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HIGHLIGHT:
Our Economics Focus of January 5th said that enterprises in Eastern Europe might be "value subtractors" -- loss-makers regardless of the exchange rate -- and that trade reform should therefore be cautions. Jeffrey Sachs, Poland's top western advisor, wrote to argue that we were wrong. Here is his letter

BODY:
SIR -- Your recent article urging a very slow retreat from the extreme protectionism of Eastern Europe is a rehash of the discarded structuralist doctrines once so ruinously applied to Latin America: that devaluation does not promote exports but only raises the prices of imported inputs; that trade liberalisation wipes out manufacturing jobs; and that protectionism should be pulled back only slowly. These arguments were false for Latin America, and they are false for Eastern Europe.

You say Poland's trade liberalisation has caused output to fall and workers to be sacked without making producers more competitive. You say other countries in the region should learn from this "mistake" and "go carefully to trade." Poland's experience contradicts you.

On January 1st 1990 Poland removed the anti-export bias in its policies by devaluing and unifying the overvalued exchange rate, ending foreign-exchange rationing and cutting tariffs. As a result, exports to the West Boomed, rising from $ 8.5 billion in 1989 to $ 11.4 billion in 1990. This increase was across the board: in electrical machinery, metal products, chemicals, processed foods and agriculture (see chart). At the same time imports fell, partly because Poland's state enterprises economised on raw materials when the "soft budget constraints" of the enterprises were tightened up.

You speculated that at world prices large parts of East European industry might become money-losing even if wages were zero. In fact, of Poland's 5,006 state industrial enterprises, only 432 (accounting for just 3.7% of employment) reported that they lost money in the first eight months of last year. No doubt the accounting leaves much to be desired, and rising prices for energy and raw materials from the Soviet Union will push many more firms into the red -- but the assumption that free trade has pushed a big proportion of industry into loss is wrong.

Enterprises did not buy their profitability with savage cuts in real wages. Measured in dollars at the official exchange rate, average monthly wages actually went up between October 1987 and October 1990, from $ 109 per month to $ 134 per month. In free-market dollars, the rise was even greater (because, on the measure, wages in 1987 were lower).

Nor has there been widespread sacking of workers, as you claim. Lay-offs have been fewer than expected; many workers are voluntarily leaving the state sector to find better jobs in the fast-growing private sector. In September 1990 less than 1% of the labour force was unemployed as the result of so-called "collective dismissals" (in which groups of workers are laid off at a time). The aggregate unemployment rate for December of about 6 1/2% -- which includes many voluntary job-leavers and new entrants -- compares well with that of the West.

In Warsaw, a shortage of labour is a bigger problem than a surplus.

It is sometimes thought that the internal recession in Poland has played an important role in the export boom. That argument, too, is overrated. Poland went into a deep recession 11 years ago, from which it has not yet recovered. Yet until this year the country never enjoyed an export boom. Moreover, the reported fall in output over the past year vastly overstates the recession. The widely reported output statistics are based entirely on production within the state-owned industrial sector. The statistics include neither private firms nor non-industrial ones.

As production has shifted within industry from state to private firms, and from industry as a whole to services, the narrow production index has shown a decline in output rather than a shift between sectors. Part of the overall output decline -- perhaps a third of it -- is real. Poland's exports to the Soviet Union are collapsing, and the credit squeeze that needed Poland's hyperinflation was deflationary, but the falls in output caused by these factors were not due to trade reform.

Free trade is especially vital in Eastern Europe. It is the single most effective way -- perhaps the only way -- to instill real competition in the industries of Eastern Europe, which are otherwise too concentrated, too politically powerful and too small to generate domestically based competition. Free trade will allow Eastern Europe to "import" a rational price structure. It will provide the principal source of contracts between East European and western firms -- contracts that are vital for improved product quality and technologies in the East. And a rapid growth of exports to the West, best served by free trade, is essential to shift exports away from the collapsing Soviet market.

Of course free trade will cause some firms to shrink or fail -- and that number will increase if wage restraint breaks down. Some firms will even be "value subtractors", as your article called them, where input costs net of labour at world prices exceed output values. But protecting such firms is unjustified. Not only would it frustrate the movement of resources to new sectors, but in the extreme it would actually cause the country to lose foreign exchange for every unit of production that receives protection. It would cost less to pay workers to do nothing than to protect value-subtracting firms.

Poland's export boom is still fragile, and so is political support for radical economic reform. The collapse of the Soviet Union, the crisis in the Middle East and the spreading recession in the industrial world will put many more firms into the red. The West can help in two ways: by sharply reducing Poland's crushing debts, so that new investors will come in to help finance the restructuring of Poland's industry; and by keeping western markets open to Poland while insisting reciprocally on Poland's continued commitment to free trade.

Though we disagree on trade, you are no doubt right on the crucial point concerning Eastern Europe. The benefits of free trade will come to little unless the region also accelerates its privatisation of industry, preferably through a free distribution of shares to the public, as The Economist has championed.

GRAPHIC: Graph, Polish hard-currency exports, Selected industries, Jan-Sept 1990, % increase over year earlier, volume, Source: Polish Central Statistical Office