

For release on delivery
8 30 p m EST
December 3, 1991

Remarks by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

at the

1991 Founders' Award Dinner

of the

New York Chapter

of the

Arthritis Foundation

New York, New York

December 3, 1991

My friends, I am honored to have been chosen to speak to you on the occasion of this important and very worthy cause. Tonight, I would like to focus on another important cause: economic reform in the former Soviet Union and Eastern Europe.

It is easy to lose perspective on certain events in a world that is changing as rapidly as ours. However, we should not lose sight of the fact that we have witnessed in the past few years one of the most remarkable developments of this century: the crumbling of communist systems in the former Soviet Union and Eastern Europe. While the inherent contradictions of Marxist systems had been understood for a long while and the disappointment of their people over their fruitless deprivations had become increasingly evident, the rapidity of this disintegration was inconceivable only three years ago.

While we rejoice with the peoples of this part of the world on this dramatic and hopeful turn of events, the easy part is now behind them. What lies ahead is the tremendously difficult task of fashioning sound, stable and fair political and legal systems and the creation of viable economic enterprises. Moreover, success in rebuilding these economies will require mobilizing large amounts of private capital and know-how, which in turn will require well-constructed commercial legal systems based on the law of contracts. This latter ingredient is rarely cited, but is essential to the success of efforts to move to a market-based economic system and to enlist the participation and vast resources of the private sector at home as well as abroad.

In general, political and economic success will depend on the wisdom of the architects of the new order in these countries, the patience of their people, which may have to be like that of Job, and

the willingness of people in our part of the world to provide assistance in many different areas

Right now, the former Soviet Union and many of its former allies in Eastern Europe are facing extremely difficult times. Output and incomes are contracting as the centralized command system for directing resources has broken down. However, the process of replacing that system is slow. It requires not only market signals but enterprises to respond to those signals.

Meanwhile, inflationary pressures are mounting and hyperinflation is a real threat as governments face rising budget deficits--in part to cover operating losses of state-owned enterprises--and resort to printing presses to finance these shortfalls. Indeed, the breakup of the Soviet Union appears to be resulting in a destructive competition in money creation among the republics that could readily engender hyperinflation. These are conditions that can give rise to social and political upheaval that, in the end, could shatter the hopes and dreams of many if new repressive systems fill the vacuum. Clearly, we all have a major stake in a positive outcome.

The great potential of the area making up the former Soviet Union is based largely on its vast endowment of resources. Its massive reserves of oil and gas and various minerals are well known as are its large areas of fertile agricultural land. Moreover, it has great human resources--especially its very large cadre of highly skilled scientists and engineers.

However, its resource endowments are considerably out of balance. Missing is the large number of business professionals that help run the private sector and markets in Western economies. These are the accountants, auditors, marketers, loan officers, and the like.

who are the "foot soldiers" of a market economy. They are the ones who enable enterprises to continually respond to the millions of market signals that in the end guide resources to their most highly valued uses in a decentralized market economy. They provide necessary information to the decision-makers who look for new ways to enhance productivity and lower costs, take calculated risks, and apply sound judgments in making credit decisions. Developing people with such skills obviously is a priority, and we in the West have much to offer in training such professionals and will need to do our part.

Certainly as challenging will be the restructuring of industries. Important to the success of market economies has been competition and, in a certain sense, industrial redundancy. Market economies typically have various firms and numerous plants producing similar or identical products and overlapping transportation systems. The existence of rivals in the market place results in a constructive tension in which sellers are continually seeking to improve their lot by offering the public new and better products and services, lowering their costs through efficiency gains, and providing more attractive prices and terms.

Moreover, as a consequence, shutdowns of individual plants, as a result of strikes or technical breakdowns, rarely have significant economy-wide effects. It is competitive pressures within a market economy that create this redundancy and, with it, economic flexibility. Clearly, the public is served in various ways by a competitive market system.

In contrast, the Marxist ideology on which the economies of the Soviet Union and its Eastern European allies were based views competition as destructive. Accordingly, production was organized through state monopolies. Moreover, Soviet planners evidently

presumed that economies of scale were pervasive--that is, unit costs fall steadily as firm size expands. This reinforced their predilection for single producers.

However, experience in Western market economies casts considerable doubt on the existence of such widespread economies of scale, implying that reliance on single producers has probably contributed to inefficiencies. Indeed, difficulties in managing large enterprises, in particular, tend to be compounded as firms increase in size. In essence, the ability to respond to changing market signals is hampered by large bureaucratic structures and inertia. The unwinding of many conglomerates during the 1980s in the West can be viewed as a recognition of such inefficiencies and inflexibilities.

Reliance on single producers in centrally planned economies has meant that whenever a breakdown of individual plant production occurs, the overall economic system has had difficulty adjusting. Indeed, it is likely that this extraordinarily poorly constructed system is one of the major reasons why energy and capital resources have been so wastefully employed in the former Soviet Union. Compounding inefficiencies further, it appears that Stalin, concerned about the prospect of economic independence of the individual republics, located individual, interdependent plants around the Soviet Union in such a manner as to enhance greatly interrepublic dependence. Imagine the enormous waste of energy as well as capital and human resources associated with moving unfinished goods from one stage of production to the next over vast expanses.

Adding still further to transitional problems is the necessary conversion from military to civilian production. A number of cities around the Soviet Union are almost exclusively devoted to military production. This means that curtailment of military

production does not lend itself readily to employees finding civilian pursuits in nearby areas in the same geographic region. Hence, conversion of plants is a significantly more difficult problem than in the United States where military facilities tend to be located in metropolitan areas where other employment opportunities are available. Moreover, because the mix of civilian manpower needs is likely much less skewed to the high-tech personnel of military factories, relocation and retraining problems for scientific and engineering personnel may be considerable. This is especially troublesome because the military industrial complex in the former Soviet Union employs the vast majority of key scientific and engineering personnel. Those first-rate minds are looked upon for major support of market-oriented economic systems.

Now, as the former Soviet Union seeks to become integrated into the global economy, it is obvious that many state-owned plants are obsolete and noncompetitive. Over time, they will need to be dismantled and replaced. Which plants to abandon immediately and which to phase down will be critical decisions. Obviously, those plants that create greater economic value, as measured by market prices, than the value of the materials processed and underlying labor costs should stay open. The need to recover a return on plant and equipment can be overlooked in these circumstances.

Those that cannot generate sufficient revenues at market prices to cover operating expenses should be shut down unless such costs can be lowered fairly promptly. Unfortunately, there are major uncertainties about implementing these basic principles in what is left of the economy of the former Soviet Union because prices do not represent market values and cost measures are highly suspect. This is where knowledgeable cost accountants would be most helpful and where a

system of market prices for outputs and inputs is essential. Barring such conditions, many crucial decisions can be made only very approximately, and the results, in most instances, are unlikely to be in the best interests of efficiency

Because of the paucity of useful plant and equipment, it seems likely that in the early stages of development of a market economy in the area of the former Soviet Union emphasis will be given to industries with low capital requirements--generally small, light industry This will be supplemented with high-tech establishments drawing on the available large pool of skilled personnel

Perhaps the most difficult challenge will be turning around cultural attitudes shaped by nearly three quarters of a century of Marxism While support for the economics of Marxism has collapsed among many Soviet politicians and there is very little support remaining in the populace, Marxist ideology and its antiprofit, anticapitalist, and anticompetition tenets has been successfully inculcated by the education system to a vast segment of the population Profit has come to be viewed as synonymous with exploitation of workers and consumers Capitalism has been seen as a system built on such profit

Accompanying these attitudes is an absence of focus on opportunities for personal gain along the lines of those that we have grown up with and have taken for granted Any American kid who has run a lemonade stand has come to spot rudimentary marketing opportunities Moreover, that kid has recognized the need to set a price that is not out of line with the local competition and at the same time covers cost Such a focus on identifying and seeking opportunities to meet economic needs is largely absent in the general population in the part of the world that we have known as the USSR

It will not be possible to construct a successful market system if such initiative is not fostered and, more importantly, if there is not politically meaningful, philosophical support within the cultural value system for such an organization of society. There also must be tolerance for some disparities in income. There must be a willingness to accept higher incomes for those who put in more effort and take risks.

On a more concrete level, efforts to introduce market system reforms in the former Soviet Union must focus on building a strong legal infrastructure. Indeed, the cornerstone of any well-functioning market system is the law of contracts. Contract law in such systems recognizes that people are going to be reluctant to exchange items of value unless they are clear about what they will receive in return. Contract law also recognizes that the parties to any exchange will need to have reasonable assurances of such returns and readily available recourse in the event that the counterparty does not comply.

A system of strong contract law thus fosters integrity and confidence in a market system. Where there is integrity and confidence, people become more willing to make commitments, especially longer-term ones, and do not require large premiums as compensation for uncertainties about contract performance. Such confidence plays a key role in guiding scarce resources to their most valued uses and in facilitating innovation.

The integrity of markets is especially important in the financial sector, where resources are channeled through the capital formation process to meet future economic needs and enhance the productivity of the labor force. When investors do not have confidence in the contract process, they require large uncertainty premiums to cover the risk of possible contract failure, leading to

distortions to the capital formation process Expressed differently, a solid legal infrastructure based on strong contract law acts to lower risks that are reducible and hence to lower the effective cost of capital, allowing capital resources to be drawn to their most highly valued and beneficial uses

In contemplating reforms to the economic systems in the former Soviet Union and Eastern Europe, we must avoid the temptation to think that what they need at this time are highly developed financial systems along the lines of ours They do not need a plethora of financial instruments and risk-shifting products buttressed by state-of-the-art information processing and telecommunications technology. At this point, they would be better advised to focus on the basics, starting with reforms to the banking systems that provide efficient, reliable payment systems and that introduce sound credit judgment into the systems so that scarce credit resources find their way to financing the most promising projects This, of course, presupposes the concurrent development of market price systems, so that, as I mentioned earlier, goods produced have greater value to consumers than the resources used in their production Indeed, when the rate of return associated with that greater value is large enough to exceed the cost of capital, we presumably have a creditworthy project

The introduction of a market for public sector and enterprise bonds also is a priority for the former Soviet Union and Eastern Europe The development of such a bond market can be important in mopping up the overhang of liquidity that has resulted from excessive money creation to finance exploding budget deficits Once these deficits are brought under control, a bond market can facilitate the noninflationary financing of any public sector deficits that may

remain. In addition, a domestic market for government debt facilitates the implementation of sound monetary policy by providing an effective means for adding or withdrawing liquidity from the banking system. Moreover, a market for enterprise debt enables state enterprises to be weaned from central bank credit while imposing more market discipline on management. Debt markets can be a very forceful disciplining influence on management, holding them to sound and promising strategies, this occurs as managers seek to convince creditors with funds at risk that management is pursuing product and cost-control strategies that will assure payment of interest and recovery of principal.

At the present time, the uncertainties about contractual rights and accompanying risks are proving to be prohibitive to all but a few investors. It is difficult to entice an investor to commit funds for only a few years, let alone the 20 or 30 years needed for many worthwhile projects, when there are few assurances of the prospects for earnings and ill-defined procedures for recourse in the event of default. However, as I have noted, these prohibitive risks are fundamentally reducible. The prompt introduction of a carefully constructed set of contract laws and a complementary supervisory structure to ensure that the rules of the game will be enforced is essential to the success of the reform efforts in this part of the world.

Let me conclude by saying that the transition to political democracy and market economies in the former Soviet Union and Eastern Europe is a very delicate task, fraught with many pitfalls along the way. We in the West cannot avoid the fact that we have much at stake in this outcome and have much to contribute, especially in the area of technical assistance. Still, the major burden falls on the shoulders

of the leaders of the former Soviet republics and newly independent Eastern European nations to develop credible, comprehensive programs for a prompt movement to a market system, where resources can be guided by market signals. They also must educate their people about the difficulties of such a transition and the need to modify radically, where necessary, attitudes toward competition, profit, and personal initiative. Reforms will not be successful, and participation from the rest of the world meaningful, until a credible legal infrastructure is implemented, built on the law of contracts. Meanwhile, efforts to curb inflation and avoid hyperinflation must be given immediate attention. Much will need to go right if their goal, which we so clearly share, is to be reached and reached in a way that minimizes human suffering and risks to social and political systems.