<u>Mr. Duisenberg assesses what we have learned from the Marshall Plan</u>

Dinner speech held by the President of the Netherlands Bank and of the Bank for International Settlements, Dr. W.F. Duisenberg, at the occasion of the Marshall Plan celebration in Washington on 15/5/97.

On 5th June this year it will be exactly 50 years ago since George C. Marshall, in a speech at Harvard University, set out his plans for the economic recovery of Europe. Although I fear that I will not succeed in making as momentous a speech as Marshall did, I am honoured to speak to you here today and commemorate this historic occasion, which I believe marks the starting point of Europe's post-war economic miracle.

Anniversaries such as this present a useful opportunity to reflect on our past successes and to draw lessons from them. This is the challenging task which the organisers of this conference have set out before me today and I will endeavour not to disappoint them. In doing so, I would like to start out by pondering for a moment on what it was exactly that the Marshall Plan contributed to post-war economic recovery. Although the importance of the Marshall Plan is relatively undisputed, the channels through which it boosted economic growth have been the subject of lively debate. Only if the role of the Marshall Plan is put into the proper perspective, can we hope to fruitfully draw on our past experiences. Subsequently, I will attempt to apply what we have learned to the current transformation process in Central and Eastern Europe, which shows some interesting similarities with post-war reconstruction. As I will argue, however, the transformation process in transition economies is, in other respects, uniquely different. In my view this precludes using the Marshall Plan as a blueprint for aid to transition economies, although it harbours some important lessons.

Finally, a word of caution is in order. I am a central banker. As such, I will focus on the economic aspects of the Marshall Plan, not the political ones. Such a discussion is necessarily incomplete; but I will leave it to others to comment on the political and diplomatic context in which Marshall aid took place.

<u>The contribution of the Marshall Plan – distinguishing fact from fiction</u>

Marshall aid was a lifeline from the United States to Europe at a time when, economically, Europe had been brought down to its knees. Between 1948–1951 the program annually transferred roughly 1% of American GDP, or around $ 13 billion in aid, to some 16 European countries. In net present value terms this amounts to roughly $ 80 billion. By 1951, six years after the war and the effective end of the Marshall Plan, national incomes per capita were more than 10 percent above pre-war levels, while the economic growth rate in the next two decades reached levels which were twice as high as for any comparable period before or since.

This temporal coincidence between the extension of Marshall aid and the "miraculous" recovery of Europe has induced the inferral of a causal relationship. It should be noted, however, that, even after extensive academic research, the roots of Europe's economic miracle are not yet adequately understood. Thus, it is difficult to isolate the contribution of the Marshall Plan. Economically, the strong post-war growth performance is in large part explained by the so-called Solow residual – that is, not by traditional factors such as capital and labour. This is an economist's way of saying we do not fully understand what is going on.

A first observation in this regard is that the reconstruction of Europe did not start in 1948 – the year in which the first Marshall aid was disbursed – but in 1945. At that time the US was already channelling large amounts of aid to Europe through the United Nations Relief and Recovery Administration and other programs. This aid, which was in the order of $ 4 billion annually in the first two post-World War II years, was – in flow terms – in the same order of magnitude as the Marshall aid.

A second observation is that, given the unprecedented magnitude of aid from the perspective of the donor community, the Marshall Plan in a quantitative sense played a smaller role than one would expect in accelerating the replacement and expansion of the European capital stock. Marshall aid accounted for less than 2.5% of the combined national incomes of recipient countries between 1948 and 1951. While this is indeed a significant sum, this resulted in at most a 1% increase in investment, at a time when domestic investment was running at 15% of GNP. In other words, this does not explain growth rates several percentage points above their historic trend levels. It should be noted, however, that growth may have been stimulated through other channels, for instance, by providing much-needed hard currency reserves which could be used for financing industrial raw materials. Over a third of Marshall aid was used in this way.

A third observation is that the Marshall Plan also did not play a large role in financing the reconstruction of devastated infrastructure as this had been largely accomplished before the program got underway. In fact, countries that were major aid recipients saw the government spending share of national income fall relative to other nations, the opposite of what one would expect if there had in fact been a shortage of public investment capital.

So how did Marshall aid matter? Recently, there has been a shift among academics to what might be termed as a "revisionist" analysis of the contribution of the Marshall Plan to European recovery. According to this view, the Plan's main contribution was to alter the environment in which economic policy was made, tilting the balance in a qualitative manner rather than quantitatively.

As you will recall, in 1947, two years after the war, Europe was still characterised by macroeconomic instability, inflation and an increasingly tight balance of payments constraint. The initial response by governments had been to counter inflation by retaining controls, thereby prompting the growth of black markets and discouraging transactions at official prices. By distorting the allocative mechanism of the market, saving and initiative were discouraged. The appropriate response as prescribed by economic theory would have been to decontrol prices to induce producers to bring their goods to market. In addition, fiscal discipline and monetary restraint was necessary, in order to reduce inflationary pressures. Such policies, however, require political compromise and sacrifice by everyone which at that time, when the needs of Europe were greatest, were not necessarily forthcoming. The Marshall Plan may have played a critical role by easing decisions over the distribution of scarce resources. Of course, the extended aid did not obviate the need for sacrifice but it increased the size of the distributional pie available to the various interest groups.

In my opinion, however, the most important channel through which the Marshall Plan contributed is through its conditionality, with which the US was able to exercise significant influence over the economic policies of Marshall aid recipients. Although over the years the Plan has become synonymous with the substantial aid flows transferred from the US to Europe, it is useful to recall that before receiving that aid each recipient country had to sign a bilateral pact with the US. In that pact, countries agreed to balance their budgets, restore financial stability, stabilise the exchange rate at realistic levels and enhance mutual cooperation. Along with the carrot, thus came the stick. In many ways this is similar to the approach followed in later years by the International Monetary Fund in its macroeconomic adjustment programs.

Not only could the Marshall aid itself not be spent freely – it could be spent on external goods only with the approval of the US government – but the recipient was also required to place a matching amount of domestic currency in a counterpart fund to be used only for purposes approved by the Marshall Plan administration. As such, for each dollar of Marshall aid, the US had control over 2 dollars of real resources. In some instances the US insisted that the funds be used to buttress financial stability. Britain used the bulk of its counterpart funds to retire public debt. In the case of France, the US used the counterpart funds as a tool to pressure the new government into reaffirming its willingness to continue policies leading to a balanced budget. West Germany found the release of counterpart funds delayed until the nationalised railway had reduced expenditures to match revenues.

Nations undergoing high inflation could not draw on counterpart funds until the Marshall Plan administration was satisfied that they had achieved a workable stabilisation program. As a condition for receiving Marshall Plan aid, each country was required to develop a program for removing trade controls in order to promote intra-European trade. The multilateral manner in which this was achieved – through the OECD in which all Marshall recipients were united – contributed significantly to the European integration process. The most important institutional innovation in this regard was the establishment of the European Payments Union in 1950, a product of the Marshall Plan. The Marshall Plan should thus be thought of as a large and highly successful structural adjustment program.

At this stage, I believe it is useful to draw two preliminary lessons:

– The first lesson to be drawn from the Marshall Plan is that the central element in post-war Europe's economic success was sound economic policy.

– The second lesson is that even aid flows in the order of magnitude as those under the Marshall Plan are likely to be small compared to resources generated domestically. Nevertheless such aid flows are likely to facilitate the adoption of otherwise painful economic policies.

<u>A new Marshall Plan for Eastern Europe?</u>

An interesting question is to what extent we can apply these lessons to the current transformation process in Central and Eastern Europe, to which I will refer as Eastern Europe from now on? To some extent, of course, this question is rendered out of date by the fact that the transition process in a number of countries has been underway for over seven years now.

The International Monetary Fund has more or less adopted a role similar to that of the Marshall Plan. Through its macroeconomic adjustment programs credits are extended on the basis of countries meeting economic performance criteria. As such, IMF macroeconomic stabilisation programs form a crucial first step in the transformation process, without which the longer lasting structural reforms cannot take hold. Of the early reformers – Hungary, Poland, the Czech Republic, Slovakia, the Baltics, Croatia and Slovenia – only Hungary still has an IMF program, but it is of a precautionary nature; no purchases are made. In fact, since 1995 these countries have been making net payments to the Fund and some have obtained access to international financial markets. Others, however, are less advanced and still in need of the required reforms.

The transition process, so far, seems to mirror the circumstances leading to the adoption of the Marshall Plan in two important regards. First, financial instability which was pervasive in the early years of post-World War II Europe is also present in several transition economies. As for Europe 50 years ago, an important precondition for growth to take off is the stabilisation of prices and, after an initial adjustment, the exchange rate. This has been the purview of the IMF in its adjustment programs, which through the extension of credits has somewhat facilitated the adoption of painful economic policies.

Second, both Europe in 1948 and Eastern Europe at present have experienced a period of intensive government intervention, albeit for different reasons. This has created a habit of control and regulation along with a certain unease with the workings of the market, similar to the mistrust of the market in post-war Europe following the failure of market mechanisms during the Great Depression. In both periods, the myriad of restrictions needs to be abolished, and structural reform needs to take hold.

But there are also important differences between the transformation process and post-war recovery. The Marshall Plan was effective at least in part because Europe had experience with markets. It possessed the institutions needed for their operation. Property rights, bankruptcy codes, court systems to enforce market contracts – not to mention entrepreneurial skills – all were in place. This institutional basis has been lacking in Eastern Europe. Moreover, the physical allocation mechanism and absence of meaningful prices were much more extreme than under wartime rationing.

Second, the scale on which enterprises in Eastern Europe need to be restructured finds no comparison in post-war Europe. On the issue, for instance, how fast to close certain factories given the absence of an adequate social safety net, the experience of post-war Europe is of little help simply because there was little to close down. In addition, the post-war experience does not teach us how to implement mass privatisation, nor how to put a huge sector of large state enterprises on a commercial basis, all simultaneously.

Third, transition economies have to liberalise their economies in an already highly liberalised international environment and of highly developed international capital markets. In such a context, policy mistakes or a lack of market confidence can easily lead to a large and rapid outflow of capital, thus draining away much-needed savings. These problems are exacerbated by weak financial systems where experience and expertise in, for instance, credit allocation is lacking.

<u>So what does Eastern Europe need?</u>

This leads me to believe that the needs of Eastern Europe are different from those of post-war Europe under the Marshall Plan. At a conference several years ago, the reform process in Eastern Europe was compared first with post-war reconstruction and then with the reconversion of regions or industries in decline.[1] Of the latter, we have plenty of examples, for instance, the shipbuilding industry in Europe or the coal, steel and textile sectors. Generally speaking, the transformation of these industries is a slow and painful process, usually at a high cost. Whereas post-war reconstruction was a process of building upon what existed, reconversion, by its nature, implies changing and perhaps destroying the existing structure, not building upon it. This is much harder to achieve. Which experience is the more relevant for Eastern Europe? In my opinion: reconversion. The discussion in Eastern Europe is not so much

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1 Blanchard O. “Panel discussion: Lessons for Eastern Europe today”, *Postwar Economic Reconstruction and Lessons for the East Today*, MIT Press, Cambridge MA, 1993.

about rebuilding existing structures, but rather about replacing them by new ones; similar to the replacement of declining West European industries by new ones.

The question is whether we can aid this reconversion process by transferring comparable amounts of money towards Eastern Europe as under the Marshall Plan. Transferring the equivalent of 2.5% of national incomes of the recipient countries, has been estimated to cost roughly $ 20 billion a year. The Bretton Woods institutions have of course been extending credits but on a smaller scale. By comparison, the annual flow of total *official* financing to Eastern Europe has been around $ 15 billion, some 25% below that which was transferred under the Marshall Plan. Total flows, however, including private financing, reached some $ 36 billion in 1996. From the recipient's perspective, therefore, the amount of financing transferred to Eastern Europe is quite significant. From a donor's perspective, on the other hand, the present effort still pales somewhat compared to the tremendous display of solidarity by the US after World War II. In this regard, we should remember that the US financed the entire Marshall Plan by itself. If industrial countries were to make a similar effort and transfer 1% of their GDP to Eastern Europe, aid flows to this region would amount to more than $ 170 billion a year, much more than the current $ 15 billion. This again illustrates the unique nature of the post-war US contribution. It is uncertain whether increasing the amount of official financing to Marshall aid standards would yield significant additional benefits. It could further facilitate support for required reforms, but to measure the marginal benefit of extra aid in these political terms is very difficult. In any case, it is critical that whatever programs are adopted, aid should be provided on the basis of actions taken rather than need.

The achievements of the Marshall Plan suggest that the transformation process in Eastern Europe would be significantly enhanced by intensifying mutual cooperation in the area. Cooperation in the fields of trade, financial and monetary matters could become the engine of economic growth just as it was during the post-war boom. Between 1948–1952 trade among European countries increased more than 5 times as fast as European trade with other continents. One of the lessons of the post-war era is that trade can be the engine in a process of economic restructuring. At the same time, the post-war experience evinced the importance of foreign demand in underpinning a supply-side response. In other words, access for the East European countries to the markets of the European Community. The European Union has concluded "Europe Agreements" with ten Eastern European countries. These are important steps and they can be built upon further. Constructive mutual cooperation will be most conducive to a positive perception of the region's stability, thereby helping attract investment.

Cooperation could gain an added dimension in the future. Several Eastern European countries have already joined the OECD as members and are knocking on the door of the European Union. Although eventual EU membership is a process that will require some time, it is a realistic perspective. The European Union is in the process of completing a process of deepening cooperation, which will find its preliminary climax in the establishment of the euro. Subsequent to the creation of full monetary union we may expect the EU to turn its sights eastwards, leading to an ever more integrated Europe.

Let me conclude by reaffirming that the Marshall Plan was an important part of the foundation for post-war European recovery. At the same time, Marshall aid was more than the transfer of money alone. The economic policy conditions attached to this aid constituted an essential element in the realisation of the reconstruction process. Like the US after World War II, the IMF has stepped into the transformation process of transition economies, albeit on a smaller scale in financial terms. In part, this may reflect the lower importance attached to the role of finance per se, and, in part, simply the lack of adequate donor funds forthcoming. Despite this, however, Eastern Europe is on the right track. And although EU membership is still some way off, the prospect of such membership and the economic cooperation and integration being pursued to achieve that membership, inspires confidence that the lessons of the Marshall Plan have indeed been taken to heart.