Mr. Greenspan examines the process by which former centrally planned economies are embracing free markets Remarks by the Chairman of the Board of Governors of the US Federal Reserve System, Mr. Alan Greenspan, at the Woodrow Wilson Award Dinner of the Woodrow Wilson International Center for Scholars in New York on 10/6/97.

On November 9, 1989, the Berlin Wall came down, symbolizing the end of an experiment in economic and social policy that began more than four decades earlier with the division of the states of Western and Central Europe into market economies and those governed by state central planning. At the end of World War II, as Winston Churchill put it, "From Stettin in the Baltic to Trieste in the Adriatic an iron curtain ... descended across the Continent." Aside from the Soviet Union itself, the economies on the Soviet side of the "curtain" had been, in the prewar period, similar to the market-based economies on the western side. Over four decades both types of economies developed with limited interaction across the dividing line. It was as close to a controlled experiment in the viability of economic systems as could ever be implemented.

The results, unequivocally in favor of market economies, have had far-reaching consequences. The long-standing debate between the virtues of economies organized around free markets and those governed by centrally planned socialism is essentially at an end. To be sure, there are still a few who still support the old fashioned socialism -- but for the vast majority of professed socialists it is now a highly diluted socialism, an amalgam of social equity and the efficiency of the market, often called market socialism. The verdict on rigid central planning has been rendered, and it is generally appreciated to have been unequivocally negative.

Over the last seven years, with the Soviet bloc books now open, we of course have learned much about how communist economics worked, or, more to the point, did not. But the biggest surprise is what the aftermath of the four-decade experiment has been teaching us about how and why our own Western economies and societies function, or, perhaps more exactly, refreshing our own long-dormant memories of the process.

Economists have had considerable experience this century in observing how market economies converted to centrally planned ones but until recently have had virtually no exposure in the opposite direction. Ironically, in aiding in the process of implementing the latter, we are being forced to more fully understand the roots of our own system.

Much of what we took for granted in our free market system and assumed to be human nature was not nature at all, but culture. The dismantling of the central planning function in an economy does not, as some had supposed, automatically establish a free market entrepreneurial system. There is a vast amount of capitalist culture and infrastructure underpinning market economies that has evolved over generations: laws, conventions, behaviors, and a wide variety of business professions and practices that have no important functions in a centrally planned economy.

Centrally planned economic systems, such as that which existed in the Soviet Union, had great difficulty in creating wealth and rising standards of living. In theory, and to a large extent in practice, production and distribution were determined by specific instructions -- often in the form of state orders -- coming from the central planning agencies to the various different producing establishments, indicating from whom, and in what quantities, they should receive their raw materials and services, and to whom they should distribute their final outputs. The work force was assumed to be fully employed and wages were somewhat arbitrarily predetermined.

Without an effective market clearing mechanism, the consequences of such a paradigm, as one might readily anticipate, were both huge surpluses of goods which, while produced, were not wanted by the populace, and huge shortages of products that consumers desired but were not produced in adequate quantities. The imbalance of demand over supply inevitably required rationing or its equivalent, standing in queues for limited quantities of goods and services.

One might think that the planning authorities should have been able to adjust to these distortions. They tried. But they faced insurmountable handicaps in that they did not have access to the immediate signals of price changes that so efficiently clear markets in capitalist economies. Just as important, they did not have the signals of finance to adjust the allocation of physical resources to accommodate the shifting tastes of consumers.

In a centrally planned system, banking and finance play a decidedly minor role. Since the production and distribution of goods and services are essentially driven by state orders and rationing, finance is little more than record keeping. While there are pro-forma payment transfers among state-owned enterprises, few if any actions are driven by them. Payment arrears, or even defaults, are largely irrelevant in the sense that they are essentially transactions among enterprises owned by the same entity, that is, the state. Under central planning there are no credit standards, no interest rate risks, no market value changes, that is, none of the key financial signals that determine who gets credit, and who does not, and hence who produces what, and sells to whom, in a market economy. In short, none of the financial infrastructure which converts the changing valuations of consumers into market signals that direct production for profit are available. But it didn't matter in the Soviet-bloc economies. Few decisions in those centrally planned systems were affected by the lack of a developed financial system.

That centrally planned economies, as a consequence, were highly inefficient is best illustrated by the fact that energy consumed per unit of output was as much as five to seven times higher in Eastern Europe and the former Soviet Union than in the West. Moreover, the exceptionally large amount of resources devoted to capital investment, without contributing to the productive capacity of these economies, suggests that these resources were largely wasted.

Regrettably, until the Berlin Wall was breached and the need to develop market economies out of the rubble of Eastern Europe's central planning regime became apparent, little contemporary thought had been given to the institutional infrastructure required of markets. Nonetheless, in the years immediately following the fall of the Berlin Wall many of the states of the former Soviet bloc did get something akin to a market system in the form of a rapid growth of black markets that replicated some of what seemingly goes on in a market economy.

But only in part. Black markets, by definition, are not supported by the rule of law. There are no rights to own and dispose of property protected by the enforcement power of the state. There are no laws of contract or bankruptcy, or judicial review and determination again enforced by the state. The essential infrastructure of a market economy is missing.

Black markets offer few of the benefits of legally sanctioned trade. To know that the state will protect one's rights to property will encourage the taking of risks that create wealth and foster growth. Few will risk their capital, however, if there is little assurance that the rewards of risk are secure from the arbitrary actions of government or street mobs.

Indeed, today's Russia is striving to rid itself of a substantial black market intertwined with its evolving market economy. Law enforcement in support of private property is uneven in its application. Private security forces, to a large extent, have taken over protection, with results sometimes less than satisfactory. The shift of vast real resources from the defunct Soviet state to private parties, whose claims in many instances are perceived as dubious, has not enhanced public support for the protection of such claims by official authorities.

Some, but not all, would argue with the Russian academic who last month told the Washington Post that "The state thinks ... private capital should be defended by those who have it. ...It's a completely conscious policy of the law enforcement authorities to remove themselves from defending private capital."

Certainly, if generations of Russians have been brought up on the Marxist notion that private property is "theft," a breakdown of the Soviet central planning infrastructure is not going to automatically alter the perceived moral base of its social system. The right to property in market economies, on the other hand, is morally rooted in its culture.

Indeed, the presumption of property ownership and the legality of its transfer must be deeply embedded in the culture of a society for free market economies to function effectively. In the West and especially under British common law and its derivatives, the moral validity of property rights is accepted, or at least acquiesced in, by virtually the whole of the population. Accordingly, a very small proportion of contracts have to be enforced through actions in the courts. Moreover, reflecting a strong commitment to property rights, a surprisingly large number of contracts, especially in financial markets, are initially oral, confirmed only at a later date, and at times after much price movement, by a written document.

The differing attitudes and views toward property ownership are passed from generation to generation through family values and education systems. Hence, the process of full transition from the so-called collective rights of socialist economies to the individual property rights of market economies and legal certainties can be expected to be slow. One prominent young Russian reformer of my acquaintance thinks the transition is moving quickly among those under forty years of age, much less so among their elders. Altering what a nation teaches its children is a profoundly difficult task and clearly cannot be accomplished overnight. Changing attitudes toward property and profit is not simple. These attitudes derive from the deepest values of personal worth people hold.

Aside from property rights enforced by an impartial judiciary, for a market economy to function effectively, there must also be widespread dissemination of timely financial and other relevant information. This enables market participants to make the type of informed judgments that foster the most efficient allocation of capital -- efficient in the sense that our physical resources are directed at producing those goods and services most valued by consumers. This requires a free press and government data information systems that are perceived to be free of hidden political manipulation.

Government censorship in any form renders information suspect. Such information will be disregarded by market participants as virtually useless, requiring individuals to rely on rumor and other dubious sources of information. This leads to misjudgments about the changing patterns of consumer demand and hence significantly eviscerates the market's effectiveness and its role in directing real resources to their optimum uses.

Most other rights that we Americans cherish -- protection against extra-legal violence or intimidation by the state, arbitrary confiscation of property without due process, as well as freedom of speech and of the press, and an absence of discrimination -- are all essential to an effective, functioning market system.

Indeed a list or bill of rights enforced by an impartial judiciary is, and I hesitate to use the analogy, what substitutes for the central planning function as the guiding mechanism of a free market economy. It is these "rights" that enable the value judgements of millions of consumers to be converted through a legally protected free market into prices of products and financial instruments; and it is, of course, these market prices that substitute for the state orders of the centrally planned economies.

We depend on government in a free society to ensure those market "rights." Perhaps of greater importance, those rights can also be viewed as a list of prohibitions delimiting the actions of government. Thus, the more effective the list is in constraining the arbitrary actions of government officials, the less it matters what they do. The tighter the proscription on government officials' discretion, the less arbitrary government power is available to the highest bidder.

The democratic process, of course, is needed to ensure that the "list of market rights" has the continued sanction of the people. Since any bill of rights specifies the limits to which government officials can infringe on the rights of individuals, the rational self-interest of the populace is always to protect and broaden individual rights. The self-interest of those officials who have the power to exert discretionary power in areas not specifically delimited by a bill of rights, is, too often, to broaden that scope. Hence, authoritarian societies, even benevolent ones, are biased to restraining the rights of individuals generally and property in particular.

Clearly, not all democracies protect the private right of property with the same fervor. Indeed, they vary widely. Nor is it the case that all societies with firmly protected property rights bend invariably to the majority will of the populace on all public issues. Certainly in its earlier years Hong Kong did not have a democratic process but a "list of rights" protected by British common law and Britain's democracy. Singapore, from a similar heritage, does protect property and contract rights, the crucial pillars of market efficiency, but does not have some of the other characteristics of western democracies with which we are familiar. There are those who argue, however, that as this remarkable city-state evolves, increasing wealth will push it toward broader freedoms.

To summarize then, the ideal state of affairs for a centrally planned economy is one in which there is continuous production of the same type of goods, of the same quality, of the same design, obediently purchased in repetitive quantities, with cash wages backed as necessary by rationing coupons. Centrally planned economies are frozen in time. They cannot readily accommodate innovation, new ideas, new products, and altered specifications.

In sharp contrast, capitalist market economies are driven by what Professor Joseph Schumpeter, a number of decades ago, called "creative destruction." By this he meant newer ways of doing things, newer products, and novel engineering and architectural insights that induce the continuous obsolescence and retirement of factories and equipment and a reshuffling of workers to new and different activities. Market economies in that sense are continuously renewing themselves. Innovation, risk taking, and competition are the driving forces that propel standards of living progressively higher.

Thus, the bold, if unintended, experiment in economic and social systems, which began after World War II in Europe, did not come to a full resting place with the fall of the Berlin Wall in 1989. Despite the ebb and flow of governments of differing persuasions, the face of the world economy continues to edge toward free-market-oriented societies. This is especially the case as increasing numbers of transition economies prosper and emerging market economies wedded to free-market paradigms grow impressively.

There has been, to be sure, much pain and periodic backtracking among a number of the nations that discarded the mantle of central planning. There will doubtless be more. But the experience of the last half century clearly attests to how far the power of the idea of market freedom can carry.