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On the Transition from a Supply to a Demand-Constrained Economic Sytem: The East European Experience

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Abstract

The transition from a supply - to a demand-constrained economy implies a fall in demand below potential supply. However, the process of transition in Eastern Europe and the former Soviet Union has led to a steep drop in both aggregate supply and demand, causing dramatic falls in output not experienced since the Great Depression. The thrust of the argument of this paper is that the bulk of the observed output declines could have been avoided. Such declines were the product of misguided macroeconomic stabilisation policies that were ill-suited for the economic conditions and institutions of economies in transition. Paradoxically, the paper contends that effective demand should have been allocated a role, at least, equal to that of supply. This is because once central planning is discarded much of the excessive demand and shortages would disappear, and hence there would be no need for further contractionary policies.

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On the Transition from a Supply to a Demand-Constrained Economic System: The East European Experience

I

The transition from a centrally-planned economy (CPE), which is typically constrained by supply, to a market economy, whose output is normally restricted by demand, implies a drop in demand below potential supply. However, the process of transition in Eastern Europe and the former Soviet Union has resulted not only in such a drop but also in a contraction of both actual and potential supply. We have now the worst of both systems: output is severely curtailed by both supply and demand. The dramatic falls in output, which have exceeded expectations, are worse than those experienced during the Great Depression of 1929-1933 (see Table I below).

This paper argues that a great deal of the output decline and the accompanying economic and non-economic costs could have been avoided without necessarily jeopardising the process of transition. Indeed, in the Asian economies in transition (China, Vietnam, Laos) the move to a market-oriented economy has led to an increase, not a fall in output (Cook and Nixon, 1995). The thrust of the argument of this paper is that the bulk of the output decline in Eastern Europe is the product of misguided macroeconomic stabilisation policies that have been originally designed for other countries with different initial conditions and entirely different institutions. Such policies do not fully take into account the unique circumstances of the former CPEs and the initial period of transition, when market forces do not work as expected. It is further contended that conventional stabilisation policies not only generate unnecessary costs but may turn out to be counter-productive in their long-term objective of creating well-functioning market economies.

More specifically, the paper argues that in the initial stages of transition effective demand should be allocated a role equal to that of supply. This may seem at first sight paradoxical, given the objective of transition is to create a demand-constrained economic system and given also that the former CPEs suffered from chronic shortages. However, it has to be remembered that the root cause of these shortages is 'systemic', the product of central planning and administrative controls. Arguably, once central planning is discarded much of the excessive demand and shortages would evaporate, and hence there would be no need for contractionary policy.

The structure of the paper is as follows: Section II provides an analysis of the initial conditions of the former CPEs on the brink of transformation, and suggests why standard macroeconomic stabilisation policies may not be appropriate. Section III records and explains the output declines, and attempts to ascertain the role of effective demand as a contributory cause. Section IV suggests an alternative set of policies that incorporates effective demand during the transition process. Finally, Section V summarises the key points of the paper and offers some concluding remarks.

II

For the purpose of this paper it is necessary to focus on certain systemic features of the former CPEs that have been either ignored or imperfectly understood by newcomers to Eastern Europe and the former Soviet Union. As Portes (1994, p182) correctly points out, "the specifities of the CPEs were not fully understood nor their implications appreciated even by domestic policy makers". Once these specifities are properly understood, it will become apparent that conventional macrostabilisation policies are at odds with the environment of economies in transition that have abandoned central planning and administrative control and have not yet established well-functioning markets.

First and foremost, the former CPEs were 'inherently' inflationary, although this fact was not reflected in rising prices but in long queues and shortages. However, since planning was conducted primarily in physical terms, the suppressed inflation had no major adverse effects on the rate of investment, the employment level, the balance of payments, or the distribution of income and wealth (Haddad 1977). Of course, shortages of consumer goods reduced work incentives and consequently labour productivity. Such shortages were the result of a deliberate policy to keep the level of consumption as low as possible in order to maximise the rate of investment. In particular, the emphasis on capital goods

and defence (non-marketable products) created disposable income without a corresponding increase of consumer goods. This resulted in chronic shortages of consumer goods and accumulation of a large volume of savings ('the monetary overhang').

Shortages of producer goods and labour were the result of 'systemic' factors, of 'taut planning' and 'planning from the achieved level'. The former kept annual demand ahead of supply, while the latter compelled enterprises to increase their output from year to year. Both planning practices encouraged enterprises to hoard labour and inventories and to conceal their productive capacities, thereby aggravating existing shortages. Additionally, inefficiencies of state-owned enterprises (SOEs), caused by absence of competition and threat of bankruptcy, contributed to chronic shortages. It is sometimes suggested that shortages were due to "soft budget constraints" (Amsden, Kochanowicz, Taylor 1995, p 24), but the concept of the soft budget constraint is more relevant for explaining inflation rather than shortages.

It is thus clear, without the benefit of hindsight, that the abandonment of central planning and control was bound to lead to rising prices, output decline and balance of payments difficulties, which then necessitate the introduction of excessively tight macroeconomic policies (to control the exaggerated price shock due to massive devaluation) and in turn further depress the level of output and employment and reduce real wages even below subsistence. More significantly from the point of view of this paper, the abandonment of central planning would by itself remove the major cause of shortages of producer goods. Also, the fall in real wages resulting from prices rising ahead of money wages would reduce demand for consumer goods. Policy-makers and their Western advisers seem to have overestimated the importance of the 'monetary overhang'; instead they should have anticipated the emergence of the problem of excess capacity and insufficient demand, once the 'monetary overhang' had been eliminated in the wake of liberalisation of prices and imports. Thus excessively tight stabilisation policies are ill suited for economies in transition.

Secondly and related to the first feature, the former CPEs were geared for production and investment, not consumption. Until the late 1970s their growth rates were high by international standards (Summers and Heston 1988) but in the 1980s they recorded low growth rates and were indeed stagnating. The causes of the decline and stagnation were many and varied. Some were policy failures and others systemic. In particular, the adherence for too long to a policy of high investment, especially in capital goods ('the law of the preferential growth of heavy industry'), and low consumption destroyed incentives and reduced labour productivity. More importantly, the decline in economic growth was due to an apparent inability of the planning system to generate the required rate of innovation to offset the law of diminishing returns. Despite the low consumption level, policy-makers continued to accumulate large volumes of savings and invest them in traditional priority sectors yielding smaller and smaller output. Thus output was already falling in much of the region before the collapse of the system and before the transformation process had started. But the fall in output was due to the inefficiency, not the lack, of investment.

Again, the sharp drop in investment should have been anticipated by the reformers and their Western advisers. Specific measures should have been taken to maintain the level of investment moderately high and to divert more investment funds to consumer goods. It should have been obvious that restructuring and systemic changes require a high rate of investment. In particular, state investment is needed to maintain and improve the social and physical infrastructures, to establish a new innovational infrastructure to encourage the emergence of genuine entrepreneurs and to lay the solid foundations for a new and dynamic private sector. Conventional stabilisation policies in the environment of transition do very little to bring about the desired restructuring 'beyond the labour shedding needed to avoid losses' (Blanchard 1994, p 1171).

A third feature of the former CPEs is the general inefficiency of SOEs and the relative absence of small and medium-size firms. Many SOEs failed to cover their costs from the sales of their products and accordingly received subsidies, mainly in the form of bank credits which never got paid back. This is the familiar 'soft budget constraint' so thoroughly analysed by Kornai (1980). It is the result of the fundamental 'socialist' principle that money is 'passive', that real output should not be constrained by financial consideration. Thus the

existence of the soft budget constraint in a climate of chronic shortages meant that SOEs were free from financial and marketing problems, but were still very much constrained by the availability of inputs allocated to them by the supply bureaucracy. However, despite their inefficiency, SOEs were 'highly productive'; they fulfilled and over-fulfilled their production plans and provided welfare services (health, housing, vacations) for their employees.

Standard transition policies seek to improve the efficiency of SOEs by the withdrawal of subsidies and the imposition of tight credit regimes, and by exposing them to foreign competition. Such measures appear at first sight to be appropriate, but to be effective they have to be accompanied by other measures. First, a comprehensive, though not necessarily a generous, welfare system is needed to provide the essential services previously performed by SOEs and to enable them to shed excessive labour. Secondly, withdrawal of subsidies and imposition of the hard budget constraint will force SOEs to raise their prices, given their monopolistic positions and thus reduce further the demand for their products; or they may go bankrupt, in which case, given their huge size this will have a major chain reaction on other enterprises and will depress aggregate output and employment. Thirdly, reliance on foreign competition to bring about the desired efficiency may make things worse for SOEs and bankrupt them. To compete with foreign products they have to restructure their production and improve the quality of their products. This will not be easy given the insatiable demand for foreign goods, with little regard to the price differential. Reducing costs is necessary but not sufficient and restructuring is a time-consuming process. Fourthly, tight credit policy and the implied high interest rate will either discourage investment or encourage the growth of inter-enterprise credit and accumulation of arrears, and thus undermine the stabilisation objective. Finally, until an effective banking system and functioning capital markets are established macroeconomic stability will be hard to achieve (Rostowski 1993).

A fourth feature of the former CPEs is 'over full employment' and the hoarding of labour by SOEs to fulfil and overfulfil their production plans. Contrary to a common fallacy among newcomers, a genuine labour market did exist, though it was far from perfect. The great bulk of the labour force was allocated indirectly through a differential wages structure. Workers were free to move from one occupation to another and labour turnover was quite high. However, because of housing shortages, the movement of labour from rural to urban areas was normally restricted by an internal passport system. The hoarding of labour, absenteeism and inadequate consumer goods reduced labour productivity.

As already suggested the collapse of central planning will remove the pressure for hoarding of labour and will encourage the reverse tendency, the shedding of labour. Further, the reduction of real wages, through the liberalisation of prices, and rising imports of consumer goods will reduce effective demand for domestic products and add to unemployment. However, it has been argued that 'unemployment may be necessary to reduce wages, so that the private sector employment can expand sufficiently' (Chadha, Coricelli and Krajnak 1993, p 774). Clearly, this kind of argument, which is implicit in current stabilisation policies, ignores the fact that the resulting unemployment from the collapse of central planning would be more than adequate. Since real wages are already low a policy that seeks to reduce them further will have adverse effects on participation rate and thus reduce potential supply as well as actual demand. Furthermore, the emergence of a large pool of unemployed people is becoming a serious problem in the former CPEs. As Ellman (1994) notes, long-term unemployment does not increase the flexibility of the economy but reduces potential output and growth and increases the fiscal burden.

A fifth feature of the former CPEs that has been overlooked is the extent of (de)centralisation of decision-making and the existence of the parallel market' or the secondary economy. SOEs were not passive recipient of 'commands' as is implied by the frequent reference to the former CPEs as 'command economies'. Analyses of the role of SOEs in the formulation and implementation of annual plans as well as anecdotal evidence suggest that SOEs often received the orders or commands they themselves had chosen (Lane 1985). Further, all the former CPEs had an official private sector whose size varied from one country to another, and a 'coloured market' in which various activities, both quasi-legal and illegal, were conducted. Policy-makers, particularly in the former Soviet Union, made the fundamental sequencing error of liberalising the economy without first establishing both a regulatory framework, which is found in all developed market

economies, and a civil society which distinguishes between legal and illegal activities. The result has been the disastrous and inimical growth of Mafia groups who are amassing personal fortunes without adding to the national wealth. Current macroeconomic stabilisation policies, which imply high interest rates, do not discourage such groups. On the contrary, they appear to encourage them; high interest rates discourage productive activities and long-term investments and encourage speculative and casino-type activities.

A final feature of the former CPEs that has been much criticised is their foreign trade conduct, particularly within CMEA. The extent of this trade varied from one country to another (from about 25 per cent in the case of Hungary to over 80 per cent in the case of Bulgaria). Trade within CMEA was conducted mainly on a bilateral basis using adjusted world prices. It was a sellers' market. Members did not face the rigours of international competition and thus were not compelled to innovate or improve the quality of their products. However, there was a tendency to sell their better quality products outside CMEA for hard currencies which they then used to finance essential imports, particularly machinery and equipment embodying advanced technology. Indeed, imports from and exports to the West were strictly controlled and treated as a single activity. Thus it paid to dump or sell below marginal cost to finance essential imports and bottle-necks whose value in terms of contribution to GNP exceeded the marginal costs of exports.

Macroeconomic stabilisation policies, which include liberalisation of imports, are bound to lead to a balance of trade deficit, even after a massive devaluation of the local currency. This is because of the initial 'monetary overhang' and the 'hunger' for foreign consumer goods (Yavlinsky and Braguinsky 1994, p 103). Under these circumstances SOEs could, for a while, resort to dumping to survive, as they did in Hungary (Kornai 1994). But since imports are no longer controlled, the foreign exchange earned in this manner would be largely 'wasted' on luxury and semi-luxury consumer goods instead of being used for importing advanced technology needed for restructuring. In Russia, up until mid-1993 leading imports included cars, liquor and cigarettes, but after the introduction of excise duties and VAT these goods gave way to food products, household electronics, furniture, footwear and cloths (Gaidar et al 1993, p 113).

Clearly, conventional macroeconomic stabilisation policies are ill-suited or, at best, inadequate to deal with the peculiar problems of economies in transition, which seemingly combine the worst properties of both planning and market systems. In particular, such policies did not take into account the depressing effects on aggregate demand and output of the collapse of both central planning and CMEA trade. Accordingly, instead of maintaining an adequate level of effective demand which is warranted by the new environment of the former CPEs, standard macrostabilisation policies sought to restrict further the level of demand. Such policies have led to a downward vicious circle in which falling demand generated less supply and in turn falling supply created less demand. Thus the aggregate supply and demand curves pushed and pulled each other inwardly.

III

This section discusses the steep output decline recorded in Table I below. Although there is general agreement that the decline is caused by several factors, there is much debate on the relative importance of the causal factors and on the extent of the actual decline as distinct from the nominal recorded in the official figures. In particular, there is a tendency to underplay the extent of the decline by suggesting that some 10 - 20 per cent is not actual but a mere statistical illusion (Osband 1992; Borensztein, Denikas and Ostry 1993; Aslund 1994; Berg 1994; Koen 1994).

Table 1 : Percentage Change of Output over Previous Year

	1990	1991	1992	1993	1994*
Bulgaria	-9.0	-12.0	-7.1	-4.0	u.a.
Czechoslovakia	-0.4	-13.4	u.a.	u.a.	u.a.
Czech Republic	u.a.	-6.6	-0.3	2.6	u.a.
Hungary	-3.3	-10.0	-5.0	-1.0	2.6
Poland	-11.0	-9.0	2.6	4.0	6.0
Russia	u.a.	u.a.	-19.0	-12.0	-17.0
Slavak Republic	u.a.	u.a.	-7.4	4.0	5.3
USSR	-4.0	-17.0	u.a.	u.a.	u.a.
Ukraine	-14.0	-20.0	u.a.	u.a.	u.a.

Sources: OECD, *Economic Outlook*, Paris, December 1993, July 1994; IMF *World Economic Outlook*, May, 1995.
*Estimates: the IMF estimate of real GDP growth for all countries in transition is -9.4 per cent for 1994.

The collapse of CMEA in January 1991 has been frequently cited as the major cause of the output decline. This is reflected, to some extent, in Table I which shows that all countries except Poland, which applied its 'big bang' strategy before the collapse of CMEA, experienced the greatest fall in output in 1991. Further, Bulgaria which depended on CMEA more than any other country recorded the largest drop over the 1991 - 1993 period. According to Kornai (1994, p55), the breakdown of CMEA, including the former Soviet market, has been the most important cause of the recession. Others suggest the collapse of CMEA is responsible for some 20 - 30 per cent of the total output decline (Borensztein et al 1993; Laski and Levick 1993). In our view, this figure seems consistent with the importance of CMEA trade for their national economies, except of course Bulgaria. In other words, falling exports were not the main cause of contracting demand.

Another common explanation suggested for the output decline is in terms of structural and transitional processes. Liberalisation of foreign trade and prices, it is often argued, leads to changes in relative prices which cause a shift to a new equilibrium characterised by a decrease in demand for the goods in surplus sector and an increase in demand for those in the previous shortage sector. Kornai (1994, p 47) insists that it is not simply that aggregate demand is insufficient: "The demand for some sectors of the economy fell dramatically while the demand for that of other sectors did not fall at all". But the decline in Russia (and elsewhere) occurred in all major industries as reflected in Table II (see also Ebrill et al 1995).

Table 2 : Selected Indicators of Economic Activity in the Russian Federation

(Real percentage change from one year earlier)

	1990	1991	1992	1993	1994*
GDP	-3	-13	-19	-12	-17
Industrial Production	u.a.	-8	-18	-16	-26
Extraction Industries	u.a.	-4	-11	-15	-14
Processing Industries	u.a.	-8	-19	-16	-30
Consumer Goods	7	-1	-15	-11	-28
Military Goods	u.a.	u.a.	-42	-29	u.a.
Agriculture Production	-4	-5	-8	-4	u.a.
Crops	-8	u.a.	-4	-2	u.a.
Livestock	-1	-7	-10	-5	u.a.
Freight	-4	-8	-24	-25	-27

Sources: IMF *Economic Reviews*, 16, Russian Federation, March, 1995. Washington, D. C.

The statistical evidence on the shifting of resources from declining to expanding industries is not very strong. With the opening of their economies to foreign competition one would expect a significant reallocation of resources in line with the comparative costs principle. However, the study by Borensztein et al (1993) indicates no strong tendency for resources to be moving towards those sectors with relatively low domestic resource costs. Further, if structural change is taking place on the scale claimed by Kornai then there should have been a significant increase in investment. But investment has been declining everywhere and net investment in some countries is near zero. In fact, Kornai himself states there has been "quiet disinvestment, depletion of the assets invested earlier" (Kornai, 1994, p54). In the absence of major investments, structural transformation in Eastern Europe has been confined largely to issues of enterprise reform and privatisation.

A further indicator of structural change, or the lack of it, is the changing composition of imports. Given the relatively backward state of industries in the former CPEs, one would expect a significant increase in the imports of machinery and equipment embodying advanced technology needed for restructuring. Instead, these items have declined while imports of consumer goods, especially of the luxury kind have grown since the liberalisation of imports. In Poland the share of machinery and equipment declined from 24.6 per cent in 1991 to 23.9 in 1993 (Ebrill et al 1994). In Russia the import of machinery and equipment in 1993 fell by 48 per cent over the previous year (Gaidar et al 1994, p135).

Clearly, attempts to explain away the depression in the transition economies largely in terms of 'statistical factors', the collapse of CMEA (an 'external factor') and structural change are not very convincing. A more plausible explanation, though by no means the sole one, is to be sought in terms of mismanagement of the transformation process, and, in particular, the application of inappropriate macroeconomic stabilisation policies. There is little doubt that conventional macrostabilisation policies designed to check the high inflation rates resulting from sequencing errors (e.g. premature liberalisation of trade and prices) led to a decline in credit, real wages, investment, output and employment. Calvo and Coricelli (1993) found that monetary contraction in Poland, the former Czechoslovakia and Hungary, had a significant effect, ranging from 5.4 per cent to 15 per cent of the output decline. It is interesting that in Hungary, which experienced the smallest credit contraction and the smallest output decline in 1989 - 90, wages increased by 2 per cent, whereas in Bulgaria, Czechoslovakia, Poland and Romania, they fell below the norms established by governments (Calvo and Coricelli 1993, p49). Similarly, Borensztein et al (1993) and Kornai (1994 p50) suggest that binding credit ceilings imposed on SOEs had significant effects on the contraction of output from both the supply and demand sides. Firms were unable to finance their inputs causing a contraction of supply and accumulation of inter-enterprise credits. In Hungary, the proportion of firms that considered insufficient financing to be an obstacle to growth rose from 20-30 per cent of the respondents in 1987 to 40-45 per cent in 1993 (Kornai 1994 p50).

Finally, we come to a more controversial cause of the output decline, the fall in aggregate demand. There are diverse views on the relative importance of this factor, reflecting both the difficulty of distinguishing in the data between demand and supply shocks and the ideological predilections of analysts. Some writers regard it of secondary importance -- 5 per cent of the total decline (Berg 1994 p 398). Others estimate the proportion of the decline contributed by insufficient effective demand to be over 66 per cent (Laski and Levick 1993). Others still take an intermediate position. Ellman (1994, p8) attributes some of the decline in aggregate output to the lack of export markets and the fall in domestic demand resulting from the fall in real incomes. Kornai (1993 p192) states that the situation in Hungary is "half-Keynesian". However, later he shifted somewhat his emphasis by stating the decline to be more Schumpeterian than Keynesian (Kornai 1994). More significantly, industry studies and surveys of enterprise managers reveal that the great majority of enterprises are suffering from a lack of effective demand. According to Gaidar et al (1994 p178), the overwhelming majority of enterprises in Russia are feeling restrictions of "solvent demand" on the part of both the population and other enterprises. Further, most enterprises in Eastern Europe are operating well below capacity (Amsden, Kochanowicz and Taylor 1995).

Similarly, surveys of industrial enterprises conducted in Bulgaria, Czechoslovakia and Romania in 1991 revealed the perceived relative importance of demand and supply factors in the output decline. In early 1991 about half of the managers viewed supply factors (import shortages, raw materials) as the most important causes underlying the decline, while only about 10 per cent cited demand factors (e.g. lack of orders and loss of markets). However, by mid-year demand factors had become the most important element for about half of the enterprises (Borensztein et al 1993 p9). In Hungary, "only half of the firms consider the insufficiency of demand as the main obstacle to production (Kornai 1993 p192). However, in the revised version of his 1993 paper Kornai (1994 p44) states: "the recession cannot be explained solely in terms of insufficient demand . . . only two-thirds of firms consider the lack of demand an obstacle to production". This is clearly inconsistent with his view that the recession is more Schumpeterian than Keynesian.

This is not to deny that supply factors are no longer a constraint. There are still shortages caused largely by the collapse of traditional trade flows, but it is quite clear that supply factors have moved to the background. Enterprise surveys in Russia indicate that only 10 - 12 per cent of factory managers complained about shortages (Gaidar et al 1994, p109). According to Kornai (1994, p42) "the shortage economy in Hungary has ceased".

Another important indicator of the role of effective demand in the output decline is the sharp decline in fixed investment. We have already referred to tight credit policies and high interest rates, (the product of macrostabilisation policies) but these only explain part of the fall. Uncertainty about the future has

discouraged investors even when credit was readily available (Calvo and Coricelli 1993). It has also caused a massive outflow of capital and 'smuggling of profits' abroad. In Poland, gross capital formation fell by 52.2 per cent during 1989 - 1992 (Ebrill 1994, p91). In Hungary, it fell by 27 per cent over the same period (Kornai 1994, p53), while in Russia business fixed investment fell 30 per cent during 1991-1993 (IMF, 1995a).

Finally, the significant and in some cases the dramatic falls in real wages, as shown in Table III, must have been responsible for some of the decrease in effective demand. Declines in real consumer spending were undoubtedly important contributory factors to the observed output falls, not offset by export demand and rising fiscal deficit. Indeed, real wage reductions were a more important cause of contraction than export declines (Amsden, Kochanowicz and Taylor 1995, p 140).

Table 3. Percentage Change in Real Wages

	1989	1990	1991	1992
Poland	8.3	-24.4	-0.3	-3.6
Hungary	0.7	-3.7	-4.0	-3.9
CSFR	0.1	-5.4	-25.2	-10.1
Bulgaria	3.0	7.3	-43.0	22.5
Romania	2.7	6.0	-16.6	-15.1
Russia	u.a.	-9.0	-10.5	-46.5

Sources: Amsden, Kochanowicz and Taylor 1995, pp 32-33.

In summary, much of the output decline, possibly as high as 50-60 per cent, can be explained in terms of insufficiency of demand for both consumer and producer goods, as well as for exports. The causes of the decline in aggregate demand are very low wages and investment, and the collapse of CMEA. The decline in these components of effective demand were primarily due to the collapse of the planning system, but macroeconomic stabilisation policies designed to control inflation caused further deterioration in aggregate demand and subsequently further output decline. In other words, the transformation process itself is contractionary; hence no explicit contractionary policy and wage cuts are needed on top. It is argued in the next section an alternative strategy that would have anticipated the emergence of the problem of effective demand would have been more successful in preventing an unnecessary fall in output and would have provided a better climate for structural and systemic change.

IV

There is convincing evidence that conventional macroeconomic stabilisation policies which focus on the supply side have undermined stability by causing contraction of both aggregate demand and supply, and in addition created an unfavourable environment for investment and restructuring (Taylor 1994; Portes 1994; Lawrence 1995; Amsden, Kochanowicz and Taylor 1995). It is bad economics, especially at the macro-level, to focus on either the demand or the supply side. Aggregate demand and supply curves are interdependent. Just as supply can create demand so too demand can generate supply. It is quite clear from the discussion in the previous section that what is needed now is a reversal of the downward cumulative effect of aggregate supply and demand.

As we have already argued, the abandonment of central planning will result in the shedding of excess labour by enterprises, and consequently there will be a fall in real wages which are already low. Also, since wage costs are a small proportion of total costs, the fall in real wages would not give strong incentives for enterprises to increase production. If wages fall below the subsistence level, as has happened in some of the former CPEs, particularly in Russia and Ukraine, consumer demand for domestically produced wage goods will fall below potential supply. Moreover, very low wages have adverse effects on productivity and labour supply. Indeed the growth in unemployment and reduction in real wages have led to a massive increase in labour migration from the former CPEs. To the extent that the best and the brightest tend to leave, migration constitutes a "potential vicious circle". It reduces the attractiveness of investment and hence the growth of output and real incomes and consequently further emmigration (Portes 1994).

An alternative policy that seeks to maintain real wages at their previous level, or under certain circumstance increase them, will maintain the demand for wage goods and will prevent the emergence of excess capacity without necessarily endangering price stability. Indeed, the traditional argument of 'the

economy of high wages' may well apply in the circumstances of the former CPEs. After decades of low wages and shortages which had damaged productivity and morale, a policy that tries to improve rather than depress workers' living standard is likely to raise productivity, and thus may turn out to be anti-inflationary.

One of the main reasons why macroeconomic stabilisation policies seek to restrict domestic demand by keeping real wages low is to promote exports. But the domestic and foreign demands for manufactured goods of economies in transition are not perfect substitutes. Devaluation, wage cuts and other forms of regressive income distribution will reduce domestic consumption, and may lead to short-run gains in the form of increasing export revenues; but such gains have to be maintained to offset the quality gap between the manufactures of economies in transition and those of Western economies. This may require regular currency devaluation and wage cuts to sustain improvements in balance of payments. Thus the process of currency depreciation and wage cuts as a means of balancing the current external account may continue until a closing of the technological gap. Moreover, given the extreme uncertainty and unpredictable behaviour of economic agents, in the environment of transition, there is no guarantee that the expected high export revenues and profits resulting from devaluation and falling wages will be repatriated and / or reinvested at home. Indeed, there is ample evidence that export revenues are channelled into private accounts in foreign banks and profits are smuggled abroad and / or used to import luxury consumer goods from the West (Goldberg 1993; Gaidar et al 1994; Yavlinsky and Braguinsky 1994).

The second major component of aggregate demand that should have been the focus of attention of macrostabilisation policies is investment. The sharp fall in investment should have been anticipated by policy-makers as the logical consequence of the collapse of the central planning system with its in-built bias towards a high rate of accumulation. However, it is not necessary to maintain the pre-reform rate of accumulation, if the efficiency of investment can be raised. But without developed capital markets and an effective banking system, investment funds are likely to be wasted rather than used for successful restructuring.

Contrary to conventional opinion, it is necessary to maintain a high rate of investment by the state in the initial stages. State investment if intelligently planned compliments ("crowds in") private investment, both domestic and foreign. Smooth and swift transition requires new infrastructures, (financial, industrial, innovational and social) which only the state can establish. The reduced investment activities of the state throughout the former Soviet Union and Eastern Europe have led to the decline in the quality of the physical infrastructure as well as the social infrastructure. This undermines long-term growth. Thus Kornai (1994, p54) has urged an increase in the investment proportion of government spending in order to overcome the recession. Such infrastructure investment is not only necessary to offset the demand gaps created by investment and real wage reductions, but also to encourage successful restructuring reform.

We have already noted the need to maintain effective demand by households so that private investment in consumer goods and services can be stimulated. Private investment can also be stimulated by reducing the climate of uncertainty. Policy-makers must provide incentives in the form of low taxes on productive investment and high taxes on speculative and casino-type activities. They must also provide credit facilities and low interest rates to new firms to engage in high value-added industries. Such measures may increase the budget deficit and thus undermine the stability objective, but if they encourage the emergence of genuine entrepreneurs willing to invest in productive activities, then the short-term budget deficit will be a small price to pay for creating a dynamic private sector, which is after all the ultimate objective of the transition. It is clear that one of the policy errors has been an overemphasis on macroeconomic relative to microeconomic policies.

The rapid decline in the physical and social infrastructure as well as uncertainties relating to privatisation and other transition problems have discouraged the inflow of foreign capital and the outflow of domestic capital. Indeed, there is a net outflow of capital from the economies in transition. The outflow from Russia alone has been estimated to be somewhere between 20 billion - 50 billion dollars annually (Gaidar et al 1994; Intriligator 1994). By

contrast, foreign direct investment in all transition countries increased from $200 million in 1989 to $6 billion in 1993 and then fell slightly in 1994 (IMF 1995a). Clearly, there is a net outflow of capital from the former CPEs to the West. Russia, it is claimed, could attract $20 - 30 billion annually but has attracted only $2 billion in five years (Gaidar et al 1994, p 143-144).

Ironically, Sachs (1994, p 44) has proposed a medium-term financial programme for Russia, linking international assistance, domestic reform and exchange rate stabilisation. He suggested the international community provides a 'modest' sum of $30 billion annually beginning in 1994 and gradually declining over the next five years. The aim is to restore confidence in the Russian currency and thereby encourage enterprises to hold their money balances in roubles. The external financial assistance will also give the government 'breathing space' to reduce the budget deficit and thus transform the economy from a high-inflation equilibrium to a low-inflation equilibrium. However, as Sachs himself admits: "any programme of international assistance is risky... Obviously some or even all of this money might be wasted; that fear has been an important one in paralysing effective Western action" (ibid). Apart from the fact that such external assistance is unlikely to be forthcoming, Sach's proposal (even if accepted by the international community) will not stop the outflow of Russian capital. This is because much of the capital flight is illegal ('hot money') and belongs to the state. It is indicative of the extent of the criminalisation of the Russian economy and the loss of state control over SOEs (Intriligator 1994). If the state could somehow stop the flight of capital, Russia would not require external assistance on the scale suggested by Sachs. An alternative strategy of stabilisation and transition for the Russian economy would be to restructure and strengthen the state apparatus first. There is little doubt that the transition process requires a strong, if not an authoritarian, state. Indeed, Sachs (1994, p 2) quotes Yeltsin with approval:

> We have learnt from our own experience that we cannot overcome the economic crisis without a strong and efficient state, nor can we secure real market orders, make economic situations predictable or create the preconditions for economic growth.

The third component of effective demand, that of exports, is the most difficult to stimulate and sustain. The low quality of their manufactured goods and low productivity due to inefficiency and low rate of innovation make it extremely difficult for the former CPEs to compete on the world markets. To increase exports there has to be a restructuring of industries and an increase in the rate of innovation. Massive devaluation and wage cuts will do little to sustain a growth of exports. Indeed, if enterprises can continue to increase their exports as a result of market advantage from further devaluation, then they do not have much incentive to restructure (Lawrence 1995, p 85). There is clearly more to restructuring than exchange rate and other price reforms. As Amsden, Kochanowicz and Taylor (1995, p 54) put it: "The best state-owned enterprises have been unable to restructure because the tasks of restructuring could not be accomplished by full exposure to free market forces or by 'pseudo-privatisation' (the transfer of public assets to private owners without an exchange of money and technological expertise)". It is often argued in the transition literature that the observed decline in output is due to a failure of 'supply response' of SOEs, to poor managerial motivations and ill-defined property rights. However, this paper has argued that much of the failure of the 'supply-response' is due to inappropriate macroeconomic stabilisation policies, and insufficient attention to microeconomic reforms.

While it could be argued that a process of restructuring to raise productivity and quality will occur naturally by means of privatisation and the operation of market forces in the goods and currency markets and as a result of macrostabilisation policies (Berg 1994), it is not clear that the private sector will generate the investment necessary for restructuring. Restructuring does not follow logically or automatically from stabilisation and privatisation. Indeed, it has been argued that "the failure of macroeconomic liberalisation and price reform in generating the desired structural reforms, may not have been totally, or even mainly, due to the absence of accompanying privatisation measures" (Yamin and Batstone 1995, p61). It may also have been partly a consequence of misunderstanding of the capacities and behaviour of economic agents during the transition.

Even promising SOEs require a period of subsidisation and protection while they are in the process of restructuring in order to become internationally competitive. Such enterprises require time and much investment as well as advanced technology from the West. Currently, there is very little prospect of this kind of restructuring occurring across industries. Foreign exchange is being dissipated on imports of luxury goods instead of equipment and machinery embodying new technology.

The best way perhaps to promote exports and thus effective demand in the near future is to re-establish some of the traditional trade flows within the former CMEA area. It is now widely accepted that the deliberate and early dissolution of CMEA was one of the major policy errors (Portes 1994). The re-establishment of CMEA trade flows could prove to be a valuable source of exchanging raw materials, intermediate products and machinery as well as agricultural products. Such trade may not be optimal in terms of comparative advantage and may not bring much lasting benefits by way of learning and technological progress, but it will stop output and employment from falling further until economies in transition restructure their industries and adapt more fully to the rigours of market forces. It has to be remembered that with the collapse of central planning, the partial re-establishment of CMEA trade flows does not necessarily imply a return to a sellers' market, in which case export enterprises will have to pay more attention to marketing problems and thus will be forced to improve the quality and efficiency of their production. Also, there may be economies of scale which could easily outweigh traditional comparative cost considerations.

V

Proponents of conventional stabilisation policies admit the fall in output has been too large but assert 'no plausible alternative has been presented to date'. It is further asserted 'a better demand management can be accomplished but this belongs to unrealistic fine tuning' (Aslund 1994). This point of view appears to preclude the possibility of designing macroeconomic policies that give equal attention to both aggregate supply and demand. Further, it is not obvious why the accepted policies are more realistic than those that are concerned with problems of effective demand. Indeed, we have shown in this paper that the application of orthodox macroeconomic stabilisation policies have overshot their targets and generated a deep depression that has not been witnessed since the Great Depression of the 1930s. Orthodox economists expected that decrease in wages, free trade and liberalisation of the economy would create a supply-side stimulus to output. This expectation has not been fulfilled. Arguably, had the policy makers paid more attention to effective demand they might have got it right.

It is readily recognised that the transition from a supply - to a demand-constrained system will naturally lead to some reduction in aggregate demand and some decline in output. But the extent of the decline could not be explained by the phenomenon of 'transformational recession' which has recently become a favoured explanation. The idea of 'transformational recession' implies both a sense of inevitability and desirability. It presents an optimistic view of the current crisis and the scale of human suffering. After describing the 'transformational recession' as Schumpeterian, Kornai (1994, p 47) adopts a moralising posture by asserting that in this type of recession, "a painful process of natural selection takes place but the trauma has a healthy, cleansing effect". A similar attitude is taken by Aslund (1994, pp 31-32) who sees the depression as the result of "desired economic transformation", a shift from a sellers' to a buyers' market and thus "a beneficial change that will raise quality". The fact that there has been a large drop in output is not a cause for alarm, because "the aim of the transition is economic transformation, not instant growth". The evidence presented in this paper does not point to much successful or lasting economic transformation. The expansion of economic activity particularly in Poland over the last three years, which is now widely seen as a success indicator and vindication of standard macroeconomic stabilisation policies, may not be sustained, if it is largely a recovery from a deep depression. Unless and until major structural changes occur, the level of output will not increase beyond the level of the previous peak. Even if in the long-run orthodox stabilisation policies proved successful in transforming the former CPEs into functioning market economies, it is arguable that the transition would have been effected with fewer costs. Judging from the swing back to the former Communists in recent elections

in Russia, Hungary and Poland, the policy errors were quite considerable in terms of both economic and political costs.