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On November 9th, 1989, the Berlin Wall came down, symbolizing the end of an experiment in social policy that began more than four decades earlier with the division of the states of Western and Central Europe into market economies and those governed by state central planning. At the end of World War II, as Winston Churchill put it, "From Stettin in the Baltic to Trieste in the Adriatic an iron curtain descended across the Continent." The economies on the Soviet side of the "curtain" had been, in the prewar period, similar to the market-based economies on the western side. Over four decades both types of economies developed with limited interaction across the dividing line. It was as close to a controlled experiment in economic systems as could ever be implemented.

With the books now open on this experiment, we of course have learned much about how communist economics works, or, more exactly, does not. But the biggest surprise is what this experiment is teaching us about how our own western economies and societies function. Or, perhaps more exactly, refreshing long dormant memories of the process.

Much of what we took for granted in our system and had grown to assume to be human nature was not nature at all, but culture. The dismantling of the central planning function of a communist economy does not automatically establish a free market entrepreneurial system. There is a vast amount of capitalist culture and infrastructure underpinning market economies, which has evolved over generations: laws, conventions, behaviors, and a wide variety of business professions: accounting, auditing, banking, and marketing.

We are gaining significant new insights into how market systems work as the new leaders of the former communist states, with our help, struggle to convert centrally planned economies to ones based on free markets. An understanding of how their systems worked, relative to ours, is crucial in managing the transition. Economists have had considerable experience in observing how market economies converted to centrally planned ones, but have virtually no exposure in the opposite direction. Ironically, in implementing the latter, we are being forced to understand fully the roots of our own system.

At the risk of being somewhat academic, I'd like to take some time to describe why countries with centrally planned economies have not been able to match those with market-based ones in promoting the welfare of their citizens, and hence why the four-decade experiment in economic systems turned out in favor of capitalism. This explanation will help us to outline the problems that will have to be confronted in a successful transition of communist economies to capitalistic ones.

The most cogent way to understand why a centrally planned economic system, such as that which existed in the Soviet Union, has great difficulty in creating wealth and rising standards of living is to examine how the production and distribution of goods and services takes place in such an economy.

In theory, and to a large extent in practice, production and distribution are determined by specific instructions—often in the form of state orders—coming from the central planning agencies to the various different establishments, indicating from whom, and in what quantities, they should receive their goods and

services, and to whom they should distribute their final outputs. The machinery factory is given a quota to produce a certain number of machines to be shipped at a certain time to industries x, y and z. At the same time, it is given authority to procure from the relevant steel works so many tons of hot rolled sheet or cold finished bars, certain electronic components from the electrical works, etc. Its employment and wages are predetermined.

But, although wages are paid in cash, the actual ability to employ cash for purchases is often constrained by the second element frequently found in a centrally planned economy, namely, rationing or its equivalent, standing in queues for limited quantities of goods.

The consequences, as one might readily anticipate, are huge shortages of products that consumers desire, and are not produced in adequate supplies by the state orders, or huge surpluses of goods which, while produced, are not wanted by the populace. I do not suspect that shoe stores ended up with an excess of left-footed shoes, but I am not fully convinced.

One might think that the planning authorities should be able to adjust to these distortions. They try. But centrally planned economies face fundamental handicaps in making such adjustments. They do not have access to the immediate signals of price changes that so effectively clear markets in capitalist countries. In addition, individual enterprises have no incentive to respond to shortages or oversupply since their only obligation is to fulfil their part of the "plan," while economic planners are generally insulated from the demands of consumers by totalitarian political systems. Finally, to adjust means to move resources, people,

equipment, and factories from producing one good to producing another. This profoundly offends the underlying culture of a centrally planned economy, namely stability

The ideal state of affairs for such an economy is one in which there is continuous production of the same type of goods, of the same quality, of the same design, obediently purchased in repetitive quantities, with cash wages backed by rationing coupons. Innovation, new ideas, new products, and altered specifications cannot readily be accommodated in such an environment. Indeed, the extent to which such changes occurred in the centrally planned economies of Eastern Europe seemed invariably to result from the overseers of the state orders endeavoring to replicate changes in western market economies. One would presume, however, that had no such market-based economies existed side-by-side with the centrally planned ones, that few changes from the old ways of doing things would have been implemented.

That these economies were highly inefficient is best illustrated by the fact that energy consumed per unit of output was as much as five to seven times higher in Eastern Europe and the former Soviet Union than in the West. Moreover the exceptionally large amount of resources devoted to capital investment, without contributing to the productive capacity of these economies, suggests that these resources were largely wasted.

In addition, such gaps in efficiency actually understate the gap in performance because they fail to take into account the impact of industrial activity on the environment. The market economies of the West have expended resources

to minimize the adverse impact of industrial activity on the environment and thereby lowered their net output. No such resource allocation was made in the Soviet bloc, and the cumulative effect of this neglect is appalling.

In sharp contrast to the quasi-permanence of centrally planned economies, capitalist market economies are driven by what Professor Joseph Schumpeter, a number of decades ago, called "creative destruction." By this he meant the continuous obsolescence and abandonment of goods and services, replaced by newer ways of doing things, newer products, and novel engineering and architectural insights. The result has been an economy of continuous retirement of factories and equipment and a reshuffling of workers to new and different activities. Indeed, what is not fully understood about the American economy is the extent to which, as the Federal Reserve Bank of Dallas recently pointed out, it "churns" as new activities and new jobs continuously displace older ones. Indeed, it is nothing short of startling to realize that in the United States approximately 400,000 workers a week lose their jobs matched normally by a slightly higher figure of newly created job openings.

Such job turnover is facilitated by the extraordinarily large number of new small businesses that come into existence every week and month, offset by a comparable number of establishments that fail, down-size through mergers, or are otherwise abandoned. Market economies in that sense are continuously renewing themselves. Innovation, risk taking, and competition are the driving forces that propel standards of living progressively higher.

Sometimes, perhaps, we do this to a degree that is not sustainable, resulting in what we call the business cycle. An example struck me several years ago as I was driving into downtown Dallas from the airport. I remember being fascinated by how brand new the city looked, almost as though it had been torn down and reconstructed overnight. It may not have been overnight, but it was close. Replacing brick and stone with steel and glass can sustain a high level of economic activity for a time, but only as long as there is still brick and stone to be replaced

What drives this innovative process, as I indicated earlier, is a whole infrastructure of market institutions. Until the Berlin Wall was breached, and the need to develop market economies out of the rubble of central planning became apparent, little thought had been given to this critical institutional infrastructure by the economics profession. It is certainly apparent from the recent experiences in Russia, and elsewhere in Eastern Europe, that the mere elimination of central planning does not in itself automatically create a market economy. Nonetheless, you do get something akin to it in that black markets replicate much of what seemingly goes on in a market economy. But there are really quite fundamental differences.

Black markets, by definition, are not supported by the rule of law. There are no property rights in such a market, that is, in the formal sense, the right to own and dispose of property protected by the enforcement power of the state. There is no law of contracts or bankruptcy, or judicial review and determination again enforced by the state, the essential ingredients of a market economy. Black

markets function in a way similar to the legendary "wild west." Recently when I raised this issue of contract law as a necessary condition for markets, some of my Russian friends countered with the example of the American "wild west" as the model for economic development they may be following. In the towns and railroad camps of west Texas in the 1880s there was no well developed system of contract law efficiently enforced by legitimate police powers. But there was a form of market. Indeed, a form of black market where contracts were crudely enforced by such legendary figures as saloon-keeper—and justice of the peace—Roy Bean, who, by his own assertion, provided the only "law west of the Pecos."

Similarly, it is true that even during the central planning era of the old Soviet Union, an impressive amount of black market activity did exist and, indeed, it may well have made living more tolerable in that it provided an escape from the failings of the planning system.

But a formal legal structure, which defines and protects property rights and trade through the laws of contract and bankruptcy, must preexist before a viable sophisticated market economy can emerge from the remnants of a centrally planned one. Even now many potential investors in these newly emerging economies fear that a signed contract, which has the force of law and is backed by police powers in the West, is nothing more than an autograph in some economies of the East. Maybe a few Russian Judge Beans may be helpful.

In addition to a legal structure, a functioning market economy also requires a number of business professions, professions that have no purpose and,

hence, no existence in a centrally planned system. I speak of accountants, auditors, and marketing specialists, all those professions whose activities are an integral part of the mechanism of production and distribution in a market economy, functions which are accomplished by state orders, rationing, and queuing in a centrally planned economy

The effects of accounting, for example, or lack thereof in the old Soviet Union, is really quite instructive. A machine or a facility in the old Soviet Union was generally continued in operation until it literally broke down. Thus, it is not very much of a surprise to see on collective farms tractors that look as though they hark back to the 1920s. What accounting in a market economy does, if perhaps in a somewhat crude form, is to estimate economic depreciation of an existing facility such that, when the net book value of a facility approaches zero, its capability of adding value to the production process also approaches zero. This is a signal that such equipment should be replaced with a newer version.

What constitutes the state of economic depreciation, itself, is of course continually changing. Obsolescence is a relative term. But no matter what principle of accounting is applied in a market economy, one rarely, if ever, finds 50-year-old facilities still functioning. But such facilities were widespread in the old Soviet Union.

The sophisticated auditing procedures that have evolved over the years fine tune our accounting procedures to improve the basis of decision making that in a market economy replaces central planning.

The profession of marketing endeavors to ascertain the multitude of choices that consumers and business make on a day-by-day basis and which, as a consequence, contribute to a system of price signals that drive production and distribution in a market economy. In a centrally planned economy this function is crudely accomplished, if at all, by the political hierarchy who substitute their judgments of what goods are valuable for those of their fellow citizens. It is, thus, no accident that in defense and military activities the shortfall in the performance of centrally planned economies was far less than in civilian activities, relative to their counterparts in market systems. Considering that the military-industrial complex was the most technologically advanced part of the old Soviet system, it is ironic that it is in defense activities where the transition to a market economy in Russia is so difficult. The military-industrial complex tended to be so special and privileged that integrating it into the rest of the economy will be particularly daunting.

Finally, the most important difference between market and centrally planned systems, is the role played by banking and finance.

In a centrally planned system, banking and finance play a decidedly minor role. Since the production and distribution of goods and services is essentially driven by state orders and rationing, finance is little more than record keeping. While there are pro-forma payment transfers among state-owned enterprises, few if any actions are fundamentally driven by them. Payment arrears, or even defaults, are largely irrelevant in the sense that they are essentially transactions among enterprises owned by the same entity, that is, the state.

There are no credit standards, no interest rate risk, no market value changes, that is, none of the key financial signals that determine who gets credit, and who does not, and hence who produces what, and sells to whom, in a market economy

As a consequence, the central planning systems of the old Soviet Union and their Eastern European satellites usually consisted of a single bank and a savings bank system, the main purpose of which was to hold the savings deposits of the populace. There were of necessity more sophisticated institutions to finance international trade and payments. Nonetheless, the domestic financial structures were primitive. Indeed, non-cash monetary instruments, important means of payment in most market economies, barely existed. Clearance of payments, which in market economies are either instantaneous or, at most, take several days, takes weeks or months. The basic reason, of course, is that it didn't matter. Few decisions in the centrally planned economies were affected by the lack of a developed financial system.

The evident primitiveness of the financial system and its irrelevancy in a centrally planned economy creates a truly important insight into how crucial in the production and distribution of goods and services are the sophisticated financial institutions and instruments in the West.

To repeat, the presumption that if you eliminate the infrastructure of central planning and free prices, wages, capital movements, etc. that a free market will automatically develop overnight is dubious. Scrapping the central planning system is obviously a necessary condition of the evolving of a market system. But unless there are rudimentary institutions that can be rapidly converted

to effective market-based structures that can facilitate production and distribution, the transition will be significantly stretched out

The differences in the pace of evolution to a market economy between the former Soviet republics, on the one hand, and those of Eastern Europe, on the other, is quite instructive. Poland, Czechoslovakia, and Hungary had the remnants of market institutions that existed prior to World War II and, while feeble, were more rapidly resurrectable than in the former Soviet Union where the last remnants of market economies were wiped out at least a generation earlier.

Even more deep-seated than the specific market institutions, the law of contracts, bankruptcy law, property rights, the disciplines of accounting, auditing, and marketing, are the attitudes of people in the most profound sense, the culture. How do people deal with one another? What is the implicit premise of the exchange of goods and services in various different types of economic systems? How do education and ideology interrelate? We have learned more about these inculcated differences as the old centrally planned economies break down and, accordingly, how much of our culture is developed and not solely the consequences of human nature

In a market economy, youngsters learn the workings of free trade and exchange very early. What are the appropriate attitudes among individuals in, for example, an exchange of money for goods at the grocer or the drugstore? Presumptively there is a status of equality that exists between the purveyor of goods and the purchaser in a market economy. There is in most instances due

respect, mutually accorded. The customers rely on their suppliers. Sellers' livelihoods rest on their customers. In a centrally planned economy, by distinction, the job of the purveyor of goods does not depend on the sanction of the consumer. And, indeed, for those of us who have been exposed to waiters and clerks in restaurants and retail establishments in the old Soviet Union, this behavior pattern is strikingly obvious.

The differing attitudes and views are carried from generation to generation through family value and education systems. Hence, the process of full transition will obviously be slow. One of the prominent young reformers of recent years thought the transition was moving quickly among those under forty years of age, much less so among their elders. Altering what a nation teaches its children is a profoundly difficult task, and clearly cannot be accomplished overnight. Changing attitudes toward property and profit is not simple. They derive from the deepest values people hold.

The process of transition will be especially difficult for economic reasons as well. "Creative destruction" in an advanced market economy is gradual. There are rarely huge discontinuities. But the centrally planned economies are frozen in time. They reflect an earlier age. I suspect that the output of Czechoslovakia in say 1988, could have been competitive in the western markets of say 1958, but not later. But rebuilding a modern competitive market economy from a 1958 base is a disruptive, expensive, and time-consuming task.

Another difficult aspect of adjustment in Eastern Europe and the former Soviet Union will be overcoming distortions in the location of economic

activity Marxist ideology has always presumed competition to be destructive and, hence, the centrally planned economies of the Soviet bloc organized their production through state monopolies Moreover, Soviet planners tended to overestimate economies of scale. As a result, the production of most products was highly concentrated geographically, often in huge "one-industry" towns. Soviet planners also tried to promote economic development in the many non-Russian regions in order to offset centrifugal forces ever-present in Moscow's multi-ethnic empire. Whole industries were distributed across the Soviet bloc with little regard to transportation costs or the other factors that determine industrial location in market economies.

Because of these policies, the regional economies of the former Soviet bloc are inter-dependent to an abnormal degree. This, in turn, has meant that the disruptions to inter-regional trade that have, inevitably, accompanied the break-up of the Soviet economic system have been very costly Moreover, the regional concentration of production means that the imposition of effective prices as part of the transition to a market economy has generated a quixotic pattern of regional impacts Some regions have benefited from the transition to a market system, particularly those regions that are rich in natural resources But many more regions are dependent on uncompetitive industries, and these regions have been hit hard by the change in economic system. Correcting these distortions will be costly, requiring a substantial portion of the labor force either to move or to learn new skills.

Given the difficulties of the transition, one almost would like to move the populations of these countries to a vacation hotel for a few years while the old system is torn down and rebuilt from scratch. Reformers, of course, have no such luxury. The adjustments as we can readily observe are slow and socially wrenching. But there is no alternative. Fortunately, the peoples of the former Soviet Union and those of Central Europe appear to understand this. The percent who would truly like to resurrect the old regimes is small.

Moreover, there is evidence that the economies of a number of countries in Central Europe have bottomed out. In fact, the situation in the region may not be as bleak as some data might suggest. According to official statistics, real output in most of the states in Eastern Europe and the former Soviet Union has fallen by one third to one half from peak levels recorded in the late 1980s. These figures almost certainly overstate the true decline, however. First of all, private sector output, which has been expanding, is probably under-reported in these statistics. Second, recent output declines may simply reflect the elimination of over-reporting that was rampant under the old system. One indication of this, is the fact that energy consumption has not fallen by anywhere near as much as GDP or industrial production. Finally, output declines are, at least to some degree, concentrated in industries where there is little demand for the products produced, suggesting that social welfare is not diminished to the same extent as output.

That the former state-dominated economies successfully change into market-based systems, hopefully with democratic political orientations, is crucial to the West. The extraordinary efforts of the G-7 major industrial countries in

mobilizing financial support for Russia indicates the importance that is attached for Russia to succeed in its transformation. Similarly, over the past few years, considerable financial assistance has been provided to East European countries in support of their reform efforts. The most productive use of such assistance would be to finance investment in the private sector rather than consumption

Official assistance is no doubt valuable and needed in supporting these countries' reform objectives. Over time, however, what these countries do themselves in utilizing their natural and human resources, mobilizing and channeling their domestic savings efficiently and productively, and attracting foreign investment will be considerably more important in determining the success of their efforts than foreign assistance.

In addition, one of the most effective ways for these countries to transform their economies is through their participation in the global trading community. Post World War II history has shown how beneficial trade among market economies has been in promoting economic growth, raising standards of living, attracting foreign investment, and nurturing peace. International trade typically takes place in highly competitive markets, and international prices provide very effective market signals for efficient resource allocation. International trade has proved over time to be a powerful and lasting engine of growth. Reliance on foreign assistance can be only a stop gap.

East European countries and the former Soviet Union can benefit from the competition of increased trade with the rest of the world. Increased exports help relax the financing constraints that these countries face, and, with increased

foreign exchange, can accommodate increased imports as well as meet other financing requirements. Given the vast resources of some of the East European economies and the former Soviet Union, there is no reason why these countries cannot substantially expand their exports in the years ahead. But the right policy environment obviously must be established and maintained

However, in order to integrate the former Soviet Union and East European countries meaningfully into the global economy, the West must be ready to allow the goods for which these countries have a comparative advantage into their markets. Protectionist measures directed against these countries give these countries the wrong message—namely, that we ourselves are not prepared to accept the verdict of competitive market forces at a time we are endorsing the virtues and benefits of competition for these countries. The avoidance of trade protection and the reduction of existing trade barriers for manufactured goods, agricultural goods, and services, therefore, should be high on the international economic policy agenda

Up to this point I have spoken exclusively about the economic benefits of a market system. But there is an important link between economic and political systems. It is no accident that real democracy developed in the part of Europe that had a market-oriented economic system. In fact, this is merely one example of a general rule. The fact that virtually all real democracies have liberal, capitalist economic systems suggests that such an economic system may well be a necessary, although clearly not a sufficient, condition for the development of democracy. When too much economic power is concentrated in the hands of the

government, the governors' self interests tend to dominate the interests of its citizens.

We should remember the most important task of Eastern Europe and the former Soviet Union today is not economic reconstruction; it is the establishment of democratic political systems that respect and protect individual rights. Market-oriented economic systems should be promoted as much because they are the economic system that is most compatible with democracy, as because of its unquestioned economic superiority

If successful, the changes taking place in Eastern Europe and the former Soviet Union today will benefit the West in many ways. The full integration of the peoples and natural resources of the Soviet bloc into the global market-based trading system creates opportunities for investment and global economic growth that are truly awesome. Most importantly, the spread of liberal democracy to this region will, in the long run, make our world safer

Eastern Europe and the former Soviet Union's transition to democratic market economies will doubtless be both difficult and slow, but the rewards are patently worth waiting for.