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**"Planning for Spontaneity: The Creation of
Free Markets in Eastern Europe"**

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*** / The views expressed herein are those of Commissioner Lochner and do not necessarily represent the views of the other Commissioners or the Commission staff.**

Good morning. Thank you.

I would like to speak to you today about the prospects for capital and securities markets in Central and Eastern Europe.

I approach this subject with not a little humility since my travels in Central and Eastern Europe have been episodic at best, since I am hardly an expert on their affairs, and since the political and economic situation there seems to change daily. So what I offer today are not final conclusions but, perhaps, something more like preliminary notes.

Let me also note at the outset that though I will refer to Central and Eastern Europe in a unitary fashion, there are, of course, vast differences between countries in those regions. What I have to say, accordingly, applies more or less to each country.

I would like, with your indulgence, to approach my subject, at least at the start, from what may be thought to be an odd perspective: I would initially like to look at Central and Eastern Europe by recalling some events in Africa of 30 or 40 years ago.

When the remaining European colonial regimes in Africa collapsed in the 1950s and 1960s, the newly independent African states adopted economic policies by which, they hoped, their economies could be made to grow and flourish.

By and large, in adopting economic policies, they chose state central planning as their model, whatever more felicitous name they

may have given it. This should have been no great surprise to any observer.

First, in what were at that time referred to as the under-or undeveloped nations, African intellectual elites had been taught the socialist and central planning economic theories then fashionable in many European universities, where properly educated young men and women learned that commerce was a bit unseemly, and that the market economy was an illusion. In that academic tradition, the Soviet Union, China and socialism were the future --- the best hope of all people.

Second, the African choice of an economic model was determined in some large part by an almost inevitable, and understandable, reaction against the formal ideology of the ruling colonial powers. The fact that capitalism was the orthodoxy of the colonial powers, and that central planning had been adopted by the communist powers which supported Africa's escape from colonial rule, provided a compelling sense of legitimacy to central planning as an economic model.

We know with the benefit of hindsight that, on the whole, African central planning failed. Socialism and central planning were largely alien to the realities of African life and their attempted implementation resulted in many cases in little more than endemic corruption, seemingly limitless poverty, wasted lives and, ultimately, in not a few cases, brutality and bloodshed.

There is a certain temptation among devotees of the free market to take a measure of self-satisfaction from this unhappy story. But there developed in post-colonial Africa too much misery for anyone to be pleased with its history over the last 30 years.

Well, what has all this to do with Central and Eastern Europe? Aren't Central and Eastern Europe --- which for convenience I will refer to here just as Eastern Europe; what in Cold War days we referred to as the "satellites", stretching from Bulgaria, Albania and Yugoslavia in the south to Poland and the Baltic republics of the Soviet Union in the North --- very different from Africa?

The answer, of course, is that, in many respects, Eastern Europe is vastly different. Unlike Africa, to take only two matters, though two very important matters, Eastern Europe is nearly universally literate and, by world standards, relatively rich.

Let me for the moment postpone answering my own question --- what has the African experience to do with Eastern Europe --- and instead offer you some brief scenes I witnessed during a trip to Eastern Europe not too long ago.

One day I, among others, attended a meeting in one country with representatives of a Ministry whose task it was, supposedly, to privatize state owned enterprises. We discussed how these civil servants expected to proceed with this task.

First, they said, they would hire western experts to value each state enterprise. Then they would need to decide whether each enterprise should be privatized: some enterprises which they viewed as vital to the nation's interests --- such as utilities --- might not be privatized at all. After thus categorizing enterprises, each enterprise to be privatized would have to be converted into corporate form so that shares could be issued. Then each enterprise would have to be examined and specific decisions made for its privatization. Was the enterprise "too big" and thus likely to become a monopoly? If it was too big it would have to be broken up before privatization. Was it "too small" and unlikely to be able to survive on its own? If it was, it would have to be combined with another enterprise. Did it make sense for a tractor factory and a tractor tire factory to be in the same corporate entity, or should they be separate corporations? Next, each enterprise to be privatized would have to have its balance sheet restructured: debts to the state would have to be converted to equity or cancelled or given commercial loan terms; receivables from and payables to other state enterprises would have to be written off or made current. Then, finally, the Ministry would offer each enterprise for sale to workers at the enterprise, and to the public generally. The hope and expectation was that all citizens would be roughly equal investors in all enterprises, except that some shares of some enterprises would be sold to

foreigners --- though not too many shares and the amounts might differ from enterprise to enterprise, depending on the nature of its business.

We asked how many enterprises there were to be privatized, after subjecting each of them to this long and rigorous process. We were told that there were about 20,000.

On another day in another country I, along with some others, visited with members of the national legislature. We asked what concerned them about privatization and one said how many regulations would be needed: regulations covering how companies keep accounts; regulations covering the creation and enforceability of contracts; regulations governing the welfare of employees; securities regulations; capital markets regulations; foreign currency regulations; laws creating relationships among shareholders; laws creating relationships between boards of directors and shareholders; laws relating to insider trading; laws relating to disclosure; laws relating to brokers and their customers; laws relating to net capital requirements; laws relating to clearance and settlement; and laws relating to taxes. Nothing can be done, one legislator said, without first having laws and regulations in place.

On another day I attended a meeting in another country with a senior state banking official, who had for years led one of several state banks this particular country had created during its 45 years of

communist rule. We asked him about his plans for the future, what he wanted to accomplish. He had been at the bank for more than two decades and he spoke proudly of the operations of his bank throughout the country. He was sure his bank could prosper in the market economy, and he was looking forward to continuing at the bank when it was privately owned. He showed us architect's drawings of the fine new headquarters he was intending to build.

On another day, in another country, in another Ministry conference room, I listened to a government official discuss plans for a stock exchange. He believed there ought to be only one exchange in his country to which all orders should flow so that there would be liquidity and centralized market information. He thought no off-floor trading should be permitted. Commodities and currency could be traded centrally too, and no longer on street corners. He said it --- his reference to the trading of currency on the streets --- with a tone which suggested that trading currency on the streets was not quite dignified.

What do these little scenes, these brief encounters with Eastern Europe indicate? One thing they suggest, at least to me, concerns one of the risks to the development of free markets in Eastern Europe. The risk can be characterized as the hasty application of the legal superstructures and assumptions of developed, western, free market

economies to countries without fully functioning markets and with a history and a tradition of centrally planned economies.

Commentators sometimes speak of Eastern Europe as having a heritage of capitalism which the Communists tried to expunge, and which is now free to re-emerge. It is true that in some Eastern European countries there is some history of a market economy --- in Czechoslovakia, for example. And it is true that there is a tradition of small shop keepers and small farmers in much of Eastern Europe. But though all Eastern European countries may have experienced some industrialization, some were in essence until very recently --- and may still be in some part --- peasant societies.

Even where entrepreneurs once existed in Eastern Europe, they were rarely at the center of the society or the government, and there was little overall societal commitment to market economics. The landed aristocracy which provided much of the East European leadership, both politically and culturally, till the end of World War I --- and later in some cases --- in many instances seemed to view those engaged in commerce as greedy and grasping and not much more than a useful evil.

Even where the market economy existed in Eastern Europe before World War II, few people are left who had any actual experience with it. Lets suppose at the time when World War II came and swept away

the past, you were twenty years of age, you had had some exposure to free markets, and you were a citizen of Czechoslovakia or Poland. That would mean you would now be seventy years old. Your children and your grandchildren would have known or experienced virtually nothing but statist rhetoric and central planning.

Not only is there not much common cultural heritage of free markets to draw on in Eastern Europe, but in many cases the statist, centralizing impulse predates even a passing experience with any briefly nascent capitalism. One government official with whom I spoke said, in frustration, that his country had a centuries old tradition of bureaucracy which was the heritage of the Austro Hungarian Empire, on which the 45 years of communist bureaucracy were a mere veneer.

It seems to me that a key risk to the development of markets, including securities markets, in Eastern Europe is that Eastern Europe will try to impose capitalism from the top down, rather than letting it grow from the bottom up.

The government which seeks to privatize 20,000 enterprises has a thorough plan for doing so, but it is one which may take years, if not decades, to execute and may require an enormous bureaucracy to complete. Is it likely that the bureaucracy will "wither away" if it ever completes its task? The 20,000 enterprises may not survive a prolonged privatization process and, at the least, the human and

economic capital in such enterprises will be at risk during a highly uncertain transition period. There is a possibility that, in the interim, being neither capitalist nor socialist, the enterprises may simply shrivel and disappear. And is it realistic to expect all citizens to end up as equal owners of all privatized enterprises? That hope may reflect socialist, rather than free market, sentiments and economics.

The legislator who listed the laws that needed to be adopted before the market could be permitted to function contemplates years of legislative paperwork in shifting political seas. But isn't it just as plausible that laws could follow the markets and reflect the unique conditions of their growth and development, rather than precede them?

The high official of the state bank who has served in that capacity for much of his adult life contemplates a future much like the past, except for a new headquarters building from which all decisions will be made. Is that thinking more reflective of market competition or socialism?

The official who believes all securities trading should be organized by the state in the state-sponsored market is engaging in state planning for free markets. But is it just as plausible that a market economy could grow faster and more vigorously from the street, from outside state-fixed boundaries, if only permitted to do so?

In one Eastern European country, the new stock exchange is

planned to be placed in the old Communist Party Central Committee headquarters. My first reaction on being told this tidbit was one of ironic amusement: how the world had changed, I told myself; how utterly bankrupt was communism, the party and central planning when the Central Committee's offices could be converted into a stock exchange. But is ironic amusement the right response? Is there not something that is at least disturbing about the state creating and installing the sole national securities exchange in a building that used to house a central apparatus of state planning? Does Eastern Europe expect that the market's fruits can be planned for, and obtained, in a highly regulated environment?

The history of economic reform in Eastern Europe prior to the crumbling of the iron curtain does not, taken alone, give one much confidence in the future. Attempts at internal reform over the last 20 years of communist rule produced little. Bureaucrats sabotaged reforms under the old regimes, and state enterprise managers were uncomfortable with change. They were used to being told what to produce and for whom, and found it unsettling to have to make decisions for themselves. After 20 years of market oriented reform under the old regime, in Hungary, perhaps the most capitalistic of Eastern European nations, two thirds of the work force was still employed by the state and more than 75% of the country's assets were

still owned by state.

These are not hopeful indicators.

It should not be surprising that at least some key individuals in Eastern Europe approach their world like this --- central planning for free markets. In some countries of Eastern Europe leaders and managers are, at least in some part, drawn from those who are experienced in state planning by virtue of their whole working lives. They are the insiders. Before the iron curtain collapsed they were employed by the state as technicians and high level bureaucrats, and have led relatively comfortable lives. They were at least nominal Communists in many cases, and they know where the files are kept, what information is trustworthy, and how to get things done inside the ministries and the state enterprises. The new governments of Eastern Europe, and the enterprises to be privatized, cannot function wholly without them at least for now.

I do not mean to suggest that Eastern Europeans are necessarily captives of their pasts. Numerous courageous men and women contradict such a notion. The media is filled with tales of the growth of the market economy in Eastern Europe. However, we are all at least influenced by our past and that influence can affect behavior.

Eastern Europe has many problems, perhaps too numerous to list, which it must face and deal with if it is to shake off its history, and

many of these are not related --- at least directly --- to markets or securities. There are ethnic rivalries: in Czechoslovakia an amalgam of Czechs and Slovaks live in sometimes uneasy alliance. Roughly one third of all those who think of themselves as Hungarians live beyond Hungary's borders, as both Hungary and her neighbors are acutely aware. Yugoslavia is a country built from ethnic diversity.

There are also basic economic problems: inflation, huge foreign debts, devalued currencies and declining living standards.

Because the Russians are insisting that oil exports to Eastern Europe be paid for in hard currency, gasoline supplies are short. In some parts of some countries the electricity is off one hour in four to conserve power. The agricultural sector is weak in more than one Eastern European country.

Though Eastern Europeans are well educated, skills relevant to a free market economy are in short supply. Books of account of state enterprises are sometimes kept on a cash basis; accrual accounting is ill understood by many. Banks sometimes take months to clear checks, and checking accounts are not widely used in some areas. In some places individual savings are rapidly being diverted to consumption as prices rise, or as the long pent-up demand for western consumer goods is released. Domestically produced goods themselves are frequently of poor quality, and the infrastructure is old and worn

out. Workers have, in some cases, grown used to leisure, to performing work shoddily, and to being paid whether the enterprise succeeds or not. Over employment and unemployment are everywhere.

The goods previously sold to customers in Eastern Europe under noncompetitive conditions now face a flood of goods from the West which are, in many cases, of better quality, no more expensive, and more attractive.

Governments seek to sell state enterprises to citizens who, in many cases, lack the savings to buy them, and who if they buy them may well be disappointed at what they've bought. At least some of those citizens with the money to invest in local businesses may be investing the proceeds of prior years of corruption under Communist governments. Those whose properties were taken by the former Communist governments are now making claims for their return. The challenges of enterprise failure --- bankruptcy and unemployment --- need to be met. Will Eastern Europeans be willing to see some of their fellow citizens grow rich, while others do not? To see some enterprises fail, while others prosper?

In spite of this defeatist litany, there is reason to be hopeful. The early buds of the free market are everywhere. Currency is bought and sold on the street, along with much more. University students sell

Russian military caps and badges to tourists. More importantly, small firms are de jure or de facto being privatized nearly everywhere. Some of those who left Hungary after 1956, or Czechoslovakia after 1968, or Poland after its internal stresses over the last decades are returning, bringing with them their skills and some capital. Aid and technical advice are pouring in. And, best of all, at least so far, there is little evidence of a real lack of political will to press forward to at least what Eastern Europeans view as market solutions to economic problems.

Now, finally, before your patience is entirely exhausted, let me return to Africa. Though Africa made its way to freedom from Western European governance, history and circumstance conspired to doom much African development and, in some cases, political freedom as well. In Africa the statist central-planning economic model was grafted onto what in many cases were tribal societies by a small Europeanized African elite. The attempt at wholesale transformation of an economy proved disastrous, despite the extensive outside advice and help offered by the Soviet Union and other countries.

What do events that occurred in Africa thirty or forty years ago have to do with the Eastern Europe of today? Like Africa then, Eastern Europe now is reacting against its past colonial masters by embracing a new and unfamiliar ideology. For Africa the reaction led to socialism, while in Eastern Europe it is leading to free markets, but in both cases

it is a reaction. Like Africa then, Eastern Europe now is adopting an ideology which may in some part be inconsistent with its history and its culture.

Unfortunately, Africa's opportunity for change and progress was squandered to such an extent that some countries have yet to recover fully. We all hope that a far better future awaits Eastern Europe.

Fortunately, as I have already noted, there are major differences between Africa and Eastern Europe. I believe that the Eastern Europeans' choice of free markets provides a far more promising opportunity to achieve economic growth and prosperity than did the choice of central planning by many African regimes. I think we would be mistaken, however, if we blithely assumed that all of Africa's tragedy can be attributed to the defects of the central-planning economic model.

It seems to me that the African experience also counsels great caution to outsiders concerning the limits of their ability to effect change in other countries. Advising a country on how to effectuate a wholesale transformation of its economy is a task that should be undertaken only with a great measure of humility, regardless of one's belief in the virtues of one's own ideas.

More importantly, Africa teaches that it is unlikely to be appropriate mindlessly to transplant the legal and economic superstructures of one

country to another. These superstructures generally have developed in response to specific cultural and economic conditions that may not necessarily be present elsewhere. In their fervor to propagate their views, outsiders often fail to see and understand the particular conditions of host countries that may call for different approaches.

This danger may well be even greater for the West in Eastern Europe than it was for the central planners in Africa. At least with the central-planning model, the appropriate level of focus for its implementation was on the government elites who would be making decisions for the rest of their country, and on the planning mechanisms that would be necessary to effectuate their decisions.

The driving force behind free markets, however, is most assuredly not in the government elites of a country, or in its regulatory structures. Transplanting the U.S. securities regulatory structure to Eastern Europe will not, ipso facto, transplant a free market in securities to Eastern Europe. The key to the success of free markets is in the rewards that they provide to private citizens for identifying and responding to the needs and wants of society.

There is a real danger that advice to Eastern Europe on the legal superstructures needed to control free markets, will be used to strengthen an already existing tendency of many Eastern European elites to maintain economic control and stifle individual initiative.

Eastern Europeans may, in short, place the "cart" of law and regulation before the "horse" of private initiative. I hope not.

The issue for Eastern Europe is not whether it can escape intellectually from socialism --- Eastern Europe has, so far, rejected that intellectual heritage. The real issue is whether it is prepared to cast off the practical fetters of state central planning and the subtle, deep seated mind-set it can engender. Ultimately one cannot plan what is spontaneous and capitalism, at its frequently unrealized best, is spontaneous above all else. To restrain its spontaneity too strenuously is to risk losing its very virtues, though we all know how those virtues sometimes need restraint.

The impulse that the United States and other Western governments have to help in Eastern Europe is a genuine and admirable one. It is born out of relief at the end of the cold war; out of a belief that the market does make sense; out of simple generosity; out of a sense of ethnic and religious identity; and out of a conviction that we can change the world for the better.

But we must also realize that we cannot make choices for Eastern Europe; those nations must do what makes sense for them, given their history and given their special set of realities. They must, in the end, find their own way and if that isn't the free market as we idealize it, it may at least be something like a free market or, at the very least, more

like the free market than what they've endured for half a century.

In the long run, whether Eastern Europe adopts a particular structure of securities laws isn't terribly important. What matters more is whether their economies begin to show signs of real life which, as I have said, I believe cannot be forced from the top.

There are grave risks involved in weak economies and the heavy hand of overregulation which cannot be ignored. If Eastern Europe fails to overcome at least part of its culture and recent history, the result may be neither freedom nor markets. As the Economist has written:

"If the economics of reform goes wrong, that will be a tragedy in its own right. It would not be the end [of the tragedy], however, because the politics would then surely turn sour as well. It is almost impossible to imagine the people of Eastern Europe either choosing or being forced to return to Communism, such is their anger and disenchantment with the system they are abandoning. But there [are]... other choice[s] besides liberal democracy combined with market economics, and [they are] hardly more attractive than communism. A failed attempt [at] market economics could.... prepare the way for... authoritarian governments...."

I urgently hope that assessment proves to be far too gloomy. If it does prove too pessimistic, I would suggest that Eastern Europeans have learned successfully how to understand and deal with their past as well as their future.

Thank you.