

**L** FOREIGN  
ECONOMIC  
LIBERALIZATION

**Transformations  
in Socialist and  
Market Economies**

edited by  
**ANDRÁS KÖVES**  
and **PAUL MARER**

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# Foreign Economic Liberalization

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and Market Economies

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András Köves  
and Paul Marer

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## Systemic Change: Constraints and Driving Forces

*László Csaba*

As can be seen from the conceptual framework elaborated in Chapter 1, liberalization of the trade regime and the policy of opening up the national economy makes sense only in the context of overall economic and political liberalization—in short, “systemic change.” Systemic change in the case of the ex-socialist countries is quite different from previous reforms. The latter were meant to preserve the underlying (power) structure via change, whereas the present policies aim at changing the fundamentals of the state socialist system. Therefore, if previous decentralization endeavors were more or less bound to founder as they reached the limits of the inherent features of the economic order, by the 1990s it has become a real possibility that liberalization of the external sector can take place as part and parcel of an overall—political as well as economic—liberalization of the state socialist system.

It may seem that, given the new overall historic context as well as the rationality postulates of economic theory, qualitative changes of the beleaguered systems will or should take place in one bold stroke. Influential political parties in the ex-socialist states as well as respected figures of the international community indeed repeatedly call for shock therapies—for the instantaneous introduction of the liberal order. The message of this essay is that such advice cannot be heeded. I will attempt to sum up the factors necessitating that the transformation to a pluralist economic order be a protracted one. Later on, the driving forces of systemic change are also surveyed to support the forecast: notwithstanding all the difficulties, the trend of evolution does point toward the market order.

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Useful comments were made by the editors of this volume on an earlier version of this essay.

In formulating long-term expectations and forecasts, it is the historical unprecedented task of systemic change that is of paramount significance. Despite many analogies to various countries in various periods (most notably in wartime and its immediate aftermath), the task of transforming a practically fully nationalized economy into a market economy based predominantly on private property has no precedent in history.

Perhaps the most fundamental problem is that the middle class—the natural subjects and beneficiaries of such a transformation—has yet to be created. Today, 90 to 95 percent of the populations in these countries are chiefly or exclusively the employees of the socialist state. In other words, the capitalists to whom the property could be sold are yet to be created, for the most part. On the other hand, as Hungary's experience during 1988-1990 amply illustrates, the issue is not merely the proxy versus real proprietor conventionally postulated in the literature on reforms, but the legitimacy (social acceptance) of the entire process. If the new capitalist class will very closely resemble the old *nomenklatura*, the political shuttle is bound to move back soon in a populist direction. As is seen in experiences in Latin America, anti-Western and anti-capitalist governments (of the left or right variety) arise, and may halt in their tracks both liberalization and systemic transformation in the name of social justice. The same applies to other socially unaccepted forms of quick enrichment that the release of unbridled market forces may produce. Therefore, from the point of view of external liberalization, the time needed for profound and irreversible internal systemic change, and the political sustainability of the process (as well as its preconditions) are of decisive importance. So it is expedient to survey first the various factors conditioning the long march of the Central and East European countries toward the market—especially those hindering fast and radical change.

#### Sociopolitical Constraints

True, the once almighty communist party apparatus, the old-time major stumbling block to radical reforms, has mostly been pushed out of its former places of command. There are, however, governing parties for which there is always the temptation to "run" socioeconomic affairs directly with and for their clientele—"for the time being" and "in order to speed up transformation." More important, the state administration has not been substantially cut. And even when it is reduced, it has an inherent tendency to recover ("for democracy's sake"). From the branch ministries to municipalities and to various commissions, there are bodies eager to "arrange" things. Moreover, as in any system, political virtues deserve a reward. Thus, licensing procedures, "consultations," and various other sorts of political interference may well survive deregulatory legislation. De-bureaucratization is easy to declare but hard to carry out.

Bureaucratic coordination<sup>1</sup> takes place not only through the conventional channels of planning governmental priority projects and via the sectoral ministries. Particularly in the reformed socialist economies of Yugoslavia, Hungary, and Poland, a peculiar economic order had emerged during the 1980s. Decisions were made mostly in financial forms, often decentralized. Still, the predominance of bureaucratic coordination remained (and this explains to a fair degree the disappointing performance of these reforming economies). Although those economies were no longer centrally planned, they were monetized and decentralized, even though money, credit, and banking did not play the same role as in market economies. This is what the new governments have inherited and so the situation is quite the same today. Financial organs remain, for the most part, integral elements of the state administration and subordinate their way of functioning to it. Dismantling planning thus has not led to the market.

Although many of the reformist ideas stem from people working in the financial sphere, even in the reforming countries the fiscal and monetary authorities remain part of the state administration. Thus, as an institution they have a vested interest in preserving their management role: to remain the visible rather than the invisible hand. Therefore, in the reformed ex-socialist economies it is in the interest of the financial authorities and banks to maintain their discretionary power to decide, case by case, the fate of companies. This might turn out to be the most serious immediate barrier to crossing the Rubicon between the bureaucratically overdetermined and indirectly managed system on the one hand, and real market order on the other. Thus, contrary to the consensus of reformers that had emerged as far back as the 1950s, enhancing the role of money alone will not lead to the predominance of market coordination.<sup>2</sup> Most probably, only a long learning-by-doing process can lead to more and more ex-socialist economies crossing the Rubicon. The first liberalizing steps will probably transform them only to the intermediate stage of an indirectly managed economy.

The controversial role of the irregular, underground, or second economy is a crucial element in the overall process of systemic transformation.<sup>3</sup> In the second half of the 1980s, the conviction grew that the size and level of activity of the non-state sector is, in fact, a success indicator of systemic change.<sup>4</sup> In reality, however, the unofficial economy is a rather intimate bedfellow of the bureaucratically overregulated and coordinated formal/first economy (the public sector). In most cases, non-state activities are either integrated into the state-run ones (as in agriculture), or they operate under circumstances conditioned by the former. In services, the entrepreneurs often live on market imperfections, whose continued presence (e.g., effective barriers to entry) is secured by their active contribution (such as corruption money paid to the licensing authorities to keep out new entrants). Thus, they live in a symbiosis with the bureaucratic structures.

By correcting for some of the malfunctions of the state-run machinery they do play a system-stabilizing role. If only for this reason, the second economy is anything but the forward bastion of free enterprise amidst an oppressive environment that it is sometimes considered in the West. On the contrary, many champions of the second economy are people who know how to get around in a generally nontransparent and arbitrarily bureaucratic environment. They therefore have a lot to lose if fair and free competition are to become the standard. In other words, the entrepreneurial stratum they constitute is just as much a foe of real competitive conditions as is the much-criticized managerial class of the large state-owned companies.

Let's not forget about the social implications of the expansion of the second economy. Because references to the market are usually made by the authorities at the time of major price increases, the population at large tends to associate these notions. Further concessions to market forces were customarily made when the expansion of the second/unofficial economy was allowed by the previous socialist governments. Therefore, in the eyes of the public, a rather pathological market behavior—on occasion, plain economic crime—is a phenomenon of what, to them, the “market economy” is all about. Precisely because it is an integral part of the outgoing bureaucratic system, the expansion of the unofficial economy (even when legalized) does not contribute to the social legitimation of market coordination. The outburst of hostility against the Soviet co-ops is but one example of our concern. In such an atmosphere governments are easily tempted to crack down on “profiteering,” thereby constraining the expansion of the supply side of consumer goods and services as well as limiting the ways in which monetary overhand can be siphoned off.

In sum, governmental policy has a crucial role to play in finding a proper place for the informal economy within the strategy of overall economic liberalization. Only by cutting back the bureaucratic, ideological, and police harassment of private business and declaring the right to start and run a business as the constitutional prerogative of each citizen, and by creating favorable conditions for new market entrants and simultaneously following a tough line on monopolistic misbehavior, can the previously established norms of conduct change. Only then will the previously unofficial sector find its legitimate place in a market order. However, such changes don't come by themselves. Governmental policies bear a crucial responsibility for taking the necessary steps, in due course.<sup>5</sup> Only then will social acceptance legitimate the former underground sector as a valued part of the private economy.

#### Economic Constraints

One of the most paradoxical outcomes of the state socialist experiment is that the system failed most conspicuously in the areas where the compara-

tive advantages of centralized decision-making could have been the greatest. These are the fields normally seen to be beyond the scope of profit-maximizing entrepreneurs: the social network as well as infrastructure, education, and environmental protection. It is important to face this unconventional feature of the East European crisis. Customary propositions of severely cutting back extra-economic outlays and simply letting the free market function (within the limits set by monetary policy alone) are out of touch with the nature of the very problem to be tackled by the twin strategies of systemic transformation and external liberalization. In other words, conditions for a liberal economic order are far from given in the region. The task of the transition strategy lies precisely in bringing them about.

What are the economic consequences of having imposed an artificially constructed theoretical model on a Central and East European landscape that was evidently unfit for it? The model was built on the presumption of uninterrupted high growth rates and, based on this, on an ever-expanding and ever more comprehensive state paternalism vis-à-vis the citizens—“supplying” them with housing (flats), catering, transportation, medical treatment, education, news, entertainment, foreign travel, and so on, all allocated through a benevolent central authority.

Though the idea was rather naive, the consequences are serious. The “expropriation of the expropriators” eliminated the interest in the return on capital. Consequently, the macroeconomic efficiency of growth remained rather low. This is illustrated by the internationally high rates of accumulation that were necessary to maintain world average growth rates during 1950-1980 and stagnation during the 1980s. Meanwhile, both standards and rates of social outlays lagged behind those of the most advanced nations.

An equally serious consequence of the application of the state socialist model has been the two-dimensional shortage of capital. This means that part of the social capital has been wasted on investments that never paid off, whereas another part was not accumulated for decades. Among the items of the first dimension are physical infrastructure, human capital (especially education and medical care), housing, and the neglect of the entire tertiary (service) sector (employing 60-70 percent of the population in the advanced countries). Among items of the second dimension are the sources for paying indexed old-age pensions, unemployment benefits, expenditures for retraining and resettlement, the substantial outlays needed to integrate a growing number of socially deviant or deprived groups, and the sizable sums needed to maintain the environment. In other words, the social welfare network criticized by standard economic theories as being overextended in the West is yet to be created all across Central and Eastern Europe.

What are the long-term economic repercussions of this state of affairs for the strategy of liberalization? First, growth performance of the region should be corrected downward both retrospectively and prospectively. The officially reported growth rates of the 1950-1985 period should be adjusted

not only for measurement biases but also for the "omissions and delays" that must be made up in keeping residential areas inhabitable and pollution-free, schools functioning, and so on. The potential economic expansion of readjusting the structures is also limited by the bottlenecks stemming from infrastructural decay and environmental degradation.

Second, the state of the infrastructure and the structure of incomes renders the labor market rigid. Because wages normally do not contain the cost of housing, while the state has practically stopped building low-rent flats, and flat-leasing has become very limited and disproportionately expensive relative to wages, substantial labor mobility is inhibited. Due to the nature of the East European crisis, structural and even regional unemployment will be a long and costly socioeconomic problem, slowing down the speed of adjustment to market signals.

Third, poverty has grown into a serious problem by the 1990s, as Hungary's example shows. Old-age pensions and social transfer payments are not adjusted for the significant (double digit) inflation rates. The initial size of these payments was already so calibrated that only in an ever-growing economy with stable price levels could they deliver a decent living for the recipients. In reality, therefore, a truly frightening devaluation of these payments has taken place, which is proportionate to the time that has elapsed since retirement or starting to receive the transfer payment. In Hungary, for example, the purchasing power of the pension of a person having retired in 1980 was less than 40 percent of the original value in 1990, whereas additional income from property or private insurance was in most cases zero or negligible. Thus, 25 percent of the people live under and around the poverty level. Only for this reason is it obvious that the state's redistribution of incomes can't be cut back as much as conventional economic theory would require. This will be a very serious constraint on the actual speed and degree of internal liberalization, since in civilized societies pauperization is not tolerable. Moreover, these people are not normally in a position to react to market pressures by improved performance. Therefore, the sociopolitical pressure to put an end to nineteenth-century experimentation with "free" market forces will be irresistible unless this factor is properly reckoned with *a priori*.

Finally, outlays for environmental protection are anything but the luxury of the rich. Air and water pollution, and the way in which waste is being managed, have reached such a degree of decay during the decades of their having been a non-issue that the need for substantial action is urgent. Physical infrastructure, too, has to be developed to some degree; otherwise it will positively hamper economic recovery and transformation. And servicing large foreign debts implies a serious drain on the domestically disposable resources of most of the East European states.

Necessary spending for these three items—social safety net, the infrastructure, and the environment—add up to a single factor from the

macroeconomic point of view—namely, that the availability of capital for economic modernization and structural readjustment will remain limited. It also implies that budgetary redistribution will remain larger, the level of interest rates higher, and consequently the expansion of the private sector substantially slower and the time needed for economic recovery much longer than optimal. Therefore, liberalization of the external sector and the move toward currency convertibility will probably remain gradual.

#### Driving Forces of Systemic Change

An egalitarian ideology no longer constitutes a barrier to a market-determined income structure. The economic crisis of state socialism, and the obvious inequalities and inefficiencies those arrangements have brought, add up to a mighty impetus to create market-conforming regulations in all walks of life. The social acceptance of remuneration according to performance has never been greater. There is a growing belief that there is no return to state socialism, property is legitimate, and savings in any monetary form will be melted away by inflation. Thus the propensity to invest and to start a new business, as an individual's way out of the ailing public sector, is bound to increase.

The collapse of the CMEA is an accomplished fact, as elaborated in the chapter in this volume by Köves. There is no return to previous normalcy. There is no easy way (soft markets) open to protected industries. It also implies that economic reorientation and the policy of export-oriented growth has no alternative. Unlike in previous years, this is not just a declaration of intent but an unavoidable fact of life. True, the shock effects of the immediate changes are considerable and the recession and unemployment they bring about will be substantial. Still, they did give the necessary first push to systemic and policy changes that otherwise might have been delayed. And if the road leads to the world economy, the need to create systemic congruity with the "outside world" has become immediate for all the Central and East European countries.

In all those countries that have opted for systemic change as defined in the introduction, there is now a social consensus on the need for bankruptcies, free prices, equilibrium exchange rates, and the necessity of balancing the budget by cutting back on the direct economic involvement of the state. In all these countries, as a consequence of one-sided priorities of socialist industrialization, there is an extreme concentration of employment in industry. Since the tertiary sector is underdeveloped, profitability in many of its sectors is usually high. This bodes well for the possibilities of job creation, as there are considerable incentives for people formerly employed in industry to switch over to the service sectors.

The reduction of the paternalistic economic role of the state will mean that more and more individuals will have to depend on themselves. The



experience of Hungary, where during the last two decades there were growing pressures as well as opportunities to find new or additional ways to become economically active, suggests that there are considerable creative energies to be tapped in these countries. Given that in Hungary during the 1980s there was a steady fall in real wages in the public sector, people found ways to compensate for this by taking jobs in the second economy; 60- to 65-hour work weeks have become a standard for over 80 percent of the economically active population.

The five listed factors and their interaction make it probable that despite the constraints enumerated, systemic change and liberalization will emerge in the 1990s—though it may take longer than many believe.

#### Notes

1. J. Kornai, "Bureaucratic versus Market Coordination," *Osteuropa Wirtschaft*, No. 4, 1984.

2. For a detailed substantiation of this point using the contemporary Soviet reform debates as empirical evidence, see H.-J. Wagener, "Plan and Market in Perestroika," *Kyklos*, 1990/3; and A. Schüller, "Die Sowjetunion auf dem Weg zur Marktwirtschaft?" in H.-F. Wünsche, ed., *Marktwirtschaft im Sozialismus* (Stuttgart, New York: Fischer Verlag, 1990), pp. 33-68.

3. The non-state sector includes non-agricultural co-ops, auxiliary servicing activities of agricultural co-ops, work partnerships, and a large number of quasi-private activities, whose being truly private may be debatable, depending on the given form of activity. For a systematic overview of various forms and analysis of empirical evidence, see B. Dallago, *The Unofficial Economy* (Aldershot, Eng.: Dartmouth, 1990).

4. K. Mizsei, "Is the Hungarian Economic Mechanism a Model to Be Emulated?" *Eastern European Economics*, Vol. 26, No. 4 (Summer 1988); J. Kornai, "Affinity Between Ownership Form and Coordination 6, No. 4 (Summer 1988); J. Kornai, "Affinity Between Ownership Form and Coordination Mechanisms: The Common Experience of Reform in Socialist Countries," *The Journal of Economic Perspectives*, No. 3, 1990.

5. L. Csaba, "Some Lessons from Two Decades of Economic Reform in Hungary," *Communist Economics*, No. 1, 1989.

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### China's Industrial and Foreign Trade Reforms

Dwight W. Perkins

Economic systems reform in China, as in most other countries that have experimented with fundamental reform, was initiated with narrow economic goals in mind. But reforms as sweeping as those attempted in China can rarely be kept confined within the boundaries of economics and technology. Such reforms inevitably spill over into the political sphere. How the political sphere reacts profoundly shapes how the economic reform process itself evolves.

Why did China begin the economic reform process in the late 1970s? The principal answer is that Deng Xiaoping and most of the others who regained power in 1978 were dissatisfied with the pace of economic growth. By the standard of Eastern Europe and the Soviet Union in the 1980s, China's 4-5 percent a year GNP growth rate in the two decades prior to reform does not seem so slow. But compared with the 9-10 percent annual rates of China's East Asian neighbors, China was indeed falling further and further behind.

There was also little doubt that slow or negative productivity growth was at the heart of China's inadequate GNP growth performance. Accumulation as a share of net material product (NMP) had risen above 30 percent, an extraordinarily high figure for such a poor country. As the accumulation rate rose, the NMP growth rate stagnated and may even have fallen slightly. Certainly further increases in the rate of accumulation were neither feasible nor likely to lead to higher growth. By the mid-1970s, China had serious worker morale problems and stagnant wages. The unavailability of consumer goods was widely believed to be a major source of this low morale. A further rise in the rate of accumulation could only have made matters worse.

The goal was to increase productivity growth by reducing the waste and misuse of resources. But there was no roadmap for how this goal was to be attained. The Chinese were not lacking for advice or models of how reform