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By Edward L. Hudgins, Ph.D.

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Now that the countries of Eastern Europe have ousted their communist rulers and are on the road to democratic elections, their next great challenge is to reverse over forty years of economic destitution caused by their socialist systems. There is no lack of good will or general support for their struggle among the Western industrialized democracies. The question is what specific policies or assistance from the West would offer the best chance for Eastern Europeans to establish growing, prosperous economies.

One of the means by which the West ostensibly intends to help would be useless at best and more likely would impede East European development. The plan to establish a European Bank for Reconstruction and Development, modeled on the World Bank, promises to inflict on these emerging democracies the same flawed policies that, for example, in Latin America failed to solve the debt crisis, probably making the situation worse, and helped perpetuate poverty in less-developed countries. The Bush Administration, unfortunately, seems more concerned that the United States appear to be a respectable and cooperative member of the international community, going along with this new Bank despite its major defects, rather than pursue policies that would best help Eastern Europe.

But guided by the lessons of the past, the U.S. should refuse financial support for this proposed European Bank for Reconstruction and Development and instead promote growth-oriented free market policies that empower the people of Eastern Europe, creating opportunities for them to profit from their own hard work and efforts.

Conceived by Western European governments, led by France, the new Bank would receive 10 percent of its $12 billion capital from the U.S., which also would have a 10 percent vote in matters of lending policy. The members of the European Community together would contribute 51 percent of the funds and have a 51 percent vote, a controlling majority, over who receives loans from the Bank and for what purposes. East European countries would be members and eligible for loans. Some 60 percent of the Bank's funds would be earmarked for the newly emerging private sector in Eastern Europe; 40 percent would go to the governments. The Soviet Union would be a member of the Bank, with a 6 percent vote and the ability to borrow up to the amount that it pays into the Bank in hard currency.

The first objection to an East European Development Bank is that transfers of funds, whether in the form of loans or grants, have very little to do with promoting economic prosperity in less-developed countries. The failures of foreign aid are becoming generally recognized by economists and U.S. policy makers alike. A report issued last year by Alan Woods, the late Administrator of the Agency for International Development, found little

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correlation between aid and development. For example, Tanzania has received more assistance per capita than almost any other country in the world, yet its economy has deteriorated over the last two decades. The West has promised the Philippines $10 billion in assistance. Yet some $4 billion that has already been allocated sits unused in development accounts because that country is unable to employ it effectively. The Philippine economy is in shambles. On the other hand, South Korea, which had its U.S. development assistance cut off in the early 1960s, is doing quite well. Chile, which has received no assistance for some two decades, has the strongest economy in Latin America. The Woods report found that market-oriented economic policies were the best means by which less-developed countries could grow.

It might be argued that the West is agreed that the newly-free countries of Eastern Europe need to move towards free market economies. But this is not altogether true and thus raises **a second objection.** A Bank controlled by West European countries with mixed socialist-market economies cannot be expected to promote the complete abandonment of socialism in favor of maximum freedom for the people of Eastern Europe to produce and prosper through their own efforts. Over the past decade the domestic policies of these West European countries have led to unemployment rates on an average twice as high as in the U.S. Almost no new jobs, on net, have been created in these countries during that time, while some 19 million have been created in the U.S. Even the integration of the European Community planned for 1992 testifies to Western Europe's economic problems: the integration is motivated in large part by their loss of competitiveness to the U.S. and Japan.

The West Europeans still talk of a "middle way" between socialist central planning and wealth redistribution and a free enterprise system for Eastern Europe. But Eastern Europe has no wealth to redistribute. Those countries must focus first and foremost on the creation of wealth, something that the West Europeans fail to understand.

A third objection to the new Bank is found in Western Europe's past record as a foreign assistance donor. East Europeans should be particularly concerned in light of the dismal results achieved by their Western neighbors as the principle provider of aid and advice to Africa. Overall, Africa has stagnated economically. In addition, the West Europeans are in part to blame for some of the current economic difficulties in Eastern Europe. Guarantees by the West German government of private loans to Poland over the last decade delayed reform, propped up a brutal regime, and left Poland with a huge foreign debt. A new Bank to promote development in Eastern Europe controlled by Western Europeans offers little hope of success.

If the history of U.S. membership in the World Bank is any indication, **a fourth objection** to participation in the new Eastern Europe Bank is that Administration and congressional attempts to influence its lending policies will be futile. The Bush Administration argues that its 10 percent share will give the U.S. considerable leverage in the new Bank. But America's 20 percent share in the World Bank has not resulted in American control. For example, currently the Congress mandates that the U.S. oppose World Bank loans to certain countries based on such criteria as human rights abuses, expropriation of private property, and using export subsidies that harm U.S. businesses. Of the 73 loans between 1983 and 1987, worth $5.3 billion, which the U.S. refused to support based on direct orders from Congress, the World Bank voted in favor of each and every one. Not once did the will of Congress prevail. The European Community will have a controlling share in the new East Europe Bank.

Therefore U.S. Congressmen will have to be satisfied with talking about the problems of Eastern Europe among themselves since nothing they say or mandate is likely to have much effect on the policies of the new Bank.

Even if there were agreement on the policies necessary to help Eastern Europe, **a fifth objection** to a new Bank is that there is serious question whether it could, as an institution, carry out its mission. Here the situation at the World Bank is instructive. While there are some staff members and some researchers who promote free market economics, many staff members simply do not understand how a market works. There is a manpower problem. Further, World Bank staffers do not have incentives to promote free enterprise policies. Since the World Bank is not like a real bank; that is, since it does not have to make a profit, and its losses are covered by the member governments, there is little incentive to deny loans to sovereign borrowers. The incentives in fact are to lend as much as possible, with little attention to where the money goes, and then seek additional funds from governments. This is exactly what happened between 1986 and 1988. An Eastern Europe Development Bank would face these same problems.

If the records of the World Bank or the InterAmerican Development Bank (IDB) are any indication, this new Bank could insure the Latin Americanization of Eastern Europe, **a sixth objection** to an Eastern Europe Bank. In Latin America, massive loans generally have delayed economic change and helped the very politicians responsible for a country's economic problems to hang on to power. In the 1980s, for example, the World Bank and the IDB poured billions of dollars into Brazil, Argentina, and Mexico to cover the continuing costs of money-losing state enterprises and bloated state payrolls. Latin American governments used these funds to reward political cronies with jobs and to fatten the personal bank accounts of corrupt officials. The resulting wasteful projects are infamous. In Eastern Europe, with Communist Party *apparatchiks* in administrative positions still running the governments, the situation promises to be just as bad. They will no doubt have a major say in where the 40 percent of the East European Bank's funds allocated to the public sector will go.

A seventh objection concerns the allocation of the 60 percent of the new Bank's funds earmarked for the private sector. There is no indication that government officials in Eastern or Western Europe are capable of picking economic winners and losers from among competing private sector firms. West European governments have subsidized many of their own failing industries, such as shipbuilding and steel, and thereby hindered the development of new high tech industries and wasted billions of dollars. These governments are hardly the doctors best suited to treat the economic illnesses of Eastern Europe.

I note here the importance of savings and small scale capital formation as a means to finance business ventures. The vast majority of jobs in most countries are in small enterprises. Personal savings, not bank loans, are the primary source of capital for such businesses. Therefore a stable currency and low inflation rather than a huge international bank is vital to a healthy, growing private sector.

The Soviet membership in the new Eastern European Bank could cause problems for Eastern European countries, **an eighth objection** to U.S. participation. The U.S.S.R. would have fuller knowledge of the economic plans and conditions of these countries and might be able to delay or derail loans to those countries that offend Moscow, for example, by trying to leave the Warsaw Pact and send Soviet troops packing. The U.S.S.R. also could block membership of the Baltic Republics as they seek to reestablish their independence. In a recent letter to Secretary of State James Baker, Lane Kirkland, President of the AFL-CIO, expressed just such concerns. The new Bank should certainly admit as founding members Lithuania, Latvia, and Estonia.

Finally, while initially Soviet borrowing would be limited to the amount of hard currency that it pays into the Bank, borrowing privileges no doubt would be expanded in the future. Yet since the Soviets send billions of dollars overseas to their own allies each year, including some $6 billion to Cuba, they hardly deserve a bailout from the U.S. taxpayers. Further, Soviet capital assets and labor are tremendously underutilized. Western loans or handouts simply would allow Moscow to continue its wasteful policies.

A ninth objection to a new East European Bank is that another international option currently exists. If a special source of funds is needed for Eastern Europe, a simpler approach, requiring little new bureaucracy and overhead costs, would be to use a special "window" or facility at the World Bank specifically for Eastern Europe. Then only if this window failed to serve the needs of Eastern Europe could the more expensive and cumbersome new Bank be established.

A tenth objection to a new Bank is that the Eastern Europeans themselves are not clamoring for such aid. Rather, they are asking for markets opened to their exports and direct foreign investment by Western businesses in their countries. These free market tendencies should be encouraged with open markets in the West, not with international welfare.

Expanding Opportunities. While the proposed European Bank of Reconstruction and Development offers little prospect of real success, there are ways that the U.S. could help the new democracies of Eastern Europe. First, assistance to those countries could be allocated specifically to expand the opportunities of individuals in accordance with an Index of Economic Freedom. Such an Index was passed last year by the Senate as part of a revision of the Foreign Assistance Act. The House version of that bill called for a study of such an Index.

Too often foreign assistance helps governments and neglects the true motor of economic growth, the individual entrepreneur. Yet in Eastern Europe, as in most less-developed countries, we see grass roots economic initiative in what is called the informal sector or black market. Repairmen moonlight to provide services to willing customers. Smugglers bring in consumer goods from the West to meet the needs of the people. The Index of Economic Freedom would help remove restrictions on such entrepreneurs so that they could operate more efficiently.

This Index, for example, promotes the right of each individual to own private property and to have it protected by government, including an independent judiciary. Too often in less-developed countries a ruling elite has arbitrary power over the possessions of others. The Index would guarantee the freedom of individuals to trade with one another for a price agreed on by mutual consent of buyer and seller. In Poland, for example, farmers who owned land were forced to sell crops to a government monopoly and at prices set by the government. This discouraged production. U.S. assistance can best help Eastern Europe by helping to establish the economic freedom for each individual.

Removing Barriers. Another means by which Congress and the Administration could help Eastern Europe is by initiating negotiations for a free trade area with the U.S. Under such an arrangement, which would probably begin with Hungary, Poland, and perhaps Czechoslovakia, partners would remove all tariffs and many non-tariff barriers to trade. This would offer East European entrepreneurs the opportunity to produce and sell in the U.S. market. It would also provide more goods for the American consumer. In addition, it would also open Eastern Europe to American products. It is important to remember that, as was the case with Germany and Japan after the Second World War, Eastern Europe during its period of recovery will require substantial imports.

A free trade area would also get the U.S. in on the ground floor of what, with the right policies, could be booming and prosperous economies in the decades to come. Consider the situation the U.S. would be in today if it had established free trade areas with Germany and Japan in the 1950s during their period of recovery. A free trade area would also give the U.S. considerable leverage over the European Community as it seeks to integrate fully by the end of 1992. With the prospect of a U.S.-Eastern European free trade area, the Western Europeans would have a strong incentive to avoid protectionist policies and seek freer trade with the U.S.

The Bush Administration has failed to defend membership in the new Bank on its merits. It seems more concerned about avoiding bad publicity than in following the best policies. Treasury Secretary Nicholas Brady has said, "Let's conjure up together what the headlines would be if we didn't join this. It's kind of a stark proposition to think of us not as a member . . . . "

I would suggest the following headlines:

> "Congress rejects failed formulas of the past. Vows to promote genuine prosperity in Eastern Europe."
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> "Congress devotes U.S. assistance to empowering people of Eastern Europe, in accordance with Index of Economic Freedom, with private property rights, rights of individuals to buy and sell as they please."
>
> "Congress seeks free trade area with Eastern Europe, offers real opportunities for entrepreneurs on both sides of the Atlantic."

Secretary Baker says the U.S. must participate in a new Bank to demonstrate U.S. leadership. Yet leadership does not mean blindly following the failed economic formulas of the past even when they are suggested by America's West European friends. Instead, leadership means going beyond the fallacy of equating cash payments with caring. It means facing directly the real problems and addressing them on their merits.

The people of Eastern Europe have struggled bravely to reestablish their political freedom. As a sign of respect to them, and in an attempt to bring about real economic change, the West should not inflict on them the same policies that have locked into poverty other less-developed countries. The U.S. should not participate in the new Bank.

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