauer (1983)).

The gradual liberalization of prices started at that time: it was in Hungary where free and regulated prices for state-owned enterprises instead of state-determined prices appeared for the first time in the socialist countries. More than one fourth of all prices – both wholesale and retail – were liberalized in 1968 and another 35 % were allowed to change within certain limits³. Beginning in 1968,

³ It should be pointed out that Hungary was implementing gradual, persistent sectoral price liberalization, keeping state control over price setting in basic industries and for the most important consumer goods over a long period. Thus in 1989, when administered prices were used for only 23 % of industrial turnover, the share of those prices in the extractive industries was 75 %, in electro-energy 90 %, in the chemical industry 43 % and

world market prices were used for all imported and exported goods; and, with greater involvement in international trade than other socialist countries, Hungary witnessed gradual changes in the structure of its internal prices. But until the mid 1980s, the state had the means to control foreign trade (subsidies and special taxes).

The first legislation on foreign investment was introduced in 1972, allowing, within certain limits, the participation of foreigners in the Hungarian economy. Together with the institutionalization of joint ventures, guarantees concerning the repatriation of profit and capital, tax benefits and exemptions were legislated in the first half of the 1980s.

Now, after a quarter of a century has passed, we may characterize Hungarian reform during the period as non-comprehensive reform – up to the mid 1980s, the banking system was not transformed, the problem of property was not even discussed and the state was still all-powerful – but in comparison with the other countries, it was a huge step forward. Hungarian policy allowed the liberalization of the economy to begin and supported general equilibrium without the instruments of the command system.

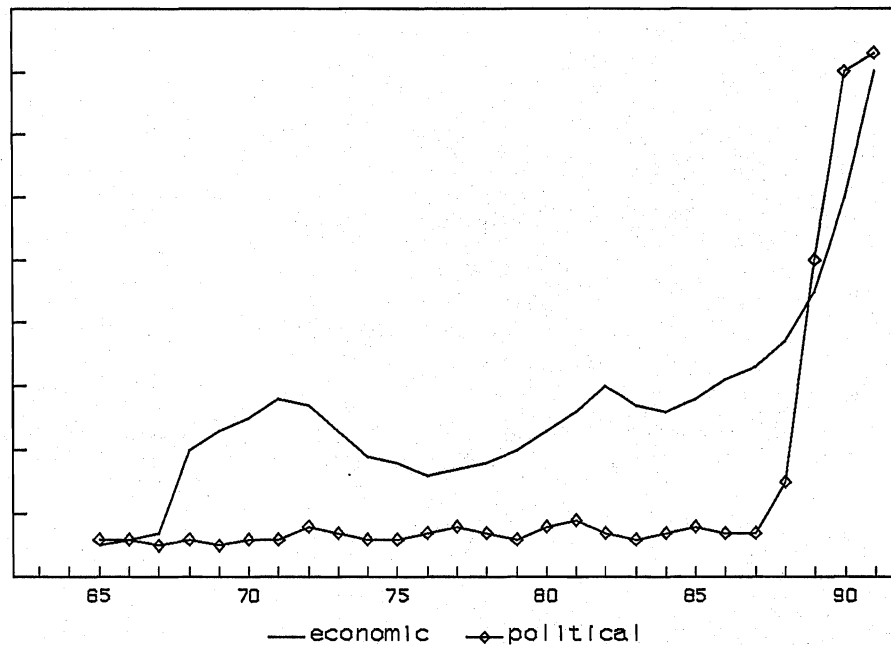
However, the speed of political change during that time was zero or possibly even negative. The events of 1968 in Czechoslovakia and of 1970 in Poland and East Germany were of course an alarm signal to Soviet politicians, and Soviet pressure on East European countries was stepped up. Internal opposition to change was also strong, mainly on the part of the HSWP organs, which understood the loss of power that was taking place. The result of such discordination in the process of transformation was a backslide in economic reform and a freeze in the situation during the period 1972-1978⁴.

In October 1972 discussions on the impossibility of national models of socialism and on the necessity of defending workers' interests and socialist ideals began in Hungary. Though the mistakes made in economic policy were not officially admitted, it was emphasized that some distortions in policy implementation had taken place and that it was necessary to improve the political line. As a result, the Hungarian Council of Ministers re-established its direct control over the operation of the fifty largest national enterprises - 60 % of fixed assets, more than a half of industrial production, more than 60 % of exported goods. Centralized supervision over the economy was strengthened in 1976 after the new five-year plan was adopted: the right to decide on all large investment programs – which required bank credit – was transferred to the central authorities, and the share enterprise profits channelled into the state budget increased.

in machine construction 4 % (Swaan (1989), (1991)).

⁴ There are documents confirming that Hungarian reformers did discuss the necessity of demonopolization and further liberalization of the economy, more radical movement to market prices, and banking reform during that period (Berend (1989)).

Chart 1. Hungarian Transformation⁵



To a certain extent, the reason for the tough, more centralized economic policy was the effect of the oil crisis (1973-1975) on Hungary and the deterioration in the terms of trade. The average increase in prices of imported goods was about 70 % for five years, while the increase in prices of exported goods did not exceed 30 – 40 %. This brought serious inflationary pressure on the Hungarian economy. Further, the Hungarian leaders supported the idea that neither the oil crisis, nor the world economy in general had any influence on the socialist countries. They demanded continued rapid growth (5 - 6 % per year) which made it necessary to increase the volume of foreign trade by 10 % to 12 %. The result of this policy was painful: the economy moved further from equilibrium, the budget deficit became substantial, and foreign indebtedness increased. It became evident that this old policy would not be accepted without a strengthening of the command structure, but this led to a rebuke of the system by all elements of the new economic mechanism. The idea of continuing the reform process was more attractive, and beginning in 1978-1979 new steps were taken towards the transformation of the economic system.

Looking back at the Hungarian transformation of the decade 1978-1987, it may be said that the general trust was the permanent improvement of the actual system, not a movement back towards the command economy. All measures helped move the old system permanently in the direction of the market system. The Hungarian

⁵ Each country's example is accompanied by a graphic illustration of the transition process. These illustrations are not based on precise evaluations, but only reflect author's personal visualization of the processes analyzed.

leaders implemented one-by-one new market-oriented instruments of economic management.

The private sector received more freedom not only in agriculture but also in industry and services; a private enterprise was allowed to employ up to 30 persons (1978). Three industrial ministries were merged (1981) and all enterprises began to have direct contacts with the central economic authorities. The largest state enterprises were dismantled (1984). The exchange rate for the Hungarian forint was unified for all current transactions (1981). The financial norms for enterprises – regulated profit distribution and wage funds – became widespread. In 1985 the gradual institutional transformation began in the state sector: about 80 % of enterprises were transformed into self-managed companies, and company councils were established. While enterprises remained state owned, all property rights were delegated to the councils. At the same time, 17 % of all state enterprises – the smallest ones – were obliged to operate under the conditions and rules in effect for the cooperative and private sector, on the basis of self-management. In addition, all directive orders were abolished for another 70 % of the enterprises. The reform of the banking sector was carried out (1987); and in accordance with the creation of a two-tier banking system, the central bank lost the right to carry on commercial activity and became responsible for monetary policy and currency regulation (Tarafas (1992)).

It is clear now that the Hungarian economy did not advance very rapidly; during the decade it moved as far as some other countries have moved in one year of transformation. And it is evident that those changes did not completely abolish the old system: the central authorities continued to supervise the operation of the largest enterprises, it remained possible for enterprises to bargain for better norms or allowances, economic development continued to be driven by the continuous growth of foreign debt. But at the same time, the system of reallocation of resources had disappeared and was not re-established, repressed inflation was converted more and more into open inflation, consumers forgot what shortage meant and the economy, having forfeited rapid growth, maintained a state of general equilibrium. And, importantly, changes occurred in people's behavior and mentality; ordinary people came to realize that the quality of life depends on one's own efforts.

At the same time, certain political leaders began to believe that the changes taking place were not comprehensive, that the transformation was not yet irreversible, that the key to successful economic reform is the transformation of property rights, that it is necessary to turn to the market economy and private initiative. But this led to the necessity of moving towards political pluralism and democracy. The Hungarian people realized that the major obstacle to overcoming their economic difficulties was their conservative political system. Kadarism – as a policy of preserving the social peace at the price of gradual economic transformation – came to an end.

The speed of political transformation – due to the wide gap that existed between the level of liberalization of the economy and the level of democratization of the society – was adequate. At the party conference (May 1988) Kadar was deposed, but the new leadership was separated into reformers (I.Pozsgai) and those who favored a return to the old social model (K.Grosz). This led to a decline of the communists' political influence, and it became clear that the communist regime was faltering. The steps taken by the HSWP in spring 1989 to preserve the social peace led to the establishment of the "Round Table" in the summer, as a result of which

an agreement was signed concerning the future course of political transformation. The general Parliamentary elections which took place in March 1990 celebrated the end of the one-party political system and the defeat of the communist system. At the same time, the communist party had disintegrated. And though the reformers (Socialist party) received the support of 8.5 % of the population and gained similar representation in Parliament, the orthodox wing was severely defeated (Schopflin (1991)).

In accord with the political change taking place, economic reform accelerated. In 1988 a western-type tax system was implemented, the allowed maximum employment in a private enterprise was raised to 500 persons, foreign firms were allowed to wholly own Hungarian enterprises and all enterprises were permitted to engage in foreign trade. Imports were gradually liberalized: 40 % in 1989, 70 % in 1990 and 90 % in 1991. Beginning in 1989, state enterprises were transformed into joint stock companies, which began to be privatized. Market-determined pricing became the general rule. Stock and currency exchanges appeared in Budapest. The convertibility of the Hungarian forint has been achieved in practice. This is literally the case for all enterprises, and the official exchange rate is virtually identical to the market rate. However, some restrictions remain on the purchase of foreign currency by private persons. The structural changes have produced some initial results – Hungarian export to OECD countries grew 25 - 30 % per year; for the first time since 1983, the balance of trade was positive in 1990; the inflow of foreign direct investment to Hungary reached USD 1.2 billion in 1991 (excl. equipment) (Tarafas (1992)).

It is too early to say that the Hungarian transformation has been achieved and that the country has successfully moved to a new system. There are still a lot of problems to be resolved. What does the future hold for multilateral cooperation existed within Comecon and of Hungarian enterprises which were involved in it? An inflation rate remains too high (35 - 40 % in 1990–1991), and until now there is no comprehensive concept on the process of transformation of property rights. When will economic growth get started? Despite these problems, it is clear that Hungary is doing a job of overcoming its difficulties step-by-step in the process of transformation. The victory of democratic forces has stabilized the dynamics of development and has made continued change inevitable.

3.2 Poland

The socio-political crisis in Poland at the end of the 1970s, which was caused by the unprecedented political activity of the workers, and the failure of the government during the previous decade to provide leadership for the transformation of the economic system to a higher level of efficiency led to an abrupt freeze of the democratic process and a declaration of martial law in December 1981. Attempts in the 1970s to implement a policy of economic growth based on the renovation of Poland's industrial capacity and financed by the massive import of capital did not lead to the growth of industry's export capacity but did cause a rapid increase in foreign debt.

The attempt to re-establish general equilibrium by increasing some retail food prices was not successful; the Poles used the old effective instrument of pressure on

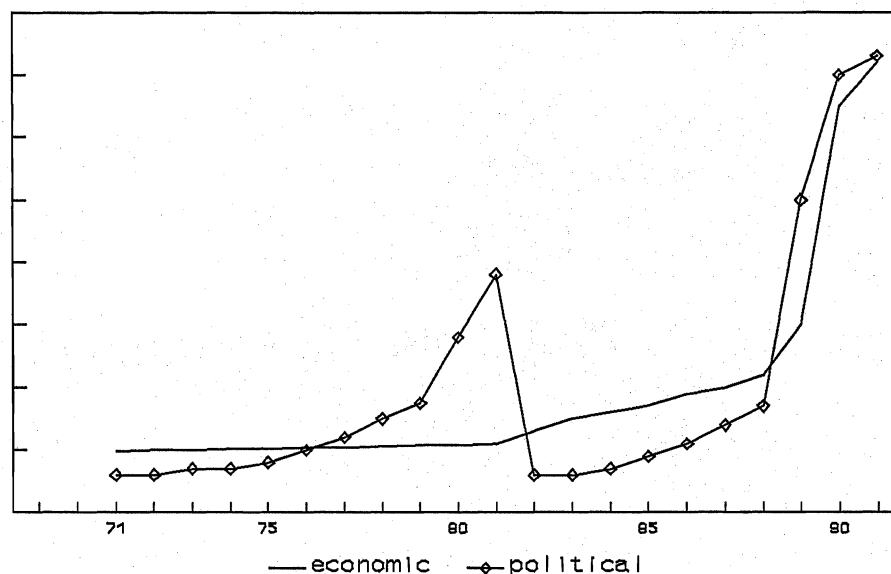
the government – the strike. Under these circumstances, the announcement of coming changes in the economic system by the Polish leaders – later named the "reform of 1982-1983" – had little impact and was delayed in an attempt to equalize the speeds of political and economic change. The absence of economic change at the end of 1970s when vigorous political change was taking place was the main reason for the freezing of the political transformation that occurred in Poland at that time (Gomulka and Rostovski (1984)).

Though martial law was declared, as from January 1, 1982, a package of reform measures was enacted. These measures had been discussed and adopted by the Plenum of the Polish United Workers' Party (PUWP) in July of the previous year. The general trust of transformation was similar to that of Hungary, but not as radical and pervasive.

Enterprises gained some independence and were oriented towards self-financing and self-management, a system of economic norms concerning the distribution of enterprise profits and the regulation of workers' incomes was implemented and some price liberalization took place – free and regulated prices were introduced. But at the same time, a directive planning was maintained, albeit on a reduced scale; and most importantly, the centralized allocation of resources was not abolished. Agricultural procurement prices remained artificially low as did retail food prices. Though the agricultural sector was not subordinated directly to the state, private owners remained dependent on two state monopolies – suppliers of technology and fertilizers, and procurement – and as a result, prices and incomes in the agricultural sector remained under strict state control.

Budget constraints for state enterprises did not firm during this period; the branch structure of industry helped to keep pressure on the government for additional subsidies, resources and allowances. Consequently, the inflation rate in Poland soon reached the double-digit level and greatly exceeded that of Hungary. The efficiency of the Polish economy did not improve, and the minor changes in the management of the economy led to greater overall disequilibrium. Enterprises were not granted freedom in decision making, and they did not become responsible for their operations. Enterprises still had a lot of room to bargain with the administrative authorities, not only – as in Hungary – for better operating conditions, but also in regard to the allocation of resources.

Chart 2. Polish Transformation



In 1987 it became evident that this attempt to improve the old economic system was not effective (Balcerowicz (1989)). But due to the slightly positive speed of even small economic change and virtually zero speed of political change the gap between these two processes didn't grow fast and the general equilibrium of society's transformation was in place. In contrast, the initial steps in the liberalization of the political climate in the second half of the 1980s showed the insufficiency of the economic changes which were taking place. The symptoms of economic crisis became more severe.

In the middle of 1986, Polish leaders began discussing further plans for economic transformation, which began to be realized as a new attempt at reform in autumn 1987. In general, the goals were the same as those of six years before: to increase the independence and initiative of enterprises, to reduce the involvement of the state in economic decision making, to reduce the burden of subsidies for procurement prices and to achieve a macroeconomic equilibrium. The list of measures was similar to that of Hungary: liquidation of industrial sector ministries and creation of a unified ministry of industry (October 1987), transformation of the banking system (1988) and increases in retail food prices (Balcerowicz (1989)).

After the Parliament had discussed the reform plan, the government put to a referendum the question of a more radical economic transformation and acceleration of the process at the cost of a more substantial and rapid decline of the standard of living. The results of the referendum showed that all decisions on economic policy have to be made by politicians themselves; and in any case, they will be responsible for such decisions. The majority of Poles voted for the radicalization of reforms, but the voter turnout was less than 50 % of those who had the right to vote. Hence, it cannot be said that the government received support for its proposal.

Later, changes began to occur at an accelerated pace: governments tried to implement transformation measures, but they were not supported by the population. Attempts to strengthen financial discipline were met with massive opposition on the part of "Solidarity"; later, an official trade union took the same stance. Under the unions' combined pressure, the law on monthly indexation of current incomes was enacted – 100 % adjustment for price increase on food and 80 % for price increase on other consumer goods – which became a built-in generator of inflation. Governments changed, but no visible results came out of their policies.

In the meantime, political transformation was moving fast: understanding the danger of social explosion resulting from political tension and the absence of compromise, Polish communists agreed with the idea of the "Round Table", and as a result, Parliamentary elections were held in June 1989. Of course, the elections were only quasi-democratic. The rules guaranteed a majority to the communist coalition, but the results also brought defeat to the communist party. Further proof of this was seen in the inability to form a new administration for PUWP. "Solidarity" came to power (Zubek (1991)). Poland entered a new stage of socio-political transformation.

In accord with this "political challenge", economic transformation accelerated at the same time. On January 1, 1989 the state monopoly on retail trade was abolished, and in April, fixed procurement prices were replaced by state guarantees of minimal prices. And the most dramatic changes took place on August 1 when virtually all retail prices were deregulated and the remaining subsidies – on 2 % milk, low-fat cottage cheese, infants' formula, and plain bread – were frozen in nominal terms (Cochrane (1990)). It should be emphasized that all this was done by the last communist government of M.Rakovski, and his projected future steps were very similar to the "shock therapy" program of L.Balcerowicz (Rakovski (1989)).

But even these radical economic measures did not produce positive results in the short run. In the weeks following the liberalization of prices, neither retail nor wholesale prices reached market clearing levels. Despite a six-fold increase in prices of the most important food products, shortages became even more severe. The rise in retail prices did not lead automatically to an increase in producers' prices, with the result that farmers began to withhold their output. Steps towards the de-monopolization of retail trade did not attract many new individual entrepreneurs in the first months. Enterprises were obliged to index their workers' wages and salaries in accordance with the law, and these increases led to further price increases.

It was not until October 1989 that prices really began to limit total demand. Shortages were felt to some extent, while more rapid increase in procurement prices led to increasing food supplies in the markets. But inflation was still very high (35 - 40 % per month), and the pace of improvement was not fast enough to achieve an overall equilibrium of the economy (Cohrane (1990)). But the massive popular support of the government made it possible to implement a reform plan, which was referred to as "shock therapy".

This plan included the elimination of the budget deficit as a result of a strengthening of the tax system, a decline in expenditures, the abolishment of wage indexation and the implementation of tax regulations concerning growth of wage funds of state enterprises. There was a distinct tightening of monetary policy, and positive interest rates for new and existing loans were put in effect. Internal convertibility and a big devaluation of the national currency (the new official

exchange rate was 46 % lower than the "black market" rate) were also effected. Retail trade was rapidly de-monopolized and privatized. This took a year and a half to carry out.

At the same time, prices of basic energy resources – which remained under state control – were increased four-fold, which led to a 78.6 % rate of inflation during January 1990. But in March the rate was only 5.5 % and in August 1.8 %. The economy achieved overall equilibrium, shortage was overcome, and economic and social situation in Poland was generally stabilized.

Of course, Poland did not reach the "happy ending": the inflation rate was 65 % in 1991 and the government's target for 1992 is 40 %. Unemployment reached 11.4 %, the positive trade balance⁶ of 1990 was replaced by a negative balance in 1991, another devaluation of the zloty did not help to revive exports or reduce imports and the budget deficit reappeared⁷. The state owned enterprises have not changed their behavior; they still expect state subsidies – the support given to some of them in summer 1991 provoked similar demands from others. The privatization of large state enterprises is plagued with problems (Slay (1992)).

New difficulties appeared on the political scene. After Parliamentary elections in October 1991, a new coalition of five parties came to power – four of which criticized current economic policy in their party platforms – and the new government has announced a change of priorities in economic policy. In my opinion, the decision to hold new elections – though it resulted in the demise of the communist party – has proven to be an obstacle in today's political transformation. While the policy of the previous Parliament was based on the ideology of "Solidarity", today twenty nine parties are represented⁸. A coalition of five of them was necessary for the formation of the government, and this has led to basic instability and the lack of clear guidelines in both political and economic transformation. Furthermore, this degree of political pluralism may destroy the consensus of the Polish people which is needed for the reform.

Poland must now resolve all these problems in the context of a balanced transformation process.

⁶ The surplus in trade with OECD countries was USD 600 million, and Poland received USD 3.2 billion as a result of liquidation of the balancing mechanisms in Comecon multilateral trade and the conversion of ruble indebtedness into hard currency at a revised exchange rate.

⁷ Being an essential stabilization nominal anchor, on the other side the devaluated exchange rate became the best protection for domestic industry.

⁸ No one party has received more than 15 % of the votes.

3.3 China

The transformation of China's economic system caused a lot of worldwide interest in the mid 1980s because the degree of success that had been achieved by that time was enormous, while conditions in Eastern Europe were still quite rigid. The events of June 1989 put an end to change in the Chinese economy and to the hope for the political transformation of the country, as well as to the interest of specialists in Chinese reform. But China's experience is important because of the dimensions of the country and the speed of change and because recent events have indicated the possibility of a rebirth of Chinese reform. This is why it seems to me interesting to review this case, which also supports the basic ideas of this paper.

Radical steps in the transformation of China's old and ineffective economic system began in 1978, when hunger had become a serious problem. Reforms were implemented in agriculture: a wave of de-collectivization took place; the family farm became the basic unit of agricultural production, obtaining rights regarding the industrial use of land, the allocation of output, and to some extent regarding assets. Procurement prices were increased to the extent that they provided a real incentive to producers. Price liberalization began in the early 1980s – by 1984 the number of agricultural products for which prices were fixed by the state had been reduced from 29 to 10, and in 1987 about 65 % of agricultural products were sold at unregulated prices. Privatization was proceeding very rapidly in the rural areas: animals were privatized in the first three years, by 1987 70 % of large and medium tractors and more than 94 % of small tractors as well as 61 % of irrigation and drainage systems were in private hands. The practice of establishing small private or collective industrial (mostly non-agricultural) firms in rural area became widespread.

The effect of these measures was enormous. The annual rate of growth of agricultural output in the reform decade was 6.5 % (in comparison with 2.6 % in the previous 26 years), the share of harvest sold increased from 46 % to 60 - 65 %, the volume of industrial (non-agricultural) output in rural areas increased 6.5-fold (Prybyla (1989)). This not only made it possible to feed the population and largely abolish food rationing, but it also brought increased pressure on the society and its leaders to pursue market-oriented reform in urban areas.

At this time, Chinese leaders did not support radical social change based on a revamping of the economic system. The slogan was 'movement to socialism with Chinese specifics'. There would be a transition from directive to indicative planning, and to some extent market instruments would be employed. Some changes would also take place vis-a-vis property relations.

The list of practical measures is well-known: partial price liberalization, less planning directives issued to enterprises – in 1987 they covered only 20 % of industrial output- and less centralized resource allocation – the number of goods allocated by the central authorities was reduced from 120 to 60, although 60 % of industrial output was still centrally allocated.

The nature of the Chinese price system should be mentioned as a milestone of China's reform. In its transformation of the state sector China used the so-called "double-sector" model in its most perfect form: all enterprises received plan directives on the supply of production to state bodies, and prices of these products were fixed by the state. The rest of the output production was sold independently by enterprises at unregulated prices. The share of centralized distribution in 1989

was 60 % while other goods were distributed through commercial channels. The result of this system - according to most specialists - was an exacerbation of general disequilibrium and more price distortions in the economy. Further, it had a negative effect on the behavior of enterprises: the small increase in the share of unregulated pricing of output brought much greater improvements in financial results than did the improvement of the industrial process. It is evident that the extent and importance of bargaining with state authorities increased significantly.

Another specific feature of Chinese reform, which was much more effective, was the establishment of "free economic zones" (FEZs) in coastal areas. These "enclaves of the future" were to become - according to the plans - the absorbers of foreign technology and investments and the intermediaries between China and the developed countries. Five such zones were created; 14 towns were declared free towns. Not all of them achieved good results, but in general this policy produced significant positive effects.

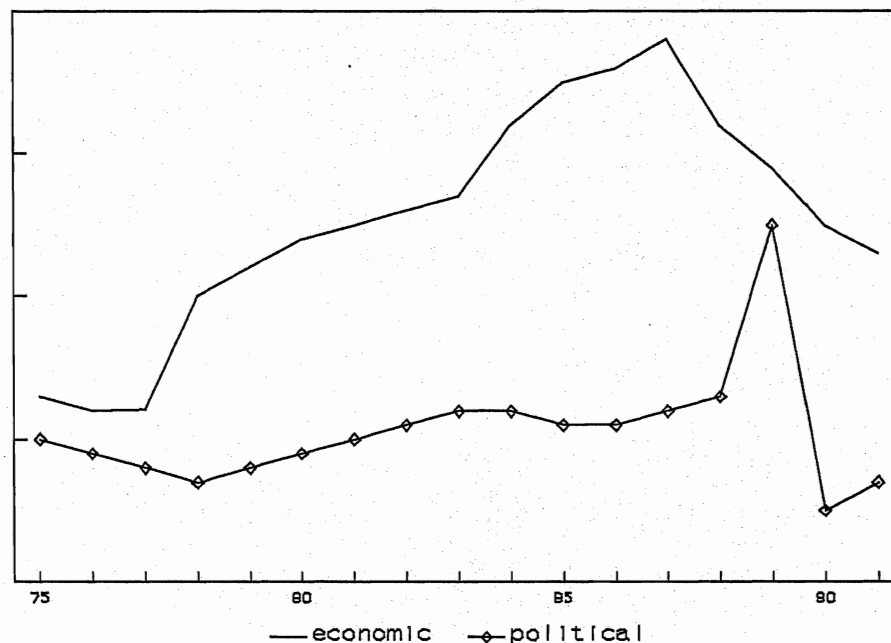
The overall result of the five-year transformation of Chinese industry was very positive. Economic growth exceeded 11 % per year. Although industrial output in the state sector doubled in the period 1978-1987, the share of the state sector in total industrial output declined from 80 % to 65 %. The ratio of heavy to light industries was 57:43 in 1978, but in 1987 it was 50:50. The volume of foreign trade tripled and the share of manufactured goods in Chinese exports reached 83 %. The inflow of foreign investment into China exceeded USD 30 billion including FEZs.

The industrial boom was so vigorous that by 1988 the economy was seriously overheated. The demand for investment increased sharply (instead of the expected decline of 14 % it grew by 17 %), and inflation accelerated. The official rise in the CPI was 21 % in 1988, having been 7.3 % in 1987 (other estimates indicated that prices rose by 35 - 40 %). At the same time, a slowing of growth in the agriculture and private sector became evident (Prybyla (1989)). By that time, the private initiative that had sprung out of the initial steps towards a market economy appeared to have lost its steam. Moreover, it became clear that the partial abolishment of command economy instruments was not compensated for by an adequate increase in the regulatory influence of market forces.

In my opinion, at the end of 1987 the real process of economic transformation in China reached the stage where further change is possible only in concert with systematic changes in society. China was at the crossroads of reform, and the decision as to the future economic system could no longer be postponed. This decision was not made in favor of a change of the system, but rather in favor of refortifying the old one.

The Chinese leaders, disturbed by economic difficulties, opted for the necessity of an "improvement of the economic environment and a strengthening of the economic order". In fact, a backslide to the old system of administrative management began. Central agencies were given more control over economic decision making. The degree of management centralization increased: small and medium-sized enterprises were subordinated to large enterprises, which in turn were put under central authority. Even the free economic zones came under central planning. The secretaries of regional party committees became fully responsible for the implementation of economic policy throughout the country. Price deregulation was delayed by at least five years, and the most important procurement prices were once again fixed by the state.

Chart 3. Chinese Transformation



The rationing of grain, pork, fertilizers, raw materials and traditional Chinese medicines was re-established. The reform of property rights in urban areas was proclaimed as a target for the next century. The main slogan of that time was 'a halfway reform is better than no reform'.

There were several reasons for this turn of events. We might mention specifically the Chinese mentality, the opposition of the party bureaucracy, the unwillingness of managers of large enterprises to become completely independent and responsible and the ineffective means of transforming the banking sector. But in my opinion, the most important factor was the total absence of change in the sociopolitical life of the society. The communist party still had a complete political monopoly, and the democratic movement was disintegrated. Changes in economic life did, however, bring enthusiasm for radical changes in policy and ideology. The people, having obtained economic independence from the state, demanded intellectual freedom.

We may generally say that the Chinese leaders tried to preserve the old political system. Nonetheless, during the 1980s Deng Xiaoping several times spoke out for political transformation, seeing it's major goal as the fortification of the party leadership. After his proclamation that political reform could be a part of general reform, a broad public discussion took place in China in 1986-1987. According to the tenor of this discussion, one can conclude that the majority of Chinese leaders supported the idea that "democracy is an instrument of mass mobilization", and that it serves to increase the dependence of individuals on the state rather than to limit the power of the state in favor of human rights (Nathan (1989)).

Presenting the reform plan at the 13th party congress (October 1987) Zhao Ziyang stated that in the current stage of development the society needed a tightening of control over information and some limits to pluralistic opinions. In addition, he pointed out that China was looking for an intellectual autocratic leader, who would support both the present order and human rights. All the suggestions that came out of the discussion of 1986-1987 fell within the scope of an improvement of the socialist model, including a greater role for the people's congress, separation of the party from the government structures and improvement in the quality of political decisions. Moreover, the Chinese democratic movement did not actually call for the abandonment of socialism⁹.

But in general, the movement of Chinese society towards democracy was delayed by the forces of the old system. The only important social force was the students' movement, whose demonstrations in 1985 and 1986-1987 attracted the sympathies of the entire urban population. The conflict between rapid and successful economic transformation and the freezing of the political system reached its climax in the bloody events of June 1989, when demonstrations by Chinese students for democratic change were repressed by army troops. The effect of this was the further strengthening of central control in the economy. The gap between the levels of development in the economy and in social life was overcome by a general freeze of the transformation.

3.4 The Soviet Union

After the failure of the attempt at transformation in 1965- 1967, the Soviet economic system was developing into a virtually steady state up until the mid 1980s, when there was a change of the top political leadership. The tenuous attempt at reform at the end of 1970s had failed before it was implemented. In the meantime, a worsening of economic conditions became more evident, and the receipts from oil exports, which had supported financial stability for a decade, fell sharply. In this situation, the new leaders tried to improve the economic mechanism. By that time, the experience of Hungary was looked on with great favor. Hungary's successes were visible, and hence it was decided that Soviet reform should follow the Hungarian example. But as always, the copy fell short of original.

Firstly, change were less radical in the USSR: changes at first took place only in certain sectors of the economy; when the new rules were extended to cover the whole economy, a large part of the new elements were lost; the five-year plan continued to have top priority among the political and economic leaders; enterprises continued to receive directives from ministries, having no freedom in the distribution of profits; and the centralized allocation of resources continued up until 1991. Secondly, having abstained from administrative methods of maintaining macroeconomic stability, the Soviet leaders were for a long time unprepared to implement price reform, which would have meant regulated increase of prices and partial price liberalization. The demand for budget subsidies in order to maintain low prices was intense; about 20 % of total budget expenditures (1990-1991) were

⁹ It is necessary to point out that the Chinese concept of socialism was by that time so broad that it encompassed all the current ideas regarding transformation.

spent on this item. When, at last, price reform was implemented (1991), the extent of disequilibrium was so great, that price increases exacerbated the situation. The decentralization of investments led to a substantial decline in their efficiency¹⁰, while the abolishment of administrative control over wages and salaries in enterprises led to a rapid growth of repressed inflation and to shortages of all consumer goods. The gradual transformation of foreign trade led not to stronger orientation of Soviet industry towards exporting, but to the growth of foreign indebtedness and, in fact, to the bankruptcy of the country.

Thirdly, Soviet leaders did not implement agrarian reform - the top priority for any country. Transformation of the rural sector is usually the engine of further reform. In the Soviet Union, the delay in this area resulted in an exacerbation of the food problem.

We may continue the list of reasons for the failure of the Soviet step-by-step approach to economic transformation, but it is evident this approach, which was taken in the second half of 1980s, was not successful, and had a negative effect on economic stability in the USSR.

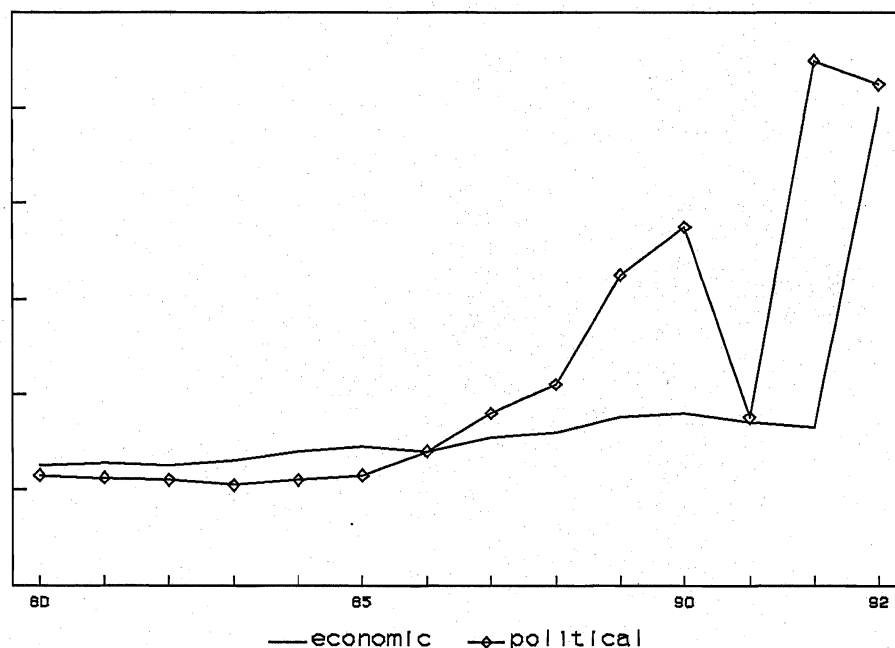
In my opinion, one of the most important reasons for this failure was the speed of political change that took place in the USSR. Perestroika produced rapid visible results in the sphere of public consciousness. There was a thawing of international relations and an opening of the country to people-to-people contacts. Glasnost was spreading permanently, there was critical public analysis of the results of 70 years of socialism, a decision on the abolishment of the party power mechanism was made by the party conference (1988) before the eyes of the whole society, general democratic elections to the Supreme Soviet (Parliament) of the USSR were held in 1989 and republican Parliaments were elected in 1990. Direct TV-transmissions of the Parliamentary sessions, renouncement of the article in the Constitution on the role of the communist party and real political pluralism were other important factors. This is a brief summary of the political transformation of the USSR during five years of perestroika. Evidently, such rapid progress under the rule of the communist party was unprecedented worldwide; and because of the role of the Soviet Union in Eastern Europe, it was decisively important to transformation in every country of this region. I want to emphasize that all those changes took place under the initiative of Soviet leaders, though perhaps not in conformity with their desires. They became hostages of the results of their first steps and their willingness to move toward a democratic society.

The gap in the speed of political and economic change was growing. The economic leadership of the country delayed the implementation of new instruments, and the general misalignment of economic policy and political change became more and more evident. The last attempt to postpone the economic transformation was N.Ryzhkov's plan (December 1989), which aimed to re-establish, at least for two years, the old system of economic management. But the attempt to implement this plan was not supported by the freezing of political transformation, and in two

¹⁰ Due to the soft budget constraint state-owned enterprises began to invest in their own production lines or social sphere, believing that it would be easier to find money in future for the finishing of construction (as it had been in the past). But growing financial troubles forced the state to reduce centralized investment, while enterprises' profits were often insufficient. Moreover, enterprises were obliged to invest in their own because of the absence (until now) of an institutional framework for capital movement.

months it had failed. After this failure, a market economy became the official goal for the government.

Chart 4. Soviet Transformation



In 1990 the Parliament of the USSR adopted several basic laws which were needed for the transition to a market economy. They concerned property, taxation, the banking system and enterprises. The privatization plan was being prepared. The attempt to accelerate economic transformation ("500 days" plan) was not supported by the government, Parliament, or the republics. A course of slow change, with active administrative maintenance of macroeconomic stability, was chosen. The government of Pavlov, which was faced with this problem, was extremely unpopular and had no any political support in the country. It could not resist the growing pressure of workers demanding wage increases and enterprises demanding licenses for export or tax allowances. In fact, by the end of spring 1991, the central government was unable to make decisions and had completely lost its influence.

Of course, by that time, the key issue, which was determining events in the USSR, was the question of national and state organization.¹¹ The maintenance of unified nation as a federation was impossible. The gap in the positions of the different republics did not allow for multilateral compromise, which was not even desired by many of the republics. People in the central government argued in favor of preserving the integrity of the nation as a federation; some republics supported that idea; some wanted complete independence; others took a middle-of-the-road

¹¹ The same question became a milestone in the course of economic reform in Yugoslavia, which was successfully implemented by the government of A. Marcovic. The same problem may aggravate the Czechoslovakian reform in the future.

position favoring confederation. The republics were moving towards independence; the conflict between the central power and the republics became more dangerous after the leaders of the largest republic - Russia - refused to support the central authorities' plea to preserve the integrity of the nation. The main instrument, and at the same time the main victim of the struggle for power, was the economy, which was systematically destroyed by politicians seeking short-term political gains. There was a tax and banking war, a struggle for the control of enterprises and a confrontation between legislative bodies at different levels. As a result, the entire structure of administrative power was destroyed, the financial and banking system collapsed and an economic crisis broke out.

The coup of August (1991), being an attempt to freeze instantly the process of political and state reform in the USSR, was a logical outcome of the immense gap between the speeds of transformation in different domains of the society. It was inevitable, and it did not come as a surprise. The failure of this event to re-establish equilibrium in the transformation led to the acceleration of change. The Soviet Union has entirely disintegrated as a single nation. The heritage it has left to the republics is bitter: a destroyed monetary system, interconnected and interdependent economies, a lot of unresolved problems and a huge external debt. Now the republics have to decide themselves how to transform their economies, and it is quite possible that not all of them will opt for a western-type market economy. The communist party has disappeared, but many former communist leaders are still national leaders.

In the incredible situation of a possible overnight disintegration of the economies of the former Soviet republics, the dominant role of Russia in the implementation of economic policy became obvious. Taking power over the monetary, financial, currency and information centers of the USSR, the Russian leaders asserted their influence on the economic policy of the other republics. But it is evident that this is a short-term phenomenon. At the beginning of 1992, the Russian government had no clear alternatives in the implementation of radical economic transformation: the political changes at the end of 1991 were taking place overnight, while the old administrative instruments for maintaining macroeconomic stability were being completely destroyed; the gap was growing. At that time, the people would not support the implementation of the old policy (administrative price increase and total control over incomes); they were ready to endure the fall in living standards as a result of new policy implemented by new leaders who were not responsible for the bitter heritage. The attempt to partially repeat the Polish shock therapy by using only market and monetary instruments is the essential challenge in trying to overcome the existing gap and to stabilize the social transformation.

In my opinion, by January 1992 the pressure of political change in former USSR burned out with the disintegration of the state. This fact is favorable for the success of radical economic reform because the pace of political transformation has slowed. In this situation, even if the success of economic reform is not complete and macroeconomic stabilization is delayed by a few months, this reform will help to close the gap between the speeds and levels of political and economic transformation in Russia, and eventually there will be equilibrium, which will form a solid backdrop for the future change of the society. On the other hand, it is also evident that the failure of this reform as a result of its non-comprehensive character, failure

to implement it or as a result of a return to the old instruments, will exacerbate the disequilibrium of society and may even provoke a political freeze.

The focal point of further analysis is the non-coincidence of space of actual economic and political change on the territory of the former USSR. Following the political disintegration, future political transformation will take place on the republican level, while - at least if there is a single monetary system - the economic policy of the Russian government will involve all the other republics and force them to pursue radical reform even if political processes in several republics may move in the opposite direction. This contradiction may be resolved by the introduction of national currencies in every republic. But this is impossible in the short term, and hence this contradiction may be a serious obstacle to future transformation on the territory of the USSR.

4 Some General Perspectives

It is clear that the experience of each country in the transformation of its social system is unique. We may not say which transition model is better or which is more successful - each country realizes its own transformation scenario, which depends on certain historical, political and social factors. It is naive to believe that an exact copy of a particular country's model will produce the same results in another country. More likely, the results will be quite different. If the specifics of the country are taken into account and if more of its own ideas are implemented, then positive results are more likely. Nevertheless, the experiences of these countries lead to some general ideas on the logic of transition, which I would like to point out in conclusion.

First, the socialist model is a complete model of the social system with its own logical construction. History has shown that this model of the organization of society is neither progressive nor effective in the long term. It cannot be seriously argued that the idea of this model was perfect but that its realization was faulty. While the socialist model was structured differently in different countries, the results were generally similar.

Second, as a result of the completeness of the socialist system, its partial transformation may not improve its quality; rather instead, partial changes lead to disequilibrium in society. The transformation has to be comprehensive in order to produce positive results.

Third, the transition from one social model to another would be more stable if the speeds of change in different spheres of society are approximately equal. The serious delay or rapid acceleration of reform in one sphere provokes the radicalization of society's transformation in general, but the resultant changes may as likely be in one direction as in the opposite one. Of course, one cannot seriously believe that such a complicated process will proceed according to the prescriptions of any written plan, in which every step can be forecasted and synchronized. It is the problem of reformers to follow the process of transition, and to adequately evaluate possible options.

Fourth, the acceleration of reforms in one sphere needs a transformation in others. But if the attempts of politicians to follow this process are delayed or not implemented at all, reform may be defeated.

Fifth, and last but not least, the transformation of a socialist society is a long process - as compared with a human life - because the time of transition is highly correlated with changes in the people's mentality and behavior, and the latter is associated with the change of generations. And because of this, persistence and permanency in transformation policy are needed for its success. There may be short-term gains and losses on the way, but from a historical viewpoint this transition is apparently positive.

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