Policy Analysis

Cato Institute Policy Analysis No. 139: Aiding Eastern Europe: The Leveraged Harm of "Leveraged Aid"

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Executive Summary

The verdict is in. The model of a centralized command economy is discredited the world over. It brought ruin in Eastern Europe, a $450 billion noose of foreign debt in Latin America, and in sub-Saharan Africa per capita incomes that are lower in 1990 than they were in 1970. With the verdict on central planning so clear, the United States and other Western governments should dismantle the international institutions that counsel and finance it--the World Bank, the related regional development banks, and the International Monetary Fund.

Instead, those institutions' annual lending to some 75 governments around the world continues to expand. In Eastern Europe, the World Bank and the IMF are extending unprecedented levels of state-sector loans. Since February 1990, the IMF has committed about $2 billion to Poland, Yugoslavia, and Hungary. The World Bank--despite its lack of any aid "graduates" in Latin America, Africa, and Asia--plans to lend $7 billion to $8 billion to East European nations over the next three years. Incredibly, two World Bank loans approved for Poland's new government in February involve an aid mechanism the bank itself has roundly criticized. And in June the Bush administration pledged $1.2 billion in U.S. funds to a new multilateral bank proposed by the French government--the European Bank for Reconstruction and Development.

In recent years Reagan and Bush administration treasury officials have strongly promoted the "leveraged aid" afforded by U.S. participation in such multilateral institutions. Largely as a result, congressional and other proponents of a Marshall Plan-like program for the region, noting the tight federal budget, increasingly look to those institutions to deliver massive levels of aid.

Advocates of large-scale assistance to the East European nations should take a long, hard look at the past record of such aid efforts. From the postwar Marshall Plan to the ostensibly new and improved World Bank of recent years, the record has been one of far more harm than good. In addition, the $938 million 1989 Support for East European Democracy (SEED) Act and successor bills drafted in the Senate and the House are loaded with mandates for U.S. federal agencies to undertake the kinds of technical assistance efforts that have clearly harmed our own economy. The Department of Labor, for example, despite a 25-year record of disastrous job-training programs, will experiment again on Poland and Hungary. Washington should not sidetrack Eastern Europe's opportunities for a true free market through support for such rear-guard socialist planning efforts.

The Myths of the Marshall Plan

In a recent article in the Washington Post, Sen. Bill Bradley (D-N.J.) applauded the "genius of the Marshall Plan" and

called on Congress to "set aside an amount of up to one percent of the defense budget [which would amount to about $30 billion] as a catalyst for East European reconstruction."(1) Similarly, financial management guru Henry Kaufman proposes a Marshall Plan whereby the major industrial countries would provide "grants, aid and soft loans [because] meeting Eastern Europe's financing needs is a political priority and not a matter that can be left to a standard market determination of risk and reward."(2)

Yet, contrary to conventional wisdom, the 1948-52 Marshall Plan, a $1.7 billion program of grants and loans to European nations to buy U.S. products, was not the linchpin of West European postwar recovery. In fact, as research by George Mason University economist Tyler Cowen has revealed, the administration of that aid program influenced many European nations to increase economic planning and controls.(3)

For example, for every Marshall Plan dollar that the United States gave a European government, that government had to set aside an equivalent amount of domestic currency to be used for public works or other state projects. As a result, every U.S. dollar sent to a foreign government caused that government to take another from its own private sector.(4) That procedure closely parallels a fundamental feature of the multilateral development banks. Each World Bank dollar borrowed for a state investment project must be matched by the recipient government with, on average, two dollars of local currency.

More directly to the point, Cowen examined the recovery records of Marshall Plan recipients and found that those that received relatively large amounts of aid per capita, such as Greece and Austria, did not recover economically until U.S. assistance was winding down. Germany, France, and Italy, on the other hand, began their recovery before receiving Marshall Plan funds. As for Belgium, it embarked on a radical monetary reform program in October 1944, only one month after liberation. Belgium's economic stabilization and recovery were well under way by 1946, fully two years before the arrival of U.S. aid. Great Britain, conversely, received more Marshall Plan aid than any other nation but had the lowest postwar economic growth rate of any European country. The critical problem facing Europe was not the "dollar shortage," Cowen concluded, but simply bad economic policy.

In Germany, suffering in the initial years after the war resulted primarily from the Allied Control Commission's continuation of the Nazi system of economic controls. The West German economy hobbled along until mid-1948 when the Allies instituted currency reform, quickly followed by Ludwig Erhard's secret weekend abolition of most Allied economic controls. Those key reforms predated the arrival of Marshall Plan funds. In fact, Allied occupation costs and reparations absorbed two to three times the Bonn government's Marshall Plan receipts.(5) U.S. policies thus caused, not alleviated, German resource problems.

In Greece, American advisers exercised considerable control and pushed for tighter price and exchange controls instead of a move to freer markets. As more U.S. aid was funneled through the government, graft and corruption increased. Greece began to recover only in 1953--the year that U.S. aid was cut to $25 million. That was also the first postwar year in which the Greek government balanced its budget. In addition, Marshall Plan-financed exports of U.S. tobacco to Europe seriously damaged the Greek tobacco industry. Before the war, tobacco accounted for 50 percent of all Greek export earnings. In its first year, the Marshall Plan funded the export of 40,000 tons of American tobacco to Europe. Greek tobacco exports fell from 17,300 tons in 1947 to 2,500 tons in 1948 and never recovered.(6)

Austria, perhaps the most economically devastated country, received $280 million in the first year of the Marshall Plan, the largest per capita sum given to any country. Yet the Austrian economy failed to recover, not only because the Nazi system of economic controls remained basically intact but because of flawed monetary and fiscal policies and U.S. discouragement of trade with Eastern Europe.(7) From 1951 to 1953 Marshall Plan aid to Austria was cut drastically, from $127.6 million to $38.5 million. At the same time, the Austrian government changed monetary and fiscal policies, and the economy started to improve. Even Marshall Plan supporter Franz Nemschak admitted: "The radical cuts in foreign aid in the last year of the Marshall Plan and the stabilization tendencies in the world economy forced Austria to make a basic change in economic policy."(8)

Congress Cooks Up Unsavory Stew

Contrary to the interpretation commonly offered by major U.S. media, Eastern Europe's recent revolutions were not primarily efforts to gain democracy--as important as that goal is, and as much as East Europeans want to be able to

vote. After more than three decades of state control over nearly every facet of their lives, East Europe's insurgents fought primarily for freedom from the intrusive, stifling, and oppressive hand of government. Much of Congress failed to understand that, however, as evidenced by last year's (fiscal years 1990-92) budget-busting $938 million SEED Act aid package for Poland and Hungary.

The 1989 SEED Act includes directives to, and funds for, several federal agencies--notably the Departments of Agriculture, Labor, and Commerce--to undertake technical assistance activities in Poland and Hungary. In November 1989, just after SEED's passage, Secretary of Agriculture Clayton Yeutter, Secretary of Labor Elizabeth Dole, Secretary of Commerce Robert Mosbacher, and Council of Economic Advisers chairman Michael Boskin headed a mission to the two countries. Upon their return, they submitted to the White House a joint report that outlined their interventionist agenda. From the Commerce Department: "Consider sending teams . . . to help develop national policy plans and business plans. Five examples might be energy, environment, agribusiness, transportation and tourism."(9) That proposal smacks of the centralized five-year plans that bankrupted those economies in the first place.

The Agriculture Department suggests that "providing help in setting up and implementing an extension system should be a high priority." Yet, elsewhere in the report, the department admits that "the current extension service is viewed by farmers with hostility" and "several private producer organizations (e.g., corn, poultry, swine) are quickly developing."(10)

The Department of Labor plans to provide technical assistance in unemployment compensation, employee training, entrepreneurial skills training, and dispute resolution techniques.(11) By congressional mandate, the department will contract some of those efforts to the AFL-CIO, despite the fact that organized labor has priced U.S. coal, steel, and automobile companies out of domestic and international markets for the past 15 years. Maybe the Department of Labor wants to head off any threat of competition from Polish industries.

Potentially even more damaging is the expertise that the Labor Department's own divisions will offer Poland and Hungary. As a March 1990 Labor Department memo explains: "[Labor's] program will apply U.S. experience in dealing with large plant and mine layoffs and will incorporate U.S. dislocated worker retraining demonstrations. . . . Technical assistance [will be] drawn from U.S. experience at the national, State and local levels."(12)

Woe to the Poles and Hungarians. Over the last quarter century, the Labor Department has directed some 50 federal training programs, which have cost taxpayers over a hundred billion dollars (constant 1983 dollars), without any major successes to show for it. America has been served an alphabet soup of failed jobs programs--from MDTA (Manpower Development and Training Administration) to CETA (Comprehensive Employment and Training Act), HIRE (Help Through Industry Retraining and Employment Program), and JTPA (Job Training Partnership Act).(13) The JTPA, passed in 1982 to replace the discredited CETA, was supposed to open a new chapter in federal job training by creatively tapping the private sector.

Cato Institute associate policy analyst James Bovard recently described the boondoggle and corporate welfare program that JTPA has become.(14) Subsidies regularly go to businesses that fire people in one place and hire them in another. Companies garner JTPA funds by simply threatening to relocate. One Ohio JTPA program spent $100,000 to train 32 unemployed coal miners to become engineering aides. Only two of the trainees got jobs.(15) Last year Helen Laughlin, a Labor Department assistant regional inspector general observed of the JTPA: "Millions and millions of dollars are being spent on trainers who are not qualified to train."(16) Ignoring its sorry record, the Labor Department is now launching "train-the- trainers" programs in Poland and Hungary.(17)

Finally, the centerpiece of the 1989 SEED Act--$300 million in "private enterprise" funds for Poland and Hungary--most fundamentally contravenes the basis of America's free enterprise system. Government-appointed boards of directors will dole out $240 million in investments in Poland and $60 million in Hungary, essentially by "picking winners." The most predictable result of those infusions (as well as of those of the new development bank for Eastern Europe) will be special interests that spring up to demand their share. As former Reagan administration treasury official Paul Craig Roberts told a congressional panel in March: "Contracts and financing will be awarded based on political connections. . . . The economic process will be taken over by 'rent-seekers' competing for a share of the largess. Real private enterprise will languish as entrepreneurial skills are directed into the political arena."(18)

The 1989 SEED Act also includes a $200 million "trade credit insurance" program to subsidize U.S. exports to Poland through the Export-Import Bank. Congress appropriated no funds to cover potential losses under that program, thereby rendering it fully an off-budget, unfunded "contingent liability" of U.S. taxpayers. Apparently Congress ignored the lesson of the $300 billion to $500 billion bailout of the Federal Savings and Loan Insurance Corporation, in which a multibillion dollar "contingent liability" of U.S. taxpayers became a very real liability. The 1989 SEED Act's unfunded Ex-Im Bank program also dismisses the fact that between 1982 and 1988 the Ex-Im Bank reported aggregate net operating losses of $2.3 billion. In 1989 the General Accounting Office reported that, of the Ex-Im Bank's $10.3 billion in outstanding loans and accrued interest receivable, $4.9 billion (48 percent) was delinquent or had been rescheduled.

Further legislation for Eastern Europe, this time to authorize U.S. aid programs beyond Poland and Hungary, is currently winding its way through Congress. On March 28, 1990, the House Foreign Affairs Committee authorized a $579 million aid program for Eastern Europe in FY 1991--effectively a $422.5 million SEED II bill, on top of $156 million in authorizations left over from the three-year SEED Act of 1989. And the House Banking Committee passed legislation authorizing U.S. participation in the new European Bank for Reconstruction and Development in July.

In the Senate, Foreign Relations Committee Democrats have drafted their version of SEED II--a $796 billion bill. The Senate bill, like the House bill, is teeming with mandates to (and funds for) numerous federal agencies, including the Agency for International Development, the Department of Labor, the Department of Education, and the Small Business Administration, to carry out programs with East European governments. Those government-to-government programs--as have countless foreign "assistance" efforts before them--will swiftly degenerate into bureaucrat-to-bureaucrat undertakings, fueling the expansion of large bureaucracies in the United States and Eastern Europe. Indeed, one senior AID official estimates that AID alone would have to expand its staff by several hundred to carry out the programs mandated in the Senate Foreign Relations Committee's SEED II bill.

That Senate bill even puts Congress itself on the dole. It authorizes $12 million to be channeled through AID to Con gress so that a congressional delegation can "explore the creation" of a 35-nation interparliamentary organization, termed the "Parliamentary Institute," that would be designed to

> foster a continuing exchange of knowledge and experience among legislators concerning--(i) the institutional workings of representative government; (ii) the efficacy of various governmental policies in critical areas including health, housing, the environment, transportation, commerce, agriculture, energy, and finance; and (iii) international security, including treaties.(19)

Congress is dealing itself in on the perquisites that it is doling out under the guise of aiding Eastern Europe. Before jetting abroad to discuss "finance" and "representative government" with foreign counterparts, spendthrift members of Congress should explain to the American public why they can neither pass a balanced budget nor pass any budget on time.

Finally, the centerpiece of the Senate's SEED II bill is authorization of $1.2 billion for the EBRD, to be appropriated in five annual installments of $235 million ($75 million for the bank and $160 million for an ad hoc infrastructure trust fund that the committee proposes for the bank).

EBRD: Rear-Guard Socialism for Eastern Europe

On May 29, 1990, in Paris, the Bush administration formally pledged U.S. participation in the EBRD, which, as noted, remains subject to congressional authorization. The EBRD would have an initial capitalization of $13 billion. The European Community's 12 member states and its institutions would hold a 51 percent share, the United States would hold 10 percent, Japan (like the four largest EC members) would hold 8.5 percent, and the Soviet Union would hold 6 percent.

During spring negotiations over creation of the EBRD, Sen. Robert W. Kasten, Jr. (R-Wis.), questioned why the world needs yet another development bank, why U.S. taxpayers should contribute to a bank from which the Soviet Union can borrow, and how European officials, many of whom still believe socialism can be reformed, can be expected to aggressively promote free-market principles at the bank.(20) In response to such criticism, treasury officials have sought to portray the EBRD as a new and improved development bank. For example, Undersecretary David Mulford

told a Senate Foreign Relations subcommittee in March:

> We pressed for and achieved agreement that most of the EBRD's lending should support the transition to a market-oriented economy and in particular the private sector. By charter 60 percent of the EBRD's aggregate annual lending by country over the first five years must be to the private sector or state- owned enterprises that are shifting to private ownership and control.(21)

Mulford's final statement would appear to suggest that the EBRD will play a large role in the badly needed privatization of state enterprises in Eastern Europe. But, in fact, there is no precedent for a multilateral development bank's making significant amounts of its assistance contingent on the privatization of developing countries' bloated and loss-making state enterprises. The World Bank's dominant emphasis, vis-a-vis state enterprise, remains rehabilitation, not privatization. Outright privatization is promoted by a very small number of World Bank loans to state enterprise; privatization is actually achieved in yet fewer cases.

One recent World Bank review of 10 years of policy-based lending lists 39 loans tagged to reform state-owned enterprises. In only three cases was divestiture an explicit condition of the loan.(22) The vast majority of conditions attached to such loans involve what the World Bank terms "institutional reforms" and include phrases such as

* "prepare strategy plans,"

* "create intervention fund,"

* "coordination of SOE [state-owned enterprise] investment plans,"

* "increase prices,"

* "organization to increase productivity,"

* "realign salaries,"

* "new tariff [price] structure,"

* "restructure goals,"

* "revise parastatal labor laws,"

* "improve control of SOEs,"

* "establish new State Enterprise Commission,"

* "develop skills mobilization scheme,"

* "improve management and delegation of authority,"

* "implementation of appropriate public-sector wage policy," and

* "introduce modern management techniques."(23)

In recent years, World Bank state enterprise loans have been used to pay off the arrears of state marketing boards in the Ivory Coast and to cover the "development expenditures" of Senegal's state agriculture boards. In Mexico, a $400 million loan to the money-losing state steel sector in 1988 supported not the privatization of that industry but its purchase of new capital machinery. Also in 1988 Mexico's state fertilizer monopoly received a $265 million World Bank loan--not to privatize it but to bail it out.

In short, despite all the "market-oriented" rhetoric, the World Bank continues to tinker with socialism and central planning. If not for the World Bank's gravy train of stopgap loans for ailing state firms, many could not continue to

drag down their economies; they simply would no longer exist.

World Bank's Loans to Poland Use Failed Model

As noted above, the EBRD's charter earmarks a large share of lending ostensibly to support Eastern Europe's nascent private sector. But what models exist for channeling multilateral development bank funds to private-sector borrowers? The principal World Bank vehicle for some 30 years has been "directed credit" via development finance institutions. DFIs are various types of financial intermediaries, most often state-run development banks, that receive large (e.g., $200 million to $400 million) World Bank loans to relend to small- and medium-scale borrowers, primarily in the private sector. Like the new congressionally mandated enterprise funds for Poland and Hungary, most World Bank-supported DFIs are run by government bureaucrats who allocate the credit by "picking winners"--or, in reality, picking anyone.

The World Bank began lending to DFIs in the 1950s with the stated aim of supporting the development of individual financial institutions. In the 1970s the goal of DFI lending shifted to the promotion of growth in priority sectors. Since the mid-1970s the World Bank has lent some $30 billion to DFIs throughout the developing world.

In recent years, several World Bank reports have been highly critical of the bank's experience with lending for directed credit. Nevertheless, in February 1990 the bank approved two directed credit loans for Poland--its first loans to Poland. The two loans include $245 million for on-lending to export-oriented industrial projects and $100 million for on-lending to agricultural processing industries. The borrowers' intermediary will be the National Bank of Poland, Poland's central bank and monopoly credit provider. To be sure, the development of a commercial banking system is an avowed priority of the new Solidarity-led government. But World Bank loans funneled through the NBP will only facilitate a continuing role for that institution as principal credit allocator within the economy.

In the mid-1980s World Bank reviews first began recognizing the sorry record of the bank's DFI lending. One 1985 report noted that at the end of 1983 almost half of a sample of DFIs had more than 25 percent of their loans in arrears and almost one-fourth had more than 50 percent. The report offered plenty of explanation:

> The DFIs were, in the 1970s, increasingly viewed as tools of development policy, channeling resources to publicly promoted or owned enterprises and to priority sectors which comercial lenders were unwilling to finance. The managements of DFIs that were heavily dependent on government resources and operated in highly regulated financial markets were unable to make lending decisions based on independent assessments of business risks and profits. In addition, the intermediaries' spreads often did not reflect the true costs and risks involved in long-term lending to higher risk projects.(24)

The 1985 report noted that, of the 153 DFIs financed by the World Bank since the 1950s, 132 remained active borrowers. Many DFIs had received four or five World Bank loans. Yet the report admitted that "few DFIs have become financially viable, autonomous institutions capable of mobilizing resources from commercial markets at home and abroad." The reasons for that sorry record are scattered throughout the study:

Much of the subsidized credit went to wealthy individuals.(25)

In many cases, neither creditor nor debtor had sufficient incentive to follow sound business practices.(26)

Recipients were induced to use overly capital-intensive production methods.(27)

Many governments used credits from DFIs for low interest rate lending to public and quasi public institutions.(28)

On loans made at the behest of government, financial discipline was often poor, and for political reasons the DFIs were not able to foreclose on delinquent loans.(29)

Rather than remove real sector distor- tions, [World Bank-financed DFIs'] financial subsidies were often used in an attempt to offset them.(30)

Repeat Indictment in 1989

Despite the embarrassing record assembled at the World Bank in 1985, the bank continued to extend about $2 billion in new loans to DFIs annually. So it was little surprise that in 1989 the World Bank's annual World Development Report returned another damning verdict on the bank's experience with DFIs. According to the 1989 report, nearly 50 percent of the loans extended by a sample of 18 DFIs worldwide were in arrears. The report further noted that the poor performance of "industrial DFIs" (development banks that lend to manufacturing enterprises) had caused them "to rely on government and foreign donors for funding." Echoing much of the earlier review, the 1989 report described how World Bank support for DFIs has actually retarded the development of efficient capital markets in the borrower countries:

> It is clear [directed credit programs] have damaged financial systems. . . . Acquiring subsidized credit could sometimes add more to profits than producing goods. . . . The ability to borrow at cheap rates encouraged less productive investment. Those who borrowed for projects with low financial returns could not repay their loans. In other cases, borrowers willingly defaulted because they believed creditors would not take court action against those considered to be in priority sectors. . . .
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> Moreover, by encouraging firms to borrow from banks, directed credit programs have impeded the development of capital markets. . . . Equity finance is a more appropriate way to finance risky ventures than bank loans. If governments establish the conditions necessary for equity finance, intervention will not be necessary.(31)

Financing Yugoslavian Communism and Hyperinflation

Relations between the World Bank and Eastern Europe go back to 1945, when Yugoslavia and Czechoslovakia became members at the bank's founding. (Czechoslovakia, which left the bank in December 1954, reapplied for membership in the IMF and World Bank in January 1990.) Poland joined the bank in 1946, withdrew in 1954, and rejoined in 1986. Romania joined the bank in 1972. Hungary joined in 1982. Bulgaria applied for World Bank membership in 1990. Approval of membership for Czechoslovakia and Bulgaria is expected soon.

Yugoslavia has unquestionably been the World Bank's favorite East European son, borrowing over $5 billion to date. In the 1980s Yugoslavia borrowed an average of $280 million annually. World Bank loans to Yugoslavia financed state road, electric power, railway, agriculture, petroleum development, and other projects. Since the late 1970s a substantial part of the World Bank's program has been loans to Yugoslavian DFIs, in this case, state-run banks. Through the 1980s the World Bank funneled about $700 million in loans through seven of the Yugoslavian government's nine regional banking groups, in full knowledge that the banks' lending rates were highly negative in real terms (-10 to -20 percent). A 1989 internal World Bank review of Yugoslavia's financial sector calculated those banks' net worth by adjusting their 1987 financial statements to account for deferred foreign exchange losses and an estimated 50 percent collectibility ratio on problem loans. The result: the banks were all insolvent; they were each between $300 million and $1.2 billion in the red.(32)

Under Yugoslavia's system of "worker self-management" introduced in the 1950s, enterprises operate with a strong built-in incentive to maximize workers' income share while limiting saving for reinvestment in the enterprise or in other companies. As part of the ownership system, moreover, enterprises establish and manage banks. The basic objective of those banks has always been to provide credit to their founder enterprises at the lowest possible cost, with little regard for the profitability of banking operations.(33)

While Yugoslavia's banks loaned funds at highly negative real rates of interest for decades, the credit subsidies simultaneously effected a fiscal and monetary expansion. When state banks increase their lending to distressed enterprises on demand, lend at subsidized rates, or relieve the foreign exchange losses that the borrower enterprises incurred on earlier overseas borrowing--all of which Yugoslavia's state banks regularly did--the effect is the same as printing more currency. That explains how Yugoslavia was able to run a modest federal budget surplus in the 1980s yet experience 2,765 percent inflation in 1989.

The expansionary sequence begins with the fact that enterprises are bound to be badly run because of a lack of private

property or, as The Economist observed recently, "capital has no representative in the system." Enterprise losses are shifted to the banking system when banks are required to grant soft credit on demand. Eventually, the losses move again to the central bank, where they are financed by the printing of money.(34) That process has also characterized the Polish and Hungarian economies.

World Bank officials were fully aware of Yugoslavia's rigged contraption of a banking system into which they poured hundreds of millions of dollars annually for decades. In 1983 Yugoslavia was the beneficiary of one of the bank's much-touted structural adjustment loans. The loan, $275 million to "improve the efficiency of investment selection and resource allocation in the economy," was disbursed to Yugoslavia's Udruzena Beogradska Banka, a large state bank. The loan certainly did not improve the UBB's own resource allocation--by the World Bank's estimation, that bank was $1.2 billion in the red in 1987.(35)

Among the major policy recommendations of the World Bank's November 1989 review of Yugoslavia's financial sector was "recapitalization [bailout] of the banking system."(36) Five months later, the World Bank appears to have begun transferring resources to that end. On April 16, 1990, the bank approved a second structural adjustment loan for Yugoslavia-- $400 million to "make public enterprises more financially via- ble, strengthen the country's financial sector, and streamline the process for identifying and selecting [state] investment projects."(37) In other words, the World Bank continues to bankroll Yugoslavia's socialist experiment.

Hungary, since joining the World Bank in 1983, has borrowed about $2 billion, or an average of $300 million annually. Like Yugoslavia, Hungary has used much of its loans for directed credit, particularly for export-oriented industrial projects. The World Bank channeled funds directly through Hungary's central bank. Today the situation of Hungary's (and Poland's) state-run banking system closely parallels that of Yugoslavia. Those countries' "commercial" banks--in fact, only extensions of their central banks--loaned funds at negative real rates of interest to inefficient enterprises year after year to keep them from defaulting on previous loans. The commercial banks regularly absorbed the foreign exchange losses resulting from borrower enterprises' foreign currency borrowings and often passed those losses on to the central bank. World Bank estimates now put central bank losses in Yugoslavia, Hungary, and Poland at 30 percent of their gross domestic products.

An April 1990 World Bank discussion paper recommended that the three governments bail out their bankrupt banking systems by injecting long-term floating-rate bonds both as new capital and in exchange for the banks' problem loans. Thus, those governments would "purchase" the problem loans but pay the banks to administer them on their behalf. The bonds would provide the banks with some income.(38)

That plan appears strikingly close to the U.S. experience with the Federal Savings and Loan Investment Corporation's post-1982 fake recapitalization of many insolvent thrift institutions with "net worth certificates." Those certificates were simply interest-bearing paper, issued to plug the black holes of insolvent thrifts. The notes had none of the risk-restraining attributes of private capital, and the thrifts that received the notes continued their reckless lending activity.

A better model for decisive banking reform in Eastern Europe is South Korea's action, in the 1950s, to cease financing in any form (budget or banking system) the investment programs of socialized enterprises. That would liberate the total investment resources of the economy for use in the private sector. Socialized enterprises would be forced to become selfreliant. They would have to generate large profits, be reduced by sheer depreciation, or find private investors willing to acquire a substantial ownership stake. Revealing the World Bank's accommodating approach to bankrolling Eastern Europe's bureaucracies, an April 1990 discussion paper dismissed the Korea model because

> it imposes a continued political strain for several years that could break the Government's determination to carry it out. Socialized enterprises can be expected to use all of [their] power to reverse the situation and become the subject of all financing at the margin. Even if the Government is able to resist initially, it is doubtful that it would resist for several years in the Eastern European context.(39)

Indeed, with large amounts of external assistance, such as that forthcoming from the World Bank itself, it will be exceedingly difficult for Eastern Europe's new governments to direct resources away from entrenched bureaucracies and enterprises.

In Romania, as Radio Free Europe senior correspondent Jacek Kalabinski has noted, World Bank agriculture loans throughout the 1970s and early 1980s financed the groundwork for the forced villagization program initiated by dictator Nicolae Ceausescu in the early 1970s. Romania borrowed $2.2 billion from the World Bank between 1972, when it joined the bank, and 1982, when it elected to stop borrowing. Most of the loans were for a variety of agricultural mechanization projects, such as setting up tractor and machinery stations. By using the World Bank loans to concentrate the means of production in state-owned machinery stations, the Ceausescu government put in place the infrastructure for the state "villages" to which peasants were forcibly relocated throughout the 1970s and 1980s. The aim was to eventually uproot all the rural peasants and centralize them in apartment buildings where they would be under the strict economic and political control of the government. In addition, largely as a result of the World Bank's agricultural lending in Romania, today private agriculture is virtually nonexistent--it accounts for just 6 percent of Romanian agriculture.(40)

World Bank Studies on Eastern Europe a Sham

Perhaps what most spectacularly disqualifies the World Bank as a leader of market-oriented economic reform in Eastern Europe is its rubber-stamp analyses of the region's self-destructive economic policies over the years. In a recent interview with Forbes magazine, Sir Alan Walters, former top economic adviser to British prime minister Margaret Thatcher, quotes from a 1979 World Bank country study entitled Romania-- The Industrialization of an Agrarian Economy under Socialist Planning:

> Between 1950 and 1975 the economy grew rapidly within the framework of comprehensive economic planning made possible by the state's control of the major productive resources and its monopoly over foreign trade. . . . According to official statistics, Social Product and National Income grew at 9.8 percent per annum for 25 years. . . . Picture for 1981-90: The prospects indicate a constant growth in the standard of living. . . . National income should grow at 8 percent to 8.9 percent per annum.

Such an analysis was not worth the paper it was printed on. As Walters told Forbes, "In 1975 Romania's per capita income was $800 or $700. If they grew at 10 percent per annum for the previous 25 years, then in 1950 they must have all been dead from starvation!"(41)

The World Bank also produced a country study on Yugoslavia in 1979. It offers this bit of good news:

> Since 1950 Yugoslavia has continually extended and refined workers' self-management as the institutional framework for decisionmaking on all social and economic matters. The country has had a predilection for innovation and testing novel organizations and systemic relations. Its innovativeness has been characterized by a blend of pragmatism and flexibility and by an irreverence for institutions and policies that fail to meet expecta-- tions.(42)

In 1985 the Work Bank asked Hungarian economist Janos Kornai to review papers prepared at the bank on socialist economies. His report firmly criticized World Bank economists for their adherence to "the wishful theory of prices." As Kornai explains, when an excessive demand for a good is perceived, the conclusion of the bank's economists is to increase the price. For example, when an excessive demand for investment resources is recognized, the conclusion is to increase the real rate of interest. Kornai points out:

> This is wishful thinking--"get the price right"--perhaps that can be adequate advice in a system where profit incentives and markets dominate the coordination of economic activities [but not in] a highly centralized bureaucratic-hierarchical command economy. . . . Similar wishful thinking is behind the suggestion to make investment decision-making less "politicized" and more efficiency oriented. This is not a change which can be achieved by preaching the reasonableness of such a shift.(43)

Finally, the prize for analytical tripe goes to a 1989 report by the World Bank's Economic Development Institute, the bank's own "think tank" where its cutting-edge economic analysis is supposed to take place. EDI's Financial Reform in Socialist Economies, a compendium, contains several papers that discuss how Yugoslavia can introduce a stock market while maintaining its prohibition on private property ownership by individuals. A chapter by Milica Uvalic concludes: "The issue is not one of returning to capitalism, but of using its financial instruments by adapting them to socialism,

and thus enabling the functioning of capital markets in socialist economies. The crucial issue is not that of introducing private property rights, but defining alternative incentive mechanisms that could play the role they play in capitalist economies."(44)

A chapter by Ales Vahcic and Tea Petrin declares: "The transplantation of financial and capital market institutions from the capitalist environment to the socialist countries . . . is relatively straightforward. The only essential difference between the two situations is that productive capital is publicly owned; therefore, socialist stock market operations are carried out by institutional agents acting on behalf of the state rather than by private individuals acting on their own behalf."(45)

D. M. Nuti's chapter on "Feasible Financial Innovation under Market Socialism" discusses how capitalist nations' options markets can be grafted onto public ownership:

> The exclusion of private individuals from direct ownership of shares in productive and financial state enterprises (investment trusts, common funds, and so forth) is not an insurmountable obstacle to individual participation in either risk-bearing or control. Risk-bearing without ownership is already present in capitalist financial markets through options trading as well as "bets" on the movements of major financial indices. . . . The idea is that one or more state agencies should buy and sell options, take bets, make loans or take deposits, at prices/ odds/rates such that individuals could gain from spotting above average and below average performing enterprises or lose from their failure to do so.(46)

And just in case his proposal should leave the central planner anxious, Nuti concludes that his system is "compatible with any degree of government interference with the economy, as long as this is consistent and predictable."(47)

Government interference is almost never consistent or predictable, except insofar as it frequently grows to excess. Similarly, "risk-bearing without ownership" cannot be found in the Western economies. (The West's options markets, cited by Nuti, are derivatives of active stock and futures markets that are fundamentally based on individual ownership.) Ownership, and the opportunity to profit from it, is the irreplaceable engine that drives risk taking in the thriving, capitalist West.

Given the World Bank's record of propping up socialism in Eastern Europe--its lending activities as well as its analytical apologia for state intervention--there is little reason to be optimistic about the EBRD. It, too, will deal primarily with governments, lending them the wherewithal to pursue a variety of undertakings in the public sector.

"Leveraged Aid" Begets Leveraged Harm

In recent congressional testimony, Undersecretary Mulford of the Treasury explained: "The [EBRD] was also viewed as a vehicle which could, through its borrowing in capital markets, leverage contributed funds into larger loanable resources."(48) The "leveraging" principle is now a familiar Treasury Department refrain. In April 1988 then-secretary of the Treasury James A. Baker III implored Congress to support a $75 billion capital increase for the World Bank by touting "the level of World Bank support to countries who are very important to us but where there is the virtual absence of U.S. bilateral assistance."(49) According to Baker, in 1987 new World Bank loans to a group of 10 countries, including Mexico, Brazil, Argentina, and the Philippines, totaled $7.7 billion, compared with $1.1 billion in U.S. bilateral aid to the group.

Despite the fact that the cited nations suffer from top-heavy government sectors--which account for 50 percent or more of their economies and stifle private-sector activity--the Bush Treasury, like the Reagan Treasury before it, cannot seem to draw the lesson. The international financial institutions, as required by their charters, deal with, and lend funds to, governments and government agencies only. Of course, more loans to governments mean more economic (and political) power in the hands of those governments.

In addition to the leveraging facilitated by Japan's and the European nations' joining the United States as major World Bank contributors, there is also a "hyperleveraging" facilitated by the off-balance-sheet manner in which Congress funds U.S. contributions to the bank. As Baker noted in 1988: "The U.S. portion of the paid-in capital (which is actual budget authority) that supported this $7.7 billion lending program was [only] approximately $60 million."(50) To be

sure, that appears quite a bargain, at least until one considers the direct parallel between how Congress funds the World Bank and how U.S. taxpayers unwittingly backed up the Federal Savings and Loan Insurance Corporation. In addition to the $60 million, Congress also authorized in 1988 (but did not appropriate) $1.94 billion in "callable capital"--that is, unfunded contingent liabilities of the U.S. government.

Congress annually contributes some $2.8 billion to the World Bank--3 percent in appropriated funds and 97 percent in unfunded pledges. The World Bank raises most of its loanable funds in international capital markets by annually borrowing, on a dollar-for-dollar basis, against the (97 percent) callable capital pledges of the United States, Europe, and Japan. Thus, the World Bank is a major issuer of bonds in international capital markets; in fact, it is the largest single issuer. In the year ended June 30, 1990, the World Bank issued some $11.5 billion in new bonds to fund its activities. Without the World Bank, part of that investment capital would have gravitated to developing countries only to the extent that they offered dynamic and secure investment opportunities. The World Bank effects a misallocation of nearly $12 billion in valuable investment capital annually--soaking it out of international markets and funneling it to state investment schemes throughout the developing world.

Plans for the new EBRD call for 30 percent of member nations' shares to be "paid in." Thus, the proposed U.S. contribution profile would comprise $363 million in paid-in capital and $847 million in (unfunded) callable capital--or $73 million paid in and $169 million callable annually for five years. Again, that sounds like quite a bargain, until one considers the FSLIC bankruptcy and recipient governments' appetite for cheap funds to finance endless loss-making programs and schemes.

Potential Latin-Americanization of Eastern Europe

The heavily indebted developing nations, particularly those in Latin America, are now on a borrowing treadmill with the World Bank. Arrears in repayment of World Bank loans have steadily grown in recent years. Currently, $3.2 billion in World Bank loans are on nonaccrual status. Although the nine nations in arrears are small ones, such as Honduras and Zambia, World Bank officials know that preservation of the bank's critical AAA credit rating requires that none of the megadebtors (e.g., Mexico, Brazil, Argentina) fall into arrears. To head off any such possibility, the World Bank is annually extending ever larger new loans to the 17 most heavily indebted developing countries in an effort to keep them servicing their old World Bank loans. Despite the fact that the World Bank's new loan commitments to those 17 countries are up from $6.1 billion in 1986 to $8 billion in 1989, net transfers from the World Bank to those countries have fallen from $319 million to -$1.9 billion over the same period.

If those nations had invested the borrowed funds productively, the positive cash flow to the World Bank would pose no problem. Net payments from borrower to lender are a fundamental stage in any borrowing relationship. But given the present conduct of economic policy in most of the Latin American countries, the growing net transfer to the World Bank will continue to be a serious problem. The borrower nations can be expected to seek--and the World Bank to encourage--ever higher levels of World Bank borrowing as their repayment requirements to the World Bank continue to grow. Latin American nations are effectively "hooked" on World Bank loans. The World Bank's radically expanded lending in Eastern Europe, together with the forthcoming lending activity of the EBRD, can easily result in "hooking" those nations on development bank loans--an effective "Latin-Americanization" of Eastern Europe.

The bottom line is that the World Bank is fundamentally a money-moving institution. Its current level of new loan generation--$22 billion annually--allows little room for discretion among potential borrowers or projects. In addition, the bank has no record of assisting any borrower government through any sort of "critical stage" after which it withdraws. Nations that become World Bank borrowers remain borrowers for decades. A major 1987 internal report on the bank's experience with rural development lending, its lending fad from the mid-1970s through the mid-1980s, reveals some of the dynamics that may play out in its rush to lend in Eastern Europe:

> Lending was supply-driven by funds and project slots and the need to meet arbitrary target criteria, rather than demand-driven by sound strategies and realistic, well-prepared project proposals. Moreover . . . the Bank lost sight of the reality that the cost of failures . . . would be borne by the borrower countries and not the Bank. . . . [The World Bank's] program divisions [are] usually allocated country lending quotas [that] determine the potential average loan size even before the requirements of individual projects are

known.(51)

Politicization of International Finance

Finally, brief mention of the proliferation of official guarantee programs run by the United States, European nations, Japan, and the World Bank is in order. Such programs are increasingly short-circuiting the free market's efficient allocation of capital by underwriting the activities of Western exporters and investors in developing countries. The programs include the U.S. Export-Import Bank (and its counterpart agencies run by European nations and Japan), the U.S. Overseas Private Investment Corporation (OPIC), the World Bank's Multilateral Investment Guarantee Agency, and the World Bank's "co- financing" program.

With the aim of jump-starting economic transformation in Eastern Europe, those programs are currently being expanded for that region. Such efforts, however, by definition paper over inadequate investment climates throughout the world and tax Americans to finance the socialization of international financial transactions.

The 1989 SEED Act made Poland and Hungary eligible for Export-Import Bank assistance. The pending House and Senate SEED II bills would further qualify Czechoslovakia, Yugoslavia, and other East European nations for Ex-Im Bank aid. As mentioned earlier, the Ex-Im Bank's aggregate net operating losses between 1982 and 1988 totaled $2.3 billion. In response, the Bush administration's proposed fiscal year 1991 budget recommended an 18 percent cut in the bank's direct loan program. In his preface to the budget, Office of Management and Budget director Richard Darman labeled the Ex-Im Bank one of the budget's "hidden Pacmen" waiting to spring forth and consume resources as further losses mount.(52)

In fact, the Ex-Im Bank is little more than a lucrative government subsidy program for the giants of U.S. industry. A 1986 OMB study found that over 65 percent of Ex-Im Bank assistance is received by just 18 U.S. firms, including the Bechtel Group, Inc.; Boeing Co.; General Electric Co; and Westinghouse Electric.

The OPIC, established in 1969, insures U.S. companies that invest in projects abroad against nationalization, political violence (war, revolution, insurrection, civil strife), currency inconvertibility, and other risks. In addition, Congress recently voted to allow the agency--backed by the full faith and credit of the U.S. government--to make equity investments around the globe.(53) The 1989 SEED Act cleared Poland and Hungary for OPIC assistance. In February 1990 the agency signed its first insurance contract in Hungary--covering General Electric's much-touted $150 million investment in Hungary's principal lighting manufacturer, Tungsram. The pending Senate and House SEED II bills would further extend eligibility to Czechoslovakia, Yugoslavia, and other East European nations.

Like the Ex-Im Bank, OPIC programs primarily benefit major U.S. corporations. During fiscal 1989 OPIC extended $613 million in investment guarantees. Seventy-seven percent of that coverage ($470 million) is enjoyed by eight major conglomerates--American Express Bank, Ltd.; Cargill, Inc.; Chase Manhattan Bank, N.A.; Citibank, N.A. (together with Citicorp and affiliated firms of the two); Coca Cola Export Corporation; Enron Energy Resources, Inc.; John Hancock International Holdings; and Transcontinental Capital Corp.

Certainly those giants can afford private insurance alternatives. The private market in political risk insurance, most notably served by Lloyd's of London, has grown extensively in recent years. Estimates are that that market accounted for between $150 million and $300 million in annual premium income in the late 1980s, compared with some $15 million in the late 1970s.(54) In contrast, OPIC's 1989 premium income totaled $33.5 million.

Survey data suggest that only 25 to 50 percent of OPIC- insured projects would not have been undertaken without OPIC.(55) The problem is clearly not that private insurance is not available but that its (higher) costs accurately reflect the true risks of investing in the world's politically or economically unstable nations. OPIC's subsidized investment insurance only diminishes nations' incentives to create sound investment climates and produces less efficient international investments.

Washington policymakers' rush to use OPIC in an attempt to leverage substantial foreign investment in Eastern Europe's new democracies is ill-advised. As U.S. Chamber of Commerce chief economist Richard Rahn argued earlier this year, "private Westerners cannot be expected to--and in fact should not--invest in [East Europe's] economies until

full property rights have been instituted, viable accounting systems have been installed and, most importantly, a functioning convertible currency has been established."(56)

The World Bank's Multilateral Investment Guarantee Agency, formed in the summer of 1988 with capital of $1 billion, offers political risk insurance strikingly similar to OPIC. In a stark indication of the growing politicization of international investments, two of MIGA's first three contracts are to reinsure contracts written by other government insurance agencies. In June 1990 MIGA agreed to reinsure $50 million of a $158 million insurance policy issued by the Export Development Cor poration of Canada in support of a $276 million investment in a mining project in Chile. Also in June, MIGA agreed to reinsure $30 million of OPIC's $130 million insurance of GE's investment in Hungary's Tungsram.(57)

MIGA is not the World Bank's only mechanism for coaxing reluctant private capital into developing nations. For some two decades, the World Bank's cofinancing program has involved the bank in lending to or guaranteeing a part of an exercise in raising capital, the bulk of which is provided by bilateral aid agencies, official export credit agencies, or private banks.(58) In mid-1988, dismayed that private banks' interest in cofinancing had waned in recent years, the World Bank launched an "expanded cofinancing program." According to the bank: "ECOs [most frequently in the form of partial guarantees] will be made available to eligible borrowers to attract private financing for specific projects or investment programs that are identified and appraised, and are accompanied by [World] Bank loans."(59)

The bank's "Indicative List of Countries Potentially Suitable for ECOs" includes Algeria, China, Colombia, Cyprus, Fiji, Hungary, India, Indonesia, Malaysia, Pakistan, Papua New Guinea, Romania, Thailand, Tunisia, and Turkey (that is, countries that have not rescheduled their private debts within the last five years).(60) ECOs may take many forms: guarantees on commercial bank loans for government projects in developing countries, guarantees on governments' medium- and long-term bond issues (either publicly issued or privately placed with institutional investors), even guarantees that grant investors in developing-country government bonds the option to "put" them to the World Bank under predetermined circumstances.(61) In short, the program is an aggressive attempt by the World Bank to entice the participation of private capital in public-sector investment programs that are initiated and financed by the World Bank.

Even though only one of the countries eligible for the World Bank's new cofinancing program is in Eastern Europe, major U.S. banks are already calling on the not yet congressionally authorized EBRD to provide cofinancing guarantees of their lending in Eastern Europe. An April 1990 report by the money-center banks' Washington-based lobbying firm, the Institute for International Finance, first warns that U.S. banks will be taking a "cautious approach" to sovereign lending in Europe. (Given Washington's entanglement in U.S. banks' losses in Latin America, that is a hopeful development.) Then the report quickly adds that much will depend on the co-financing guarantees available from the EBRD.(62)

In a misguided attempt to help developing and East European nations skip steps on the road to economic reform, Western governments are increasingly backing schemes to leverage private resources to those countries. Such programs lessen beneficiary nations' incentives to radically reform, contribute to the misallocation of international capital, and force U.S. taxpayers to guarantee America's most powerful firms against losses in their overseas business ventures.

Conclusion

Hungarian economist Janos Kornai and Polish economist Jan Winiecki are leading East European advocates of the notion that what their nations most need, above all else, is flesh-and- blood capitalists--domestic or foreign. The two have passionately argued against numerous proposals in their countries for a pseudocapitalism fashioned through "state holdings"--bureaucratically appointed managers would play the stock market but never be able to take possession of the proceeds of their activity.(63) According to Kornai:

> A most important element of the social transformation we seek is the development of a new middle class, whose core would be composed of industrious, thrifty entrepreneurs. . . . From among the proprietors of such small- and medium-size units the pioneers of economic progress and founders of large enterprises would eventually emerge as the result of the market's natural selection process. Later these entrepreneurs can be surrounded by people who do not themselves take part in the creation of new organizations . . . but

> who willingly invest in the economy through the purchase of shares or in other ways. We have every reason to believe that sooner or later these developments will lead to the emergence of genuine private stocks, authentic private joint stock companies, and a real stock exchange. . . . It is not advisable, and perhaps not even possible, to skip over this stage of historical development.(64)

The message is quite simple: there is no capitalism without capitalists. And capitalists (domestic and foreign) are something the East European nations will have to cultivate on their own--through constitutionally guaranteed and fully functional property rights systems, viable legal accounting systems, modest levels of taxation and regulation, and a functioning convertible currency.

The World Bank's counterproductive record throughout the developing world and in Eastern Europe overwhelmingly disqualifies it as a catalyst for radical change. Similarly, the new East European development bank is fundamentally a rear-guard socialist undertaking. The last things nations in transition need are multilateral development bank loans to politicize their economies. The new political structures in Eastern Europe are weak, and the inflow of massive subsidized credits can easily forestall the needed transition to market prices and private investment.

More important, Latin American nations, after being spoonfed on World Bank loans throughout the 1980s, are caught under an ever larger mountain of debt--50 percent of which is now to the World Bank and other official creditors. The United States and other Western nations should not corrupt Eastern Europe's budding democratic-capitalist regimes with central planning advisers and supply-driven multilateral bank loans. By supporting programs to advise the new democracies of Eastern Europe on how to plan for capitalism, Washington places forbidding obstacles in their path.

Notes

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(2) Henry Kaufman, "Where's the Cash for Eastern Europe?" Washington Post, July 7, 1990, p. A19.

(3) Tyler Cowen, "The Marshall Plan: Myths and Realities," in U.S. Aid to the Developing World: A Free Market Agenda, ed. Doug Bandow (Washington: Heritage Foundation, 1985), pp. 61-74. This section relies heavily on Cowen.

(4) Ibid., p. 67.

(5) Ibid., p. 64. American aid never exceeded 5 percent of West German GNP, while Allied occupation costs and reparations absorbed from 11 to 15 percent of West German GNP. The net economic transfers out of West Germany even exceeded that amount because throughout the mid-1950s Bonn repaid half of its Marshall Plan aid.

(6) Ibid., p. 68.

(7) K. W. Rothschild, The Austrian Economy since 1945 (London: Royal Institute for International Affairs, 1950), pp. 14, 58, 71; cited in Cowen, p. 69.

(8) Franz Nemschak, Ten Years of Austrian Economic Develop ment: 1945-55 (Vienna: Association of Austrian Industrialists, 1955), p. 28; cited in Cowen, p. 70.

(9) The White House, "Presidential Economic Delegation: Over view and Executive Summary," December 1989, Commerce and Industry section, p. 5.

(10) Ibid., Agriculture section, p. 2.

(11) Bureau of International Labor Affairs, U.S. Department of Labor, "Program Implementation Plan for Labor Technical Assistance in Poland and Hungary," memorandum, March 1990, pp. 4-5.

(12) Ibid., p. 16.

(13) See James Bovard, "The Failure of Federal Job Training," Cato Institute Policy Analysis no. 77, August 28, 1986.

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(18) Paul Craig Roberts, testimony before the Subcommittee on International Economic Policy, Trade, Oceans and the Environ ment of the Senate Foreign Relations Committee, March 22, 1990.

(19) Senate Foreign Relations Committee Democrats, "Support for East European Democracy (SEED) Act II," informal draft, April 2, 1990, p. 35.

(20) See Congressional Record, March 22, 1990, pp. S3089-90.

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(23) Mary Shirley, The Reform of State-Owned Enterprises: Les sons from World Bank Lending (Washington: World Bank, Country Economics Department, 1989), pp. 52-57.

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(25) Ibid., p. iv.

(26) Ibid., p. 12.

(27) Ibid., p. iv.

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(29) Ibid.

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