THE BUILDUP OF MARKET INSTITUTIONS AND ECONOMIC POLICY IN TRANSITION

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ABSTRACT

This paper has two major aims. First, it examines the peculiarities associated with the rise of institutional structures in economies in transition from central planning to market. Second, it analyzes the changing role which these structures play in relation to economic policy-making. An attempt is made to decompose the structure of institutional buildup in this process and to consider the arguments concerning the timing, sequencing and implementation of control instruments as the reform evolves. The analysis results in normative conclusions discussing the strategic guidelines for the implementation of economic policy in the process of shaking out the old bureaucratic institutions and preparing the way for the final stage of efficient large-scale privatization. The expeditious deployment of the capital market, and of financial institutions in general, plays a key role in progressing with reform, stabilization policy and efficient exploitation of market functions.

1. THE RISE OF ECONOMIC INSTITUTIONS

Conventional economic analysis is largely preoccupied with the investigation of economic transactions (exchanges) between autonomous economic entities (agents) under the tacit assumption of given institutions and hierarchies. Needless to say, this is a very useful approach if the institutional side is well established and develops incrementally in accordance to the evolution of the market. If we accept that command (planned) and liberal (market) economies are two different paradigms for the realization of economic transactions, we must conclude that there must also exist, as natural organizational complements, two different institutional structures supporting their operation. In cases of a "normal" economic state, where there is perceived only a single state of optimum and no clashes between paradigms occur, the role of an institutional superstructure can be played down or disregarded as irrelevant.

Once society commits itself to scrap abruptly the paradigm of command and to switch to a market, the economy faces numerous obstacles which lock it into a series of vicious circles

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leading to a deadlock. The recent events of the last 20 months in Central and Eastern Europe have proven that the transition to market economy presents a much more difficult problem than was originally thought. Indeed, no answer can be found within the seemingly similar, but reversed, process of switching from a market to a command economy which was economically (but definitely not politically) smoother. The transient societies from the Elbe to the Kamchatka are floundering, showing little hope for quick recovery.

Why is economic instability, which radiates throughout the rest of society (eg. into politics and morals), so difficult to solve in transient economies? Why are commodity market transactions and their contracting so inefficient? Why are transaction costs so exceedingly high? Why do markets not clear and instead operate in a highly distorted way, that is, in a situation of inelastic and contracting supply? Why is the reallocation of resources so slow? Why have the released resources not re-entered the production process? Why does the future play such a marginal role in microeconomic decisions? Why can we observe in all transient economies phenomena that have been seldom encountered in Europe before: deep depression coupled with high inflation? Why do signs of negative growth, rising unemployment and creeping international indebtedness suggest 1929-33, while other signs do not fit this image - such as rampant inflation and the parallel shortage of a large number of commodities with deregulated prices (viz. /1/). The answer to these questions, as presented in this paper, could be labelled as the consequences of collective action failure.

What rests behind the collective action concept? According to institutional economic theory (eg. Commons (1934), (1970), Williamson (1975)), it is a set of man-made rules imposed on society - a society which is essentially scattered into elements that, without these rules and under conditions of uncertainty, clash into conflicts of interest. These rules are intrinsically different in the totalitarian and the democratic society. The latter is marked by the paramount role of the market in achieving economic order. However, the existence of the "market" alone is generally not a sufficient condition to produce order from conflict. The creative and cooperative nature of agents in the market is finally achieved by the invention of rules of the market game and by economic institutions which constitute a more organized way of introducing human values, morals and a predefined behavioral pattern (something like a substitute for instinct) to the interaction of economic agents. The crucial motives for bringing about a social consensus for the build-up of market institutions are the resultant economies in transaction costs, the faster reallocation of resources and, finally, the easier adjustment of all participating agents to economic equilibrium under Pareto efficiency criteria.

Market and collective action failures can be brought about by numerous causes:

a/ The intensity and the number of exogenous shocks to which the economic system must adjust. In this respect it is important to stress that mainstream economics (ie. the general equilibrium theory) is concerned with small (marginal, infinitesimal) changes of the old equilibrium, while the number of changing variables is kept to a minimum thereby allowing an analytically manageable solution (eg. under conditions of ceteris paribus). Thus the process of subsequent piecemeal adjustments for the relevant variables to a new equilibrium (tatonnement) can be described by formal logic. Disruptive catastrophic shocks, present concurrently in nearly all variables, are less elegantly dealt with by this instrument. In addition, it has difficulty in explaining an out-and-out breakdown of the whole economy. In the moments of transition the explanatory and the prognostic power of general equilibrium economics is thus largely weakened, which undermines the analytical capabilities of economic agents.

b/ The severity of conflict of interests among economic agents. Here the depth of conflict among producers, consumers, government and unions can be measured by the extent of the forthcoming redistribution of capital, bankruptcies, unemployment, inflation and reallocation of labour. It is expected that in Czechoslovakia in 1991 a quarter of the capital and labour will be subject to a risk of reallocation. In East Germany it may be a reality for half of the labour force. In this respect the situation resembles more a war economy than any other.

c/ The extent of uncertainty in future economic contingencies. The concept of bounded rationality (Simon (1958)) helps to explain some basic behavioral problems of transient economies. The disintegration of traditional foreign markets, coalitions of corporate management in monopolistic environment, enormous shifts in relative prices and changes in consumer tastes are just a few examples of the objective sources of uncertainty in transient economies. This uncertainty is amplified by infrastructural weaknesses (eg. by malfunctioning telecommunications, thin electronic networks) and undeveloped market culture. In addition, the enormous potential for intentional distortion of basic information cannot be discounted.

d/ The complexity of behavioral patterns of managers . Since many corporate producers and their agents in a post-command economy do not accept the long-run maximization of enterprise profit as their true objective function, their set of strategies is much more complex than is the case in a developed market society. Various speculative strategies in objective functions are much more common. In transient economies even suicidal bankruptcy, stealing, embezzlement, rundown of capital, shutdown of production or maximization of hoarded "reserves" must be considered as economically rational behaviour, subject to given constraints (viz. Quandt, Tríska (1990)).

e/ The pessimism of expectations. Rational expectations theory is fully consistent with this aspect of behaviour. Once the agents accept the expectation of economic breakdown as a motive for their decisions, it is very difficult to persuade them to abstain from engaging in a vicious spiral of panicky behaviour.

f/ The extent of public goods aspects intermixing with market economic decisions. Large segments of the economy outside the sphere of traditional public goods like health, education, culture, defense, transport, justice, communication and public administration are prevented from making efficient market adjustments. Many ailing state enterprises and cooperatives bargain for being classified as socially sanctioned and are subsequently bailed-out due to their alleged "public cause".

g/ The role of negative externalities. In command economies the pollution and other environmental problems represent an enormous social cost in practically every production locale. Since these huge costs and "benefits" are generally exempted from the market, it is extremely difficult to treat them as economic variables and incorporate them into decisions, even if the markets were otherwise perfect.

h/ The degree of market imperfections. This may be the case of bargaining between bilateral monopolists or so called "small numbers" exchange relations, where no competitive forces drive the exclusive agents into competitive behaviour. Opportunistic outcomes of oligopolistic collusion naturally lead to price distortions, rent seeking and transactional difficulties. The Coase theorem and 2-person game theory apply well to this environment.

i/ The disparity of time factor. Once there is a difference between the lifespan of capital outlay and the lifespan of executive controls, while the former is evidently greater, the problem of long-term decision making arises. Seeking to protect his vested interests, the manager with only a short-lived executive power will be inclined to disregard the burden of future costs in favour of his own short-run benefits. Sound investment decisions in accordance with market signals will thus be distorted at the expense of future generations of owners or managers (viz. Pejovich (1991) /2/)

j/ The disruption of property rights. It is not only the disrupted state of the property register and the legal or the judicial system which thwarts the creation of functioning property rights, but also the confused claims of the former owners (or a queue of their heirs) employees, spontaneous privatizers, the state and the public, who bring the efforts for a quick consolidation of the decision making to a standstill.

k/ The split between economic interest of owners (principals) and managers (their agents). This kind of market failure is caused by incomplete property rights. It is quite common in transient economies that the real owner of a property is either anonymous (as in state companies) or is represented by a collective body without responsibilities at ownership (as in formal cooperatives). The managers either abstain from exercising the property rights that provide the highest long-run returns to capital or simply appropriate a part of the returns as remuneration for themselves. The clash between the vested interest of an established executive agent and the interests of a weak owner (viz. /3/) is a very serious cause of market inefficiency during transition when the judicial and ethical foundations of a society have been shaken.

To conclude, the more Heraclean are the labours loaded onto the weak emerging markets of transient economies, the higher is the risk of market inefficiency and collective action failure. The market itself is not a free good: it needs service, maintenance of rules and large investments. The larger the burden loaded on it, the more demanding the requirements necessary for guaranteeing its smooth performance. Without a doubt, the markets of former command economies have been (and still are) grossly neglected, ailing objects. In order to refine them, we must build up competent and competitive market institutions /4/.

2. TIMING AND SEQUENCING OF ECONOMIC TRANSFORMATION

The conclusion we have just arrived at, which concerns the buildup of the market, is of crucial importance. To avoid misunderstanding, let us sum up once more its significance. The economic transformation of post-command societies is a distressful process of seeking a new socio-economic equilibrium while the old social order is still active. There are sound reasons to assume that at the start of transition the market is grossly insufficient (see points a - j above) and unable to bear its pivotal functions straight from the outset. The role of State (or Authority), as a force against the looming anarchy, emerges. However, yielding fully to this pressure is very dangerous. If the transition to market is to succeed, market and collective action failures cannot be accepted as reasons for giving carte blanche back to the State, which in fact is responsible for the trouble. This is an opposite reaction to some current moods in the capitalist West, where market failures are not taken as a pathology, but often judged as a naturally evolving entity to which the society is to adjust.

Reconstruction of the market and returning to its preconditions, as defined by neoclassical theory, are the most pressing economic tasks of transition. A substantial part of social resources should be directed for these purposes. In this process the state cannot stay idle or neutral. However, its active role must be a rather contradictory one: to prepare its own negation in many fields. It is the state, by means of superintending the rules (instead of superintending the decisions), who should prepare the road to a decentralized market, reallocation of resources and to the transfer of economic decision making to entrepreneurs and consumers. Because of the nature of transition as an unstable second-best process ("economic purgatory" is perhaps much better label to use), the reconstruction of economic institutions should commence immediately, and proceed as quickly as possible on all fronts. In some recent papers on transition it is argued that there are no other reasons for quick reform but the political ones (ie. reasons to evade the political instability and recoiling to anarchy or some sort of totalitarian rule). It is only a part of the truth. The transient period is by its nature a very inefficient state of affairs, and as such it is also economically rational to speed up the course of these events and minimize the economic losses /5/.

Should all economic institutions be assigned the same weight, the same pragmatic value, the same urgency for functioning, or the same time schedule for completion? Certainly not! There are two reasons. First is a traditional argument where the institutions are only the means, serving certain ends, while the ends may be subordinated into a hierarchical structure. In other words, the institutions are a sort of a soft catalysts accelerating the processes in the exogenously given real (hard) sphere. There they should follow the time-ranked discrete steps, for the promotion of which they were created. The technocracy of this approach is clearly transparent /6/. The second argument is that not all market institutions require the same time requirement to bring them to operation. Some can be implemented in a few days (eg. changing the discount rate or banking reserves ratio), while others require many years (eg. the buildup of the labour market). So the observed "timing" and "sequencing" of steps in economic transformation may finally be less a result of conceived plans for restructuring than a result of (generally unwanted) different natural paces of evolution and deployment of individual segments in the mosaic of institutional changes /7/.

If we observe that it is the economic institutions which are the laggards retarding the whole process of real changes (ie. the efficient reallocation of resources) and we want to speed up their evolution, we must turn to the control interface between the economy and the society - to economic policy. Let us therefore analyze the structure of the transformation policy in transient economies.

Policymaking in transient economies has been concentrated nearly exclusively in the following list of eight specific policy instruments. It is necessary to stress that each of them is primarily designed to promote deregulation and competition:

a) fiscal policy
b) monetary policy (including interest rate adjustments)
c) exchange rate policy (including currency convertibility)
d) foreign trade policy
e) commodity price policy (including fair competition)
f) labour market policy
g) capital market policy
h) privatization policy (including property rights).

It is quite apparent that the above set of instruments widely differs from those used in old Keynesian therapies, while the difference in relation to new classical remedies rests in its magnified dosage. The policy target variables, as presented here, are primarily focused on the Heraclean task of fundamental reallocation of resources. Only secondarily is there the task of controlling inflationary pressure and external equilibrium, while the role of employment and of short-run growth is assigned a marginal importance. Both policy instruments (control variables) and target variables in transient economies in principle differ from the conventional approach to policy-making (see Tinbergen (1952)), which accentuates the macroeconomic and the demand sides (and not the microeconomic and the supply sides). This is quite natural because in normally functioning economies the microeconomic sphere could be exempted from social control and from centrally guided policy-making. The accommodation of the microsphere and its supply side could be left to their own gradual evolution under the guidance of well functioning markets and entrepreneurs. Dramatic changes in this sphere, as well as in the institutional sphere, were under these circumstances neither expected nor necessary. But exactly this is the *sine qua non* of the changes in transient economies! Without concentrated social surveillance promoting the microsphere and its supply side, the emerging uncohesive class of entrepreneurs will not be able to overcome the built-in gravitational forces safeguarding the survival of the old local structures.

In transient economies, only by completely discarding the philosophy of keeping the institutional arrangement constant, the microeconomic supply side can become an object of policy control. So finally we came to a very important link between the economic policy-making and the urge for deep microeconomic real ("hard") changes, which are mediated through coordinated institutional ("soft") changes. Especially the non-conventional policy items e-h are designed to fulfill this crucial task. This process is nevertheless partial and indirect. Some important economic activities were deliberately excluded from our list (a-h), eg. the harmony of interpersonal relations in the workplace, the level of entrepreneurial control, efficiency or innovations. These activities were not assumed here as possible policy instruments, because they were assumed to be final targets, mediated through the effects of indicated instruments (viz. /8/).

The mentioned ranking of policy instruments (a-h) is not haphazard, too. It takes into account the sequencing and timing of the operational availability of instruments, which in turn reflects their different degrees of natural complexity and thus their readiness to function as an efficient instrument for policy purposes. Since the primary problem of transient economies is to find a trajectory from the old equilibrium of command economy to a new socioeconomic equilibrium of the market economy, each of the presented instruments is earmarked for the fulfilment of two tasks: first, to destabilize the equilibrium of the command economy and, then, to safeguard the process of convergence to the new market equilibrium. Each of them therefore has its own "shakeout" stage and its own stabilization stage. The failure of any instrument in either of the two stages must thus be balanced with the compensating effects of some remaining instruments - in the first place by those ones listed above that one in default.

3. THE KEY ROLE OF FINANCIAL INSTITUTIONS

Now we are ready to turn to the more practical question of sequencing. Let us use an example of Czechoslovakia (CS) in 1991 - a country plunged decidedly into reforms in all fields, but evidently well before experiencing the rock bottom of the trough of recession and ensuing stabilization. With the exception of East Germany, the situation in other European transient economies is not too far ahead or behind.

Actually, in CS, there are two instruments of the market economy which can be still treated as non-operational: the competitive labour market and privatization. The capital market situation is also highly controversial because its instruments are still in infancy and not ready to perform its delicate shakeout and stabilization roles. At the same time, there are fierce foxhole battles in price liberalization and foreign trade deregulation. Given that, the only instruments available for safe stabilization policy are the first three mentioned: fiscal, monetary and exchange rate policies. It is obvious that if at this stage the "midway" policy instruments d-e are not progressing, transformation cannot progress either, because the limited shakeout and stabilization powers, concentrated so far only to a-c, come quickly to a dead end. There is a danger that the credibility of the government's reform program will quickly dissipate, the entire transformation will grind to a halt and, finally, a political backlash will loom.

Having this situation in mind, a more important role must be assigned to a quick take-off of the competent and competitive capital market instruments of economic policy (g). It is here where the roots of financial institutions are concentrated. Financial institutions (in the wider sense) are the most complex of economic institutions, because they are directly or indirectly embedded both in all policy instruments (a-h) and in all economic transactions. This is natural, since it is the pricing and monetary phenomena that lies at the core of market economies and that strikes the difference between market and command economies /9/.

In fact, the capital market policy is the only one practically available at this critical state of reform of the CS economy. The revival of the core of financial institutions will have a positive effect upon the other financial institutions, resting so far idle within the remaining instruments. The capital market represents a much more operational instrument than the competitive labour market or privatization, which are more politically vulnerable and liable to fail at a most inopportune moment. For example, during a deepening recession the nominal wages often become sticky or even rise (instead of being downwardly flexible) due to the populistic push of trade unions against weak managers and government. Similarly, privatization easily stalls because of various counteracting clashes of vested interests for property redistribution. In the current critical stage of CS transformation it is absolutely essential to get the emerging capital market into working shape. Its success or failure is closely connected with the concomitant resuscitation of financial institutions, which may be the crucial move which wins or loses the whole battle.

Another important aspect of the sequencing of transformation is emerging at this point. It is the necessary demise of the institutional superstructure belonging to the old command system. It is widely accepted that prices, money and financial institutions, as such, played a third class role in the functioning of command economies. What institution substituted for them, then? Logically, these must have been the almighty bureaucratic hierarchies - in a figurative sense the command economies' blood and nervous system. Once we accept that market and command institutions are disjunctive, the constructive process of economic transformation to a market economy cannot work without abolishing the old institutions, including the cross-sectional network of bureaucracy.

In fact, the role of bureaucracy in contemporary transient economies of Eastern Europe is far from being broken. It has lost, perhaps, its central drive. But it was just this moment, which enabled the bureaucracy to strengthen its operational autonomy at the grass-roots level. The actual situation of power distribution in the vast majority of Czechoslovak state enterprises does not disprove this hypothesis. Attempts at forceful dissolution of the bureaucracy without abolishing its causes is a Quixotic task. What is more realistic, is to make its existence irrelevant by stripping it of power by cutting its hierarchies and by granting more opportunities for alternatives to bureaucracy, that is to entrepreneurial individuals, to markets and to their own institutions. Small islands of strongly motivated creative people cropped up everywhere in Eastern Europe, once the command rules had been dismantled. But the island proliferation philosophy of transformation was not given a free hand. Their fate, at least outside the area of small shops and household services, has so far been generally frustrating: their creative potential has been refused and steamrolled by the more straightforward counter-objective of the bureaucracy: to redistribute existing resources. The promotion of production motivated entrepreneurial individuals and curbing of the redistributional motives should not be left on the invisible hand only. Anonymous market signals must always be coupled with a well visible finger of its institutional background which represents point-blank responsibilities for decisions of executives or referees. The problem is how to build this into a new economic order.

4. THE IMPLEMENTATION OF MARKET INSTITUTIONS

Let us now bring the previous analysis to its global conclusions, pointing to the philosophy of policy-making and its strategic aims. In contrast to the previous analysis, the language in this part is purely normative.

Transient economies should not follow a central command approach to the creation and the functioning of both the economy and institutions, as they have been used to. While the command economies contrived a sophisticated bureaucratic system of direct control over the allocation of resources, the development of remaining economic institutions was practically left to a slow evolutionary growth bordering on anarchy. A contrary approach, which I suppose fits better with the state of affairs of transient economies, is to leave the allocation of resources to the market, while the development of institutions should be strongly supported by direct supervision and central surveillance. The latter does not imply introducing an exclusive central planning of institutions, but governmental fostering of initatives with positive powers in charge of responsibility for their promotion, toolmaking and rulemaking. These kinds of auxiliary "visible hands" would function in addition to spontaneous activities.Of-course, these activities can in no case be supposed as grounds forincreasing the government share on national income.The principle of steadily decreasing taxes and shrinking state sector can in no case be allowed to be politically challenged during the transition.

A large part of the creative role could be supervised by ministries - either directly or indirectly
- by offering tenders or open contracts to firms for the buildup of market institutions or even for any service financed by the government. Similar functions on district levels of the government could be exercised by Local Administration Authorities. This would lead to a twofold pressure to strip the bureaucratic networks of their uncontrolled suffocating power. On one hand it would induce a profound revision of personnel policy in the governmental sector, on the other hand it would supersede previous semi-secret discretionary distributive powers of many bureaucratic organizations by transparent creative tasks /10/. The central role of all new governmental institutions would be informational and advisory service. This service would be used as a cheap support for development of capital acquirement procedures, real estate markets, international assistance, legal rules, educational programmes, business standards, fiscal conditions, etc. Such a system would bring about more public control to the government services.

Let us now follow individual policy instruments, as discussed before, and inquire what financial institutions can be expected to develop in the present phase of transition in countries like Czechoslovakia, ie. those ones characterized by their halfway to break-even point for stabilization and recovery.

As an economy is plunging deeper into recession, the fiscal policy should terminate its shakeout stage and switch gradually into its stabilization functions. It should offer a clearly defined perspective of the tax system, tax relief schemes and subsidization rules. The establishment of new firms and new organizations should be given an explicit preference to patchworking of the old ones. Special schemes of the government promotion, the infant industry relief and the budget support should be designed for these purposes.The development of private small businesses and their enterpreneurship, which will gradually permeate into the corporate sphere, must be seen from the start as the only viable long-term perspective of economic survival of emerging market economies.

The same should be said for monetary policy, which should offer clear rules for the role of the central bank and its relationship to the ministries of finance, commercial banks and international organizations. The aim is to gain credibility for the continuity of anti-inflationary policy. Closely linked to this are the exchange rate and foreign trade policy. Both of these instruments should now be prepared for a transition from shakeout to stabilization functions. The most effective answer to this problem is the establishment of a credible exchange rate commitment. A devaluation or depreciation-free exchange rate requires a firm anchor, safeguarded by stringent financial constraints imposed on the domestic economy (see Begg /1990/). The pseudo-floating of CS Koruna, as observed during 1990, should be abolished. International cooperation, even forcibly conforming some domestic institutions to international standards, mediated for example by European System of Central Banks, European Monetary System, European Monetary Union, Exchange Rate Mechanism, European Bank for Reconstruction and Development, IMF or World Bank, is unavoidable.

Another crucial step in this respect concerns the establishment of normal trading and payment relations with countries of Eastern Europe. At least, three countries (Poland, Hungary and Czechoslovakia) should introduce convertibility of their local currencies, including some limited forms of the capital account convertibility. Their interim Payments and Free Trade Union should be established as an interim and without doubt a makeshift institution before wider forms of European integration are available. EC seems to be a much more resistent partner for entry as it seemed a year ago. The reason is to return back to intensive trading and to find new "friendly" markets for the shattered trade flows among the former CMEA partners. The rationale is that intra-CMEA trade has had a long tradition. It did show (whatever its irrationalities) both the elementary effects of interindustrial comparative advantages and deep intraindustrial specialization patterns. At least in Eastern Germany and Czechoslovakia, the CMEA trade breakdown has been regarded the most important single shock causing the current recession. For example over 2/3 of the recent CS fall in output (i.e. approximately 20 % decline of GNP in the first half of 1991) can be explained by this exogenous factor. It is still only the Eastern European demand which is capable of absorbing in the short run that peculiar quality and image of local products, redressing therefore producers, at least partially, for the huge losses in terms of trade deterioration or even the total loss of demand when trading had to be switched to the West.

On the side of foreign trade policy the government should anticipate the urgent need for exported quantities to become more responsive to downward price changes, following the exchange rate devaluation. I.e. the supply curve of exports should become more elastic in relation to prices fetched on foreign markets. This will also contribute to making the supply curve for total export earnings more elastic to exchange rate changes, while the demand curve for foreign exchange should stop its shifting to the right. This long expected watershed point, marking the stabilization of convertibility, should be made a prime target of trade policy which concentrates on a rational tariff system, transparent government export promotion and import substitution schemes /11/.

Financial institutions in the field of price and competition policy should take on more of the burden of market shakeout functions and so relieve the instruments just mentioned (a-d). Government should help in establishing independent (non-governmental) Consumer Protection Boards, which should inform the public about regional prices, real production costs, profit markups, shortages, supply rigidities, substitutes, monopolistic or cartel practices, quality standards, etc. - so that each household or outside producer can respond more expediently to current alternatives in the market. The result would be a deep decentralization of the "voice" (and consequently the "exit") functions of the commodity markets (viz. Hirschman (1970)) and their increased efficiency. This consumer based intervention presents a more natural arrangement of market surveillance than the ministerial harassment of producers.

Similar requirements can be applied to labour market policy. Unfortunately, this field has many imperfections due to government and/or trade union constraints and the perpetuation of command period labour ethics. The new market wage prices should reflect the efficiency of labour, including its aversion to risk, responsibility, initiative, subordination and innovation. This means that the dispersion of market wages in transient economies, if they were to reflect the marginal revenue products of labour, would have a natural inclination to be extremely high /12/. The indexing of minimal wages to the aggregate price level (eg. as was lately accepted by the CS government) should be abandoned, because in some industries the minimal wage claims could soon be higher than the existing average market wage. There is no economic reason to have ceiling or floor restrictions in a sound competitive labour market subject to socially agreed income tax policy. These are the areas where the wage policy should expand to.

A very important long-run problem is the solution of the skilled labour gap. The problem is clearly defined as a lack of human capital and education. This gap is probably widest and most acute in the field of economic and financial management, because for various reasons in command economies these activities were neither practised nor taught. The Ministry of Education should challenge the old bureaucratic concepts of egalitarian treatment, queuing, preference for the weak at the expense of the strong, hierarchical organizations based on a fuzzy set of subordination, redistributional motivations, liquidation of "parallel" activities and collective irresponsibility, which former educational institutions were subject to. The necessary private or semiprivate reorganization of Czechoslovak education, motivated by the concept of human capital, should be considered as a real alternative.

Having considered the human capital problem we have at the same time touched upon capital market policy, which plays a key role in the future evolution of transient economies. It is upon this sphere to decide whether the thrust of the heated-up boiler of CS economy will either shuttle its growing idle energy into productive entrepreneurially motivated activities or explode. Financial institutions should be established here in such a way that they can cope with rising bottlenecks on both the supply and demand side for capital.

Even though CS is still in an investment depression, the shortage of capital (financial, physical and human) is apparent. A revival of investment activities, so essential for the economy to catch up, may lead to frustrating capital market failures at the most critical moment. And even if CS economic agents would once more trust their savings, which have now suffered a setback from recent price shocks, domestic savings would still provide only a small fraction of the requirements needed for reconstruction. Thus the task of financial institutions should be to help reallocate the idle or inefficient capital resources. The prospective physical capital transactors - buyers, sellers, renters or leaseholders - should not find themselves in a corner, because the capital market as an institution is offering them little help. In CS this problem is closely linked with the solution of the property rights question.

Now that it is recognized that privatization in all transient economies in Europe is going to proceed much slower than was originally expected, due to the clash of vested interests and legal and technical problems, a makeshift provision for stranded property rights transfers should be found. For example the managers of enterprises, which wait in uncertainty for privatization, should be given such powers and incentives for the reallocation of resources which would enable them to behave in the meantime as entrepreneurs, and not like custodians of a lost property. In this respect a reappraisal of the spontaneous ("wild") privatization and the "dirty investment money" notions should be conducted. Both of them enjoy a very negative ethical reputation throughout all transient economies. However, at least in CS, it cannot be denied that they played an important role in the formation of local entrepreneurship. The institutionalized control of these spontaneous capital operations, if they guarantee competitiveness, transparency and the legal character of purchasing or leasing conditions, might lead to highly efficient provisional steps towards entrepreneurial motivation.

The dead situation at local capital markets can be partially revived if private housing, land and real estate ownership receive top priority in privatization schemes. This should be introduced as an alternative to pending extensive rent increases, which may be supposed as a serious attempt at their living standard by nearly a half of the CS population (ie. by those living in state or cooperative houses). This relatively simple privatization move, so successful in Britain a few years ago, may provide numerous benefits, such as improved relationship of the public to property, increased saving for investment, higher labour mobility, as well as the possible increase of mortgages and collaterals as an efficient institution for obtaining capital.

Another important institutional problem is represented by foreign capital flows. It is an indisputable fact that without external capital injections CS cannot satisfy its needs for restructuring of production, its modernization and entry to the global world economy. The xenophobia, hidden behind the bogey of "cheap sell-out to foreigners", is one of the most counterproductive attitudes against the market. Such fields as banking, pension funds, insurance, accountancy expertise, financial communication, securities and equity market, portfolio investment, mutual funds, banking surveillance, investment consultancies, bankruptcy procedures, fiscal auditing, futures market, financial education, competition policy, etc., cannot wait for a nicer partner to call. All foreign capital or financial expertise willing to come should be offered a public tender or an open auction for its premises, disregarding the price it fetches.

The re-establishment of the whole legal and judiciary system should be given a first-class priority.Such undeveloped fields like bancruptcy procedures, courts for contracting conflicts resolution, anti-trust and trade practices law are just in the center of the conflict of the transient societies.Being under the state wage regulation scheme, they discourage the employment of capable lawyers, since these can find higher remuneration in the private sector, where they often see their oportunity in protecting the rent-seeking activity of their employers, well prospering under the veils of trail and fuzzy legal system. Also a scheme for promoting option of private arbitration parallel to a very inefficient state arbitration, can increase the speed of adgustment and contracting in firms. A well defined legal and judiciary system will quickly help to reduce the huge transaction costs (see Williamson (1991)) which hamper the exchanges and contracts among economic agents in these still not fully monetarybased societies.

The effects of external economies caused by such moves are a far greater benefit to society than any "better" dealings postponed to the remote future. Where else, if not in the field of so neglected local financial services, can the well-known Pasinetti's (1981) notion of learning-by-trading be applied? As Stiglitz (1991) has recently pointed out, the functions of the financial system, and especially the functions of the capital market, are so crucial for the viability of newly emerging market economies, that they cannot hesitate with their development. The government also cannot relieve itself from the conceptual and supervisory duties in this process.

Let me close with a final remark that the renaissance of financial institutions in transient economies is a necessary condition for the effective process of forthcoming privatization and for the efficient reallocation of resources, both of which are the concluding acts for transforming command economies into their mature market counterparts.

F O O T N O T E S :

/1/ This new paradoxic phenomenon of recession and inflation would be better renamed "recflation" than to keep it masquerading under the more innocent name of stagflation. The mentioned omens are more similar to some sad cases of South America than to the economic history of Europe.

/2/ It is not only the case of labour managed firms where the managers have secured a temporary executive position only. It is more serious in case of managers of state enterprises waiting for privatization expected to come in 1-3 years. It may also be a serious problem for cases of "privatization" projects which are realized by auctioning short-term leasing contracts. Eg. in Czechoslovakia it is the majority of cases in so called "small-scale privatization", where shops are rented for 2 years.

/3/ This case was extensively discussed by J. K. Galbraith as a relation between a large group of small shareholders as principals on one hand and a network of skilled professional managers (in fact technocrats) on the other hand. Since the 1970s it became evident that his high praise for the efficiency of this relationship did not survive a test of time.

/4/ But not all economic transactions are market mediated. Ethics, moral values and many governmental economic functions (eg. fiscal policy, interventions, education) fall into this category. Thus we should not forget that, along with market institutions, there is also a large spectrum of complementary "sideline" economic institutions, which we shall not discuss here.

/5/ We can even paraphrase here an old buddhistic wisdom: transition is a bridge, therefore do not dwell upon it. Many socialistic political parties (not only in Eastern Europe) should realize that a "third-best bridge" is never an ideal structure for basing their political programme upon it. Of course, it does not imply that a suicidal cold turkey is a better solution.

/6/ In the best case the technocratic approach to timing and sequencing says that the government should not rush off and declare a certain institution completed, if in fact it is still developing. The argument based on discrete and discretionary evolution of hierarchical ends reveals an engineering approach to human control which is rather difficult to defend in such a dynamic social environment like transient economies. All institutions interact and develop gradually. For example, the price liberalization cannot develop without anticartel institutions, but anticartel institutions cannot develop without commodity markets already functioning.

/7/ In the objectivist argument for timing and sequencing of reforms the subjective attempts at masterminding the events must fail. They must simply adjust to different natural pace of development of individual institutions. However, the timing can be influenced in a negative sense: by delaying the deployment of certain institutions. It is a paradox, because then it means that any argument for postponing certain pro-market creative activities is a counter-productive argument for paralysing the evolution of market institutions. It is quite characteristic that in the transition period many alleged "economic" arguments are simply disguised political value judgments.

/8/ The opposite, rather metaphysical view is advocated by some populistic leaders, who propose to control the process of economic transformation by direct interference with human nature - its philanthropic motives, cooperative instincts, religious persuasion, ethics or moral values. These alleged control variables are considered autonomous from the bequeathed distribution of resources, hierarchies and the backfire of political clashes. The critique of this non-economic approach to economics rests in confusing ends with means.

/9/ In addition to financial institutions there is another set of distinct market institutions dealing with property rights and transfers of legal control. In this paper these are not the focus of analysis. This should not imply, however, that the property rights are taken as irrelevant in our context.

/10/ Maybe these organizations will prove totally unsuitable for such tasks. But that is actually irrelevant. The principle which matters is *primum non nocere* - first avoid harming. The point is to divert the bureaucracies from their anti-market activity into a more creative role - giving them at least a fair chance to help society. This would also require to reduce the notoriously intransparent system of permissions, bans and paternalism, which forms their main reason for existence, to an unavoidable minimum. Of course, they should be remunerated according to their creative results only.

/11/ The existence of government export promotion or import substitution schemes does not imply the need to return to central planning. Such instruments like performance conditioned tax allowances, export promotion credits, flexible optimal tariffs, informational service or moral support of the government have negligible distortionary effects on the efficiency of the market.

/12/ The natural tendency of free market wages in transitional economies to show wider variance around statistical mean (in comparison to market economies) is primarily due to the lack of labour market adjustment and the very low marginal efficiency of labour. Particularly it would be revealed in their left tail of wage distribution function , which goes from the average wage through zero, and plunging even to negative values.

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