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The Transition in Central and Eastern Europe: The Experience of Two Resident Representatives

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This essay reflects the thoughts and experience of two staff members. Mark Allen has been a resident representative in both Poland (1990–93) and Hungary (1996–1998), two countries that have moved well along the road of transformation. Rick Haas was the resident representative in Belarus (1996–98), a country where much remains to be done. In some respects they had similar experiences, in others very dissimilar ones. In what follows they describe the circumstances they found themselves in, the advice they gave, the lessons they learned, and they recount some of their experiences as resident representatives. [JEL A13, E20, E50, E65, F15]

From the earliest days of the IMF, staff members have been assigned to live and work in designated member countries, typically those with an active financial program. In March 1990 a resident representative post was established in Warsaw, Poland, the first in a transforming economy. The breakup of the Soviet Union significantly expanded the resident representative program; ultimately virtually every transforming economy had a resident representative assigned to it.

At most posts (Moscow and Kiev, and for a time, Warsaw, being the exceptions), a single staff member is assigned, typically for two years, assisted by two

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or three local people. Resident representatives are charged with helping senior local officials formulate and implement policy, providing technical assistance at the working level, gathering data and information for the IMF, and, more generally, explaining the work of the IMF to the people of the country to which they have been posted.

Resident representatives in transforming economies have had a unique opportunity to witness and participate in one of the most interesting and challenging events of the economics profession in the past 50 years: the transformation of centrally planned economies into market based systems. The job is intellectually fascinating, frequently extremely rewarding, occasionally frustrating, but never boring.

It is relatively easy to list the long list of actions needed to transform an economy, and when approached in this manner the task does not seem overwhelming, just very difficult. But, when one realizes that what is really being attempted is getting an entire society to change the way it thinks and acts, in a very fundamental way, the task can seem daunting. Yesterday's vices—individual entrepreneurial activity, for example—are today's virtues—something to be rewarded, not punished. When approached from this direction, it is clear that time and patience are required.

I. The Setting We Found Ourselves in

The history of the breakdown of central planning is well known (see Campbell, 1992). Nevertheless, a brief overview is useful to set the stage on which IMF resident representatives found themselves.

The old system was not so much a planned as a large administered economy. Enterprises performed tasks one year because they had performed them the previous year. Coordination between enterprises was largely done through administrative channels. Planners, rather than consumers, were sovereign in the system, and this meant that the political authorities and the associated bureaucracy had complete legitimacy to intervene as they wished to achieve the outcomes they wanted. The price system was loosely based on domestic cost structures and operated more as an accounting mechanism than as a guide to resource allocation. Enterprises paid little attention to profitability as an ultimate objective, but instead concentrated on maintaining or increasing output. The system was characterized by a chronic hunger for imports and foreign exchange.

While, in its early days, the system of central planning delivered rapid growth, stagnation set in throughout the region during the 1970s, which led to a general disillusionment about the ability of central planning to deliver prosperity to the population. From the late 1950s, economists throughout the region had tinkered with the planned economy in an attempt to revive growth, but nothing they did restored the growth rates of the early Communist period. Among the results was that, when communism collapsed, there was little popular or intellectual support for the planned economy per se.

II. Legacy of the Past

One of the most challenging—and important—things a resident representative has to do is to understand the mind-set of the local authorities. If this is not done, the two parties will simply talk past each other. Linguistic differences are a minor—and easily solved—aspect of this problem; the major hurdles come from the legacy of the old regime. Some of the difficulties are generalized and often include a suspicion and mistrust of foreigners. While this is frequently based on incomplete or inaccurate information (something that can be corrected), it often takes time to establish a good working relationship with officials of the host government. Some of the other difficulties are fairly specific.

In the former Soviet Union, the general suspicion and distrust of foreigners complicated attitudes toward the IMF resident representative. In Central Europe, where foreign influence was more welcome, the translation of IMF resident representative as *Fund rezydent* occasionally engendered suspicions that the feared KGB residency had been replaced by an equally sinister IMF office.

It was an article of faith (shared with many other civil services) that the state has the best interests of the population at heart and should be proactive in defending them. At the core of the matter is a deep-seated belief that the state can always improve on market solutions because truly free prices are the reflection of greed and, as such, are suspect *prima facie*. The concept of the "invisible hand" is unknown, difficult to communicate, and even more difficult for many officials to embrace: it was completely contrary to their instincts.

The person who did most to explain the "invisible hand" to both the Poles and other East Europeans may well have been Jeffrey Sachs. He was particularly good at talking to the politicians in Poland and giving them confidence that the market would supply things when the bureaucrats left it alone. He gave them confidence that free prices would give someone somewhere an incentive to find or produce the goods and sell them on the street. He also instilled confidence that ordinary people would have the wherewithal to buy these goods. He just had a knack of explaining the elementary functioning of markets in a simple and convincing way. Some of this is discussed in his book, *Poland's Jump to a Market Economy*.

The principal problem was convincing the authorities that markets were a good way to organize economic activity. This was relatively easy in places where the positive results were very visible, such as Central Europe, and in places where there was a deep dislike of the old system, such as the Baltics, and more difficult where the old system was most entrenched. In Belarus, Turkmenistan, and Uzbekistan, it was often relatively easy to get lip service to market ideas but difficult to get substantive policies implemented.

Where western economists see the orderly function of markets solving economic problems, many local officials see instability, disorder, and even chaos. And it scares them. Often enough they revert instinctively to direct controls. A large premium is placed on stability, not in any equilibrium sense of the word, but in the sense of not changing. Indeed, the desirability of equilibrium in markets is often not fully appreciated by officials who have known nothing but queues and shortages but for whom the need for social—and therefore economic—stability is self-evident.

The importance of stability surfaces quickly when questions of unemployment arise. One of the boasts of the old regime was that every citizen had a guaranteed job, and they did. Maybe not productive, maybe not value adding, but they had a job. ("The state pretends to pay us and we pretend to work" is a phrase heard early and often.) No doubt guided by a strong desire for social and political stability, the first question many officials ask about any new policy is, "Will it increase unemployment?" If the answer is yes, even if only temporarily, the discussion is over. Of course this is not unique to policymakers in transitional economies; officials throughout the world should—and do—ask this question. But the preoccupation with it is unique and detrimental because the essence of transformation requires precisely that many workers in inefficient jobs relocate to new, different jobs. This necessarily implies some, albeit transitory, unemployment.

Old ways of thinking also affect policy through a strong desire for equal income distribution, even if such equality decreases incentives to save and invest. This is not unrelated to the desire for social stability. Simply put, the tendency is to devote a lot of effort into making sure the economic pie is sliced up evenly, even if it means that the pie will be smaller and many will have less to consume in absolute terms.

An intuitive understanding of markets is often lacking. So is a global (that is, a macro) view of the economy. In the old system, the practice was to divide up all economic problems into a large number of small, individual tasks. Almost no one could visualize the entire system, nor did they need to. A common experience of resident representatives is to be presented with a list of problems when, in fact, the list is not a list of problems at all but rather a list of undesirable consequences of a single policy. Interrelationships between the exchange rate, exports, imports, and the price level is a case in point.

The method of compartmentalizing problems and setting individual tasks has had another legacy. It has firmly established the view that, if the desired results are not achieved, it is the result of individual failure. It is rarely seen as a policy failure or a systemic flaw. In this view, people and personalities are important; policies and principles are not, which is almost exactly the inverse of the resident representative's view.

The old system—and the versions of it that still persist—was, in fact, flawed; by its very construction it was inconsistent. The individual tasks were invariably overambitious and, indeed, frequently unachievable, which meant, of course, that the plan could not be met in its entirety. There are two very different—and not necessarily incompatible—views on why this happened. The positive view is that setting high targets guaranteed maximum effort; even if the tasks were not totally fulfilled, more would be done than would have been the case with more modest goals. The negative view is that setting unachievable targets means that the authorities will never lack for a reason why the complete plan failed. "K'to vinovat?" (Who is to blame?) is a phrase learned early in the former Soviet Union.

Another legacy of the old system was the view toward speculators. Speculation was a criminal activity and punished as such. It requires a Damascene conversion for an official to see currency speculators as Mandeville's bees in a social garden of Eden and not just as Mafia thugs. The notion that speculation can be a stabilizing force and should be tolerated, even encouraged, was one of the more difficult concepts to get across.

Frequent reference is made to the "mentality of the people," especially in the Commonwealth of Independent States (CIS) countries where no living memory of a market economy remains. By this it is usually meant that, despite the clear need for reforms, they must go slowly, because people—not the policy makers—lack the understanding to move quickly. Our experience was generally the reverse. Anyone who has ever seen how quickly and well a few people can make a freed-up plot of land produce vegetables, or how quickly something can be constructed in the right conditions, knows that incentives matter. The mentality at fault is usually that of the officials, who are either overly fearful of the unknown or find the rent-seeking opportunities presented by slow or incomplete reforms too tempting.

It was not always clear what the underlying motivation was. Corruption and ignorance are often observationally equivalent: are tax officials and enterprise managers behaving the way they do because they are getting substantial side payments for protecting rent seekers and criminals? Or, do they simply not understand what needs to be done and why? Of these, ignorance is obviously a lot easier to deal with. Both of us mounted elaborate education campaigns on various levels. First, and foremost, with the authorities, both on the technical level and at the policy level. Second, with the population, through the media and by giving lectures and teaching at the local universities. Corruption and rent seeking, more generally, have to be dealt with by focusing on incentives, good governance, transparency, and the legal system.

In brief, there is frequently a reluctance to believe fully that free markets are a better way of organizing economic activity than the old system.

Our Interlocutors' State of Knowledge of Market Economics

In Poland, and even more so in Belarus, there had been little formal training in market economics, since it was not a discipline with particular value in the planned economy. The one exception was probably those trained in the foreign trade schools, who had been taught enough economics to allow them to support the marketing activities of foreign trade corporations. This situation meant that relatively few of those who found themselves dealing with the emerging market economy in 1990 had had training in economics as we know it in the West. And, of those few, only a handful really had confidence that a wide range of market solutions was possible. Poland was fortunate that many of that handful were in positions of responsibility.

Paradoxically, and even tragically, a number of those who had devoted much of their life to studying market economics, and to promulgating it within the communist system, turned out to be the most strongly opposed to the stabilization and reform program of the Polish government and supported by the IMF. These economists, who had risked being dissidents under the Communist system thanks to their espousal of Western economics, found themselves totally overtaken by events when communism collapsed. Their focus had often been on how to deliver the Third Way, a social democratic approach, that would use a combination of market and intervention to achieve the goals of socialism, in terms of a just and prosperous society. Their ability to follow the development of economic thought in the West had been severely limited by the sporadic nature of the contact, and for many, the vaunted ability of Keynesian demand management to deliver growth and full employment represented the last word. The more fundamentalist turn that economics had taken in the 1980s and the lessons of heterodox stabilization programs were not part of their experience. They consequently expressed some of the most articulate, if misguided, opposition to the so-called policy of "shock therapy."

In Hungary, the situation was a little different. At the start of the transition, Hungary had more sophisticated economists than anywhere else in the Soviet bloc. Of course the bureaucracy was full of people who had been trained in the planning tradition, but there was no shortage of economists who understood market economics very well. Here the problem was more that they had spent much of their careers reforming the Hungarian economy. The New Economic Mechanism, incorporating substantial market elements had been introduced in Hungary in 1968, and in the following years economists in Hungary had been involved to a man in trying to make this system work more efficiently within the established constraints. Thus, when the transition occurred, most Hungarian economists were generally convinced that they already had a market economy and that the transition would be quite smooth. It took some years to realize how far the socialist market economy of the late 1980s was from a true modern market economy and the size of the adjustment effort required to put it on a sustained growth path.

III. The Policy Advice We Gave

Standard IMF programs focus on macroeconomic stabilization issues—helping a country get its spending and financing needs to realistic and sustainable levels. The transitional economies were no different in needing to do this, but the magnitude of the tasks was arguably larger than the typical case. But it was also clear from the outset that responsible monetary, fiscal, and exchange rate policies were just a part of the required actions in the case of transforming economies where much of what had to be done involved structural change at the most fundamental level. Macro stabilization was necessary, but not sufficient, to achieve transition. Appropriate policy advice for transitional economies has been dealt with extensively elsewhere; what follows are merely some idiosyncratic observations.[1]

Conventional Stabilization Issues

The breakdown of the old regime meant the almost immediate breakdown of the revenue collection process, but not a concurrent reduction in expenditures, with the state continuing to provide most of the social services it had always provided. This was exacerbated by the state's assumption of the enterprises' social

[1]See Bruno, 1992.

expenditures made necessary to allow enterprises to concentrate on their core responsibilities. This meant that budget deficits exploded. Foreign borrowing went up, as did money and credit, and an increase in arrears of all sorts followed: tax arrears; budget arrears; wage and pension arrears; and inter-enterprise arrears. The government sector was simply too large and underfinanced for a market-based system.

This was often viewed with more concern by IMF staff than by the authorities. The single lesson of modern economic history taught in the old system was Roosevelt's New Deal and how a large state had spent itself into prosperity. If a local counterpart only knew one thing about western economics—and they all seemed to—it was this oversimplified half-truth of Keynesian economics. The old system relied on a monobank that was both a central bank and a commercial bank. But it was never central to economic policy, rather it largely functioned as an after-the-fact bookkeeper. Setting up a true central bank was important. It was equally important that it be an independent central bank. This, in many cases, turned out to be more difficult than might be thought, because it involved a separation of powers, an alien concept in many transitional countries.

A difficult problem encountered early on was to decide how credit should be allocated. Relying on markets totally and completely could not be done. First, credit analysis was an unknown practice. No one was equipped to assess the creditworthiness of the various firms. Information was lacking as well, and where it existed, it could be misleading. Firms that might well be profitable if prices were liberalized might not be when they were not, as was often the case early on. Nor was there any way to evaluate the debts that had sprung up from the absence of a hard budget constraint and how these affected a firm's balance sheet.

Another problem arose when credit auctions were used. Auctions in normal circumstances can be an extremely efficient way of allocating credit—or anything else—but in a system where many of the agents are insolvent, there is a very real adverse selection problem. Bankrupt firms, or firms that are confident they will be bailed out if they lose money, have an incentive to bid very high rates for funds. This will squeeze out commercially viable firms subject to hard budget constraints, and the likelihood is that credit extended to these shaky firms will never be repaid.

There were few monetarists in transitional economies, at least in the beginning. The common view was that the decline in activity was the result of insufficient money and credit. Indeed, the argument was heard that a decrease in the real money supply (as was commonly observed in inflationary times) was the result of monetary policy being too tight. The idea that prices were related to money was often not intuitive. Rather, the price formation process was viewed as a complex process that involved many technical elements and many factors outside the authorities' control, especially external factors. In fact, tight monetary policy was precisely designed to make the traditional cost-plus-markup pricing policy impossible.

This meant that the same situation IMF economists would see as inflationary would often be viewed as too tight a monetary policy setting by the local authorities. They frequently argued that the "monetary coefficient" (that is, the reciprocal of velocity) was too low, and the level of activity required more—not less—money to support it. Convincing them that increases in money led to increases in prices and that inflation would lead people to hold less money was not easy in the more recalcitrant countries. It is easy to see how it is counterintuitive to many to argue that monetary tightness will lead to an increase in the ratio of money to output, and there was always a local variant of the real bills doctrine—namely, credit expansion is not inflationary if it is issued for productive purposes, typically construction or agriculture.

Even when the money-price nexus was acknowledged, there was no reason to believe that a common policy prescription would emerge. Indeed, the Phillips curve was a concept that was easily grasped by many local authorities. For example, they often had little trouble in deciding where they wanted to be on the curve—the point that minimized unemployment. Inflationary considerations were secondary. The idea that price stability was necessary was difficult to convey, and Fischer, Sahay, and Végh (1996) was useful in doing this, especially after it was translated into Russian.

Economics professors have always known that foreign exchange topics are among the most challenging to teach. This is certainly true for resident representatives and their students, local officials. The relationship between money creation and exchange rate movements was often not properly understood. Generally, the response—almost invariably termed "scientific"—was to argue that the exchange rate should be adjusted by precisely the same amount as inflation. This is, of course, a purchasing power parity view. The idea that real exchange rates needed to change in some circumstances was particularly hard to communicate, largely because of a view in which price changes were felt to have little effect.

The IMF has shown a fairly ecumenical approach to exchange rate systems. It has supported programs in which the rate has been rigidly fixed and programs where it has been free to float. There are technical arguments on either side. The inescapable fact is that, if the fiscal and monetary fundamentals are not right, it doesn't make any difference which system is chosen; neither will work. On the other hand, if the fundamentals are in order, either system will work reasonably well.

Often the authorities were loath to let rates float, even when reserves were at alarmingly low levels and there was little choice. Market solutions were rarely trusted, but administrative controls in the form of surrender requirements and capital controls were. One view was that a liberalized exchange rate regime could be established only after the central bank was able to hold sufficient foreign exchange reserves (obtained from the IMF) to stabilize the rate long enough to allow export receipts to materialize that could be used to repay the IMF.

Conspiracy theories of the foreign exchange market were always popular. The argument was that the nominal rate should be stable between the country and its major trading partners. If it wasn't, it was because markets were being corrupted by banks and criminal elements that had a vested interest in destabilizing the rate.

A major concern in many countries was the need to set the exchange rate to accommodate energy policy—in particular, the need to keep energy (in local currency) cheap. This was the result of compartmentalizing problems and not viewing the economy as a whole.

Structural Issues

Stabilization of the economy and liberalization of transactions are at the center of the IMF's policy role throughout the world. The distinguishing feature of work in the transition economies, however, has been the vastness of the structural change that was needed. Work on structural issues occupied a major part of the resident representatives' time.

Some of this work fell clearly into the mainstream of the IMF's activities. Thus much time was devoted to fiscal reform issues, covering the consolidation of accounts, the reform of spending systems, and the establishment of modern tax structures. The struggle was often one of replacing the discretionary systems preferred by the traditional bureaucracy and its clients with transparent, predictable, and nonnegotiable systems. Another area of central IMF concern was the banking system, replacing the monobank with a narrowly defined independent central bank and a number of properly supervised commercial banks. This also proved a difficult area, as the managements of the newly created, or newly separated, commercial banks were faster to exploit their new freedoms than the authorities were to appreciate the need for close supervision, not to mention make such supervision effective. Thus, most transition economies followed the path beaten by so many market economies where the need for good supervision was only really appreciated after clocking up losses of 5–10 percent of GDP in bad loans.

As resident representatives, trying to help countries through the totality of the economic transition process, we were also involved with trying to ensure that the full agenda of structural reform measures was implemented. Central to this was privatization, an area where the IMF's own expertise was limited. Our approach was usually that the faster enterprises could be privatized, the better, and the more privatization brought in foreign capital, the faster the modernization of the economy would occur. There was considerable local opposition to this approach. The first argument was that, since foreigners were flush with money while residents were impoverished, the entire economy would fall into foreign hands. Thus schemes for privatization needed to be devised that would prevent this outcome. The second argument was that the nation's patrimony, created by the huge sacrifices of previous generations, would be sold for a song in its current state. Thus, what was needed was an extensive industrial policy designed to upgrade industry to a level where it could be sold for something closer to its value. As resident representatives, our voices were not very influential in these debates. We were quite hostile to an expanded industrial policy on the grounds that it ran the risk of being a backdoor return to central planning, and we were skeptical that such a policy would not be dominated by special interests. In the event, interventionist industrial policy did not take off, but this probably owed as much to the absence of fiscal resources to finance such a policy as to our advice.

The structural reform agenda extended to other areas, which, while clearly essential, fell outside our expertise. Land privatization and laws on the use and possession of collateral were clearly vital for a properly functioning market economy, but their technical (and political) ramifications fell outside our orbits. Some observations on the housing and mortgage finance markets are given below.

Contract enforcement and predictable dispute settlement systems were recognized as being central to the functioning of a market economy, but not areas where IMF economists had relevant skills.

IV. Emergence of Markets: Successes and Failures

Growth of Markets in Warsaw

One of the most rewarding aspects of the resident representative job in Poland at the start of the transition was to observe markets springing up and evolving. The day to day changes allowed one to observe adjustment in action. As macroeconomists, we are used to seeing the results of our recommendations reflected slowly, if at all, in daily street scenes. What was so satisfying as resident representatives was to see change happening so quickly and positively, and to see it so clearly as a result of the policies that we were helping the government implement. Conversely, the frustration of the job in the slow-reforming countries was to witness, on a daily basis, the immobility of patterns that could easily be changed.

At the end of World War II, on the site of the Warsaw ghetto, destroyed in the fighting of 1943, the Poles (on Soviet instructions) built the Palace of Science and Culture, Warsaw's Stalinist Gothic masterpiece. The building is surrounded by open space, over part of which May Day marches were held. On this ground, a fascinating market sprang up. It started with people selling items purchased in Berlin supermarkets, largely foodstuffs that had been novelties or scarce in previous years. Bananas, a considerable rarity in the past, were sold one by one in this market. The car trunk trade was joined by people selling their surplus assets. Pensioners sold clothes and other odd items either draped over their arms or from a plastic sheet spread on the ground. Then people began to bring tables and chairs to sell from, and the first booths were erected. Other enterprising types set up hot kielbasa and mustard stands or sold bread products. Someone had the idea of importing brightly colored ready-made sales booths and renting them out. This gave the market a growing air of permanence. The next stage reflected the developments in countries further east. Initially, Poles would go east and purchase goods on whose resale they could turn a profit. These included tools and industrial parts, precision drawing equipment, and toys. These catered to the impoverished side of the Polish market that could afford to buy cheap Russian goods that had previously been scarce, but could not afford the relatively more expensive, higher quality western products. The whole market was a visible exercise in the power of arbitrage, as the differences in the relative price structures and relative scarcities prevailing in Germany, Poland, and Russia became equalized.[2]

[2]While this was not visible to the local resident representative, the street markets in Warsaw had their counterparts in the large number of Poles and other Central and East Europeans who appeared on the streets of Berlin, Vienna, and other cities, selling stuff they had brought from home, and using the proceeds to buy up goods to take back home.

Some Poles quickly acquired sufficient capital by this trade to move up the retail market. The government quickly (by mid-1990) ensured that the Warsaw municipality and state enterprises leased out the retail space they owned, and some of these traders, who had started by filling their car trunks in Berlin, were able to come in from the cold and set up their shops. The market then gradually acquired a more eastern flavor, as Russians moved in selling cheap clothing and tools. It became a daily occupation to wander around the market to see who was selling what. Perhaps the most remarkable sight we saw was a group of Mongolians selling brand-new Japanese pumps with the instructions in Mongolian. How the economics of transporting pumps from Ulan Bator to Warsaw worked out was hard to fathom.

Then the authorities started to put up signs in Russian to tell people where to park and where not to spit, and the market became more and more settled. One area was cleared after a year or so, and large hangars erected where better security could be maintained and shoppers would be protected from the elements—such an anarchic untidy market in the center of Warsaw did not agree with many officials' view of what a modern European capital should look like. Regulations on street trading were tightened, and the market outside the Palace of Science and Culture was closed. In its place, a new market, the "Russian market" was opened in a large stadium on the other side of the Vistula river. This allowed better policing of "undesirable elements," without stopping trade, but it lacked some of the vibrancy of the open market in the center of town.

While the street market was being removed from the sight of those to whom it gave aesthetic offence, a remarkable transformation was visible in Warsaw's retail space. Warsaw had a reputation as a gray and drab city. (See O'Rourke, 1988). The courage and heroism of the Warsaw Ghetto uprising in 1943, the Warsaw uprising of 1944, and the vindictive and wanton destruction by the retreating Germans had left over three-fourths of Warsaw in rubble. Huge efforts in the immediate postwar years to house the population had created a city of generally uninspired concrete apartment blocks. Not only was the whole effect profoundly depressing, but also it was hard to imagine how anything could be made of this legacy.

That, however, was a failure of our imagination. When in command of their own destinies and out to make something of themselves, people come up spontaneously with remarkable solutions. Often, people who had accumulated some capital and business connections from the early street trade rented retail space that the local authorities had made available or that state enterprises no longer needed. The dingy and cavernous spaces on the street level were opened up, given a coat of paint, lights were installed everywhere, and the windows filled with promotional material and goods. Advertising sprung up to cover the vast slabs of gray concrete on the sides of buildings. Car dealerships and innumerable groceries, clothing shops, and the like opened up, and the city was transformed. Within three years, the drabness was gone, replaced not, perhaps, with beauty but with excitement and vibrancy, and this was followed by the construction of the first shopping malls.

Poland and Hungary thus joined the group of countries where shopping could become a major leisure pastime. While the change was overwhelmingly favorable, there were some causes for nostalgia. In particular, the number of bookshops, subsidized under the old regime and a source of cultural pride, could no longer exist. One indicator that we waited for with mixed feelings was the closure of the shops open in every socialist capital selling the books and cultural products of other socialist countries. While there had, perhaps, never been much demand for Russian books in Warsaw, it occasioned some regret to see the Soviet Bookstore closed, even though this was inevitable and logical given the prime piece of commercial real estate it occupied in Warsaw. The resident representatives also regretted the transformation of the Economist's Café next door and under the Polish Economic Association offices into a shop selling expensive perfumes.

Housing and Mortgage Market

One missed opportunity was the failure to develop a housing market. Even where, as in Poland and Hungary, the belief that an acceptable equilibrium would develop in most markets if appropriately freed, no one had the confidence to apply this to the market in that basic commodity, housing. The population, particularly the urban population, was largely housed in apartments owned by the state or by enterprises. Since rents were very low, the demand for apartments greatly exceeded the supply, and at the same time, complicated rules governed who was permitted to occupy what sort of an apartment. In these rules, possession played a very important role, and so young families were stuck living with their parents waiting for elderly relatives occupying other apartments to die. While the stock of apartments was privatized and the apartments sold to residents for relatively low prices, the very low level of incomes in the early transition period, the absence of a mortgage market, and the fact that people could continue to rent and buy their apartments only gradually, meant that for most people there was very little change in their perception of the housing situation. People, especially those dependent on incomes from the state or state industry, were unable to buy outright, and if they did, they would not immediately plan to move, so the supply of housing coming on to market was very small. Thus the price for an apartment looked horrifically high to the average apartment dweller, and this in turn made him less likely to think about moving. As a result, there was a highly suboptimal allocation of housing: many relatively large apartments were occupied by old couples who had originally been allocated the space when they had children living with them, while in other relatively small apartments three generations would be stuck together.

To an economist who genuinely believed in the ability of markets to find acceptable equilibria, the solution would have been to get more apartments onto the market. This could have been done by waiving the purchase price and just giving apartments and full title to residents. Then an old couple on a low income occupying a prime location in town might realize they were sitting in a rather valuable asset. Someone earning a reasonable salary, but with wife and children living cheek by jowl with his parents in two or three rooms, might be prepared to pay the older couple to move out. The latter would then have realized some of the capital they were sitting on, could move to more modest accommodation if they wanted, and have a pile of cash left over to be used to augment their income.

The number of apartments in dilapidated buildings was also a problem, since the communal (utility) fees charged for maintenance and services had been kept at very low levels. Given the severity of the adjustment, it was hard to persuade a majority of tenants to spend more on renovation, but a renovation would have increased the value of the property severalfold. Indeed, cases started to appear where strong-arm tactics were used to encourage the older and poorer tenants to move so that the remainder, or someone entrepreneurially minded, could get in and improve the property, with the aim of making a packet on the resale. Here the market failure was a mixture of the failure to give clear property title to residents, the unwillingness or inability of banks to develop a small loans business using the value of the property as collateral, and outright criminal behavior.

Similar problems occurred in the individual housing sector. Many people both urban and rural had dreamed of building their own houses, either in the suburbs or in the country. Under communism, house-building had the nature of a savings account. The country was littered with half-finished homes. The problem then was not that cash was scarce, but that building materials were in short supply. As soon as someone could lay his hands on a pallet of bricks or a load of cement, they would be snapped up and a bit more of the foundation or some of the next story would be built. The construction of houses in this fashion could last for years, and for much of the period the investment was unusable since the half-finished house was completely uninhabitable. This illusion of construction activity often caused first-time visitors from the West to believe they were witnessing a construction boom.

As resident representative, this problem hit home as the stock of suitable houses for an economist and his family, used to living in the suburbs of Washington, DC, was very limited. (While the reward of helping to make history might have been enough to compensate living very poorly for many well-motivated resident representatives, it was not clear that spouses and children would get the same psychic rewards.) The few suitable houses had usually been constructed and completed by someone who had had access, in the old days, to reasonable amounts of foreign exchange, often through working in the West. With the influx of well-heeled foreigners and the expansion of the diplomatic community that followed the transition, the prices of such places were bid up to a level several multiples of the prices of similar accommodation in Washington. It was very frustrating to walk the streets armed with the IMF's administrative guideline on house rental and see so much unfinished construction. If only there had been a mortgage market, the owners of these places could finish them within weeks or months and start to realize a large rental income, sell them, or move in themselves from cramped accommodation elsewhere.

The obstacle to this was not so much the high rates of interest prevailing in the early days of the transition, but the lack of appropriate legislation on collateral. The authorities shied away from allowing eviction in the event of failure to pay a mortgage, which meant that even if the bank could treat the house as collateral, it could not effectively foreclose on the mortgage. The inexperience of the banks and the inability of their advisors to devise schemes for mortgages under conditions of high inflation also played a role.

In all these matters, a misperception of the economic consequences lay at the failure of policy. Legislators had a fear that simple freeing of the housing market and the passage of proper regulations on the control of collateral would result in a general rise in housing prices that would leave a good part of the electorate destitute and unable to afford housing. Arguments that this would not happen—that since the immediate effect would just be to reallocate the existing stock, the free market would lead to a Pareto optimal reallocation of the existing stock—were not believed. Nor was it believed that, fairly soon, the supply of new housing would increase and the cost would fall. What was particularly frustrating in this situation was that the true liberalization of the market would have countered the sense of impoverishment felt by the majority of the population following the liberalization of prices in general. Had the housing market been liberalized quickly, there would have been a countervailing wealth effect from the realization that people possessed a valuable asset in the form of the real estate they were sitting in. It is not only in transition economies, however, that people have difficulty in appreciating the advantages of a free market in housing, judging by the frequent use of rent controls in the West.

While the spread of street markets was the first visible sign of the penetration of market relations, capitalism requires far more than this. The transition from socialism to capitalism requires the accumulation of capital and large-scale production and distribution based on market principles and relations. While this further extension of market relations has been slow to come about in Belarus, and has been fraught with difficulties in several countries of the former Soviet Union, it happened relatively smoothly in Poland and Hungary. It was possible to gauge the development from day to day by observations in the street.

In the first days of the transition, an amusing occupation was to note the different reasons why shops, at which one needed to buy something, were closed at hours when they might have been expected to be open. Under the sellers' market prevailing before the transition, shopkeepers could open and close at their convenience, knowing that customers needed them and would wait. Thus there was no question about opening for anything other than the standard working hours. Maybe a department store would be open in the evening one day a week and most shops were open from 8:00 a.m. to noon on Saturday, but no longer. People were expected to take time off work to do their shopping, but even during these working hours it was normal to find shops closed. The commonest cardboard sign to find in the window was "Break," another was "Vacation," and a third, reliably seen at least once a month, was "Taking Inventory." Another frequent sign (and the bane of those looking for gasoline) was "Taking Deliveries." Then there were the more exotic, such as "No Electricity," or "Pipe Burst." At one point, we collected a list of about ten conditions that one might expect to find a shop in.

As the transition progressed, and in particular as shops started to face competition from street traders in a buyers' market, these signs started to disappear, shops started opening for longer periods, and shopkeepers began to organize themselves in ways to ensure that they did not have to close in prime shopping time. About a year and a half into the transition in Poland, we realized how fundamental the change had been when the tiny corner store near our house was not only open on

Sunday, but was taking deliveries from its suppliers and serving its customers at the same time.

End of the Black Market in Poland

The black market, especially in foreign exchange, was a feature of life under socialism. In any city, travelers would be accosted by people offering to sell them local currency at black market exchange rates, more or less openly, depending on the degree of repression. In Poland, this was particularly the case, since the zloty had long been among the most risible of socialist currencies.

The first move in the transition process in Poland was to eliminate current account restrictions and move the exchange rate to a competitive level where it could be supported. This had been a central element in the first stand-by arrangement negotiated for Poland in late 1989, and in the first months of 1990, there was clear evidence that the policy was working. On every street corner, small foreign exchange dealers (*kantors)* opened up for business, openly and legally buying and selling foreign currency for zlotys at very narrow rates. As a resident in Poland, the resident representative could always take a US$100 bill into any *kantor* and get the zlotys needed for daily activities, and it looked as though Poles could get any amount of dollars too. So why didn't the suspicious looking characters offering an exceptionally favorable rate of exchange disappear?

Economic logic suggested that when the resident representative could openly buy and sell a dollar for Zl 9,500, and so apparently could anyone else, there was no way that someone could offer Zl 15,000 for a dollar and make money on the deal. But, perhaps this was some form of Potemkin village, and there were really exchange restrictions that we were not being told about. Perhaps the freedom to buy and sell at the *kantor* was more circumscribed than we thought. Perhaps the restrictions on capital outflows were preventing Poles engaging in the capital flight that they desperately wanted to do, and somehow this demand was being satisfied through shady men who were prepared to pay a premium to get their hands on our dollars. Unlikely, but as representative of the institution that is supposed to know everything about countries' exchange restrictions, it was the resident representative's job to find out.

So it was decided to use $20 of the resident representative's own money, not knowing how to account for it in the Resident Representative Office accounts, to explore this black market, even if it meant doing something illegal. The next day, as the resident representative walked past a big department store in the center of town, someone approached him and surreptitiously indicated that he would buy dollars at Zl 15,000. I agreed, and he ushered me into a corner of the department store with a great show of making sure that we were unobserved.

Since the exchange of currency was not illegal, as far as was known, the precautions seemed unnecessary. Under the cover of his raincoat, he then counted through a large wad of Zl 1,000 bills which he set aside. Then the $20 bill was exchanged for this wad of zlotys again making sure that no one was watching, and the "black marketeer" disappeared rapidly, as if afraid of being stopped by a newly materialized policeman. The resident representative looked at his wad of zlotys and discovered that only the top one was a Zl 1,000 bill, and the rest were virtually valueless Zl 5 bills. He could thus happily report that he was the victim of a confidence trick, and that the liberalization of Poland's exchange system was as perfect as we had been led to believe.

V. What We Learned as Economists

The first is that incentives are important and markets really do work to solve the allocation problem. This is something we learned intellectually from Samuelson's *Principles of Economics*, but the experience of life in the transition economies gave us daily, living proof it was true. It took considerable courage for the politicians in the more westernized transition economies to make the jump to trusting that spontaneous forms of supply and entrepreneurship would spring up to replace the old systems of administrative coordination. It may be that they had few alternatives, but they did take a huge responsibility when they committed themselves to "leap into a market economy." It is also understandable if other politicians further east did not have the courage to make this leap. In the early phases of the transition, the responsible authorities faced the question, "Precisely how will such or such needed good be delivered to the people who need it if we scrap the old system?" And the answer that, "Somehow, it would be worth someone's while to sell the good to those who needed it," was not always convincing ex ante.[3] To people used to administering a system of production and supply, it was hard to give up the control.

The second lesson was that there usually is an equilibrium solution, no matter how unlikely it may seem at first. While many western economists were extremely optimistic at the start of the transition that a set of relative prices would quickly be found to allow the productive assets of the former socialist countries to be put to work, and that growth would follow very soon, some of us were more pessimistic. For fifty years and more, these countries had been pouring resources into ill-advised investment projects that had resulted in a proliferation of industrial behemoths, using obsolete technology to produce substandard products; in short, junk producing junk. Was there really a set of prices at which any of this could be viable? Or was the entire investment of the socialist period worth merely its scrap value, and would the entire industrial plant of the nation need to be shut down, throwing urban millions out of work?

It turned out, however, that a good part of this unpromising legacy could be used. The transition process imported a set of relative prices from the West. The exchange rate played a crucial role in ensuring that some part of production could remain profitable, as did the low dollar wages at the start of the transition. In addition, crucial breathing space was given by implicit subsidies in the form of the erosion of state-owned capital and the credit from the banking system that ultimately went bad. But central to the process was the economics of desperation and the resulting entrepreneurship.

[3]This gave rise to a new version of the old Polish joke. "In the new Poland, how many Poles does it take to change a light bulb?" "None. The market does it."

It took time, maybe a year or two in Poland, for those entrusted with managing enterprises to realize that they were running out of options. Fiscal subsidies were limited, attempts to establish an industrial policy had been beaten back by the reformers in the Ministry of Finance, and the days when banks would provide credit to cover the service of old debts stopped. The tax authorities were insisting that taxes be paid, and the workers were resisting financing their enterprises themselves through unpaid wages. The budget constraint had become hard.[4] Management had run out of the sort of options that required no effort on their part other than lobbying. These desperate circumstances forced a change in attitude and the resort to entrepreneurial behavior patterns largely unknown before. They started to look for the ways they could economize through small production line changes, inventory management, and small-scale investments. They piled into cars and scoured Germany for outlets for their products. They started to look for customers in Poland itself, and to control their accounts receivable. In this way, the inherited means of production were salvaged and a new and acceptable equilibrium reached.

In this connection, another lesson was that the switch from the sellers' market of socialism to the buyers' market of capitalism entails profound psychological change. All psychological change is very hard to bring about, for people will resist changes in their way of thinking. The experience of Poland and Hungary showed that the psychological change can be made if the government is credible in its hardening of the budget constraint. There will be considerable resistance, however, to the change and very widespread calls for loosening the constraints. If these siren songs are resisted, which can be a challenge for an emerging democracy, the prospects for renewed growth are good. If it is impossible to resist them or if the government is not serious about tightening the constraint, then the recovery is likely to be much slower, as was the case further east.

Another lesson concerned structural reform. From the outset, it was recognized that structural reform was central to the transformation process, but it was initially thought that such reform would largely happen spontaneously once stabilization had been achieved. Subsequently a fairly extensive structural reform agenda was set, but in the former Soviet Union it ran into vested interests that were more deeply entrenched than in Central Europe. Structural issues are important and figure prominently in the process; macroeconomic stabilization by itself is not sufficient to ensure transformation.

A major lesson for economists that have had the experience of living with transition is that attention must be paid to establishing the institutional underpinnings of the market. The task of creating market economies has reminded us that markets are embedded in a set of institutions and behavior patterns that economists have normally taken for granted. A legal system compatible with market behavior is critical. Bankruptcy and collateral laws are needed, as is a dispute resolution mechanism to resolve contractual differences. Economists in general have paid no more attention to the institutional structure in which markets work than fish pay to the water they swim in. But once the first step of the transition was completed—that of

[4]See Kornai, 1980.

scrapping controls, opening markets and liberalizing prices—the problems that immediately surfaced were those of inadequate or nonexisting institutions. In particular, a strong, independent central bank is important. In those countries where the transition was more successful, the inherited institutional structure or people's memory of pre-socialist structures were in better shape than in those countries further east. Thus the tendency for the latter to reach back for controls rather than introducing the needed institutional change is understandable.

We also learned that transformation has noneconomic consequences. In particular, it leads to the collapse of traditional values. The old systems in Central and Eastern Europe and in the Soviet Union were based on political repression and brutality, but nevertheless, certain values were promoted. The resistance of parts of the elite to change reflected their adherence to a set of admirable values that the transition process undermined.

The first of these values was a sense of social justice. No matter how poorly the system actually delivered social justice, it was a broadly accepted goal that society should care for all, and that universal education and health care should be provided. The system did deliver on job protection, and it did provide a minimal level of universal health care and education. Those who thought about these things—and that included many of the officials with whom we came into contact with on a daily basis—hoped for a new system that would deliver these social benefits, at least at the level the old system aspired to do. The undelivered promises for social welfare were among the strongest causes of the loss of legitimacy of the old system. The transition, however—for a variety of reasons, including the need for transparent and disciplined fiscal processes—initially made it more difficult to deliver on these social goals. Indeed, the papers were full of stories of the worsening conditions of pensioners, hospitals unable to finance the care they wished to give, and underfunded schools.

Related to this sense of social justice was a sense that society should reward people according to their merit. The hierarchy of pay scales under socialism, the availability of rewards, and the associated prestige given to different jobs corresponded *grosso modo* to society's conception of the appropriate way of rewarding people. Of course, there were exceptions, in particular the privileges appropriated by the *aparatchiks* and those gained through overt corruption, and these exceptions again fueled the opposition to communism, but otherwise the social order seemed intact.

With the transition, however, the wrong people, in the public's view, seemed to be getting rich. The skills of the black marketeer, associated with criminality in the past, became the way to thrive in the new economy. Operators using sharp practices began to become very rich as they exploited the opportunities for arbitrage. With the new legal framework unclear, these individuals were often none too scrupulous about how they enforced contracts, and, along with some from the *nomenklatura*, smartly appropriated state property. The border between legitimate economic activity and criminal behavior was very unclear at the start of the transition, and remains unclear in some parts of the former Soviet Union. It is not hard in these circumstances to see why decent, hard-working people felt that the new system was undermining their values.

Finally, the transition brought the immediate triumph of western material values and undermined the position of the *intelligentsia* in these countries. While the prevailing ideology of the socialist system was an illiberal Marxist-Leninist one, it claimed to be descended from the finest traditions of the enlightenment. Similarly, the national cultural traditions were fostered to give added legitimacy to the socialist regime. Thus, for whatever reason, these countries devoted considerable resources to the promotion of the best Western cultural traditions. At least since the end of the Stalinist repressions, the intelligentsia, a term that encompasses the liberal professions, journalists, artists, etc., was able to live in a humanist tradition, while paying no more than lip-service to the official ideology.

Many of these people were happy to see communism collapse, but then found that the level of material support available for cultural life had collapsed along with it. Books were published not when the publishers, editors, and authors considered them important when viewed through their own cultural prism, but when there was a large enough market. So the bookstalls were flooded with lurid copies of translations of Western best sellers of doubtful literary merit. To those for whom high culture was a central and meaningful element in their lives, the new system brought cultural vandalism. Such people, influential in the media, and often in the bureaucracy, came quickly to see the systemic change as a very mixed blessing.

A Final Thought

In writing this essay, it became clear that experiences of the former Soviet Union countries differed in some important respects from those of the transition economies in Central Europe, which have been more successful in the transition process. While most of the negative phenomena that occurred in the former Soviet Union were present, at least in embryonic form, in Central and Eastern Europe, the élites in the latter countries had a better idea of the sort of economy they wanted to create, so there was less work to do to explain how a capitalist economy worked and more of a commitment to reform. This also helps explain, in part, why the IMF's advice worked better in Central Europe than further east.

The reason for a good part of the differing experience, however, lies in the political process. It proved relatively easy in Poland and Hungary to establish a normally functioning democracy in which checks and balances among different branches of government could function properly in a civil society. In Russia, Belarus, and the neighboring republics, the democratic political framework proved much more difficult to establish. Thus, we would be remiss if we did not highlight the importance of the political system as one of the necessary preconditions for a properly functioning market economy.

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