Dilemmas in establishing a new pattern of cooperation

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It is becoming more and more unquestionable that in the development of a new system of international security the economic factor will play an increasingly important role.

Already during the détente of the seventies the belief arose that a security system can only be durable if international cooperation becomes the material substance of peaceful coexistence. This was strongly underlined in the 1975 CSCE Final Act. Economic cooperation has never, however, played such a role. There have been at least two reasons. First, a security system founded on a balance of forces and terror and a basic antagonism between two blocs was bound to the subject to the rules of a zero-sum game. What strengthened one side could only be treated as a weakening of the other. From that sprang mutual distrust and numerous restrictions on East-West trade and technological cooperation. Second, and probably more important, even when the political climate improved and dialogue began in the politico-military and humanitarian sphere, the incomparability of economic systems made it impossible to cultivate rational ties in the economic sphere and a common language was ruled out by the fact that economic terms, though identical, meant one thing in the East and another in the West. This applies to such fundamental concepts as price, profit, exchange rate, interest rate or tariff, to mention only the most basic instruments and tools of economic relations. The socio-political transformations now in progress in Eastern Europe open the way to the disappearance of both these barriers. The role of society in shaping these countries' economic systems is changing basically. *Joining Europe* is now the predominant political slogan, embodying a popular determination to enter the mainstream of civilizational advance. And here lies the basic dilemma in constructing a new framework of relations between the West and the nations of Eastern and Central Europe which have embarked on changes that will clear the path to embracing its political, economic and social value system. As we know, the progress

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made in this direction in the political, military and institutional sphere is astonishing and has qualitatively altered the system of politico-military relations in Europe. However, the permanence of these changes is jeopardized by the failure of effective economic linkages to keep up with political developments and the continued widening of the gap between the eastern and western halves of the European continent. That gives rise to a serious fear that this growing gap could undo what has already been achieved in the sphere of politico-military, social and humanitarian relations. We believe that here lies the biggest threat to the construction of a new system of international security. The chances of rapidly overcoming this threat are slender since it has objective sources which cannot be eliminated in a short period of time. These must therefore be realistically identified and a complex of shock-absorbers simultaneously created which will allow the most difficult stages of the transition to a new socio-political system to be negotiated with the least possible pain and risk. Though the economic dilemmas faced by the countries of Eastern and Central Europe vary, there are certain general patterns common to all which generate similar socio-economic consequences.

From this point of view it is vital to identify at least three sets of threats to stable socio-economic development: one, those stemming from the necessity of society having to bear and accept the costs of overturning the old economic system and building a new one; two, those stemming from the dislocation of the existing model of intra-Eastern Europe linkages within the CMEA; three, those stemming from the solution of the debt dilemma.

The high costs of building a new economic system

All the countries of Central and Eastern Europe aim at replacing a command economy with a market system. Experience indicates this is a far more difficult process than moving from a market to a command system. It is easier to nationalize private property than to denationalize a state-owned economy. It is easier to replace the market with central control than to restore conditions for the operation of objective market laws. Two problems come to the fore in the implementation of a market economy: one, determination of proper price relationships reflecting the cost relationships in production and services; and two, development of a proper ownership structure, without which markets and competition cannot exist.

As we know, the economic system of "real socialism" was based on a price system divorced from the actual cost of inputs which served the purpose of pseudo-equitable distribution of goods rather than exchange. If relations between producers, and between output and consumption, are to be put on a rational footing, this system must be totally overhauled. That requires a price and income revolution of acute social impact. The regulation of price ratios cannot take the form of reduction since that would carry the risk of further drastic disturbance of market equilibrium and the viability of production. The only answer, therefore, is a differentiated increase. As a result nobody has yet succeeded in carrying out a reform of price ratios that brings them into line with cost relationships and closer to world market relationships without triggering an inevitable inflationary spiral. International differences in this respect can be reduced to the pace and depth of change. There are only two possibilities: shock-therapy and attaining sound price relationships through activation of very strong inflation (hyperinflation) or spreading out this process and attaining them through toleration of a defective market (with all its negative consequences) over a longer period of time. Each of theses methods has its good and bad points. Which one to choose depends on the specific sociopolitical conditions of each country. Poland opted for shock-therapy and attaining market equilibrium via hyperinflation but it is doubtful whether this is a universal recipe since the social costs are in the short term exceptionally high. Polish society was prepared to accept these in view of the compensation it was offered in the political sphere. The popular enthusiasm aroused by genuine recovery of independence, formation of the first post-war non-communist government and establishment of the foundations of authentic democracy was sufficient to ensure social peace and visible progress towards market equilibrium and installing market-economy mechanisms. This process was accompanied by the traditional "economy of scarcity" giving way in many segments of the market to an "economy of glut". How much headway has been made in marketization is epitomized by the introduction of internal convertibility of the zloty, eradication of the black market in foreign currencies and maintenance of the exchange rate at the same level for what is now the best part of a year. That represents a good start, but the social price has been high. It continues to be accepted by the public thanks to the relatively high degree of popular trust enjoyed by the government and a pattern of internal politics unique in this part of Europe. The size and strength of the Solidarity movement plus the positive role played in the party that ruled previously by its "revisionist" and reformist wing allowed for a variant involving gradual superseding of the old political order and consolidation of the new system of parliamentary democracy.

In the other countries of Central and Eastern Europe the conditions are different and shock therapy would be either extremely risky or impossible. It has so far been eschewed by the Soviet Union in view of the immense political dangers of such an operation given political and social tensions quite incomparable to anything in Poland (and with different sources, ethnic among them). In Hungary and Czechoslovakia the disparate reference point of the reforms currently underway offers a greater likelihood of securing similar marketization objectives by less dramatic and radical means. There is yet another situation in Bulgaria and Romania, where a centralized economic system still predominates and more radical measures depend on further political change. Despite these differences, there seems to be little question that the introduction of new market conditions entails considerable social costs. First, market transformations are inevitably accompanied by high inflation and, second, alterations in price relationships force a certain number of producers out of the market and make a substantial proportion of the output of other enterprises highly unprofitable, thus causing a more or less acute recession. It is therefore an illusion that market transformations will in the short term accelerate economic development and increase output; on the contrary, retrenchment and falls in real consumption of longer duration can be expected as an inevitable part of the price of restructuring the economy as a whole[1].

Another facet of this process are the costs arising out of changes in ownership structures. These also have to be paid if the ground-rules of a market economy are to take hold. The experience of economic reform under *real socialism* has conclusively demonstrated that it and the market are incompatible. A market economy cannot operate if state ownership predominates. The monopolistic practices that flourish in such a soil inevitably distort market-led price structures. In other words, as long as state ownership enjoys a monopoly position, marketization stands no chance of being lasting even if the groundwork is in place. This is a typical situation in countries such as Poland, Hungary or Czechoslovakia, which have gone some way down the road of market reform and find that the fundamental barriers to the durability of healthy market tendencies and market equilibrium are the old ownership structures. Privatization is, however, also an extremely difficult and initially very costly process. There are three possible ways of replacing state with private ownership. The first is expansion of the private sector which, though it existed under *real socialism*, contributed only marginally to the East European economies. In this area, too, there are major differences between each country. A relatively specific situation exists in Poland whose small-scale private sector played a much larger role than, say, in the Soviet Union

[1] An EEC report shows that in the first quarter of 1990 industrial output in the six East European countries fell by 13,4 per cent (28,7% in Poland in the first half of the year), exports by 14,2 per cent and imports by 5,8 per cent. *Financial Times,* 10 July 1990.

since throughout the period of *real socialism* much of agriculture was in private hands and there was also an extensive network of small businesses. In Hungary, too, the latter was much more prominent than in Czechoslovakia or Bulgaria. However, regardless of these differences, everywhere the principal avenue of privatization will be the building of a private sector generating its own capital formation. The changes in the political system and favourable legislation have opened up wholly new prospects for this sector of the economy and in most of Central and Eastern Europe governments are now committed to its support. The basic barrier to its growth is physical lack of capital. The scope of operations in this sector is still limited, though it already performs important functions in retailing, services and small-scale industry. But attainment of a significant position in industrial output will require the time needed for natural capital formation. Since internal sources are for obvious reasons still extremely meagre, far greater possibilities for profound change in the ownership structure lie in privatization of the state sector. But here, too, overnight transformations cannot be expected. Conversion of state enterprises into joint-stock companies requires a capital market and persons willing to buy shares who, as well as possessing the necessary capital, ought to know how much to pay for their investment. The rise of capital market and the time it will take to accumulate the capital resources needed are the factors which will in this case determine the pace of privatization processes. Another option is distribution of state property among the public. But that immediately raises the question of how this is to be done and who are to be the beneficiaries. How fair is employee-share ownership - preferential sales of shares to the workforce of an enterprise - when other members of society can also claim to have contributed in varying degrees to the creation of public wealth? All of this poses very difficult problems. If the squandering of already limited fixed assets is to be avoided, changes in ownership structures cannot go forward with excessive haste. That leaves the chance presented by a flow of private capital from abroad. However, it is unlikely to grow rapidly until changes take place in the countries concerned which stabilize the socio-economic situation and legislative provision is made for outside investment to operate on terms similar to those on the world market. That pinpoints one of the most formidable threats to the effective introduction of market relations. Though privatization cannot be carried out overhastily, it has to proceed relatively swiftly if there is to be no risk of the old monopolistic structures blocking the emergence of competition and the free interplay of market forces. There is, therefore, a justifiable tendency to accelerate these processes, which has inescapably negative short-term consequences since the old economic mechanisms cease to function before the new ones have started producing the expected results. This is one of the basic causes of the inevitability of decline in growth-rates in the first stages of systemic transformations and a source of recessionary phenomena which is particularly hard to eliminate. The social costs of changes in the economy's mechanisms and ownership structures represent a serious threat to the stability of systemic transformations. As can be seen from the arguments set out here, they call for considerable popular sacrifice and patience over a prolonged period as the transition is made from the old to the new system. The extent of this patience will depend on a number of other economic and non-economic factors to which we shall now turn.

The collapse of the old model of intra-East European economic ties

The systemic changes in Central and Eastern Europe have been taking place in circumstances determined by external economic linkages dating back to an earlier period and of a nature crucially affected by these countries' participation in "socialist integration" within the CMEA framework.

The progress of integration in Western Europe makes the results of CMEA efforts look exceptionally sorry. The weaknesses of the command system and absence of a market, plain enough in the functioning of the internal mechanisms of each of these countries, become still more glaringly apparent in the sphere of their external relations. A great deal has now been written about the faults of the old system of socialist integration and it is not my purpose here to go back over this ground in detail. However, a question that still remains unanswered has to do with the prospects of development, in other words: Where does the CMEA go from there? At least three options have emerged from the discussions to date and the course of official negotiations. The first is to streamline this organization by eliminating its known faults and weaknesses. The second is to disband and leave each country free to link itself as rapidly as possible with the economy of the West, Western Europe in particular. The third is to keep the CMEA temporarily in place pending the formation of a new organization while simultaneously making use of its existing infra-structure and several of the institutions created in the past. We shall try to show that the last is the most rational option, though its implementation cannot disregard the arguments behind the more radical proposals.

Thinking about future cooperation between the countries of Central and Eastern Europe must first identify the principal defects of the old system, chiefly responsible for the gross deformations in the international division of labour within CMEA. The root causa can be traced to the fact that "socialist integration" was integration of unequal partners which opened the way to domination by the integration of smaller countries (most of them at a higher level of development) around the Soviet Union. The result was the formation of complementary economic structures primarily in relation to the core. Whatever the intentions (and for many years they were bad, dictated by the political and military interests of the USSR), the existing asymmetry objectively limited the other countries' chances of outward opening to the world economy. Even given greater purity of intentions (which the change in progress in the USSR makes possible), integration of unequal partners curtails the weaker members' freedom of manoeuvre in differentiating their external relations. The single vast market of the senior partner is capable of absorbing almost everything produced by the weaker partners, but can supply only a limited range of the goods they need. Such objective asymmetry was made all the more acute by the lack of objectivized criteria of economic exchange. This is the second of the basic defects of the "socialist integration" model. The use of an artificial, arbitrary unit of exchange, the so-called "transferable ruble", created a situation in which it was impossible to say who got the best or worst of a particular bargain. The total insulation of the exchange rates of each country vis-à-vis the transferable ruble ruled out any realistic calculation of cost-effectiveness. However, it served to fan the popular belief that everyone was helping someone for reasons of high polities and at the same time being robbed and cheated by everyone else. The Soviet public was convinced that the USSR's economic setbacks were due to having to prop up other socialist countries, while the average Pole or Hungarian attributed his low standard of living to economic manipulation detrimental to the national interest. In actual fact, the arbitrary system of prices and price-determination makes it impossible to prove who cheated whom, though the popular impression was no doubt not far from the truth. The exchange system could operate only through the construction of programs which balanced - in terms of quantity, not value - requirements against the means of satisfying them. At the same time, financial settlements, based on the transferable ruble, were reduced to the servicing of barter transactions, virtually commodity for commodity, which is, of course, a well-nigh prehistoric form of trade.

Unfortunately, neither of these faults can be eradicated simply by improving and refining the existing system: scrapping the transferable rule, for instance, a point to which I will return. That puts the first option (streamlining the CMEA) out of court.

The second option - dissolution of the CMEA and orientation of each country towards integration with the common West-European market - looks attractive and enjoys considerable public support. However, it is to be seriously wondered whether the road to Europe lies through totally dismantling the existing system of ties between the countries of Central and Eastern Europe and so scrapping arrangements which, however defective and primitive, cater to much of the trade essential to the functioning of their economies. That would be a very risky move. We believe that the last CMEA session acted wisely in deciding not to disband and appointing an intergovernamental commission independent of the Secretariat to make the necessary changes in the principles and mechanisms of the organization. The only stipulation that might be added is that the steps taken should be directed towards measures of a temporary nature (designed to prevent a systemic vacuum from arising) and limited to the transitional period essential to the development of a wholly different and qualitatively new model of multilateral cooperation between the countries of this region.

In the quest for such a model two specific circumstances must be taken into account. The first is in a sense of a psychological nature. There can be no doubt that there are many reasons why countries going ahead with fundamental transformations of their systems would do well to join in a common search for solutions to their development and cooperation problems. That springs from the fact that for a long time to come the economies of the countries of this region will continue to be hybrids with similar organizational and ownership structures, technological standards and operating mechanisms. The creation of a market economy will encounter the same kind of difficulties, and the replacement of the old rules with new mechanisms will be a long process. This is a situation that should encourage the framing of institutional arrangements, specific and common to this region, which favour the regulation of mutual relations. It seems, however, that these countries' shared past and experience of "socialist integration" is a divisive rather than unifying factor. Consequently, they are tending to look for more reliable partners likely to be of greater use and assistance in carrying out the systemic transformations on which they have embarked and their trade statistics reveal an appreciable decline in mutual turnover and competition between them in establishing ties with western markets (see Table 1). This tendency was already very apparent in 1989 and has grown since. It will continue to do so, especially given the switch to a new system of intra-CMEA settlements as a result of replacement of the transferable ruble with convertible currencies. That brings us to the second circumstance.

It follows unarguably from what has been said about the shortcomings of transferable ruble settlements that the basic step in arriving at a proper model of cooperation between the countries of the CMEA group should be a move towards pricing trade according to world market conditions and settlements in convertible currencies. A number of decisions have already been taken and preparations are under way for putting this new formula of exchange into practice on a wide scale. It is not, however, an unmixed blessing.

Table 1
Foreign Trade of the Countries
of Central and Eastern Europe and the USSR in 1989
(1988 =100)

Country	Total	CMEA countries	Capitalist countries	Developing countries
Imports:				
Bulgaria	90	89	96	94
Czechoslovakia	103	100	107	121
DDR	103	-	-	-
Poland	100	96	106	105
Romania	100	-	-	-
Hungary	105	93	119	90
USSR	105	99	116	116
Exports:				
Bulgaria	95	100	102	59
Czechoslovakia	105	99	117	113
DDR	103	-	-	-
Poland	100	100	101	100
Romania	110	-	-	-
Hungary	109	100	118	105
USSR	101	97	110	97

Source: See *Gospodarka swiatowa i gospodarka Ploski w* 1989, IGS, Warszawa, 1990

Two direct ill-effects are already evident. The first is a situation in which each country seeks to maximize convertible currency sales of goods and services to other CMEA partners and simultaneously to minimize purchases from them in these currencies. For obvious reasons each prefers to spend its foreign exchange earnings in western markets where it can buy goods and services of much higher technical and performance standards and parameters. There is no need to stress that such a policy will contribute significantly to a further reduction of mutual trade.

The second consequence for the majority of CMEA countries (with the exception of the Soviet Union) is that transition to convertible currency settlements causes them to suffer losses in their balance of trade. This is due to the fact that in the USSR they purchase chiefly raw materials, fuels in particular, at world prices, which have been rising recently, and sell manufactures, for which the demand in the Soviet Union is moreover dwindling and less competitive than what western markets can offer for convertible currencies. It has been estimated that the switch to convertibility currency settlements is costing Poland an annual loss of some one billion dollars in its balance of trade. Nevertheless, all things considered, this is a price worth paying in the interests of abandoning once and for all the misleading transferable ruble, especially as in the longer term the terms of trade may improve as the products of manufacturing industry become more competitive. There is, however, another profounder consequence of intra-CMEA settlements in so-called hard currencies: they reveal the necessity of a complete overhaul of the philosophy of cooperation within this grouping, that is, of a clean break with the existing model and its supersession by another economic organization conducive to the full participation of each country in international economic life.

The point is that the introduction of convertible currency settlements and the pricing of trade at world rates are feasible in the present conditions only on a very limited scale. The number of commodities quoted on world exchanges is small, chiefly raw materials, farm products and fuels. It is much more difficult to set world prices for manufactures and totally impossible in the case of technically individualized items, such as components for different kinds of machinery and plant or new consumer products. In this area there are no world prices and to compute their market worth a properly determined exchange rate is essential. Given the existing highly differentiated and hitherto arbitrary structure of domestic prices in each country, exchange rates cannot find their own level. A realistic exchange rate can only be fixed if domestic price relationships correspond to world price relationships. As a result it is hard to see how exchange rates can be properly determined until domestic currencies attain internal and external convertibility. This is, as we know, an extremely difficult problem and Poland is the only country which has succeeded so far in making its currency internally convertible. It is a significant achievement, but one that required radical changes in domestic market price relationships. In these circumstances short-term hyperinflation proved unavoidable. Shock therapy brought the desired results but at a heavy price to society. Though it is debatable whether shock treatment is better than more gradual cures, one thing is certain: the introduction and subsequent consolidation of convertibility is a process involving very profound economic changes, transformation of ownership structures among them. Stabilization of market relations and the kind of competition essential to the market mechanism are unlikely prospects if state ownership is the predominant or sole form in the principal sectors of the economy. Such a monopoly is capable of rapidly distorting price relationships and undoing the positive effects of radical changes in economic mechanisms. Tackling the problems involved in privatization of the state sector and development of price-determination conditions that meet world market requirements will be a long haul for the CMEA countries. It can safely be said that progress down this road will be harder without harmonization of economic actions transcending the boundaries of national economies since this is a question of making the systems of exchange between these countries comparable. That being so, the institutionalization of cooperation becomes all the more necessary. Its basic objective ought to be harmonization of steps towards genuine marketization of internal relations and objectivization on this basis of the criteria of economic dealings. What is needed here, therefore, is action that brings these countries closer together rather than drives them apart. There can be no doubt that harmonization of efforts in this field will entail a radical rejection of the old methods of coordinating production programmes and targets. The prime requirement will be a synchronization of economic policy instruments exerting a direct influence on the course of price-fixing processes - in other words, tax systems, tariff regulations, the principles of determining exchange rates and a whole set of measures aimed at comparability in calculating the value of goods and services. That cannot be done without lowering the level of economic linkages and developing realistic settlement arrangements by involving enterprises directly interested in the results of their operations in economic exchange. Nor can it be done without progress towards creation of a proper regional infrastructure of economic linkages. This is essential to meeting the challenges presented by advances in contemporary civilization and technical culture, which in the first place means the necessity of constructing a proper system of mutual economic information, communications, transport and energy links and of preventing destruction of the natural environment. All these ties are indispensable if by attacking regional problems the road to uniting Europe is to be shortened, not lengthened. Only if there is such an approach will regional international cooperation cease to divide the continent and become a factor reinforcing the positive tendencies in pan-European integration and construction of a new system of international security.

The foreign debt dilemma

The international debt liabilities of the countries of Eastern and Central Europe are one of the most serious threats to economic stability in this region. One can debate at length the issues of how this problem arose, who is to blame and who should bear the consequences. But no constructive conclusions can come from such discussions. It is increasingly widely recognized that the causes of the high level of indebtedness of some of these countries lie primarily in their governments' ill-judged economic policies in the seventies, mistakes which were compounded by the specific conditions of the world capital and credit market resulting from the cyclical disturbances of the seventies and eighties. However, even the most precise identification of the causes of the present problems will be of use only to the formulation of recommendations for future financial and economic policy-making but will not tell us what has to be done in the situation as we now find it. Which for some of the East-European countries is dramatic. Nor can it be expected to go away. It is equally naive to suppose that the problem will disappear as soon as the debtor countries recover their production (and export) capabilities and are in a position to come to grips with the debt burden. The dilemma lies in the fact that debt service requires expansion of production and export capabilities, which in turn requires capital surpluses, but these are consumed by debt service: a vicious circle, which can only be broken by means of emergency measures. The threats posed by international debt liabilities are common to almost all the countries of Central and Eastern Europe, though the size of the burden varies. Our table, which is drawn from OECD data, shows that a truly dramatic situation exists only in the one extreme case of Poland. It belongs to the group of countries classified as "very heavily indebted". At the end of 1989 it owed a total of $41 billion and the extent of the burden is underscored by very high debt/exports and debt service/exports ratios: 532 and 88 per cent respectively. This indicates that external debt could prove one of the chief barriers to putting the economy on track for accelerated and balanced growth. The situation is not much better in Hungary, where the external debt stands at $20 billion (considerably higher per capita than in Poland) but the debt service/exports ratio is almost only half Poland's (45 per cent). Bulgaria is slightly better off in this respect, but its total debt and all the other indices of an economy burdened by debt are rapidly on the rise. Countries with a medium debt level are the Soviet Union and also Yugoslavia and so was the former GDR, though this last case eludes analysis in view of its altered status in Europe. A low level of debt is represented by Czechoslovakia and Romania. The level of Poland's debt (and as we have seen Hungary and Bulgaria are not far behind) creates a situation in which clearance by conventional methods is simply impossible. The structural character of this phenomenon means that even given satisfactory economic progress the debt will keep growing. To make the picture of the looming difficulties more concrete let us considerer Poland's position in 1989[2]. If Poland had wanted to meet all the payments due on its total $41 billion debt it would have had to pay $3,418 million in respect of debt service and $3,096 million in respect of principal maturities, a total of $6,514 million. That sum can be set against that year's level of exports (relatively high considering Poland's capabilities) which carne to $8.1 billion and a balance of trade surplus of $120 million. It will, therefore, hardly seem surprising that Poland paid only $1.075 billion in debt service and $497 million in principal payments. The unpaid principal maturities ($2,599 million) were partly restructured and partly written-off ($109 million). The remaining $2,267 million were capitalized and added to the total obligations. Thus in the course of a year Poland's debt rose by $2.2 billion. It is certain that, other things being equal, the situation in the near future will not improve and the size of the debt will continue to grow. There is a general belief, shared by creditors, that Poland will never be able to pay off its mounting debt. It is growing not because Poland is incurring new debts but because unpaid maturities are capitalized. The situation is, therefore, a hopeless one which cannot, as has been noted, be resolved solely by traditional methods. There can be no doubt that the policy of international financial organizations is now evolving in a very positive direction and we can see many efforts being made to accommodate difficulties especially if they are of an interim character. An example often cited is the Paris Club which in February 1990 carried out a restructuring of Poland's debt under which it has been released from its obligations to all members of the Club. The total value of the restructured debt comes in this case to $9.5 billion. A moratorium on debt service payments has been set for a period of one year, that is, to March 1991. Undoubtedly, action of this kind provides relief, but it does not solve the long-term

[2] Data drawn from: J. Jedruszek: *«Economic Conditionalities»* in *Systemic Transformations. Implications for Poland's Foreign Policy,* PISM Occasional Papers, no. 18/1990.

problem since it is obvious that after the moratorium has expired Poland will be in a similar situation of being unable to meet payments due and the same problem will recur. According to realistic forecasts of the schedule of maturities, Poland ought to pay $6.5 billion in 1991 and $8 billion in 1992. However, even in a best-case scenario it is projected that the accumulated surplus in the balance of trade for 1990-93 might come to $7.2 billion while the payments due in this period will total $23 billion[3]. Even if the whole of this surplus were earmarked for repayments, the debt would still grow in the course of the next three years by $15 billion. The debt spiral may, therefore, spin with dramatic speed totally out of control. We have used the example of Poland to show the kind of threats to national economies burdened by a high level of debt. Though it is, as we said, a special case, similar difficulties may shortly confront the other countries of Eastern Europe, particularly Hungary and Bulgaria. Of course there is always the possibility of not paying the whole sum due, a practice that has been followed by Poland since 1982. Nor is it unique in this respect. However, there are very grave consequences which have highly damaging repercussions in other are as of economic activity. Here three major threats to economic stability need to be singled out. First, a high level of debt and so high debt/exports and debt/ GNP ratios have a paralising effect on the flow of outside capital just when it is most badly needed. Even the most attractive investment and repatriation regulations cannot offset investors' natural fears of the risks to their capital in countries with a low degree of payments credibility[4].

These are justified fears since a payments crisis invariably affects the rules governing repatriation of profits and curtails the freedom of capital flows. Secondly, a high level of debt makes for a tighter credit policy which is geared to achieving surpluses in the balance of trade and payments and reduces the possibilities for securing new credits, often of vital importance to putting export-oriented manufacturing capacities into operation. Thirdly, excessive debt restricts private enterprises' access to external credit services and so checks the process of privatization. Quite understandably, foreign banks consider the general situation of a country when assessing the credit-worthiness of one of its enterprises. All these consequences are evidence that a high level of debt is one of the principal barriers to rationalization of economic policy and to activating mainsprings of economic development and encouraging systemic transformations. How this dramatic dilemma will be solved is

[3] J. Jedruszek, *op. cit.* p. 30.

[4] See Witold Matecki, Grzegorz Kotodko: «The Indebtedness of East-West European Countries», Paper presented to the round-table in Sveti Stefan, 28-30 June 1990.

anybody's guess, although there are numerous proposals in circulation. Nor would it be hard to demonstrate that in the most extreme cases the most rational solution for both debtor and creditors would simply be a measure of debt forgiveness. A large number of studies have reached the conclusion that creditor countries furthering the growth of debtor nations stand to gain much more by cancelling debts than by demanding repayment and not receiving it anyway[5].

Decisions to write off debts are not, however, easily taken since they involve moral as well as purely pragmatic considerations. From the moral point of view it is hard to explain why creditors should be made liable for the economic inefficiency of debtors. Forgiveness in one case and uncompromising insistence on repayment in another are also morally dubious. Why for instance should Poland's debt be annulled, but not Czechoslovakia's which has behaved much more sensibly in this respect, particularly during the borrowing spree of the seventies? For their part, pragmatic considerations bespeak the necessity of observing certain principles in the discharge of obligations. Permitting exceptions and creating precedents could totally loosen relations between creditors and debtors and change the criteria regulating payment obligations. Hitherto a point was made of seeing they derived from the law and were consistent with market forces but more and more frequently non-economic, often purely political criteria are coming into play. Such a situation does not favour the development of healthy relations on financial markets. This is, therefore, unquestionably a difficult problem and the search for solutions must concentrate on the economic principles. For this reason it is worth exploring the possibilities of two so far untried areas of action: debt elimination through debt to equity swaps and recourse to the secondary financial market where, as we know, securities representing the nominal value of the debt can be bought at a market price of 16-17 cents per dollar in the case of Poland. A number of interesting proposals have been put forward with regard to both debt to equity swaps and buybacks on the secondary market. Unfortunately, there are still no precedents for the practical utilization of either possibility in the case of East-European countries any more, for that matter, than there are for definitive write-offs of the debts of medium-income countries. It cannot be ruled out that a positive solution of the latter question might follow the commencement of effective efforts to put into practice the aforementioned unconventional methods of debt relief.

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5 See J. M. Rollo with Judy Batt, Brigitte Granville and Neil Malcolm: *The New Eastern Europe: Western Reponses,* Chatham House Papers, London 1990.

Table 2

The indebtedness of East European Countries

	Poland		Hungary		Bulgaria		USSR		Romania		Czechoslovakia	
	1988	1989a)	1988	1989a)	1988	1989a)	1988	1989a)	1988	1989a)	1988	1989a)
Gross external debt UDD millions	39,116	41,000	17,305	20,600	7,946	9,500	40,856	48,000	2,810	1,000	5,721	6,900
Net debt b) USD millions	35,572	37,520	15,926	19,446	6,168	8,260	25,601	32,778	2,001	-60	4.049	5.370
Debt owed to private banks as share of total %	19.0	-	57.0	-	71.0	-	62.0	-	19.0	-	59.0	-
Debt/Exports ratio c) %	504.0	532.0	290.0	326.0	196.0	263.0	90.0	113.0	32.0	-1.0	78.0	95.0
Interest/Exports ratio d) %	40.4	49.0	21.0	20.0	12.0	14.0	6.0	7.0	4.0	1.0	5.0	5.0
Debt service/Exports ratio e) %	6.0	88.0	54.0	45.0	39.0	40.0	23.0	23.0	23.0	15.0	16.0	17.0

Compiled from tables in: Witolda Malecki and Grzegorz W. Kolodko, *The Indebtedness of East European Countries,* Sveti Stefan, 28-30 June, 1990.

a) Preliminary

b) Gross debt less reserves

c) Net debt/Exports (goods only) in convertible currencies

d) Scheduled net interest/Exports (goods only) in convertible currencies

e) Scheduled debt service/Exports (goods only) in convertible currencies

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