Macroeconomic Aspects of Entrepreneurship in Central-East Europe

Jens Hölscher

1. Introduction

Managerial aspects of economic transformation are normally addressed within a micoreconomic framework. Such an approach would look at incentives for the behaviour of economic agents within the specific market constellation of transition economies (see for example Hölscher/Tomann 1996). Even the bold message of how to transform successfully a planned economy into a market economy, which is built on the two pillars of internal privatisation and external liberalisation, follows a micoreconomic line of argument.

In this paper the focus is on macroeconomic aspects. The question is: How does the macroeconomic environment affect entrepreneurship in transition economies? The potential existence of entrepreneurs is taken as given by assumption and carried forward as 'black box' in the course of this enquiery. Furthermore the institutional infrastructure for entrepreneurial behaviour is only considered as far as it affects the typical macro variables of inflation and exchange rates. The crucial link between the entrepreneur and the overall level of economic activity is the decision to invest. If profit expectations are a component of the black box, investment depends on the real rate of interest. The positive decision to invest would require higher profit expectations than interest rates to finance the investment. As investment decisions are long run decisions, further expectations about the stability of the price level and the development of the exchange rate have to be considered. In the broad sense these long run expectations regarding macroeconomic variables will affect the investment decision at the entrepreneurial level.

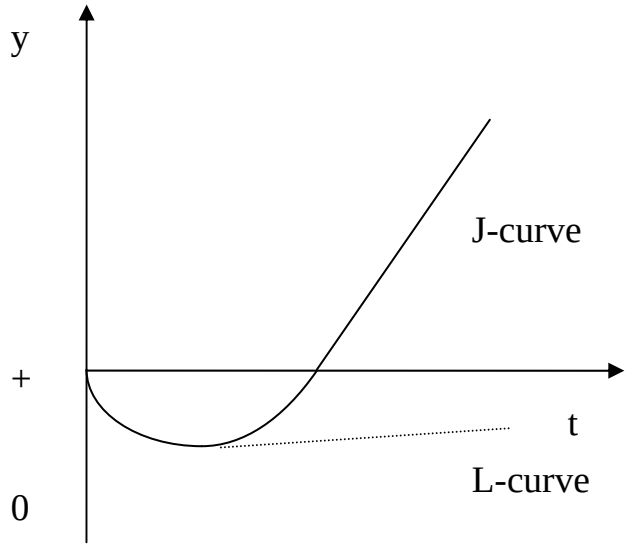
The following section will approach the interrelationship between internal stability and economic growth. The underlying intuition is that macroeconomic stability is promoting growth. The discussion of this intuition is a reflection on the trade-off between growth and equality, which found its way into economic textbooks as 'Okun's law'. Although evidence of this law can be found for transition economies the section points to the priority of stability. In the third section the issue of stability is taken forward further to the external dimension. Here the paper is arguing in favour of a strategy of 'stability oriented undervaluation'. The enquiery concludes with the message that from a

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

macroeconomic point of view far more than liberalisation and privatisation is needed for successful transformation under the conditions of the global monetary economy.

2. Stability and Growth: Is there a trade-off?

At first glance the process of 'creative destruction' in transition economies goes along with rising income inequality. Few get very rich and many people become poor. To a certain extent this observation is depending on the starting condition from socialist systems, where income equality was extremely high and growing inequality mirrors simply an adjustment to capitalist systems. Real incomes were typically devalued by hyperinflation phases of early phases of transition. In general the hypothesis of a trade-off between stability and growth does underline the so-called J-curve of transition.



The J-curve effect is supposed to describe economic development during transition analogue to the Schumpeterian paradigm of 'creative destruction': From a supply side point of view the introduction of stabilisation programmes together with liberalisation bring about a reduction in income not only as an effect of the demand shock, but also because of rigidities in the supply response. Over time reallocation of ressources would tehn lead to the upward branch of the curve, forming the shape of a 'J'. Unfortunately what can be observed is, rather, an 'L-curve', with portracted though decelerating recession (see also Lavigne 1995, p. 152). For the macroeconomics of transition this result is not at all surprising. Before we enter the following synopsis it should be stated that the 'big trade-off' does not apply, where it causes political instability, which can have damaging effects on investment and macroeconomic efficiency in general.

The synopsis below shows the two basic market constellations of dynamism: acceleration and deceleration. Both scenarios are presented within the

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

framework of a monetary economy, which are shown as inflation and stagflation[1].

Figure 1: Market constellations and economic dynamism upwards or downwards tendencies are shown by arrows, two arrows symbolise strong movements)

market constellation	r > i	r < i
market process I	$Y \uparrow\uparrow = P \cdot y \uparrow\uparrow$	$Y \downarrow = P \downarrow \cdot y$
cumulative process	$Y \uparrow\uparrow = P \uparrow \cdot y \uparrow$ $Y \uparrow\uparrow = P \uparrow\uparrow \cdot y$	$Y \downarrow = P \uparrow \cdot y \downarrow\downarrow$
	inflation	stagflation
policy response	demand management (1960s/1970s)	restrictive monetary policy (1980s)
exception	$w = \lambda$ (Germany of the 1950s, Austria)	

with r = profit, i = interest, P = price level, y = income,
w = wage increase, λ = labour productivity

The market constellations above are characterised by two disequilibria. The first constellation illustrates the accumulation case, where profits (r) exceed the rate of interest (i), and the second constellation shows the recession case, where profits are below the rate of interest. In equilibrium interest rate and rate of profits are equal. In the dynamic context profit expectations, which are independent from present profits, are decisive. In the accumulation constellation the first step of the market process leads to strong income creation (Y) by increased production (y). As the second step the entrepreneurial sector raises prices (P) while output and income are still growing. In the boom of the business cycle the labour force tries to retain its proportion of the division of income, which again leads to further price increases. This cumulative process is called inflation.

The scenario of the recession shows the opposite development. Profit expectations below the rate of interest lead to falling prices due to lack of demand for investment while output is still constant. The cumulative process is characterised by a profit deflation which is overcompensating the income inflation. The result is falling income and output with increasing prices: the case of stagflation.

[1] The extreme case of deflation is not considered here.

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

Economic policy responses towards these results of economic dynamism in industrialised countries are well known: demand management in the Keynesian era of the 1970s and restrictive monetary policy in the times of monetarism of the 1980s. Both periods, either inflation or stagflation particularly in Germany, ended up with a higher level of unemployment. This frustrating result provides an indication of the limited possibility of influencing the market process by economic policy. This is the case in particular when both constellations appear in sequences due to an economic policy of 'stop and go'. The ratio in those phases was a restrictive monetary policy to stabilise the price level with the consequence of falling production and then increased public demand to compensate for the depressive effect. This kind of economic policy mix leads to the 'stop and go' of inflation with rising unemployment.

The exceptional market constellation is essential for economic development. The Austrian example is only mentioned to show, that the constellation is exceptional, but not singular. Here the German constellation of the 1950s should serve as example for economic dynamism. Within the dynamic framework the German case of the 1950s is not constructed by income policy, but a result of the market process. In behaviourist terms one could speak of a failure of the workforce to catch up with growth of productivity. Subsequently this failure is the key to success for economic development. It has to be emphasised that this result is not a consequence of a clever strategy, but the ultimate development constellation resulting from a dynamic market process.

For the transition economies the macro dynamic danger is that the experience of western european economies will be repeated, but at a far lower level of income. This would drive them into the constellation of developing countries. In fact this is what can be observed for most of the transition countries.

The overall picture of the transition landscape shows an extremely disappointing growth performance (see table 1). Even the Central East European frontrunners of transition display falling growth rates from 1996 to 1998. In 1997 falling out put could be observed in Albania, Bulgaria and Romania, whereas the Czech GDP contracted in 1998. Only very few countreis reached the estimated GDP level of 19989, which is taken as pre-transtition point of reference.

The shape of the 'J-curve' is even more questionable for the 'Commonwealth of Independent Sates' (CIS). Here only half of the 1989 GDP level is reached and with regard to the graph above the 'L-shape' with a sharp decline in the beginning and stagnation in the course of transition does apply. CIS countries are still highly dependent on Russia's development. After the Russian financial crisis fo 1997 the real economy is now facing a credit sqeeze and it seems likely that a further general loss of confidence of investors will lead to a further drop of output.

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

Table 1: Growth performance (source: EBRD)

								Estimated level of real GDP in 1997 (1989=100)	Projected level of real GDP in 1998 (1989=100)
	(percentage change)								
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**		
Albania	-7.2	9.6	9.4	8.9	9.1	-7.0	9.0	80	87
Bulgaria	-7.3	-1.5	1.8	2.1	-10.9	-6.9	4.0	63	66
Croatia	-11.7	-8.0	5.9	6.8	6.0	6.5	4.2	76	79
Czech Republic	-3.3	0.6	3.2	6.4	3.9	1.0	-1.0	98	97
Estonia	-14.2	-9.0	-2.0	4.3	4.0	11.4	5.0	73	77
FYR Macedonia	-21.1	-9.1	-1.8	-1.2	0.8	1.5	5.0	56	59
Hungary	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6	90	95
Latvia	-34.9	-14.9	0.6	-0.8	3.3	6.5	4.0	56	58
Lithuania	-21.3	-16.2	-9.8	3.3	4.7	5.7	3.0	61	63
Poland	2.6	3.8	5.2	7.0	6.1	6.9	5.2	112	118
Romania	-8.7	1.5	3.9	7.1	4.1	-6.6	-5.0	82	78
Slovak Republic	-6.5	-3.7	4.9	6.9	6.6	6.5	5.0	95	100
Slovenia	-5.5	2.8	5.3	4.1	3.1	3.8	4.0	99	103
Central and Eastern Europe and the Baltic States	-3.8	0.4	3.9	5.5	4.0	3.6	3.0	96	99
Armenia	-52.6	-14.8	5.4	6.9	5.8	3.1	6.0	38	40
Azerbaijan	-22.6	-23.1	-19.7	-11.8	1.3	5.8	6.7	40	42
Belarus	-9.6	-7.6	-12.6	-10.4	2.8	10.4	5.0	71	75
Georgia	-44.8	-25.4	-11.4	2.4	10.5	11.0	9.0	32	35
Kazakhstan	-2.9	-9.2	-12.6	-8.2	0.5	2.0	1.0	63	63
Kyrgyzstan	-19.0	-16.0	-20.0	-5.4	7.1	6.5	4.0	57	60
Moldova	-29.1	-1.2	-31.2	-3.0	-8.0	1.3	-2.0	35	35
Russia	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-5.0	58	55
Tajikistan	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	3.0	40	41
Turkmenistan	-5.3	-10.0	-18.8	-8.2	-8.0	-26.0	5.0	42	44
Ukraine	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	0.0	37	37
Uzbekistan	-11.1	-2.3	-4.2	-0.9	1.6	2.4	2.0	87	88
Commonwealth of Independent States	-14.2	-9.3	-13.8	-5.1	-3.5	0.9	-3.6	57	55
Central and Eastern Europe, the Baltic States and the CIS	**-9.7**	**-5.1**	**-6.2**	**-0.6**	**-0.2**	**2.0**	**-1.0**	**73**	**72**

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

Here we are right in the centre of macroeconomic aspects of entrepreneurship: the state of confidence. Investment is a long run decision based on future expectations. Stability of these entrepreneurial expectations determines the level of growth. So far transition economies in particular in the CIS have seen rather volatile growth rates reflecting prevailing general uncertainty. In fact a trade-off between macroeconomic *instability* and growth can be observed. The question remains, how macroeconomic policy can contribute to stabilise expectations of investors.

3. The strategy of stability oriented undervaluation

The startegy of stability oriented undervaluation takes up the "exceptional scenario" of the synopsis above and puts it into an international context. The internal aspect of stability of the price level is combined with devaluation expectations of the currency. To generate revaluation expectations of the currency an export surplus of the balance of trade is required. This might sound unrealistic, because transition countries might not be competitive within the international market, but then a closer look at the liberalisation strategy is on the agenda. In the beginning of transition liberalisation has been asymmetric, as following western 'expert' advice the East opened the markets for imports from the West, whilst the European Union maintained barriers for eastern goods in so-called 'sensitive' areas. These areas (textiles, steele, agriculture) were exactly those areas, where eastern products were competitive on western markets. Although it challenges the widespread liberalisation doctrine it seems appropriate to define 'sensitive areas' of transition economies as well, in order to allow a recovery of demostic production for a transitional period of decreasing protection. Elsewhere we argued in favour of a strategy of 'semi-liberalisation' with respect to financial markets (Hölscher 1998). Other authors propose more far-reaching measures of protection for domestic markets against western imports (see for example Semenkov 1999). Such protectionist measures have been practised already as part of packages to attract foreign investors in various cases. However, some control of external movements of goods seems less problematic in comparison to the imposure of capital flow controls in order to safeguard the current account.

In principle capital flow controls introduce devaluation expectations in international financial markets, because they suggest that the exchange rate is stabilised artificially and would drop after steps towards liberalisation. As this robust logic is undisputeable, a specific case has to be made for transition economies. First of all it would be counterproductive for the creation of stability to make an attempt to control long run capital movements, i. e. foreign direct investment. Investors need the exit option and profit transfer possiblities in order not to become deterred in their decision to invest in transition countries. For short term capital movements the case might be different. Due to their lack of

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

foreign currency reserves central banks of transition countries are unable to fight specualtive attacks. Unlike 'key currency' economies as Euroland and the United States these central banks can not act as 'lender of last resort' in the event of domestic bank runs and/or specualtive attacks of international capital markets. Chile is the most recent example of careful and successful practice of short term capital flow controls in order to reduce volatility of the exchange rate[2]. Instruments such as specific minimum reserve requirements are an enrichment of instruments of the central bank, which can be used to stabilise expectations in the short run.

For a long run strategy of stability oriented revaluation the stability of the exchange rate is only a necessary, but not a sufficient condition for an incentive to invest. Increasing competitiveness is achieved by stability of the domestic price level, too (see section 2). To induce undervaluation expectations internal inflation rates must be lower than those of competitors. This general comeptitive advantage of a national economy would inspire entrepreneurial profit expectations. With reference to Joan Robinson this constellation could be labelled as 'golden age' of transition. In the real world of global capital markets however, the exchange rate is a market price within asset markets and within that currency race the undervaluation strategy of one country challenges the stability of other currencies. This means that macro economic aspects of entrepreneurship in transition countries have to be international aspects.

4. Conclusion

The point of view presented in this outline was that a specific market constellation is required for successful transition from planned to market economies. The macroeconomics of transition stresses the exceptionality of such a constellation and calls for far reaching international cooperation in order to reduce the level of uncertainty in transition economies. This is seen as 'conditio sine qua non' to overcome obvious problems and even set-backs of economic transition. The proposed development strategy is not in contrast to widespread proposals for micoreconomic reforms, but assumes that these might not be enough.

References:

EBRD (European Bank for Reconstruction and Development) (1998): Transition Report, London

[2] Even the IMF praises the Chilenean experience, although it contradicts the bottom line of IMF recipies.

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY

Hölscher, J. (1999): Social Cohesion and Transition Dynamics, in: Collier, I., et al. (Eds.): Welfare States in Transition: East and West, London Macmillan Press, New York: St Martin's Press

Hölscher, J. (1998): Zur Formierung marktwirtschaftlicher Ordnungen in Zentralosteuropa, in: *Konjunkturpolitik - Applied Economics Quarterly*, 44. Jg., Heft 4

Hölscher, J., Tomann, H. (1996): Privatisation and Structural Change, in Hölscher, J. et a. (Eds.): Conditions of Economic Development in Central and Eastern Europe, Marburg: Metropolis

Lavigne, M. (1995): The Economics of Transition, London: Macmillan Press

Semenkov, V. (1999): August-98 as turning poin of Russian reforms, in: Hölscher, J. (Ed.): Financial Turbulences and Capital Markets in Transition Countries, London: Macmillan Press, New York: St Martin's Press (forthcoming)

https://doi.org/10.5771/0949-6181-1999-4-323 https://www.inlibra.com/de/page/agb - Open Access - (cc) BY