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Robert Schönfeld (Hrsg.)

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The Role of International Financial Institutions in Central and Eastern Europe

Die Rolle der Internationalen Finanzorganisationen in Ostmittel- und Südosteuropa

Edited by Roland Schönfeld
In collaboration with Josef C. Brada and Ben Slay

Südosteuropa-Gesellschaft

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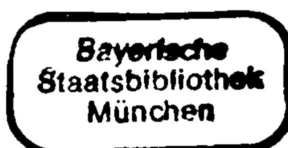

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PREFACE

The papers in this volume are drawn from a conference on "The Role of International Financial Institutions in Central and Eastern Europe" held on April 12-14, 1994, at the castle of Nymphenburg in Munich, Germany. The conference was organized and sponsored by the German Südosteuropa-Gesellschaft. We are grateful for the financial support of the Joint Committee on Eastern Europe of the American Council of Learned Societies, New York, and the Social Science Research Council. The Carl Friedrich von Siemens Foundation kindly provided their magnificient conference facilities.

We wish to express our gratitude to Professor Josef C. Brada, Arizona State University, who worked out the concept of the conference and was a constant source of help during the preparations. He and Professor Ben Slay, Bates College, contributed greatly to the planning of the conference and of this volume. The editors gratefully acknowledge the assistance of Ms. Rita Stumpf of the Südosteuropa-Gesellschaft staff in the preparation of this book.

Roland Schönfeld
Südosteuropa-Gesellschaft

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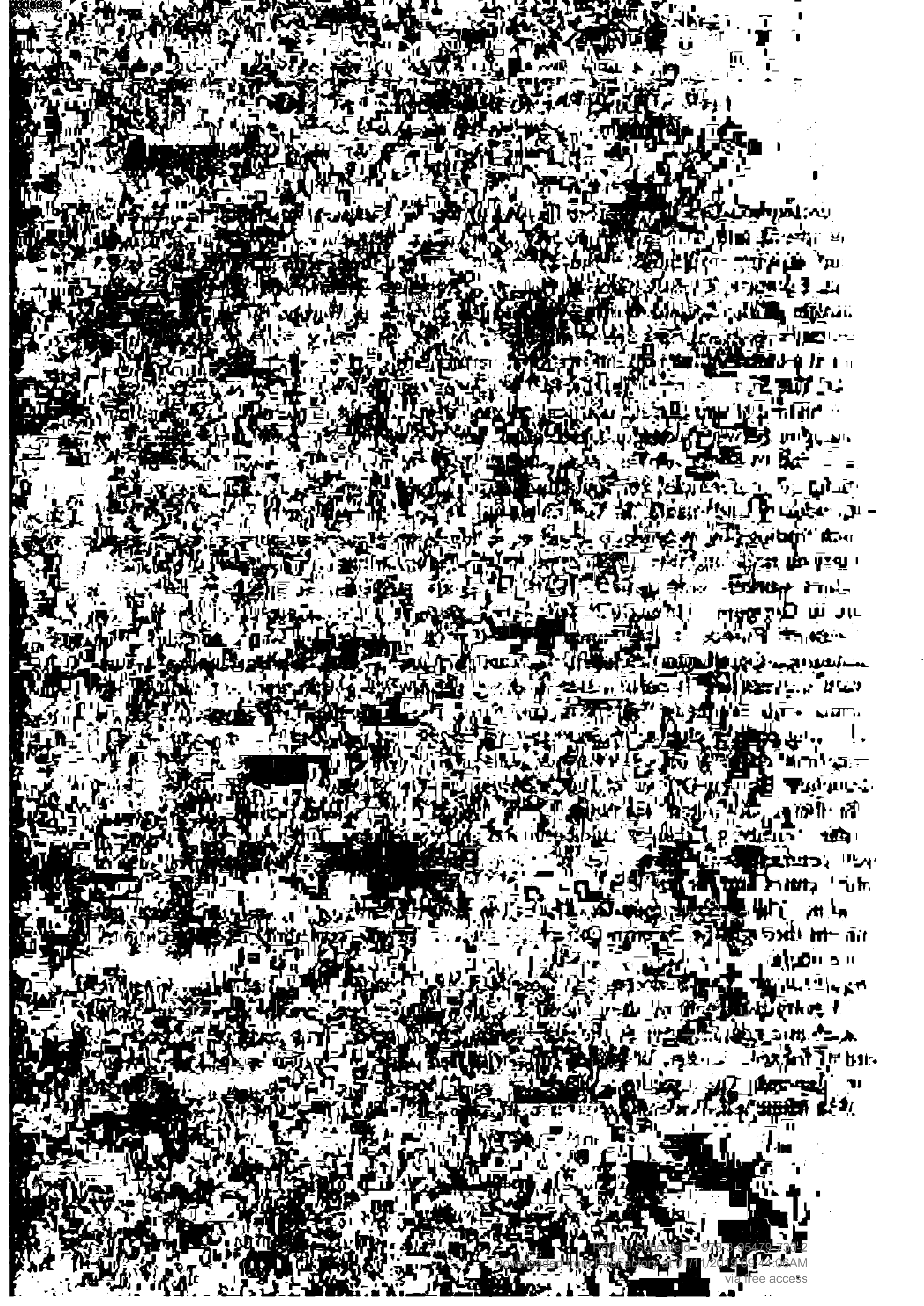

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JOSEF C. BRADA
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The Role of International Financial Institutions in Central and Eastern Europe

I. Introduction

The papers included in this volume deal with various aspects of the role of international financial institutions (IFIs) such as the International Monetary Fund (IMF), the World Bank, and the European Bank for Reconstruction and Development (EBRD) in supporting, both materially and with advice and technical assistance, the economic transition of Central and Eastern Europe from socialism to capitalism. The former two organizations in particular have been the main conduits of official western assistance and policy advice to the region. It is therefore not surprising that they also have borne the brunt of the criticism and controversy that has followed in the wake of the output declines, delays in privatization, and ongoing inflation that have, to differing degrees, plagued all countries in the region.

While the critiques of the programs promoted by the IFIs are many and varied, they can be grouped into two categories. The first criticism is essentially ideological in nature and charges that, because IFI programs embody a certain ideological agenda, one that reflects the conventional concepts of neoclassical economics, the programs promoted by the IFIs are often divorced from the recipient countries' economic realities, exact excessive socio-political costs, and may ultimately be self-defeating.[1] Eastern Europe is only the latest venue in which such critiques have been made, and, to the extent that differing assessments of IFI effectiveness stem from underlying ideological differences, prospects for developing a consensus on the IFIs' strengths and weaknesses in the region are doubtful at best. Second, even when there is basic agreement concerning the appropriateness of stabilization and market liberalization as goals, IFIs and their programs have been criticized on technical grounds. Indeed, some of the technical requirements for successful IFI programs, such as some insulation of domestic policy makers from short-run pressures, imply a certain conflict between technical and ideological dimensions of IFI programs. Moreover, the IFIs', and especially the IMF's, traditional role of serving as lightning rods for domestic opposition to unpopular, but ultimately necessary and inevitable stabilization and structural adjustment programs indicates that even IFI programs that are successful from a technical point of view can be expected to engender a healthy dose of politically motivated criticism. It should also be noted that, even when there is basic agreement concerning goals, conflicting assessments

[1] As one critic has aptly put this argument, "The economic transformations envisaged [in Eastern Europe]...implement an intellectual blueprint...drawn up within the walls of American academia and shaped by international financial institutions" (Przeworski, 1992, p. 45).

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of IFI programs may stem from differing analytical frameworks. Thus, while academics tend to emphasize optimal policy regimes and to judge stabilization programs against ideal standards, policy makers and the IFIs are more likely to view the successes and failures of real-world IFI programs in the binary framework implied by some ad hoc measures of success of failure.[2]

Both types of criticisms have appeared in the Eastern European context. The introduction of the Balcerowicz Plan in January 1990 was followed almost immediately by ideological attacks on the Polish program and allegations of sinister motives behind the IMF and World Bank support it received.[3] The IMF's failure to supply the Russian government with the foreign exchange deemed necessary to launch the ruble stabilization fund in mid-1992 has been roundly criticized by Jeffrey Sachs (1994) and others as a technical blunder that seriously undermined prospects for macroeconomic stabilization in Russia. More generally, it is now widely acknowledged that the IFIs were unprepared for some of the surprises served up by the largely unprecedented nature of the post-communist economic transition, especially during 1990-1992.[4]

II. View from the International Financial Institutions

In light of this, how can and should the IFIs' performance in Eastern Europe be assessed? The articles presented in this symposium seek to provide answers to this question. In this, the first part of the symposium, representatives of the IFIs present their views on the region's economic transition and their institutions' roles therein.[5] Markus Rodlauer, the IMF's senior resident representative in Warsaw, concludes that Fund-supported liberalization and macroeconomic stabilization programs in Central and Eastern Europe have produced the best results when rapid liberalization was accompanied by the introduction and maintenance of tight financial policies. This combination has been essential for introducing tight budget constraints for state enterprises, as well as for reducing inflation to manageable levels. On the other hand, Rodlauer points out that, even in the Central European countries, structural reforms have proceeded relatively slowly, which has made liberalization and stabilization more difficult. However, Rodlauer argues that the slow pace of structural reforms is not an argument for a more gradual approach to

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[2] See Åslund (1994) for some discussion of this point.

[3] Such criticism was a major element of the populist, or more correctly, demagogic campaign of Stanislaw Tyminski, who eliminated incumbent Prime Minister Mazowiecki in the first round of Poland's presidential elections in late 1990.

[4] This was recently acknowledged by World Bank President Lewis T. Preston (Carrington, 1994). For a more specific list of mistakes and admissions of same, see Ellman (1994, pp. 2-3). At the same time, the IFIs have encountered problems that are often identical to those faced by indigenous institutions, e.g., in finding creditworthy borrowers in the enterprise sector. This point was raised at the conference by Volkhart Vincentz, Osteuropa-Institut, Munich.

[5] Needless to say, the authors are writing as private individuals, presenting their own views rather than those of the institutions they represent.

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liberalization and stabilization. Instead, it underscores the need to redouble efforts toward enterprise reform, fiscal restructuring, and financial sector reform.

While Rodlauer's article reflects what might be described as the standard IFI view on appropriate transition strategies, it does not detail these organizations' roles in supporting the transition programs introduced in various countries. Christine Wallich, lead economist in the World Bank's Central European Department, takes up this issue, in terms of the Bank's activities in her article. In emphasizing the unprecedented problems facing the Bank in the former Soviet bloc, Wallich shows that perhaps the largest problem has been the scale of the demands placed upon the Bank's technical and financial resources. Yearly World Bank lending to the region, including the former Soviet and Yugoslav republics, averaged $3 to $4 billion during 1991-1993, a sum representing about one-sixth of total Bank funding. Poland received the largest share of these loans, absorbing some 30% of the funds loaned during 1990-1993. Wallich also points out that, even though the Bank has been the largest supplier of external finance for most of the region, the challenges posed by transforming economic institutions inherited from the old system and creating new ones have meant that the need for technical assistance is even greater than the need for money. While Wallich positively assesses Bank programs promoting the reform and strengthening of social safety nets and environmental policies, she views as less successful the Bank's role in supporting the development of the private sector.

The article by Salvatore Zecchini of the OECD offers the most general assessment of IFI activity in the region. Zecchini shows that most of the IFIs' support for the region has not taken the form of direct financial assistance, largely reflecting the region's relatively weak capacity for absorbing that assistance. More important, Zecchini argues, was the IFIs' role in: (1) imposing and maintaining program and policy conditionality on recipient governments; (2) providing technical assistance; and (3) catalysing financial assistance from other external, usually governmental, rarely private, sources. While these four elements taken together have, in Zecchini's view, provided an important support package for many countries, none of the package's four elements has been a clear success or non-controversial. The IFIs' treatment of these elements has therefore changed over time: conditionality at both the program and the project levels has undergone a certain evolution, and the IFIs have begun to pursue better coordination of technical assistance programs.

III. Czechoslovakia and Hungary

In the second part of the symposium, Zdeněk Drábek and László Csaba examine Czechoslovakia's and Hungary's relations with the IFIs. The article by Drábek argues that, while IMF support was critical in mobilizing international financial resources for Czechoslovakia during 1990-1991, the significance of the IMF's role declined precipitously thereafter. Indeed, following the execution of two successful standby agreements with the IMF, the Klaus government in early 1994 decided not to draw down the remaining tranches on its third standby and to accelerate the repayment of some of its IMF loans. The activities of the World Bank and EBRD

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seem to have been similarly low-key; as of early 1994, only two Bank projects were ongoing in the Czech Republic. Drábek ascribes the IFIs' relative unimportance to the successes of the Czechoslovak, and then Czech, stabilization programs, which have managed to reduce inflation to the lowest levels in Central and Eastern Europe, while simultaneously maintaining external balance, government surpluses, and low unemployment rates. In any case, according to Drábek, there has been little substantive disagreement between Czech policy officials and the IMF.

László Csaba's chapter describes Hungary's relatively long relationship with the IMF, which began in 1982, and he criticizes the Fund for not making better use of its conditionality to encourage more rapid systemic reform. Csaba argues that, in the 1980's and the 1990's, the Fund placed too much emphasis on Hungary's debt-servicing capability. As long as the Hungarian government has been able to maintain external creditworthiness, the IMF has generally been unwilling to push systemic issues, even during those times, e.g., the 1982 international debt crisis, or the precipitate decline in the country's foreign exchange reserves in 1990, when the Fund's influence on Hungarian policy making was at its zenith. Also important has been the ability of both communist and non-communist governments to dilute the IMF's influence through an array of domestic economic and political filters. Csaba concludes that, while Hungary's twenty years of systemic reform may have given the country a certain advantage relative to the region's other economies, Hungary's relationship with the IMF had little, if anything, to do with the advanced state of the reforms.

The counterpoising of the Czechoslovak and Hungarian experiences also raises interesting questions regarding the dynamics of the relationship between the IFIs and the client countries. For example, the IMF has had little success in, and, indeed, has shown little enthusiasm for, pressing Hungary to reverse the gradual appreciation of the forint in order to deal with its external disequilibrium. On the other hand, in the case of the Slovak Republic, the Fund acted swiftly and decisively to induce a reluctant Mečiar regime to devalue the Slovak koruna. To what extent this difference in IMF advice and pressure reflects the possibility that the Hungarian client has captured IMF policy advisors and to what extent it reflects the greater economic sophistication and thus bargaining skill of the Hungarian government relative to those of the Slovak government is unclear.

IV. Poland and Beyond

In the third part of the symposium, the focus shifts to the Polish experience and to the lessons that can be drawn from it and applied to those countries in the region that continue to suffer from declining output and from high rates of inflation. The article by Stanislaw Gomułka compares the Polish and Russian experiences with the IMF and World Bank. While the post-1989 relationship between the Polish governments and the IFIs has been fairly harmonious, policy disagreements have existed over such issues as energy pricing, wage policy, and tariff policy. According to Gomułka, these relatively minor disagreements have generally been resolved with the IFIs accepting the Polish position. On the other hand, both the IMF and

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the Polish government committed serious errors in forecasting changes in GDP, inflation, enterprise profitability, and the fiscal deficit during 1990-1991, as well as the growth in investment spending in 1992. While both parties anticipated that any eventual resumption of economic growth would be led by exports and investment spending, when recovery commenced in 1992, it was driven by consumption. In Russia, even larger forecasting and more significant policy mistakes were made while preparing and implementing the Gaidar program during 1991-1992. These were most evident in the dramatic underestimation of the corrective inflation that followed price liberalization in January 1992 and in the IMF's insistence on preserving the ruble zone. Still, Gomułka assesses positively most of Poland's IMF-approved stabilization programs, and he argues that the Russian program is a "macroeconomic failure but a transformation success." Perhaps the most interesting dimension of Gomułka's article is his insider's account of the policy debates among the architects of the 1990 Polish stabilization program and of the 1992 Russian stabilization program.

Jan Winiecki's paper constitutes the strongest technical critique of IFI activities, arguing that the standard IFI reform packages are partly inapplicable in Eastern Europe. This is because the packages are based upon a set of institutional and behavioral assumptions that are transplanted from developed or developing capitalist economies, and many of these assumptions do not hold during the post-communist transition. Had the IFIs made better use of the literature on (post-) Soviet-type economies in constructing their programs, Winiecki argues, some of these mistakes could have been avoided.[6] For example, Winiecki argues that state enterprise size tends to be negatively correlated with efficiency and positively correlated with bargaining power. The introduction of the high real interest rates encouraged by the IFIs therefore meant that large state enterprises crowded smaller but more efficient firms out of credit windows. Likewise, the limitations upon wage growth in state enterprises included in many IMF programs generally serve to politicize labor relations while reinforcing managers' resistance to higher wage demands to only a limited extent.

V. Lessons and Questions

An obvious contribution of the symposium is the systematic description of the programs that the IFIs have deployed to aid the transition process in East Europe. Certainly few critics of IFI policy could criticize the IFIs' support for the region's balance of payments and for the creation of a viable social safety net. The broad range of World Bank programs clearly encompasses many activities that are sensible when judged by criteria other than those of neoclassical economics.

[6] The lack of attention to the relevant literature was also raised at the Conference by Wolfgang Schrettl, Deutsches Institut für Wirtschaftsforschung, Berlin. At the same time, a close analysis of Winiecki's argument raises the question of whether a better understanding of the relevant literature would have resulted in different policies or only in gloomier forecasts of what such policies could achieve.

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The symposium is unlikely to have closed the gap between critics and supporters of IFI stabilization and market liberalization policies. On the stabilization question, the IFIs have two important advantages on their side. The first of these is that there is now a number of successful stabilization stories, including Albania, the Czech Republic, Estonia, Poland, Slovenia, and, at least for now, much to everyone's surprise, Slovakia. In some of these countries, stabilization has been accompanied by extensive liberalization of markets and privatization, and in others by little of either. Instead, the common thread appears to be government adherence to stabilization policies of a type advocated by the IFIs.[7] The critics of such orthodox stabilization policies, on the other hand, can point to no stabilization successes for countries following their approaches; the argument that their approaches have not been given a trial strengthens rather than blunts the force of this criticism.

One reason why countries have been reluctant to follow the stabilization proposals of the critics of the IFIs stems from the second advantage of the IFIs' approach to stabilization. This is that it rests on a coherent and relatively transparent model of the economy. Of course, such a model may be wrong, and the adherence of western economists and policy advisers to such a model may be the result of ideologically induced blindness, but it would be a brave Central and East European government that would cast aside such orthodoxy in favor of homegrown iconoclasm. Moreover, with the notable exception of McKinnon (1993), no coherent alternative stabilization policy has been put forward by the critics. Some have called for growth or exportoriented industrial policies, and others for Keynesian stimulation that, in small trade-dependent economies, would seem to be a prescription based on the wrong model.

The symposium also raised a number of questions that may be less controversial but that are worthy of further research. One broad area is the political economy of relations between the IFIs and their Central and East European clients. The IFIs, of course, have their own objectives and motivations and, in the case of Eastern Europe, they have been subject to considerable pressure from western governments. What these institutional agendas were, and how they were influenced by outside pressure, remains to be investigated by economists and political scientists.[8] Much the same can be said for the IFIs' relationships with their clients in the region. The application of pressure on IFI clients is a skill that institutions such as the IMF have practiced for years, attempting to press upon reluctant governments austerity policies that may prove unpopular with the electorate without pushing so far as to lead to a fall of the government. In the case of Central and Eastern Europe, walking this tightrope is even more difficult because democracies are new and fragile and because the opposition party waiting in the wings is often the former Communist Party.

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[7] That market liberalization is not necessary for stabilization should not come as a surprise to students of these economies, since they were stabilized, if distorted, during most of the era of central planning.

[8] In a conference contribution, Marie Lavigne ably demonstrated how the EBRD's lack of clarity over its goals led it to become marginalized in Central and Eastern Europe.

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INTERNATIONAL FINANCIAL INSTITUTIONS IN CENTRAL AND EASTERN EUROPE

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MARKUS RODLAUER

The Experience with IMF-Supported Reform Programs in Central and Eastern Europe

The purpose of this paper is to review the transition experience in Central and Eastern Europe from the viewpoint of the International Monetary Fund.[1] The emphasis will thus be mainly on macroeconomic issues, although key issues of structural reforms are also discussed, reflecting the close nexus between stabilization and structural change. The paper is organized as follows: first, a few comments on the extraordinary conditions faced by the countries on the eve of starting the transition; second, an outline of the reform strategy employed in the countries under review; third, an overview of the progress made thus far; fourth, a discussion of key issues that have emerged from the experience; fifth, a few words on the role of the Fund; and sixth, a summary of conclusions.

1. Starting conditions

Two points are worth recalling: (i) the exceptional nature of the transition problem, and (ii) the considerable differences between individual country's starting conditions. Superficial comparison might note that most of the countries in Central and Eastern Europe were middle-income countries facing the results of prolonged maladjustment similar to, say, Brazil, Mexico, or Israel. However, what makes the transition economies different is the sheer magnitude of the change required in institutional circumstances at a time of sudden collapse of the entire political and economic framework. These economies, therefore, began the process of transformation in circumstances of deep crisis and vacuum. At the same time, the revolutionary political changes opened a window of opportunity for Governments to take dramatic measures to address the crisis, a period of extraordinary politics as Professor Balcerowicz (1993) would call it. This setting has both dictated and allowed a more comprehensive approach to the reform process than has ever been attempted before.

Regarding individual country's starting conditions, Table 1 provides an overview that illustrates the considerable diversity that influenced both the detailed shape of programs as well as subsequent performance. While virtually all countries, except Albania, had embarked on partial reform efforts, only Hungary entered the dramatic changes of 1989-90 with some degree of preparation in the form of substantially liberalized price and trade regimes, small-scale private ownership, a two-tier banking sector, some tax reform, and a corporate law. Poland, of course, had also

[1] The discussion in this paper includes the following countries: Albania, Bulgaria, Czechoslovakia/Czech Republic and Slovak Republic, Hungary, Poland, and Romania. It does not include the successor states to the former Socialist Federal Republic of Yugoslavia.

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made progress in dismantling state control, allowing private sector activities, and looking for markets in the West, but it started comprehensive reforms in the midst of hyperinflation, which undermined confidence in the national currency for years to come. Macroeconomic conditions, on the other hand, were perhaps most favorable in Czechoslovakia, with a good inflation record and the absence of both monetary overhang or large external debt problems. Poland, Bulgaria, and Hungary had to cope with large external debt, with Hungary nonetheless having retained access to international capital markets, while Romania and Czechoslovakia did not. Of course, Albania's legacy of decades of strict isolation and most rigorous Stalinist control, and its huge external debt problem, were of a different category altogether.

2. Transition strategy

The transition strategy has three major elements: (i) dismantling controls, particularly on prices and trade, (ii) adjusting macroeconomic imbalances, and (iii) institution building. Countries embarked on these elements simultaneously because they are interdependent and no single element could succeed without the other two. Differences across countries in the size of imbalances and distortions dictated some differentiation in the speed and strength of reforms: while the most dramatic big-bang approach was necessary in Albania, programs in Poland, Czechoslovakia, Bulgaria, and Romania were also conceived as big-bang moves, whereas Hungary was able to go with a more gradualist program, although it was still far more comprehensive and front-loaded than anything Hungary had attempted in the past.

The first of the three basic building blocks was to free the economy, mainly through liberalization of prices and of external economic relations so as to give undistorted signals to producers and consumers.[2] The two should go hand in hand so that foreign relative prices, transmitted through an open trade system, can guide domestic price formation and import competition can constrain monopoly profits. Clear price signals, in turn, are critical for the reorientation and reconstruction of the economy, which invariably takes time, to begin as soon as possible. Price liberalization has also been the most efficient way to eliminate the liquidity overhang that had built up in most of these countries in the latter years of central planning and to reduce the budgetary burden of price subsidies.

This leads to the second challenge faced by transition countries, that of stabilizing the economy through appropriate monetary, fiscal, and incomes policies. In practice, this means early and decisive progress toward domestic price stability, together with sustainable external and internal balances. The attainment of low inflation is viewed by the Fund not only as a goal in itself, but as essential for several reasons. Inflationary pressures tend to be especially virulent at the beginning of the transition process, against the background of large price distortions and the

[2] In some countries, such as Albania, freeing the economy required even more fundamental measures such as the legalization of private economic activity which had been almost completely forbidden under the previous regime.

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liquidity overhang in shortage economies; the adverse effects of inflation, such as the obfuscation of price signals, tend to be especially destructive when the direction of change needs to be clear; and confidence in the domestic currency, embodying much of the new economic regime's credibility, is a critical, albeit tenuous, asset in an environment that is undergoing such vast change. The immediate task was thus to prevent the initial jump in the price level associated with liberalization from becoming rampant inflation.

From the start, a tight fiscal policy was considered critical to this end, and countries initially aimed at budget balance within a short period of time, with the exception of Albania where the initial imbalance was much larger. The strategy placed initial emphasis on short-term expenditure reduction combined with structural measures to boost revenues. Major sources of expenditure reduction were price and enterprise subsidies, investment and defense expenditures, as well as budgetary wage restraint. Tax reform included the replacement of the old turnover tax with the VAT and of direct profit transfers from enterprises with a transparent corporate tax structure. Monetary policy was designed in support of the inflation and balance of payments objectives, with either domestic credit or broad money as the chief target variable depending on the type of exchange rate regime. Introduction of two-tier banking systems, an interest rate policy, and other market-oriented measures for monetary control were important ancillary reforms in this area. Typically, the programs have been heterodox in their approach to price stabilization, involving, in addition to the monetary and/or exchange rate anchor, an important second anchor in the form of transitory incomes policies including wage controls in state enterprises.

As noted above, the third component of the strategy has been systemic reform, that is not just the nurturing and strengthening of market systems, but their wholesale new construction. The range of necessary changes includes laws to define and ensure ownership rights, contracts, resolution of conflicts, accounting, and so forth; reforms to support the implementation of macroeconomic policies, such as building a new tax administration, modernization of statistical systems, and creation of a macroeconomic database; policies that strengthen financial discipline and efficiency at the micro-level, particularly in state enterprises and banks. Also needed are an improved social safety net, targeted at the truly needy at acceptable budgetary costs and measures to improve the functioning of labor and capital markets.

Within these three components, liberalization, stabilization, and institution building, there are many strategic choices to be made according to national circumstances: the choice of exchange rate regime, the structure of taxes and expenditures, the approach to privatization, and so on. Also, the strategy could not be fully mapped out in advance, and we all have learned continuously as the transformation has unfolded. I shall now turn to an overview of how much progress has been made on each of these three basic accounts before examining some issues in greater depth.

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3. Progress made

Regarding liberalization, governments moved to free their economies more quickly and with more determination than many observers had expected. By now, prices have been almost completely liberalized; subsidies have been substantially reduced; currency convertibility has been established to a significant degree; and the trade regime has been largely liberalized. Although in 1992 some countries raised tariffs on some imported goods, most countries in the region are in the process of harmonizing their trade tariffs to conform to EU levels. The broadly sustained level and scope of this liberalization is unambiguous evidence for the irreversible rejection of central planning in favor of market-based systems.

Regarding macroeconomic stabilization, the challenge doubtless has been more demanding than originally envisaged. Three unexpected developments stand out: (i) the decline in output was greater, (ii) inflation was higher, and (iii) fiscal balance proved much more difficult to attain than programs and most observers had hoped. I shall return to the issue of output in the next section. On inflation, the initial imbalances and repressed inflation hidden in the old systems were underestimated. This applies particularly to the possible existence of a larger unabsorbed monetary overhang in Bulgaria and partly Poland, underprediction of the effects of initial devaluation in Poland, and to the monopolistic behaviour of state enterprises. Apart from the inertia effects of the bigger initial price jump, subsequent stabilization was also complicated by the greater than expected output loss and fiscal difficulties. On fiscal issues, more later on; for now, suffice to say that while programs at the very start seemed to do well, the structural problems of public finances soon turned out to be much more intractable than expected.[3] This, together with the greater output loss, made for sizeable budget deficits compared with the initial objective of budget balance.

These major problems notwithstanding, significant progress has been made on the macroeconomic front (Table 2). There is reason to believe that the collapse of output is bottoming out, and some countries, notably Poland, experienced positive growth in 1993. This turnaround reflects mainly improved supply conditions in response to the reforms that have been implemented; in addition, the improvement was supported in 1992 by growing exports. More recently, exports have suffered from the recession in Western Europe, while rising domestic private demand has provided an impetus to economic growth in many countries. Inflation has been reduced substantially following the initial price corrections; and external positions also strengthened appreciably during 1991-92. Nevertheless, there have also been setbacks, such as in Poland in 1991/92 and more recently in Hungary, and where there is success there is no room for complacency. The emerging output recovery is fragile and needs to be underpinned by continued vigorous structural change as well as financial stability; inflation in most countries is still significantly, and in some countries very far, above Western Europe, requiring inter alia continuing cur-

[3] Mainly because of unexpectedly buoyant corporate income tax revenues reflecting inflation-related valuation gains on inventories: once these "paper profits" vanished, corporate tax collections declined with the onset of structural change.

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rency depreciation; and, as noted above, the external accounts deteriorated in 1993. Initial strong improvements on the fiscal front have not been sustained, although in some countries, notably Poland, part of the slippage has been reversed in the more recent past. Not unrelated to this, the social problems that have emerged during the transition have been immense, and it is argued that recent electoral trends in the region reflect in part the electorate's desire for a more equitable distribution of the burdens and benefits of reforms. It is generally recognized, however, that these distributional goals should be pursued within the framework of continued stabilization, as redistribution through higher inflation would simply make everybody worse off. In this context, as well as more generally, it has become clear that further progress in transforming toward stable market economies depends to an important extent on successful systemic reforms, the third pillar of the transformation strategy.

Systemic reform has clearly been the weakest element of the strategy. It is of course understandable that the microfoundations of economies have proved most resistant to change because what is involved is no less than a complete overhaul of society. It is also not that progress has been negligible or small, it has been far-reaching in many areas, but from what is required for a well-functioning market economy, there is still a vast distance. A few examples are given below.

While considerable progress has been made in establishing the basic legal framework, the administrative and judicial machinery for enforcement remains weak. For instance, while most countries have adopted bankruptcy laws, little use has been made of such laws to date except in Hungary.

Most Central and Eastern European countries have been successful in privatizing small-scale enterprises and, where necessary, farms, and there has been a proliferation of less formal private activity, the true magnitude of which is not easy to gauge. But privatizing medium and large state enterprises has proven more difficult. In some countries, such as Hungary and Poland, an initial wave of self-privatization generated a backlash against privatization that still hampers progress. In Albania, Bulgaria, and Romania progress has been slow because of political uncertainties and the difficult economic environment. Poland and the Czech and Slovak Republics have recently implemented, or are in the process of adopting, measures to speed up this process, including mass privatization schemes. Until this process is much further advanced, markets will remain weak, the supply-side response tenuous, and the effectiveness of macroeconomic policies impaired. Unreformed enterprises tend to be unresponsive to interest rate policy and other price signals, and their aggregate financial losses have potentially serious implications for government budgets, the banking system, and macroeconomic stability. There is no doubt that enterprise reform is now a challenge of the greatest importance.

A crucial area where progress generally has been good is the establishing of effective central banking institutions; at the same time, the creation of modern commercial banking systems has turned out to be more difficult. Again, this should not come as a surprise as it involves, like enterprise reform, a much more decentralized approach than at the central banking level or, more generally, than the one entailed in stabilization.

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4. *Selected issues*

This section examines some of the most prominent issues in the transformation experience so far.

a. Was the output decline avoidable?

The reasons commonly given for the unexpectedly large output declines in virtually all the countries under review are numerous: (i) hoarding in anticipation of price liberalization, with a subsequent drop in demand; (ii) the collapse of the CMEA; (iii) the supply side shock described by Bruno (1992) as comprehensive management shock, the near-chaos faced by producers and distribution channels as the old structures broke away; and (iv) the sharp contraction of domestic demand that occurred in all countries in the initial stage of transformation. While there is broad consensus that some output decline was unavoidable, the relative contribution of the above factors to the actual decline is less clear. In addition, there is a debate whether official data fully captured the supply response of emerging private activities. Nevertheless, it is a valid question whether particularly the latter two factors, management shock and demand contraction, might have been softened by a different set of policies. Most often, this question is framed as a call for a more gradualist approach, both to systemic reforms and to macroeconomic stabilization. Before turning to this aspect, two points should be noted, one empirical and the other more hypothetical. Accumulating evidence suggests that output declines have been severe even in those countries that have tried alternative or more gradual strategies on these two accounts, while countries, notably Albania, the Czech Republic, Hungary, and Poland, that have pursued ambitious strategies, along the line of those mapped out above, appear to be among the first to experience renewed growth.[4] The second point is, even if the output decline could have been softened, there is great uncertainty as to how much of the productive base inherited from the past was viable in the long run, that is, whether the slower initial decline might not have translated into a prolonged period of retrenchment.

b. Big-bang versus gradualism

As noted above, the speed of price and trade liberalization in Central and Eastern Europe was unprecedented. Yet this process took place against the background of largely unreformed financial, factor and product markets where progress has been more difficult and subject to delays. The question of sequencing follows naturally. In particular, one might ask whether a more phased approach might not have cushioned the output decline, say, by liberalizing trade in tandem with the adjust-

[4] The evidence is similar in neighboring countries, with strong, frontloaded programs such as those implemented in the Baltic States being relatively more successful.

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ment speed in commodity and labor markets and with the reconstruction of the productive and legal base.

However, in addition to the doubts mentioned above whether such a cushioning would have served to diminish the overall, cumulative output loss or perhaps even worsened it, it is doubtful whether such an approach was a realistic option. First, the basic strategic decisions were made at the outset, that is when the political commitment to freeing up was strongest. A more gradual and controlled approach simply was not on the policy makers' minds, particularly among those conscious of the limited duration of the period of extraordinary politics. Second, even if politically palatable, such an approach probably would not have been feasible given the lack of political and administrative control. Third, in order to work, gradual liberalization requires a credible forward commitment by the government, and it is doubtful whether any government would be able to carry such credibility in the extremely unstable conditions that characterize the transitions.

The second question here is whether more gradualism in macro-stabilization, say easier financial policies, might have been appropriate, particularly in cases like Poland where the unexpectedly high price shock caused tighter demand conditions than initially programmed. However, it is precisely the persistence of strong inflationary pressures and external constraints that suggests that the room for a more relaxed stance of policies was very limited. For example, in Poland, the deliberate easing of policies in mid-1990 quickly lead to higher imports and prices, and it is not clear whether the slowdown in output decline reflected mostly higher demand or a normal abating of the impact of the initial shock. A similar easing in Czechoslovakia was followed by continued sharp output declines; and the rapid build up of inter-enterprise arrears in Romania, which softened the measured output decline, clearly complicated the entire reform and adjustment process, and thus also postponed, if not precluded, any early recovery.

c. Sustained fiscal adjustment

As noted above, the initial hopes of achieving budget balance were soon frustrated by pressures on both revenues and expenditures. On the revenue side, difficulties included the steeper output decline as well as those of building an entirely new tax system suitable to market economies. Perhaps even more difficult, the challenge on the expenditure side was that of moving from an egalitarian, well-endowed welfare system to a market system with much wider differences in incomes and wealth, but also with all the adverse social side effects of capitalism, like unemployment, that need attention. In addition, there are other new claims that arise as part of the transformation process, such as the tremendous infrastructure needs and the costs of non-performing bank portfolios. Two principal questions arise: whether with all these difficulties, there is a case for a temporary widening of the budget deficit, and how to solve the medium-term budget problem.

First, it has been recognized that budget balance was probably unrealistic in the early stage of transformation, and programs have accommodated this. Particularly where the debt/GDP ratio is low and the deficit does not require undue reliance on

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the inflation tax, deficits might be expected to partly self-correct when output eventually recovers and social spending cuts should become easier. However, one must also point to the fragility of the stabilization gains made so far. The stakes are high because hard-won credibility can be lost quickly, and especially when the emerging private sector starts to put pressure on resources there is ever less room for non-inflationary deficit financing. This constraint is particularly tight in a country like Poland where confidence in the domestic currency still suffers from the lingering effects of past hyperinflation. The resulting low level of base money relative to GDP implies that even a small slippage from the deficit target can translate quickly into much higher inflation. For the medium and long term, the direction should be clear: approximate budget balance; continued tax reform; and reform of the big traditional spending blocks such as education, health, and social welfare, while providing resources for critical aspects of the transformation such as infrastructure, enterprise restructuring, and financial sector reforms. The overall budget constraint implies that strict expenditure priorities must be established both within and across sectors. Reforming the major public expenditure programs into affordable yet effective systems is now the key fiscal challenge for the countries under review. A crucial role is to be played by social reforms.

d. Social aspects

To make the transformation politically and socially sustainable, it was considered essential to incorporate into all programs some minimum protection for those that would suffer most, such as the newly unemployed. However, these social safety nets were mostly grafted onto the existing ones inherited from the command economies. It has become clear that those systems are not only unsustainable financially, but also not very effective as benefits are spread too thinly without clear focus on the most needy. At the same time, as noted above, recent electoral trends in countries like Poland imply a mandate for governments to address painful tensions in the transformation process, mainly by attempting to distribute the burdens and fruits of reforms somewhat more evenly.

For continued successful transition, governments will thus have to attempt to reconcile three concerns: the overarching goal of maximizing their countries' longer term prospects for high growth and rising living standards; the mandate to aim for greater social equity; but also the need to prune back unsustainable social programs. Three implications follow: (i) there is no real alternative to the overall path of stabilization and market-oriented reforms; (ii) where policy options exist to bring about a better distribution of the burden of reforms, without breaking the financial framework of programs, these options could be used, for instance, by making the tax system more progressive, casting the tax net more widely, and/or increasing minimum social benefits while holding back on other entitlements; and (iii) reforms of the existing social spending programs should no longer be delayed. In this context, it will be particularly important to establish clear social priorities, within available resources, translate them into concrete spending decisions, and carry them out efficiently to make sure they reach the targeted beneficiaries. Better

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benefit administration, including decentralization to lower levels of government, can make an important contribution here. The options for a more active policy of redistribution will probably widen as countries emerge from recession and administrations strengthen; however, governments should be cautioned against the temptation of distributing the entire growth and reform dividend for social purposes; rather, part of that dividend should be reserved for tackling the remaining large structural problems.

e. Enterprises governance, bad loans and arrears

While there is little debate in principle about what to do with clearly non-viable enterprises, which is not to say that it is not a difficult social issue, a few points are worth making about privatization, as well as more generally about that middle group of enterprises that are too good to be liquidated, yet too bad to be privatized. First, there should not be any doubt that privatization is, as a strategic objective, fundamental to successful transformation. Even in countries with a tradition of strong administration, the experience has been that private ownership is the best way to tighten the budget constraint, to make managers responsive to that budget constraint, and to mobilize private savings for efficient investment. Of course, it is also one of the most political issues in the transformation, and, as noted above, it has been one of the points on the agenda most prone to delays. The basis and circumstances for rapid large-scale privatization are also different from country to country, and some have chosen a deliberately fast-track approach and thereby favoured considerations of speed over those related to finding the perfect solution. The trade-off between speed and efficiency is a particularly stark one in the various forms of voucher privatization; there is the concern that this method could either result in a diffused ownership structure or essentially preserve the status quo of de-facto ownership by large creditor banks, both of course complicating effective enterprise governance. The jury here is definitely still out; I personally am attracted by the aspect of speed and getting it done, and the hope is that financial markets will eventually deliver an appropriate ownership structure. In this regard, Poland's mass privatization program appears well-balanced as carefully selected investment funds should be able to embody ownership in an appropriate fashion. The hope now is that the program can indeed be implemented over the next year or so.

Regarding that middle group of enterprises that will remain in state hands for some time, the key is to institute mechanisms that generate efficient behavior. Three elements are crucial here: (i) to create performance-oriented management incentives such as shares in future privatization; (ii) to maintain a hard budget constraint in that sense, a tight monetary and fiscal policy stance is directly relevant to the structural transformation as well, and wage controls have their role as long as the control mechanisms of the market are not yet fully in place; and (iii) to shift enterprise control from workers to managers, often facilitated by making workers share more directly in the results of enterprise performance.

A few words should also be said on the issue of bad debts. Although in large measure an asset overhang from the past, the problem has worsened in many coun-

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tries since the start of reforms, mainly reflecting the output decline as well as the perverse incentives for banks and enterprises in limbo between central control and market discipline. In general, countries have not dealt with this problem up-front, and while there are pros and cons for one-time solutions, in hindsight the balance of risks appears against premature wholesale bail-outs mainly because of the moral hazard problem and the large, and *de facto* open-ended, macroeconomic costs. Instead, an effective strategy should have three basic goals: (i) to strengthen enterprise discipline with a view to avoiding new bad loans later on; (ii) to help create a new banking philosophy whereby banks chose and monitor clients carefully and learn to deal with nonperforming assets; and, of course, (iii) to deal with the bad debts as such within the overall macroframework, including bank recapitalization through the state budget. A comprehensive, well-circumscribed approach such as that being implemented in Poland under the Bank Restructuring Law appears to satisfy these criteria.

f Choice of exchange rate regime

A natural corollary of price and trade liberalization was the unification of the exchange rate and the attainment of at least current account convertibility in all countries under review. Beyond that, the choice of exchange rate regime reflected the particular circumstances of individual countries. While a fixed exchange rate has an obvious value as a nominal anchor, particularly in the period immediately after domestic prices have been liberalized, it makes little sense to try to peg the rate unless there is confidence that financial policies will be appropriately tight and there is an adequate level of international reserves with which to defend the rate if necessary. Thus, Czechoslovakia and Poland established fixed rate regimes at the outset of the stabilization process, both after sizeable initial devaluations to afford a margin of competitiveness.[5] On the other hand, in Albania, Bulgaria, and Romania, the lack of reserves, uncertainties about financial policies, and difficulties in determining an equilibrium exchange rate for any peg, suggested the adoption of a floating exchange rate regime. Hungary adopted an adjustable peg as an intermediate solution, as the external position, albeit reasonably strong, was considered vulnerable mainly to swings in the capital account. While the initial choice was thus influenced mainly by countries' starting conditions, later on, the sustainability of fixed rates as well as the stability of flexible rates was a function of the consistency of underlying financial policies. Poland, for instance, after experiencing policy slippages and an erosion of competitiveness, in mid-1991 changed toward a crawling peg system that accommodates persistent, albeit progressively narrowing, inflation differentials while preserving many of the anchor functions of a fixed regime.

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[5] In addition, Poland was provided with a US$1 billion Stabilization Fund from foreign creditors in support of the currency peg.

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5. Role of the IMF

The role of the Fund in this historic process can only be limited, mainly because the countries, their populations and their political leaders, have to undertake and pursue the transition themselves, with all the risks and hardships involved. Also, we have been fortunate to be able to share our role with our colleagues from the World Bank, the EBRD, and other institutions. In a fundamental sense, the Fund's role here is little different from that which its Articles of Agreement intend it to fulfill for all its 178 member countries: to support policies that promote macroeconomic stabilization and unrestricted trade and payments, and more generally, to promote international monetary cooperation. What we could do in practice falls broadly into two categories: (i) financial support; and (ii) policy advice and technical assistance. As shown in Tables 3 and 4, all of the countries under review have embarked in the last few years on stabilization programs supported by the use of Fund resources. This support has come through the Fund's traditional facilities: Stand-by Arrangements, typically for 12-15 months; Extended Arrangements, involving a country's commitment to a medium-term adjustment framework, and Compensation for Export Shortfalls (CCFF), as well as through its concessional facility (ESAF) for low income countries and the recently created Systemic Transformation Facility (STF).[6] The use of Fund resources by Central and Eastern European countries, as by any other member of the Fund, typically has been conditioned on the member's adoption and implementation of an economic program that promises progress toward sustained adequate growth and balance of payments viability. This aspect of the Fund's support, its so-called conditionality, has received its share of criticism as well as praise over the years, and I shall not attempt to add to this debate in this paper. Suffice to note here that perhaps the most critical condition of a program's success has been the conviction and determination with which governments themselves have undertaken its implementation. In that sense, outside conditionality can only play a rather limited role, supportive of the right intentions, but hardly forcing countries to do much of anything. In addition to its own contribution, the Fund has been actively involved in the mobilization and coordination of financial support from other sources, mainly in the framework of the Group of 24 Donor Countries (G-24). Usually, this process would involve an assessment by the Fund of a country's macropolicies and outlook, including, importantly, that for the balance of payments. This assessment is then presented to other donors, with the Fund usually coming in with its own resources only when the financing of the program is assured.

An important part of the Fund's contribution is provided through technical assistance (Table 5). This revolves mainly around the design and implementation of macroeconomic policies, fiscal administration, central banking, and economic and

[6] The STF was created in April 1993 as a temporary mechanism to assist members in dealing with severe disruptions caused by a shift from state, non-market to multilateral, market based trade. It reflects the recognition that many of the transition economies had only a limited capacity in the short-term to implement fully elaborated adjustment programs and that meanwhile a somewhat different conditionality might be appropriate.

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financial statistics. After a first wave in the early years, this effort has recently become somewhat more focused, reflecting many countries' progress in carrying their systemic reform efforts to a broadly self-sustaining level. Last, but not least, the Fund is also involved in training of senior government officials from transition economies, both in our Institute in Washington and, together with other Organizations and governments, in the recently established Joint Vienna Institute.

6. Conclusions

While definite judgements on many accounts of the transition will have to await further evidence, some general conclusions can certainly be drawn from this progress report. Overall, the records of such countries as the Czech Republic and Poland can be judged as impressive, and even Albania has achieved a measure of macroeconomic stabilization and an output response that few might have expected during the winter of 1991. The main lessons are given below.

The best results have been achieved when both liberalization was rapid and financial policies were tight from the outset and persistently thereafter. Key to such outcomes has been a fundamental commitment by policymakers to the adjustment program, including a genuine consensus among all principle parties to the policy process, including the government, the central bank, and the parliament.

Even in the most successful cases, other elements of structural reforms have proceeded more slowly. This has tended to hold up the pace of both macroeconomic stabilization and structural transformation. Since gradualism rarely is an option, it follows that even greater emphasis must be placed on rapid institutional change. Enterprise reform, fiscal restructuring, and financial sector reform are the most critical challenges in this regard.

One of the most important engines of structural change has been the existence of tight budget constraints at the micro-level. This is, of course, where tight financial policy and discipline at the micro-level are most closely intertwined: inflation cannot be beaten without micro-discipline, and structural change will be faint under weak monetary and budget policies. Important additional agents of micro-discipline include rapid privatization, profit-orientation of commercial banks, and credible bankruptcy procedures.

Popular support for rapid and comprehensive reforms remains, of course, essential. Persuasive political leadership is certainly part of what is needed, but it also implies a clear need for effective social safety nets. In addition, governments may be called upon by their electorates to reconcile the over-arching goal of assuring high growth and rising living standards over the medium term, with a mandate of providing for a more equitable transition mainly by distributing its burdens and fruits more evenly. Governments that wish to manage these mandates successfully will have to define and execute clear social priorities, and find a judicious balance between short-term social concerns and the need to invest in reforms and infrastructure.

A final word about the role of government. After a period of extraordinary politics and rapid liberalization, it is only natural that the pendulum would tend to

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swing back at some point in time. Indeed, there is no doubt that markets often remain far from perfect and that a hands-off approach by governments is neither politically possible nor, in certain cases, appropriate. However, there is always the temptation to fall back into old mistakes or replicate the mistakes of others. What is needed instead is a clear vision of the overall scope of Government intervention, its benefits and risks, and its implications for the three essential pillars of the new regime: freedom, stability, and well-functioning market institutions.

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Czechoslovakia	Hungary 2/	Poland 3/	Romania
15.8	10.6	37.9	23.2
3450	2590	1790	1012
4.6	4.5	5.5	9.3
1.4	0.5	-0.7	1.8
100	15	All except food	80
Economy-wide	90	70	Economy-wide
0.7	0.4	0.6	0.6
19	65	77	3
23	57	56	NA
60	43	41	37
25	16	14	6

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Table 1. Central and Eastern Europe: Starting Conditions

	Albania 1/	Bulgaria
Population (in millions, mid-1989)	3.2	9.0
GNP per capita 4/ (in 1989 US$)	450	2320
GNP growth (average annual rate in percent at constant prices)		
1970s	5.5	7.0
1980s	0.4	2.0
Administered prices (in percent of total)	100	100
State ownership (in percent)	Economy-wide	Economy-wide (except 15% of agriculture)
Money(M2)/GDP, 1990	0.7	1.3
External Debt/GDP (1990 in percent)	35	50
External debt-service ratio (1990)	550	116
Exports to CMEA		
(in percent of total exports)	67	69
(in percent of GDP)	10	34

Source: M. Bruno, Stabilization and Reform, 1992; and IMF staff estimates.
1/ The initial year for Albania is 1991; exports to CMEA are 1990 estimates.
2/ External debt service ratio as a percent of merchandise exports.
3/ M2/GDP and exports to CMEA are 1989 figures.
4/ These data are highly sensitive to the choice of exchange rates.

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Table 2. Central and Eastern Europe: Selected Economic Indicators

	1989	1990	1991	1992	1993 (prel.)
GDP at constant prices		(Percent change)			
Albania	9.8	-10.0	-27.7	-9.7	11.0
Bulgaria	-0.5	-9.1	-11.7	-5.4	-3.5
Czech & Slovak Republic 1/	1.4	-1.6	-14.7	-7.1	–
Slovak Republic	...	...	...	-6.0	-4.5
Hungary	0.7	-3.5	-11.9	-4.4	-2.0
Poland	0.2	-11.8	-7.2	1.5	4.0
Romania	-5.8	-7.4	-15.1	-15.4	-2.5
Consumer/retail prices (end year)		(Percent change)			
Albania	–	–	104.1	236.6	31.0
Bulgaria	10.0	72.5	338.9	79.4	63.9
Czech & Slovak Republic 1/	1.5	18.4	53.6	12.7	18.2
Slovak Republic	...	...	...	9.1	25.0
Hungary	18.9	33.4	32.2	21.6	22.2
Poland	639.6	249.3	60.4	44.3	37.6
Romania	...	...	222.8	198.5	266.0
Fiscal balance 2/		(Percent of GDP)			
Albania	-5.5	-3.7	-43.7	-21.8	-16.0
Bulgaria	-1.4	-8.5	-8.4	-6.9	-11.1
Czech & Slovak Republic 1/	-2.4	0.1	-2.0	0.4	0.3
Slovak Republic	...	...	...	-13.1	-7.9
Hungary	-0.8	0.8	-4.4	-6.9	-7.0
Poland	-7.4	3.1	-5.6	-6.9	-3.5
Romania	8.4	1.2	0.6	-6.1	-4.5
Broad money		(Percent change)			
Albania	14.8	23.4	104.4	152.7	75.0
Bulgaria	10.2	18.6	122.0	43.5	52.9
Czech & Slovak Republic 1/	3.5	0.5	26.8	22.8	17.7
Slovak Republic	...	...	...	4.7	15.3
Hungary	13.8	29.2	29.4	27.4	19.8
Poland	236.0	121.9	47.4	57.5	36.0
Romania	5.6	22.0	101.2	74.8	130.0
External current account (convertible)		(In billions of US$)			
Albania	-0.1	-0.1	-0.2	-0.4	-0.3
Bulgaria	-1.3	-0.9	-0.3	-0.4	-1.0
Czech & Slovak Republic 1/	0.4	-1.1	0.4	-0.1	0.5
Slovak Republic	...	...	...	0.3	-0.2
Hungary	-1.4	0.1	0.3	0.3	-2.5
Poland	-1.8	0.7	-2.2	-0.3	-2.3
Romania	2.9	-1.8	-1.3	-1.5	-1.3
Official foreign exchange reserves (stock)		(In billions of US$)			
Albania	0.4	0.2	–	–	0.1
Bulgaria	0.3	0.3	0.6	1.2	1.0
Czech & Slovak Republic 1/	1.1	0.5	1.4	0.7	3.8
Slovak Republic	...	...	...	0.4	0.4
Hungary	1.7	1.2	4.0	4.3	6.2
Poland	2.5	4.7	3.8	4.3	4.3
Romania	2.0	0.5	0.5	0.7	0.7

Source: Information provided by the authorities, OECD, and staff estimates.

1/ Data for former Czechoslovakia until end-1991; Czech Republic from 1992.

2/ Data for different countries are not comparable due to differences in definition coverage. Data for Albania (entire period), Czechoslovakia (1989, 1990, 1991), and Romania (1989) are for the general government cash balance, and for all other countries for general government domestic commitment basis (excluding accrued but unpaid external obligations).

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Period of Arrangement 1/
August 1992-July 1993
July 1993-July 1996
February 1991
March 1991 - March 1992
March 1992
April 1992-April 1993
January 1991-March 1992
January 1991
April 1992-April 1993
March 1993-March 1994
July 1993
March 1990-March 1991
February 1991
February 1991-September 1993
September 1993-December 1994
February 1990-March 1991
April 1991
April 1991-February 1993
March 1993-March 1994
March 1991
April 1991-April 1992
April 1991
May 1992-March 1993
June 1992

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Table 3. Central and Eastern Europe: Fund Financial Arrangements and Facilities (1990-1993)

Country	Fund Arrangement or Facility	Amount SDR million
Albania	SBA	20.0
	ESAF	42.4
Bulgaria	CCFF	60.6
	SBA	279.0
	CCFF	56.9
	SBA	155.0
Former Czechoslovakia	SBA	619.5
	CCFF	466.0
	SBA	236.0
Czech Republic	SBA	117.0
Slovak Republic	STF	64.4
Hungary	SBA	159.2
	CCFF	226.2
	EEF	1114.0
	SBA	340.0
Poland	SBA	545.0
	CCFF	162.6
	EFF	1224.0
	SBA	476.0
Romania	CCFF	209.0
	SBA	511.5 2/
	CCFF	38.3
	SBA	314.0
	CCFF	76.8
Total		7513.4

1/ In the case of CCFF facilities, the date of approval of the first purchase.
2/ Including contingency financing mechanism.

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Table 4. Central and Eastern Europe: Purchases from the Fund (1990-1993)
(in millions of SDRs)

Country	1990	1991	1992	1993	1990-1993
Albania	...	...	9.7	11.9 1/	21.6 1/
Bulgaria	...	289.2	200.3	31.0	520.5
Former Czechoslovakia	...	917.9	238.6	...	1,156.5
Czech Republic	...	...	...	70.0	70.0
Slovak Republic	...	...	...	64.4	64.4
Hungary	127.4	703.8	118.4	56.7	1,006.3
Poland	357.5	239.1	...	...	596.6
Romania	...	565.8	338.5	...	904.3

Memorandum items:

	Membership Data:		
	Date of joining IMF	Quota	
		SDR million	US$ million 2/
Albania	Joined October 15, 1991	35.3	48.7
Bulgaria	Joined Septemebr 25, 1990	464.9	641.6
Former Czechoslovakia	Joined September 20, 1990	590.0	814.2
Czech Republic	Member since January 1, 1993	589.6	813.6
Slovak Republic	Member since January 1, 1993	257.4	355.2
Poland	Rejoined June 12, 1986	988.5	1,364.1
Romania	Joined December 15, 1972	754.1	1,040.7

1/ Includes a disbursement under the ESAF of SDR 8.5 million.
2/ Using an exchange rate of 1.38 US$ per 1 SDR.

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Table 5. Central and Eastern Europe: IMF Technical Assistance

Country	Technical Assistance
Albania	IMF assistance has included help in the areas of tax policy and administration, price statistics, exchange system reform, and creation of an independent central bank.
Bulgana	Since it joined the IMF in the fall of 1990, the IMF has provided technical assistance to help Bulgaria assess the overall quality of its database, develop monetary and national accounts statistics, improve the operation and income of the central banking system, and strengthen tax administration.
Czech Republic	IMF technical assistance has helped in the modernization of central banking, focussing on bank supervision, monetary policy instruments and operating procedures, foreign exchange operations, research and analysis, organization and the legal framework for central and general banking; the IMF also assisted with a major tax reform.
Hungary	IMF technical assistance to Hungary has included advice on reform of the banking system, help in establishing monetary and credit policy instruments, assistance in establishing an interbank foreign exchange market, the introduction of value-added and personal and corporate income taxes, and reform of the budget, and social security.
Poland	IMF technical assistance to Poland has included modernizing the operation of the National Bank o f Poland in areas such as monetary control procedures, banking supervision and statistical support to implement monetary policy; and aspects of budget reform such as the introduction of personal income and value-added taxes, tax administration and expenditure management.
Romania	IMF technical assistance has focussed on the creation of an independent central bank and tax reform. Specific areas of assistance have been: banking legislation, the foreign exchange market, monetary management, payments system reform, bank supervision; design and the implementation of the value-added tax, profit and income tax policies, and the development of macroeconomic statistics.
Slovak Republic	IMF technical assistance includes the development of the legal framework for central and commercial banking; advice on the design of corporate and personal income taxes; advice on policy and administrative aspects of the introduction of VAT; and advising the Slovak Central Bank on monetary instruments, operation and analysis, foreign exchange operations, and banking supervision.

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CHRISTINE L. WALLICH

What's Right and Wrong with World Bank Involvement in Eastern Europe[1]

The countries of Eastern Europe and the former Soviet Union have undertaken a transition from a centrally planned, closed economy to a market system, attempting simultaneously to restructure their entire economic system; protect the well-being of their citizens; stabilize prices and external balance; and introduce the legal, financial, and economic institutions needed for a market economy. This transformation is happening in an environment of severe economic dislocation, and in many cases, in an environment of regional or internal instability.

While much has been achieved over the past four years, much still remains to be done. In some countries there is still a need to reduce the dominance of state monopolies and monopsonies and to limit heavy political and administrative interference. In others, significant progress has already been made on both the institutional and policy front, especially as regards privatization. All of the countries involved, however, share a common need to restructure and privatize heavy industry and to establish a rich supply of local, non-traded goods and services characteristic of market economies. All also have a need for continued fiscal retrenchment and watchfulness, especially on the expenditure side. Since these reforms have social as well as political dimensions, all need to integrate political economy considerations into the policy-making process.

To accomplish this policy transformation, Eastern European countries have sought financial and technical support from outside agencies. For many countries of the region, the World Bank has become an increasingly important, and in some, the most important, single source of external finance. While the World Bank has acted in its traditional role of provider of financial resources, it has also endeavored to help with policy advice, technical assistance, and to act as a catalyst for other sources of support.

A large and diverse institution, the World Bank is involved in a wide range of activities in the region. This paper discusses some dimensions of the role it has played in Eastern Europe and the former Soviet Union focussing on areas where, in the author's opinion, the Bank's involvement has been noteworthy, on areas where Bank support is of necessity limited, and areas where its activities are controversial. The paper concentrates mostly on Eastern Europe, although some aspects of the discussion also touch on the former Soviet Union. Although some of the countries of the former Eastern Bloc have been Bank members and borrowers for a far longer time, the focus of this discussion is mainly on World Bank involvement following the political changes of 1989.

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[1] The author is Lead Economist in the Central Europe and Central Asia Region of the World Bank. The views expressed in this paper are solely the author's and should not be attributed to the World Bank or its affiliates. The research assistance of Simone Wunsch and Caroline Freund is gratefully acknowledged. Thanks are also due to Jan Pakulski, Jane Loos, Kemal Derviş, Alex Preker, Hans Apitz, Bernard Montfort, Margret Thalwitz, Marcelo Selowsky, and Isabel Guerrero for helpful comments and ideas.

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Following a short history of the World Bank's association with the countries in Eastern Europe and the former Soviet Union, the World Bank's strategy in Eastern Europe is outlined. A brief review of World Bank activities in Eastern Europe and the former Soviet Union - amounts lent, sectoral composition of lending, types of nonfinancial support - is then presented. After a discussion of Bank successes and shortcomings in specific programs in the social sectors, environment, privatization, and the reform of the state, common criticisms of the Bank are discussed. A concluding section provides a summary assessment of World Bank activity in the former Eastern Bloc.

The History of World Bank Involvement

Since 1989, political and economic changes in Eastern Europe and the former Soviet Union have brought the total number of World Bank members from this region to 25 and have significantly changed the regional thrust and scope of the Bank's operations. The history of World Bank involvement with the countries of Eastern Europe is long, although by far the majority of countries in the region became members only after 1990 (Table 1). While Poland and Czechoslovakia were founding members of the Bank, both withdrew in the 1950s without having borrowed. Poland joined again in 1986 and Czechoslovakia in 1990. Yugoslavia, also a founding member, was an active borrower until its political breakup. Although Romania joined in 1972, it borrowed little from 1983 to 1990. Hungary joined the Bank in 1982 and has been a steady borrower since then. More recent members, Albania joined in 1991 and the Baltic countries and eleven Soviet republics, including the Russian Federation, joined in 1992. Tajikistan, the most recent member, joined in 1993.

The World Bank's Strategy in Eastern Europe

For many countries in the former Eastern Bloc, for so long frozen out of the free market world, their overriding objective is to join Europe, both economically and politically. Europe Agreements have been ratified for two countries, Hungary and Poland, and four other countries, the Czech Republic, Slovakia, Romania, and Bulgaria, have signed Europe Agreements with interim trade arrangements until their Agreements are ratified. For this objective to be met, and for these hopes not to be dashed, many adaptations must be made by the European Union. However, the task ahead in the transition economies is also huge, to bring their per capita incomes up to a level where the prospect of joining Europe near the end of the century, as equal partners, is a realistic one. The growth imperative is equally strong in the former Soviet Union, where living standards are low and poverty is on the rise. Their productivity must rise, and their competitiveness must continue to improve. This will require significant further economic restructuring.

The World Bank strategy and support differs from country to country, and is tailored to each country, based on individual needs, the stage of transition, and the state of the economy. In each case, World Bank support is designed, broadly, to support this ambitious growth goal, and process of catching up. The transition economies must move ahead with far-reaching reforms that will increase their pro-

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TABLE 1

THE WORLD BANK AND EASTERN EUROPE

	Date joined	Population (in millions)	Per Capita Income (in US$)[a]
Albania[b]	10/15/91	3.3	289
Bosnia-Herzegovina	applied	4.4	n.a.[c]
Bulgaria	9/25/90	9.0	1 330
Croatia	2/25/93[d]	4.8	1 600[e]
Czech Republic	1/1/93[f]	10.4	2 440
[Czechoslovakia	12/27/45][f]		
Hungary	7/7/82	10.2	3 010
Macedonia[i]	2/25/93[d]	2.2	852[h]
Poland	1/10/46, 6/27/86[g]	38.4	1 960
Romania	12/15/72	22.9	1 090
Slovak Republic	1/1/93[f]	5.4	1 920
Slovenia	2/25/93[d]	2.0	6 330
Republic of Yugoslavia			
Serbia, Montenegro	applied	10.6	n.a.[h]
Yugoslavia	12/27/45[d]		
Armenia[i]	9/16/92	3.5	780
Azerbaijan	9/18/92	7.2	870
Belarus	7/10/92	10.4	2 910
Estonia	6/23/92	1.6	2 750
Georgia[i]	8/7/92	5.5	850
Kazakhstan	7/23/92	17.0	1 680
Kyrgyzstan[i]	9/18/92	4.5	810
Latvia	8/11/92	2.6	1 930
Lithuania	7/6/92	3.8	1 310
Moldova	8/12/92	4.4	1 260
Russian Federation	6/16/92	148.9	2 680
Tajikistan[b]	6/4/93	5.6	480
Turkmenistan	9/22/92	3.9	1 270
Ukraine	9/3/92	52.1	1 670
Uzbekistan	9/21/92	21.3	860

[a] *World Bank Atlas methodology*, 1992 base period.
[b] IDA-eligible Countries
[c] Estimated to be low-income ($675 or less).
[d] Yugoslavia ("Socialist Federal Republic of Yugoslavia") ceased to be a member of IBRD/IDA/IFC effective February 25, 1993 and ceased to be a member of MIGA effective March 19, 1993; succeeded by Croatia, Slovenia and fYRMacedonia as members of IBRD/IDA/IFC effective February 25, 1993.
[e] Estimates
[f] Czech and Slovak Federal Republic ("Czechoslovakia") was an original member of the Bank but ceased to be a member on December 31, 1954; was readmitted as a member on September 20, 1990 and ceased to be a member effective January 1, 1993; and was succeeded by the Czech Republic and Slovak Republic effective January 1, 1993.
[g] Poland withdrew its membership on March 14, 1950, and rejoined on June 27, 1986.
[h] Estimated to be lower-middle-income ($676-$2,695).
[i] IBRD/IDA Blend Countries.

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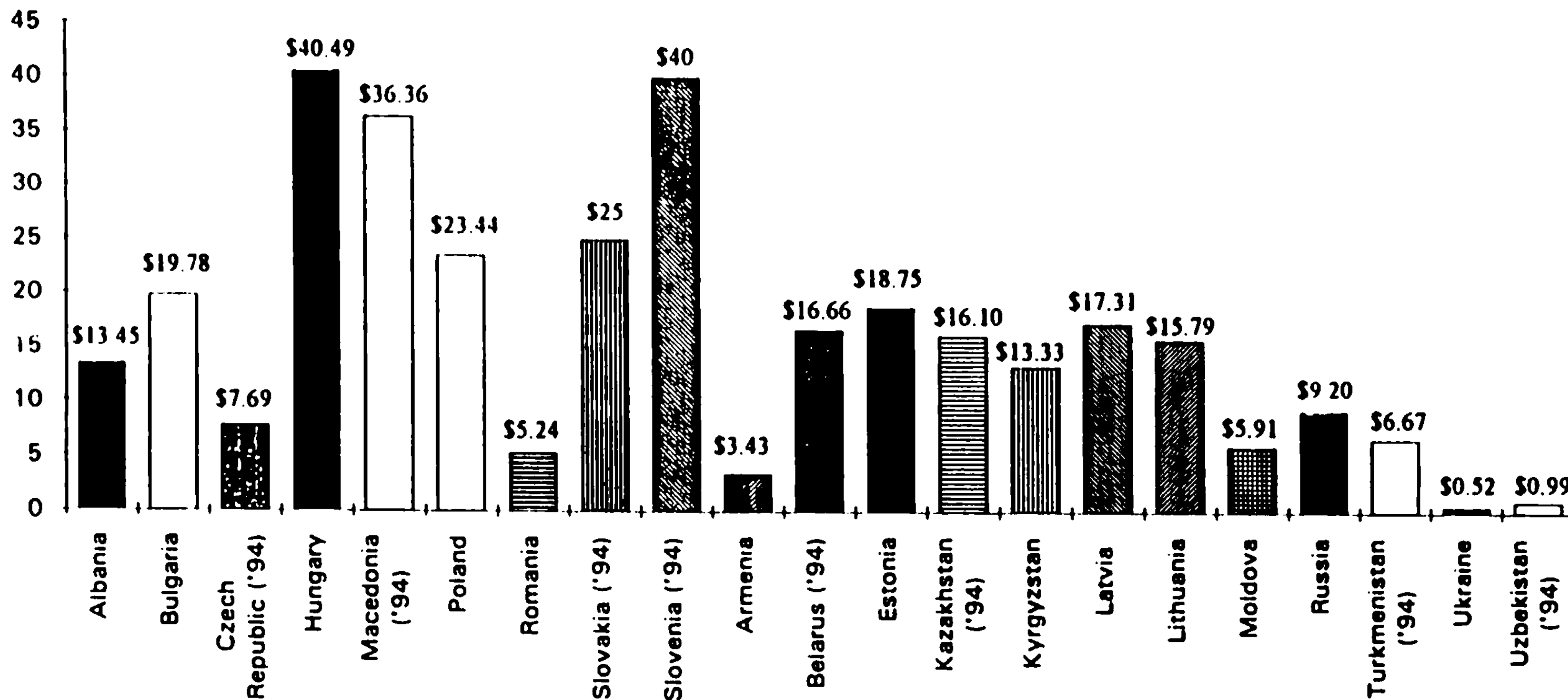

FIG. 1. Lending per capita in Europe and Central Asia in 1993 (or in the most recent year that lending took place).

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duktivity and their competitiveness so that they can achieve their growth objectives without inflation. The economies of the former eastern bloc, especially those in central Europe, begin with many pluses: locational advantages, low labor costs, and a highly skilled work force. Building on these advantages, the aim of the World Bank's assistance strategy in Eastern Europe is to promote sustainable economic growth, based on the development of a strong private sector, and to smooth the transition from centralized to market economy. The structural policies and investment projects supported by the Bank are designed to achieve this objective by encouraging needed macroeconomic adjustment, including scaling down the budgetary needs of the state, and by helping develop the economic, regulatory and physical infrastructure that supports greater efficiency in production and provides that basis for private sector growth.

A stable macroeconomic environment is key to achieving this growth objective. Hyperinflation is not conducive to growth, and virtually all studies of transition show that the output decline is reversed only when acceptable levels of inflation have been reached (Bruno and Easterly, 1994). In most countries, the World Bank's first priority is to help countries restore solvency and macroeconomic stability. Quick disbursing balance of payments assistance, see below, helps fill the external financing gap and simultaneously finances the state budget in a non-inflationary way. Such adjustment lending also provides a fiscal cushion that allows a less abrupt budgetary adjustment and thereby, softer overall landing, e.g., by providing resources for a social safety net that allows reform to remain politically feasible. For many countries, a longer run reduction in the size of government and an increase in its efficiency is also fundamental to the growth objective. The suspicion that the heavy hand of government may have a heavy cost in terms of growth has received validation in a recent study associating a one percent increase in economic growth with a ten percent decline in government spending, a striking finding for transition economies with expenditures as high as 60% of GDP (Easterly and Rebelo, 1993). Reduced government spending and borrowing can help to crowd-in private investment.

Retooling the state's macroeconomic, financial and regulatory institutions to make them more compatible with a market economy has been another strategic element. Systemic transformation from planning to markets requires not only a new central bank and banking system, but the regulatory regimes, the courts, legal systems, the payments system, the fiscal system and an effective civil service and well-trained public administration. This economic infrastructure is critical if private enterprises are to function and true financial intermediaries to operate responsibly to support an expanding private sector. Strengthening and supporting the development of such economic infrastructure through lending and technical assistance is a principal element of the World Bank's strategy across Eastern Europe and the former Soviet Union.

Finally, raising growth rates by enhancing the efficiency of both capital and labor in transition economies is also a major objective. If real wages, consumption and household income levels are to rise without an associated loss in comparative advantage, productivity gains are necessary in these economies. Projects aimed at improving physical infrastructure and developing the key social sectors of the economy are therefore critical. Removing structural barriers, such as exist in energy, transportation, and telecommunications will significantly increase productivity and growth. Environmental projects serve to improve living standards. Social sector projects, for example, education and health

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development, can also improve living standards directly in the short run, while improving, over time, the human capital needed to better position the Eastern European economies in the competitive world markets.

For each country, the combination of support for stabilization, physical and social infrastructure investments, and economic infrastructure or institution-building will differ. The strategy for each country is revised annually, and examines economic performance, the external environment, and the government's development objectives and policies, to identify which sectors should receive priority, and how cooperation with other institutions can be bettered. In Poland, for example, where the impact of reform on the population has been severe, and the government has been fully committed to macrostabilization, adjustment lending was initially the most important focus of the World Bank. The economic restructuring that followed has been a long and difficult process, and Poland is now at a stage in this transition where lending is more targeted. Projects that help to establish a modern public administration, contribute to the development of a private enterprise and financial sector, and improve the social sectors and physical infrastructure now absorb much of the World Bank's current assistance to Poland. In a country such as Albania, the support strategy has been quite different, focussed on the rebuilding of that country's neglected infrastructure and on projects, such as in agriculture and rural credit, with direct poverty-alleviation effects. The Bank has also focussed on its role as a catalyst for mobilizing concessional donor funds for this, the poorest country in Europe.

In sum, there is no single recipe for World Bank support. The exact package of support depends on the country's stage of transition and the initial conditions of the economy, as well as on government policies and programs.

World Bank Activities in Eastern Europe

World Bank lending during the transition is designed to support current and future reform policies. Investment lending, which comprises the majority of World Bank assistance to the region, provides funding for infrastructure that is necessary for sustainable growth. Adjustment lending is geared towards macrostabilization and advancing key sectors of the economies. Other types of lending equip the countries with the market oriented technical skills and education that were absent in centralized economies. In many cases the World Bank has been the largest source of external finance.

Types of Involvement

The World Bank employs a variety of instruments to support governmental reform and restructuring efforts. On the lending front, quick-disbursing structural adjustment loans (SALs), often undertaken in conjunction with IMF-supported programs, are designed to support countries' stabilization and economic liberalization programs and to help them tackle such macroeconomic imbalances as rising inflation, fiscal deficits, or balance of payments deficits. Typical adjustment policies supported by the World Bank involve reducing and reallocating public expenditures, opening the economy up to competition,

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freeing administered prices, and improving government delivery of social and infrastructure services (Appendix, Box 1). Beginning with Hungary and Yugoslavia in 1990, and Czechoslovakia and Poland in 1991, the Bank has supported adjustment programs throughout Eastern Europe.

Sector adjustment loans (SECALS) support fundamental policy and institutional changes in specific sectors such as agriculture, financial institutions, energy, etc. These support such government programs as introducing a sector regulatory framework that promotes competition, establishing a new price setting regime, and designing strategies for commercialization and demonopolization of state-owned enterprises. For countries where critical short-term needs range across many sectors, the rehabilitation loan has been developed as a new lending instrument. To support economic stabilization programs, a policy-based, quick-disbursing, single tranche econonuc recovery loan (ERL) was developed to work in parallel with the IMF's Structural Transformation Facility (STF), for countries where a full IMF Standby Agreement is not yet in place. Both have been key to supporting stabilization programs at an early stage, giving new governments the breathing room to undertake difficult reforms, thereby helping to maintain the pace of economic reform.

The mainstay of Bank lending is its investment lending, which has accounted, on average, for 75 percent of total Bank commitments in recent years. Investment lending supports projects and finances a range of specific investments such as the building of schools, infrastructure, environmental investments. Sector loans on the other hand, finance a time slice of investment expenditures in a given sector, such as railways or roads. Hybrid loans have features of both types, financing specific investments and focussing on the overall policy regime needed to make those investments successful. Technical assistance loans, although a small proportion of total lending, also deserve to be mentioned. They typically finance resident advisors and consultants, training, studies, and some equipment. Finally, World Bank guarantees can be used to support and enlarge member countries' capital market access.

Which of these interventions is most important will vary across countries. On average, just under 40 percent of World Bank lending in Eastern Europe and the former Soviet Union has been adjustment, or nonproject, lending, including sector adjustment loans; about half has been investment lending; some 3 percent went to technical assistance loans and 8 percent were recovery and rehabilitation loans. Guarantees are, at this stage, *de minimis*.

Sectoral Allocation of Lending

The activities of the World Bank have varied greatly within Eastern Europe and the former Soviet Union, depending on sectoral needs and the situation of the individual country (Table 2). On average, the largest share of World Bank commitments during 1990-93 has been for energy, including power, 22 percent; followed by agricultural development, 10 percent; transport, 10 percent; and the social sectors, education and health, 6 percent.

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TABLE 2

LENDING TO EUROPE AND CENTRAL ASIA[a], BY SECTOR, 1990-1993

Sector	% of total lending	Millions of U.S. $
Non-Project (Adjustment , Rehabilitation)	29	3 536.1
Energy (Oil, gas, coal)	12	1 469.0
Transportation	10	1 123.0
Energy (Power)	10	1 120.0
Agriculture and Rural Development	10	1 043.4
Development Finance Companies	6	740.0
Urban Development	4	485.0
Industry	4	451.0
Education	3	407.2
Public-sector Management	3	402.0
Water Supply and Sewerage	3	377.5
Population, Health, and Nutrition	3	371.0
Telecommunications	2	300.0
Technical Assistance	1	159.2
Small Scale Enterprises	-	60.0
Total	100	12 044.4

[a] Data includes Turkey and Cyprus.

Other Support-to-Country Programs

Economic and sector work provides the analysis of each country's economic situation that serves as the basis for the policy dialogue with borrowers and for devising supporting country strategies. For Eastern Europe and the former Soviet Union, country economic reports have addressed, *inter alia*, issues of stabilization, the enterprise-financial sector nexus, trade and external sector policies, the environment for private sector development, public finance, fiscal decentralization and public administration reform, and such social issues as the social safety net and poverty alleviation. Regional sector reports have concentrated on agriculture, energy, telecommunications, environmental strategies, and housing, areas where policy reform is essential to an early supply response. World Bank country economic memoranda and sector reports also provide the basis for wider donor information about countries' adjustment or investment needs and, as such, can be central to garnering donor support for these programs.

Finally, the World Bank's research program for the former Eastern Bloc has addressed a range of issues relating to economic and political transition such as enterprise behavior and governance, labor market and incomes policies, and different approaches to financial sector restructuring. Coordination with local research institutes in both research and dissemination is important to the research process. The Economic Development Institute (EDI), as the Bank's training arm, offers training and regional workshops in areas ranging from macroeconomic management and economics of the market to human resources development. In Eastern Europe and the former Soviet Union, there are now

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twelve World Bank field offices that maintain working contacts between Bank headquarters and local governments and support project implementation.

Magnitude of Lending Support

In the past three years, overall lending to the former Eastern Bloc averaged about $3 to $4 billion per year. In fiscal 1993, the region received about 17 percent of the World Bank Group's total commitments of $23.6 billion and since 1989 to mid-1994, a total of $13.8 billion has been committed to the region, with Poland, Hungary, the Russian Federation and Romania the largest recipients of funds in that period.[2] Today, the Slovak Republic, fYRMacedonia, Moldova, Armenia, Georgia, Kyrgyzstan, and the Baltic states are also borrowers, although because of their smaller scale and more recent membership, commitment levels to them are modest in the overall regional context (Table 3). In per capita terms, however, support for these smaller countries has been significant (Figure 1), with the World Bank often being their largest single source of external finance. By contrast, the share of Eastern Europe and the former Soviet Union was 7.1 percent of total overseas development aid (ODA) flows in 1993 as compared to 1.4 percent in 1990. Over the same period, total ODA rose from $4.7 per capita to $12.2.[3]

How the World Bank Works

Given the magnitude and complexity of its portfolio of operations in Eastern Europe and the former Soviet Union, it is not surprising that the World Bank has achieved notable success in some areas and only uncertain, and even controversial, results in others. The following discussion accepts the Bank's limited mandate as is given by its Articles of Agreement and its present organizational structure, and lays aside such theoretical questions as whether or not the World Bank should be a fund or how it could be structured differently. It focuses below on some nuts-and-bolts aspects of the World Bank's operations in Eastern Europe and the former Soviet Union.

A Quicker Response to Needs

While the World Bank is best known for investment projects that require extensive preparation, it has shown considerable speed in responding to special demands in Eastern Europe and the former Soviet Union. Although not itself a relief agency and clearly without a comparative advantage in direct crisis intervention, the World Bank has nonetheless been able to mobilize support by providing emergency assistance, support

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[2] The Bank Group consists of four related but distinct entities, the World Bank itself, which lends on market terms to credit-worthy borrowers; IDA, the concessional window; IFC, the private sector arm of the group; and MIGA, which guarantees private direct investments.

[3] World Bank, IECAP projections.

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TABLE 3

THE WORLD BANK LENDING TO EASTERN EUROPE AND THE FORMER SOVIET UNION 1989 - 1994

	Commitments[a]	
	% of total	Million $US
Poland	27.9	3 852
Russian Federation	21.0	2 895
Hungary	12.0	1 658
Romania	9.8	1 350
Yugoslavia	7.2	992
Bulgaria	6.3	873
Czechoslovakia	3.3	450
Czech Republic	2.4	326
Kazakhstan	2.0	274
Belarus	1.3	173
Kyrgyzstan	1.0	140
Slovakia	1.0	135
Albania	0.9	126
Moldova	0.6	86
Macedonia	0.6	80
Slovenia	0.6	80
Estonia	0.5	73
Latvia	0.5	70
Lithuania	0.4	60
Armenia	0.3	40
Ukraine	0.2	27
Turkmenistan	0.2	26
Uzbekistan	0.2	21
Total	100	13 807

[a] 1990-end February 1994; no lending had yet been committed to Croatia, Azerbaijan, Georgia, and Tajikstan.

for debt work-outs, and by meeting critical import needs. The government of Moldova, for example, was provided with a quick-disbursing loan for needed agricultural inputs to help alleviate declining incomes and poverty after a drought. The Bank's initial lending instrument in Kyrgyzstan, in the three Baltic countries, and in Russia was a rehabilitation loan, a new quick-disbursing operation designed to finance imports critical to production and infrastructure while providing rapid support to the governments' ongoing stabilization and reform efforts. In all of these cases, the elapsed time between project preparation and approval was approximately six weeks. Within weeks of fYRMacedonia's request for World Bank membership, which had lapsed following the break-up of the former Yugoslavia, the World Bank had designed a financial workout that enabled that country to clear its arrears and resume its membership in the Bank. At the same time, an economic recovery loan (ERL) assisted fYRMacedonia with critical imports and supported its stabilization program. A critical imports credit for Albania was prepared

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soon after that country joined the World Bank Group. This credit helped the Albanians get the imports needed to prevent further downward spiralling of their country's agricultural production and living standards. An IDA credit to Armenia following the earthquake provided fast funds for the reconstruction of housing and factory shells in devastated areas and supported liberaliza-tion of the construction industry.

Additional Support for Country Programs Can Be Leveraged by the World Bank's Economic Work and Through Cofinancing

Other donors such as the EU, bilateral sources, and, to a lesser degree, other multilateral banks active in the region use the World Bank's economic analyses as a framework for aid coordination and as a compass for the policy measures that donor-supported programs finance. A World Bank-prepared public investment review of Albania, for example, led to general donor and government agreement on a public investment program, and it is within this program envelope that many other donors have now chosen to provide financial support. Such aid coordination is time-consuming, but is key to ensuring that policy advice, technical assistance, and investment financing will be concerted. Given constraints on the absorptive capacity of many countries of the region, aid coordination is also needed to ensure that donor support will fit government priorities. The centerpiece of aid coordination is the consultative group (CG) process. In Eastern Europe and the former Soviet Union, the World Bank has participated in many EU- or G-24-led, country-specific coordination efforts designed to help reduce these countries' constrained external financing and to coordinate the overall program of foreign resources in a range of countries, including, in 1993, Bulgaria, Romania, fYRMacedonia, and some nine countries of the former Soviet Union. Sector-specific coordination meetings have also been held, as, for example, conferences on agriculture in Poland and Albania.

World Bank lending can also be leveraged financially through cofinancing. In certain kinds of project preparation, the World Bank arguably has a comparative advantage, given its diverse global experience and broadly trained staff. Yet World Bank resources, especially concessional resources for the poorest countries in the region, which must be spread across 75 IDA recipients, have been a severe constraint to the Bank's ability to provide the needed support.[4] Cofinancing of Bank-prepared projects and adjustment loans has enabled bilateral donors, multilateral financiers, and, rare in Eastern Europe as yet, commercial financiers to disburse funds more easily. Region-wide, the direct financial leverage of World Bank projects has ranged from 2:1 to 3:1 in recent years, with some projects as high as four to one.[5]

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[4] The Bank group presently has 60 IDA-only eligible countries and 15 IBRD/IDA-blend countries.

[5] SECM 94-212.

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World Bank Loans Provide Direct Foreign Financial Resources for the External Accounts

For sustained growth in output and private consumption to materialize in Eastern Europe and the former Soviet Union, countries there will need to continue to invest in and to retool their productive apparatus. Sustained growth will therefore result in increased import requirements and the need for additional foreign finance. More generally, the foreign resource transfer of World Bank loans has, in many countries, been central to a stabilization program by providing balance of payments and fiscal finance in a non-inflationary way.

Predicting the provenance of these needed flows is problematic, the combination of official and private borrowing and direct investment will differ across countries, but for many countries, official creditors, bilateral and IFIs, will remain their main or only source of external finance, and official, multilateral finance will play an important role for some time to come. While the World Bank is only one among many official creditors, in some countries of Eastern Europe and in the former Soviet Union, its loans and credits cover a major share of the country's external financial requirements. In the Slovak Republic, Albania, and fYRMacedonia, for example, Bank Group funds contributed as much as 25 percent of external financing needs in a given year. In Poland, the Bank at one time provided some 90 percent of external finance. For some of these countries, moreover, the Bank's resources have come on highly concessional (IDA) terms. Six countries of the region, Albania, Kyrgyzstan, Armenia, Georgia, fYR-Macedonia, and Tajikistan, are considered IDA-eligible and receive credits on 40 to 50-year terms at a zero interest rate (Table 1). The World Bank, furthermore, will help Poland and Bulgaria restore and normalize their international creditor relations by financing part of the down-payment required under the commercial debt and debt service reduction (DDSR) agreements that these countries reached in 1994 with their London Club creditors. The Bank (IDA) will also support a similar debt-reduction exercise now planned for Albania.

Financing the Fisc

World Bank borrowing, along with other prudent uses of external finance, simultaneously helps finance a country's budget deficit, thereby permitting a smoother fiscal adjustment and a less abrupt stabilization/adjustment process. How and when Bank or any other external loans finance the budget depends upon the type of loan and its disbursement schedule. Foreign loans made directly to the Ministry of Finance, such as the World Bank's quick-disbursing SALs, SECALs, rehabilitation and recovery loans, simultaneously provide a foreign reserve boost and immediate and direct budgetary finance as the loan is disbursed and the corresponding local currency amount, so-called domestic counterpart funds, is credited to the budgetary accounts. Such foreign resource transfers can help governments finance a desired program of fiscal expenditure in a noninflationary way, that, moreover, does not crowd out domestic private sector borrowers. World Bank investment loans to state or parastatal enterprises, or to other entities that receive budgetary funding, or that, in the absence of a Bank loan, would need it,

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also directly finance the budget. In Poland, for example, as much as ten percent of the fiscal deficit has been financed by World Bank disbursements in some recent years; in other countries, it has been far higher. As lending programs mature in Eastern Europe and with a stable disbursement profile, this level will become more significant over time, except in the very largest countries where the needs are that much larger in absolute terms.

The World Bank as a Bank: IBRD Loans and the Alternatives

Because the World Bank's mandate is to support economic development, its interests are expected to go beyond the purely financial. Its loans finance projects and adjustment programs and are not merely commercial transactions, but, as a financing vehicle, World Bank loans, with a seventeen to twenty-year maturity, have terms substantially longer than bilateral and commercial financing terms available from trade and export credit lines. The World Bank also offers a five-year grace period during which only interest is paid. With respect to interest rates and costs, IBRD loans carry a pooled interest rate reflecting the IBRD's past costs of borrowing; single currency loans are available on a limited basis.[6] This means that the World Bank is not always the cheapest source of financing. In a long-term declining interest rate environment such as the recent past, the World Bank's pooled rate, now about 7.27 percent, may well be higher than the market. In a rising interest rate environment, the pooled rate also lags behind the market. Over a full market cycle, however, World Bank interest rates are less volatile than any single market rate, and the Bank's currency pool also analogously reduces the volatility of loan principal. In addition, the relative dependability of the Bank's support has made the World Bank, and other IFIs loyal lenders as compared to the sometimes fickle financial markets. Even such credit- and market-worthy countries as Chile, China, and Indonesia, therefore, have made significant use of IFIs, including the World Bank, to ensure a dependable inflow of resources over time and to conserve their scarce sovereign market. Finally, IBRD lending can play a catalytic role by bolstering the confidence of financial markets in private borrowers and thereby increase their market access. While its primary objective is to transfer resources, the World Bank is a bank and must also look to maintaining its strong financial base by avoiding undue risk and lending that could jeopardize its portfolio. This means that, in many circumstances or in certain countries, the World Bank's contribution will be severely limited.

Project Preparation and Cost Savings in Procurement

At a more micro level, but equally of note, is the way World Bank projects are processed, using specific project-evaluation methodologies such as cost-benefit analysis and procurement procedures such as international competitive bidding. Both of these have applications far beyond the implementation of Bank-financed projects, and exposure to them can have significant spill-over effects for government investment programming,

[6] Single currency loans have hitherto been available on a limited basis.

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particularly where investment planning is rudimentary and subject to political forces, and for the design of government purchasing programs. In aggregate, the effects can be quite significant, particularly with regard to procurement. World Bank projects finance only goods and services that are competitively procured, either through international competitive bidding or through international shopping, except for very small contracts, where local competitive bidding or local shopping is accepted. The objective is to ensure the least-cost package for a given design. In many countries in Eastern Europe and elsewhere, procurement is traditionally done through sole source contracts, by purchasing from sources that provide associated finance, or by other less-competitive procurement practices. Studies of international competitive bidding suggest that the cost-savings from competitive procurement may be as much as 30 percent.

All member countries are eligible to participate in bidding, which in turn can contribute to enhanced market access for new exporters. It is interesting to note that it is fYRMacedonia's construction firms who have won a number of civil works contracts in Albania. Based on their experience with procurement requirements under World Bank projects, some countries have amended their procurement codes to make competitive procurement mandatory for government and other agencies that use public resources. The Czech Republic, for example, which recently borrowed from the World Bank for a major telecommunications project, acknowledged the contribution of international competitive bidding in promoting economy and efficiency in procurement, while Poland's soon-to-be introduced Procurement Code follows the World Bank's approach in many respects.

Where World Bank Support Has Worked Well

Since 1989, the World Bank has made an effort to support the full range of reforms that member countries pursued in the transition to a market economy. World Bank assistance between 1990 and 1993 provided $9.8 billion in loans supporting such needs as macroeconomic adjustment, oil exploration, and technical assistance for tax administration. Some sixty projects have been supported. Some have asked whether the World Bank's focus has not been too broad, and whether there should not have been a greater concentration of efforts in key sectors, where a critical mass is needed for reforms to succeed. At the same time, the World Bank has been faulted for not being broad enough. Certain issues it does not address are discussed in a section that follows.

The focus below is on the World Bank's involvement in three key sectors: (i) the social sectors, supporting government policies designed to alleviate the economic and social costs of transition; (ii) lending in support of government efforts to protect the environment; and (iii) support to government efforts to restructure, rebuild and reform the public sector. Although these are traditional areas for Bank involvement, working in Eastern Europe and the former Soviet Union has meant considerable on-the-job training and learning by doing, both for governments and for the World Bank. With greater involvement has come greater experience, but more time is needed before projects are completed and evaluated so that one can truly take stock.

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Social Sectors and Safety Nets: Critical to the Transformation

Strengthening the social sectors must be as much a cornerstone of economic transformation in Eastern Europe as the pursuit of macroeconomic balance, privatization, and the creation of modern financial markets. Restoration of this region's economic growth and international competitiveness depend both on the restructuring of industry, or physical capital, and on the restructuring of human capital to meet the needs of a market economy. The importance of human capital investments is now broadly acknowledged. A recent study of the East Asian Miracle has linked the extraordinary economic and export performance of East Asian economies to their heavy investment in improving their human capital, especially through education (World Bank, 1993).[7] Political stability, continued popular support, and further reforms also depend upon government's ability to ensure that core social services such as education, health, and social welfare do not deteriorate with economic transition.

Redesigning Social Programs

Many Eastern Bloc countries have recognized the need to redesign and reorient their social sector programs in education, training, and health to make them more efficient and to ensure delivery of the right services over the longer term. This will require fundamental changes in social programs' content, financing, management and delivery mechanisms, and will have to include a role for the private sector. In health, provision under the socialist command system was generally free. The system generally emphasized more expensive, curative interventions rather than cheaper, primary health and preventive measures. In virtually all transition economies, major issues of health financing need to be addressed. There is also an almost universal need to move away from the public sector monopoly in the ownership and provision of curative services, to strengthen primary care, and to improve and reorganize the pharmaceutical industry. Governments also want to make these changes for budgetary reasons, to improve incentives, and to improve efficiency (Barr *et al.*, 1994).

In education, many countries see the need to move away from their present emphasis on narrowly-focussed vocational education and over-specialized training programs that no longer correspond to labor market needs and to move towards more general secondary and technical education. Tertiary education also receives a disproportionately large share of spending in Eastern Europe and the former Soviet Union in view of these countries' demographics and its small share of overall enrollments. Transition countries also recognize that education that prepares workers well is necessary for a well-functioning labor market, which is the key to reducing the strains of unemployment and enabling a supply response.

The redesign of social-sector spending is also key for fiscal adjustment. Social programs in Eastern Europe and the former Soviet Union now absorb as much as 30 percent of GDP, and, without policy reform, will grow beyond this in some countries, compromising macrostabilization. In sum, many countries are rethinking completely the alloca-

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[7] The World Bank, 1993b.

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tion of resources, both between sectors and within the social sectors and studying the cost-effectiveness and overall scale of social service provision.

World Bank Support to the Social Sectors

Projects in the social sectors usually have high economic returns, but a low, or even zero financial rate of return. Because the World Bank's mandate is to promote economic development its interests go beyond the purely financial. For this reason, the World Bank, unlike other lenders, will lend for projects that have a high economic rate of return even where the financial return is nonexistent.[8] It is thus possible to borrow from the World Bank for investments in health, education, reforming cash-benefit systems, and modernizing public sector administration although projects in these sectors do not directly generate income and need to be repaid from general government revenues and foreign exchange. Many countries have reservations about borrowing for such projects, preferring to borrow only for more traditional investments such as infrastructure improvement. Key to deciding whether to borrow for social projects is the economic efficiency of the investment. In many circumstances, social program and public administration reform may have high economic returns. Poor health leads to low productivity and unemployment. Poverty relief, basic education, and health status, therefore, all have a role to play in economic development.

The World Bank has a number of vehicles for financing social sector policy reforms and associated investments, and has become more experienced over time in its approach. In some cases, such as operations in the former Czechoslovakia, the Slovak Republic, and fYRMacedonia, implementation of selected social policies has been an integral part of a Bank-supported structural adjustment program. In Hungary, a Pensions Administration and Health Insurance Project has been designed to improve financial management and enhance efficiency and targeting of benefits. Such policies include modification of the pension system or steps towards better cost-recovery in the health sector. In other cases, World Bank assistance has been provided through traditional investment.

In the labor area, the general goal is to support programs that will enhance labor mobility, introduce efficient employment information and services, make it easier to hire and to dismiss workers, decentralize wage determination and allow for wage differentiation, and introduce market-driven training programs for the unemployed. In Poland, for example, both the SAL and an employment services project are designed to minimize the effects of mass layoffs, with proactive labor market policies focussing on the strengthening of governmental labor offices, retraining, providing micro-credit to start new businesses, and other supports. A similar project has been approved for Russia. The supporting environment, most notably housing policy, is clearly also key to improving labor mobility and choice.

In the health sector, the World Bank has supported similarly broad government objectives. In Hungary, a Social Insurance project is in place to help move the focus towards primary care and prevention, improve sector management, contain costs, and decentral-

[8] Economic returns differ from financial returns by incorporating both social benefits, a healthier, better educated population, and social costs, e.g., pollution and congestion.

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ize and demonopolize delivery. In Hungary and Romania, World Bank-supported projects have introduced more targeted and cost-effective public health interventions, rehabilitation of medical facilities, introduction of management information systems in hospitals, and technical assistance for health services management. Designing appropriate changes in the health sector however, has been difficult, since, world-wide, which models are best is still very much under debate (*World Development Report*, 1993). It is also unclear if the time is right for payroll-contributions-based financing. Although it may improve efficiency, there are equity effects that need to be considered. In addition, the negative labor incentives of high payroll taxes may not offset the benefits from the reduction in commitments against the state. Formalizing the oft-encountered black market gratuities as official co-payments may be an alternative worth pursuing during the transition.

The World Bank also does substantial sector work, including poverty assessments and technical assistance. Social sector reviews are typically a prelude to project identification. They have been prepared recently for Kyrgyzstan, Russia, and Ukraine, and earlier for Hungary and Poland. Poverty assessments based on statistical surveys of household income and expenditure have been undertaken or are underway in Poland, Albania, fYR-Macedonia, and Russia. These poverty assessments help to identify the new poor who have emerged in the course of the transition, to analyze the incidence of social benefit programs and to determine who has benefitted from them. Policymakers can use World Bank poverty assessments to determine how changes in the structure or the level of benefits might affect their country's poor so that they can design better, more targeted and fiscally sustainable programs. A recent Bank-supported project in Albania was designed to test approaches to rural public works and small-scale rural credit and to promote employment creation and improve the cash incomes of rural households. The project is now being replicated in urban areas of Albania. Although its mandate is to alleviate poverty, the World Bank, with its large scale projects, is never likely to be as effective at hands-on poverty relief as are the many smaller non-governmental organizations now active and successful in this field.

Environmental Policies

The system of incentives used under the command regime has much to do with the current poor ecological situation in Eastern Europe. Across Eastern Europe and the former Soviet Union, despite the fact that decreased output has reduced pollution levels, water and air pollution continue to undermine both livelihoods and health. Regionally, the main sources of pollution are power generation, industry, motor vehicles, road transport, and municipal/industrial waste water. Lignite coal-fired power plants operate without pollution abatement equipment. With energy prices, particularly to household consumers, still much below costs and in some cases one-third to one-half of world prices, overconsumption remains the norm. The region's industrial structure is severely skewed and will remain so as long as prices do not change.

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Support for Better Environmental Policies

In order to stop and eventually reverse environmental damage, know-how and financial means not presently available in most of the region are needed. Lack of funds and weak implementation capacities have impeded many kinds of environmental improvements. Given this situation, the World Bank has tried to be responsive across a range of areas. It has supported measures to raise public awareness and strengthen those institutions responsible for supervising remedial action on the environment and has helped governments establish better pricing, regulatory and fiscal incentives so that energy consumption will be reduced and more environment-friendly technologies adopted. Adjusting energy prices in relative terms, as between households and industry, and absolute terms, however, is key, and more rational resource pricing remains an important issue in most country dialogues. The World Bank supports countries' efforts to adjust energy prices through investment and adjustment operations, but such changes are neither quick nor easy. Price adjustments affect many households that benefitted from low energy prices. Some kind of social pricing or compensation mechanisms will almost certainly be needed to mitigate these effects. Price changes also call for major adjustments by industrial users, whose demand elasticities in the short run are low. Labor has also resisted industrial power price increases, fearing what these may do to enterprise profitability and employment. If these objections successfully slow price adjustments, reductions in pollution will be slower too.

World Bank Support for Environment Projects

While some environmental problems will be helped by price changes, others will need specific, targeted investments. Bank-supported environmental investment projects are underway in a number of countries. An energy and environmental project in Hungary was developed to improve emission control, find a least-cost approach to pollution control, and strengthen the power company's institutional capabilities to address environmental issues. In Slovenia, an environmental project seeks to help both households and industry shift away from such polluting fuels as coal, to gas or district heating by financing gas-connection works and purchases of gas-fired appliances. In Czechoslovakia, an environmental project was designed to improve power system efficiency and reduce air pollution in northern Bohemia, the most polluted region in Eastern Europe, and thereby to improve the environment and health of the local population. Focussing also on an overall reform of the energy sector, the project aimed to reduce consumption of pollution-causing lignite by making thermal power plants more efficient, to curtail power plant sulphur dioxide emissions with flue-gas desulferization, to reduce power plant dust and fly-ash pollution, and to increase the reliability and efficiency of the transmission system to facilitate inter-connections of the Czech and German power grids.

The World Bank's involvement in this area also includes environment strategy studies, which have now been completed for most countries in the region. These try to rank environmental priorities on the basis of their health impact and cost effectiveness. Nonetheless, many important policy issues remain, such as defining environmental standards and deciding when to enforce them, determining the impact of closing polluting enter-

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prises on workers and nearby towns, and, especially of concern to private investors, deciding who will be made liable for cleaning-up past pollution.

Generally, policy dialogue has emphasized the importance of stopping ongoing pollution first, before addressing the clean-up of already polluted areas, which will have to be done over time and when resources become available. In other words, the focus should first be on the flow, not the stock. Ensuring that environmental policies are market friendly is also key. Past environmental damage is generally deemed the responsibility of the government, while for privatization or joint venture investments, stricter pollution standards would typically apply only to future operations (Ackerman *et al.*, 1994). Many environmental issues, however, remain unresolved.

At the World Bank, research is also ongoing regarding environmental taxes and other fiscal instruments. Vehicle taxes, fuel taxes, and improved traffic management, for instance, can contribute substantially to environmental improvement. Such economic policies often can make a difference at a lower cost than direct clean-up investments (*World Development Report*, 1992). These economic measures, if accompanied by the appropriate industrial investments, can go a long way toward reducing environment degradation that, over the long term, a rebound in economic growth would otherwise bring.

Given the magnitude of the environmental problems in Eastern Europe and the former Soviet Union, progress in this sector will be measured, and even significant World Bank involvement can contribute only a small fraction of what is needed. The backlog is so large and the sums required so huge, that steering clear of lower-priority projects will be key. The decline in GDP and industrial output, which somewhat reduces pollution, gives a temporary respite for making these needed changes.

World Bank Support for International Environment Programs

In addition to efforts to support national programs, the World Bank and other multilateral donors also take part in cooperative environmental efforts in the region such as environmental programs designed to restore the ecology of the Black Sea, the Baltic, and the Danube river basin and to enhance cooperation among countries on the environment where there are cross-boarder issues. Here too, however, the problems are massive and complex, and no miracles can be expected from World Bank involvement alone.

Finally, in the nuclear energy sector, the World Bank has limited capacity and the lead role is with other agencies. The Bank has participated in a G-7 study of environmental clean-up in nuclear projects to identify possibilities for phasing out and closing unsafe plants and replacing them with ones internationally certified as safe or with power plants based on alternative fuels. For some countries in the region this transformation is problematic, for example, the Baltics, which are reliant on a sole source supplier of gas and fear the vulnerability that gas conversion would imply. Financing of such operations is generally led by the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), or the private sector.

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Retooling State Institutions

The state apparatus inherited from the command system is not geared to fulfill its vital role of supporting the market economy. To meet the needs of a market economy, the civil service, organization of government, public finances, and regulatory frameworks all need to be modified. For example, the central bank, relieved of its direct lending functions in almost all countries, needs to be strengthened in new functions of indirect monetary control, domestic debt and interest rate management, and bank supervision. Furthermore, many countries in the region have inherited highly centralized state structures and now need to strengthen local governments so that they can mobilize resources and deliver services more efficiently. In most countries, the introduction of market-economy tax systems brings with it a need to strengthen tax administration to ensure that it will be able to capture the newly emerging tax bases, consumption and private sector incomes. Better tax administration and a broader tax base would permit, in turn, lower and less distorting tax rates.

Due to stabilization-induced fiscal contraction, public investment is at an all-time low across the region. Today, neither the level nor the composition of public investment is compatible with the growing needs of the private economy. While the previous regime's general over-investment and support for questionable projects suggest that some decline is appropriate, current public investment levels, sometimes as low as 2 percent of GDP, mortgage the future. To ensure that scarce budgetary resources go where their returns will be highest, reform of public investment programming, rethinking its financing and accounting for the recurrent budget implications of public investments are key.

Finally, fiscal stringency has led countries in Eastern Europe and the former Soviet Union to reconsider public expenditures meant to provide a social safety net for people affected by economic transition. These expenditures, the most explosive element of state budgets, are almost certainly fiscally unsustainable. Despite their expense and generosity, moreover, they are typically so poorly targeted that they fail to protect those most at risk. Poverty assessments confirm that there are both significant leakages and omissions. Across the region, countries are focusing on how to reform their social insurance programs, which in some countries now consume as much as 20% of GDP. Financed by payroll taxes that sometimes account for over 60% of wages, when health care is included, the system is highly distortional and is thought to affect international competitiveness. International comparisons suggest that these social expenditures are not well allocated, with some countries in Eastern Europe overspending on transfers and income-maintenance programs and underspending on education. On the positive side, a reallocation of expenditures within the social sectors should be relatively easier because its budget share is so large. Nevertheless, for fiscal, labor-market, efficiency, and international competitiveness reasons, cutbacks are inevitable.

Given present fiscal constraints, better targeting of social benefits is needed to protect the poor, and poverty-monitoring systems need to be developed or strengthened. There is evidence that the transition has given rise to many new poor, especially older people and families with many children, and that poverty is increasingly concentrated in areas where there is industrial restructuring. As it now stands, many social programs do not reach the poor, for example, family allowances paid for children up to the age of 26, if they are students, and the incidence

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of social programs is not always progressive. Notable among mistargeted benefits are food subsidies from the pre-reform era. World Bank analysis of who benefitted from these subsidies (World Bank, 1991a) has helped to break the grip of the notion of the efficiency of these old policies.

From a budgetary perspective, pension reform, including raising retirement ages that are, in some cases, ten years lower than comparable retirement ages in industrial countries, improving pension payroll tax collection, reducing the number of special regimes for privileged worker groups, such as those in heavy industry, is also urgent. Moving toward a multitier pension system, which relies in part on contributory, funded, and even privately managed pension funds, could provide stimulus for capital market development, support privatization, and reduce budgetary commitments.

Supporting a retooling of the state

This difficult area of World Bank activity involves issues that are politically and socially complex and extremely difficult to resolve. Bank support in this area, furthermore, is relatively recent and experience is still being gained. To date, the World Bank has helped support adjustment in the public sector both by investment lending and quick-disbursing operations. In Albania and Hungary, tax administration technical assistance projects have sought to strengthen tax and custom offices, train tax officials, and computerize tax records. Financial sector loans under implementation or planned in Poland, Slovenia, and the Slovak Republic provide technical assistance to improve central banking skills, bank supervision, and financial market regulation. This support for fiscal and monetary institutions helps create the economic infrastructure needed by a market economy. The World Bank has also financed specific investments in the social insurance system of Hungary and Albania, assisting governments to control net pension expenditures and improve labor incentives. Nevertheless, policy reforms critical to efficiency and financial viability have sometimes remained elusive.

Retooling legal systems is also key to the transition process. In Eastern Europe, the existing legal frameworks have been analyzed for major gaps in legislation needed to support economic reforms, including definition of property rights, commercial and financial laws, and banking legislation and regulatory systems. For example, in the initial rehabilitation loans to Russia, Kazakhstan, the Baltic states, and the Kyrgyz Republic, loan conditionality encompassed the legal and institutional framework for private sector development, inclusive procompetition and antomonopoly policies, and the environment for foreign direct investment. In the Slovak Republic and Poland, adjustment operations have supported the introduction of bank and securities market regulation and antimonopoly policies. The Bank has also worked to establish law reform groups in the government to identify, prioritize, and coordinate a market-based law reform agenda. Finally, the Bank has provided direct financial support for law reform in several former Soviet republics, in the area of privatization, energy legislation and banking, through both grants

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and loans for legal advisers, legal information systems, training, and judicial reform.

The Bank has also advised all of the countries on the need to reform legislation dealing with international borrowing. Since many of these countries did not exist prior to 1991 and those that did usually did not borrow in their own name, the Bank has provided advice on international best practice, which has resulted in constitutional provisions in some countries and special borrowing legislation in others. In Albania, legal assistance is also being provided in the context of a debt- and debt-service-reduction operation.

In some countries, quick-disbursing public sector adjustment loans (PSAL) are under consideration to support improvements in public administration, reorganization of ministries, and civil service reform. These could, for example, support the government's program to streamline civil service employment based on a job census and to raise and decompress civil service wages so that, in an increasingly competitive job market, skilled public employees can be retained. Such PSALs could also support the streamlining of the transfer and income-maintenance budget and help design a program of social expenditure reconfiguration to better meet equity objectives. A country needs to borrow for this purpose because the cost savings of the expenditure adjustments are reaped only after a time; and budgetary support is needed from the World Bank to finance the temporary expenditure hump. PSALs can also be used to support the design of fiscal decentralization programs and to strengthen and upgrade technical capacities within local governments, now responsible for many key public services.

World-Bank-financed technical assistance has also helped countries to prepare public investment reviews aimed at devising a market-friendly public investment program that supports economic recovery and private-sector growth. A public investment program thus identified can be partly financed by the World Bank, and it is often used as a framework for external financing by other donors. Rationalizing and catching up with appropriate public investments is essential for developing private domestic industries, attracting foreign direct investment, and facilitating trade flows. There are presently, for example, severe capacity constraints in telecommunications, a sector that was systematically neglected in the past and that now also suffers from outdated technology. In many countries the transport sector needs reorientation to new markets, or a different geographic orientation, for example where countries have broken up. Greater emphasis on infrastructure maintenance should also provide large payoffs if well designed.

Shortcomings and Controversies

It is generally accepted that the World Bank should be active on many fronts and address simultaneously the numerous issues crucial to the success of economic reforms. Still, questions remain about its ability to respond in three key areas: (i) the World Bank's role in supporting the private sector (ii) the suitability of World Bank's lending instruments to address problems relating to export markets and foreign direct investment; and (iii) whether the World Bank has the flexibility to

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respond to the very special challenges of Eastern Europe and the former Soviet Union.

Can the World Bank Do More for the Private Sector?

In Eastern Europe and the former Soviet Union, the World Bank has sometimes been faulted for involving itself mainly with governments, thereby supporting a continued economic hegemony by the state sector. For better or worse, as it is presently designed, World Bank lending of necessity involves the public sector. The World Bank's Articles of Agreement require that any lending to private enterprises be supported by government guarantees of both interest and principal. Such World Bank Group lending, as well as equity financing and other forms of support, as is made directly and without guarantee to the private sector is carried out through the Bank's private sector arm, the International Finance Corporation (IFC). The IFC in 1993 directly lent or invested resources amounting to US$419 million in 20 projects in Eastern Europe and the former Soviet Union, in financing packages amounting to some 21% of its total commitments that year. The Multilateral Investment Guarantee Agency (MIGA) is also available to provide guarantees for foreign direct investment against political risk.

Although amending the World Bank's Articles has been discussed over the years, there is presently no strong constituency for that, and therefore no likelihood of change. Despite the fact that it has been faulted for providing insufficient support for private sector activities, even now the World Bank has a number of options for making resources available to the private sector. First, the World Bank can and does lend directly to private entities with a government guarantee. Second, the World Bank can use financial intermediary loans to support the private sector, for example. through lines of credit to domestic banks or other APEX institutions that are designed to be onlent to borrowers on commercial terms and that are fully accessible to the private sector. However, perhaps not surprisingly with hindsight, credit supply does not seem to have been the binding constraint. In Eastern Europe, World Bank-financed credit lines have in fact been remarkably slow to disburse. Weak economies and new and still inexperienced banks have created a poor environment for the emergence of strong credit demand, and many credit lines remain untapped. Finally, and perhaps most importantly, however, there are the World Bank's indirect contributions, through its financing of infrastructure that will support private sector activity or through its support of financial intermediaries and development of financial markets and services. More generally, to the extent that the World Bank supports government programs that would have been undertaken anyway, the World Bank's financing frees up resources for the private sector since the government no longer has to tax or borrow domestically to fund these programs.

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Financing market-friendly infrastructure

Perhaps the greatest contribution the World Bank can make to private-sector development in the region today is financing for the development of market-friendly regulatory systems and infrastructure. Strengthening Eastern Europe and the former Soviet Union's physical and economic infrastructure systems may do more for the private sector and indeed, for attracting foreign investment, than direct World Bank financial support to the private sector. Catching up on the public investment backlog is key to attracting foreign direct investment and facilitating trade flows, particularly in transport and other infrastructure sectors, the condition of which affects the strength of the supply response. World Bank infrastructure projects contribute to private sector development in three main ways: by enhancing, and sometimes actually making possible, private activities; by establishing a regulatory framework for both foreign and domestic economic activity; and by supporting the commercialization of key enterprises, so they are readied for privatization.

In Poland for example, an energy-sector adjustment loan supports the government's efforts to develop an energy-sector regulatory and pricing framework and to restructure and commercialize public utilities. Thus, steps are needed to attract the approximately $3 billion in energy investment required by the gas and power sectors in the next years. In the Slovak Republic, a possible Bank-supported power-transmission investment project would permit the government's commercialization of parts of its power generation sector and the breakup of the state-owned power company into individually privatizable parts. The project would also support the development of an effective regulatory framework to enhance competition and define the tariffsetting process clearly. Similar examples are investment projects to expand and modernize the telecommunications facilities in Hungary, the Slovak Republic, and the Czech Republic. Telecommunications, by some assessments, is Eastern Europe's most critical infrastructural bottleneck. Such projects typically include plans for commercialization of the sector, readying it for privatization. While not providing direct support for the private sector, such loans to state-owned companies help create the market infrastructure needed for the private sector's success.

Strengthening Capital Markets[9]

Another indirect means of support for the private sector are World-Bank-supported projects that strengthen the financial sector and deepen intermediation. Ideally one would want to first build the supervisory and regulatory environment and create or import well-functioning financial intermediaries with the appropriate skills and, only then, let these new banks make credit allocation decisions influencing the path of the economy. In reality no country has had this luxury, and there was little choice but to use the shell of the old banking system. In the event, the old socialist central-cum-commercial monobanks were hastily split, and a two-tier banking sys-

[9] This draws on Dervis *et al.* (1994).

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tem was established. The new regionally or functionally specialized, publicly owned banks continued to take deposits and make loans. While much was expected of them in terms of improved credit allocation, directed credit continued to play an important role, and little in the incentive framework for the banks was, in fact, changed. Too rapidly, some thought, the door was also opened to a large number of small private banks, even though the regulatory and supervisory framework could not be created overnight and was far from being adequate. All this took place simultaneously with restructuring, downsizing, and privatization in the enterprise sector, leading to continued accumulation of nonperforming loans and deterioration of the balance sheets of the newly formed banks, public and private.

World Bank support to financial sector reform

While there are important differences among the countries in their financial sectors, there are enough similarities to suggest a broad set of common issues that need to be addressed strategically. These include: (i) improvements in the legal and regulatory systems, especially in the areas of banking legislation and supervision; (ii) modernization of payment systems; (iii) restructuring and/or privatizing the former state banks: (iv) support for the emergance of core of good commercial banks; (v) provision of extensive training in banking services, creditoperation, accounting, and auditing, etc; and (vi) moving to market-based credit allocation by phasing out directed credit and non-budgeted interest rate subsidies.

Technical assistance and institution-building

Given initial conditions, World Bank support for financial sector development has naturally tended to have two distinct phases. In phase one, there is intense focus on technical assistance both to the future regulators and supervisors and to the staff of the banks themselves. This involves developing the banking infrastructure via basic legislation, introducing improved accounting and auditing, encouraging prudential regulation, modernizing the payment system, and training staff and managers in project evaluation, corporate finance, and risk assessment techniques. One such project in Poland supported a program to strengthen financial institutions, the regulatory and supervisory capacity of the central bank, and the policy and institutional environment. It included technical assistance and institution-building, using twinning arrangements between Polish and European commercial banks. A similar financial-institutions modernization operation was undertaken in Hungary. In Russia, the Bank's largest-ever technical assistance loan, a $200 million financial-institutions development project, aims to build the capacity of a core group of 30-40 private commercial banks that will operate at higher banking standards; it also provides the basis for a private clearing system operating at the federal level. Technical assistance programs are also being supported in many of the other FSU states.

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For the more advanced countries of Eastern and Central Europe, the enterprise and financial sector adjustment loan (EFSAL) has become the vehicle of choice for restoration of banking system viability and more effective financial intermediation. These support government financial-sector policy reforms and are designed to resolve jointly the debt overhang of state-owned enterprises and the portfolio problem of state-owned banks. Both are needed to free up bank lending, much of which is now tied up in rolling over nonperforming loans, so that credit can be redirected toward performing SOEs and, increasingly, the private sector. In such operations, as the experience of Central and Eastern Europe shows, the need to address problems in the banking system and in enterprises jointly is paramount. Dealing with the bank problem alone would risk that future lending of the newly sound and recapitalized banks would again be channeled to their traditional client base, including weak and debt-burdened or loss-making enterprises. Thus, solving the enterprise problem and insulating the financial system from its problems is a *sine qua non* for any lasting viability, as distinct from a one-time cleanup, of the banking system. Increasingly, the World Bank is taking the view that a lasting solution to the enterprise problem cannot be found without active involvement of the banks that had lent to them in the first place. Banks, not the government, nor some centralized debt collection agency or hospital for sick enterprises, may be the best, and indeed the only, agent of change for troubled enterprises.

EFSALs support government policies aimed at strengthening bank management and governance and reforming bank supervision, accounting, licensing, and regulation. Typically EFSALs incorporate incentives for bankled conciliation and restructuring of enterprise debt reduction. Such loans have already been made in Poland (Appendix 2) and Slovenia and are now under consideration in fYRMacedonia, Albania, and the Slovak Republic. In its loans supporting financial sector development, the World Bank has also provided technical assistance for capital market development, and the strengthening of bank regulation and supervision.

The second phase of the World Bank's financial sector support, therefore, focuses more on recapitalization and work-out strategies that should allow the newly reformed banks to function as competitive entities with positive net worth, most often at least partially privatized.[10] Key questions relate to the most desirable form of and timing of the inevitable recapitalization and the degree of its linkage to bank privatization. Another key issue is the linkage of bank rehabilitation to restructuring, liquidation, and privatization of enterprises themselves, i.e., the degree to which the banks themselves can handle problem loans, or the carve-out of problem enterprises into a central agency outside the banking system.

Between 1990 and 1994, there have been 11 financial sector operations totalling US$2 billion dollars in commitments, of which one-fourth are in the form of adjustment loans that can help cover the budgetary costs of bank recapitalization or enterprise restructuring. Other operations have aimed at strengthening the banking system in two complementary ways: (i) directly through the finance of equipment needs or technical assistance of the banks themselves; and (ii) indirectly through

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[10] This draws on Dervis *et al.* (1994).

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credit lines that provide resources that banks intermediate, and hence, supplementing domestic savings.

Technical assistance for the design of privatization programs

This is another vehicle of support. While unable to lend to the private sector, the World Bank's support for privatization programs in Eastern Europe and the former Soviet Union has been quite significant. Early support to the Chubias' privatization program in Russia, as well as policy advice and conditionality in the context of adjustment loans in the Slovak Republic, Poland, and fYRMacedonia, are examples. The EFSAL in Poland, for example, directly supports the mass-privatization program. In the context of EFSALs, there has also been significant work on divestiture of state-enterprises' social assets and on the design of privatization programs, both for banks and enterprises.

Indirect support to the private sector through guarantees

The use of the World Bank's guarantee facility, and in particular, its contractual compliance guarantees enlarge the scope of World Bank support for the private sector. The World Bank's traditional guarantee instrument has been the sovereign guarantee, where the Bank guarantees a country's repayment of borrowed principal and associated interest. Even though a conventional borrowing guaranteed by the Bank is on-budget, and therefore adds to the country's external public debt, it is still attractive in a variety of circumstances. Hungary recently made use of this facility, for instance, for an international bond issue to lengthen a loan's maturity and improve its terms. By contrast, the contractual compliance guarantee instrument is designed to be responsive to governments that do not want to borrow on their own account but are seeking to encourage private financing for a project. The objective there is to minimize a government's potential exposure to the commercial risk it would encounter if it financed or borrowed for the investment itself.

Contract compliance guarantees

These are designed to separate out commercial risk from contractual risk. They guarantee loans made by a private financier to a private project entity undertaking an investment desired by the government against the risk that the government will not meet certain agreed-upon undertakings critical to the project's viability. While no such operations have yet been completed in Eastern Europe, several have been discussed with reference to financing motorway projects in Poland and the Czech Republic and a proposed pipeline project in Poland. In the first of these cases, private lenders to a private toll-road concession are beneficiaries of the guarantee. The contractual risk protected against in this example is the government's agreement to maintain a preagreed toll rate schedule increase, critical to financial viability of the

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concession. With this performance guarantee, private lenders can be attracted to the project, who otherwise might not offer loans with the long-term maturities needed for its financial viability. Getting private financing for the project would allow the government to focus its limited spending and borrowing capacity on other high priority and socially desirable projects that are not commercially viable. World Bank compliance guarantees cover none of the commercial risks of the project.

How much is enough?

Whether all this is sufficient is difficult to say. Even if not, it is questionable whether the World Bank should use its publicly supported resources to compete with the private sector. Rather, one might argue that it should use its comparative advantage in the policy dialogue to work with governments to enable the private sector to operate more efficiently and to develop those aspects of physical infrastructure as well as the economic infrastructure that are needed for the private sector to flourish.

Can the World Bank do More to Promote Trade Access and Private Investment?

The resumption of growth in Eastern Europe and the former Soviet Union will depend on the region's ability to secure enhanced access for its exports to OECD markets and especially to West European markets. Eastern European countries are now much more open to price signals from international markets than in the past. In principle, Association Agreements with the European Union have opened up market access for many products from the region. However, other European Union policies have resulted in severe limits on exports of steel, textiles, and agricultural products where low labor costs could give Eastern Europe a competitive advantage (Kaminski and Walters, 1993).[11] These trade restrictions by the EU, especially those on agricultural products, limit the World Bank's effektiveness in advising countries in the region since much best practice advice is not always reflected in the actions of the role model countries in Western Europe. Presently, Eastern Europe accounts for less than 2% of share of world trade, a very small participation that would seem even less threatening with faster economic growth in Europe.

Better market access and consistent flows of private investment are the important long-term guarantees for successful transition to a market economy. Unfortunately the World Bank does not have either the political muscle or the instruments to address these issues. World Bank and IMF-supported stabilization policies, including appropriate exchange rate policies and investment projects, can help countries to attract direct investment and help create a supply response that encourages exports to growth, but direct instruments

[11] The Europe Agreements between the European Union (EU) and Czechoslovakia, Hungary, and Poland were signed on March 1, 1992, and the latter two were ratified in February 1994; the Agreements between the EU and Romania and Bulgaria were signed on April 1, 1993 and in February 1994, respectively.

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are few. In some countries, the World Bank's support for infrastructure development may help promote trade, as in the Central Asian republics who will be able to diversify exports and attract investment once South Asian transport, pipeline, and telecommunication links are established.

Looking to the World Bank Group, the Multilateral Guarantee Agency (MIGA) and the International Finance Corporation (IFC) provide promotional assistance and advisory services to private investors and technical assistance to countries to help encourage direct private investment. The Foreign Investment Advisory Service, MIGA's joint facility with IFC, has completed projects aimed at identifying and removing legal, institutional, procedural, and other impediments to foreign investment and replacing them with appropriate incentives in a range of countries. To date, MIGA has undertaken twenty operations, in the region, from the Czech Republic to Kyrgyzstan, guaranteeing some $300 million in foreign investments (Table 4).

TABLE 4

MIGA GUARANTEE OPERATIONS IN EASTERN EUROPE AND THE FORMER SOVIET UNION, 1989 - 1994

Country	Number	Amount of Guarantee (US$ million equivalent)
Czech Republic	3	83.0
Hungary	3	10.4
Poland	8	74.7
Russian Federation	1	9.9
Turkey	4	84.5
Uzbekistan	1	40.0
Total	20	302.5

Is the World Bank Responding Well to the Challenge of Eastern Europe?

The World Bank has been accused of focusing so closely on long-term economic growth that it has failed to see the here and now. The Bank, it is said, tends to transplant models blindly from region to region without sufficient reference to their performance in each new context. In response to these criticisms, the World Bank has made considerable efforts to make its workings transparent to client countries and to pay more attention to noneconomic factors, as is evidenced by the increasing variety of capabilities, eg., sociologists, political scientists, represented on its staff.

Yet the former Eastern Bloc, now in the process of transforming a centrally-planned economy to the market model, poses unique problems. Neither the Bank, nor other institutions, can predict the precise outcome of individual reforms. Paradoxically, however, when it comes to the former Eastern Bloc, the World Bank is

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criticized both for moving too quickly and for allowing institutions to crumble before substitutes can be put in place. Realizing that insufficient project preparation, haste in developing projects, and making loans just for the sake of dispensing money to the region could jeopardize Eastern Europe's economic future, it is likely that the Bank will proceed with the same deliberate speed it has used in the past, supplemented by occasional loans for emergency aid, for some time to come.

Finally, the World Bank has been accused of becoming politicized, a real danger particularly when the G7 exercises pressures to step up loans, as it did in the case of Russia. With some justice, other client countries have complained that they face tougher loan conditions than does Russia. Other regions, however, still absorb and will continue to absorb the bulk of the World Bank's resources, lending, and concessional support.

The former Eastern Bloc's transition to a market economy is surely one of the World Bank's most difficult challenges and rivals even the post-World War II rebuilding of Western Europe. While the Bank's mandate restricts it in many ways, it does offer the countries of the former Eastern Bloc a rich vein of economic, financial, and technical skills.

A Hard Look at World Bank Performance in the Former Eastern Bloc

The World Bank has enormous potential, as well as considerable limitations, for contributing to reforms and growth in Eastern Europe and the former Soviet Union. On the positive side, the World Bank can lend to vital sectors that strictly commercial finance would not support, and it can lend to support macroeconomic stabilization. World Bank lending can support market-friendly infrastructure projects and the creation of the regulatory environments required for the private sector and foreign direct investment and help create the economic infrastructure that is needed. Its tools of intervention to support the private sector, promote exports, and generate direct investment, arguably the keys to sustainable transition, are limited and largely indirect.

Although by far the bulk of its investment projects have lengthy gestations, the World Bank has had the capacity to respond quickly to emergency needs in Eastern Europe and the former Soviet Union. While poverty alleviation is its major mandate, the World Bank is not designed to run, as some nongovernmental organization do very well, relief-based projects that touch the hard-core poor directly.

Seeking how it may best contribute to the economic betterment of the former Eastern Bloc, the World Bank, along with virtually all organizations working in this area, is exploring unknown terrain. This paper has sought to inform others engaged in this effort of how the World Bank Group works, something of its contributions to the region thus far, and something of its limitations. The World Bank's willingness to learn from rigorous appraisals of its past projects, and from open exchange with others, especially borrowers, can only strengthen the World Bank's usefulness to the region and the world.

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Appendix 1: Czechoslovakia Structural Adjustment Loan (SAL)

The 1991 Czechoslovakia SAL focused on the stabilization and incentive policies that represented the first steps toward a market economy. The following specific actions were conditions for tranche release in the Loan Agreement:

- *Macroeconomic Framework*. Satisfactory execution of stabilization policies, reduction of subsidies, and introduction of a new tax system.
- *Price and Trade Liberalization*. Regulated prices reduced from over 85% of turnover to about 6% in 1991. Price controls on all but a few items eliminated in 1992. New import tariffs, approved by GATT, became effective on January 1, 1992. The temporary import surcharge was phased out.
- *Large Privatization*. Preparation of half of all medium and large scale state-owned enterprises for privatization using a variety of methods. (Small privatization through auctions was virtually complete.)
- *Financial Sector Reform*. Adoption of legislation which provides a regulatory framework for the licensing and operations of banks and for supervision by the Central Bank; and adoption of prudential regulations. Privatization of several state-owned banks under the coupon scheme.
- *Energy*. Preparation of a least-cost energy study for the power sector; an increase of electricity prices payable by households by at least 70 percent in nominal terms; and environmental impact assessment procedures.
- *Labor Markets*. Government controls on gross wage formation were limited to minimum wage requirements for private enterprises and to minimum wage requirements and total wage bill ceilings for state-owned enterprises.
- *Targeting of Social Benefits Payments*. Establishment of social insurance funds and a program of social assistance. Introduction of selected measures to improve efficiency in the health and education sectors.

The SAL was split between the two successor states, the Czech Republic and Slovakia, in January 1993, and each country fully complied with the remaining conditionality.

Appendix 2: Enterprise and Financial Sector Adjustment Loan (EFSAL) in Poland

In 1993, Poland embarked on a far-reaching restructuring of its banking and enterprise sectors through its enterprise and bank restructuring program (EBRP), supported by a $450 million EFSAL adjustment loan from the World Bank. The program assumed that banking and enterprise problems must be jointly resolved, and that banks, not the government, some centralized debt collection agency, or "hospital for sick enterprises" were thought to be the best, and indeed the only "agent of change" for a certain subset of troubled, indebted enterprises. Banks know their clients best, and can distinguish better than can a government agency or outsider, between those borrowing enterprises that are loss-makers under any scenario and should be pushed into bankruptcy or liquidation; and those that under

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some cases can be restored to profitability if properly downsized/restructured and their debt overhang reduced. And, with the right incentives, they can put this knowledge to more effective use than other players. What incentives are needed for this to work? There are five elements.

- First, banks must face a hard budget constraint. Practically speaking, this means that they must be privatized, or that they must believe that no further resources are forthcoming to support them from the fisc. (The latter is the case in Poland, where bank privatization is part of the loan conditionality, but the agent of change role is already being played by non-privatized banks, governed on a tight leash by a very determined Ministry of Finance).
- Second, the accounting and bank regulatory and supervisory framework must be right, with market valuation of loans in bank portfolios and required provisioning of non-performing loans. In Poland, a comprehensive program to strengthen bank supervision was supported by the EFSAL.
- Third, there must be a recapitalization of banks which will give the banks a sufficient capital cushion to appropriately write off loans to problem/non-viable debtors following restructuring or liquidation.
- Fourth, and absolutely critical is a privatization program and governance framework for enterprises that ensures prudent management and a hard budget constraint. The Poland EFSAL supports the mass privatization program, and set specific targets for more traditional privatization tracks.
- Fifth, bankruptcy procedures must function smoothly; given the expected workload and inexperience of courts, the Polish EFSAL supports temporary out-of-court conciliation procedure led by banks that would facilitate creditor-led work-outs. Banks were given a deadline - a one year window - to conclude conciliation proceedings, with creditor banks accounting for 50% of loans also permitted to 'cram down' a solution on other minority creditors. For enterprises where agreement on conciliation or bankruptcy was not reached in the one year window, a government-managed intervention fund, with a limited budgetary envelope, was set up, but - as a punitive entry ticket - banks would have to write off essentially all loans of enterprises handled by this fund.

With these incentives, a profit minded bank will do its utmost to recover value from its non-performing loans, either by pushing the borrower into bankruptcy/ liquidation, or by restructuring the borrowers debt (jointly with other creditors through the conciliation process) such that the enterprise once again becomes a profit-generating client for the bank.

What have been the results in Poland? Thus far, two banks have been privatized, with another privatization in process. The mass privatization program is on track, as well privatization through other routes. By the end of the one year window, banks had dealt with 80% of their bad loans in value terms, and were expected to complete the job in a matter of weeks. Bank-led conciliations were used to work-out 60% of bad loans in value terms; the balance was dealt with through triggering bankruptcy, or auctioning off the assets.

What are the risks, and where might one not chose this creditor-led approach? One case might be where banks are not yet truly banks - as in Albania or Moldova,

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where banking and credit skills are still too rudimentary for the role. Another case might be where bank privatization is not on the agenda, and the government is not credible in its policies to govern public sector banks such that they could effectively play the enforcement role.

And, clearly, banks could not fulfil this role for all enterprises: the largest SOEs, especially those that were politically powerful, in strategic or critical sectors (coal, steel, chemicals) and public infrastructure enterprises (railways, etc.) would likely have such influence that they could hold the banks hostage, rather than the other way around, colluding with the banks to obtain more credit and subsidies from the government, rather than restructure and/or downsize. And, finally, there may be enterprises making large losses that are not in fact large debtors to the banking systems: here the intersection of the "enterprise problem" and the "banking problem" is a null set.

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SALVATORE ZECCHINI

The Role of International Financial Institutions in the Transition Process[1]

I. Introduction

Strangely enough, to discuss the support given by the international financial institutions (IFIs) to the transformation of formerly centrally planned economies, i.e., the transition process, implies examining a broad range of aspects among which the financial aspect is not the most important. The reason is that the IFIs have fulfilled three main functions in addition to their institutional financing task. They have catalyzed financial support from other sources: they have embodied the most pervasive form of economic conditionality that can be applied to a sovereign state, albeit subject to multilateral surveillance; and they have supplied critical expertise to help neophyte countries in the field of market economics to analyze economic policy issues, to design market-oriented policies, and to implement these policies in an effective manner. By combining these four functions, the IFIs collectively have come to play the most important role among the external supporters of economic reforms in CEECs and NIS,[2] far outpacing any other in terms of effectiveness.

This outcome is not the result of fortuitous circumstances but rather of a strategy that evolved from the convergence of interests of the major donor countries, even in the absence of a determined effort by these countries to coordinate themselves to this effect. None of the donor countries has at its disposal large amounts of public resources to grant to the CEECs and NIS because of the need to redress their own fiscal deficits and to use also the so-called peace dividend to this end. At the same time, they wanted to help and to be sure that the resources provided would not be wasted in perpetuating the inefficiencies of the old economic system but rather would help build a new, more productive system. They also lacked an appropriate national infrastructure to pursue these goals, because the main national institutions at their disposal for this purpose, i.e., export credit agencies and development assistance institutions, are not geared to this particular task. Since the IFIs are unique in having both the infrastructure and the resources for this task, they have become, since 1990, the main instrument used by the major donor countries to support economic reform in the CEECs and NIS. The aim of this paper is to assess these functions, limiting its focus to the main IFIs, namely the International Monetary Fund (IMF), the World Bank (IBRD), the European Investment Bank (EIB), and the European Bank for Reconstruction and Development (EBRD). This is not to deny that other IFIs, such as the Bank for International Settlements, the Interna-

[1] The views expressed in the essay are the sole responsibility of the author and do not necessarily reflect those of any institution with which the author is associated.

[2] CEECs stands for Central and Eastern European countries and NIS for new independent states of the former Soviet Union.

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tional Development Agency, and the Asian Development Bank, have been active in this area, but their contributions have not been as important as those of the former Institutions. It is, instead, necessary to add the European Union although it is not a financial institution, because its financial support in the framework of the Group of 24 donor countries' (G24) assistance has been very significant and in many respects similar and complementary to that of the IFIs.

In principle, these IFIs had different institutional mandates and specializations. The IMF, for instance, was called to focus on macroeconomic and balance of payments issues, which are its traditional domain, while in view of their institutional roles or experience, the others were expected to concentrate their assistance on structural reforms, investment projects, and development of the private sector. Nevertheless, in practice no clear-cut division of responsibilities and areas of competence has emerged; their activities at times have overlapped, albeit not necessarily leading to wasteful duplication. In such a context, tight coordination among IFI programs would have been necessary in order to fill gaps, enhance assistance effectiveness, and avoid waste of resources. Such a degree of coordination, however, has not yet been achieved, but progress in this direction has been made, particularly through collaboration in specific initiatives. There are many examples of the World Bank and EBRD cofinancing the same project or of the EU complementing IMF lending with its own loans or grants for the purpose of filling the balance of payments gaps of countries in transition.

Among the IFIs, the IMF has emerged as the leading institution that has assisted these reforming countries in defining the framework strategy that must permeate the entire economy and set the general conditions for sectoral measures or projects for which the assistance of other IFIs is called for. Such a leading role of the IMF has resulted from the strong backing of the Group of 7 major industrial countries and from the enforcement of cross conditionality, whereby financing by other IFIs has been made conditional upon agreement with the IMF on the overall economic strategy of the country concerned. This aimed at ensuring coherence among different measures that address various parts of the economy and whose success ultimately depends on the presence of a sound macroeconomic environment.

Until 1993, the IMF also had a leading role among the IFIs in financing these economies. This reflects the fact that, in the initial stages of economic transformation, postcommunist countries mostly need general purpose funding to absorb the impact of economic liberalization on their external accounts and to mitigate the deterioration of living standards. The IMF is, by its mandate, the main institution responsible for supplying such financing even though the IBRD's mandate has gradually extended to this area since the mid-1980's. As these countries advance in the transformation of their economy, their needs become greater because they are linked to the implementation of structural projects that fall more within the purview of the other IFIs than of the IMF. Hence, it might be expected that, in the coming years, the IMF will lose this lead financing role. This might also result from another factor, which depends on limitations in IMF resources because they depend, first, on the allocation to the IMF of government funds, and second, on the possibility of mobilizing these resources, namely the liquidity of IMF resources. The other IFIs could expand their lending instead, subject to certain gearing ratios

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related to their capital, since they can tap private savings directly, without resorting to government funds, and still benefit from the privilege of being primary borrowers because of the guarantee provided by major shareholders. The constraints on credit expansion for the other IFIs seem somewhat less stringent than those for the IMF. Accordingly, the current trend indicates a leading financial role being played in the near future by the other IFIs, especially by the IBRD, which has the greatest financing potential as well as the largest operational infrastructure.

II. The Impact of IFI Financing

Let us consider the financial impact that the IFIs under consideration have had thus far on the advancement of economic transformation in the CEECs and NIS. The general impression one draws from the data on actual gross disbursements is that direct financial assistance in the first phase of the transition, i.e., from 1990 to 1993, has been relatively modest. The combined annual flows from all IFIs have been in the range between $ 1.7 and $5.7 billion, with a sharp increase in 1991 and a stable flow of around U.S. $5 billion in 1992 and 1993. Since five Central and Eastern European countries had collaborated with the IFIs earlier than the other reforming countries, it is not possible to draw significant conclusions from the yearly financial flows. For instance, the financing received by each country on a yearly basis amounts to about 1 % of the GDP of the borrowing countries in Central and Eastern Europe, and much less than 1 % of the GDP of the NIS. Another way to assess the relative magnitude of these annual flows is to compare them with the estimates of the capital requirements that are necessary in order to sustain a GDP growth rate between 4 and 7% per annum. This is the range of growth rates required to narrow the current gap in per capita income between Eastern and Western Europe. The capital needs for the five major CEECs are estimated to be in the range between $75 and $226 billion annually.[3]

In absolute terms, among the economies in transition, Russia and Hungary are, in order of importance, the largest recipients of funds, with amounts of around U.S. $3 billion for the entire period 1990-1993 (see Table 1). In relative terms, if financial flows are compared with the economic weights of the beneficiary countries, as measured by their GNPs, it instead appears that Hungary and the Czechoslovakian area are the largest beneficiaries while Russia is among the smallest recipients of funds. Using the 1992 GDP figures as benchmarks, total borrowing from the IFIs for the 4-year period equals 9.4% of Hungary's 1992 GNP and 8.3% of Czechoslovakia' s 1992 GNP, while it amounts to just 0.8% for Russia. On the basis of the same comparison, Romania seems to be a relatively large beneficiary, about 8% of its 1992 GNP, and Poland a relatively small recipient, about 3%. Hence, it is not evident that the geographical distribution of financial flows has necessarily reflected the relative intensity of financial needs; that is to say that priority has been given to the countries with the lowest per capita income or the most severe de-

[3] For a survey of estimates of investments needs see EBRD (1993) and Handler and Stankovsky (1992).

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velopment problems. Apparently, the IFIs' financial assistance has *de facto* rewarded mostly those countries that embarked on the transformation of their economies earlier than the others, that have progressed more rapidly, or that had not been burdened by the excessive weight of accumulated external debt. Examples of these three different cases are, respectively, Hungary, the former Czechoslovakia, and Romania.

Even taking into account these differences, the scale of financial support has not yet reached the target level needed to achieve sustained economic growth. This overall impression is not substantially modified if one considers the IFIs' financial commitments rather than their disbursements. There is indeed a gap between the two sets of figures, with the disbursements being between three-fifths and one-sixth of commitments, depending on the institution and the year. The IMF has actually been the fastest disbursing institution, while other IFIs' disbursements have been constrained by the pace of the implementation of investment projects by the beneficiary countries. This is one explanation of such a gap as well as of the fact that the gap has widened over the years. There are, however, other good reasons that are related to the demand for loans.

In general, borrowing countries have encountered several problems in dealing with the IFIs. Some countries have had difficulties in defining or committing themselves to a coherent macroeconomic policy framework that could be accepted by the IMF for financing. Others have not been able to present enough investment projects that are worth financing. Some, because of political and social difficulties, have not been in a position to comply with the policy commitments that they had undertaken, thereby losing access to funding. Countries such as Bulgaria and Romania have failed to implement fully their programs for economic stabilization because the financing, which was promised, but not pledged, by donor countries to complement IFIs' lending, did not materialize. Other countries could not secure in their budgets the funds necessary to cofinance public investment projects with the IFIs because of the fiscal stringency advocated for macroeconomic stabilization. Shortage of domestically generated private capital for investment has also hampered IFIs' complementary lending. In some countries, such as Russia, there has even been reluctance to borrow, either because it would have aggravated the accumulated debt burden or because there was uncertainty about which public institution should be held responsible for debt repayment.

There have also been countries, such as the Czech Republic, which have not borrowed because they did not actually have an urgent balance of payments need.

Overall, demand factors have prevailed over supply factors in determining the large difference between the financial potential of some IFIs and their actual lending. Supply factors are mainly related to the inevitable time delay that is required for the IFIs to analyze the demands of these largely unknown economies, to define their lending strategy, and to create the internal infrastructure to manage these activities. By early 1992, all these institutions had completed fairly accurate reconnaissance work on these economies and had developed operational structures and strategies. If they have not succeeded in sharply increasing their lending after 1992, this is due to the negative economic conditions still prevailing in these countries, with investment still modest, a legal and institutional environment beset with

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all the uncertainties of the transformation, and a shortage of credit-worthy enterprises or of viable investment projects of significant size.

To overcome these obstacles, it is necessary that the IFIs invest more than they have in the past in raising the capacity of each country to absorb financial support and that they adapt their financing methods to the peculiar needs of these countries. Efforts have been made by the IFIs in these two directions, but such efforts need to be intensified, not just to increase lending but in order to enhance its impact, especially in the less-developed transition countries. In particular, the development-oriented IFIs should focus more on: (a) restructuring of public enterprises; (b) helping the fledgling private enterprise sector to develop sustainable capital structures; and (c) financing newly established export-import banks in these countries. To this end, the range of IFIs' financing methods should be widened, for instance, by expanding the use of instruments such as credit guarantee schemes and equity participation.

The sectoral breakdown of financial flows shows that the direct support to these three areas has been relatively minor. The main share of lending has been devoted to financing reforms in general, namely filling the gaps that were caused in the balance of payments and public budget by price and trade liberalization, the rise in social expenditure, and shortfalls in fiscal revenue.

In order of importance, financing of infrastructure represents the second major area, with a concentration of loans for transport and telecommunications, as these sectors are critical elements for promoting trade and business initiative. The sector that is the largest single beneficiary of funds from the IFIs is the energy sector, and this in recognition of the substantial returns that can derive from investment in energy in terms of a lower dependency on energy imports or a large potential for increasing convertible currency proceeds through energy exports.

Lending to manufacturing and to the private sector, particularly to small-scale enterprises, has attracted a relatively limited amount of funds, owing perhaps to the particularly risky nature of these loans. In these sectors there has been a useful diversification of financing instruments, as the International Finance Corporation and EBRD have resorted, to some extent, to granting credit guarantees and making investment in equities. The EIB has also financed several small enterprises by granting so-called global loans to local financial institutions.

Apart from this diversification, the lending activities do not indicate any significant specialization of any IFIs in any particular economic sector. All development-oriented IFIs have been operating in roughly the same sectors, although some have focused more on lending to the emerging private sector and others have invested in less risky assets. Some sectors, in spite of their importance, have received little funding. For instance, no significant financing has been provided as yet for the establishment of a social safety system and an institutional framework for a new labor market, even though these are considered essential to ease opposition to industrial restructuring and to help enterprises achieve productivity gains by reallocating excess labor. Similarly, few resources have been channeled to projects aimed at environmental protection.

On the whole, in the first phase of the economic transition, the IFIs' financial support in itself has not been a determining factor for the advancement of the

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reform and transformation of these economies because of the relatively limited transfer of resources, particularly with respect to some sectors and some countries. It could not have been otherwise because the IFIs themselves had to undergo some transformation in order to address the problems of economies largely unknown to them. Moreover, the financing demands presented by both the public and the private sectors of these countries often did not appear in line with the objective of promoting the expansion of the most competitive or viable sectors. Instead, they frequently reflected the need to deal with industrial crises or lacked an adequate analysis of the prospective returns on investment. Albeit quantitatively limited, the IFIs' financing has not been marginal, particularly for reforming countries that do not have alternative sources of convertible currency financing. IFIs have actually filled, to some extent, the financing gap of countries that experienced a decline in national saving, lost their most important export markets, and, due to a severe shortage of convertible currencies, have not often been able to ensure the minimum levels of imports necessary to maintain domestic production. If not in terms of actual direct financing, the IFIs' intervention has nevertheless been very important in three other respects that are collateral to the financial activity: (1) in catalyzing additional financing from other sources; (2) in inducing the reforming countries to make proper use of their resources through conditionality; and (3) in raising the level of skills with the aim of developing the institutional infrastructure of a market-based system and improving the management of the new system.

The Catalytic Role

The IFIs have been very active in soliciting donor countries for additional financing and have succeeded in attracting substantial foreign aid and credit. For some countries, such as Romania and Bulgaria, they even had to exert some pressure on donor countries to fulfill their financial promises, as these resources were indispensable to ensure the full implementation of the reform adjustment program supported by the IFIs themselves. For other countries, such as Russia, it was the opposite case; some donor countries had to spur the IFIs to modify their traditional approaches in order to address the particular socioeconomic difficulties of these countries and to facilitate reaching an agreement on the reform and adjustment program that is the precondition for a rapid release of the IFIs' funds.

The success achieved by the IFIs in attracting complementary, official financing has not been matched with respect to private funds. The financial engagement of the IFIs in a given country has not generally been regarded by private lenders or investors as a sufficient condition to make that country creditworthy in the international financial markets or to make it an attractive place for foreign direct investment (FDI). Other factors have also contributed to this lack of private funds, particularly with regard to the business environment, taxation, monetary convertibility, and political stability. Only Hungary and the Czech Republic have regained access to borrowing in international markets following the implementation of IFI-supported stabilization programs and the continuing monitoring of their economic performance by the same IFIs. The fact that Hungary, but not the Czech Republic

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or other reforming economies, has received sizable FDI confirms that the catalytic role of the IFIs has been mainly confined to official funding.

The latter includes several forms of financing, such as grants, export credits and related guarantees, and official debt reduction. Private debt reduction has been more difficult to achieve than official debt reduction inspite of the IFIs' pressure in this direction, as the cases of Poland, Bulgaria, and Russia indicate. To some extent, foreign private creditors have tried to transfer their financial risk to the official sector by resisting reductions in the value of their claims and by seeking official guarantees for their loans or other benefits from their governments. Whatever reduction has been achieved in private debt would have been virtually impossible had the IFIs not shown clear support for the economic policies pursued by these countries.

The attitude of the IFIs *vis-á-vis* the reforming economies has also had a reverse catalytic function in two cases. First, the presence of a so-called negative pledge clause in IBRD financing has somewhat discouraged potential foreign creditors or investors from committing their capital in these countries since their potential claims could not receive adequate guarantees because of the competing guarantee given by the country to the IBRD. This impediment has been overcome recently because the IBRD renounced such a clause. Second, a negative assessment by the IFIs of a country's economic performance or lack of adequate compliance with the economic program agreed upon with the IFIs has had a significant disincentive effect on foreign official and private financing. Given the limited information available on the evolving conditions of these countries and the IFIs' unparalleled capacity to scrutinize their economies, IFIs have been used by the international financial community as a sort of beacon to shed light on economic prospects. No country belonging to this area has been able to disregard the IFIs' assessment or policy conditions and at the same time to rely on alternative sources of market financing. This leads to the question of which criteria the IFIs applied to guide the economic policies of these countries or to form a judgment of their appropriateness.

The IFIs' Conditionality

Two types of conditionality have been used: one related to the economic policy to be pursued at the macroeconomic, systemic, or sectoral level, and the other linked to the microeconomic projects to be financed. The former by its very nature has laid the path for the other, albeit in some countries sectoral policies have sometimes been the result of individual microeconomic decisions more than of a preordained strategy. The IMF and, to a lesser degree, the IBRD have been most influential in the definition by these countries of their macroeconomic policies. In this area, no apparent inconsistency or contrast has risen between the IFIs as to the policy measures that the country seeking assistance was requested to take. When differences in points of view arose, they were sorted out through consultations and discussion, also involving major donor countries, before reaching the stage of linking financial support to the implementation of policy recommendations.

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The IMF approach in *the early phases of the transition process* called for assigning priority over other economic objectives to the restoration of macroeconomic balance which had been lacking at the time of price and trade liberalization. Its conditionality was based on the traditional financial planning model which, in principle, is appropriate for any economic system since it aims at ensuring consistency in the evolution of macroeconomic aggregates for the purpose of achieving low inflation, narrow public deficits, and a sustainable balance of payments position. If this approach is, in theory, appropriate, its feasibility in these countries in which the instruments necessary for its implementation in a market-oriented context were lacking or untested was controversial.

The effectiveness of the standard IMF conditionality rests on a number of assumptions that did not actually match the reality of these countries. First, it was assumed that by the use of standard demand management tools, such as central bank credit, interest rates, expansion of the banking system's assets, and limiting fiscal deficits, it was possible to force the necessary adjustment of structural imbalances. The enforcement of financial discipline at the macroeconomic level was considered instrumental in prompting the government to introduce radical reforms and bringing about, consequently, far-reaching and swift adjustments at the microeconomic level. Second, it was expected that market forces, once liberated from government repression and inserted in a balanced macroeconomic context, could set into motion a sustained growth process. Hence, the task of the government was to withdraw itself from any involvement in the production system and banking industry and to dispose of its enterprises. This could, however, give rise to a vacuum of decision-making at the micro level leading to disruptions of economic relationships and ultimately to declines in output. Such a scaling down of economic activity was deemed inevitable during the transition to a new economic system, but it was considered a transitory phenomenon that would be overcome by the expansion of private output and investment following the restoration of macroeconomic stability. Third, it was advocated that the authorities rely mostly on standard macroeconomic tools and abandon all forms of direct control on prices, wages, and income. Misgivings were expressed, for instance, about the appropriateness of a tax-based income policy, which was eventually accepted, although it was considered to be less effective than a tighter management of aggregate domestic demand and a source of distortions.

This conditionality approach seems by and large to be the reflection of an idealized view of the workings of a market-based economy that is far removed from the socioeconomic conditions that prevailed in the postcommunist countries early in the transition. This ideal of a market economy seems valuable as an ultimate goal that any economy should strive to approach, but it appears to be a poor guide for policy choices during the transition. Even for the most developed European countries, several decades were needed after the Second World War to develop competitive market mechanisms, market-oriented policy instruments, and economic agents capable of responding to market signals in terms of seizing new opportunities or adjusting themselves to changing market conditions. During these decades, the development of these countries relied, among other things, on

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government measures that were not fully in line with the principle of no interference with free-market competition, except, in cases of market failures.

The IFIs conditionality for the countries in transition did not address the supply side of the economy, the institutional framework, the effectiveness of available policy instruments, and the weaknesses of emerging markets with the same timeliness, precision, comprehensiveness, and exactingness as in the case of macroeconomic demand policies. In the systemic and structural areas, the commitments taken by reforming countries *vis-á-vis* the IFIs were more generic, their linkages with other parts of the economic strategy were not spelled out, and the difficulties of implementation were not properly accounted for. The development of the necessary tools for macroeconomic management, particularly in the fiscal and banking areas, lagged behind, thereby signaling either an excess of ambition in setting the program targets or an unsustainability of their achievement. In brief, an imbalance emerged, especially in the first two years of the transition, between macroeconomic conditionality and its systemic and structural counterparts.

The programs supported by the IFIs led to macroeconomic results that showed progress in the desired direction but fell short of the intended targets as well as of the ultimate goal of a noninflationary economic recovery (see Table 2). Furthermore, the achievements did not appear sustainable over time unless greater efforts were deployed to accelerate systemic transformation and structural adjustment, thereby leading to output recovery. In most of these countries, the fall in output was deeper and more prolonged than that *ex ante* expected by the IFIs and by the country concerned in deciding the degree of macroeconomic policy tightening. Such a downward deviation was not due mainly to external factors, although the economic recession in Western Europe, the war in Yugoslavia, and the collapse of intra-CMEA trade contributed to this result. The main causes instead lay among domestic factors, particularly the combination of financial policy tightening, the abrupt end of central planning with the consequent lack of orientation for the public enterprises, the relatively slow change of economic institutions, and the still-low contribution of the expanding private sector to GDP formation. Inflation slowed down much less than expected and has not reached a single-digit annual rate in the current year even in countries in which macroeconomic stabilization has progressed farther. The reduction of the trade deficit was mainly the result of an import compression that seems incompatible with the needs of output recovery.

At the same time, public budgets turned increasingly negative under the pressure of mounting social expenditure due to the economic depression and incipient enterprise restructuring, on the one hand, and the shrinking of the tax base, on the other. Private production managed to expand rapidly although the contribution of privatization of public firms to this expansion was limited. Even in 1994, in spite of its rapid growth, the private sector does not account for the largest portion of national output in most postcommunist countries.

The sharp fall in output coincided with several slippages in implementing the macroeconomic stabilization strategy recommended by the IFIs; after all, policies were not as tight as intended. This might contradict some claims that the stringency of the IFIs' policy conditionality brought about or accentuated the production downturn. Nevertheless, there is little doubt that full compliance with the

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IFIs' tight policy requirements would have led to a deeper output decline over the short term and higher social tensions that would have raised greater uncertainty about the possibility of a strong output rebound over the medium term. Some flexibility was needed in managing policy conditionality in the face of deviations from expected policy performance, and the IFIs have shown such a flexibility. They have continued to cooperate with CEECs and NIS in adapting the policy strategy to the emerging difficulties, albeit at the cost of some delays in loan disbursements.

Structural adjustment and development of market-oriented institutions did not progress at the same pace as macroeconomic stabilization and economic liberalization. This imbalance caused the recommended macroeconomic stabilization measures to produce a number of perverse effects. For instance, steep rises in the cost of credit did not necessarily curtail credit expansion and improve its allocation. Rather, they tended to crowd out the credit demand of fledgling private enterprises in favor of public enterprises that, because of government guarantees, are less responsive to changes in credit cost. In addition, monetary policy tightening did not prevent banks from having to support heavily indebted public enterprises toward which they were heavily exposed. Nor did it prevent the explosive growth of interenterprise credit in the form of arrears in countries such as Romania and Russia.

Despite these shortcomings, in the initial phase of the transition, such conditionality served well the purpose of injecting a degree of policy discipline in countries that had lost direct control over the economy. It also prompted these governments to innovate new methods of economic management and to deepen their economic analysis for policy making. After the first two years of experience, it became clear that the standard macroeconomic approach recommended by the IFIs, apart from not delivering entirely the expected results, was facing increasing social resistance, leading also to non-compliance with policy commitments. The policy approach had to become more pragmatic and less doctrinaire, had to recognize the specific difficulties of these economies undergoing radical transformation, and had to allow second- and even third-best solutions to unusual economic problems. The transition policy had to be seen more than in past as the planning of a sequence of macroeconomic, systemic, and structural measures in a multi-phase process in which quantum leaps are very risky and solid progress before entering into the next phase matters more than the speed of advancement.

In this context, it seems that a number of unsolved problems have to be addressed as a matter of priority. First, leaving aside the vexing issue of whether or not to assign priority to macroeconomic stabilization, attention must focus on ways and means to interlink tight macroeconomic management with structural changes. Second, efforts need to be concentrated on completing the construction of the institutions of a market economy, its legal system, and the infrastructure for the markets to work properly. Third, any policy measure has also to pass a more stringent test of political and social sustainability after the past four years of sharp cut-backs in living standards and dwindling confidence in the ability of the political leadership to bring about an economic recovery. Fourth, a solution must be found as to how the IFIs should deal with those countries which deviate from recommended policies, without jeopardising the country's efforts in case they cut their support, and

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without losing evenhandedness in case they accommodate policies which are not endorsed for countries in other regions of the world.

In the past two years, IFIs macroeconomic conditionality has evolved under the pressure of the above problems. Emphasis has shifted from macro-stabilization to the establishment of conditions for the resumption of economic growth against a backdrop of continuing progress toward macroeconomic stability. The traditional approach has been enriched in order to incorporate better-defined linkages between demand management measures and structural adjustments. This has been achieved by setting benchmarks to monitor structural reforms or by requiring prior actions before supporting a program, even at the risk of delaying financing and complicating countries' policy difficulties. The IFIs' attention has increasingly been focused on two major reform areas: (a) social security programs and reform of taxation; and (b) the development of the enterprise sector by dealing with the problems of privatization, bank rehabilitation, debt reduction, and corporate governance. New flexibility has been added to IMF financial intervention through the recent creation of the Systemic Transformation Facility, which aims at helping these countries to phase in radical reforms involving substantial social adjustments.

Such evolution of conditionality cannot yet be considered as having reached the final stage, but it must continue as long as the transition process unfolds and raises unprecedented policy challenges. There is still room for shifting the focus of economic strategy from the macroeconomic level to the structural and sectoral ones without generating macro imbalances. Once the construction of the infrastructure of a market system in these countries is completed, it must be decided whether to revert to the standard focus on macroeconomic conditionality or to move toward the comprehensive policy approach recommended to developing countries, such as in the context of the Enhanced Structural Adjustment Facility.

Compared to program-based conditionality, the project-based conditionality appeared easier to define and monitor, its scope being much narrower. It turned out, however, to be equally difficult to comply with. This conditionality has been directed mostly toward promoting appropriate pricing policies for energy resources and public services, toward improving the scrutiny of prospective rates of return on public investment, and toward ameliorating public procurement procedures. The effectiveness of project conditionality has, however, been limited by the slow pace of project implementation by the beneficiary countries resulting from the reduction of resources allocated to public investment, shortage of privat capital, and administrative and legal hindrances.

Technical Assistence

For countries sailing in the uncharted waters of systemic transformation, IFIs' technical assistance (TA) and training in the design and implementation of policies and projects have been equally, if not more, important than their financing. For the IFIs this has not been just a necessary complement to financing but an objective to be pursued on its own for the purpose of smoothing and accelerating the transformation of reforming economies. A relatively large volume of resources has been in-

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vested in this area, as shown in Table 3, and it has covered a wide range of sectors. Enterprise and industrial restructuring, energy, and transport and telecommunications are the three areas that have attracted most technical assistance resources. In general, TA has targeted government officials or public enterprises, while few projects have been opened to the participation of the private sector. Central and Eastern European countries have been the major beneficiaries, owing not to any preferential status, but because they have shown a better absorptive capacity. The European Union has been the largest donor, but in several sectors the assistance of the IFIs has had an equally important impact.

In the first years of the transition, TA has responded mainly to the IFIs' views of priority areas and the most appropriate modalities of intervention. This reflected the fact that the countries in transition had limited knowledge of the areas in which TA was most needed for their reforms to be successful and that they were not funding TA. Subsequently, in view of the need to obtain a deeper involvement and commitment of the reforming country in reform implementation, the IFIs' assistance has been made more sensitive to the specific requests of the beneficiary countries, particularly in order to attune its operational modalities to each country's conditions. Its impact on reforms and sectoral problems has been most effective in those countries that were most determined to advance rapidly in the transformation of their economy and were ready to apply innovative solutions. Good examples of effective assistance can be found in the privatization of public firms, restructuring of the banking systems, and development of central banking and national payments systems in the Czech Republic, Poland, and Hungary. In contrast, limited results have been achieved, for instance, in the same areas in countries in which the reform process is progressing slowly.

Although the IFIs' TA has been valuable in facilitating reforms, it is not exempt from some problems. First of all, coordination among IFIs as well as with other donors, both bilateral and multilateral institutions, has been less than adequate at times. This has allowed some wasteful duplication of efforts to emerge at times, or it has left some gaps. In some cases, assistance relying on outside consultants with limited experience with a country's conditions has been considered of little value by the recipient. The large demand for training of officials has been satisfied only to a limited extent, leaving several countries with the difficult task of having to manage a new economic system by officials trained to deal with the old system. Inconsistencies in policy advice between different IFIs have also appeared in a few cases, specifically in dealing with exchange rate policies, price liberalization, and sequencing of reforms.

Some solutions have been devised for these problems in the last two years. A clearinghouse of information on all TA supplied by all donors and demanded by these countries has been created by the OECD for the purpose of enabling the donors to coordinate their assistance activities. A number of training institutes and facilities operating in the fields related to financial policy have been created by the IFIs and the OECD. A program of assistance in public management reform and training for the public administration has been launched by the European Union and the OECD. A fair amount of collaboration between IFIs on TA projects has also emerged.

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Other improvements are still needed, particularly in the modalities of assistance. For instance, TA should be concentrated on activities in the field, focus on concrete, operational issues, and rely mostly on the direct collaboration with officials responsible for addressing issues rather than on lecturing. The opportunities for cross-fertilization of experiences among the reforming countries themselves should be better exploited with the aim of allowing some reforming countries to benefit from the experience of those that are most advanced in the reforms. Special TA programs should be designed for countries that still lag behind in economic transformation.

III. Conclusions

On the whole, the evidence gathered for this analysis suggests that, in the first four years of the economic transition, the IFIs have made an important contribution to helping the reforming countries understand their economic problems, devise viable strategies, and fund policy implementation. Technical assistance and financial catalysis have been as important as, if not more than, IFIs' direct financing. It is also evident that progress made in the economic transformation has not relied on and could not rely only on the IFIs' support. Instead, it has had to rest on the inner forces of these countries, in particular on the determination of their people to renovate their economy, to adjust their economic behavior, and to take from their government a larger share of responsibility for their own prosperity.

The economic transformation has been a learning process for both the reforming countries and the assisting IFIs. If their assistance has shown some delays, imperfections in approach, and limitation in scope of intervention, these have had a minor impact on the effectiveness of their action. The constraining limitations that IFIs' operations have encountered on the demand side have had much more influence, due to the limited capacity of these countries to make proper use of the available assistance.

The outlook for the second half of the 1990's seems to indicate a trend toward the expansion of the IFIs, financial disbursements and a sharpening of their TA, particularly in the field of training. Among the IFIs, the role of development-oriented institutions, such as IBRD and EBRD, is bound to increase in parallel with the recovery of output and investment in these countries. In contrast, the growth of general policy financing is likely to peter out in the coming years. In both cases, the relative importance of IFIs' financing over total financing is expected to be outweighed by the growth of nonofficial lending. The restoration of creditworthiness among these countries should allow them to satisfy an increasing share of their needs in the international capital markets. More diversification of IFIs, financing and TA by country and type of operation is also probable for the purpose of meeting the particular requirements of lagging countries.

The need to support the transition has led to several changes in the IFIs mandates and their *modus operandi*. The IMF, for instance, can no longer be regarded as a mere monetary institution with the aim of temporary funding of balance of payments deficits while they are being corrected. It is, instead, heavily involved in fostering structural adjustment, and in this endeavor it has come close to perform-

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ing the role typical of the other IFIs. The evolution in the IFIs' *modus operandi* is not yet complete and must continue with a view to increasing the effectiveness of their intervention and ultimately to ensuring a rapid conclusion of the transition process. In continuing in this evolution, the IFIs cannot be expected to fulfill all the roles that donors and beneficiary countries now wish of them. To attempt to do so involves several risks, namely to lose sight of the IFIs' original mandates especially *vis-á-vis* the rest of their member countries, to distort the use of their resourses in favor of a group of countries, to stretch their financial viability, and to apply uneven conditionality compared to that required of other countries. Hence, even at the end of such an evolution, the question remains as to whether other instruments apart from the IFIs have to be mobilized to help some reforming countries catch up in the quest for a liberal and prosperous economy.

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TABLE 1

FINANCING OF INTERNATIONAL FINANCIAL INSTITUTIONS TO ECONOMIES IN TRANSITION (1990-1993)

	Cumulative commitments[a] (U.S. millions)					Cumulative disbursements[b] (U.S. millions)				
	EIB	IMF	IBRD	EBRD	EU	EIB	IMF	IBRD	EBRD	EU
CEECs										
Albania		87.3	111.0	45.0	242.5		18.0	22.0	4.3	167.2
Bulgaria	218.6	763.1	445.0	146.3	382.2	13.3	731.7	153.0	5.1	127.3
Czechoslovakia		1869.5	696.0		294.9		1641.1	456.4		100.6
Czech Rep.	247.7	247.2	80.0	215.2	70.3		96.2	8.0	82.9	7.5
Slovak Rep.	153.9	89.9	135.0	97.1	46.8	5.9	88.5		16.6	4.1
Estonia	5.6	71.8	30.0	74.0	27.0		57.5	23.0	28.7	4.4
Hungary[c]	451.4	2646.9	3873.7	707.7	503.7	134.7	1428.7	1175.7	233.4	151.3
Latvia		141.2	70.0	57.9	40.5		106.9	23.0	4.5	7.9
Lithuania		152.5	60.0	48.3	55.1		120.9	45.0	3.2	8.1
Poland	628.3	2636.5	4272.0	570.3	995.2	164.9	850.6	1067.1	102.0	243.3
Romania	160.9	1409.9	950.0	430.9	545.9	15.8	1274.7	411.0	94.5	223.8
Yugoslavia			3247.5					376.8		
Croatia								4.0		
Slovenia	52.4		80.0	127.0	24.5				2.2	10.5
Total	1918.8	10115.7	14050.1	2519.8	3228.6	334.6	6414.8	3764.9	577.3	1055.8
NIS										
Armenia			40.0	64.9	na			1.0	3.4	na
Azerbajan					na					na
Belarus		97.9	128.0	102.6	na		96.3	10.0	5.7	na
Georgia					na					na
Kazakhstan		86.4	218.0	127.8	na		85.0	36.0	0.0	na
Kyrgyz Rep.		82.9	60.0		na		60.3	28.0		na
Moldova		153.9	86.0		na		86.5	35.0		na
Russia		2518.3	1670.0	449.9	na		2469.7	473.0	129.7	na
Tajikistan					na					na
Ukraine			27.0	10.6	na			0.0	0.7	na
Uzbekistan			21.0	127.3	na			0.0	10.8	na
Total		2939.4	2250.0	883.0	1584.8		2797.8	583.0	150.3	255.1

Sources: Author's calculations based on data from EBRD, EIB, EU, IBRD, and IMF.

[a] EIB, cumulative commitments through 31 December 1993. IMF, cumulative commitments, 1990-1993. IBRD, undisbursed balance as of 30 June 1990 plus all commitments through 8 March 1994. EBRD, all "signed operations" through 28 February 1994. EU,1990-1993 commitments of PHARE program (CEECs) and TACIS program (NIS). EU figures converted from ECU using annual average exchange rates. EIB/EBRD figures converted from aggregate amounts using average of $/ECU exchange rates. IMF figures converted from SDR using period average exchange rates. Cumulative commitments do not include any subsequent cancellations. All amounts are quoted in nominal terms. Due to full disbursement immediately following Executive Board approval, amounts committed and disbursed are identical under the IMF's Systemic Transformation Facility and Compensatory and Contingency Fianancing Facility (CCF).

[b] Cumulative gross disbursement through 31 December 1993. IMF, 1990-1993. IBRD, disbursements from 1 July 1990 through 8 March 1994. EBRD, all "disbursing operations" through 28 February 1994. EU, 1990-1993 "payments" of PHARE program (CEESs) and TACIS program (NIS). EU figures converted from ECU using annual average exchange rates. EIB/EBRD figures converted from aggregate amounts using average of $/ECU exchange rates. IMF figures converted from SDR using period average exchange rates. All amounts are quoted in nominal terms.

[c] Cumulative commitments of IMF include SDR 50 million undisbursed from a standby arrangement agreed upon in 1988.

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TABLE 2

MACROECONOMIC PERFORMANCE OF CEECs

Country	Date of program	Year	GDP (% change)		Consumer prices (% change)		Convertible current a/c ($ billion)		General government balance (% of GDP)		Intermediate targets
			Program[a]	Outcome	Program[a]	Outcome	Program[a]	Outcome	Program[a]	Outcome	
Bulgaria		1990		-9		26		-1.2		-9	
	Feb. 1991	1991	-11	-17	234	490[b]	-2	-0.9	0.1	-3.6	
	Apr. 1992	1992	-4	-8	65-44[b]	82-79[b]	-1.4	-0.7	-4.5	-6.9	Broad money targets "broadly" met in 1992: standby suspended in 1993
		1993				64[b]		-4		-11	Budget deficit and interest arrears: pledged taxreforms not implemented
	Apr. 1994	1994			30		-0.8		-7		Renewed in April 1994
Czechosovakia		1990		-0.4		19[b]		-1.1		0.7	
	Jan. 1991	1991	-5	-16	30	54[b]	-2.5	0.4	0.8	-1	
		1992		-5		12		-0.5			
Czech Rep.	Mar. 1993 (standby)	1993	1-3	-1	18	21	0.7	0.7	-1.2	0	Broad money undershot
		1994	-	-	-		-		-		Standby repaid
Slovak Rep.	June 1993	1993	-9	-4	26	25	-2.4	-1	-7	-6.5	STF has low conditionality; money targets seem to have been met
		1994	0		15		N/A		-4		Standby is in place and second *tranche* of STF granted
Hungary		1990		-3.3		28		0.1		0.2	
	Jan. 1991	1991	-3	-11.9	37	35	-1.2	0,3	-1.5	3.9	December 1992 target of budget deficit was exceeded and standby was interrupted
	Dec. 1992	1992	-5	-5	21	23	-0,65	0.5	-0.5	-7	
		1993	0-3	-2	14-17	23	-0.1	-3.1	-6.0	-5.5	Government revised its forecast of 1994 budget deficit in June 1993

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		1994							-8.0		
Poland	Dec. 1989	1990	-3	-12	94	586	-3	0.7	-1	0.5[e]	Exceeded targets for budget and reserves
		1991[d]	3	-8	36	70	-2.7	-2.2	-2.5	-5.9[e]	End 1991 suspended: failed to meet reserves and budget targets.
		1992[d]	0	1.5	36	43	-0.3	-0.3	-5	-6[e]	No program
	Mid-1993	1993	4.0	4.0	35	35	-2.6	-2.3	-5.2	-2.8	New program: All targets met
		1994	4.5		23		-2.5		-3.8		1994 and 1995 program framework settled but not yet the conditionality
								% GDP			
		1995	5.0		16		-2.0		-3.3		
Romania		1990		-7.4				-1,7		1	
	Feb. 1991	1991	-5.0	-14	163	166	-2.4	-1.4	-2.4	-0.8	Criteria met
		1992	0	-13.5	270	210.4	-1.6	-1.7	-2	-4.6	Undershot reserve targets
		1993		0		256		-1.5		-0.1	Target on finance to the budget and reserves not met: program suspended
	Apr. 1994	1994	0		156			-0.8	-2.5		1994 combined standby and STF
		1995	2.0		38			-0.8	-2.0		

Source: Author's compilation from IMF, OECD, and national sources.

[a] Program data or projections.
[b] End period.
[c] At the time of signing the 1994 standby, it was clear that the inflation target was unattainable, because of a sudden depreciation of the currency. On the other hand, the target is actually expressed in nominal terms.
[d] The 1989 Polish program covered expectations only for 1990. Subsequent "program" figures represent government projections for each successive year.
[e] State budget figures are used for Poland, since the definition of general government has been changing.
[f] Not including unpaid interest.
[g] Systemic Transformation Facility.

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TABLE 3*

TECHNICAL ASSISTANCE OF MULTILATERAL FINANCAL ORGANIZATIONS (in Thousands of U.S. $)

Sectors	EBRD	IBRD	IMF	EC	Total:
Region: CEECs: status, planned					
Agriculture and food	3627	na	na	26,910	30,537
Communications	9945	154	na	3510	13,609
Economic cooperation	5616	220	na	3510	9346
Education and training	na	100	na	10,530	10,630
Energy/nuclear safety	8768	104	na	24,993	33,865
Enterprise and industry	21,671	126	na	143	21,940
Environment	6260	62	na	27,050	33,372
Financial sector	13,755	273	na	12,063	26,091
Government/democratization/institution building	1521	200	na	23,985	25,706
Health/medical	na	117	na	na	117
Science and technology	na	na	na	8190	8190
Social sector	433	132	na	44,460	45,025
Tourism	4680	na	na	na	4680
Trade and investment	9086	na	na	na	9086
Transport	1988	na	na	597	2585
Total:	87,349	1488	na	185,941	274,778
Region: CEECs: status, underway					
Agriculture and food	14,773	na	na	58,625	73,398
Communications	19,823	na	na	9360	29,183
Economic cooperation	na	201	na	9149	9350
Education and training	na	na	na	3276	3276
Energy/nuclear safety	58	4800	na	70,153	75,011
Enterprise and industry	440	224	na	109,804	110,468
Environment	na	216	na	14,704	14,920
Financial sector	4783	450	270	20,826	26,330
Government/democratization/institution building	na	574	na	8775	9349
Housing	9621	na	na	na	9621
Science and technology	na	na	na	1872	1872
Social sector	na	na	na	21,177	21,177
Tourism	na	na	na	5265	5265
Trade and investment	107	275	na	25,367	25,749
Transport	na	1980	na	5148	7128
Total:	49,606	8720	270	363,501	422,096

* Source: OECD Register.

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TABLE 3-*Continued*

Sectors	EBRD	IBRD	IMF	EC	Total:
Region: CEECs: status, completed					
Agriculture and food	196	na	na	na	196
Communications	290	154	na	na	444
Economic cooperation	na	1349	na	na	1349
Education and training	na	100	na	na	100
Energy/nuclear safety	397	118	na	7962	8477
Enterprise and industry	497	642	na	78	1216
Environment	56	210	na	10,062	10,329
Financial sector	437	757	180	na	1374
Government/democratization/institution building	na	20,160	na	na	20,160
Social sector	na	383	na	na	383
Tourism	201	na	na	na	201
Trade and investment	36	3200	na	na	3236
Transport	59	150	na	na	209
Total:	2169	27,222	180	18,101	47,674

Sectors	EBRD	IBRD	IMF	EC	Total:
Region: NIS: status, planned					
Agriculture and food	2958	na	na	75,585	78,543
Communications	937	na	na	5458	6395
Defense conversion	352	na	na	5733	6058
Economic cooperation	na	3225	na	1170	4395
Education and training	na	na	na	27,437	27,437
Energy/nuclear safety	11,048	7681	na	53,249	71,978
Enterprise and industry	13,950	591	na	32,918	47,460
Environment	na	13,500	na	na	13,500
Financial sector	na	40,295	187	26,470	66,942
Government/democratization/institution building	na	37,135	na	20,077	57,212
Health/medical	na	620	na	na	620
Science and technology	na	na	na	468	468
Social sector	na	1570	na	3943	5513
Trade and investment	831	4020	na	2340	7191
Transport	4228	2200	na	24,439	30,869
Total:	34,305	110,827	187	279,287	424,606

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TABLE 3-*Continued*

Sectors	EBRD	IBRD	IMF	EC	Total:
Region: NIS: status, underway					
Agriculture and food	1499	625	na	69,026	71,151
Communications	5790	na	na	3411	9201
Defense conversion	na	na	na	11,653	11,653
Economic cooperation	292	2079	na	23,672	26,042
Education and training	na	558	na	28,196	28,754
Energy/nuclear safety	1127	3240	na	87,636	92,002
Enterprise and industry	3968	1324	654	39,558	45,504
Environment	257	na	na	4070	4327
Financial sector	3281	4013	1040	52,857	61,191
Government/democratization/institution building	na	1351	na	9123	10,474
Housing	na	615	na	na	615
Social sector	na	na	na	6032	6032
Trade and investment	147	na	na	4211	4358
Transport	350	na	na	29,950	30,300
Total:	16,711	13,806	1694	369,395	401,605
Region: NIS: status, completed					
Agriculture and food	na	2600	na	4107	6707
Economic cooperation	na	7955	na	na	7955
Education and training	na	na	na	336	336
Energy/nuclear safety	20	1034	na	498	1552
Enterprise and industry	548	3114	na	na	3662
Financial sector	399	1209	na	2332	3940
Government/democratization/institution building	na	991	na	na	991
Science and technology	na	na	na	176	176
Social sector	na	1417	na	336	1753
Trade and investment	na	475	na	na	475
Transport	3966	na	na	7234	10,300
Total:	4032	18,795	na	15,019	37,847
Region: NIS and CEECs: status, planned:					
Agriculture and food	129	na	na	na	129
Energy/nuclear safety	92	na	na	na	92
Environment	1755	6000	na	1324	99079
Total:	**1976**	**6000**	**na**	**1324**	**9300**
Region: NIS and CEECs: status, underway:					
Agriculture and food	4217	na	na	na	4217
Communications	1069	na	na	na	1069
Financial sector	371	na	na	na	371
Total:	**5657**	**na**	**na**	**na**	**5657**
Region: NIS and CEECs: status, completed:					
Energy/nuclear safety	na	39	na	na	39
Total:	**na**	**39**	**na**	**na**	**39**

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CRITIQUES AND PERSPECTIVES ON THE CENTRAL AND EAST EUROPEAN EXPERIENCE

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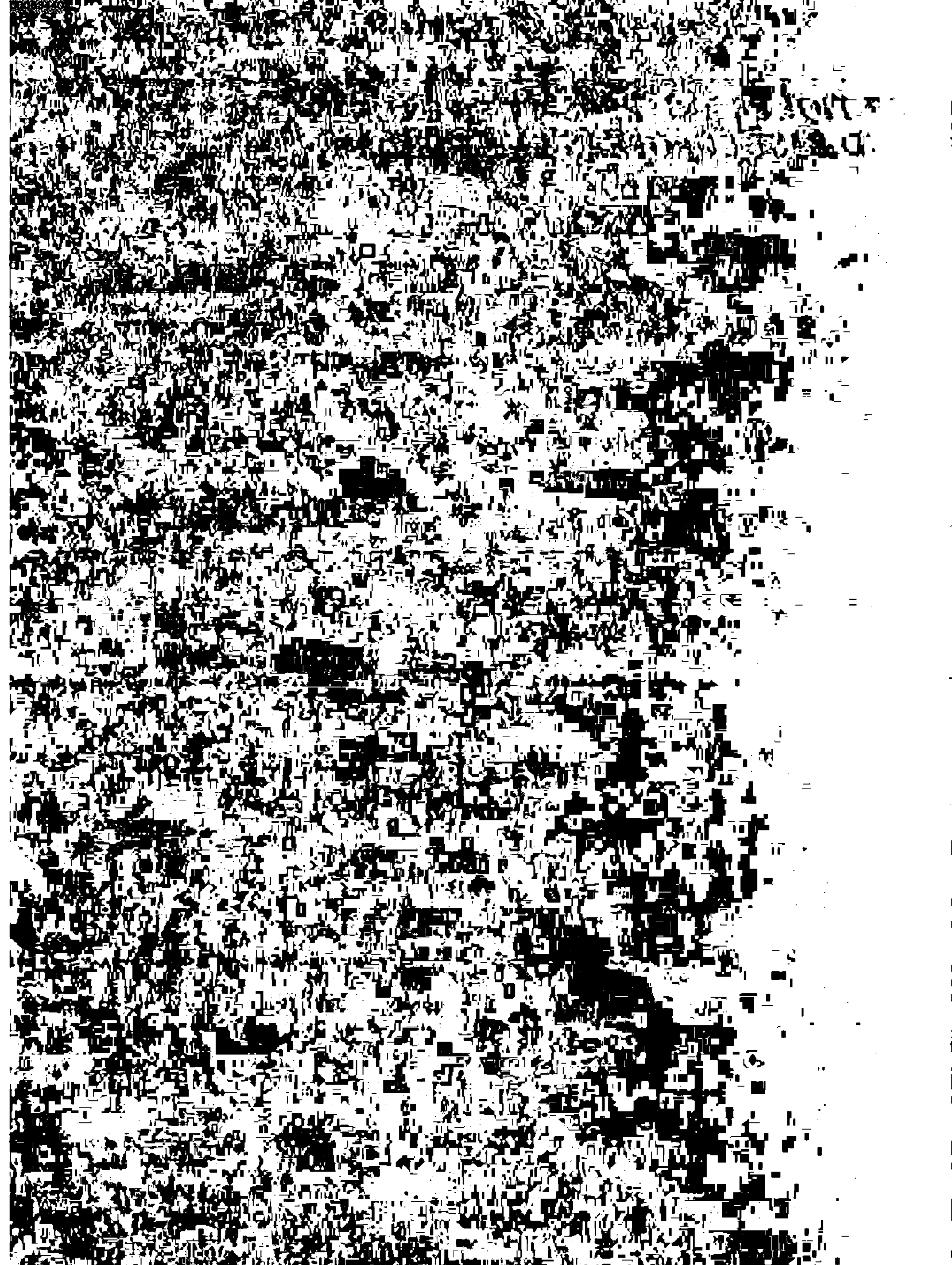

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MARIE LAVIGNE

The EBRD in Eastern Europe

In October 1989 the French President François Mitterrand proposed to set up the first post-cold war international financial institution, the EBRD (European Bank for Reconstruction and Development, reminding of the official name of the World Bank, the IBRD). The EBRD, sometimes called in France 'the chic Bank of stricken Europe', began to operate in April 1991. In 1994 it had 57 shareholder states (donors and recipients), and two international members, the EC and the European Investment Bank. Its statutory aims were to promote democratic institutions and open market economies in Central and Eastern Europe, including the former USSR, through lending and investing, with 60 percent funding at least being directed to private sector enterprises or to state-owned enterprises engaged in privatizing.

The notorious first president of the EBRD, the French academic and presidential adviser Jacques Attali, was designated to this position by the shareholders in May 1990, when the treaty to establish the Bank was signed in Paris. From April 1991 when the Bank began to operate in London to Attali's resignation in June 1993 following a barrage of criticism over the management of the Bank, the controversial style of the President attracted much more attention than the activities of the Bank. The first months of Attali's successor, formerly head of the IMF and later of the French central bank Jacques de Larosière, who took over in September 1993, were devoted to internal restructuring. Overall, in three years of operation the EBRD has not yet given a clear image of itself. The book by which its first president comments on his experience (Attali 1994) gives interesting insights but hardly helps to provide such intelligibility.

Section 1 will investigate the concept of the institution. Why to establish such a bank? What were the initial aims? Were the procedure and means consistent with the aims? It will be argued that from the very beginning the Bank's concept was unclear, and that this fuzziness impaired the actual operation of the bank, up to making it largely irrelevant to the needs of the countries in transition to the market. Section 2 looks at the current reform of the bank that is being undertaken under a new management. Is it possible to reactivate the role of the EBRD without substantially changing the project?

1. The Concept of the EBRD

The idea of a new institution was first floated by the French President François Mitterrand in a speech to the European Parliament in Strasbourg, in October 1989 (Sobell, 1990). In his book, Attali claims that he actually wrote the speech, on the basis of an idea born in his mind in August 1989. As he later explained, the idea was to set up the first post-cold-war pan-European institution, "in order to make

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totally irreversible the end of the split of the European continent in two".[1] This institution was a part of a "grand design" to promote a continental Union which would offer the new democracies prospects for integration within a larger Europe without committing the EC members to a quick enlargement. Such an institution had to be a bank because the main problem of the East was finance. But that bank should not be likened to the existing international financial institutions (IFIs) such as the IMF, or to the multilateral development banks (MDBs): "This is not an IFI. This is not an MDB. This is an institution of a third type, of a new type...".[2]

The ambiguity about the Bank's concept did not help finalizing its charter, which was however ready a few months later. The founding treaty was signed on 30 May 1990, and the Bank officially began its operation less than one year later, in April 1991.

Why a new institution?

Was the EBRD really necessary? Why not use existing agencies to achieve the goal of helping the transition? The question was very early asked. As a French banker put it, the new agency looked as useful to Eastern Europe as braces to a shellfish (Laulan, 1991, p. 119). When Mitterrand launched the idea, most of his Western counterparts expressed strong reservations, suggesting that a new 'bureaucracy' was redundant and that institutions such as the EIB (European Investment Bank) or the World Bank could well tackle financial assistance to the transition.[3] It could well be argued, however, that the EIB was devised to provide lending for investment primarily for projects located in the EC, and the World Bank to assist the Third World.

Such objections are in order if the new institution is seen first and foremost as a means for providing assistance. The initial vision certainly included that aim but was much larger and political. The Bank was to become the first pillar of a future pan-European confederation, a project cherished by President Mitterrand, for which he never won support from his Western or Eastern counterparts, short of a half-hearted agreement of Vaclav Havel.[4] In this sense, the EBRD could be seen as an "alibi" for postponing membership in an enlarged European Community.[5]

In the years following the establishment of the new institution, it became obvious that the EBRD project was totally unrelated to the developments occurring in Eastern integration into Europe. The integration debate focused on the association (so-called 'Europe') agreements that were signed with the Central and Eastern Euro-

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[1] Interview with Jacques Attali, conducted by Peter Norman, "Visionary with a global goal", *Financial Times*, 15 April 1991.

[2] *Ibid.*

[3] Leigh Bruce, "Aid Bank for East Europe Faces Stiff Challenge", *International Herald Tribune*, 27 December 1990. See also Attali (1994), chapter 2 ("Death of an empire, birth of an institution").

[4] Vaclav Havel agreed to chair with François Mitterand the sittings of the European Confederation in Prague, 12-14 June 1991.

[5] Paul Fabra, "La EBRD, cet alibi", *Le Monde*, 23 April 1991.

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pean countries (in December 1991 with Hungary, Poland, and the CSFR, and in the beginning of 1993 with Bulgaria and Romania). Both the pan-European confederation project of Mitterrand and the 'European stability area' later developed by the French Prime minister Balladur[6] remained fleshless visions.

Should one look for a specific feature of the EBRD as an agency, this may be found in the principle of political conditionality, embodied in Art. 1 and 8 of its charter. Art. 1 provides that the purpose of the Bank is to assist the reconstruction in central and eastern European countries 'committed to and applying the principles of multi-party democracy, pluralism and market economics'. Art. 8 states that if a member of the Bank conducts a policy that is incompatible with Art. 1, it may be deprived from the access to the Bank's funding. Such provisions are quite exceptional. The IBRD charter explicitly excluded any political intervention of the Bank or any consideration of political factors (Art. IV of the Agreement). The charter of the IMF was less explicit but was understood in the same way (Yamane, 1994). In fact, it may be argued that there is indeed a political philosophy underlying the IMF/World Bank adjustment programs. Conversely, the political conditionality of the EBRD seems largely declarative. To exert such a conditionality presupposes first a clear perception of the political aim and of its link with economic developments; second, it implies that the Bank has a strong leverage it could bring to bear on the recipient countries. Both conditions are lacking. There is no agreement among the members of the Bank on what the breach of the commitment to multi-party democracy and pluralism would exactly mean.[7] The resources of the Bank are too small to allow for a strong leverage.

Thus the political concept of the Bank seems quite fuzzy. The initial vision of a pan-European institution has not been endorsed in the significance it had for its 'founding fathers' Mitterrand and Attali. The political conditionality embodied in the charter is the faint reminiscence of the same idea "to hook irreversibly the East to the West",[8] which is yet to be applied. For instance, what would have happened if the Bank had extended loans to Yugoslavia - a founding member? Would it have called in the loan after the conflict erupted in the Balkans? On what grounds and with which consequences?

Why a bank?

The answer is apparently straightforward: the east needs money, which a bank makes available. But money may be granted on concessionary terms, or on purely commercial terms. In the first case one has the MDB format, i.e. an institution fi-

[6] Presented at the European Summit in Copenhagen, 21 June 1993.

[7] Philippe Aghion (1992), Chief Deputy Economist at the EBRD, qualified the political conditionality as "rather subtle": "The EBRD would not interrupt the flow of money to private investors if the democratic situation in the respective country changed for the worse. However, sooner or later the investor would decide not to further invest in that country due to political risks and hence the EBRD would also withdraw by then".

[8] Interview with Jacques Attali, quoted in note 2.

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nanced by contributions of its richest members and supporting projects that have an impact on the development of the recipient country. In the second case one deals with the merchant bank type, which has to be profitable so as to be credible and which selects borrowers according to the profitability of the projects submitted. In Attali's vision, the EBRD was to be all that at once. It was supposed to help restructure eastern Europe as an IFI would do, to concentrate on triple A status projects as an outstanding commercial bank, and yet to be something else - hence the aversion toward the current designation of its members as "shareholders".

In his speech to the European Parliament in October 1989, Mitterrand had mentioned a "Bank for Europe" without elaboration, however likening the future institution to the EIB. Later Attali translated it into a "Bank of Europe", a wording rejected by Chancellor Kohl who wanted to keep it for the future European central bank to be set up in the building of the EMU, and proposed "Bank for Eastern Europe". According to Attali, the name of the EBRD was ultimately suggested by the Danish minister of Foreign Affairs. Indeed the parallel with the IBRD was obvious, and hence suggested that the EBRD would be a MDB. In fact, the proposal was made so as to keep the Bank's affairs in the jurisdiction of that minister, who was already dealing with matters related to the World Bank; otherwise, they would have fallen into the jurisdiction of the ministry of Finance, if the new institution was devised as a merchant bank (Attali, 1994, p. 47).

Was the EBRD to be a standard development Bank then? Not quite. What is embodied in the charter is that the Bank merges the features of merchant and development banking. Hence the Bank had two operations vice-presidencies. The merchant banking division was to provide lending and equity investment to private corporations, and to support privatization by lending to state-owned enterprises implementing a programme to achieve private ownership and control. The development banking division focused on four main areas: defining country strategies for Bank operations; helping to build the financial and physical infrastructure sectors, with the provision that no more than 40 percent of the Bank's funding would be devoted to public infrastructure projects; supporting activities of co-financing, training and procurement; and conducting local office activities. Both divisions were supposed to interact, in particular in activities connected with privatization - in fact they often overlapped, which later led the second President of the EBRD to merging them. In addition, the Bank could also provide advice and technical assistance, using special funds committed by a few shareholders.

This combination of lending, project financing, equity investment, credit guaranteeing, co-financing with other private or public banks, and a few concessionary activities, was by no means clear to the professionals of banking and finance by the time the Bank launched its operations in April 1991. The Bank was not credible, not just because its President was not a banker himself. The role of "catalyst between the capital and know-how of the West and the businesses of the East", as identified by President Mitterrand at the signature of the founding treaty,[9] looked appealing but slightly unrealistic due to the high risk of lending to the East. The

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[9] Stephen Greenhouse, "A New Bank Plans East European Aid", *The New York Times*, 30 May 1990.

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goal of developing a private sector of small and medium-size companies, though quite respectable, entails the risk of many bad loans. Lending to privatizing large state-owned companies is risky in another way, as it may involve the institution in lengthy restructuring actions. Thus it seemed that the Bank was doomed to inefficiency and could be very soon choked by bad loans, taking into account its limited resources, which amounted to an initial working capital of 10 billion ECUs, of which 30 percent were to be paid out by 1995.[10]

Why a European agency?

The answer to this third question seems obvious - the project was to help central and eastern Europe to achieve their transition to the market - until one realizes that the EBRD is not quite a European agency. True, most of its members are European countries. But there are also non-European members, including developing countries whose experience might be of help to eastern Europe, such as Mexico, Morocco, Egypt, Israel, and Korea. All non-European developed countries are also members, so that membership includes the G-24 in full. The most controversial inclusion has been that of the USSR, which was finally admitted under strong limitations to its borrowing during the first three years. Following the collapse of the USSR, the Board of Directors lifted these limitations in January 1992. But lending to the former USSR and particularly to Russia remained low in comparison with the central and eastern European countries, and was concentrated on a few projects mainly in the energy sector. From the very beginning the United States and Japan had cautioned against lending to the USSR, which huge needs in the area of infrastructure could easily absorb an excessive share of the Bank's limited resources.

The rationale of the Bank membership is thus clear on the side of what is called in the Bank's parlance the "countries of operations". Though the countries belonging to the former USSR are members, the focus is on central and eastern European countries: quite logically, as the Bank is supposed to promote the nascent private sector, a process clearly more advanced in these countries. The Baltic countries have benefitted from a treatment closer to that of Eastern Europe.

Could one say that there is a bias in favor of the countries which are sooner or later to be integrated into the European Union, i.e. the signatories of association agreements, or of agreements likely to evolve toward the association format as is the case for the Baltic countries? The members of the Union together with the two member institutions (the EC, and the EIB, a very unusual case of an IFI being a member of another IFI) hold the majority of the shares (51 percent). But this does not turn the Bank into a clearly focused pan-European institution, on the model Mr. Attali and Mr. Mitterrand certainly dreamt of. The Western European members never displayed a coherent front. The United States strongly influenced the drafting of the charter through the G-7. The G-7 itself detains a majority of the votes, which are distributed according to the shares. Overall the G-7 countries have a 55.9 percent stake, with the US holding the single biggest stake (10 percent) (see

[10] Interview with Ray C. Smith, "Un risque d'inefficacité", *Le Monde*, 16 April 1991.

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figure 1). However the US do not have the power to block essential decisions as in the IMF and World Bank.[11]

Why the EBRD at all?

In April 1993, a few days before the annual meeting of the institution, the British newspaper Financial Times launched a harsh attack on the EBRD, claiming that the Bank had so far done little for eastern Europe and lavishly spent on itself.[12] Three months later, after promising to restructure the EBRD and to curb its expenses, Mr. Attali had nevertheless to step down. In his self-justifying book Europe(s), he both claims that the Bank has successfully fulfilled its initial goals and that it did not implement the initial "vision" (Attali, 1994, p. 123).

In fact the concept was never clarified. To have a new agency was justified if the Bank had really been a "catalyst for change" and helped to implement a "vision"; without that, there is nothing in the scope of its activities that existing institutions, such as the World Bank and its affiliates, the EIB, the European Commission or the Western states and banks could not have done, and actually did. Mr. Attali identifies the potential political role of the bank: "to prepare Eastern countries to cooperation among neighbors, to take ecological needs into account, to press for the opening of trade barriers, ... for progress in the field of democracy" (Attali, 1994, p. 119). On all these accounts the grand design failed. The East sees pressure for 'co-operation among neighbors' as an excuse for postponing membership in the European Union. It still considers environmental protection as a luxury for developed countries, the latter being afraid of the costs incurred if the EBRD had really to tackle that.[13] In the view of the European Commission, it is not really the task of the EBRD to campaign for a quicker lifting of trade barriers than what is negotiated between Central and Eastern Europe and the Commission.[14] As we have seen, the crucial concept of political conditionality has never been clearly defined, whatever the useful role of the political department of the bank in monitoring elections, training the press, watching the observance of the human rights.

Just because the EBRD deals with activities performed by various financial institutions and because of its dual structure, it is not quite perceived as a bank. Though claiming that it wanted to be assessed as a highly rated, profitable bank, the EBRD made it clear, on the occasion of its first offering on the international capital

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[11] In the IMF or the World Bank the qualified majority for very important votes is 85 percent of the shares. The US detains 17.82 of the votes and thus has a blocking minority. In the EBRD, the important decisions have to be taken by a majority of two-thirds, and the US has a much smaller share in the votes than is the case in the IMF.

[12] Robert Piston, "The Bank that likes to say yes to itself", *Financial Times*, 13 April 1993.

[13] Françoise Lazare, "La BERD n'est pas prête à lancer ses premiers programmes", *Le Monde*, 19 April 1991, quoting a US comment on the point that "the budget of the Bank could easily be entirely absorbed by the cleaning of the Baltic sea".

[14] Leigh Bruce, "East's Banker Vows to Fight Protectionism", *International Herald Tribune*, 18 April 1991.

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markets, that it was "profit-guided" rather than "profit-maximizing".[15] The banking world is always cautious as regards non-conventional institutions of "a third type". While not a standard merchant bank, the EBRD has been less active than the World Bank in the field of infrastructure reconstruction and development - a consequence both of its limited resources and of its commitment to priority financing for the private sector.

Finally, the Bank is not so much European as "non-Third World". It is the association of the G-24 with the post-communist ex-Soviet block, with a few "samples" from the middle-income Third World. Thus, looked upon with mistrust in most of the developed member countries, never really endorsed in the East where it is seen as a dwarf World Bank with even more red tape, it is considered in the Third World as a device to divert to the East funds which could be better employed in the South. Is the picture too black and unfair?

2. The New EBRD and the Transition

The new concept of the EBRD emerging after a few months of a new presidency has been somewhat clarified. Mr. de Larosière reversed the initial design. By suppressing the political department he abrogated the "global vision" that had led to the establishment of a new agency. By merging the two operational vice-presidencies - the merchant banking and the development banking ones -, and by restructuring the bank along a geographical division among "northern" and "southern" countries of operations, he made the EBRD closer to a standard development bank. By bringing the staff closer to the East and specifically to the central European countries, he established the institution as an agency focused on the specific needs of Eastern Europe on ground level.[16]

But then, the Bank is no longer a unique agency, however unusual it may appear. It is just a development bank with commercial constraints. What can it achieve in the fields of lending and assistance to transformation?

Careful Lending

Due to the low amount of paid-in capital (3 billion ECUs out of 10, made available in instalments by the end of 1995), the Bank has to resort to borrowing on capital markets or from other financial institutions. It set its first bond issue, for 500 million ECUs, in September 1991.[17] With an expected yield of 8.91 percent, the Bank

[15] Tracy Corrigan, "Raising Cash to Invest in the East", *Financial Times*, 26 September 1991.

[16] Robert Piston, "EBRD bord approves reforms", *Financial Times*, 9 November 1993; David Marsh, "EBRD raises local profile", *ibid.*, 7 February 1994; *id.*, "Excess gives way to restraint", ibid., 4 March 1994.

[17] "EBRD Sets First Bond, 500 million Ecu Issue", *International Herald Tribune*, 27 September 1991.

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had obviously to charge a higher interest rate to its clients, and it is said to charge more than the EIB.[18]

This alone may explain why lending has been slow. The necessity of selecting good projects in the nascent private sector, a very time-consuming task as central and eastern European private borrowers have no credit history, led to a slow start and a great country concentration of the projects. By the end of 1992, out of 1 bn ECU commitments signed (in loans and equity) only 126 million had been disbursed; by the end of 1993 the commitments had increased to 2.8 bn ECU and the disbursements to 556 million, displaying a slightly more favorable ratio of the disbursements to the commitments (see figure 2 for the country and sectoral distribution of the commitments). The 60/40 split between loans to the private sector and loans to the public sector had been basically observed, with an actual 57/43 split. Poland, Hungary, the Czech and Slovak Republics have accounted for the greater share of the projects, not surprisingly as these countries have started privatization earlier and achieved better results in macro-economic stabilization.

Though it had first seemed that the Bank might lend more under its new management, developments in 1994 show that the 1994 commitments will hardly exceed the 1.8 billion ECUs total for 1993. The priorities of the bank have been stated: first it will build operations in the borrower countries themselves, and the decentralization of the bank's activities will allow to identify profitable projects in the private sector; second, it will invest more in small- and medium-sized enterprises. The first priority is mainly a matter of credibility in eastern and central Europe. Besides, Attali himself wanted to redeploy part of his staff in the countries of operations, and never succeeded due to the reluctance of the staff. The second priority was also already stated in the past, as a focus on developing "an entrepreneurial spirit at grass roots level by helping the establishment of small enterprises".[19] Specifically, in 1991 it was envisioned to support the development of SMEs by promoting a new network of merchant banks which would in turn be able to finance the enterprises. It seems that the new management also wants to strengthen the local banks and investment funds to this effect.

The surprising conclusion that emerges is that apart from conveying a more focused image and shedding the pomp and circumstances of Attali's era, the new management is not proposing really new ways. The EBRD will obviously spend less on itself, but not much more on eastern Europe.

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[18] *Financial Times*, 4 March 1994. The EIB charges 0.15 percent, whereas the EBRD charges 0.50 percent - true, as pointed out to me by the Director of Financial Studies at the EIB, Alfred Steinherr, the EIB has lower operating costs and no risk premium. Also, its loans have longer maturities.

[19] Peter Norman, "EBRD draws up list of its priorities in east Europe", *Financial Times*, 7 May 1994.

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A stronger involvement in transition?

Reflecting on what might be done (or not) one has to take into account both the needs of the transition and the profitability constraint of the EBRD, remembering that the Bank operates at the micro-economic level. The following points can be made:

(i) Profitable deals to be financed in the private sector of the countries in transition are scarce, be it in form of loans or of equity. The best deals are understandably made by private foreign investors, and the involvement of the Bank in such deals is more a help to the western investor than to the eastern partner (as had been said, for instance, of the share taken in 1992 by the EBRD in the CSA Czech airline, a deal in which Air France was involved as well). Helping privatizing big state-owned enterprises is very risky when they are not first restructured, an approach highly questionable in central and eastern Europe where industrial policy is not in favor. Focusing on small and medium sized enterprises looks appealing but cannot easily be done from London, or even from the countries in operation themselves with a limited staff. Besides it may involve the institution in unpleasant cooperation with local mafias. The indirect approach of the SMEs through the support of local banks and funds is potentially more efficient but no less risky. The EIB itself has undertaken such an approach, lending to local banks for on-lending to SMEs in the manufacturing, tourism and service sectors in Czechoslovakia (mainly in the Czech Republic).[20]

(ii) Global lending for development is much more secure, as here we are in charted waters. But then the EBRD looks as a competitor of the standard development or regional banks. The EIB has already done better in eastern Europe, and its resources for infrastructure lending have been strengthened in September 1993.[21] The World Bank is the biggest project lender to the countries in transition, and has clearly taken the lead in the case of Russia in the field of commitments for the revamping of the oil sector. However the World Bank is constrained by the conditionality of the IMF, and the disbursements of its loans to Russia were suspended when Russia failed to reach agreement with the IMF in 1993. The EBRD is not tied by this kind of constraint; the political conditionality and the profitability constraint may however be very restrictive here. In addition the EBRD cannot devote more than 40 percent of its resources to development lending. It is not surprising, therefore, that the largest share of its funding went to the telecommunications sector, potentially the most profitable in the field of infrastructure.

Thus the options open to the Bank are either limited or already taken over by other, more standard institutions. It is very difficult to be a successful development bank without large resources and strong backing. It is no less difficult to act as a private bank when being a cumbersome multilateral agency. The second president

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[20] *Economic Bulletin for Europe*, Vol. 45 (1993), p. 62.

[21] The Council of Ministers of the EC proposed to allow the EIB to lend an additional 3 bn ECU over three years to Eastern Europe and the Baltic States. *Economic Bulletin for Europe*, Vol. 45 (1993), p. 92.

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of the bank tries to tackle both tasks while the first one tried to transcend them into a vision of his own.

Conclusion

Can the EBRD usefully contribute to the emergence of a market environment in Eastern Europe? The answer to this question opens a broader debate. Western assistance at large helped in this respect, and the EBRD played its modest part. But it had the most difficult part in the play, i.e. to provide microeconomic assistance while making it profitable for its shareholders. In addition, the countries where it has been most active - Poland, Hungary and the Czech Republic - will soon no longer need its help, while the others may not yet have a private sector ready to absorb what may be offered.

Could the EBRD have improved the integration of the east in the western (European) economy? It was certainly naive to expect such a development. Integration through trade is a matter of jurisdiction of the European Union, and the suggestions of the EBRD Presidency toward a greater market access for eastern Europe have always been considered as irrelevant. Integration through infrastructure financing requires huge resources that are beyond the EBRD's capacities. At best, the EBRD may work in parallel with the EIB and the World Bank, in particular through co-financing, and play the same role of catalyst to attract private funds.

The EBRD thus emerges either as helpless or redundant. It has helped a few specialists and policy-makers of the east to become more familiar of the ways market institutions operate in the West. It has demonstrated negatively, as the Marshall plan did positively some forty years earlier, that assistance to reconstruction and development requires built-in self-interest of the donor(s) to be successful. It may still prove useful on a modest and supplementary scale.

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Figure 1: Membership of the EBRD
(in percentage of shares)

Source: EBRD, Organization of the European Bank for Reconstruction and Development.

Notes:

The "EC G-7" are France, Germany, Italy and the United Kingdom.

"Other EC" are: Belgium, Denmark, Greece, Ireland, Luxembourg, the Netherlands, Portugal, and Spain.

"Other G-24" are Australia, Austria, Finland, Iceland, Liechtenstein, New Zealand, Norway, Sweden, and Switzerland.

"Developing countries" are Cyprus, Egypt, Israel, Korea, Malta, Mexico, Morocco, and Turkey.

"Countries of operation" comprise the Central and Eastern European countries (Hungary, Poland, the Czech Republic, the Slovak Republic, Romania, Bulgaria, Albania), Slovenia and Macedonia, the Baltic countries, the countries of the former USSR.

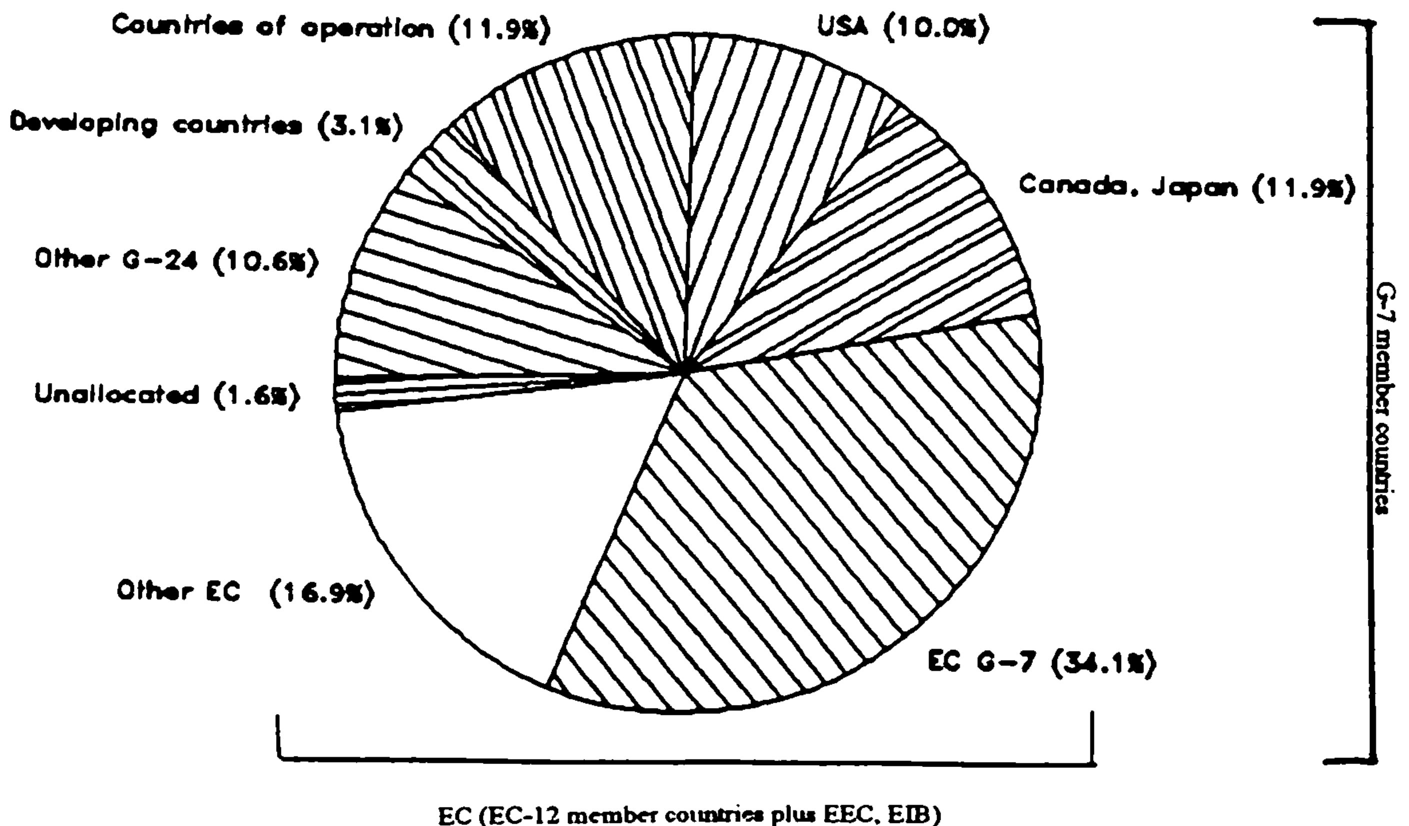

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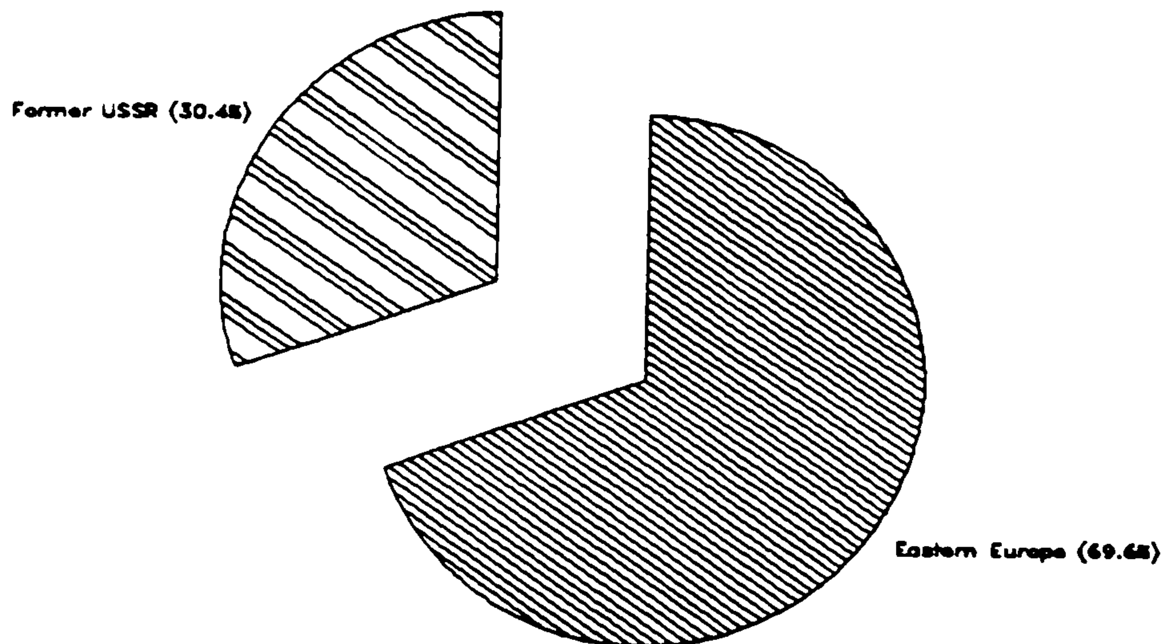
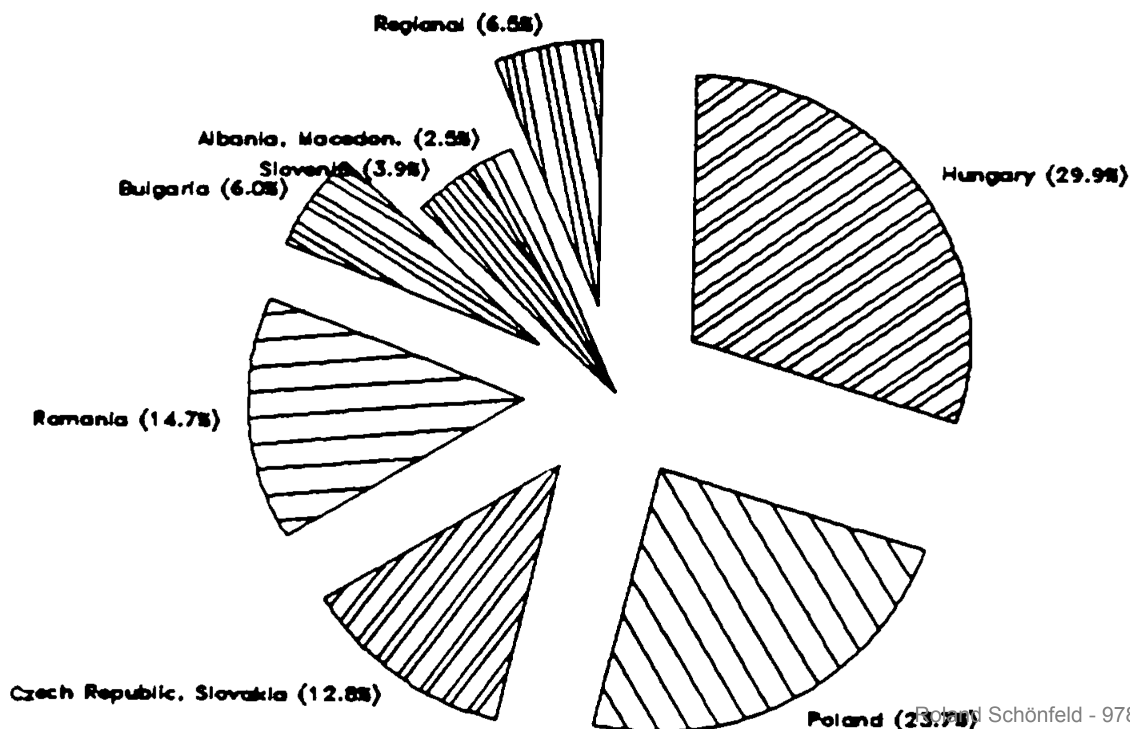
Figure 2: Country and sectoral distribution of EBRD loans
(in percentage of the total commitments)

A: Regional distribution; B: Country distribution, East Europe; C: Country distribution, former USSR. D: Sectoral distribution

Source: Compiled by the author from EBRD, Projects approved and signed, 1991-3, February 1994.





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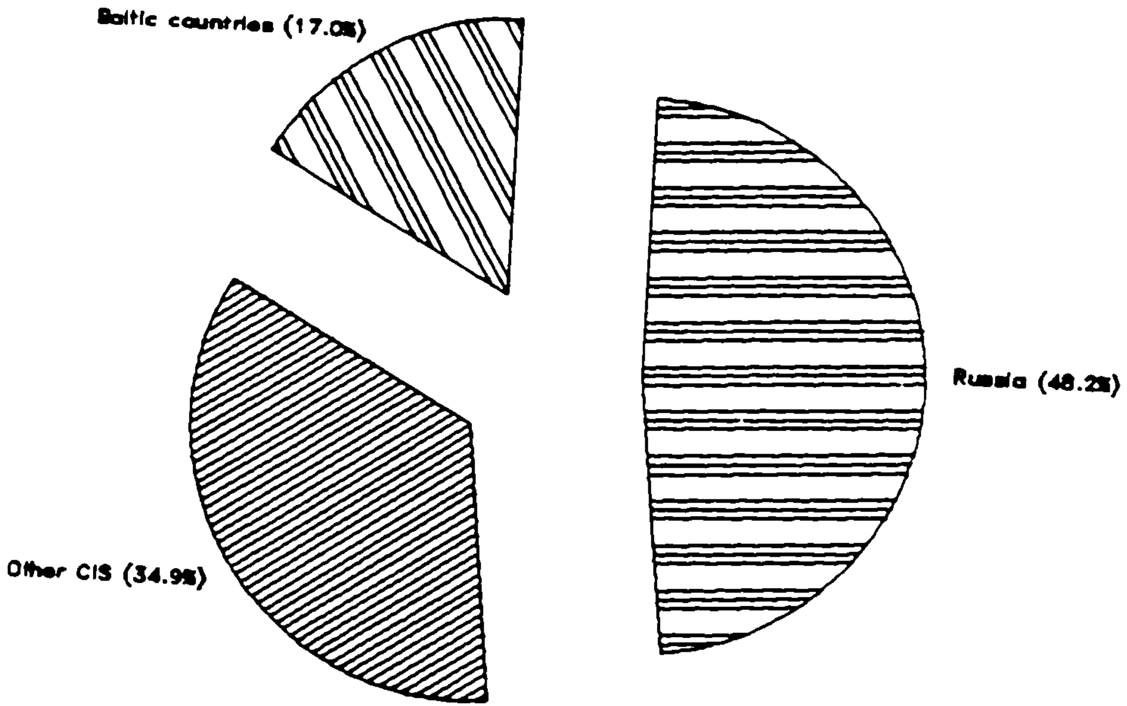

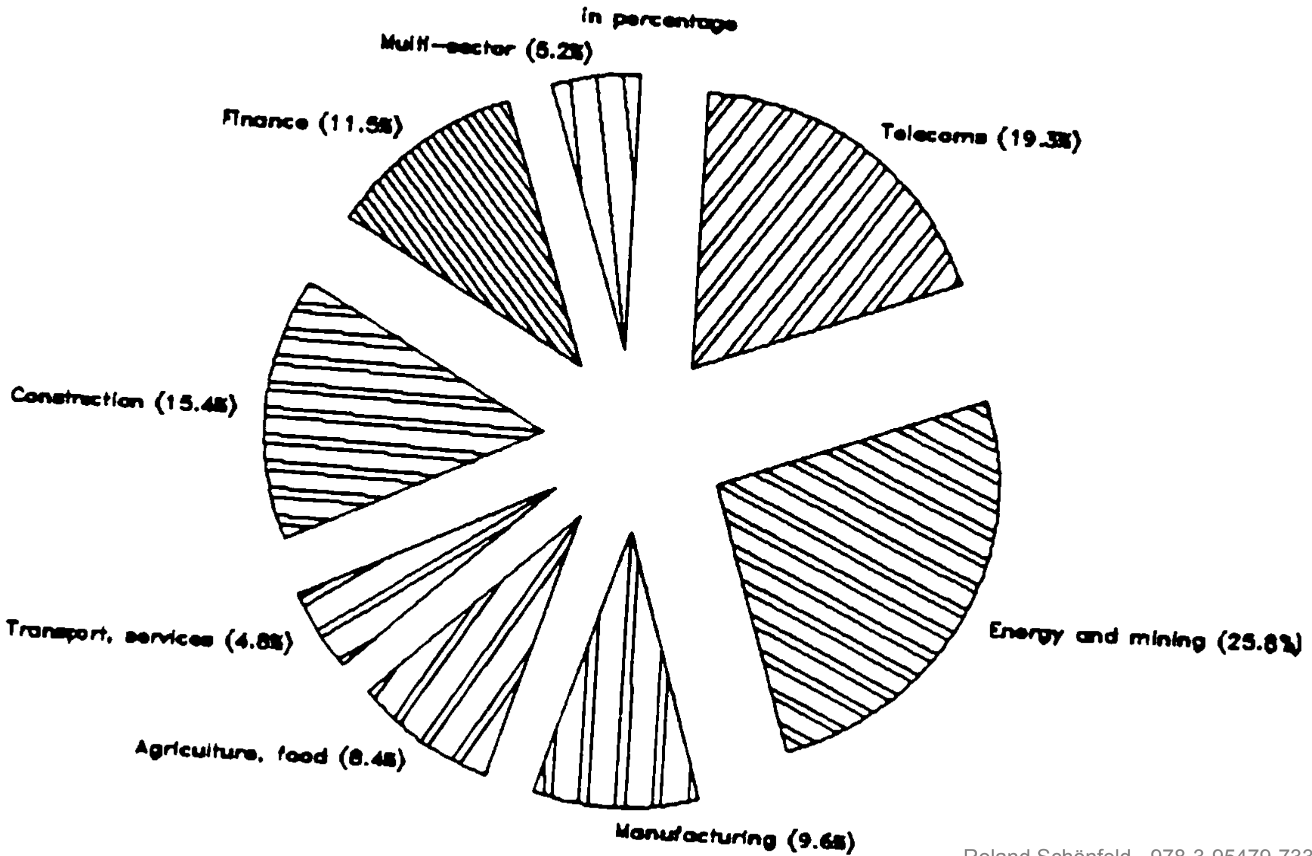

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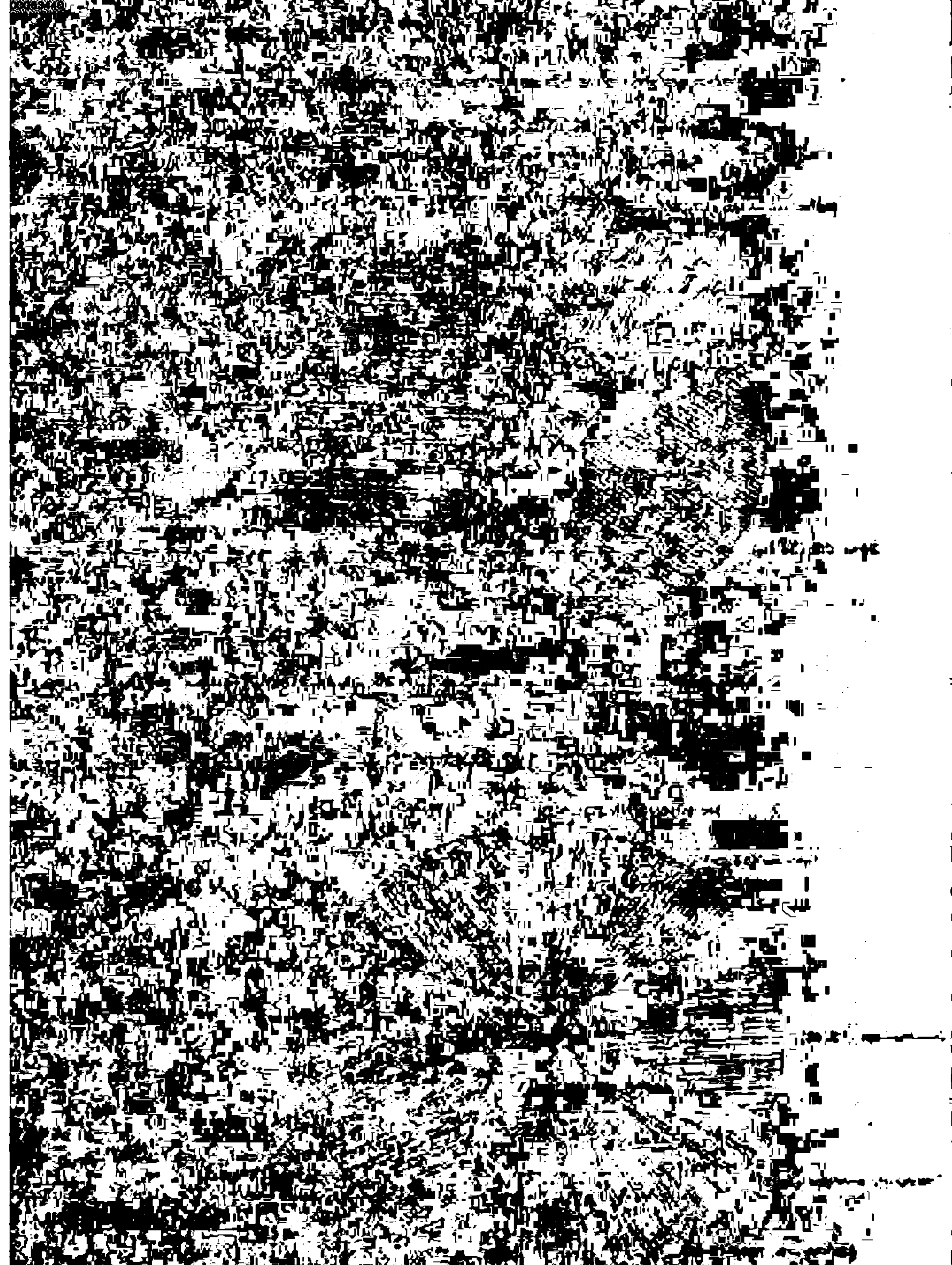

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KARSTEN VON KLEIST[1]

Recent Developments in Commercial Bank and Bond Financing of Countries in Eastern Europe

1. Introduction

The purpose of this article is to provide additional information to those interested in utilizing the data collected and published by the Bank for International Settlements (BIS) on the bank and securities financing of countries in "Eastern Europe". The survey covers all countries in transition, that is, the countries of central and eastern Europe, but also the former Soviet Union and former Yugoslavia (see Table 1). The focus of the paper is on the period from 1988 to 1993, because major changes in the structure of the reporting banks' positions vis-à-vis these countries took place during that period. Any substantial subsequent changes are however mentioned in the text.

2. *BIS reporting banks' positions vis-à-vis countries in Eastern Europe*

The BIS aggregates and publishes data on international banking activity collected in two reporting systems, which are stratified by the *residence* principle of balance of payments methodology on the one hand and by the country of *risk exposure* principle on the other. The quarterly, residence-based reporting system has the broadest coverage, with national banking authorities in 18 industrialized countries and 6 other financial centres supplying data that in most cases cover nearly 100% of the cross-border positions of their banking sectors. The data are published by the BIS about five months after the end of the reporting period and thus tend to be a timely public data source on bank financing for many countries with less developed statistical reporting systems.

Over the ten years 1983 to 1993, the financial position of BIS reporting banks vis-à-vis the countries in Eastern Europe developed in two phases. During the first period up to 1988, the *claims* of BIS reporting banks on this group of countries rose rapidly, as the local authorities tried to sustain faltering economic growth. Thereafter, output started to decline in most of the region, reflecting numerous factors such as the move to world prices for inter-regional trade and the resulting decline in regional trade, the breakdown of the old command system and cautious fiscal policies. This output decline was accompanied by a reduction in financial claims outstanding (net of exchange rate movements) which was the result of reduced new credit and some write-offs. This reduction in claims would have been even more

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[1] Monetary and Economic Department of the Bank for International Settlements. The views expressed are those of the author and not necessarily the views of the BIS. I am grateful to Rainer Widera for comments. Responsibility for any remaining errors is my own.

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pronounced if a build-up of arrears towards the reporting banks had not led to a substantial increase in claims vis-à-vis selected countries.

The development of the outstanding *stock* of claims needs to be interpreted with care. Firstly, with nearly four-fifths of the banking debt of these countries now denominated in currencies other than the dollar, exchange rate fluctuations may have large effects on the data which are expressed in US dollars. For instance, 55% of the observed rise in the stock of banking debt of the region over the 5 years up to end-1988 was attributable to the decline of the US dollar against the currencies in which the claims were mainly denominated (see also Graph 1).

Secondly, in the wake of German monetary union on 1st July 1990 and the transformation in central and eastern Europe, reclassifications and increased coverage by Germany and other countries added $ 19.2 billion to outstanding claims, although actual exchange rate adjusted lending fell by $ 3.3 billion over the period between end-1988 and end-1992.

Table 1: BIS reporting banks' positions vis-à-vis Eastern European countries, 1983 - 1993, US $ billion

Countries	Claims				Liabilities				Net positions*			
	Dec. 1983	Dec. 1988	Dec. 1992	Dec. 1993	Dec. 1983	Dec. 1988	Dec. 1992	Dec. 1993	Dec. 1983	Dec. 1988	Dec. 1992	Dec. 1993
	Amounts outstanding											
Bulgaria	1.8	6.9	7.4	6.5	1.2	1.8	1.4	1.2	0.6	5.1	6.0	5.2
F. Czechoslov.	2.7	4.5	4.9	4.7	0.9	1.7	3.8	4.4	1.8	2.8	1.1	0.4
Hungary	7.1	11.5	8.6	7.3	1.3	1.4	2.8	2.3	5.8	10.1	5.8	5.0
Poland	11.3	10.6	13.1	11.7	1.2	3.6	7.5	7.0	10.1	6.9	5.6	4.7
Romania	3.9	0.7	1.5	1.7	0.5	0.8	0.7	0.9	3.4	-0.1	0.7	0.8
F. Yugoslavia	10.0	9.0	4.7	3.9	2.1	3.8	5.3	6.1	7.9	5.2	-0.6	-2.2
F. Soviet Union	16.2	36.9	59.0	54.2	10.9	15.3	14.2	16.5	5.3	21.5	44.8	37.6
Total	**53.0**	**80.0**	**99.2**	**90.0**	**18.1**	**28.4**	**35.8**	**38.4**	**34.9**	**51.6**	**63.4**	**51.6**

Countries	Claims 1984 - 1988	Claims 1989 - 1992	Claims 1993	Liabilities 1984 - 1988	Liabilities 1989 - 1992	Liabilities 1993	Net positions* 1984 - 1988	Net positions* 1989 - 1992	Net positions* 1993
	Exchange rate adjusted changes								
Bulgaria	4.0	-0.9	-0.7	0.3	-0.3	-0.1	3.7	-0.6	-0.6
F. Czechoslov.	1.0	-0.9	0.0	0.5	2.1	1.1	0.5	-3.0	-1.0
Hungary	2.0	-4.4	-1.1	-0.6	1.5	-0.5	2.6	-5.8	-0.6
Poland	-3.6	-0.5	-0.6	2.0	3.9	-0.2	-5.6	-4.4	-0.4
Romania	-3.8	0.0	0.2	0.2	-0.1	0.2	-4.0	0.1	0.0
F. Yugoslavia	-2.3	-5.0	-0.7	1.2	1.0	1.1	-3.5	-6.1	-1.8
F. Soviet Union	14.8	8.4	-1.9	3.3	-1.2	2.2	11.5	9.6	-4.0
Total	**12.1**	**-3.3**	**-4.7**	**7.0**	**6.9**	**3.8**	**5.1**	**-10.2**	**-8.4**

* Minus sign = net liabilities in case of amounts outstanding, decrease in net assets or increase in net liabilities in case of changes.

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The *liabilities* of BIS reporting banks to these countries, which had amounted to no more than $ 18 billion at the end of 1983, had doubled by 1992, with the rate of increase during 1993 (11%) double that of the previous four years (5.5% on an annual basis). These developments reflected the funding of increased trading links with the Western economies and perhaps some capital flight, especially in the case of former Yugoslavia, where the reporting banks' claims have been declining since 1987. The overall decline in the claims evident in Table 1 was delayed in the case of the former Soviet Union until 1993 due to the accumulation of arrears.

Table 2: BIS reporting banks' positions vis-à-vis Eastern European countries, 1993-1995, US $ million

Countries	Claims		Liabilities		Net positions*	
	Dec. 1993	June 1995	Dec. 1993	June 1995	Dec. 1993	June 1995
	Amounts outstanding					
Bulgaria	6461	3175	1225	1671	5236	1504
Czech Republic	2674	5394	2258	2910	416	2484
Slovak Republic	362	730	686	2054	-324	-1324
F. Czechoslovakia	1712	1822	4358	1193	-2646	629
Hungary	7314	8590	2322	2137	4992	6453
Poland	11694	7270	6994	12050	4700	-4780
Romania	1697	2241	901	1526	796	715
Belarus	241	702	128	271	113	431
Russia	47184	52102	9426	10301	37758	41801
Ukraine	611	945	728	1078	-117	-133
Uzbekistan	35	290	377	1049	-342	-759
Other former Soviet Union	6088	4823	5868	3827	220	996
F. Yugoslavia	3921	4144	6092	9116	-2171	-4972
Total	89994	92228	41363	49401	48631	42827

	Claims 1994 - June 1995	Liabilities 1994 - June 1995	Net positions* 1994 - June 1995
	Exchange rate adjusted changes		
Bulgaria	-3837	277	-4114
Czech Republic	2203	253	1950
Slovak Republic	292	1162	-870
F. Czechoslovakia	-67	-316	249
Hungary	-90	-410	320
Poland	-5591	4234	-9825
Romania	334	550	-216
Belarus	399	130	269
Russia	-3432	230	-3662
Ukraine	181	306	-125
Uzbekistan	253	663	-410
Other former Soviet Union	-1869	-2208	339
F. Yugoslavia	-301	1965	-2266
Total	-11525	6836	-18361

* Minus sign = net liabilities in case of amounts outstanding, decrease in net assets or increase in net liabilities in case of changes.

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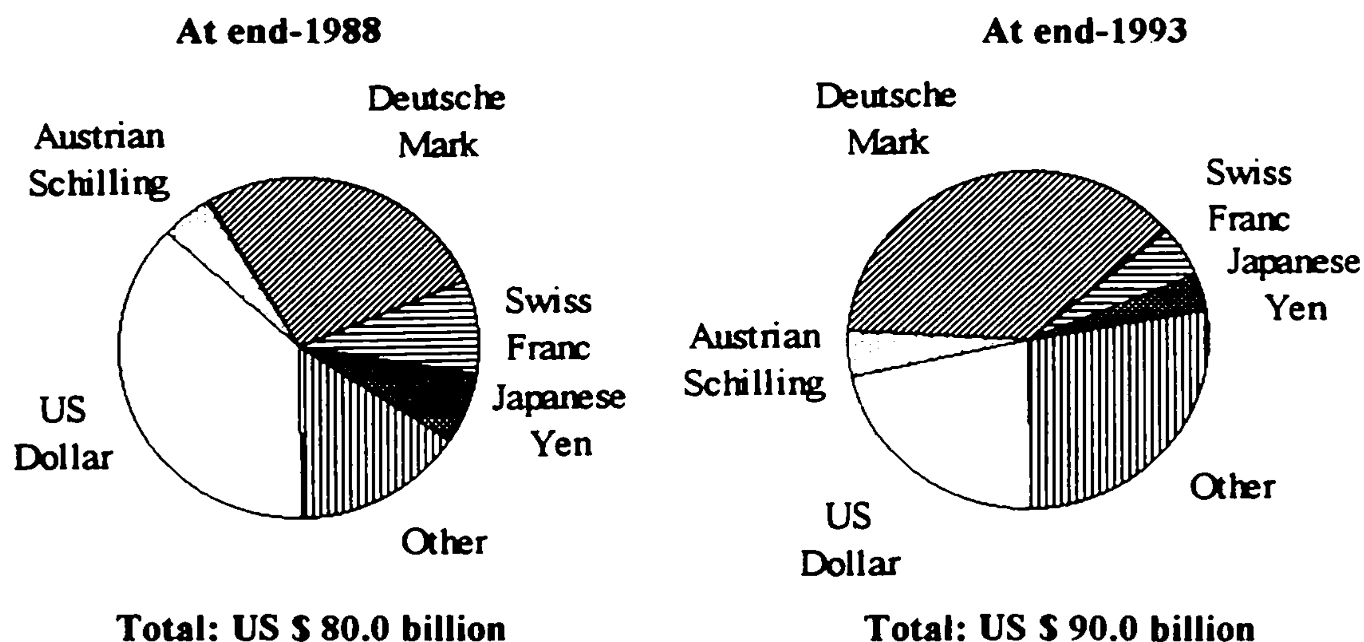
The BIS provides separate data for the economies in transition in Central and Eastern Europe as well as for other countries of the former Soviet Union from December 1993 onwards (a selection of which are shown in Table 2). While claims on Poland, Bulgaria and Russia were cut substantially in this last period, due to write-downs of existing claims, new lending to the Czech Republic and the build-up of a net creditor position by Poland (in line with its accumulation of foreign exchange reserves) and to a lesser extent the Slovak Republic are indicative of the further strengthening of economic growth in selected countries.

3. *Currency composition of BIS reporting banks' positions*

At the end of 1988, only a third of BIS reporting banks' total outstanding claims on the countries in transition represented traditional loans in domestic currency, while two-thirds reflected Eurocurrency lending, i.e. lending in a currency that is not the domestic currency of the country in which the lending bank resides. Such foreign currency credits remained at their established level in absolute terms in the five-year period thereafter, although the composition of both debtor and creditor countries changed. All growth therefore was due to the marked expansion in domestic currency credits (partly resulting from the increased coverage of the statistics reported by Germany and Italy mentioned above), which implied a rise in their proportion of the total to almost 50% at end-September 1993. While domestic currency credits are often trade-related and may benefit from official guarantees, Eurocurrency credits are more often purely financial in nature and tend to be funded in the interbank market. The increased risk seen in lending to the area during these five years undoubtedly contributed to restraint in Euro-currency lending.

Graph 1: Currency composition of BIS reporting banks' claims vis-à-vis Eastern European countries



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As is evident from Graph 1, the currency shares as a consequence shifted quite markedly from 1988 to 1993. Over the most recent period up to June 1995, the currency distribution then remained largely unchanged. While the US Dollar accounted for 37% of the total initially, it has now shrunk to 22%; the main counterpart was an increased share of the Deutsche Mark, which rose from 27 to 37% (38% in June 1995). The shares of the Swiss franc and the Japanese yen have declined. By contrast, the proportion of lending in Austrian Schilling remained stable and rose to 6% in June 1995. The share of all other currencies (including claims in transferable rubles) was up from 15 to 28%.

Although one might surmise that the change in the currency composition was purely a reflection of the sources of lending, there is some indication that trade and currency diversification considerations of the borrowers also played a role, since a similar shift can be observed in these countries' deposits with the reporting banks. Thus, while the share of the US dollar has declined only slightly from 51% at the end of 1988 to 47% at end-1993, the share of the Deutsche Mark has shown an increase from 20 to 32% (33% in June 1995), with the share of other currencies declining to a few percentage points each.

4. *Share of various banking groups in positions vis-à-vis Eastern European countries*

The *quarterly* BIS statistics record positions on the basis of the *location* of the banking offices irrespective of their nationality. They therefore also convey information on the role of the various banking *centres* in supplying funds to countries in Eastern Europe and on managing their assets held with banks. In terms of percentage shares, at the end of 1988, banks in each country were supplying broadly the same proportion of funds as were deposited with them.

Five years later, the distribution of lending to Eastern Europe had clearly changed. Banking offices located in the United Kingdom, which had accounted for $ 21 billion or 26% of all reporting banks' claims on the region had reduced their claims to $ 10 billion or 11% (10% in June 1995) of the total. Banking offices in France reduced their share from 14% to 7%. In consequence, the increased exposure of banks in Germany from $ 9 billion to $ 41 billion implied an increase of their share from 12% to 45% (51% in June 1995).

On the other hand, banks in the United Kingdom remained the most successful in attracting funds from the region, increasing their share from 22% in 1988 to 26% in 1993 (25% in June 1995). Banks in Germany moved to second position and increased their share from 7% to 16% (14% in June 1995). Finally, banks in the United States moved from a minor 4% in 1988 to 8% in 1993 and 13% in June 1995.

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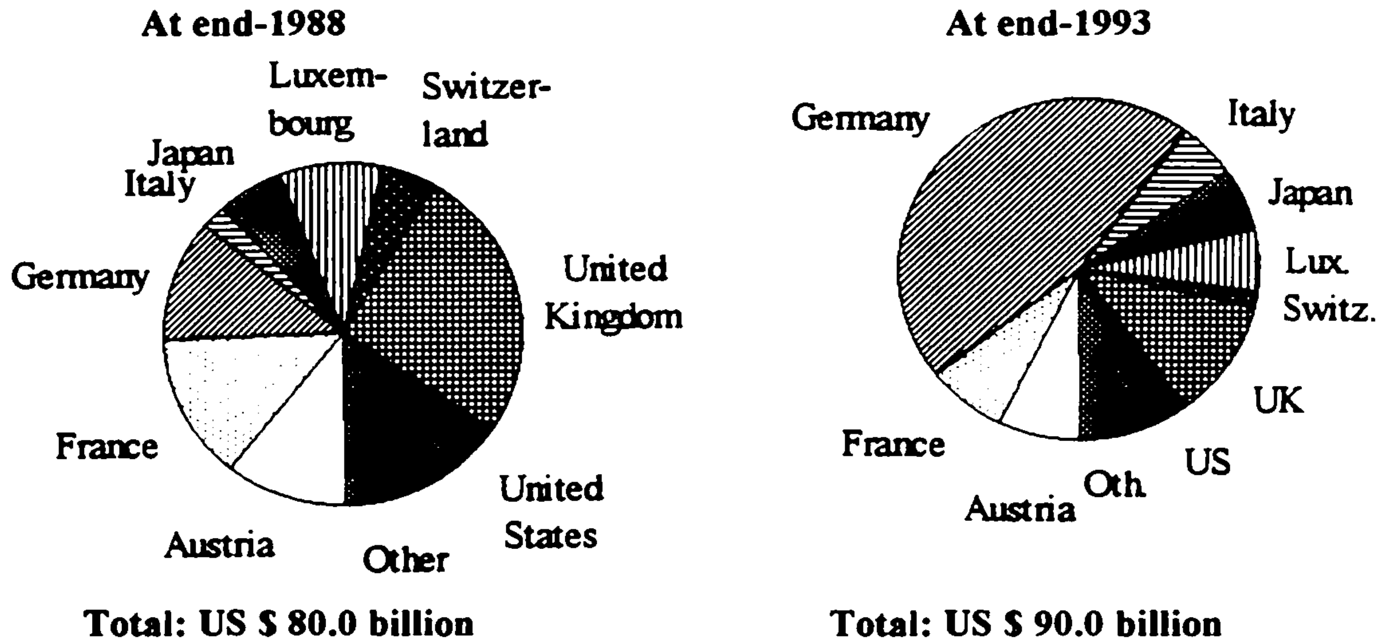
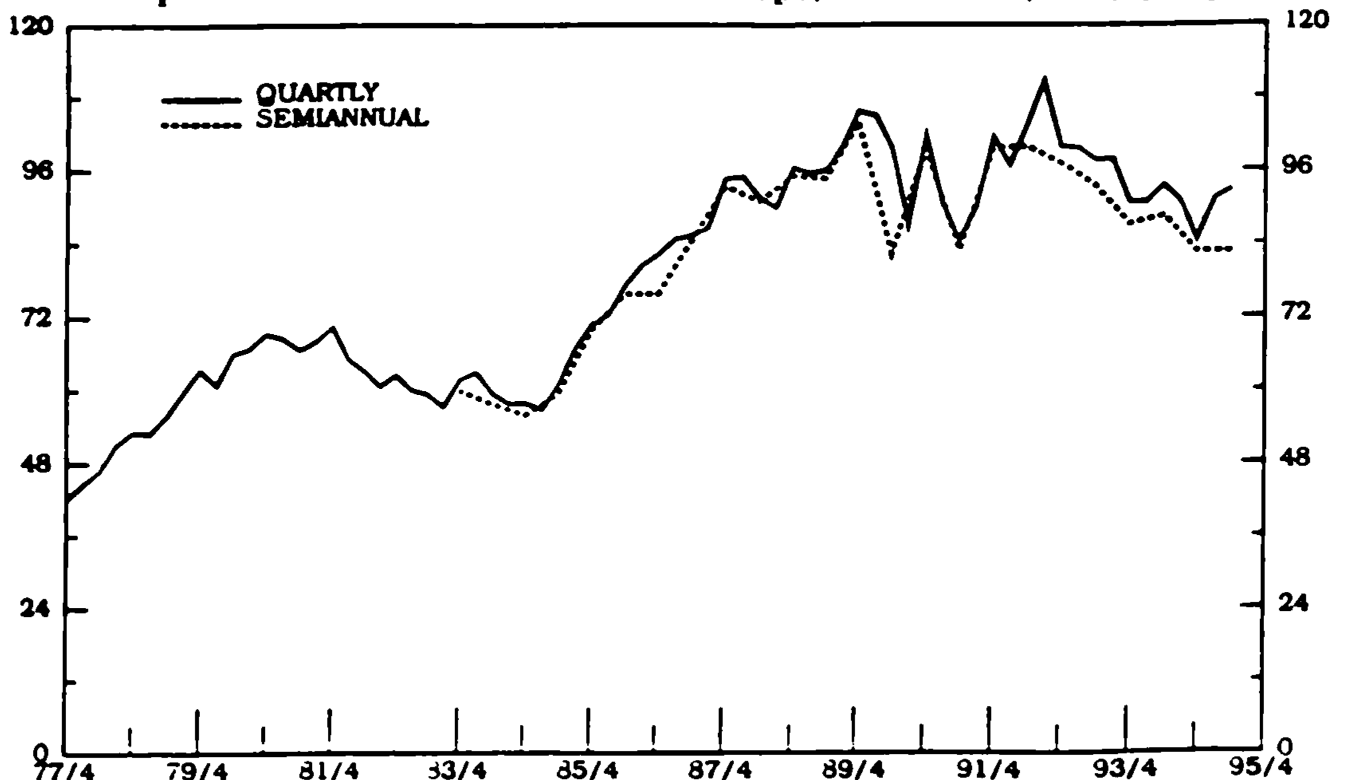
Graph 2: Share of various banking centres in claims vis-à-vis Eastern European countries



5. The sectoral and maturity distribution of BIS reporting banks' positions

Next to the quarterly statistics, the BIS also has been mandated to collect, since 1983, a *semi-annual* set of banking data on banks' assets (lending) vis-à-vis developing countries. Although this data is reported only by the industrial reporting countries, the data is more comprehensive than the quarterly report for those countries who do participate, because it is reported on a consolidated basis.

Graph 3: Banks' claims on Eastern Europe, 1977 - 1995, US $ billion



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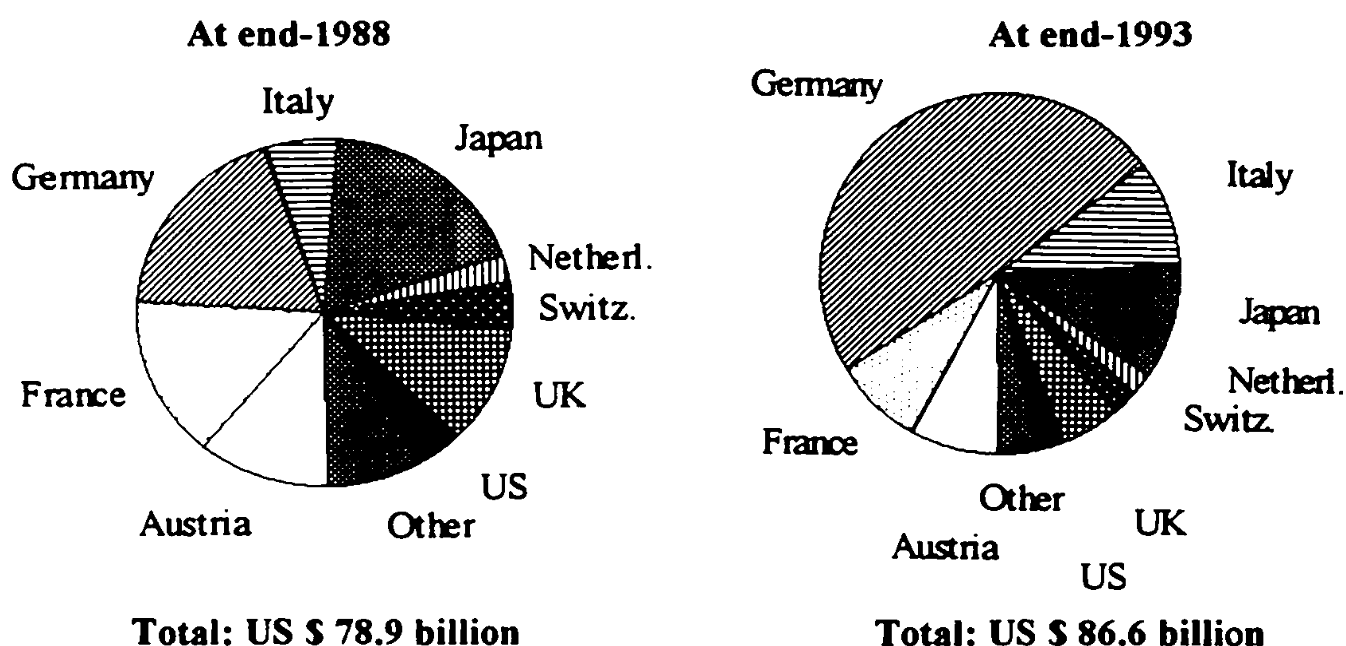
As can be seen from graph 3, the coverage of both series for countries in Eastern Europe is very similar. Because the semi-annual data is more burdensome to collect, the publication tends to lag about 2 months behind the publication of the quarterly data, but it makes up for this by providing details on the *maturity* and the *sector* of lending.

Since data in the BIS semi-annual statistical reporting system is reported to the BIS largely on a consolidated basis, it also conveys an accurate picture of the *nationality* of banks with claims on the area and thus of the assumption of credit risk by nationality of ownership (Graph 4).

Graph 4: Share of claims vis-à-vis Eastern Europe by banks' nationality



The five years between 1988 and 1993 showed strong shifts in the composition of creditors, with German and Italian banks increasing their exposure (partly due to increased coverage, as explained above). In December 1994, the three major creditors to the countries of the region were German (49%), Italian (9%) and Austrian (8%) banks, while banks from other countries had curtailed their lending. A comparison of Graph 4 with Graph 2 reveals that in 1993 a large part of the lending to central and eastern European countries from banks in the United Kingdom was actually accounted for by foreign banks operating in the U.K.

The *sectoral* distribution of lending as at end-June 1995 is shown in graph 5 in percentage shares. While in 1988 there had been no direct claims on the non-bank private sector apart from small amounts registered for the former Yugoslavia (not shown), the private sector is now beginning to be represented in lending, although most lending to that sector is still channelled via local banks which then on-lend to local entities. In the Czech Republic and in Poland the private sector currently

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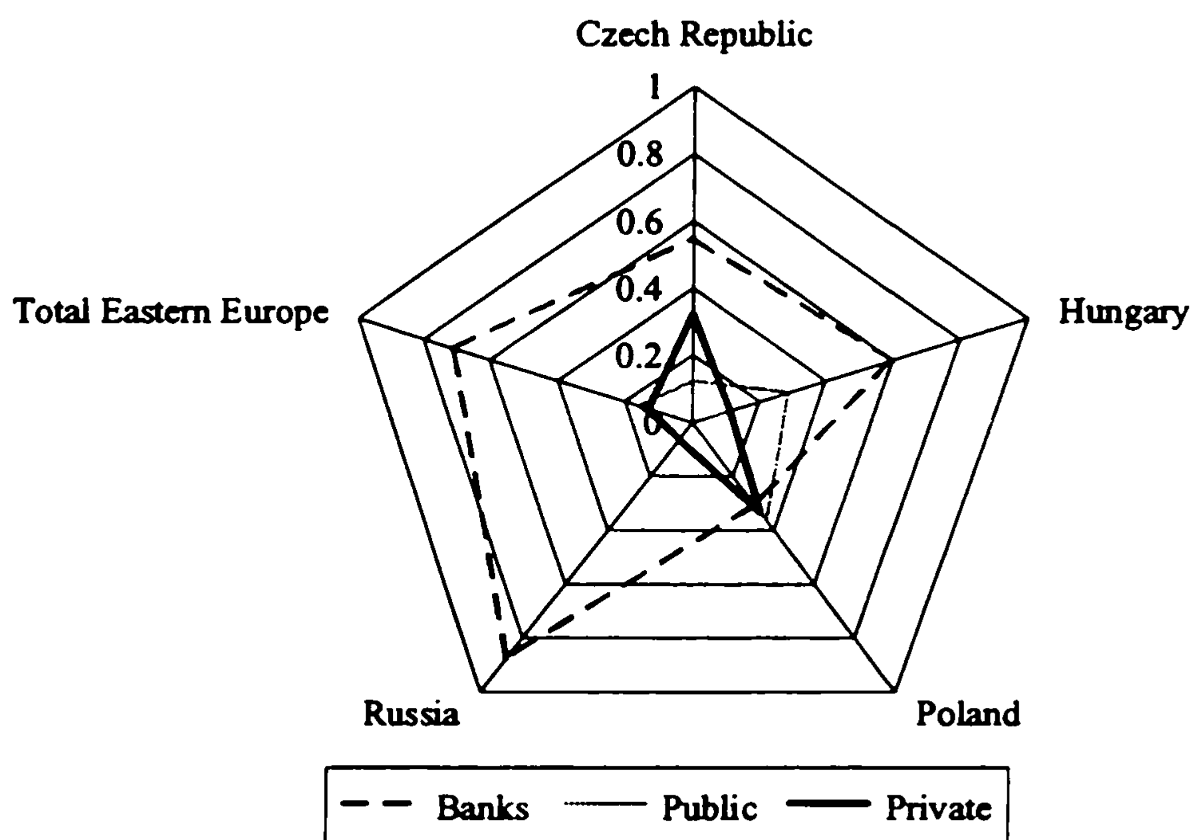
takes up 40% of lending directly, indicative of dynamic private sector development in these two countries.

The maturity distribution of claims on the region has remained largely unchanged over the years, with the proportion of short-term claims (i.e. those with a remaining maturity of less than one year) fluctuating between 30 and 40% of total borrowing. This was due to the large weight of the former Soviet Union in total lending to the region. In cases where arrears of interest and principal accumulated, the proportion of short-term lending could reach spectacular heights, such as 67% in the case of Bulgaria before its restructuring at the end of 1994, when its commercial bank debt was halved and the proportion of short-term claims fell to 24%.

Graph 5: The sectoral distribution of claims vis-à-vis eastern European countries, at end-December 1994, percentage shares



6. *International bonds issued by entities in Eastern Europe*

The BIS also publishes quarterly data on *net issues and amounts outstanding* of international bonds and Euro-notes, which is difficult to obtain elsewhere. This is based on data from the Bank of England, the International Securities Market Association (ISMA) and Euroclear. The BIS data is published one month after the end of the period reported on.

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Hungary and the Czech Republic, the two countries which were issuing international bonds already in 1988 have managed to maintain this additional source of credit. Hungary preferred to use the international bond market for all of its substantial borrowing in 1993, while it further reduced loans from banks (Table 1 and 2).

Table 3: Net international bond issues by entities in Eastern Europe, US $ billion

Countries	1988	1989	1990	1991	1992	1993	1994	Jun.95
Hungary	0.8	0.9	0.9	1.1	0.8	3.7	2.4	0.6
Czech Republic	0.1	0.0	0.4	0.3	0.0	0.6	0.3	0.1
Total	**0.9**	**0.9**	**1.4**	**1.4**	**0.8**	**4.3**	**2.7**	**0.7**

7. *Conclusion*

The BIS data is not intended as a measure of countries' external debt and should not be understood as such. However, it does provide timely, comprehensive and reliable data on two important building blocks of external debt: commercial bank and securities lending. In these sectors, it provides analysts with data for countries where domestic data sources may not be able yet to supply the data to the extent to which it is available from the BIS[2]. The international banking statistics indicate that cross-border capital transactions of private nonbanks often are considerably larger than the amounts reported in national balance of payments statements. If due consideration is made for the inclusion of securities holdings in the published banking data, the banking data can improve the quality of balance of payments statistics for many countries[3]. While this paper has provided a short overview of the types of BIS data available and their relationship to one another, more detailed information can be found in recent statistical publications of the BIS[4].

[2] The BIS statistics are published every quarter in "International Banking and Financial market Developments".

[3] "Report on the Measurement of International Capital Flows", International Monetary Fund, Washington, September 1992.

[4] "Guide to the BIS Statistics on International Banking", Bank for International Settlements, Basle, April 1995.
"The BIS Statistics on International Banking and Financial Market Activity", Bank for International Settlements, Basle, August 1995.

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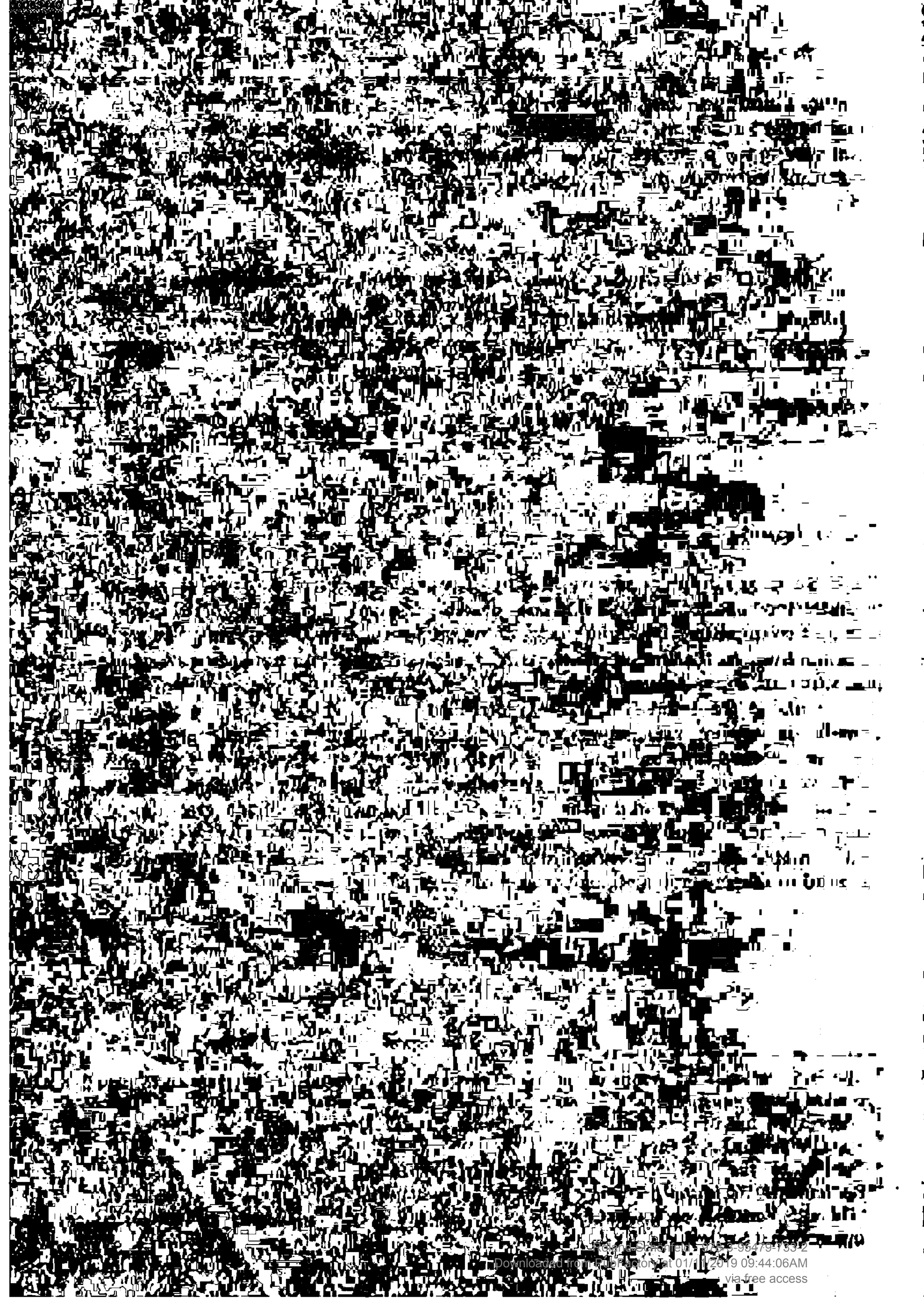

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JAN WINIECKI

The Applicability of Standard Reform Packages to Eastern Europe

1. Introduction

With the collapse of communism in East-Central Europe in 1989 and in the former Soviet Union in 1991 the 'Washington twins' found themselves in an unprecedented situation. A large group of countries whose economic system differed sharply from capitalist market system (even a distorted one - see below) found itself in need of a stabilization *cum* liberalization, both necessary given the disequilibrated and distortion-ridden state of these economies and their centrally-managed nature. Simultaneous need for a measure of financial support brought IMF and IBRD into the picture.

To this challenging task these institutions, in spite of their intellectual potential, were not particularly well prepared. Not a few reports on those Soviet-type economies (STEs) that joined these institutions before 1989 revealed deep misunderstanding of the characteristic features of the economic system in question. Articles and papers on STEs by analysts from IMF/IBRD written in the 1980s reinforce this author's assessment.

Lack of any deeper knowledge of STEs reinforced the instinctively preferred standard reform package. Standardization has been based on the otherwise reasonable principle that economic rules of the game are universally applicable. After all, as Mancur Olson once remarked at a Kiel Week conference, 'water always flows downstream, rather than upstream, regardless of political or economic system'.

However, outcomes are not necessarily identical or even similar under differing institutional conditions and inherited behavioural traits. This is exactly what in many respects protagonists of standard stabilization and liberalization packages faced in post-STEs in question. Thus, without in any way questioning the need for a stabilization and liberalization programme for an economy shifting from socialist, centrally-managed to capitalist, market-driven economy, its particular components need not have matched one for one those applied elsewhere. And even if they did, effects of their application need not have been the same - with implications not only for economic policy but also for political feasibility of the transition process.

It is a contention of the present writer that numerous problems of application of the standard reform package came from their being invented and modified with market economies in mind. There is, however, a difference between a market economy, even a heavily distorted one such as in many less developed countries (LDCs), and an economy without markets. Thus, although post-STEs at the start of transition were closer to distorted LDCs, they were distorted to a much larger extent or not always in an identical manner. Therefrom stemmed numerous surprises, often unpleasant ones, that affected policy making and transition process itself.

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The following parts of the paper deal with various components of a standard package largely, albeit not exclusively, in the light of the then available knowledge on Soviet-type economies. Not exclusively, because some components of the package have already been criticised when applied to LDCs in need of opening up toward the world economy.

2. *Output and Prices in Early Transition*

This and next section of the paper largely follow Winiecki [1993a]. As stressed there, expected changes in output as a result of stabilization programmes were to be small, in accordance with theoretical considerations of protagonists of the 'heterodox' stabilization approach. Some empirical investigations correlated this assessment by stressing that, in actual fact, output might even slightly increase (although for theoretically rather dubious reasons [see Kiguel and Liviatan, 1992, on output growth based on programme's low credibility]). However, a more thorough investigation into the nature of the STE regime and the impact of its legacy upon transition suggests a radically different outcome.

In the opinion of the present writer [expressed already on many occasions, see Winiecki, 1990b, 1990c, 1991a, 1991e, 1992c] one should expect a very large decrease in output at the early stage of the transition process. These expectations are based on both the knowledge of distorted macro- and microeconomics and that of distorted output structure.

To begin with the former, one would at first approximation expect a fall in output registered only by offcial statistics. A paper presented at a symposium attended by those who often dealt with the Soviet-type (centrally-managed) economy detailed considerations of the phenomenon in question are perhaps unnecessary. Therefore I signal only the types of output existing only on paper that must have disappeared already in the early transition.

The first and simplest were *write-ins* (the russian term is *pripiski*). There was a very long tradition in STEs of reporting higher output than the one actually produced. The second were hidden manipulations of output structure registered as output growth but actually increasing prices only [there is an extensive Sovietological literature on the subject]. One should expect these ways of doctoring reports on output to disappear with the shift from an economic system where firms are paid by what they tell to the one where they are paid by what they sell.

However, even more important as a determinant of an expected steep fall in aggregate output is output that did exist in reality but would not have existed in a less wasteful economic system. It is output resulting from microeconomic realities of the STE regime known as economics of shortage [for the best exposition of shortage phenomenon, see Kornai, 1979, 1980; see also e.g. Birman,1983].

The STE regime was known for decades to have been plagued by persistent shortages. Therefore economic agents adjusted to that systemic reality in ways that were microeconomically rational, even if macroeconomically wasteful. Especially state enterprises, with their soft budget constraint, i.e. non-binding financial outcomes [see Kornai, 1980 and 1986], consistently demanded from their superiors and/or

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purchased wherever possible larger quantities of inputs (as well as capital goods) than would have been necessary elsewhere.

The outcome of such behaviour of state enterprises (SOEs) in STEs were input inventories that were very much higher than those of enterprises in capitalist market economies. According to Shmelev and Popov [1989] inventories-to-GDP ratio was in mid-1980s in the USSR 2.5 times higher than in the United States. Various estimates put inventories in STEs within 60-80% of GDP range. Some such estimates on selected East European STEs are presented in Table 1. They are largely estimates owing to the fact that data on GDP (in contrast to offcial net material product, NMP) have not always been available (other statistics often also needed recalculation).

TABLE 1

SHARE OF INVENTORIES IN GDP IN SELECTED STES, ESTIMATES IN %

Country	**Year**	**Share**
Czechoslovakia	1977	70.6
	1984	72.6
Hungary	1982	81.0
	1988	69.0
Poland	1973	57.8a
	1985	51.4a
USSR	1985	79.0

a Without animal stock in agriculture
Sources: Estimates based on national statistical yearbooks; for USSR corrected estimates from Shmelev and Popov, 1989.

Now, with the fundamental realignment of supply/demand relationship expected under the impact of stabilization programme and product price liberalization, suppliers would be forced to search for customers rather than *vice versa* (as in the STE past). Customers would expect better supply discipline (timely delivery, higher and/or less variable quality, etc.) and, consequently would not see the need for maintaining such high level of inventories. Their decision would be all the more incentivised to behave in that manner as the shift to market-based regime would simultaneously tighten SOEs' soft budget constraint, making high inventories a real financial burden.

Given the enormous size of excessive inventories, even partial downward adjustment of inventories-to-GDP ratio at the early stage of transition should result in a substantial cut in orders for new inputs. Old inventories would be drawn down and one-off reduction in industrial output would occur.

It should be noted, however, that not only SOEs but also households carried larqer inventories under the STE regime (even if their budget constraint was definitely stronger). Thus, households, adjusting to shortages, made, e.g., larger food

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purchases then required by their current needs because they did not know when they would be able to buy the next batch. A lot of that food was subsequently spoiled [on adjustment in this respect see E.D.Winiecki & J.Winiecki, 1990). With the disappearance of shortages after price liberalization, excessive precautionary purchases should be expected to disappear as well. The adjustment of households would quickly translate into lower purchases and lower orders by the retail trade sector also contributing to the fall in industrial output.

But output demanded for higher than elsewhere inventories is not the only one expected to disappear during the transition. STEs were also known to specialists in the area for their excessive level of investment. For one per cent of economic growth they throughout their existence neeeded about two percent of growth in investment, a ratio unprecedented in economic history (for selected contemporary comparisons, see Table 2).

A substantial part of these excessive investments stemmed from the same high degree of uncertainty under the STE regime that made SOEs to persistently run excessive inventories. In consequence, state enterprises became conglomerates of sort, establishing various technologically unrelated divisions (constrution, machinery maintenance, instruments, transport, etc.) because it was safer - even if much costlier - to ensure that various renovations, repairs and other activities unrelated to given SOE's production profile are implemented in-house.

TABLE 2

GROSS FIXED CAPITAL INVESTMENT TO-GDP: GROWTH RATES' RATIOS OVER 30 YEARS PERIOD (1950-1979) IN EAST EUROPEAN STES AND SELECTED MARKET ECONOMIES

STEs	**Ratio**	**Market Economies**	**Ratio**
Bulgaria	2.04	Canada	0.95
Czechoslovakia	1.66	Finland	1.01
East Germany	2.26	Greece	1.15
Hungary	2.43	Italy	0.97
Poland	2.35	Netherlands	1.11
Romania	1.95	Sweden	1.13
Soviet Union	1.62	German FRG	1.17
Average (unweighted)	**2.04**	**Average (unweighted)**	**1.07**

Source: Pryor [1985]

One should expect that increasing reliability of supplies after the beginning of transition, imposed by market discipline, results in decline in demand for, say, metal working machinery (for repair workshops of non-machinery producing enterprises), for construction equipment (for construction divisions of non-construction firms), for lorries, vans, and pick-ups (for all producers that used to fetch up undelivered inputs from unreliable suppliers), or for buses (bringing employees from

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distant towns and villages under the pervasive conditions of excess demand for labour). The reversal of the despecialization process thus generates a fall in demand for and, in turn, output of capital goods. The reduction of demand for capital goods will be of a permanent nature.

For the above-mentioned reasons, industrial output would be expected to experience a very substantial fall. The foregoing overview of determinants of this fall in output of intermediate products, as well as final (investment and consumer) products is based on the widely accessible knowledge found in the literature on the STE regime.

The foregoing expectations of a substantial fall in output and, in consequence, of the shrinkage of the industrial sector, could be formulated on yet another basis. The present writer, together with his wife, wrote a series of articles [J.Winiecki, 1986c, 1987 and 1988b; E.D.Winiecki and J.Winiecki, 1987; E.D.Winiecki, 1987 and 1991] on underspecialization of STEs and resultant distortions of their GDP, output and employment structures. The authors in question stressed the oversized industrial sector that was 1/4 to 1/3 larger than in capitalist market economies at comparable levels of development (see Table 3).

TABLE 3

ACTUAL AND EXPECTED SHARES OF INDUSTRY IN SOVIET TYPE ECONOMIES IN GDP AND EMPLOYMENT IN %

	Share in GDP [a]		**Share in Employment**	
	Actual	**Expected**	**Actual**	**Expected**
Bulgaria	63	38	38	31
Czechoslovakia	71	39	48	35
East Germany (DDR)	69	40	50	37
Hungary	59	39	52	32
Poland	64	41	39	33
Romania	50	40	34	29
USSR	62	40	54[b]	31
Average (unweighted)	**63**	**40**	**44**	**33**

[a] Actual shares of industry in GDP are distorted upward due to non-market relative prices in STEs.
[b] Data in STEs were generally unreliable. In this particular case *glasnost* revealed that about 4 million employees in military industry were not counted in national statistics (fact not known at the time of making calculations). Thus, the actual share of industry in USSR has been higher.
Source: J.Winiecki [1988].

The oversized industry was not in any way an indicator of strength but rather the reverse. State enterprises strived for extremely costly self sufficiency at the enterprise level (see above). Simultaneously official development strategy was based on

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also costly import substitution at the STE level. One of the consequences ot these two mutually reinforcing factors was an inflated share of industry and, within it, of so-called, modern, 'progressive' industries going hand-in-hand with low quality, obsolete products manufactured at a high cost by these pseudo-modern inflated industries.

Both changed incentives at the micro level at the start of stabilization *cum* liberalization and simultaneous opening up of the economy at the macro level suggest that oversized industry will be forced to shrink. The most affected will obviously be heavy industries whose shares by far exceeded the same industries in non-STE countries at similar development levels. In other words one would expect industrial structures in post-STEs in transition to begin to resemble more the same structures in Spain, Greece or Ireland rather than those of Germany, the United States or Japan as they did in the past.

In post-STEs in transition one would expect some other developments that might permanently reduce industrial output. Thus, since real transition to the market is inconceivable without preceding political transition to the democracy [see Winiecki, 1990a and 1992b], one would also expect the permanent reduction in military expenditures. These, in turn, would entail reduced orders for military equipment and, again, reduced industrial output. It should also be noted that reduced investment demand and reduced level of military expenditures would be expected to affect any given post-STE in transition also indirectly through foreign trade effects of similar changes in other post-STEs.

The neglect of knowledge of the STE regime and its legacy's impact upon transition is also present in the case of expectations concerning the behaviour of prices. Here, the problem stems from wrongly applied generalizations based on experience of liberalizing LDCs. Again, price distortions in STEs, apart from being larger, were also partly different in structure.

Let us start with the stylized facts of price behaviour within the framework of stabilization *cum* liberalization in LDCs. Before the beginning of the process relative prices in a given LDC show a characteristic pattern: prices of non-tradeables tend to be high *vis-a-vis* those of tradeables. Price controls usually affect some non-tradeables, such as e.g. price of eletricity (a subsidy to domestic industry, especially heavy industry), but most non-tradeables are priced at the market-clearing level. And this level is based on the lack of foreign competition and their low price elasticity.

The same cannot be said about the tradeable sector. Existing pattern of tariff and non-tariff barriers (both export controls and import restrictions) makes some exportables, especially traditional ones (agricultural products and minerals) too cheap. Often the same applies to manufactures as a range of subsidies reduces their costs to producers and result in lower domestic prices than those obtainable abroad under more realistic exchange rates. In any case, even with extensive (although usually erratic) protection of import-competing industries, the tradeable sector is not in such a comfortable position as the non-tradeable one. Therefore it tends to be too small.

One of the aims of internal and external liberalization is to increase the former sector by generating a shift of resources from the non tradeable to the tradeable

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sector (although no less important is the internal restructuring of the tradeable sector in favour of exportables and away from strongly protected import-competing industries). This aim is usually achieved by simultaneous freeing of domestic prices of most goods and devaluing domestic currency. The latter measure is combined with the elimination of export and import controls and reduction, as well as uniformization, of import tariffs. Such measures are rarely undertaken in favourable conditions. Usually they take place under pressure of strong internal and external disequilibria, high inflation and growing balance-of-payment deficit. Therefore price liberalization initially adds to the existing inflationary pressures, while devaluation tends to be large.

The price adjustment in LDCs is rather fast as domestic prices of exportables rise to the (relatively well known) world market levels, while prices of importables and import-competing goods now also reflect world market prices plus whatever level of protection (more uniform than in the past) has been accorded to domestic producers of the latter. In consequence, the period of rapid price increase is relatively short because world market prices for agricultural produce and manufactures are relatively quickly established. The foregoing changes usually generate also a desired shift of resources to the tradeable sector owing to the change in relative prices in favour of tradeables.

However, the price adjustment process outlined above is not, in the opinion of the present writer, replicable in full in post-STEs in transition. To begin with, price structures in LDCs and STEs differ drastically. In contrast with relative prices in LDCs, prices of non-tradeables in STEs were drastically lower than those of tradeables, as could easily be seen from all international comparisons of production and consumption such as those conducted by Summers and Heston [1988] and from various quantitative Sovietological studies [for a useful overview, see Marer, 1985].

The reverse relative price pattern would suggest somewhat different and more complicated behaviour of prices after the start of transition. Since prices of most of tradeables were also below the world market level (although the pattern here was much more complicated), the initial freeing of prices would result, as elsewhere, in their rapid price increase to world market levels. However, the price adjustment process would last longer at least for two reasons.

First, suppliers of various private and public services would encounter more difficulties in establishing a 'world market price' for, say, rent for an apartment in a publicly owned apartment house (usually hideous and unbelieveably low quality [see E.D.Winiecki and J.Winiecki, 1990]) or even what is a 'world market price' of, e.g., a visit to a barber or other personal services (to say nothing about much more complex bussines services that were then few and far between). Therefore, the process of finding equilibrium prices for services would naturally last longer.

Second reason is that in STEs prices of services were often ridiculously low and new governments would be reluctant to increase them by a factor of ten or twenty at one stroke of a pen. Thus, in order to moderate the shock, prices of many services would be expected to remain controlled and the market-clearing levels would most probably be reached in stages. This is, *nota bene*, what has been happening everywhere with respect to prices of electricity, heating, rent, public transport, etc. With governments' intentions in this respect well known already at the start, one could

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safely predict that these periodic price increases would fuel inflation in terms of years rather than months.

The different relative prices of tradeables and non-tradeables do not exhaust the list of basic differences between LDCs and STEs that have serious implications for price adjustment after the start of transition. Another radical difference is that in STEs the tradeable sector was everywhere too large, not too small (as in LDCs). Apart from the oversized industry, agriculture was in most countries too large as well. The tradeable sector was too large *vis-a-vis* the non-tradeable sector, especially services.

Again, one should expect that persistent and growing discrepancy between supply and (rapidly growing) demand for services in STEs will influence price developments after liberalization. Quite obviously pricing policies of service firms would be more agressive under rapidly growing demand than under stagnant one. Therefore, services' contribution to price increases would be both higher and more lasting. Altogether, prices should be expected to behave differently. After the initial burst of inflation, largely due to the price adjustment of tradeables, they should be expected on the whole to grow for a longer period and at a higher rate than under similar stabilization *cum* liberalization in LDCs.

3. Macroeconomic Policy Implications

Of the two arms of macroeconomic policy it is monetary policy that, in the opinion of the present writer, should undergo more modifications when knowledge of the Soviet economic system has been taken into account. To give justice to protagonists of 'heterodox' stabilization and IMF analysts, some knowledge of the STE regime was indeed applied in the programmes devised for East European post-STEs. Architects of the 'heterodox' stabilization programmes absorbed the most general lesson that state enterprises in STEs display 'soft' budget constraint and therefore credit to SOEs should be controlled through central bank's control over the quantity of credit [see, e.g., Fischer and Gelb,1991]. This, however, was not enough to reduce an adverse impact of large SOEs' behaviour under monetary restraint on the economy as a whole.

But before this author restates his considerations on this point, he sees first of all the need for drawing readers' attention to an even more general - and fateful - question. Namely, if economic policy-makers should expect a very large output fall at the outset (as explained in the earlier part of Section 2), with its obvious deflationary implications, what influence should it have on monetary policy, more precisely on the extent and length of monetary restraint?

There are good reasons to recommend monetary restraint at the start of transition from STE to a capitalist market system. Hyperinflation, as in Poland and former Yugoslavia, was an obvious reason. The existence of a monetary overhang (forced savings of the population) was usually added as another reason for monetary restraint. Some authors added a more generel reason for monetary restraint: the need to send a strong signal to the enterprise sector that the era of persistent excess

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demand and sellers' market is over [for the present writer, see Winiecki, 1990b and 1991d], i.e. building up the credibility of the transition programme.

Expected steep fall in output implies, i.a., a fall in aggregate profits (that was delayed for other reasons) and in aggregate wages. The former limits own resources for investment, the latter - for consumption. Thus, by itself it strongly restrains demand. A question ought to be raised to what extent monetary policy should add to the expected restraint by raising the cost of money (increasing interest rate) and limiting its availability also by other means (credit limits for commercial banks). There are no facile answers to that question; nor are there any rules of thumb than could be invoked for the very unusual occasion of a shift from one economic system to another. But what bothers this author is the fact that, owing to the ignored system-specific consequences of transition for output behaviour, the question was simply absent from IMF staff considerations, as well as from those of post-STE economic policy-makers.

It is at this point that the present writer returns to the issue only implied at the beginning of this section, that is the need for supplementing traditional instruments of monetary policy with various prop-ups reflecting different ownership structure of the enterprise sector in post-STEs in transition. The architects of the 'heterodox' stabilization programmes drew only one conclusion, namely that SOEs' 'have autonomy without responsibility' [Fischer and Gelb,1991] and therefore concluded that their access to credit should be controlled through central bank's credit limits.

This is, however, only a part of the story that should be taken into account. It has been known from numerous empirical studies done in various STEs since the 1960s that efficiency of state enterprises was negatively correlated with their size. The larger the enterprise was and the more showered with privileges (easier access to subsidies, credits, foreign exchange), the less efficient it really was. The consequences of the above should not be underestimated.

Post-STEs entered the transition with what this author calls 'nobody's' banks and 'nobody's' enterprises. The former did not care for the price of money, while the latter did not look at creditworthiness of their clients and riskiness of submitted projects. This situation, in combination with the earlier stressed bad performance of wasteful giants, called for more sophisticated approach than traditional prop-up in the form of credit limits by the central bank.

Under the circumstances the very real threat was that wasteful giants, thanks to simple inertia in bank-client relationship, would continue to receive the lion share of loans within the credit limits imposed by the central bank. In this they would be supported by the old nomenklatura linkages (between state banks' and SOEs' managers). The outcome of the above would be that under the initial monetary restraint largest - and worst - enterprises will receive as much as they used to get in real terms, which under monetary restraint means a larger share of total credit. At the same time relatively better performing smaller state enterprises would get substantially less. An atypical form of crowding out would occur that must have an adverse impact upon the situation of better performers (quite a few of which could be pushed to the brink of bankruptcy) and, in consequence, upon the aggregate performance of the economy [on these issues, see Winiecki, 1991d and 1992a].

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To prevent the foregoing from happening, another type of a prop-up for monetary policy was needed [and proposed by this writer in a report for the Presidential Advisory Committee, Winiecki,1991 b]. There should be a credit limit that freezes the share of large enterprises, according to some accepted definition, to what it was in, say, the last two-three years before the start of the transition. In fact, it would be even better to reduce that share below the old one - and keep reducing it over time - to make room for credit expansion for the growing private sector (a politically difficult step).

Another consideration affecting monetary policy decisions is that of the nature of expected greater persistence of inflation after its initial outburst due to price liberalization at the start of transition. We know already from the preceding section that these price increases come to a large degree from the service sector, where price elasticity of demand is low or, in some cases such as, e.g., electricity or heating costs, non-existent in the short to medium run. This being the case, monetary restraint applied to squeeze the persistent inflation will affect price setting in the service sector to a limited extent only. On the other hand, it will adversely affect output in the goods producing sector by making money dearer.

The present writer approaches his last comment on the impact of the legacy of STE regime on monetary policy with some hesitation. In contrast with well established empirical base for his earlier comments, it is only rough calculations that underpin this one. As stressed in Section 2, SOEs displayed very much higher inventories-to-output ratios. However, when all working capital is taken into account, not only inventories, this ratio (roughly calculated) tends to be significantly lower than in Western enterprises. It follows that SOEs must have very much lower money holdings and other relatively liquid financial assets (in fact they did not have any financial assets at all!)

If this is indeed the case, then it implies stronger enterprises' sensitivity to changes in monetary policy than in the case of Western firms. If is, in the opinion of the present writer, yet another argument in favour of cautious, measured changes in monetary policy, and against large swings in policy stance that may overly influence SOEs' behaviour in both directions: expansion and contraction. I used the term 'yet another' argument because everything that has been written so far in this section about the expected impact of various STE legacies on monetary policy outcomes suggests the same. Measured restraint at the start, coupled with rather stable money supply after the initial burst of inflafion, avoidance of large swings in interest rate (as, e.g., in Poland in summer 1990/summer 1991 period) would seem to serve post-STEs in transition better than any alternative.

There are definitely fewer conclusions that could be drawn with respect to the impact of STE legacy on fiscal policy. One such source of impact has already been implied in the analysis of sources of output fall at the start of transition. Large inventories of inputs not only influence demand for new inputs but also influence profitability since they were acquired at low, controlled prices and are used in outputs sold at high, liberalized prices. Windfall profits thus obtained should be expected to boost tax revenues and support efforts at balancing the budget. Balancing the budget right from the start should become easier as a result. Furthermore, since it would be easier to do so at the early stage, a modified approach could be

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taken to cutting the subsidies. They would not need to be cut right from the start to such a great extent because taxes on SOEs' profits would support budgetary revenues at that stage but deeper cuts could be left for a later period, a second year of transition, when SOEs' windfall profits would not boost budgetary revenues any more.

Still on the revenue side a general warning should suffice. SOEs had for decades practised various ways of avoidance of central controls. This applied also to their ab-ility to increase employees private and enterprise-wide 'public' consumption at the expense of profits. One could predict with a high degree of probability that they would carry over these skills to the new economic regime. Therefore, enterprise profits should not be seen in the longer run as a reliable source of budgetary revenues.

4. Economics and Political Economy of Wage Controls

A linchpin of a standard, 'heterogenous' stabilization programme recommended by IMF has been for some time various methods of wage controls. This has been one of the so-called 'nominal anchors' of the said programme. Its presence there has been maintained in spite of the neoclassical criticism that a system cannot have but one fixed nominal value; otherwise the system cannot well reach stable equilibrium [see, e.g., Claassen, 1991, and Meltzer, 1992]. Even more interestingly, it has been maintained in spite of an assessment of its low level of effciency even by some of its intellectual fathers [see Dornbusch, Sturzenegger, Wolf, 1990].

What matters here, however, is its applicabilty to a particular group of countries. Countries, let it be noted, with a share of the state enterprise sector (including *quasi*-cooperative sector) approaching in the limit 100%. It is this factor that, although self-evident, has not been taken properly into account in this particular context.

In the West, where the public enterprise sector reaches at most 10-15% of the aggregate output, or in LDCs, where it is larger but still contributes a smaller part of the aggregate output, efficiency of wage controls has been regarded as low but still, as we have seen, recommeded. In the opinion of the present writer, there has been even less reason to expect positive effects in economies, where state ownership approaches 100%.

In private enterprise wage limit may reinforce manager or owner manager resolve to resist workforce wage demands. Thus, it strengthens the will to limit cost increase that is already there. In a post-STE state enterprise there is little, if anything, to strengthen in the first place. For decades under the STE regime managers learned to play on the same side in the team - with the workers and against the state (see Kornai,1980]. This attitude has changed little under the transition because the position of managers has not been very clear and their structure of incentives has not been compatible with that of an owner, that is the state.

Therefore the easiest way for managers has been to play the generous but helpless uncle and say that they, of course, would accept wage increase but it is the government that says 'no'. In consequence, in post-STEs in transition the microeconomic

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conflict over wages has been politicized. The government becomes a party to every conflict in the state enterprise sector, and a much larger one at that. A politicization takes place over a much wider spectrum than elsewhere. There is of course a difference across countries, with more intense conflicts in countries with stronger tradition of workers' militancy (comparison of Poland and the Czech Republic is very pertinent here). But the striking difference between post-STEs in transition and economies with the dominant or at least larger private sector is the intensity of political conflict over wages.

Economic disadvantages of wage controls are well known, and stressed already in the context of post-STEs in transition [see the draft of a first transition programme in Eastern Europe, Beksiak et al., 1989, Beksiak and Winiecki, 1990; Winiecki, 1990a, Walters, 1991]. They slow down the microeconomic restructuring of firms. This serious loss should be weighed against the short-run (or even purely potential) gains in faster slowing down the price rise after initial price liberalization.

There is, however, an even more important loss in political Economy terms [see, for example, Winiecki,1993b]. Balcerowicz [1993] points to the existence of what he calls a period of 'extraordinary politics' following major historical discontinuities (this is an interpretation of an earlier Olson's [1982] view on discontinuities as a source of an improved performance). During such periods the level of readiness of society to accept far reaching economic changes, often painful ones, increases sharply. Over time 'reform fatigue' [Bruno,1992] sets in and that readiness declines.

Seen in those political economy terms, wage controls commit a major sin. First, the particularly high intensity of conflict over state controlled wages reduces political capital. Worse still, political capital of a transition-oriented government tends to dissipate at a faster rate than under wage liberalization alternative.

Second, wage controls shift politically difficult and painful measures such as bankruptcies to a later period of ordinary politics, where there is much more 'reform fatigue' and much less willingness to accept such measures. Therefore, traditional approach advocated by free marketeers is defnitely preferable in the case of post-STEs in transition.

In the counterfactual scenario (since wage controls were accepted everywhere) state enterprises are allowed to price themselves out of the market as a result of wage increases granted to employees, a dreaded outcome for all do-gooders believing in the absolute necessity of a nanny of some sort. Free marketeers assumed that one or two dozens or even a few more, large SOEs might really get bankrupt. Compared to a much larger number that have to be closed anyway due to their fundamental unviability, it is not anything particularly out of proportions. But the spate of early bankruptcies would have a salutary effect on the whole transition process. The kind of credibility gained by the transition programme in this manner could not be matched by any other.

At that early stage, in the era of 'extraordinary politics' and readiness to accept painful measures at its peak, bankruptcies would have most probably been accepted by both the body politic and the general public. No strikes or demonstrations, if any, would engender a wholesale rescue operation. In the end other SOEs would learn a lesson whose implications were abundantly clear for all to see. Microeconomic adjustment would be speeded up. As the situation developed in reality,

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bankruptcies of large SOEs were avoided (as intended in the early stage and later became a rare thing (Hungary) or even next to non-existent one (elsewhere). In the end probably many more enterprises could be saved if the shock of a spate of bankruptcies galvanized many SOEs into action.

Compared to the foregoing major problem of standard package applied to post-STEs, other problems of employment and wages arising out of the neglected knowledge of the legacy of STE regime seem to be almost trivial in comparison. Sequence and nature of redundancies, as well as higher probability of acceptance of real wage reduction belong to these problems and they are considered in greater detail in Winiecki [1993a].

5. Outward Orientation, Exchange Rate Regime and Policy

An area where the legacy of the past has also been strongly underappreciated, is external trade, as well as exchange rate regime choice and policy making. A surprising element here has been somewhat different, though. Lack of understanding of the impact of STE regime on transition has been a fixed element of the picture, so to say. Here, however, the choice of foreign exchange regime and subsequent policies pursued by countries in transition (under the influence of 'Washington twins') neglected experience not only of post-STEs in transition but also earlier experience of liberalizing LDCs.

There is an important link between the shift toward outward orientation of an economy, no matter whether underdeveloped (LDC) or maldeveloped (STE), and the choice of an exchange rate regime and policy. An indispensable part of greater reliance on markets must be an outward orientation i.e. greater reliance on the world markets. This can only be achieved through a shift of resources (capital and labour) from non-tradeables to tradeables (in post-STEs only exportables, see below) and resultant higher exports/GDP ratio. But steady export expansion needs a relatively stable real exchange rate. And here the problems with the choice of a fixed (pegged) exchange rate regime, recommended by the IMF, begin.

Theoretical underpinnings of the problem in question are not well presented in textbooks on international economics but the crux of the matter is that benefits of opening up a previously inward-oriented economy are reaped in two phases. Phase one is rather short and associated with liberalization of both foreign trade and foreign exchange. Domestic producers realise that shifting some output from domestic to foreign markets brings higher profits. The result of phase one may be a rapid increase in exports from the existing production capacities. This is by and large what has happened also to post-STEs in transition soon after external liberalization. However, once liberalization reveals comparative advantages some goods become more profitable to produce and export on a more lasting basis. In consequence a shift of resources begins to take place toward these more profitable activities. The capacity of export-oriented sectors grows larger over time. Outward orientation becomes an ever better established reality. This is phase two of the strategy of outward orientation, where lasting export expansion is achieved.

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Let it be noted that a pattern of resource shifting in post-STEs is particularly complicated since under the STE regime the share of tradeables has been continuously too large rather than too small as in other countries undergoing stabilization *cum* liberalization [see Winiecki, 1988a]. Therefore the shift of resources takes place within the tradeable sector away from goods not saleable on the world markets and toward those that can be sold there.

But apart from additional complications, fixed (pegged) exchange rate regime comes into conflict with phase two of the opening up of post-STEs in transition. The use of pegging as an indispensable nominal 'anchor' of stabilization *cum* liberalization and an associated tendency of policy to use exchange rate as an anti-inflationary weapon [see Winiecki, 1992c] are inconsistent with maintaining relatively stable real exchange rate over time.

Sticking for too long to a given 'peg' results in progressive overvaluation and slows down the shift of resources to export-oriented sectors. The shift in question is predicated on the existence of a lasting higher profitability of producing and exporting some goods rather than producing other goods and selling them on the domestic market. With higher profitability being progressively eroded by overvaluation, shift of resources slows down or, in the limit, disappears (as exports become more than temporarily unprofitable). Export capacity ceases to grow. At the same time imports progressively cheaper put more than usual pressure on domestic producers. Other developments and policy errors apart, this is what might have happened in East Central Europe in the 1991-1993 period after the initial good export performance.

Of special interest, as stressed at the beginning of the section, is the fact that criticism of fixed (pegged) exchange rate regime as a part of the standard 'package' has been noted already before in the case of LDCs [see, i.a., Edwards, 1992, on Latin American experience].

Another interesting point related to the legacy of STE past concerns this time a feature of the standard package that reveals striking difference between post-STEs in transition and liberalizing LDCs, namely the need for a stabilization fund. Let us briefly recall stylized pattern of foreign trade behaviour after the start of stabilization *cum* liberalization.

Countries trying to shift from inward to outward orientation were usually faced with a dilemma. External liberalization brought about in its wake faster increase in imports than in exports, since exporters needed time to find their niches on the world market, while importers were only prevented from importing what they wanted by foreign exchange and trade controls. If foreign exchange reserves were small or growth of imports particularly fast, the whole programme became jeopardized. Policy-makers were in some cases forced to abandon currency convertibility and freer trade. Therefrom emerged the idea of a stabilization fund offered to a country undergoing such outward-oriented transition [see Krueger, 1980]. This idea was applied also to post-STEs.

However, a better knowledge of the STE regime would tell the architects of the 'heterodox' programme that whatever import increase would take place after the opening-up (such as the inflow of consumer goods that were long denied to STE households) would be countered by a substantial drop in traditional STE imports.

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Net effect of all these changes would be an import fall of both temporary and permanent nature.

Thus, the simultaneous regime change to the one where money begins to matter and a shift to restrictive macroeconomic policy force SOE managers to reassess both the rationale for extremely high input inventories and for preference of imported inputs over domestically produced ones. A reassessment should produce a sharp fall in import orders because an economically efficient choice for SOE managers is to draw on existing inventory of imported inputs rather than to keep them at an extremely costly high levels of the past. (This reasoning is, quite obviously, a part of larger reassessment discussed earlier in Section 2).

However, quite apart from one-off drop in import orders to reduce inventories of imported inputs down to (cost wise) manageable levels, one should also expect a permanent reduction of imports (at a given structure of output). The latter would come from different sources. First comes the disappearance of excess demand for investment and a reduced level of military expenditures. The author will not dwell upon these issues as they have already been analysed in Section 2. The only thing worth doing here is to note their impact upon imports. STEs were well known for their heavy use of imported parts and components in both consumer and producer goods. Imported high quality inputs were used to produce low quality outputs saleable only on domestic and other COMECON markets [see, i.e., Winiecki, 1984, 1985 and 1988a]. This applied also to capital goods and to goods for the military. With the demand for both reduced, demand for imported inputs to them would be permanently reduced.

Second, internal price liberalization coupled with initial devaluation of the generally overvalued exchange rate reveals a part of exports, based on costly inputs, that is unprofitable. In consequence, their exports and often their production will be discontinued. This applies as much to energy-intensive goods, once the heavy underpricing of energy inputs ceases, as to import-intensive goods. All this should result in a fall of the extremely high share of inputs in aggregate imports (a feature characteristic of STEs as seen from Table 4).

TABLE 4

IMPORT STRUCTURE OF SELECTED STES PERCENTAGE SHARES IN AGGREGATE IMPORTS

Country		**Inputs**	**Investment goods**	**Consumer goods**
Czechoslovakia	1973	67.1	13.8	12.6
	1987	68.4	12.6	15.4
Hungary	1983	67.5	16,5	16.1
	1989	61.6	18.1	20.4
Poland	1985	68.5	10.0	10.2
	1989	61,1	12.6	12.9

Sources: For Czechoslvakia and Hungary national statistical yearbooks; for Poland: Polski Handel Zagraniczny w 1991 r. Raport Roczny. (Polish Foreign Trade in 1991. Annual Report). Prepared by Foreign Trade Institute, Warsaw, 1992.

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This share usually fluctuated over time (approximately between 60 and 80%) depending on the position of a given STE in its investment cycle. With the expansionary phase of investment cycle the share of imported investment goods would rise and that of inputs would fall toward the lower limit of the range.

Thus, with imports strongly reduced at the start of transition, and with a part of that reduction made permanent, the pattern of trade after liberalization should be expected to differ from the one in liberalizing LDCs. Any surge in long desired imports would be more than compensated by a steep fall in imports typical for the STE regime. Consequently, there would be no need for any stabilization fund. The resources frozen for the purpose could with greater effect be used elsewhere in the transition process.

At the same time it should be kept in mind that some of the determinants of imports from the STE past will be influencing not only imports but also exports. Forgotten was the simultaneity of the transition process. As more than one country began shifting from Soviet-type to market-type economic system, simultanous stabilization programmes, coupled with internal and external liberalizations, created parallel output declines that affected imports from other ex-COMECON countries for the same reasons they affected domestic output.

Thus, imports of, say, Poland from Hungary or Hungary from Czechoslovakia were affected by the decumulation of input inventories, reduction of persistent excess investment demand and reduction in military expenditures. Quantity of goods imported by any country undergoing transition from other ex-COMECON countries will in each case be significantly reduced. It should be understood that transition changes the pattern of demand and only ex-COMECON countries not yet undergoing transition could be counted upon to import in accordance with the old STE pattern (as the former USSR did in 1990).

6. *Inventories: The Most Conspicuously Missing Component of Analysis*

This Section is again based on Winiecki [1993a]. Thus, it is stressed there that throughout the analysis pursued inventories of state enterprises under the STE regime figure prominently as a factor to be taken into account in most respect. However, this factor has been conspicuously missing from considerations. The omission has been all the more surprising since inventories' component plays a very important role in any analysis of business cycles in capitalist market economies. Nowhere is it as important as in predicions of changes in output.

Why then the omission? May be a survey among theorists and policy-makers would help to answer this interesting question. Without it the present writer offers two hypotheses. The first is that they (rightly) perceived that transition is something different from an ordinary business cycle. The second, that in no way excludes parallel presence of the first type of reasoning, is that they (wrongly) neglected the influence of legacy of the STE past upon the transition process.

And yet the level and structure of inventories inherited from STE past should be expected to influence transition in many direct and indirect ways - as already transpired from our earlier considerations. It directly affects the level of output and

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imports. It indirectly affects the level of employment. It makes some macroeconomic policy options, popular among those who reject rapid transition, completely irrelevant (so-called Keynesian reflation that becomes useless when there is no demand that can be restored without the return to Soviet-type economy with its attendant excessive input inventories, excessive investment and militarization).

It also affects indirectly macroeconomic policy outcomes within the framework of stabilization *cum* liberalization. The expected utilization of inputs that had been bought at low, controlled prices in outputs sold at high, liberalized prices implied the emergence of windfall profits. These windfall profits should be expected to have twofold impact. First, they should be seen as an opportunity for management not to adjust or postpone adjustment and as such they should be taken into account in government strategy (political economy impact). And, second, they would be expected to give temporary relief for the budget on the revenue side, as taxes on enterprise profits played such an important role in aggregate revenues of the budget. As they would allow to plan budget expenditures, e.g. change in subsidies, according to a different time schedule (see above, Section 4).

Altogether, inventories should be expected to play an extremely important role in considerations concerning transition. It is amazing that they did not. The stylized facts from the STE regime, i.e. high inventories of state enterprises were well known to everybody who had contact with these economies even at a fairly superficial level. The abnormally high ratios of inventories to output are well known (for some estimates, see Table 1 above). According to various sources the different structure of inventories, that is a much larger share of inputs in STE enterprises, makes these anomalies even larger. This structure is shown in Table 5.

TABLE 5

INPUT INVENTORIES TO OUTPUT INVENTORIES' RATIOS FOR SELECTED STES AND MARKET ECONOMIES IN MANUFACTURING (AVERAGE FOR 1981-1985 PERIOD)

STEs	Ratio	Market Economies	Ratio
Bulgaria	5.07	Austria	1.06
Czechoslovakia	3.07	German F.R.G.	0.71
Hungary	6.10	Japan	1.09
Poland	4.49	Portugal	1.66
USSR	3.16	United States	1.02
Average (Unweighted)	**4.38**	**Average (Unweighted)**	**1.11**

Source: Kornai, 1992

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7. *Stabilization cum Liberalization Programmes: A Restatement*

A review of Sections 2-6 reveals that the standard package offered by the IMF/World Bank clearly neglected most of the legacy of these countries past economic system. This omission meant that policies and particular policy measures taken within the framework of stabilization *cum* liberalization were sometimes expected to deliver outcomes that a better knowledge of the STE regime would regard as unattainable (such as expected low output losses after the start of transition). It also meant that a variety of policy measures were in need of modification as a result of taking into account this system-specific knowledge [see Winiecki,1993b].

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IVAN T. BEREND

The Self-regulating Market Model of Central and Eastern European Transformation and the Role of the International Financial Institutions

After a short period of confusion and ambiguity and, in several cases, coquetting with a "third road" approach of mixed economy and collective workers ownership, Central and Eastern Europe turned to a Western-type laissez faire road. The rapid marketization, liberalization of prices and import, a dramatic transformation of the ownership structure, in some cases with restitutions and "voucher-privatization," withdrawal of state activity and subsidies, opening the countries for a free competition were initiated according to the blueprint of a self-regulating free market economy. It is "an economic system controlled, regulated, and directed by markets alone," defined the model Karl Polanyi, and added: "No measures or policy must be countenanced that would influence the action of these markets... Only such policies and measures are in order which help to ensure the self-regulation of the market by creating conditions which made the market the only organizing power in the economic sphere."[1]

This model had a relatively short history from the end of the 18th century in Britain, followed by the core countries in Europe and later the United States. The model, however, was highly challenged in the 1920s and even more in the 1930s to the 1950s. Self-regulated market was, however, successfully restored after World War II by the United States and some of the core countries of Western Europe but was effectively applied only in a handful most advanced countries of the world.

The rapid market transformation was accompanied by a dramatic decline of industrial and agricultural output and Gross Domestic Product in all of the countries of the region between 20% to 50%. Unemployment jumped to 10-14%, standards of living declined and poverty hit large masses of the population. Although the economic turmoil was much more dramatic and harsh than predicted, and caused severe political backlash and the emergence of political dangers, several economists, political thinkers and most of the governments of the region are still convinced of the validity and applicability of the model of self-regulating market.

Rolf Dahrendorf's phrase, that "things get worse before they get better" and the people of Central and Eastern Europe have to march through the "Vale of Tears" to arrive market prosperity was often quoted. It means that there is an unavoidable negative side effect of market transformation, but it will pay a high profit after a while.

János Kornai, one of the best experts of the state socialist economy, shared this view when stated in December 1992:

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[1] Karl Polanyi, The Great Transformation. The political and economic origins of our time. Beacon Hill, Boston: Beacon Press. Fifth printing. 1964. pp. 68-69.

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> There were some factors, connected with international fluctuations, which contributed to the decline, but their role had a secondary importance. The primary explanation is the following: the severe decrease of production is a painful side effect of the healthy process of changing the system. Whereas several elements of the mechanism of economic decline seem on the surface to be similar to other cyclical phenomena and structural transformations of various types of economies, this is something rather different...its cause is the transition from socialism to capitalism...To end the decline one should not go backward, but forward, preserving the results of the transformation already achieved and accomplishing even faster the tasks still remaining.[2]

The "transformational recession," as Kornai called the economic decline in Central and Eastern Europe, has a multi-causal explanation. He speaks about six main factors of it: "Shift from a sellers' to a buyers' market; Contraction of investment; Shift in the composition, of output; Shift in the composition of foreign trade; Disruption of coordination; Enforcement of financial discipline."[3] In this interpretation even the "disruption of coordination" and "enforcement of financial discipline" are strong reasons for decline since once the command economy was abolished, a market could not automatically start to function because a coordination void developed. That was the main reason of the dramatic decline and economic chaos in Bulgaria and Albania, where the elimination of the old regime was not immediately followed by consistent reforms.

In Michael Mandelbaum's interpretation, the only question is time and patience. The editor of the important Makina Markets stated:

> The chances for...[an] ultimate success will depend...on how long and how consistently the policies can be sustained...Free markets will work...The harsh economic medicine will ultimately have the desired effect. So if the people of formerly communist Europe can endure the hardship that the policies of stabilization, liberalization, and institution building inflict, they will emerge at the other end...of the valley of tears, into the sunlight of Western freedom and prosperity.[4]

Transformation was undoubtedly accompanied by accidental events, such as the collapse of the Comecon market and a severe Western recession, and, indeed, itself has several negative side effects which all contributed to an unavoidable decline. Deeper analyzes, however, had not satisfied with the above argumentation and searched for further factors of decline. Several maintained that besides "transformational decline" and unfavorable international circumstances, the most important factors of economic disaster were severe policy mistakes.

Some analysts found the roots of mistakes in attempting to transform state socialist economies overnight. The first critics of shock treatment emerged in Poland.

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[2] János Kornai, *Magyar Hirlap*, December 24, 1992.

[3] Interview with János Kornai, "Anti-Depression Cure for Ailing Postcommunist Economies." *Transition. The Newsletter about Reforming Economies*. The World Bank. Vol. 4, No.1, February 1993. p. 2.

[4] Michael Mandelbaum's "Introduction" In: M.Mandelbaum and Sh.Islam (Eds.), *Making Markets. Economic Transformation in Eastern Europe and Post-Soviet States*. New York: Council on Foreign Relations Press. 1993. pp. 11,15.

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Tadeusz Kowalik the former Solidarity adviser argued that sharp decline was most of all a consequence of mistaken shock therapy: "To a certain degree this is a consequence of the collapse of trade with the USSR, but undoubtedly the main reason was an orthodox, and very rigid, austerity policy."[5] "It is clearly evident," added Andrzej Kozminski, "that continuation of the shock treatment policies enhances further cost driven inflation...and further reducing demand."[6]

The accusation of shock therapy, often heard in 1991 and early 1992, was, however, discontinued afterwards. It happened partly because severe economic decline characterized not only the countries which applied shock treatment but those of gradualist and even overcautious approach alike. Furthermore, the decline of income and output in Poland stopped in the summer of 1992, and growth followed. In 1993, Poland with a 5% growth rate was not only the only single country in Central and Eastern Europe which began to rise but was ranked first in growth in Europe and shock therapy was celebrated as the most efficient method and a real success.

A new doubt emerged in 1993, partly because an unstoppable decline continued in most of the region's countries, and, especially in the fall and winter of the year, as a consequence of the Polish election of September and the Russian political crisis, the revolt of the old parliament and the armed "solution" of the crisis, then, most of all, after the December election and the clear danger of mass dissatisfaction of the population with every fourth voters voted for the extreme right-wing, fascist-type Zhirinovsky's party.

The experts who denounced "fast transition" and maintained that capitalism was never "introduced" by a "Big Bang" gained ground. As Shafiqul Islam, the co-editor of the already quoted *Making Markets* suggested, a more "evolutionary model - a growth oriented, sector-sensitive, and...gradualist approach - [is needed which] has a much better chance at controlling inflation, promoting recovery, and putting the transitional economies on a sustainable path toward capitalism than the 'creationist model' being tried currently.[7]

Paul Marer sought to challenge the over all validity of celebrated shock treatment and reestablish the genuine concept of shock therapy as a cure of "large macroeconomic disequilibrium," which is required only in certain situations and certain countries, while in others "had no need for shock therapy."[8]

Michigan economist Thomas Weisskopf argued that "shock therapy is extremely unpopular...[and Russian government] would search far and wide for an alternative strategy of transition that would not impose such huge immediate costs on so many

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[5] Tadeusz Kowalik, *Creating Economic Foundation for Democracy*. (Manuscript, Los Angeles), 1992. p. 6.

[6] Andrzej K. Kozminski, "Transition from Planned to Market Economy: Hungary and Poland Compared." *Studies in Comparative Communism*. Vol.XXV. No.4. December 1992. p. 325.

[7] Shafiqul Islam, "Conclusion: Problems of Planning a Market Economy." In: Sh. Islam - M. Mandelbaum (Eds), *On.cit*. p. 211.

[8] Paul Marer, "Economic Transformation in Central and Eastern Europe." In: Sh. Islam - M. Mandelbaum (Eds), *Op.cit*. p. 78.

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people."[9] The Columbia University economist Padma Desai stated: "The IMF has to relax its insistence on rapid, sweeping market reforms...Russia must introduce, step by step, a package of feasible measures...The shock of sharp cutbacks...hasn't worked - and won't."[10]

American policy makers in a broad scope from Senator Bob Dole, Senate minority leader, to Vice President Al Gore openly criticized Western misunderstanding and pressure to carry on strict austerity measures and use shock treatment to force rapid transformation in Eastern Europe. Strobe Talbot, the designated second man in command in the Department of State urged "less shock and more therapy." Western media began to question too rapid transformation because of its social costs and political consequences.

There is, however, another school of thought which describe policy mistakes in a rather different way. They do not stop at the problem of timing and rapidity of transformation and go beyond accusing shock therapy. They see much more general and widespread policy mistakes in all of the countries of the region.

Richard Portes argued that there was a

> serious macro-economic policy error in both Poland and Czechoslovakia: initial excessive devaluation of the currency...A move to convertibility must be accompanied by a sensible exchange rate policy: do not devaluate excessively; peg initially: then go to a crawling peg. Some of the output loss...is due...to violation of one or more of those principles. The opening to trade with the West - with convertibility, low tariffs, and few quantitative restrictions - was too abrupt...many important industrial branches became vulnerable.[11]

The drastic deterioration of general economic conditions, Domenico Nuti observed, "is not [a] necessary concomitant of transition, nor a consequence of shock therapy..., but the unnecessary consequence of policy failures."[12] Nuti lists several policy failures, such as the dearth of liquidation and bankruptcy procedures, which had long encouraged firms to accumulate debt. He also criticized the lack of a "clear and coherent privatization program." But the primary focus of his criticism is regarding "the failure in government management of the state sector."

Indeed, in most of the countries, the state sector was handled as if it was an instantaneously disappearing group of companies. State-owned big industry was written off, and served only as a source of state income. In most of the countries, state companies were and are overtaxed, unable to invest in themselves. They utilized their last reserves and began to concentrate on exporting to the West, but, renounced by their respective governments and unable to adjust to the rapidly changing situation, they were for the most part doomed to obligation. This "betrayed," ailing state sector, however, still represents the bulk of the economy,

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[9] Thomas Weisskopf letter to the Editor in *The New York Times*, December 6, 1993.

[10] Padma Desai's article on the Op-ed page of *The New York Times*, December 10, 1993.

[11] Richard Portes, "From Central Planning to a Market Economy." In: Sh.Islam - M.Mandelbaum (Eds), *Op.cit.* pp. 45-46.

[12] Domenico M. Nuti, How to Contain Economic Inertia in the Transitional Economies. *Transition. The Newsletter about Reforming Economies*. The World Bank. Vol 3, No.11. December 1992-January 1993. p.2.

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manufacturing 50 to 70% of domestic production, but there is little interest to revitalize a part of them.

The list of policy mistakes is quite long. Sándor Kopátsy added a few more items to it:

> It is fashionable to explain the decline of the economy as a necessary sacrifice of transformation. In reality it is not true. During the past five years, financial requirements for Hungarian firms were so mistaken that they could destroy the big industrial sector of each country of the world.[13]

Kopátsy mentioned, among others, the abolition of subsidies without any kind of compensation, the mistaken taxation of inflationary profits, the lack, then the mistaken bankruptcy law, a too high interest rate which channels industrial profits to the state-owned banks, and the exchange rate policy which overvalued the currency and made imports more expensive and exports less profitable.

These mistakes undoubtedly contributed in an unexpectedly deep and long economic decline in the transition economies. Some of the mistakes were certainly unavoidable because of the lack of experience how to direct a process which was unprecedented in history.

In a closer analysis, however, most of the above listed policy mistakes were not only the consequences of an understandable lack of experience. Several mistakes were connected with an unquestioned, religious neo-liberal economic philosophy predominating in the region. A group of scholars maintains thus the central reason of the severe policy mistakes and economic turmoil in Central and Eastern Europe is an ideological approach to the practical problems of transformation. They denounce the policy makers of the region as 'new believers' who are convinced that there is only one single "design," an imagined ideal laissez faire capitalism without state ownership and intervention, and rejected all other options.

Unlike in 1988-89, when the West European mixed economies, the "Scandinavian model" and Austrian "Sozialpartnerschaft" were rather popular in Central and Eastern Europe, the new governments soon enthusiastically copied "Thatcherism" and "Reaganomics." The highly redistributive Scandinavian model is considered too etatist and socialist. In the place of "Sozialpartnerschaft," the regimes seek to crush the trade unions, which they view as being either "Red" or anachronistic to the changing times, and they frown upon union organizing as potentially undermining the democratic order. The half century triumph of West European mixed economies in France, Italy and Austria, with a 20 to 50% state owned economy, was counterbalanced by a pronounced trend towards privatization in the eighties. The successful road of the East Asian countries, which in several cases combined dictatorship with market-oriented modernization, and in all cases utilized strong state interventionism, was not even considered, or immediately denounced in Central and Eastern Europe.

This ideological approach was also the source of other serious mistakes. Since the neo-liberal paradigm is based on the assumption of an ideal equilibrium and a

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[13] Sándor Kopátsy, "Gazdaságpolitikai úttévesztés" (Economic policy mistakes) *Napi Gazdaság*, November 17, 1993.

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perfect market and market mechanism, the followers imagined the possibility of "introducing" this type of market which would automatically solve everything.

Alec Nove, in a study on the gaps and illusions of transition, critically cited Marek Dambrowski and Václav Klaus as ones resisting "interventionist pressures" and "the demand for a kind of government investment policy." As Nove points out, any kind of source allocation for restructuring, any "state influence on the branch structure of the economy...[and] priority in government policy" over the market mechanism is rigidly opposed.[14]

David Stark strongly criticized the ideological approach of Central and Eastern European transition and rejected "design capitalism." He even suggested not to use the word "transition" regarding the region's transformation since it implicit means an exact blueprint to follow: a transition to Western type of capitalism. Stark argues that "transformation schemes that rely on a single coordinating mechanism [i.e. market] do not so much emulate capitalism, as echo the implementation of state socialism." He added: "A policy of all-encompassing marketization across all sectors would therefore pose a new obstacle to international competitiveness. Markets are but one of a many coexisting coordinating mechanisms [such as 'networks,' 'alliances,' 'inter-firm agreements' etc.] in modern capitalism."[15]

Why became an ideological laissez faire policy triumphant though at first most of the post-communist parties and leaders looked for a kind of "Third Road" compromise? In Michael Mandelbaum's explanation because of the example of the West: "the West supports the creation of Western-style politics and economics...simply by the example that it sets. Many of the people who lived under communism wish to remake their countries in the image of the West...Western prosperity can be seen on television...by everyone from Berlin to Vladivostok."[16]

Alec Nove went further when he passionately remarked: "Extremist neo-conservative think-tanks send missionaries to expound the gospel: roll back the state, do not copy Western Europe...laissez faire is seen as the answer."[17] Jeffrey Sachs, Anders Aslund and many other Western advisors, indeed, "expounded the gospel" of laissez faire.

The attractive Western blueprint and the promising advises to copy it initiated and mobilized the new elite to adopt the model, even if it is difficult and painful. They thought that it is a rational price, an "entrance fee" for joining Europe. "I understood the difficulties that we faced because of the Balcerowicz Plan," stated Bronislaw Geremek one of the most influential Solidarity leaders, "but at the same time I knew that this was the only way that could secure the chances for Poland of getting place in the European economic order. In other words: without...a very painful renunciation...we had no chances to overcome the distance separating us from the threshold allowing us to start the process of integration. I was also aware

[14] Alec Nove, *Economics of Transition - Some Gaps and Illusions*. (manuscript, Berkeley), 1992. pp. 5,10.

[15] David Stark, "Can Designer Capitalism Work in Central and Eastern Europe?" *Transition. The Newsletter about Reforming Economies*. The World Bank. Vol. 3, No.5. May 1992. p. 4.

[16] Michael Mandelbaum, *Op.cit.* p.13.

[17] Alec Nove, *Op.cit.* pp. 4-5.

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that we must move very quickly...because Europe had frankly no intention to wait for us."[18] As Andrzej Olechowski a close aid to Walesa and member of several Polish cabinets added: "even unilateral opening of the economy to the world is advantageous...Liberalization may be harmful... Nevertheless, the overall prosperity will increase."[19]

Geremek, Olechowski and many others were convinced that a bold policy to introduce Western laissez faire system will conclude in a great leap to Europe.

The role of the international financial institutions such as the International Monetary Fund and World Bank, however, played a central role in effectively helping the realization of these concepts. Most of the countries of the region were arrested by an indebtedness trap and needed foreign assistance for their macro-economic stabilization. All were highly dependent on Western trade, markets and, above all, the acceptance of the European Community. In other words, they had no other choice but follow the "advice" of the so-called G-7 governments, the IMF and World Bank, which were often accompanied with strict conditions of credits and trade concessions.

As Mira Muc, head of the Slovenian privatization office stated in the early summer of 1993: "We gave our word to the World Bank for privatizing 400 firms in 12 months...without that there are no credits.[20] The U.S.Government Accounting Office's publication on the assistance to Eastern Europe reported on 1989 that the Commission of the European Communities was given the authority to manage and control assistance to Eastern Europe from EC members. As a prerequisite to receive assistance from EC members, recipients were required "to make market rapid movement toward free market economies...and furthermore, 60 per cent of its lending is earmarked for private sector projects, directing capital away from the hands of the state. Conditionalities favors the radical over gradualist model of transition."[21]

The international financial institutions represented a rigid stand regarding social policy and welfare programs. They always subordinated the social issues to "economic rationality," and pushed the governments to this direction. This author had this personal experience during a day-long meeting in the World Bank in the spring of 1989, together with a group of American experts. Governments of the countries of the region were forced to keep the budgetary deficit under 5% of GDP and cut social expenditure in a drastic way. In the fall of 1992, the newly appointed prime minister of Poland, Hanna Suchocka had to face crucial decisions since the IMF suspended credit to the country because its budgetary deficit surpassed the pre-

[18] Bronislaw Geremek, "Rok 1989." Warsaw, 1992. p. 365. Cited by T. Kowalik, *The 'Big Bang' as Political and Historical Phenomenon. A Case Study on Poland.* (Manuscript. Milan), 1994. p.10.

[19] "Integracji dzien powszedni." Zycie Gospodarcze, No.44, November 5, 1993. Cited by: T. Kowalik, *Op.cit.* 1994. p. 15.

[20] *Napi Gazdaság*, June 5, 1993.

[21] "Eastern Europe: Donor Assistance and Reform Efforts," Washington,D.C.: US Government Printing Office, 1990. Quoted by: Beverly Crawford, *Market States and Democracy: The Transformation of Communist Regimes in Eastern Europe and the former Soviet Union.* (manuscript), Berkeley, 1993.

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scribed limit. Decreasing the deficit from 7.5% to 5.5% of the GDP, in accordance with the conditions of the IMF, pushed governmental policy toward harsh social conflicts in the summer and early fall of 1992, which undermined the government.

In the fall of 1993, when the Rumanian government sought to receive a major IMF assistance for helping its transformation, the Western media rightly reported: "if an agreement with the IMF is reached, Rumanians are bound to feel even more pain for the sake of long-term economic health."[22] This attitude and policy of the international financial institutions led to a lack of social sensitiveness of governments which directed transformation. In a period of sky-rocketing unemployment, the Minister of Labor in Solidarity's new government, Jacek Kuron, the former initiator of the "Workers' Self Defence" in the late seventies, now followed a non-interventionist policy. Retraining and job creation was left to local initiatives. The period of eligibility for unemployment benefit was reduced. "Society...cannot be permitted to go bankrupt," stated deputy minister Piotr Mierzewski, "because of health expenditures."[23] Tens of thousands of pre-schools were, indeed, closed in the Polish countryside, and drug consumption in Hungary also declined by 22% and 33% in 1991 and 1992 respectively. Only very recently some slight signs of changes appeared. A new understanding, a readiness to change appeared after the frightening Russian elections of December 12, 1993. "Officials of the International Monetary Fund said today," reported the New York Times a few days after the election, "that they were considering loosening their conditions for...Russia...The IMF, the World Bank and the wealthy industrial nations are straining to find ways to expand social programs for Russia's poor."[24]

"The West is imposing strict and damaging conditions on the new democracies," noted Misha Glenny, "in order to influence their socio-economic development...The Western economic strategy...has clearly been designed to coerce them into the swift construction of a market or capitalist economy along lines preferred by the West."[25]

"The actual economic programs of the governments", stated Federigo Argentieri, an Italian expert of the Central and Eastern European transformation, "are more dictated by the International Monetary Fund than anybody else, leaving not too much place for maneuvering, except for nationalist and populist demagoguery."[26]

Moreover, the newly established parties and freely elected governments began to compete with each other in demonstrating their determination to follow the American-led Western world. The applause in the West that immediately followed was encouraging. The shock therapy definitely became the greatest propaganda success achieved by the former state socialist countries. The West awarded Poland with a unique and unparalleled gesture: it forgave 50% of Poland's official debt in April

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[22] J. Perlez, "Bleak Rumanian Economy Growing Ever Bleaker." *The New York Times*. November 24, 1993.

[23] *Rzeczpospolita*, February 22, 1990.

[24] Stephen Greenhous, "IMF May Loosen Conditions for Aid to Russia's Economy. Call for a Social System. *The New York Times*, December 22, 1993.

[25] Misha Glenny, *The Rebirth of History. Eastern Europe in the Age of Democracy*. London. Penguin Books. 1990. pp. 194, 197.

[26] Federigo Argentieri, "Hosszú, gyötrelmes út." (A long, painful road) *Népszabadság*. August 8, 1992. p.17.

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1991, while the American administration took the spectacular step of reducing Poland's American debt by 70%.

In competing for foreign aid and for easy access to the European Community, which was seen as a realistic possibility after the historic year of 1989, the Central and Eastern European governments became free-traders and anti-state-interventionists to a degree surpassing the countries that were classic adherents of that policy. The new elite thus became the world's most ardent advocates of free trade ideology, and they followed it with neophyte bigotry and orthodoxy. Anyone who questioned this policy fell under suspicion and was arbitrarily accused of harboring nostalgia for the collapsed regime and of attempting to preserve certain elements of it, or being attracted by 'dirigist'-dictatorial and 'statist' models.[27]

Laissez faire market economy without state interference, protectionism and public ownership became a religious commitment in the 1980s. The conservative's attitude (in the American case) was excellently characterized by Guy Molyneux: "Where today's conservatives leave *terra firma* is their unquestioning faith in markets...Expanding markets and cutting taxes is the answer to every - not just some, but every - social problem...If problems remain, that is only because we still haven't gone far enough - the response of all true ideologues."[28]

Moreover, this unquestioning faith did not remain the monopoly of certain conservative groups but became a sort of *Zeitgeist* by the 1980s. It was not the case in the 1930s and most of the European countries and all of the successful Asian modernizing economies followed a state interventionist policy and several had a mixed ownership in the unparalleled growth period after World War II. When the new structural crisis emerged after 1973, previously triumphant Keynesism was defeated by a jubilant Chicago school version of free market ideology. 'Reaganomics' successfully promoted laissez faire ideology and free market policies, and offered the spectacular American upswing by the early-mid eighties as an example to be emulated. Reaganomics was presented as a simple and quick solution to the world's complex economic ills. Similarly, 'Thatcherism' offered a 'vaccination' against the "Sozialpartnerschaft" and social-democracy, and initiated instant privatization in Britain. The relatively successful adjustment of the Western core to the new technological and structural requirements of the eighties thus led to a triumphant vindication of free market ideology.

Indeed, the entire world was on a spectacular march towards a laissez faire system. From Great Britain and France to Latin America, countries which had

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[27] This author expressed his view on the role of government in modernization in the Hungarian weekly *Figyelö*. András Bródy, a reknown economist denounced it in the following way: "I have never believed in government-led modernization. The government should leave things happened. In contrast of this view, the concept of Ivan T. Berend's article met with the views and statements of Péter Boross and Viktor Orbán [prime minister of Hungary and the head of the Young democrats respectively who are seemingly not sympathetic to Bródy who also sought to strengthen the role of the state. I think none of them are happy with each others company." (*Figyelö*. Gazdasági Hetilap December 22, 1993. p. 18-19.)

[28] Guy Molyneux, "Conservatives: Are They Now Softheaded?" *Los Angeles Times*. October 17, 1993:

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turned towards strong state interventionism, built a huge public sector and instituted planning during the postwar period, now dramatically revised their policy and introduced privatization. Marketization became a leading trend through deregulation and elimination of obstacles to free trade set up during the postwar decades.

The application of the self-regulating free market model in the transforming Central and Eastern European countries was certainly a historical mistake. A pragmatic approach to the tasks of economic transformation in the region rightly realize the need of "tariffs at a significant level" along with a 'transitional wage subsidy," and "all this," stated Richard Portes, "argues for an active policy, for the kind of industrial restructuring that cannot be left to the market."[29]

Rather close to this argumentation, Shafiqul Islam urged "temporary protective walls of tariffs, as well as direct budgetary subsidies." The philosophy of "the survival of the fittest should be perused first at the national level, and the survivors should then be gradually exposed to foreign competition." Islam denounced Polish non-tariff policy ("incredibly...average tariff rate in Poland [9%] was only slightly higher than in the United states [5%], and while Washington maintained quantitative restrictions on almost forty food and agricultural items...quotas and other non-tariff barriers are virtually non-existent in Poland"), and called for "a strong state with a coherent plan, [since this] is precisely what [the] command economy needs to free itself from the strangling grip of the state...The creationist model of laissez faire capitalism is an appealing but abstract ideology."[30]

State intervention, industrial, structural and investment policies are especially needed to make significant advance in restructuring the economy. The central goal of marketization and privatization is the creation of the prerequisites of an efficient, reactive economy. In the first years of transition, however, because of a religious "de-stateization," economic restructuring and the attempt to generate an adequate response to the challenge of the world economy 'temporarily' was pushed aside.

As Alec Nove pointed out, any kind of source allocation for restructuring, any "state influence on the branch structure of the economy," or any "priority in government policy" over the market mechanism is rigidly opposed. "No industrial policy, no energy policy, no investment strategy. All will come about by itself if and when macro-economic stabilization is achieved."[31]

The Schumpeterian term of "creative destruction" was certainly never used more often than in these three-four years in Central and Eastern Europe. By 1992-93, however, there was a destruction so unexpectedly striking that the creative character of the transition is still delayed.

"The fall in output," stated two World Bank experts, "does not seem to have been accompanied by the radical economic restructuring that many expected as part of

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[29] Richard Portes, *Op.cit.* p. 46.
[30] Shafiqul Islam, *Op.cit.* pp. 209-212.
[31] Alec Nove, *Op.cit.* p. 5.

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the reform process."[32] Richard Portes added: "Industrial restructuring... has made little progress. Privatization will not cure that."[33]

The core issue of the structural crisis, the need for a structural-technological adjustment, is thus yet to be addressed.

The first minor small steps toward the needed structural changes are linked, almost without exception, to a few isolated large-scale investment projects of several Western conglomerates, mostly car makers such as Volkswagen, General Motors, General Electric, Audi, Unilever and Suzuki. There is a definite drive to create a modern car industry in Central and Eastern Europe.

Others, such as Ameritech International and German Bundespost will contribute to create a modern communication infrastructure which is a major basis of restructuring as well. But very few multi-nationals have shown genuine interest in the area, and those who have mostly did so at the beginning of the transition.

Some other Western giants prefer to build profitable Pizza Hut and Kentucky Fried Chicken chains and went to monopolize the cigarette market. Needless to say, however, Pepsico and Philip Morris cannot possibly generate a major structural change.

Moderate domestic sources and small foreign enterprises made already a major difference in improving services which were highly neglected in the postwar decades. They had, however, little real impact on the development of competitive export branches, partly because of a lack of financial strength, partly because of their preference in investing in trade and services.

There are further frightening signs regarding the lack of structural adjustment. The severe industrial decline namely unevenly hit the various branches of industry. Paradoxically, the characteristic branches of lower development level, those which produce relatively primitive products containing a high degree of energy and raw materials such as iron, steel, textile, are more competitive on the world market than the more sophisticated processing branches. Cheap export helped thus to keep production on a relatively higher level in the former branches than in the latter. Engineering, electronic, transportation and communication technology, pharmaceutical branches, those which are responsible for technological development and modern adjustment, suffered the most. According to the analysis of the Ministry of Industry and Commerce there was a negative structural change, an opposite trend than that of the advanced industrial nations' in the Hungarian industry. While the energy sector's weight (including mining) increased from 25% to 36%, the output of engineering declined nearly by two thirds in four years and its percentage share dropped from 30% to 22% between 1988 and 1992.

This trend was exactly the opposite than that of the advanced countries and represented a highly negative structural change in the entire Central and Eastern European region.

Although three-four years are too short a period to foresee the various adjustment processes of the twelve countries of the region, historical parallels are warning.

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[32] *Ibid.* pp.2-3.

[33] Richard Portes, *Op.cit.* p. 41.

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What is emerging in Central and Eastern Europe now is rather similar to the region's response to two previous challenges of similar structural crises.

In the 1870s-80s and in the 1930s major structural crises were generated by the change of the old technological regime. A whole set of changes required a dramatic adjustment by shutting obsolete branches and establish rapidly developing new ones. Central and Eastern Europe could not successfully accommodate and responded by attempting to save and protect the obsolete branches of its economy. Grain production remained dominant and grain continued to be the leading export item of Russia, Romania and Hungary. The latter succeeded to build high protective tariff around the Austro-Hungarian empire and compensated the lost Western markets by the huge imperial one.

During the Great Depression, almost the entire region "escaped" from economic adjustment and preserved the obsolete structure of the economy by accepting Hitler's offer and take refuge in the German "Grossraumwirtschaft," a protected, isolated regional agreement system (based on bilateral trade agreement with Germany). The countries of the region, after signing the agreements in 1934-35, escaped the depression, recovered the serious decline and reached, moreover, even surpassed the pre-depression level of GDP and output. They could not adjust, however, to the technological-structural transformation of the, as it is often called, 'fourth industrial revolution.' They remained agricultural countries and the gap between them and the advanced world continued to broaden.

The essence of the transformation of the 1990s is to create the prerequisites of the economic adjustment and accommodate to a dramatic technological-structural modernization. A marketization and privatization program definitely belongs to the most important prerequisites of catching up. Marketization and privatization itself, however, does not mean structural and technological adjustment and does not lead automatically to it. One may not forget that peripheral pre-World War I and II Central and Eastern European market-private economies were unable to give an adequate response to that time world market challenges.

In other words, the heart of the matter is not just to stop further decline and generate a new growth process. It is actually already in the horizon. Poland successfully halted decline in mid-1992 and became the fastest growing country of depression-ridden Europe in 1993 with its nearly 5% growth. Albania also stopped to decrease output and income and accomplished positive growth results. The Czech Republic, Slovenia and Hungary may follow in 1994 or 1995.

It was and will be crucially important to cope with the deterioration and achieve growth. One should not forget, however, two important limitations of a possible recovery. First of all, the countries of Central and Eastern Europe hit the bottom by their dramatic and unprecedented decline. A kind of reconstruction-type of growth rate, as in reconstruction periods in general, and in the case of the region after both world wars, is always rather high. Reconstruction, however, might happen on the old technological and structural basis, as, again, occurred in both post-world war reconstruction periods in this century.

Rising output and GDP is thus good sign but not yet the real success of transformation. It may not be successful without a breakthrough in economic adjustment to the world economy.

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All these might lead to the conclusion that Central and Eastern Europe ought have to apply a more adequate model of transformation. The self-regulating free market system, based on market automatism is a basic prerequisite but itself unable to promote structural adaptation in a non, or at least incomplete market environment. The regulated (often mixed) market economy would offer a more suitable setup for the basic goals. In this pattern a centralized administration influences the flow of money as well as supply and demand; and labor and land, meaning the society and its surroundings are often not subordinated merely to the laws of market. In this model the economic system is controlled, regulated and directed by both the state and the market. State regulations both assist as well as replace the market mechanism (which is highly incomplete). With its investment and structural policy, with a combination of free market, and selectively market protective policy, the countries of the region could more successfully apply the methods of the post-World War West European and Asian modernization policies.

In February 1992, Frank Hahn delivered a Keynes Lecture at the British Academy in London. His concluding remarks were as follows:

> I hope I may have convinced you that the problems raised by incomplete markets are real...Keynes...has been declared out of date and wrong by the very simple device of ignoring and assuming away all of the difficulties which he thought to be important. But they will not go away. When, as now appears to be the case, they are again recognized, economists will again become more circumspect in their judgement of market economies...The General Theory...will again be seen as pointing to the right questions.[34]

The "invisible hand" cannot arrange everything, and cannot solve the central questions of the "economies of missing markets" or "incomplete market." Most of the policy mistakes and economic difficulties of Central and Eastern Europe are connected with the mistakenly chosen model of transformation. To replace a non-market with a market economy was an unavoidable prerequisite for adjusting to the technological-structural transformation of the world. Privatization of an almost entirely state-owned economy was inseparable from marketization. But a transformation to a regulated-mixed-market economy would have been more 'organic' and smooth than one to an imagined free and self-regulating laissez faire system.

History rarely tolerates U-turns and new regimes always have to carry the heavy legacy of the rejected past which, against the will and dreams of the new governments and systems, often pushes them towards genuinely rejected tracks. Additionally, the peripheries have never had a successful free market economy. It could not work in a backward economic environment and in non-market societies, and in fact has never worked outside the advanced core countries.

A deep analysis of the lessons of the transformation years, a realistic acceptance of facts instead of believes and hopes, a complex policy reorientation of the international financial institutions and the Central and Eastern European governments is needed.

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[34] Frank Hahn, "Incomplete Market Economies." *Proceedings of the British Academy,* 80. 1991 Lectures and Memoirs. Oxford University Press. 1993. p. 217.

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STANISLAW GOMULKA[1]

The Role of International Financial Institutions: The Polish and Russian Experiences 1989-93

1. Broad Policy Objectives and Major Errors

The main economic actors whose policy objectives I consider in this paper are the local reformers, the IMF and the World Bank. The local reformers include above all finance ministers and presidents of Central Banks who are the key policy designers and the formal negotiating partners for the two Bretton Woods Institutions (BWIs). The governments (in Russia including the President) and parliaments are, however, the key institutional partners and policy makers. The immediate analytical problem is the wide variation of views amongst reformers at any time and the considerable changes of their views over time. Some changes of objectives have also occurred on the part of the IMF and the World Bank. Nevertheless, at a very broad level, there were important policy objectives which have been common and stable, and there have also been distinct differences in objectives between the IMF and the World Bank, and between these two institutions and the local reformers. Since I wish to comment on reform programs in terms of success and failure, and such an evaluation depends critically on the objectives of the program designers, the nature of these objectives is important.

1.1. Differences in policy objectives

At the level of broad and long-term objectives the approaches of local reformers and the Bretton Woods Institutions have been remarkably similar. The first Polish Letter of Intent states that "the sustained growth of output and living standards and the strengthening of our external position over the medium term...are the ultimate goals of our efforts" (LOI, covering letter, December 22, 1991, p.1). The proposed strategy to achieve these goals had the familiar three components: extensive and rapid liberalization of prices and trade, macroeconomic discipline, and market-oriented structural reforms, particularly privatization. Safety nets and external assistance were additional, supportive features. Most reformers would also agree with the IMF that "it has taken us far too long to shake off two dangerous misconceptions of the 1970s: first, that monetary stability and growth are at odds with one another; and second, that external financing - borrowing - is the best path to

[1] As Economic Adviser to Poland's successive Finance Ministers since September 1989, the author participated in all negotiations with the IMF and the World Bank concerning macroeconomic and other policies for Poland. In 1990-91, he was a member of the Polish delegation negotiating the debt reduction with the Paris and London Clubs. In late 1991 he also advised the Russian government on the liberalization and stabilization policies for 1992.

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growth" (Camdessus, July 11, 1990). To meet popular criticisms, the Director of the IMF also explains that "we are striving to improve the design of our programmes to ensure a better blend of adjustment, growth and equity,...we encourage governments to avoid raising taxes on the basic staples...and to protect critical social expenditures" (op.cit. p.4).

However, the traditional, central concern of the IMF has been macroeconomic stability in the short and medium terms. Its main role is that of a global regulator of economic policy, acting on behalf of member states to assist in maintaining a proper international economic order. Its services are called upon when that order is endangered, and the Fund programmes are designed specifically to remove the danger and restore order. Hence the core policy concerns of such programs are the restoration and sustainability related to external and internal macroeconomic equilibria. The policy objectives and the performance criteria are related to these concerns. The recipients of the IMF funds are therefore typically Central Banks, not governments or enterprises, and their primary purpose is to strengthen the external position during the adjustment period.

While the IMF is concerned mainly with creating the right macroeconomic conditions for growth, the World Bank is a development agency concerned with the promotion and financing of economic growth itself. To fulfil this role the World Bank aims to create the right economy-wide microeconomic conditions for growth, largely by promoting price and trade liberalization, removal of subsidies and excessive import tariffs, market competition and privatization.

The coordination of policies for transition economies between the two sister organizations became, however, somewhat of a problem. For institutional and other structural reforms are the core of the transformation, and they are neither macro nor microeconomic. In principle, these reforms were supposed to be the province of the World Bank. But the immediate problems in Poland, 1989-90, and in Russia, 1992-94, were those of stabilization. This initial primacy of macroeconomic issues gave the IMF the leading role in formulating conditions for all Western assistance, including that of the World Bank. The policy interest of the IMF has consequently over time expanded to cover also all economy-wide market-oriented structural reforms. Except on the occasion of negotiating so-called Structural Adjustment Loans (in Poland, Spring 1990), the role of the World Bank has been reduced to discussing sectoral adjustments and specific investment projects.

The Polish authorities have all along taken the view that the two institutions' long-term objectives coincide with the ultimate interests of Polish reforms so much so that the success of reforms could and would become for them an important policy objective in itself. By far the dominant concern of the Polish reformers was therefore to enlist the international authority of the BWIs in supporting the case for a deep reduction of Poland's large foreign debt. The eventual reduction by about US$20 billion has been by far the dominant form of external assistance. The intermediary role of the BWIs, especially of the IMF, in obtaining the reduction has been clearly helpful to both the creditors and Poland. The second objective was that of the central reform group, based largely in the Finance Ministry and the Central Bank. It was to enlist the BWIs in supporting its policies within the government, the parliament and the country in general. For this purpose it was useful of the

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group to stress, even exaggerate, the external influence of the BWIs among governments, banks and private investors. The third Polish objective was to secure new credits, which have been particularly significant in the case of the World Bank (Tables 1 and 2). Finally, the missions of the BWIs represented a large think tank of highly professional analysts and advisers who have been providing Polish reformers with systematic analysis and helping them to formulate specific policies.

1.2. Policy Arguments and Controversies

Policy controversies in Poland between the BWIs and reformers concerned important issues, such as energy pricing, the role of expectations in formulating exchange policy in 1990, the methods of financial restructuring of banks and enterprises in 1993/94, the form of wage policy, the choice of nominal anchor(s) in 1993, the speed of state-led privatization, the ideal level of subsidies and the level of tariff protection. However, the disagreements were relatively minor and were in most part resolved by the BWIs accepting the Polish view. Of overriding importance has been the agreement that dramatic actions are required to liberalize prices and foreign trade, impose a restrictive macroeconomic policy to discipline enterprises and stabilize liberalized prices, and to establish a process for fast privatization. The common ground eventually also included the acceptance that a large fall of output is inevitable and that the fall is largely the effect of a rapid pace of systemic transformation rather than the cost of stabilization.

Perhaps the most controversial issue has been the possibly excessive weight accorded by the IMF to inflation during transition. One view is that low inflation is neither necessary nor sufficient to effect systemic transformation. The IMF's view on that matter has been changing somewhat, but the initial position appears to have been that low inflation, while not sufficient, is certainly necessary to effect systemic transformation successfully. Consequently, despite large progress with the main systemic reformers in Russia, the IMF has been most reluctant to support the reforms financially. The IMF is an institutional guardian of low inflation, and its credibility worldwide depends on how that role is discharged. It may have therefore developed a bias in attributing to high inflation excessive resource costs and in refusing to accept that, in conditions of extraordinary output falls, there may also be sizeable welfare benefits, arising from income redistribution from rich to poor among both households and enterprises, through the inflation tax. There may therefore be a case, in transition economies, for a gradual disinflation path, such as that adopted by Poland.

1.3. Major Errors in Assumptions and Policies

Part III of the paper discusses actual programmes and their outcomes. However, it will be useful to collect and list in this introductory section the major errors in assumptions and policies. It will be evident that these errors are related mainly to the inadequate understanding of the transformation process by the programme de-

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signers at the start of the process. Despite large errors, the Polish stand-by programme for 1990 was successful in its own terms. But the errors contributed to the failure of the Fund-supported programmes for Poland in 1991/92 and for Russia in 1992/93. The last Polish programme, for 1993, was however almost error-free and exceptionally successful.

Poland

Error 1. Assumptions concerning GDP growth:
- 3.5% in 1990 against actual -11.4%
+ 3.5% in 1991 against actual -7.4%

The so called actual numbers above are, in fact, the official estimates of measured changes in GDP. The really actual GDP falls were apparently significantly lower than officially stated (Zienkowski, 1992). Nevertheless the errors were probably large, especially for 1991, when the impact of the collapse of the CMEA and the dollarization of trade with the former CMEA area were grossly underestimated. In the programme for 1990, little attention was given to the other two phenomena which deepen the fall of output: de-stocking of inventories and high savings propensity of households. While these assumptions on GDP growth were made by the Polish Finance Ministry, they were accepted by the IMF.

Error 2. The assumptions concerning 'corrective' inflation (Consumer Price Index), following price corrections and price liberalization (compared to average December 1989):
45% against actual 79.6% in January 1990
75% in Q1, 1990 against actual 133%.

The IMF team produced calculations, dated December 5, 1989, which formed the basis for the choice of the dis-inflation path in the course of 1990 and the choice of the exchange rate in Polish stabilization program for 1990. The calculations were based on the following assumptions: the 41 price effect of excess liquidity was 20% and the excess to be absorbed by coal and other energy price increases (12% in January, 5.4% in February and 1.7% in March). The coal price increase would be 500% and gas increase 200% in January (these were approximately the actual increases); the January wage increase was to be equal to inflation minus the impact of exchange rate adjustment, wage levels fixed in February-April, and indexed on inflation of the same month with 70% coefficient from May (this assumption was approximately correct, except for January when wage increase was much lower); the new exchange rate would be 9706 zloty to the dollar, the result of adding up the December 'unification level' (5888) zloty, export incentives (430), the effect of January inflation of (2505) and a 10% safety margin (882) (the actual rate chosen was 9500). The wage increase was assumed to be 26.5% in January, but its contribution to inflation would be only 4.3% (and 2.1 % in February and 0.7% in March). The cumulative price impact of devaluation was thought to be 24% (14.4% in January, 6.3% in February and 2% in March). At the request of the Polish

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authorities, I discussed these calculations with Mr. Russo, the Director of the IMF's European Department and the leader of the team. My notes show that I proposed corrections (three times higher impact of wage increases and two times higher impact of energy price increases, no impact of the stock excess demand but an impact of the flow excess demand of 10% in January), which implied the following inflation rates: 70% in January, 30% in February and 10% in March. The actual rates were: 79% in January, 24% in February and 4.7% in March. My projection for Q1, 1990 was therefore close to the actual outcome (143% against actual 133%), especially since the actual wage increases were lower than assumed in these discussions. On the other hand, our price projections did not take into account the impact of sharp increases of interest rates and depreciation rates. The lower IMF inflation rates were seen by the Polish side as unrealistic, but were adopted nevertheless as an built-in safety margin of the program.[2]

Error 3. The misinterpretation of the reasons for large taxable 'statistical' profits in 1989 and 1990, the consequent large underestimation of holding gains during that period, and a large over-estimation of taxable profits in 1991.

These matters are discussed best in Schaffer (1993). The presence of holding gains was known in principle, but the absence of good data on inventories prevented the Polish/IMF program designers from coming up with a credible estimate of any gains and their impact on profits and budget revenue. In the absence of the estimate, a popular hypothesis, later abandoned, was that very high profit margins (and sharper than assumed output falls) reflected the monopolized market structure.

Error 4. The explosion of social transfers in 1991 and later.

It was overlooked that a background-looking indexation rule, linking current changes in transfers to past changes in wages, would result in a sharp increase in the ratio of benefits to wages with the progress of stabilization.

[2] On December 7, 1989, the IMF team produced "Alternative 2" projection, in which the impact of price liberalization, including energy price rises, was increased from 20% to 40% in Q1, 1990. The impact of wage rises was also increased somewhat. In this scenario, prices would rise 53% in January, 21% in February and 6.6% in March, giving a total increase, in Q1, of 97%, and an exchange rate of 10,385 zl. to the US$. That alternative was eventually dropped as 'too pessimistic'. The Polish program was later often criticised for adopting an excessive devaluation of the zloty. The Polish authorities assumed initially that the new exchange rate would be 10,500 zl. and that it would be progressively increased to 14,500 zl. by the end of 1990. The advice of the IMF team to keep the rate of 9,500 reduced the size of over-devaluation. In a personal note to Leszek Balcerowicz, dated December 4, 1989, Michael Bruno, at that time Governor of the Bank of Israel on a visit to Poland, suggested that there may be no need to devalue, or make only a small correction at the launching of the stabilization program. The suggestion would imply a rate of about 6,500-7,000 zloty per US dollar. The note influenced the correction of the Polish original intention. Bruno's suggested rate would be probably correct, although the actual choice was in my view justified by the urgent need to increase international reserves and to provide a safety margin for the program.

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Errors 3 and 4 were large enough to set the stage for the fiscal crisis in 1991-92 and the collapse of the EFF progam in late 1991.

Error 5. The targets for state-driven privatization were initially excessively optimistic.
However, an explosive growth of the original private sector has neutralized the impact of that particular error on the assumed growth of the private sector.

Error 6. The Extended Fund Facility (EFF) programme for 1991-92 assumed a hugely optimistic growth rate of 15% per year for the level of investment activity.
In 1990 the perception was that the recovery in output would be led by investments and net exports. It was overlooked that, following large falls of output and real incomes, the recovery is likely to be consumption-led. The Polish government programs for each year of the period continued to call for a redistribution of expenditure from private consumption to investment and net exports, only to find out that the actual developments had each year moved in the opposite direction.

Russia

Most errors in that country were of implementation rather than of design. The Russian IMF team from late 1991 included several experienced members of the earlier Polish IMF teams. But the IMF impact on policy implementation in Russia was clearly less substantial than in Poland.

Error 1. An initial error of the Gaidar Plan was a vast underestimation of corrective inflation in January, 1992: assumed 100% against actual 245%. The assumption was based on the advice of the IMF team, which itself was influenced by an analysis due to Mario Bleijer (December 2, 1991). The analysis appeared careful, with many caveats, but it concluded that "the initial rise in the price level needed to restore stock balance to the money market should not exceed 70-75 per cent" (p.5.). An internal estimate by the Russian Economics Ministry, based on unit cost analysis, was of an increase by about 200%. This appeared vastly excessive and was rejected in a written directive to the Budget Group of the Finance Ministry by Gaidar himself. The error was not fatal by any means, but it was large enough to undermine significantly the credibility of the first Gaidar budget for Q1, 1992.

Error 2. Initial support of the IMF for a common currency and a monetary union spanning most of the FSU was a policy mistake that betrayed technocratic bias and political naïvety or insensivity. The proposal could not be accepted by Russia without its Central Bank controlling fully the credit expansion by the non-Russian members of the rouble zone, and such a control would be at variance with independence aspirations of most of those members (J. Odling-Smee, 1992).

Error 3. As mentioned earlier, probably excessive emphasis by the IMF was placed initially on inflation and insufficient weight was given to the substantial

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progress of the transformation-related structural reforms and the major improvement in the external position of the country.

The IMF's 1993 Systemic Transformation Facility of US$4 billion was a financial innovation intended essentially to redress the imbalance.[3]

2. The conceptualization of Policies and the Performance Criteria

The standard IMF program has five interconnected components: fiscal, monetary, external balance, incomes (wages) and structural/institutional. It sets principal policy aims and formulates policies in ail these five components to achieve these aims. Given initial conditions and some behavioural and other assumptions, it also formulates performance criteria for the purpose of monitoring the programs' implementation.

2.1. The Underlying Theory to Achieve Consistency

Using standard notation, a demand-driven macroeconomic model may be written in the form of the following ten equations:

$$Y = C(Y_d, M/p) + I(\Pi, r) + \bar{G} + X(p_q) - p_q Q(p_q Y) \quad (1)$$

where $p_q = ep^*/p$, the ratio of foreign to domestic prices, r is the interest rate, Π is profits, Y_d is disposable income, X is exports and Q is imports;

$$Y_d = Y_d(Y, T, r) \quad (2)$$

$$T = T(Y, \Pi, \text{tax rates}) - \text{transfers} \quad (3)$$

$$\Pi = pY - wL(Y) \quad (4)$$

$$M_d = V(r)\ pY \quad (5)$$

$$Ms = eR + \int (p\bar{G} - T)dt + K(r) \quad (6)$$

where T is net government revenue, R are net international reserves and K is bank credit to the non-fmancial sector of the economy

$$M_d = M_S \quad (7)$$

[3] In support of the G-7 proposal for an exceptional programme of assistance to Russia, the World Bank has an Accelerated Program of lending also amounting to US$ 4 billion. The Bank's Rehabilitation Loan of US$ 0.6 billion, approved in 1992, belongs to the same category.

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$$X - p_q Q + NCF = \Delta R \quad (8)$$

$$p = p(w,e,r) \quad (9)$$

$$w = w(p\text{-}1, p^e, u, ...), \text{ or } MP_L = w, \text{ or } w = \bar{w} \quad (10)$$

where NCF is the net capital flow, p^e is the expected price level, u is the unemployment rate, and MP_L is the marginal product of labour.

The ten endogenous variables in this model are: Y, $Y_{d'}$, Π, T, $M_{d'}$, $M_{s'}$, p, w, r and either e, under the floating exchange-rate regimes, or R if the exchange rate is exogenously fixed.

In the terms of our four macro components of the programme, the relevant variables are these:

fiscal: the budget deficit, $BD = p\bar{G} - T$
monetary: r
external: e and R
incomes: w

The quantity of money is endogenously determined:

$$M = eR + \int BDdt + K(r).$$

In order to stabilize quickly, the wage rate w is sometimes fixed. In this case, under the fixed exchange regime, w and e are exogenously given, and all the other variables of the model are functions of the two variables. In particular, w and e determine the price level, as well as the interest rate, the budget deficit, NIR (not international reserves), the demand for credit K and money M. The standard IMF approach is therefore to regard e and w as key nominal anchors of a stabilization programme, as was the case in Poland in 1990.

The budget deficit is, however, also subject to the choice of government spending, G. In transition economies, and especially in periods of high inflation, both taxes and government spending undergo large changes and they, rather than the exchange rate or the level of international reserves, are under direct government influence. In such circumstances, BD and w are the nominal anchors. In this case the policy instruments remaining under the formal control of the Central Bank, such as the money supply, the exchange rate and the interest rate, are effectively decided by the government. When the interest rate is set too low to bring the market for credit into equilibrium, which is often the case in transition economies, the credit to enterprises is subject to administrative limits imposed by the Central Bank. In this case, credit to enterprises and (direct or indirect) Central Bank financing of the budget deficit are the main nominal anchors. This has been the case in Russia, throughout the transition so far, and also the case in Poland in 1992-93.

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2.2. Hazards in the Choice of Macroeconomic and Other Assumptions

The starting point for a programme designer is usually the price path, specified in terms of the monthly inflation rate, in the course of the period covered by the Fund-supported program. Achieving the targeted price path could be a principal short-term policy aim of the programme. If it is a stabilization program, it would typically have the price path showing a strong disinflation. Already at this stage the problem is to estimate correctly the unavoidable, cost-push impact on prices of intended policy actions. This impact is largest at the start of transition and, as I discussed earlier, it is also the time when the choice of the disinflation path represents the greatest hazard.

The second step is to use the Fisher equation to determine the quarterly changes in the quantity of money that are consistent with the targeted price path (equations 5 and 6 above). At this stage assumptions have to be made about the level of GDP and the velocity of money circulation. Again, in the period of systemic transformation, the risks are that the adopted assumptions would be seriously wrong, as in Poland in 1991.

The third step is to divide the available money increase between credit to the government, credit to the economy (the non-financial sector) and a change of the NIR. The money increase thus represents a budget constraint. In order to decide about that division, it is essential to know the size of the budget deficit which would have been under existing legislation, the likely net inflow of foreign capital, and the size of the so-called directed credit to economic units. During systemic transformation, major revenue and expenditure reforms take place, level of activity changes rapidly and fiscal discipline is difficult to maintain. Assumptions underlying the government budget are consequently often wrong by wide margins.

The fourth step is the consideration of detailed policy measures which appear needed to bridge the gaps between the targets implied by the division made at the third stage and the likely outcomes in the absence of new measures. By the nature of things, these measures are concentrated on public finances.

To achieve consistancy, the analytical framework cannot be linear, a sequence of steps outlined above, but must be one of a general equilibrium type. In particular, the original inflation path may be altered in view of the policy measures taken at stage four, and this may lead to the next round of programme design.

2.3. The Inherent Tension Between Quantitative Criteria and Quantitative Analysis.

The choice of performance criteria by the BWIs reflects the strongly macroeconomic and short-term orientation of the IMF and the microeconomic and medium-term orientation of the World Bank. The IMF criteria are typically few, quantitative and quarterly. The interesting feature of these programmes is that the inflation rate is a policy objective rather than a binding target. This is in recognition of the fact that policy-makers do not control inflation directly and their indirect control is imprecise (IMF, 1988, p.16). The key criteria are as follows:

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(a) The upper limit for the cumulative change in net credit of the banking system to the General Government;

(b) The upper limit for the cumulative deficit of the General Government;

(c) The upper limit for the cumulative change in the net domestic assets of the banking system; and

(d) The lower limit for the cumulative change in NIR in convertible currencies of the banking system. There may also be a limit for changes in average wages or wage funds in the socialized sector, and a limit on contracting or guaranteeing of new external debt.

These criteria are not different in conception from those of the "standard" IMF programme, they are in fact the same. This underscores my earlier point that despite occasional claims to the contrary, the inflation rate and the external position, and not systemic transformation as such, remain the central focus of IMF programmes for Eastern Europe. The only concession for transition concerns the 'quality' of programmes - reflected in the tightness of criteria. Of the three types of programmes; the Extended Fund Facility, the Stand-by Agreement and the Systemic Transformation Facility, the first is the most demanding and the last the least demanding. Fund programmes for economies in transition are usually of the last two categories. The credibility of the IMF requires that it treats the agreed quantitative targets seriously. While waivers may be granted, the programmes are usually suspended if limits are breached by wide margins.

3. Programmes and Outcomes

This section discusses briefly four IMF-supported programmes with a view to identifying their distinct features and purposes.

3.1. The Polish Stand-by Programme for 1990: A Conditional Success?

This extremely important programme both for Poland and the IMF had a number of unusual features. They were directly linked to the launching of a radical reform in crisis circumstances and the absence of any similar experiences by policy designers. The main paradoxical feature of the programme was that many of its important assumptions and policy aims were missed by wide margins, yet all of its six performance criteria were comfortably met during most of 1990, allowing Poland to draw three tranches of the total support granted out of the four available. Compared to the initial assumptions, the output fall was much larger, yet the fiscal outturn was much better (3.1% GDP surplus instead of O.6% GDP deficit); the exchange rate had held throughout the period, yet prices increased by 250% rather than the assumed 94%; and despite the large appreciation of the zloty, the trade surplus was much higher than assumed. All these developments have good ex-post explanations, but were wholly surprising for the programme designers, both Polish and the IMF's. The two major concerns of the designers were the rules for indexing the wage norm in the first six months of the programme (particulary in the first

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month), and whether a public and binding commitment could be made to defend the exchange rate at a fixed level for a period of time, e.g. three, six or full twelve months. For the IMF a satisfactory agreement about these matters was crucial for the success of the entire programme. Discussions of these issues were therefore both intense and time-consuming. In the event the much tighter than planned fiscal and monetary policies, and a deeper than expected fall of output, rendered the two issues irrelevant.

In retrospect, given the novelty of systemic circumstances and the initial crisis conditions, the programme served its role remarkably well. The built-in safeguards and errors of the programme have resulted in a stop-go sequence of policies which proved more pronounced than desirable, but this feature was secondary compared to large achievements (IMF 1991, Gomulka 1991, 1992, 1993a, Berg and Blanchard 1992).

3.2. The Polish EFF Programme for 1991-93: A Failure Which Served a Purpose?

This three year programme was meant to be a successful follow up of the first standby. However, errors 3 and 4 discussed in Part 1, section 3, led to its suspension a few months after approval on April 18, 1991.[4]

In early 1991 the flaws of the programme were already apparent, but there was no time to re-negotiate it. For, on March 18, 1991, the Paris Club offered Poland an immediate 30% debt reduction, conditional only on her having a Fund-supported economic programme. The condition was met on April 18, 1991 and the reduction was granted on April 19, 1991. The EFF therefore served its purpose.

3.3. The Polish Stand-by for 1993: A Model of Success?

The errors 3 and 4 mentioned above produced a threat to the progress of stabilization in the form of a large budget deficit. Despite corrective measures, the deficit of the general government reached 6% of GDP in 1991 and 7% in 1992 (Table 4). The deficits were financed nearly wholly by monetary expansion and, by 1992, became the main source of inflation. In the meantime, the Paris Club accepted that Poland would qualify for a further 20% reduction of the official debt if it ran a successful Fund-supported programme in 1993. Reaching an implementable agreement with the Fund became therefore essential. This was made easier by the more flexible position displayed by the IMF in 1992. Influenced probably by the course of events in Hungary and elsewhere in Eastern and Central Europe, the IMF has increased its tolerance level for the budget deficit. Moreover, to ease the deficit problem, the organization offered to support the Polish case for an import surcharge. However, a package of strong fiscal measures, amounting to about 5% of

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[4] Poland breached the criteria already for June 1991. The negotiations of new criteria for the second half of 1991 and 1992 were not successful.

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GDP, was proposed by the Polish authorities, not the IMF. The package reflected the outcome of an internal policy debate within the government and the country about the potential net costs and risks associated with a large budget deficit. To increase the change of success, the programme for 1993 was based on conservative fiscal assumptions. Its implementation was also helped by economic recovery which was stronger than assumed. In the event all performance criteria were met comfortably, and in a manner which should help the progress of recovery and stabilization in the post-programme years.

3.4. The Russian Experience: A Macroeconomic Failure but a Transformation Success?

There has been much confusion about what kind of strategy Russia has followed and much discussion about policies which the country should follow, less shock and more therapy or more shock and more therapy. Was the strategy excessively gradual? With respect to macroeconomic policies, why have they been so inflationary? Were they irrational?

From the perspective of the student of systemic transformation, there is much evidence in favour of the view that Russia in its own chaotic manner has followed a very radical reform, a form of managed shock therapy. The three main components of that strategy have apparently been implemented: fast liberalization of most prices, including the exchange rate, has permitted the replacement of central planning by market co-ordination; considerable foreign trade liberalization has led to large shifts in the geographical and product composition of trade; and large progress in privatization and other structural changes have taken place. A deep fall in industrial output is an indirect evidence of the large volume of painful reforms having been implemented. Moreover, the floating exchange rate policy led to an extremely deep real devaluation, and this in turn has produced a fairly dramatic improvement in the external position of the country.

Russia's reforms have been extremely gradual and controversial only with respect to inflation. The country's inflation crisis has been due almost entirely to the monetization of large budget deficits and even larger subsidised credits to enterprises. In this respect, the sharp differences in public spending between Poland and Russia are worth noting: much higher spending in Russia on defence, (6% versus 2%), and producer and import subsidies (10% versus 1.5%), but much lower spending on social transfers, particularly pensions (8% versus 20%).[5]

The distinct feature of the Gaidar stabilization plan was that neither the wage rate nor the exchange rate was proposed to serve as a nominal anchor. This feature caused concern of the IMF already by the end of 1991. However, a strict monetary policy probably could have controlled wage increases. Real wages fell sharply in 1992, as required by the stabilization objectives. The problem was the failure of the government to eliminate the need for the domestic bank financing of the budget

[5] The estimates of subsidies and social transfers in Russia are highly imprecise, but hopefully indicate the orders of magnitude involved.

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deficit (of 6% of GDP in 1992, IMF 1993, Table 5) and an excessive flow of much subsidised credit to enterprises by the authorities.

The first Fund-supported programme for Russia, of June 1992, was of a Standby type. It expired on January 4, 1993. During that period the inflation rate increased from about 10% a month in the second quarter of 1992 to about 25% a month. In terms of this particular indicator of performance, the programme was therefore a complete failure. The second programme was of the STF type. It started in June 1993 and is still continuing. Again, the chief aim of the programme in 1993 - reducing the monthly rate of inflation to single digit levels by the end of 1993 - was missed. However, in early 1994 Russia is showing an unexpected determination to bring the rate of inflation down.

4. Foreign Assistance in a Broader Perspective

In his address to the Group of Thirty at its Spring 1993 planning meeting in Vienna, Mr. Klaus, the present Prime Minister of the Czech Republic, summarized his experiences as a major reformer in the form of Ten Commandments for what he calls profound, fundamental, structural reforms. One of the Commandments asserts that the role of foreign aid in these reforms is marginal. This also happens to be my view with respect to most transition countries of the region. The reason is self-evident. Using purchasing power parities, per capita GDP in the FSU and Central Europe was, just before the reforms, some US$ 5000 and, therefore, the total GDP of all the transition countries was about 2000 billion US dollars. The average fall of measured GDP during the contraction phase of transition has been about 40%, or $500 billion in flow terms. The investment needed to restructure the region's capital stock sufficiently so that, at least, the pre-reform level of GDP is regained must be several times the lost output; that is, of the same order of magnitude as the initial annual GDP, or some $2000 billion. The combined resources of international financial institutions are clearly too small by comparison to make a sizeable contribution to such an investment effort. The resources can in any case be provided only on a commercial basis, rather than as development aid, and therefore subject to strict conditions which transition economies cannot easily meet.

The argument above appears to fly very much against the general perception of the potentially large role which foreign assistance can and should play. That perception may in part be based on a fairly large actual role of the international financial institutions, particularly the IMF, in providing the expertise and policy guidance for economic stabilization and institutional development, and on confusion concerning the motivations guiding the cooperation between local reformers and international institutions. An extreme view would be that the West has been attempting to impose specific reforms and policies which reflect its own values and interests rather than the needs of the reforming countries. A large Western assistance has been provided or offered to transition countries as an incentive, indeed a form of compensation, for the countries to adopt the capitalist system and specific policies. One of the reasons for the reluctance of Western governments to offer

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sizeable foreign assistance to transition countries may have been the concern not to lend support to such a view.

Another, and perhaps more popular view, has been based on a drastic downgrading of the size of transition economies and a corresponding exaggeration of the potential economic impact of foreign assistance. Extreme devaluations of local currencies have for some periods reduced wages to some 20 US dollars a month, and the region's GDP to about $200 billion. By this account, Russia's GDP in 1992 was a mere $100 billion, or less than 1% of the West's GDP and about the size of West German annual assistance to the former GDR. It would therefore appear possible to stabilize the Russian economy by providing relatively small external aid to the government budget and the enterprise sector. Such a stabilization plan would of course be based on the illusion that the exchange rate would remain vastly depressed after stabilization has taken place.

5. Concluding Remarks

The impact of foreign assistance can be substantial, even vital, only on a few occasions, especially when it is in the form of grants and debt reductions. However, large grants, if not linked to performance, reduce the financial discipline of local economic agents, and may have an impact on transition economies similar to that of a soft budget constraint on state enterprises. The post-communist economies are also simply too large and their transition to capitalism too costly for the foreign assistance to have a more than marginal impact. Most of these economies are already heavily indebted, and this gives them little room for contracting new debt. A far more important foreign impact may come from the inflow of Western private investment and know-how. However, internal reform efforts rather than external financial assistance seem to be needed for this inflow to take place.

International financial organizations, especially the BWIs, have been helpful for Russia and Poland in providing local reformer with modern analysis and expert policy advice. They were also most helpful in pressing Western creditors for a sizeable debt reduction of Polish debt and a fast removal of trade barriers to West European markets. However, the sequence of reforms and the speed of transition in the countries have been decided largely by the initial circumstances, the new long term goals of the countries and the various internal political and institutional factors during transition. The difference between Poland and Russia has been mainly in the conduct of macroeconomic policy, and not in the core of transformation reforms. Some errors have been made, both in analysis and in policy, but in the crisis circumstances the main body of reforms, especially in Poland, has probably been about right.

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TABLE 1

Poland: Credit lines of the World Bank and their utilisation until 31. Jan. 1994

	Name	Receiving institutions	Approval Date	Sum in ml. US $	Utilisation, in ml. US $				Cumulative utilisation 1990-31 01.1994	
					1990	1991	1992	1993	in ml.	in percents
1	Ind. Export Develop.	NBP	6.II. 90	260	10.1	17.7	12.0	24.4	60.2	23
2.	Agricult. Export Develop.	NBP	6.II.90	100	14.9	9.1	32.4	15.0	71.4	71
3.	Environmental Management	G	24.V.90	18	0.5	0.4	6.5	3.0	10.5	58
4.	Transport General	E	1.V.90	4.75		1.0	0.6	1.4	3.0	63
5.	Transport Railways	E	1.V.90	145		16.0	18.5	20.6	57.3	39
6.	Energy Resource Develop.	G	5.VI.90	250		32.2	46.6	8.1	161.0	64
7.	SAL	G	31.VII.90	300	28.4	270.9	0.7		300.0	100
8	Telecomunications	G	23.IV.90	120		24.3	23.2	1.8	49.2	41
9.	Employment Promotion	G	23.VI.91	100		2.0	3.1	0.1	5.2	5
10	Financial Inst. Develop.	G	11.VI.91	200			75.1	7.2	82.3	41
11.	Privatisation Restruct.	G	11.VI.91	280		0.1	74.6	8.2	82.9	30
12.	Agricultrual Develop.	G	11.VI.91	100			1.00	4.7	5.7	6
13.	Heat Supply Restruct.	E	26.VI.91	285			47.5	25.3	73.2	14
14.	Health	G	7.V.92	130						
15.	Private Enterprise Deve.	E	7.VI.92	60						
16.	Housing	G	25 VI.92	200				4.6	4.6	3
17.	Roads	G	9.III.93	150						
18.	EFSAL	G	4.V.93	450				27.7	100.0	33
19.	ASAL	G	4.V.93	300				4.7	4.9	3
20.	Forestry	G	29.VII.93	146						
	Total			3598.75					1071.3	

Notation: NBP = Central Bank (National Bank of Poland), G = Government, E = economic units.

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TABLE 2

Poland: Credit Lines from the institutions other than the World Bank, until 31. Dec. 1991

	Credit taker	Credit	Equity Capital	Utilisation %
EBRD[Δ]	Private sector	264.0	75.5	?
IFCΔ	Private sector	158.1	32.6	?
EIB[+]	Economy	303.0	-	45
EBRD[Δ]	Government	166.5	-	1
IMF[*]	NBP			
(i)	Standby 20.II.90 - 14.III.91	545 (about $710)		60
(ii)	EFF IV.91 - V.93	1,828.6 (about $2500)		16
(iii)	Standby III.93 - IV.94	476 (about $600)		80
G-24	Government	1000 (Stabilisation Fund)		100

Source: Poland's Ministry of Finance, "Information concerning the utilisation of foreign credits", mimeo, 23 February 1994.

Note: Δ ml US Dollars, + ml. ECU, * ml. SDR.

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TABLE 3

Poland: Selected Economic Indicators, 1988-94 (Percentage change unless otherwise indicated)

	1988	1989	1990	1991	1992	Est. 1993	Proj. 1994
Domestic Indicators (in real terms)							
Gross domestic product (SNA basis)	4.1	0.2	-11.6	-7.6	1.5	4.0	4.5
consumption (SNA basis)	2.6	6.1	-11.7	3.3	5.0	4.1	2.4
gross fixed investment	6.1	-2.1	-10.6	-4.5	2.8	9.8	8.5
Consumer prices (period average)	60.2	251.1	585.8	70.3	43.0	35.3	-
Consumer prices (12 month increase)	72.9	639.7	249.3	60.4	44.4	37.6	23.1
Average monthly wages (period average)							
nominal	81.9	291.8	398.0	70.6	39.2	33.6	
Fiscal indicators (in percent of GDP)							
State budget revenue	35.6	30.8	33.3	25.7	27.0	29.6	30.1
State budget expenditure[2]	37.0	36.9	32.7	32.7	33.9	32.9	30.1
State budget balance[2]	-1.4	-6.1	0.7	-7.0	-6.9	-5.4	-4.2
General government balance[2]	-	-7.4	3.1	-6.5	-6.7	-2.9	-3.9
Monetary indicators (end of period)							
Net domestic assets[3]	127.3	192.3	38.4	142.0	35.6	21.7	21.1
Money and quasi-money	133.0	236.0	121.9	47.4	57.5	36.0	27.7
External indicators in convertible currencies (in terms of US dollars)							
Exports[4,5]	17.6	4.5	43.4	17.5	9.7	-2.9	0.8
Imports[4,5]	23.1	16.3	17.9	46.9	6.1	17.7	2.0
Trade balance							
in billions of US dollars	0.9	0.2	2.2	0.1	0.5	-2.3	-2.1
in percent of GDP[6]	1.4	0.4	3.6	0.1	0.6	-2.7	-2.4
Current account							
in billions of US dollars	-0.6	-1.8	0.7	-2.2	-0.3	-2.3	-2.7
in percent of GDP[6]	-0.8	-2.7	1.1	-2.9	-0.3	-2.7	-3.2
External debt (end of period)[7]							
in billions of US dollars	39.1	40.2	48.9	48.3	47.6	48.4	46.2
Ratio to exports of goods and nonfactor services in convertible currencies							
External debt services ratio[8]							
Due	85.0	61.6	56.3	71.5	20.0	21.5	17.5
Paid	20.0	16.0	6.9	6.6	9.9	11.2	-
Commercial exchange rate depreciation(-)							
Against US dollar (period average)	-.38.4	-70.2	-84.8	-10.2	-22.4	-24.9	-

Sources: IMF (March 11, 1994), where the sources are: Central Statistical Office, Rocznik Statystyczny, data provided by the authorities, and staff estimates.

1. In the five main areas of the socialised sector through 1990; thereafter in the six main areas of the economy.
2. On a commitment basis, except external interest which is on a cash basis.
3. In relation to broad money at end of the previous year.
4. Balance of payment basis.
5. Including transactions with former CMEA area for 1991 and 1992.
6. Gross domestic product in zlotry terms is converted into US dollars at the commercial exchange rate.
7. Including arrears in the Fund.
8. In percent of exports of goods an nonfactor services in convertible currencies, including the Fund.

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Table 4
Poland: General Government Operations, 1989-92[1]

(In percent of GDP)

	1989	1990	1991	Estimate 1992
Total Revenue	41.4	43.0	41.5	42.8
Tax revenue	35.5	37.2	33.6	37.0
Profit tax	9.7	14.0	6.1	4.4
wage tax	3.4	3.0	2.4	6.3
Turnover tax and excises	8.8	6.3	7.4	9.0
Social security contributions	9.1	9.0	11.7	13.1
Custom duties	-	0.6	2.1	2.3
Tax on excess wage increase	1.8	1.5	3.3	1.5
Other taxes	2.8	2.7	0.6	0.3
Nontax revenue	4.4	5.1	3.9	3.1
of which: Dividend requirements	1.7	2.2	1.5	0.6
privatisation receipts	-	-	0.2	0.4
other extrabudgetary revenue[2]	1.6	0.6	4.0	2.7
Total expenditure[3]	48.9	39.8	47.5	49.8
Current expenditure	38.9	33.2	39.5	44.8
Wages and salaries	6.8	5.8	7.4	9.1
Other goods and services	2.5	3.6	6.0	7.7
Interest payments[4]	-	0.4	2.3	3.7
Social security benefits	11.7	11.0	17.0	20.6
Pensions	8.2	8.1	12.2	15.0
Unemployment compensation[5]	-	0.1	0.9	1.3
Others	3.5	2.7	3.9	4.3
Subsidies	12.9	7.3	4.6	3.1
Producer subsidies	4.6	3.4	1.6	1.1
Consumer subsidies	0.4	3.9	3.0	2.0
Other current expenditure	5.1	5.2	2.1	0.7
Capital expenditure	3.3	2.8	2.2	2.5
Other extrabudgetary expenditure[2]	6.5	3.9	5.9	2.5
Overall balance[3]	-7.5	3.1	-6.0	-7.0
change in arrears, net[6]	2.0	-0.3	1.7	-0.4
Overall cash balance	-5.4	2.8	-4.3	-7.3
Financing	5.4	-2.8	4.3	7.3
Domestic	5.6	-2.7	5.1	7.1
Banking system	5.2	-2.8	5.0	6.6
Nonbank	-0.4	-	0.1	0.5
External	-0.3	-0.7	-0.1	-0.2
Others[7]	0.1	0.6	-0.6	0.5

Sources: IMF January 12, 1994, Table 14, here the sources are: National authorities and Fund staff estimates.

[1] Comprising the state budget, extrabudgetary operations, and the local government operations.
[2] Extrabudgetary operations that are excluded from the state budget, and, for 1991-92, includes local authorities operation (since 1991), state budget excludes local authorities).
[3] On a commitment basis, except for external interest payments which are on a cash basis.

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ZDENEK DRÁBEK

IMF and IBRD Policies in the Former Czechoslovakia

1. Introduction

When the revolution came to the former Federal Czechoslovakia, its relations with the international financial institutions changed from one extreme to the other. From virtually zero contacts before 1989, Czechoslovakia was inundated with International Monetary Fund and World Bank missions. The first contacts between the IMF and IBRD with the former Czechoslovakia were, indeed, very rich and promising. It might have been the attractive location, the history of the country, or its relative sophistication as a client that brought the staff of international financial institutions to the country with such great frequency. The plans of these institutions had virtually no bounds: technical assistance programs, new projects, policy support, and even a resident mission and possibly even a regional resident mission. Similar hopes were building up in the newly created European Bank of Reconstruction and Development and in the International Finance Corporation, the private sector arm of the World Bank.

However, the actual role of these institutions has fallen far short of these early expectations. The activity of IBRD has been limited to three projects, of which only two are actually ongoing. The only substantial drawing on funds from these institutions has so far been under the Structural Adjustment Facility (SAL) in the amount of USD (U.S. dollars) 450 million. The other Bank project was the Power and Environmental Improvement Project (Energy I) in the amount of USD 246 million to improve power plant efficiency, to reduce air pollution in Northern Bohemia, and to modernize the transmission system. The relations with the IMF have been more active: two standby arrangements with the federal government and one standby with the Czech government. The first standby of December 18, 1990 included a 14-month arrangement in the amount of SDR 619.6 million including SDR 147.5 million with a contingency element for oil purchases, and the so-called Compensatory and Contingency Financing Facility (CCFF) in the amount of SDR 483.8 million to help finance the rising costs of oil imports. The second standby of March 2, 1992 amounted to SDR 236 million. The third standby arrangement of March 1, 1993, this time with the Czech government only, was for SDR 177 million. The IMF has also established a resident mission in Prague.

Other financial institutions have also played a role, albeit a limited one. Arguably the most active has been the European Investment Bank, which has expanded its activities into the market of Czechoslovakia under the provision made in the Europe Agreements. Their role has been restricted to a small number of projects in the area of infrastructure. The other financial institution with activities in Czechoslovakia was the EBRD, which has negotiated several highly visible transactions that included infrastructural projects in the public sector as well as investments in

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the private sector. Nevertheless, the number, as well as the nature, of these projects was below the expectations of most observers.

Even the role of the Fund has been much smaller than originally expected. The government has not fully utilized resources available under the third standby. However, in contrast to the usual suspensions of IMF programs elsewhere in the world, the suspension of the Czech standby was at the request of the Czech government. The government found the financial position of the country to be so favourable that it decided against drawing on the remaining two tranches of the standby and for prepaying its debt.

The activities of the international financial institutions can be discussed in two different ways. The role of these institutions may be important in terms of their contribution to resource mobilization and in terms of their impact on policies. There is absolutely no doubt that the contribution to resource mobilization in the Czech and Slovak Republics has been vital. This contribution was especially important in 1990-1991, the first years of transformation when the country needed a fast response from the international community, and these institutions did respond very quickly indeed. Therefore, I shall focus my discussion mainly on those activities of these institutions that have had important policy content.

The activities with important policy content have been concentrated, so far, primarily on assistance for macroeconomic stabilization and a broad economic reform. They involved the above-mentioned standby arrangements of the IMF and the SAL of the World Bank. Other activities with a policy content have been directed towards sectoral policies in the energy sector. This activity has involved a joint effort of the World Bank and the EBRD; also under the discussion is a project in telecommunications.

The purpose of this paper is to review the policy-based lending of the IMF and the IBRD in the former Czechoslovakia. The focus will be on the stabilization policies because other policy-based lending does not exist with the single exception of the energy sector. This means that excluded will be also an evaluation of specific projects of the EBRD and IFC, both of which have been relatively active in the private sector. I also shall not discuss the technical assistance efforts of these international financial institutions nor those of other agencies, which have been quite extensive. Discussion of all these issues would be very much beyond the scope of this paper.

The questions to be addressed in this paper include: (1) Have stabilization policies been successful in the former Czechoslovakia? (2) If so, why, and what were the reasons and what role has been played by the IMF and the World Bank? My argument can be summarized as follows. The stabilization program has been relatively successful as evidenced mainly by the success in reducing the rate of inflation, maintaining low unemployment, and requiring small recourse to external borrowing. Moreover, on all these fronts the country has done better than other economies in transition. The explanations for this are complex. The factors were partly exogenous, such as smaller initial inflationary gap and social peace with modest wage claims, no strikes, and political support. But the good results were also due to good policies, including strict monetary policy, fiscal restraint, large devaluation of the exchange rate, and strong external support, foreign exchange

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and trade liberalization, in the formulation of which the IBRD and IMF played an active role.

Nevertheless, problems remain and these include falling GDP and an inflation rate well above that of the country's competitors. Even though there are signs of the end of recession, unresolved issues remain: wage growth is too fast in terms of productivity as well as in comparison to inflation, and this is a policy issue. Other policy issues include the exchange rate, interest rate policy, and the shortage of long-term resources. It can also be argued that industrial productivity has been falling due to a slow rate of adjustment of firms, which raises a host of policy issues, e.g., lack of financial discipline, weak corporate governance, highly leveraged firms, and a fragile banking sector.

The paper consists of four sections: Section 2 describes the stabilization policies, that is, their objectives, policy instruments, timing and sequencing, the performance criteria, and the role of structural policies. Section 3 focuses on the performance in 1991-1993 and demonstrates how well policy has been implemented in spite of exogenous influence such as the split of the country, the collapse of external markets in the East, and the recession in the West. Section 4 suggests that the country is not yet over the hill and identifies areas of concern including policy issues.

2. The Stabilization Program

The fundamental objective of the stabilization program has been to contain inflationary pressures generated by the policy of liberalization. These policies, together with wide-ranging institutional reforms to be discussed below, have been an integral part of the economic transformation from central planning toward a market economy. These objectives have been fully shared by objectives of the standby arrangements with the IMF as well as by the IBRD under the SAL umbrella. The objectives of the SAL program loan were slightly broader in that the loan emphasized assistance in reducing the unacceptably high economic and social costs which would otherwise be associated with the first phase of the economic transformation.

The important feature of these programs was a broad agreement between the Fund, the Bank, and the Government regarding the direction of the economic reform as well as the specific objectives and instruments of the stabilization program. The principal objective of the stabilization program was to ensure the internal and external stability of the currency, which was translated into the targets for consumer price inflation, 30% in 1991, to 12% in 1992, and to 15% in 1993, and the stability of the exchange rate. The main instruments of the program were (1) strict fiscal targets, (2) tight monetary targets, (3) unification of the exchange rate and devaluation, and (4) wage control. These measures were directed toward restricting the growth of domestic demand, encouraging the growth of exports, and reallocating resources from nontradeables to tradeables. In addition, the government agreed with the international institutions on price and trade liberalization, competition and deregulation, steps toward financial sector reform, energy policy, labor market, and social policy.

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Another interesting feature of these programs, especially that of the IBRD, was the inclusion of structural policy measures in the reform packages. This may not be an interesting phenomenon to Western readers, especially those who are familiar with the IBRD structural adjustment facilities, but it is a point that cannot be emphasized enough for Czech readers. Some Czech experts are still calling for the introduction of structural policy reforms as if the government has refused to do so. Others, this time from the present as well as from the previous governments, argue with passion that no structural policies will be adopted by the government since these interventions would only distort the operations of the markets. Clearly, all these disputes stem from a serious misunderstanding about the real meaning of structural policies. The present government officials typically understand structural policy to mean investment decisions by the government, in the spirit of the central planners of the past. But these are fundamental misunderstandings. Fortunately, the implications of these misunderstandings are not too serious. What matters is that the present government in fact has been willing to adopt a great number of structural policy measures without perhaps even realizing it, and it has been playing down their importance for political reasons.

The structural policy measures agreed with the government included under the SAL facility (1) tax policy measures; (2) price liberalization; (3) liberalization of foreign trade, including elimination of foreign trade monopolies, abolition of QRs, tariff restructuring, selective tariffreduction, and reduction of export licensing; (4) privatization; (5) enhancement of competition policies including adoption of the Competition Law and the creation of an anti-trust office; (6) banking sector reform focusing on the establishment of a two-tier banking system, opening of the banking sector to foreign banks, submission to the Parliament of the Banking Law, strengthening of bank supervision, introduction of a new payment and settlement system, and preparation of strategic financial audits; (7) energy efficiency measures emphasizing an increase in energy prices toward the market level, selection of the least-cost investment program for the electricity sector and submission to the Parliament of the Public Utilities Law; and (8) extensive measures establishing the social safety net. In sum, the SAL facility has provided for an extremely large policy-based program that probably far exceeds the standard SALs that the Bank has concluded elsewhere. The vast extent of these measures was possible, of course, primarily because the measures had been either already adopted by the government before the agreement with the Bank or they were in the process of being implemented. The extent of the policy-action program notwithstanding, some policies were clearly critical while others were less significant. More important, certain policy measures crucial to a successful transformation were missing.

There were also two significant differences between the programs agreed with the Fund as compared to the program agreed with the Bank. The first difference was, of course, the question of emphasis on tranche release conditions. While the Fund approach is traditionally more geared to fiscal, monetary, and international reserve conditions, the Bank's SAL program emphasized additionally other policy, typically structural, measures. The SAL project was "front-loaded," which means that the first tranche of the loan was released on the day of effectiveness, but the two remaining tranches were tied to conditionality. These conditions were:

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Second Tranche: (1) Additional liberalization of domestic prices and export quotas, (2) preparation of the privatization program and submission to Parliament of new banking legislation, (3) least-cost investment program in energy and increase in electricity prices, (4) wage control limited to minimum wages and to total enterprise wage bills, and (5) targeting and delivery of social benefits.

Third Tranche: (1) Continuation with the privatization program, (2) introduction of governing principles for the reform of the banking system, (3) submission to Parliament of a Public Utilities Law, (4) enactment of legislation on social insurance fund, measures to improve efficiency of higher education, and research and development and health sectors.

The IMF conditionality included targets on net domestic assets of the banking system or, alternatively, net credit of the banking system to the Government, the cumulative change in net international reserves in convertible currencies of the banking system and on the net disbursements of external debt. These are, of course, standard Fund conditions.

The implementation of the programs, both the Fund's and the Bank's, has been smooth. Even though some disagreements have existed, mainly between the government and the Bank, the differences were small and easily resolved. The inflation targets have been broadly achieved even though the 1991 target turned out to be substantially more optimistic than the actual figure for the year. One area in which the implementation process has been slightly derailed was the reform of state enterprises for which the Bank anticipated much faster action by the government in preparing and submitting the new Bankruptcy Law. The law was not adopted until much later, which slowed down the introduction of better discipline in public and newly privatized companies. Moreover, apart from this policy reform, the SAL program had very little to add to public enterprise reform except for a superficial requirement for the government to introduce a hard budget constraint in the state-owned companies. Minor difficulties have also arisen in the case of, for example, social policy measures, but these were more a question of timing and sequencing rather than of substance. In the end, none of these program loans has been subject to any disruptions, such as the need for renegotiation of contract terms, let alone disagreements that might lead to suspended disbursements. On the contrary, the IMF stabilization program has been proceeding so well that the government decided not to make the last drawings and began to repay its debt earlier than contractually agreed, as noted above.

All this is relevant for one important reason: it is very difficult to distinguish between the actual program and recommendations of the IMF and program of the government. Typically, of course, all IMF programs are in fact programs of the government concerned, but not all governments are as keen on taking the necessary medicine of restrictive measures as has been the Czechoslovak government. In fact, the government stabilization measures have been so radical at times that they have kept even the Fund staff blushing: viz., for example, the size of fiscal surplus, below-target growth of credit.

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3. The Success of Stabilization Policies

The stabilization program in the former Czechoslovakia and in the present Czech Republic has been considered by many observers a major success. The program has been even heralded by some as one of the most successful Fund programs in its history, and it is often presented as an example of what such programs can achieve. One indication of this success is the fact that the Fund's resources have not been fully utilized by the Czechoslovak and Czech governments respectively. The main evidence of success is, however, the actual performance of the economy.

The best indicator of good economic performance has been the remarkable success of the government in containing inflationary pressures once prices were liberalized in 1991 and 1992. After the initial pricejump of 25.8% in January 1991, the rate of monthly inflation slowed dramatically. The overall annual inflation rate for 1991 was 56.7% (Tables 1 and 2). If we omit the extraordinary increases in prices that were attributable to administrative measures, the monthly rate of inflation was in the range of only 0.0-2.0% that year. The annual inflation rates in 1992 and 1993 were lowered even more as the government continued with its determined effort to reduce the inflation rate. By the end of 1993 and the beginning of 1994, the monthly inflation rate was down to the range of 0.2-0.6%.

Success was also demonstrated in other areas. Throughout the duration of the stabilization programs, unemployment, a major concern of reformers, has never got out of control. Again, the numbers have been remarkably positive. Unemployment first appeared in 1990 but began to grow only in 1991. However, throughout the whole period, the unemployment rate has remained substantially below the rate not only in other transforming countries but also in the West.

Real incomes of the population have also held up reasonably well. After the initial fall in 1991 of an estimated 25.5% real incomes started to grow again in 1992 and 1993. By the end of 1993, it is estimated that real incomes of the population were about 17.9% below the level of 1989. Thus, if we add to the successes of low inflation and unemployment also the fact that real incomes of the population have been rising since the initial decline in 1991, we can see that the costs of transformation have remained reasonably low in the Czech Republic. This also explains why the social scene has been spared any major disruptions.

There are other indicators of success. Consumer markets have been greatly improved so that the consumer market equilibrium has been widened and strengthened. Corruption has not been, of course, fully avoided but it is far less of an issue than it appears to be in other transition economies. The most impressive indicator has been the growth of international reserves reflecting a rapid increase in confidence among international investors (Table 1). This was partly due to financial assistance arranged by, or through, international financial institutions and to the growth of foreign investment and to foreign borrowing.

The only major macroeconomic indicator adversely affected under the stabilization program has been the growth of GDP, arguably the most important of all macroeconomic indicators. As Table 1 shows, it is estimated that GDP fell in the first year of the reform in 1990 by 1.2% and the decline continued in all subsequent years. The only consolation has been that the rate of decrease has been itself

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decreasing so that by the end of 1993 the rate of growth of GDP stabilized at around 0%.

Even these GDP figures have been interpreted by the Government fairly positively. The Government has consistently argued that the GDP figures have been biased downward for two reasons. The first is that the GDP statistics cover the activities of small businesses poorly due to tax avoidance and also because the statistical authorities have not yet been able to monitor the activities of this brand new sector. The second reason concerns the problem of product-quality and product-mix. There is no doubt that the reform has brought along a major shift in the mix of products that have appeared in the markets due to the expansion of imports, joint ventures with foreign companies, and greater responsiveness of domestic companies to market pressures. Similarly, the quality of products has improved as consumer sovereignty, as well as the pressures of competition, has increased. Due to these factors the government has repeatedly argued that the official GDP figures understate the true rate of growth.

What is even more remarkable is that these successes have been achieved despite three major external shocks, which under any circumstances produce serious disruptions to trade, capital flows, and domestic production. The first of these shocks was the collapse of the CMEA market, which used to be particularly important for the former Czechoslovakia. In its heyday in the mid-1980's, the share of all CMEA countries in Czechoslovak trade was almost 80%, which is considerably more than in the other European CMEA eountries. By the early 1990's, the share dropped to less than 20%. Total losses of output due to the collapse of CMEA were estimated in the range of 30-50% in 1991-1992 (Rodrik,1993). The country has successfully adjusted its trade pattern by increasing its trade with the West, especially with the European Union. The second external shock was the deep recession in the West in 1990-1993, which put severe barriers on the growth of Czech exports to these countries. The third and arguably the most serious external shock by far was the collapse of the former federation of the Czech and Slovak Republics, which has led to the creation of two independent states with their own governments and economic institutions, as well as their own currencies. The impact on trade has been dramatic: the real value of Czech exports to the Slovak Republic declined by about 22% in 1993.

a. The "Luck" Factor

The relatively successful performance can be explained by a number of exogenous factors. The first reason was the starting position of the Czechoslovak government which was considerably better than the starting position of other governments in Central and Eastern Europe including the countries of the former Soviet Union (see Drábek et al.,1994). The level of general macroeconomic disequilibrium in 1989 and 1990, the period of the critical political and economic changes, was much lower than in these other countries. Moreover, the absolute level of the disequilibrium was so low that the total amount of resources, domestic and external, required to support the transformation could be mobilized relatively easily. Thus, Czechoslovakia in 1990-1991 quickly gained access to more than USD 1.5 billion through

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the IMF and IBRD facilities, which were further supplemented by additional borrowing of the Czechoslovak National Bank in the commercial market. The highly successful effort to mobilize resources externally, together with the low level of disequilibrium, made it possible to apply fairly modest restrictive measures domestically.[1] This was reflected in the fairly small general price increase generated by a sudden liberalization of domestic prices. Other starting conditions were also highly favorable: a balanced government budget, low domestic indebtedness of the government, small external debt, and a consumer market that was relatively well supplied with consumer goods and that did not have widespread queues and shortages or parallel markets.

Other non-policy-related factors have been also conducive to good performance. They include a favorable improvement in terms of trade (see Table 1). Social attitudes and placid behavior of the population have been highly conducive to the implementation of the reform. The attractiveness of the country in general, and of Prague in particular, stimulated enormous growth of tourism. The total number visitors to the Czech Republic in 1993 was estimated at between 70-80 million tourist days. The total receipts from tourism in 1993 exceeded USD 1.5 billion, contributing to the financing of trade deficits in the early period of the reform. Another important factor was the proximity of the country to the German and Austrian markets, providing a great opportunity for Czech traders and producers after the collapse of CMEA. This proximity has been also extremely important in providing job opportunities for people in border areas that were particularly exposed to the domestic recession.

Savings behavior of economic agents has been another positive variable. Savings behavior has been subject to several adverse influences and uncertainties, such as the separation of the country and the elimination of old currency and introduction of new money, to name just two, albeit very important, events. Real interest rates, especially short-term deposit rates, have remained negative throughout the whole period. Moreover, taxation of savings has been high by international standards. Nevertheless, household savings have been growing quite impressively despite all these factors. The savings behavior of the Government sector was similar. For example, the outturn of the central budget showed in 1993 a large surplus against the anticipated balanced budget. Local governments, in particular, were very cautious, and they accumulated substantial surpluses (see Table 4). All these agents had one thing in common: a strong financial conservatism.

b. Success of Policies

The economic performance has been also positively affected by the conduct of government policies. The effect came in four areas. The first was the flexible real wage policy. As Table 1 above shows, the growth of wages was very moderate in 1990

[1] We have now evidence to support the thesis of many critics that the domestic policies have been highly restrictive on the growth of domestic demand. See, for example, Kotulán (1993).

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and 1991 in the aftermath of price liberalization. The growth of nominal wages was 3.5 and 16.7%, respectively, well below the rate of inflation, which led to an estimated fall of real wages of 31.2%. This was possible mainly due to the government policy of controlling wages. This policy lasted until 1992, when the controls were lifted and replaced by a Tripartite Agreement between the government, the unions, and the employers. The Agreement provided for growth of wages tied to the rate of inflation plus up to 5%, which effectively allowed more-than-inflation indexing. The unions took full advantage of these provisions of the Agreement, and, indeed, the growth of wages excceded the growth of inflation by almost 5% in 1993. The government was, therefore, forced to return to wage controls in the second half of 1993.

In addition to wage policy, other elements of price policy have been instrumental to success. Product prices were liberalized almost completely and in one step, and this had the following positive effects. Enterprise liquidity increased, and this helped especially those enterprises that lost budgetary support. Price liberalization also changed domestic relative prices, and these are now close to world market relative prices, a *sine qua non* for a small trading nation like the Czech Republic. The liberalization of prices has also been the key factor in stimulating the private sector and the inflow of foreign investment. Last but not least, price liberalization has reduced the scope for government allocation of resources and the dangers of corruption.

Another aspect of policy that helped create a successful transformation was the privatization policy of the government. This policy was ultimately the one aspect of the government reform package that most differentiated the Czech Republic from other countries and that made the biggest contribution to the success of the economic program. The process included two methods of privatization: small and large privatization. Small privatization led immediately to the change in effective ownership as properties were auctioned off to their new owners. Small privatization introduced, therefore, better conditions for financial discipline in newly privatized firms as new owners were under greater pressure to repay loans used to acquire the property and to survive as new businesses. Large privatization also made a difference. This was the case in spite of the widely voiced criticism that the voucher method was an inefficient and inequitable way of transferring property from the state to private owners.[2]

Privatization policy made several important contributions: strengthening corporate governance and the balance of payments, encouraging the inflow of foreign investments, expanding the service sector and small and mediumsized enterprises (SMEs), and facilitating government budgetary policies. Large privatization was important for corporate governance on two accounts. First, a vast number of state assets were sold directly to domestic or foreign investors who have fundamentally changed the management of their companies. Second, large-scale privatization led to the commercialization of the banking sector. Large-scale privatization has been also successful in strengthening the balance of payments because it has affected a large number of enterprises (Table 3). The key was, again, foreign investments. The

[2] See, for example, Kouba (1993) and (1994).

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mass privatization approach enabled the government to privatize about 1500 enterprises in 1 year and in the first wave of privatization alone. It attracted more than USD 2.0 billion of direct foreign investment in the 3 years,1991-1993. Privatization policies have also opened up room for a dramatic expansion of the service sector and for the growth of SMEs (see Table 1). Last but not least, the policies have considerably reduced the financial burden of government support to enterprises (Table 1), while they dramatically increased the revenues of the state.

Even though large-scale privatization was an important element of the agreements with the international lending institutions, the voucher method initially was not supported by the World Bank. Fortunately, this never became an issue because whatever disagreements existed on this topic could not affect the actual agreements about the stabilization program. As noted above, the method was not seen as an efficient way of introducing corporate governance, and the advantages were, therefore, seen as mainly political rather than economic. Nevertheless, both the Bank and the government have seen privatization as being vitally important in ensuring that the impact of monetary policy measures filtered down to credit providers and credit recipients. The position of the Bank toward the voucher method of privatization has changed quite dramatically over time, which shows a considerable degree of flexibility. Today, the method is fully supported by the Bank not only in the Czech Republic but also elsewhere in the transition economies.

The third important area where reform supported success was foreign exchange liberalization. The initial step included a complete liberalization of all foreign exchange transactions on the current account, excepting the transactions of physical persons who were domestic residents and all transactions involving inward foreign investments. The main attraction of this step was its positive impact on the inflow of foreign investments, which was favorably influenced by the right of unrestricted transfer of profits, dividends, and capital abroad. Foreign exchange liberalization has also enabled a complete liberalization of imports, which in turn has provided more competition for domestic firms and helped to break domestic monopolies. Liberalization has also kept a brake on the growth of domestic prices and was instrumental in improving consumer market equilibrium.

The fourth important reason was the conduct of fiscal, monetary, and exchange rate policies, which effectively eliminated dangers of hyperinflation within 3 months of 1992 (Table 2). The positive role of fiscal policy lay mainly in stimulating companies' liquidity and savings and reducing their demand for bank credit. The starting fiscal position was relatively favorable, as noted above, but the government faced two major challenges. Privatization, together with the liberalization of commodity, factor, and financial markets, were expected to increase the pressures on the government to increase support for ailing companies and rising unemployment. The other challenge was self imposed. The government set itself two objectives: to minimize the claims of the state on domestic savings and to reduce the role of the state in the economy. Both objectives have been met, as can be seen from Table 4, which shows the highly disciplined behavior of the government sector, which consisted of the federal government and two national governments until the separation of the two countries in 1993, as well as of local governments. The consolidated public sector position was in surplus in 1989-1990

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and incurred a small deficit in 1991-1992. Fiscal stringency increased further in 1993.

Fiscal performance was achieved both by restraining government expenditures and by reducing the tax burden (see Table 5). The expenditure restraint was concentrated on two major steps, a significant cut in budgetary subsidies to enterprises, which were, therefore, forced to increase their selffinancing capabilities, and by a large cut in real capital expenditures. For example, the real capital spending of the government in 1993 is estimated to have been reduced by 70.8% in comparison with the level of 1990. At the same time, the reduction of the tax burden has been primarily channeled to the enterprise sector, helping the companies at the time when production subsidies were lowered. Moreover, the government attempted to help companies by reducing indirect taxation in order to stimulate domestic demand.

This, too, was a sensible policy even though, for other reasons, the supply response to this policy remained limited, and the policy resulted in higher financial profits for companies. This thrust of fiscal policy continued in 1993. Since the fiscal numbers are not easily comparable between 1992 and 1993 due to the split in the federation, the 1993 budget is not reported here.

The success of monetary policy lay in the ability of the Central Bank to meet its monetary targets. The success was, of course, not foolproof, as I shall discuss further below, but there is no doubt that the Czech National Bank has been able to contain the growth of money supply at relatively low rates for three reasons. First, the demand for credit by the government has been extremely low, as noted above. Net credit to government declined in 1992 and 1993 after a small increase in 1991. Second, other components of bank credit also have been growing well within the target zone. The most rapidly expanding component of credit demand has been credit to enterprises, but even this component has been growing at reasonable rates (see Table 6). Third, the monetary authorities have been able to restrain the growth of money even in the face of a rising net inflow of capital that was related partly to speculative movement of money from Slovakia and partly to the inflow of direct and portfolio investment, which, in 1993 alone, reached a level of USD 1.6 billion.

Control of the growth of money stock has been achieved by the authorities through a combination of direct and indirect instruments. During the first 2 years, the authorities relied primarily on indirect instruments by setting interest rate and credit ceilings both on the overall level of credit and by setting individual credit ceilings for major banks. This policy was practiced for about 2 years, and interest rate ceilings were abolished in April 1992 and credit ceilings in October 1992. Since then, authorities have relied almost exclusively on indirect instruments such as minimum reserve requirements, discount and Lombard rates, rediscounting facilities, the auctioning of refinancing credits and, from July 1992, sales of Central Bank bills.

The final point is the conduct of exchange rate policy and the success in maintaining a stable exchange rate since 1991. There is no doubt that the stability of the exchange rate must be considered a success in light of the government's overall objective to control inflation. A stable exchange rate has been instrumental in helping to keep inflation down by avoiding an upward pressure on domestic

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prices from rising import prices, which would have occurred had the currency been devalued as was done in other Central European countries. The foundation of this policy consisted of the three successive devaluations that took place in 1990-1991 and that resulted in the depreciation of the currency to the level of the unofficial rate for the koruna in Vienna. This resulted in a devaluation large enough to stabilize the balance of payments by encouraging exports and providing for adequate protection from imports. It is estimated that the devaluations overshot the rate of the purchasing power parity by a factor of three, and this gave the government considerable leeway to allow real appreciation and time to protect domestic firms from foreign competition.[3] In addition, by fixing the nominal rather than the real rate of exchange, the government was able to eliminate one potential source of inflation, as noted above. Clearly, all these steps were negotiated with the international institutions, although these have recommended rather different policies in Hungary and Poland where the government followed more closely the movement of real exchange rate.

4. The Stabilization Policies and Economic Growth

However successful government policies to stabilize the economy have been, there are concerns about the future. Some of these have to do with policies that have been applied thus far and others may be due to policies that have not been applied at all. The reasons for concern are twofold. As noted above, GDP has been declining for the past 4 years, at least in statistical terms, and for at least 2 years longer than projected by the World Bank and by the Fund in the early phases of the programs. Clearly, GDP growth has been affected by exogenous shocks, as noted above, but there are also reasons to believe that the existing recession is also partially policy-induced. The other reason for concern is inflation. Even though inflation control in the Czech Republic has been undoubtedly more successful than in other transition economies, this success is not sufficient to ensure that any future recovery can be sustained. This is because the inflation performance relative to other transition economies matters only marginally in view of the small volume of mutual trade that exists among these countries. In contrast, relative inflation performance matters much more when it comes to the comparison with OECD countries, and, in this comparison, Czech performance is considerably worse.

Appreciation of the Real Effective Exchange

Given the faster inflation rate relative to the inflation in the OECD countries, the real effective exchange rate (REER) vis-á-vis the dollar and the Deutsche Mark, two currencies that make up the basket used in setting the koruna's exchange rate, has been appreciated rapidly. The initial competitive advantage of Czech tradeables obtained by the original devaluations has been, therefore, gradually eroding under

[3] See, for example, Pick (1994).

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the existing policy of a fixed nominal exchange rate. The current exchange rate probably still provides sufficient advantages for domestic companies to compete with foreigners, but, unless there is a dramatic reversal in the decline of domestic productivity or the domestic inflation rate is pushed down to the rate prevailing on the country's main markets, the policy of fixing the nominal exchange rate could turn out to be a serious constraint.[4] This is primarily because the loss of competitiveness could seriously affect restructuring plans of domestic companies, which are becoming not only more uncertain but also more costly. In sum, what may appear to be an equilibrium exchange rate in the short run may not be sustainable in the long run.

Furthermore, there is also no doubt that a fixed nominal exchange rate also complicates the conduct of monetary policy. In the course of the last 7 months of 1993, the Czech Republic received more than USD 1 billion of portfolio investments. This, together with about USD 550 million direct foreign investment, foreign borrowing by local companies of almost USD 1 billion, and receipts from tourism of more than USD 1.5 billion increased considerably the liquidity of the domestic banking system. This, in turn, has put considerable pressure on the monetary authorities to mop up excess liquidity. Whether this is the right time to do so remains unclear because banks' lending continues to be extremely cautious and to expand at a relatively slow pace. Moreover, the intervention would have to bring about an increase in interest rates, which would only further delay the expansion of credit needed to jump-start the economic recovery. On the other hand, even though there are costs to the existing exchange rate policy, there is no clear alternative. The only other policy option would have been a revaluation of the currency to slow down the inflow of foreign capital, but this would have been even more costly in terms of the impact on competitiveness of producers as noted above.

Critics of the exchange rate policy viewed the magnitude of the original devaluation as excessive because it was forced by the speed and magnitude of trade and price liberalization. Liberalization caused serious damage to domestic industry because it brought about a fast penetration of the domestic market by imports. This, in turn, forced the government to apply restrictive demand management policies in order to maintain the balance of payments in equilibrium.[5] However, without getting into a theoretical dispute with this argument, which clearly ignores and completely misunderstands the role of exchange rate policy, it is quite evident that the argument has so far not been supported by empirical evidence. It is difficult to argue about excessive costs of liberalization in a situation in which real wages have been growing since 1991 and the rate of unemployment is one of the lowest in Europe. Exports increased in 1993 by more than 20%, which also indicates that export incentives have been very powerful so far and that the supply response has been quite impressive. So far, no major complaints have been registered about injuries from import penetration. It is needless to point out, however, that the magnitude of the devaluation has prevented the authorities from making an effective

[4] These policies are beginning to be understood also in the Czech Republic. See, for example, Jonas (1993).

[5] See, for example, Pick (1990) and Turek (1990).

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anchor of the exchange rate, as they had hoped. The domestic price level has not been anchored by the foreign price level, as is evident from the faster domestic inflation in comparison to that in Western Europe.

Tightness of Monetary Policies

As noted above, the monetary authorities have been often criticized by those who argue that the monetary stance has been too tight (e.g., Klacek, 1994, Vienna Institute,1993). Before we turn to this criticism in some detail, it is necessary to put monetary policy into a broader context of overall macroeconomic management. This raises, first of all, the question of whether the inflation rate should not have been lower than what has been actually achieved. Here the answer is very clear: inflation continues to be a real danger. Current inflation erodes the real value of savings: most short-term deposit rates after tax are below the rate of inflation and this discourages savings.[6] The current rate of inflation is also much faster than that in competing countries, which impedes the adjustment process, as noted above. Until inflation is reduced to the rates at least comparable with the rest of Europe it must remain the number one priority of the government.

The tightness of monetary policy can be assessed in the context of the effects of other economic policies. Here the main issue has been the wage policy of the government. The policy, it could be argued, has allowed too rapid a growth of wages. Wages have been allowed to grow without any reference to the growth of productivity, which, it appears, was perilously declining throughout the period. The only exception was 1991 when real wages declined even more than the fall of productivity, but this outcome has not been repeated since.[7] Clearly, under such circumstances, all wage increases have been purely inflationary, and they have been monetized by central bank policy.[8] The disturbing story is that the current wage regulations may even allow the growth of wages to be faster than in 1993 as indicated by a high official in the Ministry of Labor.[9]

Fiscal policy, too, has had a major impact on the movement of monetary aggregates. The latter have been greatly affected by budgetary policies of different parts of the government, i.e., by the federal and the two national governments prior to 1993 and by local governments throughout the period. As we have seen, the con-

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[6] See Vojtíšek (1994).

[7] We have no analysis of true factor productivity. Available studies mix together structural changes with true factor productivity. There is also a disagreement whether output per worker has been falling, or rather rising as recently proposed by the Central Bank. Nevertheless, most observers would probably agree that output per worker has been falling since 1990. See, for example, Flek and Buchtíková (1993). See also the discussion of productivity and wages in Janáčková (1993, pp.27-33) and Kouba (1993).

[8] The only other alternative is, of course, external financing. There is evidence to suggest that external funding has been indeed instrumental in financing the trade imbalance in the course of the first three quarters of 1993.

[9] See "Letos mohou mzdy růst o desetiny procenta rychleji než v loňském roce": Hospodářske noviny, March 1,1994, p. 3.

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solidated budgetary position during the federation was in surplus in 1989-1990 and in small deficit in 1991-1992. Fiscal stringency became even more pronounced in 1993 after the breakup of the federation. The total consolidated surplus was 12.2 billion crowns at the end of June 1993. This, together with 6.9 billion crowns set aside from government debt service and 6.3 billion crowns of collected but temporarily retained tax revenues, accounted for about 4% of total outstanding credit of the banking sector at the time.[10]

Because the government keeps most of its accounts with the central bank, it is clear that the consolidated budgetary policies of the government had a contractionary impact on money supply. Some of this impact was not predictable in view of the unexpected surpluses of local governments which were unable to disburse all their funds assigned to investment projects. Moreover the fiscal surpluses together with the rising importance of foreign resources have increased the role of autonomous factors that determine the moment of money stock in the economy and reduced correspondingly the role of credit. This further complicates the conduct of monetary policy particularly in view of the policy of a fixed exchange rate.

The critics of the government's monetary policy have pointed to the very high nominal interest rates that have reduced the provision of credit to new and established companies and encouraged extremely risky investments. Some have even pointed out that the growth of money supply has been too slow, which has limited the access of companies to bank resources.[11] The criticism can be, therefore, split into two parts, interest rate policy and liquidity management by the central bank. The level of interest rates has been affected by four important factors, the expected rate of inflation, the limited scope for monetary authorities to lower interest rates, the shortage of long- term resources, and the banks' efforts to clean up their balance sheets. The expected rate of inflation has kept up the nominal interest rates on deposits, and this has adversely affected the costs of funds to banks. Effective competition among banks, both on the deposit and credit side, has remained limited despite a large number of new licenses issued by the central bank since 1990. This, in turn, has given large banks an opportunity to have better access to deposits than do smaller or newer banks. At the same time, the smaller banks have been aggressively luring depositors with higher deposit interest rates. The impact of the central bank on interest rates has been limited by the shortage of monetary instruments. This reflects partly limited effectiveness of the central bank's own interest rates and partly the shortage of government paper.[12] This was the main reason why the central bank had to rely on credit rationing in the first phase of the reform until 1992. The range of instruments has expanded impressively over the past 2 years, e.g.,

[10] For more details, see Kotulan (1993, pp.37-39).

[11] The distinction between the impact of policies on interest rates and the growth of money stock may seem redundant. Nevertheless, the impact may be sometimes different due to other interventions such as regulations or due to the role of competition.

[12] Given the policy of a balanced budget, the government reduced its recourse to debt financing. The securities market has been, therefore, extremely thin, which has forced the central bank to issue its own bills. In March 1994 the market traded with 24 billions Kc of Treasury bills, 16 billion Kc of bills of the Fund for National Property but with 58 billion Kc of central bank bills. See Kučera (1994).

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rediscounting and the issuing of bills, but the benefits are beginning to be visible only now.

The shortages of long-term resources can be partially attributed to policy and institutional issues. The authorities have been verv slow in designing the legislation and instruments to attract long-term resources from pension funds, insurance companies, other institutions, and the general public. For example, mortgage legislation, an ideal instrument to attract long-term savings, was first discussed only at the end of 1994 and the law has not yet been passed.[13] Finally, the level of interest rates has been fundamentally affected by the government policy to privatize banks without providing aid for all the existing nonperforming loans that the banks had on their books at the time of privatization. This policy was designed to avoid the "moral hazard" of banks but it has also forced the banks to make large provisions for bad or doubtful loans. The latter had to be financed by adding large margins to deposit interest rates; the 1993 average was more than 7%. These margins have remained persistently high and could not be reduced without major costs to the banking sector. It may be interesting to note that these issues were already well understood in the early years of the reform, and both the World Bank and other independent experts have favored a more radical method of cleaning the banks' balance sheets.[14] The criticism of the liquidity policy of the central bank also seems misplaced. There is no serious evidence to support the view that there was an overall shortage of credit to the nongovernment sector.[15] The arguments have thus far been based on anecdotal evidence about difficulties of small businesses in obtaining credit. The criticism also centers on the failure of the central bank to keep monetary growth within the stated monetary targets.[16] However, this criticism fails to take into account the fact that the original monetary targets were based on more optimistic assumptions about the growth of output, and the failure to achieve the monetary targets reflects nothing more than a response of the central bank to slower growth. Moreover, we can deduce some trend from the partial evidence that, on the whole, confirms the conclusion that the Czech economy has not suffered from a credit crunch. In particular, the velocity of circulation remained on average more or less constant over the period under observation even though temporary fluctuations on a quarter-to-quarter basis have been observed. These fluctuations could be partially explained by temporary withdrawal of savings that took place on at least two occasions. The first occasion occurred in 1990-1991 when a small monetary overhang was absorbed by higher money expenditures on consumption. The second occasion occurred in 1993 when the monetary movements were affected by a small withdrawal of deposits in early 1993 at the time of separation of the two republics.

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[13] In spite of their impressive start, the capital markets in the Czech Republic cannot be expected to be an effective alternative for some time to come. See Drábek (1994).

[14] See, for example, Long (1991) and Begg and Portes (1992). Needless to say, however, that the Bank itself has not been entirely convinced about this solution. For a contrasting view see, for example, van Wijnberger (1992).

[15] The only serious attempt to analyze the liquidity position of the banking sector is, to my knowledge, that of Siklos and Abel (1993); who do not find any evidence of credit crunch.

[16] See Hrnčíř (1993) and Kotulan (1993).

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Another indicator of a possible credit crunch, interenterprise debt, has shown movements that could be explained by other factors. It is true that the total interenterprise debt increased significantly between 1990 and 1993, and this has been interpreted by some writers as the product of tight monetary policy.[17] The total amount of interenterprise debt amounted to 157.6 billion Kc, about USD 5.3 million, at the end of December 1992; the corresponding Czech and Slovak figures were 94.4 billion Kc and 63.2 billion Kc respectively, which represented as much as 27.6% of total outstanding bank credit.[18] However, the interesting aspect of this debt was that it changed over time, including a significant reduction in the course of 1992 before the total amount increased again. This would suggest a different interpretation of the emergence of interenterprise debt, that is, the debt has been at least as much due to the financial indiscipline of enterprises as it has been due to the shortages of credit. By far the most powerful argument against the criticism of monetary policies has been the growth of domestic aggregate demand. As can be seen in Table 1 above, private consumption has been growing in real terms since 1991, or at an average annual rate of 5.1%. The growth has been fueled by the rapid growth of wages, which has been partly channeled to a growth of household savings, by 26% in 1992 and by 22.6% in 1992 and 1993, respectively, as well as to the growth of consumption.[19] The growth was rapid enough to offset the initial fall in capital spending in 1991 (see also Table 1). Total domestic aggregate demand was rising relatively fast in 1990 and 1992, and this growth was met by rapidly expanding imports and partly by rising prices. As noted above, the domestic supply response remained more than sluggish.

Limitations of Structural Policies

If any serious criticism can be raised against the government policy, then it will concern primarily structural policies that might have been more conducive to growth of output. There has been a major controversy in the country about how much demand management the government should, or indeed could, have done.[20] Given the growth of domestic demand and the existing low level of unemployent, the risk of faster inflation stemming from demand expansion must have been very high. Moreover, given the structural rigidities in the financial sector, it is extremely unlikely that monetary policy could have been used more effectively to stimulate aggregate demand, as noted above. On the other hand, more effective structural policies could have provided a significant impetus to growth of output. Even though the government has adopted a number of important structural policy meas-

[17] See Hrnčíř (1993).

[18] See "Indikátory měnového a hospodařského vývoje v roce 1993," Czech National Bank, 1993. Unfortunately, these data are no longer collected and published.

[19] See Měsični Bulletin ČNB, No. 3, 1994.

[20] See, for example, Klacek (1994) but also OECD (1994) and Vienna Institute (1993) to name just a few of the protagonists who have been pushing for a more active demand management.

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ures, as noted above, the structural policy interventions have not been sufficient. The role of the international financial institutions has not been, in this respect, forceful enough to convince the government that the adoption of some of these policies would be crucial to restoring economic growth. Among these policies, one should include mainly those that affect the corporate governance, the financial sector, and the infrastructural policies.

The issue of corporate governance was expected by the pioneers of the voucher scheme to be fully resolved with the implementation of privatzation policies, but this expectation was not met. The voucher method has been very successful in de-etatizing state property, but it has not yet brought about a major improvement in corporate governance. This is reflected, for example, in a huge intra-enterprise debt that was created after the imposition of tight monetary targets and that represents partly the reaction of nonfinancial enterprises to the lack of bank credit but mainly the absence of financial discipline as mentioned above. The reasons for the lack of effective ownership are several. Legal limitations on equity ownership imposed on investment funds restrict the control of companies by their owners, the investment funds. Banks are subject to conflicting interests as owners of major, investment funds and as creditors of enterprises owned by those funds. Moreover, banks have been unwilling to be more aggressive in collecting the outstanding loans by putting companies into bankruptcy in order to avoid taking possession of properties that have been securitized by their clients or to avoid debt-for-equity swaps.[21]

Financial sector policies have been vigorous over the past 4 years but they, too, have not been entirely satisfactory. Bank competition has been greatly increased through the central bank licensing procedures, and most banks were recapitalized following the stricter capital adequacy requirements of the monetary authorities. An expansion of banking products and services was made possible by amendments to the banking law and the foreign exchange law and by the adoption of the law on securities, investment funds, and the stock exchange. Banks were assisted in restructuring their balance sheets by the government's move to refinance a part of their nonperforming loans, to name just a few main elements of the policy reform. However, major problems still remain. One problem has been the banks' credit policy which has been constrained by intertwined relationships among borrowers, the investment funds, and the banks themselves, as noted above. This has been made possible by the decision of the monetary authorities to establish a universal banking system, a decision that may turn out to be a major weakness in the future.[22] Furthermore, the banks' credit policy has been biased toward short- and medium-term credits since banks have very limited access to long-term resources. This reflects partly the lack of legislation to develop institutions in areas that could attract long-term resources. Another problem has been central bank supervision policy, which has been hampered by lack of experienced staff. The role of international financial

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[21] The process is best described in Kouba (1993) who called it a "modified paternalism of commercialized state enterprises."

[22] The practical experience with the behavior on banks offers the best evidence that the decision to allow universal banking may not have been the best one. For a different view see, for example, Stern (1994).

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institutions has been rather limited in these areas.[23] The central bank has been receiving assistance on supervision policy from bilateral sources, but IMF assistance would have been more effective in this case, particularly as an integral part of standby arrangements.

Furthermore, the balance sheets of several major banks have continued to be burdened by a large proportion of doubtful or nonperforming loans. This distorted the banks' interest rate policy as we have seen above. The central bank estimated the total amount of so-called classified assets, non-repaid loans with at least 30 days arrears maturity, or poorly secured loans that have not been repaid after 90 days, at 133.1 billion Kc at the end of December 1992, or about USD 4.2 billion. The measures adopted by the government to address the issue of nonperforming loans, e.g., debt-for-equity swaps, encouragement of forfeiting agencies, and the sale of these loans to the Consolidation Bank, have not been effective. These issues have been regularly disussed with the World Bank, which took a rather different stand. The lack of action in resolving the problem of nonperforming loans was not surprising to some observers, one of whom remarked: "It appears that ... the World Bank was right when it recommended to undertake the cleaning of the balances as early as possible while property was mostly in the hands of the state. With the diversified ownership of debt-ridden companies and the banks holding the non-performing loans, the administration of this process becomes more difficult and the use of public money more questionable" (Kerouš,1994).

The method of cleaning the banks' balance sheets, too, can be considered highly controversial. As noted above, assistance has been provided in the form of transfers of a part of nonperforming loans to the Consolidation Bank. This operation has been financed partly by the government, but by far the most important source of financing has been the proceeds from privatization. This approach has been already taken in three different operations involving the banks. In other words, the government has taken a very small responsibility for the banks' liabilities. While the policy has been probably most desirable on political grounds it has most likely not been the most efficient use of proceeds from privatization. The policy has simply transferred the debt from one creditor to another, and this has tended to ossify the existing structure of resource use, including all its inefficiencies. *Pari passu*, the privatization proceeds could not be used for investments with higher returns.

The last policy that I wish to discuss is the government policy toward infrastructure. This policy has suffered from one major drawback: the lack of an overall strategy in virtually all segments of infrastructure. It will not be perhaps an exaggeration to say that in some areas the absence of strategy reflected the inability to define the role of the state in the provision of infrastructural services such as in telecommunications, health, rail, road, and city transport. The translation of strategic goals into specific policies has taken an extremely long time in situations when the basic principles of strategy had been agreed upon. The slow speed with which these policies and specific projects are prepared and implemented remains a serious problem in all areas. The role of the World Bank and the EBRD, two prime donors who could have been extremely helpful in these areas, has been very small due to

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[23] For details see Kerouš (1994).

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the unwillingness of the Czech Government to use these institutions for the purpose at hand.

5. Conclusions

In this paper I have looked at the activities of the international financial institutions, mainly the World Bank and the IMF, in the Czech Republic. The main idea was to describe and evaluate the role of these institutions in the process of transformation to a market economy. I have not considered all their activities but rather focused on their role in the stabilization process. This role had two aspects, the transfer of resources and the influence of these institutions on policy-making in the country. The positive role is quite evident, clear, and extremely important when it comes to the assistance of these institutions in terms of resource transfer. This role cannot be sufficiently emphasized. The role is less self-evident when it comes to the policy-making aspect, and it has been the policy aspect that has been covered in this paper.

In sum, the role of these institutions has been relatively small in the Czech Republic. This was partly due to the fact that the institutions had only a limited range and number of instruments that could be used for this purpose. The instruments included three standby arrangements with the Fund, a Structural Adjustment Loan facility, and an energy loan from the World Bank. Moreover, there was virtually a complete meeting of minds when it came to the design of the stabilization programs, with many elements of the program being introduced even before the signing of the actual agreements. Under such circumstances, it is obviously diffcult to discuss the specific role of these institutions.

The standard question about the IMF and the World Bank programs is whether the programs are not too restrictive and, consequently, too costly for the recipient countries. The question has probably been asked ever since the introduction of stabilization programs all over the world. The question is naturally also asked today in the transition economies. The answer provided by the critics of the programs is typically also the same, irrespective of whether they happen to be in Latin America, Africa, Asia or, currently, in Central and Eastern Europe. The general criticism of these stabilization programs is that they move into liberalization programs too fast in terms of the institutions that are necessary to support such programs. As a result, the governments are obliged to adopt highly restrictive policies to contain inflationary targets and to maintain balance of payments equilibrium. The absence of the right institutions is today vehemently argued by critics in the Czech Republic or Poland as much as it is criticized in, say, Africa.

The question of speed is not a straightforward matter of pure economics. It may involve a choice between current costs and future benefits, which is typically a matter of politics. The Czech story is, however, a rather different one. It is difficult to be critical of the stabilization program on the grounds that the program has been too costly in view of the growing real incomes of households since 1991 and the level of unemployment that is currently minimal and far lower than in Western countries, let alone lower than that in other countries in transition. Under these

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circumstances, the continued preoccupation of Czech authorities with inflation is understandable.

The government has succeeded partly because of good policies and partly because it was lucky. The cost of stabilization has been very mild so far, and this has been crucial in ensuring social support. To the credit of the government, it is necessary to stress that the Czechoslovak and, later, the Czech governments also were instrumental in mobilizing social support. There is very little evidence that government policies were excessively restrictive in terms of domestic demand as demonstrated, for example, by growth of wages and private consumption. The starting position has been much easier than in other transition economies, and the government has been also very successful in mobilizing external support. Other exogenous factors, in particular the spectacular growth of tourism and favorable changes in terms of trade, have also made major contributions.

Moreover, we have witnessed no collapse of output such as we have seen in other countries in similar situations. This was partly due to the growth of tourism noted above but also due to the positive contribution of government policies. Four components of government policies should be particularly singled out. The mass privatization program has exceeded most expectations. Small privatization enabled a rapid expansion of the service sector and the growth of SMEs. It has led to some improvement in corporate governance, and it has enabled much easier adjustment in the government sector by reducing the budgetary support to enterprises. Moreover, privatization has been responsible for a significant inflow of indirect and portfolio foreign investment. Foreign exchange and price liberalizations have been crucial in attracting foreign investors, improving liquidity of enterprises, and stimulating domestic competition. The major contribution of monetary policy has been its focus on inflation and its ability to attract savings into the banking sector. Finally, exchange rate policy has achieved three vital objectives: it provided strong incentives to exports, it avoided tariff and quantitative protection, and it mitigated inflationary pressures from imports.

Nevertheless, the supply response has not been fully satisfactory. It has been adversely affected by major exogenous disturbances as well as by government policies. Major problems may be building up that could seriously affect future performance. Wages have been growing much faster than the growth of productivity. Domestic inflation has been much faster than foreign inflation, but this discrepancy has not been reflected in the corresponding adjustment of the nominal exchange rate, which has been kept unchanged. Output has been falling while employment has adjusted at a much slower pace. The lack of coordination between monetary and other policies has put an inordinate burden on the monetary authorities to control inflation and to stimulate economic growth. Since inflation has not been fully subdued, the central bank has been in the position of having to target both growth and inflation with only one instrument, interest rate policy. Clearly, the bank needed more help from government policies to moderate the growth of wages, and, as the study has discussed at some length, more effective structural policies of the government would have been particularly helpful in stimulating a better supply response.

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Table 1: Czech Republic: Selected Macroeconomic Indicators 1990-1993
(annual percentage change)

	1990	1991	1992	1993
GDP (const. prices)	-1.2	-14.2	-6.6	-0.3
Private consumption (const. prices)	6.7	-23.9	8.6	1.5
Fixed investment (const. prices)	-2.1	-17.7	6.3	-7.9
Exports (current prices)	0.2	43.8	6.1	20.0
Imports (current prices)				
Industrial output	-3.3	-22.3	-13.8	-5.3
Nominal wages	3.5	16.7	22.0	25.0
Real wages	-5.7	-25.5	9.8	3.5
Consumer prices	9.7	56.7	11.1	20.8
Terms of trade	-	-	2.4	4.1
Services output				
Ind. output of enterprises (up to 25 employees)	-3.3	-24.4	-13.7	-7.4
Total employment	-0.8	-9.2	-2.5	-2.3 [a]
Industrial employment	-3.2	-11.6	-11.8	-6.3
Production subsidies	3.6	-22.5	-9.5	-5.3
Memorandum Items:				
Unemployment rate (%)	0.8	4.1	2.6	3.4
Gross reserves (bn USD)	-	-	3.6	6.2
Official reserves CNB (bn USD)	-	-	0.8	3.8

General note:
GDP, consumption and investment data are measured in constant (1984) prices while industrial output is expressed in constant (1989) prices. Consumer prices are represented by the consumer price index. Real wages have been reported by the authorities and they are not consistent with the figures on nominal wages and consumer prices in this table.

Note:
[a] Preliminary figures

Sources:
Indikátory měnového hospodářskéhovývoje České republiky 1994, No.2, Prague, Czech National Bank, Z. Drábek, K. Janáček and Z. Tůma [1994] and Czech National Bank

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Table 2: Czech Republic: Official Price Indices, 1991, monthly changes

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
CPI [a]	25.8	7.0	4.7	2.0	1.9	1.8	-0.1	0.0	0.3	-0.1	1.6	1.2
of which:												
- foodstuffs	31.4	1.0	-2.2	-1.6	-0.5	-0.1	0.4	-0.1	0.8	-0.1	3.5	2.9
- durables	23.0	13.9	11.4	3.9	3.5	0.5	-0.6	-0.1	0.0	-0.5	0.3	0.5
- catering	43.7	1.8	-1.0	-0.1	-0.3	0.9	0.5	-0.3	0.2	-0.5	0.0	1.1
- services	8.6	3.6	1.5	4.8	4.2	12.8	0.6	0.4	0.5	2.5	3.6	0.6
PPI [b]												
- industry	24.0	19.3	0.1	2.9	1.7	-0.8	0.5	0.4	-0.4	0.0	0.9	0.6
- construction												
- work	33.1	8.3 [c]	1.7 [c]	0.8 [c]	2.2 [c]	0.3 [c]	1.3	-0.3	-0.2	0.6	0.2	0.0
- material	42.6	10.4	1.8	1.1	3.3	0.3	-0.3	-0.3	-0.4	0.1	0.3	0.0
- agriculture	-	2.7	1.3	-0.6	-1.8	2.9	-0.7	0.4	-3.8	11.5	11.7	11.2

Notes:

a) Consumer price index

b) Producer price index

c) Estimate

Source:

Drábek, Janáček and Tůma [1994], Table III.

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Table 3: Czech Republic: Key Dimensions of Czechoslovak Voucher Privatization in the "First Wave" (1992)

	Before reorganization	After reorganization
Total Number of Companies Privatized:	1491	1491
Czech Republic	943	988
Slovak Republic	487	503
Federation	61	0
	Kčs bn	USD bn
Book Value of Property:	299.4	10.3
Czech Republic	206.4	7.1
Slovak Republic	90.1	3.1
Federation	2.9	0.1
Number of Shares Offered for Sale:	299,393,282	with a face value of
Czech Republic	212,490,000	Kčs 1,000, or USD 34.5
Slovak Republic	86,900,000	
	million	
Number of Participating Investors:	8.54	(or 54% of the total population, some of
Czech Republic	5.95	whom invested through more than 400
Slovak Republic	2.59	investment funds)

Source:
PlanEcon, Washington, DC: 31 Dec. 1992, p.3

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Table 4: Czech Republic: Federal, National and Local Government Budgets, 1989-1993
(CSK bn)

	1989	1990	1991	1992	1993
Total Expenditures	414.90	455.90	515.90	551.00	420.08
of which: National	263.10	292.40	479.00	502.90	356.92
Total Revenues	415.40	463.10	505.50	540.00	432.29
of which: National	259.60	296.20	461.50	486.20	358.00
Balance of national budgets	-3.50	+3.80	-17.50	-16.60	-
of which: Federation	-0.80	+4.00	+6.40	-0.70	-
Czech Republic	-1.30	-0.20	-13.60	-1.70	+1.08
Slovak Republic	-1.40	-0.40	-10.30	-7.90	-23.00
Balance of budgets of local governments	+0.40	+3.30	+7.10	+8.60	+11.13
Balance of all budgets	+0.50	+7.10	-10.40	-8.00	+12.21
GDP (Czechoslovakia) in current prices	758.70	811.30	977.60	1009.00	923.10
Share in GDP					
- of balances of all budgets	0.04	0.80	1.00	0.60	1.32
- of balances of national budgets	0.06	0.40	1.70	1.60	0.12
- of balances of local budgets	0.50	0.40	0.70	0.90	1.20

Source:
Dlouhodobý vývoj finančních ukazatelů ČSFR; Praha, Federal Ministry of Finance 1990, 1991
Závěrečné účty k státnímu rozpočtu; Praha, Federal Ministry of Finance 1990, 1991, 1992 a 1993

Note:
Data are shown in the Czechoslovak crowns for 1989-1992 and in the Czech and Slovak crowns respectively for 1993. The 1993 figures refer to the Czech Republic.

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Table 5: Czech Republic: General Government Expenditures and Revenues
(Billions of current crowns)

	Czechoslovakia			
	1990	1991	1992	1993
State budget and local authorities expenditure (consolidated)	559.2	542.2	589.1	420.08
Current expenditure	498.5	474.4	530.6	362.14
Capital expenditure and net lending	59.8	68.0	58.4	57.94
Timing adjustment total expenditure	0.9	0.2	0.1	..
State budget and local authorities revenue (consolidated)	501.9	547.8	562.3	432.29
Personal income tax	54.7	58.5	76.0	29.71
Profit tax	100.3	132.6	114.0	70.88
Payroll tax	120.7	89.9	92.0	..
Turnover tax	147.8	123.7	125.8	117.08
Home-ownereship tax	-	-	0.0	..
Property tax	0.2	15.1	17.1	3.04
Social security contributions	-	-	0.0	108.97
International trade and transaction	25.8	11.5	17.5	15.17
Non-tax revenue	61.3	103.8	118.6	62.72
Timing adjustment total revenue	-8.9	12.7	1.3	..
Balance (deficit -)	-57.3	5.6	-26.8	12.21
As percentage of GDP				
State budget and local authorities expenditure (consolidated)	68.9	54.2	55.7	46.83
State budget and local authorities revenue (consolidated)	61.9	54.7	53.2	45.51
Balance (deficit -)	-7.1	0.6	-2.5	1.32
Memorandum item:				
GDP	811.3	1000.7	1057.0	932.10

Sources:
Czech Ministry of Finance
for 1992: State Bank of Czechoslovakia, Annual Report 1992

Note:
GDP figures are not fully comparable to those in table 4. The 1990-1993 figures refer to the federation.

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Table 6: Czech Republic: Monetary Survey
(in bn of CZK, 28 CZK/USD)

	12/91	12/92	12/93 [a]	12/93 / 12/92 (%)
ASSETS				
NET FOREIGN ASSETS	9.0	27.6 [c]	75.6 [c]	173.9
FOREIGN ASSETS convertible	73.1	100.4	172.5	71.8
FOREIGN LIABILITIES convertible	64.1	72.8	96.9	33.1
NET FOREIGN ASSETS (CR/SR)	11.1	26.0	26.0	0.0
NET DOMESTIC ASSETS	467.4	544.0	600.4	10.4
DOMESTIC CREDITS	537.6	634.0	722.7	14.0
- Net credit to Government [b]	31.6	74.7 [d]	60.3	-19.3
- Net credit to property funds	7.1	-24.5	-34.4	40.4
- Total credit	498.9	583.8	696.8	19.4
- Credit to e.+h. in CZK	495.4	567.8 [e]	672.0	18.4
- Credit to enterprises	459.2	521.3	627.0 [f]	20.3
- Credit to households	36.2	46.5	45.0	-3.2
- Credit in foreign currency	3.5	16.0	24.8	55.0
LIABILITIES				
LIQUID LIABILITIES	487.5	597.6	702.0	17.6
MONEY	256.0	306.9	351.7	14.6
CURRENCY OUTSIDE BANKS	55.3	58.9	59.7	1.4
DEMAND DEPOSITS	200.7	248.0	292.0	17.7
- Households	65.7	71.0	85.0	19.7
- Enterprises	131.7	174.4	202.5	16.1
- Insurance companies	3.3	2.6	4.5	73.1
QUASI MONEY	231.5	290.7	350.3	20.5
DEMAND,TIME and SAVINGS DEP.	393.7	484.6	589.8	21.7
TIME AND SAVINGS DEPOSITS	193.0	236.6	297.8	25.9
- Households	145.1	168.9	198.3	17.4
- Enterprises	8.9	30.0	61.5	105.0
- Insurance companies	39.0	37.7	38.0	0.8
FOREIGN CURRENCY DEPOSITS	38.5	54.1	52.2	-3.0
- Households	24.1	36.7	42.7	16.3
- Enterprises	14.4	17.4	9.3	-43.7
OTHER ITEMS NET	70.2	90.0	122.3	35.9

Notes:
[a] Preliminary data
[b] Excluding clearing with SR, EC loan to Government etc.
[c] Including swap operations in gold
[d] Including transfer debt to the Czech Government (CSOB, KTUK)
[e] Excluding transfer debt to the Czech and SLovak Governments (KTUK)
[f] Including deferred income (uncollected interest KOBP)

Source:
Czech National Bank

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LÁSZLÓ CSABA

Hungary and the IMF: The Experience of a Cordial Discord[1]

I. Introduction

In setting the task and scope of this paper I set out from the following presumptions. First, the circumstances in which, as well as the facts, about how Hungary has become one of the most indebted countries in the world in terms of per capita liabilities are discussed in detail in widely available and up-to-date source material (Lőrinc-Istvánffy, 1992; Oblath, 1993; and Riecke,1993). Second, there are a number of relevant theoretical reflections on the general issues pertaining to the vices and virtues of applying stabilization policies to formerly planned economies at a time when they are on their way to the market (Balcerowicz, 1993; Winiecki, 1993; and Csaba, 1995, Chap. 5). I try to minimize overlap with any of these. I also try to contribute to what may be the summary of the discussions conducted in this symposium, i.e., to the evaluation of how the Washington twins, the IMF and the World Bank, fared in the troubled waters of systemic change in Central and Eastern Europe. In order to do this, I shall focus exclusively on the Hungarian experience.

The key aspect of the argument is a search for an answer to the following question: Even though all Hungarian governments in power since our accession to the IMF and IBRD in 1982 have been explicitly cordial, even forthcoming toward the aspirations of these institutions, why has the leverage of these institutions over systemic change in Hungary remained as limited as that in any other country on the globe? In other words, why could the Fund and the Bank not bring about even more marketization in a country where nobody close to the commanding heights has ever challenged the conventional wisdom of these institutions, and furthermore, where, even in academe, the Fund-busters constitute a miniscule marginal minority? What makes the question even more important is that Hungary has not had to face the problems typical of, say, Bolivia, Russia, or Poland, i.e., the conflict between stabilization and market liberalization has not come to the fore. In many ways, at least in systemic terms, Hungary seems to have been predestined for the role of an exemplary pupil, but she has surely underperformed relative to such expectations. Fiscal reform, social security reform, and banking reform still have a very long way to go. Though against the performance of her fellow travelers Hungarian performance may well be judged satisfactory, one cannot escape the temptation to apply a different standard to Hungary.

A country that has had 20 plus years of reform experience, that has legislated commercial banking, bankruptcy, VAT, and PIT reforms, that further launched

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[1] The author acknowledges, without implicating, useful suggestions by György Szapáry, First Vice-Governor of the National Bank of Hungary and former resident of the IMF. Further comments by Imre Tarafás, former First Vice-Governor of the National Bank of Hungary and by Ben Slay on a previous version of the manuscript helped to correct mistakes and clarify points.

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trade liberalization and reorientation before the collapse of communism, certainly had a certain edge in terms of institution building. This circumstance, coupled with the professedly cordial relationship with the Washington twins and the lack of political and philosophical differences over economic issues, so typical in the underdeveloped world, could well have led one to expect Hungary to accelerate rather than decelerate the pace of change once geopolitical constraints and ideological taboos suddenly evaporated in 1989-1990. While one can list the domestic factors explaining these developments, one may wonder why the Washington twins, and primarily the Fund, could not make better use of the leverage they certainly had over a country whose balance of payments was in a very precarious position in 1988-1991.

The Fund and the Bank are, of course, no substitutes for a world government. However, ever since systemic transformation started and especially since the Russian accession to membership in 1992, these organizations suddenly assumed roles far exceeding their original mandates and the aspirations of the bulk of their staff, who invested a considerable amount of time, funds, and expertise into understanding the formerly communist systems. They produced important theoretical and policy findings (Bruno 1992; Tanzi, 1993) explaining why standard balance of payments adjustment recipes and other conventional considerations might not be directly applicable to, or helpful in, mastering the task of economic transformation. Thus the customary references either to the dogmatism of the IMF or to the political narrow-mindedness of the local elites are inadequate to explain the Hungarian story.

II. The Pretransformation Period

Since Hungary was not a founding member of the United Nations, it could not inherit Bank and Fund membership from the pre-cold-war era. Understandably, ever since the first thaw in East-West relations started in 1953, culminating in Hungarian membership in the United Nations in 1955, there was an undercurrent of political debate over joining the Washington twins as well. Several twists and turns delayed membership. The most logical step would have been to join these organizations at the time Hungary joined the UN. This was indeed discussed by the government, but the return to power of the Stalinist Mátyás Rákosi in July 1955, the crowding out of the reformist Imre Nagy from all political positions, and the return to the pre-1953 economic policies made this step untimely.[2] Following the crushing of the 1956 revolution, the Economic Commission convened by János Kádár, and composed mostly of avowedly non-Marxists discussed the issue again, but this proved immaterial. First, the Hungarian case was still open with the UN, and Russia would have distrusted the new Communist rulers' following in the footsteps of Imre Nagy and his dangerously neutralist policies. Second, due to the internal political dynamics of consolidating Communist rule, the propositions of

[2] Personal communication from József Bognár, then Minister of Foreign Trade (1950-1956).

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the Economic Commission were considered so far off the mark by the Central Committee that they decided not to put it on the agenda of any decision making organ (Berend, 1983, p.115).

The rule of János Kádár rested on a new compromise with the USSR. The Soviet leadership, at least formally, gave up its claim to having the recipe for the only correct way of building socialism, in exchange for unconditional Hungarian loyalty in foreign affairs. Though neither side completely followed this understanding, in the end, it did work. Later analyses of Party archives (Horn, 1989) shed some new light on this, proving that it was Kádár who rejected Khrushchev's troop withdrawal proposition in 1958, which was offered to Romania as well. This means that the compromise between the USSR and Hungary was not only an arrangement imposed on the country from outside, but also part and parcel of the original self interpretation of the person who ruled Hungary for 32 years. Thus, any attempt to take some even trivial reform steps encountered fierce resistance for quite some time.

As in the 1949-1953 period, in the early 1960s maybe carried away by the *sputnik*-shock of 1957, economic target setting was based on a fundamental misjudgement of both Soviet and domestic economic potential as well as on the disregard for all nonquantitative aspects of development. This attempt ended in a catastrophe. Instead of catching up with Austria by 1970, in 1963 and 1964 serious financial problems surfaced in a country whose external liabilities had been negligible. Output stagnated, which was worse than depression, against the background of loudly preached promises of accelerating growth.

Not surprisingly, in October 1964 a new reform committee was convened to discuss how to get out of this dead end. Due to the severity of the crisis, the debate was not constrained by the ideological straightjackets of the day (Szamuely, 1986). The debates went much the same way as in 1957, but the outcome was different. The most radical reform variant was approved, albeit with a gradual implementation scheme, and 1968 was chosen as the year in which to implement the first, more timid version of the reform, with 1971-1972 targeted for the introduction of the more radical market socialist variant. This decision had a great impact over the next 25 years, since everybody knew that offcial approval was, or could be, more far-reaching in terms of market reforms than official dogma ever would have allowed.

Since these developments were brought about by Soviet and CMEA inability to deliver what had been promised, conflicts within the CMEA intensified, and, with the Romanians vetoing integration, the decision to orient the Hungarian economy toward the West proved correct. Russian-German talks on what culminated in a *Grundvertrag* in 1970 and the Helsinki Summit provided the necessary leeway for Hungary to attempt to join the IMF. Talks were successful, but the Hungarian leadership wanted to play it safe, and they asked for formal approval from the USSR. The answer was a flat n'iet (Bakó, 1990, pp. 226-227). In the memory of other participants in the discussions, the answer was not at all that clear. Kosygin stated: "It is your job, comrades. But. . . ", and then followed a litany of complaints against the IMF as the extended arm of American imperialism. So, while the Hungarian leaders got all they could ever hope for, the constraints described above made them

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unwilling to make a decision. Following the invasion of Czechoslovakia in August of 1968, such a decision again became inappropriate.

The 1970s saw the replication of the eastward-looking, import-substituting industrialization endeavors of 1949-1953 and 1958-1963, indicating how strong an ideological bias can be against fairly clear-cut economic realities. The result was much the same. By 1978 it was obvious that neither growth acceleration nor greater reliance on the CMEA could bring about the increased consumer welfare that was part of the implicit social contract struck after 1956. In October 1977, the leadership decided to turn west-ward again.

This decision did not reflect concerns over indebtedness, which came to the open only as late as December 1978. However, some unpleasant news was taken into account, including the facts that the oil crisis did not stop at Hungary's borders as had been hoped in 1974: the planned economy per se was not a sufficient buffer against external shocks; membership in CMEA was not a guarantee of ample energy imports; acceleration of GDP growth was not a viable substitute for market reforms; and, if anything, Hungary had to rely on more, rather than less, Western financing. Importing Western technology and Western management methods seemed to be the best way to preserve the underlying social construct.

The Kádár leadership turned its back on Moscow, but they again wanted to play it safe. Though discussions on Hungary's accession to the IMF were again fairly advanced, the rulers again sought Soviet approval. To be more precise, they were trying to play the card of what were later called implicit subsidies. They told the Soviets that Hungary would follow Romania, which had joined the IMF in 1971 without prior discussion with the Soviets. Reference was also made to Polish membership. But, so went the Hungarian bargaining strategy: Hungary was ready to refrain from this step if the USSR could find an extra couple million tons of crude oil to be paid for in soft currency. This strategy proved to be a winning one. Brezhnev started his talk in the summer Crimea meeting by stating that, as it is an extension of American imperialism, joining the IMF would be an infringement of socialist brotherhood. A couple of million tons of oil could not be an issue among true allies.

The Hungarians took Brezhnev's promise at face value, as such commitments had been honored on past occasions. The problem was that the world had changed. As was documented at the time (Csaba, 1980), there was absolutely no reason to believe that the Soviets could honor their promise, even in the best of circumstances. Thus it was both surprising and unsurprising that in October 1981 the Soviets declared that, reflecting upon their original proposal of 1978, all increments in oil supplies had to be paid for in hard currency.

This was an extremely well-timed announcement. First, it angered Kádár who had just been acknowledged by the Soviets at the 1981 Party Congress of the CPSU as having run a Hungary worthy of emulation. He was deeply hurt because he had seen the withdrawn concession as his personal victory over his narrow-minded economic advisers. Second, it was a time when the shadow of martial law in Poland or of Soviet intervention seemed to have been avoided by General Jaruzelski's taking charge of both Party and Government. Thus, neither the stick nor the carrot was in the hand of the Russians. Only 60 minutes after the Central Committee approved

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Hungary's IMF accession by a narrow majority, János Fekete's plane was taking off for Washington.

This was a typically Hungarian last-minute rescue operation. May 1981 had been the last time the country could tap medium-term international funds. In that summer, Romania had covered its insolvency by means of dubious practices such as nonpayment of their part of swap operations. By September, Yugoslavia had to reschedule its foreign debt. Polish insolvency was an accomplished fact. Following the imposition of martial law, a lending embargo on the Soviet Bloc was declared. This prompted the *de facto* Soviet-run International Bank of Economic Cooperation and some Arab investors to withdraw deposits of 1.5 billion U.S. dollars from the National Bank of Hungary to relend it to Poland and to bridge Soviet cash-flow problems. This would surely have knocked out the Hungarian economy and forced it into rescheduling, had not the BIS, on two occasions, Manufacturers Hannover Trust, and Margaret Thatcher extended their help. As the one-time Vice-Governor of the National Bank, István Szalkai (1990, p. 195) noted, these exceptional forms of assistance would hardly have been conceivable, had not the Hungarian application for IMF membership been well under way. Thanks to these operations, Hungary could maintain her solvency.

It is hard to overemphasize the Copernican revolution IMF membership and the associated rescue operations implied for Hungarian policy-making. They signaled an end to the Soviet-first approach that had shaped the first 25 years of Kádár's rule. Ferenc Havasi, Secretary of the CC in charge of the economy noted in his speech to the Parliament:

> As you know, at the beginning of this year, Hungary has run into exceptional difficulties in her international financial relations. First, we were turning to our allies. Unfortunately, they were all preoccupied with their own headaches. They were not in a position to help us...Then we were turning to our Western partners. As the Hungarian proverb says: it is in times of difficulty when you find out who your real friend is. We were assisted, and I can report to the Parliament with pride: the financial crisis has been overcome. (Havasi, 1982)[3]

But how? In theory one could have envisioned a radicalization of reforms, since the blueprint for a second economic reform (Bauer, 1984) was already elaborated in expert commissions. From the introduction of a two-tier banking system to currency convertibility, from tax reform to bankruptcy legislation, more or less all the measures finally introduced in the time span of a decade were already available. Note that it was not the urging of the Fund that caused Hungary to radicalize reform deliberations. Rather, it was analyses of the inherent weaknesses of various aspects of the Hungarian economy, conducted by Hungarian economists, that led to these findings. Many of the reformers of the day were of the opinion that IMF would give us a hand in convincing the political leadership of the desirability of more radical reforms. In fact, the result was disappointing.

I have spent a relatively long time in explaining what a long-awaited fulfillment it was for the Hungarian leadership to achieve full membership in the IMF. It is

[3] It is probably not a coincidence that the reference was printed in the narrowly circulated government daily, whereas the influential Party daily dropped this reference.

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important to see the professional consensus behind the radical market socialist measures, as well the fact that references to Russian concerns were made irrelevant by the step of accession. Moreover, the financial crisis of 1982 was so severe and immediate that it did make sense to expect that IMF proposals for systemic change would have the ears of the decision makers, and, conversely, that the latter would feel more comfortable if they could make offers on their own, which were known to have the blessing of the Fund.

In any event, due to the instability in and around Poland, the bulk of large-scale reform measures was rejected.[4] As a temporary solution, the worst and most primitive version of the command economy was restored. Headed by the Economic Commission of the secretariat of Deputy Premier József Marjai, a military-style day-to-day management gained the upper hand. Whatever were the formalized structures of economic and political decision making, this informal chief of staff reigned. Imports were administratively restricted, operating committees were set up to license imports of individual items, export orders and obligatory contracts were also employed. The Treasury and the Bank supplemented this system by individual, often retroactive, measures restricting demand. Supply bottlenecks and other growing irregularities in intra-CMEA relations were used to justify this practice, and not only because it was congruous with everything that had become the norm of behavior in intra-CMEA relations by then, but also because, in macroeconomic terms, the outcome was reasonable. According to the retroactive calculations of the National Bank of Hungary, filtering out the several elements of misreporting in the contemporary statistics, the following conclusions were reached: if the actual government deficit was 7.1% of GDP in 1980, it was 5.1% in 1981, 2.9% in 1982, 2.5% in 1983, and 0.5% in 1984. As far as the actual corrected balance of payments was concerned, in 1973-1978 net foreign debt grew by 5.3 billion dollars whereas in 1979-1984 it grew by only 408 million, with 1983 and 1984 being very rare surplus years (Nyers *et al.*, 1993 Part II, p. 48 and Part III, p. 28).

At this point, the story starts to resemble those of developing countries. Since administrative measures brought quick results, a political leadership, otherwise hesitant to support reforms reducing its discretionary power, finds an excuse for postponing overdue structural and institutional reforms by pointing to satisfactory macroeconomic performance. The Washington twins, were internally deeply split, but they could not step over the boundaries set by their respective statutes. If the quantitative performance criteria were, or at least appeared, satisfactory, the two banks could only extend friendly advice to their Hungarian client, but they could

[4] Meanwhile, several limited reform steps, like intraenterprise partnerships (VGMK), lease contracts in retail trade, foreshadowing what was later turned into small privatization, and a more lenient approach to private business took place. These contributed significantly both to the theory of the informal, or second, economy and to the erosion of socialist structures. However, as I argue elsewhere (Csaba, 1995), unintended consequences of sidestepping should not be confused with intentional restructuring at the macrolevel, which reforms originally imply. Without preempting an interesting interpretative debate, I think it is telling that the idea of a second reform had constantly been rejected, giving way to transforming or transcending rather than improving the market socialist system by the end of the 1980s.

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not insist upon specific reforms in the internal workings of the Hungarian economy.

The new *dirigiste* mechanism, never formally promulgated in Hungary, but certainly applied seems to have worked. Macrocriteria were met. Reform deliberations continued, as committees never ceased producing documents, and from late 1982 they resumed activities with many famous people involved. Guidelines for the next reforms were ready by mid-1983. Party and state organs discussed them, parts of these ideas were aired in the press. A decision was taken in April 1984, when an extremely watered-down version of the projects was approved by the Party. In sum, in the years 1982-1984 the leadership could buy time, and it was not vulnerable to outside pressure.

There were several concrete reasons why Hungary had such a measure of policy autonomy. First, basic economic information was quite limited within the country. The IMF could require a certain degree of disclosure of the Hungarian authorities, but not enough to attain a breakthrough. Thus the balance of the National Bank or the balance of payment figures were available in the English version of the quarterly report of the Bank and were later also published in some major Western dailies, but this information could not be quoted inside the country, even in professional and narrow-circulation sources. Not only did legislators know little about the actual situation, even governmental agencies, including the top leadership of the Planning Board, were underinformed. This proved to be a rather fundamental deficiency, since the forecasts of the five-year plan for 1986-1990 were elaborated without prior adequate knowledge of the state and prospects of external financing. As one of the active participants openly acknowledged (Zdeborsky, 1990), it was a small team, hand-picked and controlled by then Vice-Governor János Fekete, that was running external finances in complete secrecy and without any external control. If and when any major decisions needed to be taken, Kádár and Fekete arranged it between themselves without regard for proper procedures.

These arrangements built an extremely effective filtering mechanism into Hungary's relations with the IMF. For one, all relations with the IMF were channelled through the National Bank. This was paradoxical in more than one respect. First, according to the formal decision making structures of the day, it should have been the Commission on Planning, composed of the chiefs of the Planning Board, the Minister of Finance, the National Bank's governor, and some key ministers who would have undertaken this task. If we temporarily ignore the parallel hierarchy of the Party only this economic cabinet had all the prerogatives needed to take measures pertaining to the entire macrostructure. Second, the National Bank of Hungary was traditionally an agency with its own particular interests. As could be demonstrated at the time (Csaba, 1986), it held an ambiguous position toward marketizing reforms. On the level of generalities it had always been a free marketer, but when it came to financial deregulation, it tended to act much more conservatively. Third, the secrecy around the Bank and around external financing created an atmosphere in which any citicims, or indeed, public discussion of any aspect of the activity of the Bank became impossible. I do not know of a single case in which any leading personality of the Bank has ever acknowledged having made a mistake while in office. Fourth, as reflected in contemporary analyses, while the standing and influ-

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ence of the other actual center of power, Marjai's Secretariat, was rapidly eroding, the power of the Bank was increasing. Finally, since the external financing compartment of Fekete was hermetically separated from the rest of the Bank, a very small group of people held a disproportionately high degree of power in their hands. They lacked any checks and balances or the control of publicity. This allowed for highly individual considerations, not legitimated by outside authority or economic theory to play a crucial role.

These circumstances may explain how the questionable self interpretation of this small group of people could prevail over the deliberation of the mighty Washington agencies. It might also explain how the Fund and the Bank proved unable to forestall what retroactive analysis shows to be the gravest mistake of the National Bank's policy in 4 decades: its support for the growth acceleration policies of 1984-1985 (Csáki, 1994).

Those who have had the patience to follow this history to this point will be less than surprised to read that the unchanged political and power structure in Hungary made its last attempt to turn eastward and to accelerate growth rather than to let the market in. What looks simplistically trivial in historical perspective was anything but that after 15 years of reform thinking. In fact, it was the Planning Board headed by former Finance Minister Lajos Faluvégi that had become the bastion of resistance to these growth-accelerating propositions. The Board was joined, in an uncoordinated fashion, by the IMF, which refused to agree to a three-year standby arrangement since the Hungarians insisted on keeping prices low through administrative methods. Nevertheless, this was a very mild protest, and in both 1984 and 1985, annual stand by agreements were implemented, and only the launching of a pilot project of a three-year standby program was prevented.

Formally, there seems to have been no way to escape the policies advocated by the IMF and the domestic professionals, and a restrictive macroeconomic policy complemented by accelerated institutional reforms, which had been postponed for the fifth year in 1985.[5] However, due to the filter mechanism explained above, questions were raised in a completely different fashion. Systemic thinking was pushed to the background, and the conventional, more narrow financial considerations, and the related formal and informal prestige considerations and success indicators, of the National Bank came to the fore. As the retrospective reflections of Szalkai (1990, p. 201) show the dilemma for the Bank was whether they should maintain that no external financing was available, which was untrue, or whether they should tell the truth, knowing that it would be misused for setting false economic targets. The less philosophical Fekete (1989) put his views more bluntly. In his view, there was a leadership in the country, whose sole responsibility was to set economic targets. It was not his job to correct them, but rather to obtain all the

[5] The introduction of enterprise councils is difficult to see as a step toward a market economy, as Kornai (1992, Chap. 20) demonstrates convincingly. Contemporary Hungarian reformers used the related concept of self management in a rather unscrupulous fashion to undermine the power of the center. Such an arrangement, however, did little to promote the development of capital markets, banking reform, bankruptcy legislation, or opening the trade regime, all of which were integral parts of the concept of a second reform in 1981.

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money he could to fulfill these targets. Knowing the informal imbalances in decision making and information that existed, this view is unacceptable. It is clear that no major actions could be taken at the time without Fekete's approval.

And he gave approval to an economic program that most of the profession resisted from the very outset. As a leading official of lasting tenure and experience noted bluntly, they were simply giving in (Balassa, 1990, pp. 165-168). The IMF was unhappy, but private markets provided considerable freedom for the Hungarian government to maneuver. The Communist authorities could but the years of 1985 and 1986, when the radical reforms could be further delayed. One wonders whether this all could have happened, had not it been for the filtering mechanism and the overall secrecy surrounding major decisions. These two interlinked factors explain why the pressure of the profession from inside and of the IMF from outside could not join forces to hinder this dangerous policy, which resulted in the doubling of Hungary's external debt in 1984-1987.

By September 1987 conspicuous nonattainment of the targets set by the five-year plan and the dramatic deterioration on the external front triggered the replacement of one of the longest-ever serving Hungarian Premiers, György Lázár, by Károly Grósz. The latter, coming from the quarter traditionally most hostile to reforms, surprised everybody by promulgating a three-year government program of export orientation and marketization. Besides domestic professional pressure, the IMF was instrumental in molding this turn in the overall policy line. The IMF kept reiterating the need for institutional reforms, particularly import liberalization. However, structural reforms were basically outside the immediate focus of attention of the IMF.

As compensation for the political breakthrough of industrialists in the 13th Party Congress, reformers could push through the decision on the two-tier banking system, which began functioning on January 1, 1987. In doing this they capitalized on the poor bargaining power of the Bank and the Treasury, which had become politically weak due to the victory of the industrialists. The decision to liberalize imports had been contemplated since 1986, but it would hardly have been implemented had not the need to please the IMF played a role.

This seeming infringement on national sovereignity was particularly useful. As early as 1987-1989 Hungary had to, indeed, was fortunate to, implement several of the institutional reforms other Central European nations only started years after their transformation. Actually, tax reform, import liberalization, application of bankruptcy procedures, reliance on tight monetary policy, and the problems of how to cope with at first only nominally independent, commercial banks are all issues where learning by doing cannot be avoided. Thus IMF insistence on an early start to reforms gave Hungary an important edge over the latecomers. Whatever the shortcomings of any of these arrangements might have been, and they were numerous indeed, three years of experience is of more use than a decade of speculation, all the more so when millions of agents are involved in the learning process.

In 1989 the IMF again played a useful role. The administration, modestly calling itself a government of experts, made possible a surplus 10 times greater than planned in Hungary's trade with the ruble area alongside a parallel deficit of 1.4 billion dollars with the West. The latter depleted the currency reserves of the coun-

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try nearly totally. In the midst of policy improvisation by the experts, the IMF suspended the standby agreement on May 15. Thus the IMF could ensure that, unlike in 1981-1983 the liberalization of imports would not be reversed, although this could well have been the most trivial, and harmful, response of the Hungarian authorities. Under the pressure of a growing number of analyses published domestically and abroad, and facing the prospect of a competitive political system with the concomitant public scrutiny, Miklós Németh was forced to admit the regular misreporting of the foreign debt, conducted by the previous governments. The Hungarian public was confronted with the actual severity of the situation for the first time. The IMF required the country to repay 150 million SDR. Thus the outgoing administration bequeathed to its successor an economy in which many of the institutions of the market were already available, with most public companies corporatized, both entry and exit of firms secured, and the trade regime liberalized. Discontinuation of the CMEA, as well as agreement on Russian troop withdrawal, was achieved. Meanwhile, at the time the new, democratically elected government took office, the foreign exchange reserves of the country sank to 300 million dollars, covering only 10 days of imports.

Against this background, one wonders why the IMF could not push the Hungarian government more strongly in the direction of the market in 1987-1990. Reforms were long overdue and had been well elaborated by government agencies and expert commissions. The answer may be found if we look into the recalculated general government deficit series already quoted above (Nyers *et al.*, 1993). It shows the following deficit/GDP ratios: 1986, 3.8%; 1987, 2.8%; 1988, 0.7%; 1989, 3.2%; and 1990, 0%. In other words, the IMF was back in the situation of a banker who is in no position to impose anything on his client as long as the client's quantitative performance criteria are met.

III. The Posttransformation Period

The year 1990 was full of expectations. Systemic change took place peacefully. It seemed that both geopolitical and internal structural resistance withered away. Representation of vested interests, so intimately intertwined with the old regime, had suffered a heavy blow. Unions hardly survived, employers' organizations blossomed in large numbers, and political representation was decoupled from both ideological and regional interest articulation. The window of opportunity for sweeping reforms seemed to have been opened. All political forces agreed on the need for a market without adjective and to the need to turn toward the West. Various expert groups advising the new government underscored the singular nature of the opportunity and called for radical changes, and fiscal reform figured high on the agenda. The IMF came to the rescue immediately after the new conservative government was formed by signing a standby agreement in May 1990. The IBRD signed a new Structural Adjustment Loan (SAL) and helped to organize a cofinancing project in September 1990. Finally, the new three-year standby agreement was signed in February 1991. Therefore, even in the most unstable year of 1990, Hungary could rely on private foreign capital markets.

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However, formation of economic strategy by the conservative government lasted much too long. Only four months after taking office did the government produce a document, the Program for National Renewal, but it was a collection of good intentions, not an operational policy document. Meanwhile, government ministers quarreled in public and acted single-handedly, following at least four different economic policy platforms. The Minister of Finance was somewhat puzzled to see that no agreement had been reached with the IMF, though he himself conceded in the same interview that the three-year policy platform of the government was as yet in a preliminary stage (Rabár, 1990). In fact, he was the one who acted the most unprofessionally and most single-handedly in his short period in office. Driven by his own professional conviction, he declared a 100 billion Ft subsidy cut in a single stroke, which would have led to a 65% hike in fuel prices in a single day. This triggered the first, and to this day the last, massive social protest, with taxi drivers blockading the major bridges of Budapest for 3 days. In fact, Ferenc Rabár put an end to the revolt equally single-handedly. Without prior agreement of the hospitalized Premier, he made major concessions. This good news, however, can by no means overshadow two basic shortcomings: (a) he did not enjoy the support or formal endorsement of the entire government for his subsidy cuts: and (b) this attempt was in open contradiction with the election promises of the largest governing party, the MDF, which portrayed itself as an adherent of small, gradual changes in the economy.

When both shock therapist Ferenc Rabár and his opponent, supply-sider György Matolcsy, resigned in November 1990, a three-year economic program (Figyelő, 34, 49, and 50) could finally be adopted. Without going into detail, suffice it to note that this was a slightly edited version of the policy document of 1989, whose major thrust was to pass the operating losses of the system onto the population without touching any of the fundamentally ill points. To list but a few of the issues not addressed by this policy guideline: banking reform and handling of inherited bad debt, fiscal reform, privatization, anti-inflationary policies, social safety net, financing the pet project of the administration, the World Exposition of 1990, etc. In sum, this was basically a single-year document, with vague, if any, propositions for longer periods of time.

In the meantime, a new Finance Minister emerged on the scene. Mihály Kupa was known domestically and at the IMF for being the father of PIT reform, who had the courage to explain this most unpopular way of paying public dues in a televised series week after week. He was an avowed adherent of urgent fiscal reform. Furthermore, both the new Hungarian democracy and its first Premier seemed to be in pretty bad shape. Altogether the IMF has had good reasons to apply its famous educational exercises by unexpectedly signing a three-year standby agreement in February 1991.[6] The collapse of CMEA was a much-feared event both for public

[6] During the 1970's and thc 1980's. the Fund had often been criticized for its overemphasis on short-term current-account figures as performance criteria. In response, the Fund attempted to be more generous, thus (a) institutional criteria were included among performance criteria: (b) 3-year agreements were signed; and (c) nonattainment of conventional quantitative performance criteria was intentionally overlooked or waivered. All three elements aimed at providing strategic guidelines for governments. These attempts were

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finance and for the balance of payments. A current account deficit of 1.2 billion dollars was approved as a target for that year, and, out of the 1.1 billion standby facility, 500 million could be drawn in 1991 alone; besides a special facility bridging the losses from the CMEA collapse in the amount of 348 million SDR was agreed upon of which 226 million SDR could be drawn in 1991. The budget deficit was waivered from among the performance criteria (Brüll, 1993, p.127). Obviously, both the impact of the Gulf War on global oil markets and the impacts of the collapse of CMEA were misjudged, to the benefit of Hungary. In fact, the years 1990-1991 ended with a combined current account surplus of 394 million dollars in those two years. The fiscal balance ended with an equilibrium in 1990 and a 5% deficit in 1991.

It is important to emphasize that, as in all previous cases, it was the expectations rather than the actual performance that shaped IMF policies toward Hungary. Judging by the documents listed above, Hungary was obviously unfit for support. Meanwhile, the IMF had two expectations, both of which proved to be wrong. First, they believed in mechanistic approaches and dramatized the impact of CMEA disintegration on the Central European economies. In this case, the flexibility of adjustment in the microsphere was clearly underestimated. Second, the IMF overestimated the reform commitment of the Hungarian government. At that time, the Kupa Program (Stabilization... ,1991) seems to have made a step in the right direction by declaring the legislative aspect, i.e., institutional change, as its major thrust, and putting the quantitative estimates into its supplement. But in many ways, this program too, lacked support within the government and the coalition parties. In fact, none of the major elements of legislation were submitted to Parliament by the governing factions, which enjoyed a comfortable majority. By the autumn of 1991, Kupa lost the support of the Prime Minister, who asked a Minister without Portfolio and Vice-Chairman of the MDF, Tamás Szabó, to convene a Working Group on Economic Policy. The ideas of this group, from populist privatization schemes to an overall policy of growth acceleration, were diametrically opposed to those of Kupa, but they received official blessing. Szabó was not the only member of the government who proposed a line inconsistent with the policy of institutional reform and fiscal restraint. When the consultations with the IMF on the budget for 1993 ended with the Hungarian side proposing a 250 billion Ft deficit, double of figure proposed by the IMF, the latter suspended the three-year standby agreement.

This seemed short-sighted and ill-mannered. After all, and despite its many weaknesses, the Hungarian government did legislate some very radical reform measures unmatched by those preaching shock therapy and reform radicalism. For one, bankruptcy legislation was severe, producing over 16.000 cases between April 1992 and December 1993. The law on accounting and the law on financial institutions have brought Hungarian practice up to those of the European Union. This was the first serious legislation on banking in the region, and it uncovered much of the financial strain inevitable under restructuring and recession. Private enterprise was

less than satisfactory, as those countries who resorted for IMF advice often lacked conditions for policy credibility and sustainability.

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booming, but unemployment was increasing quickly to double-digit levels in 1992, showing that, for the Hungarian economy, cold winds were blowing. And then the IMF discontinued lending.

With the benefit of hindsight, the IMF was quite right in sending this signal, serving the same educational purpose as signing the agreement had. By mid-1992, it became clear that the government had lost control over fiscal processes and that the fiscal expansion was threatening to derail many of the favorable processes that were then under way. There was surely an inadequate awareness of problems. In an article written just about this time, the new Governor of the Bank emphasized that the financing needs of the state could be covered from domestic sources. His counterposing this with practices of preceding decades (Bod, 1992, p. 8) suggested that it was a long-term trend that could be relied on for a long time. Already in 1993, and even more in 1994, domestic savings fell behind the financing needs of general government spending, not the least because of the Bank's continued, and temporarily successful, attempt to depress interest rates. In the middle of July 1993, financial organs still disputed the repeated claims of the Ministry of international Economic Relations that there would be a collapse of exports (Kádár, 1993). The collapse materialized, with only 8.9 million dollars exported in 1993 against 10.7 in 1992, resulting in a deficit of $3.6 billion on the trade and $3.4 billion in the current account.

Besides foreign trade, fiscal reform also became controversial. Despite many promises, virtually nothing has been done to date. The Fiscal Act is a collection of procedural norms only. The Committee on Rationalizing State Finances has been convened, but it has not even started working except for two introductory encounters where members were familiarized with one another.[7]

Seeing the danger, realistic individuals in the Hungarian government attempted to forestall the deterioration of situation. A small team headed by the Minister of Industry elaborated propositions for sizable fiscal cuts. These were complemented by the dormant fiscal reform plans of the Minister of Finance. This was a daring project produced by secretive camarilla policies. In September 1992, the Hungarian delegation made very radical promises to the IMF, promising to cut back fiscal spending, without any backing from the government and or from among the coalition MPs. The figures approved by Parliament had no relation to the ones presented to the IMF. Kupa remained alone, alienated, misused, and he was retired in an act balancing the ousting of the populist rightist wing of the MDF in February (Lengyel, 1993). His successor, Iván Szabó, has earned a name as a friend of large industrial programs and the reputation of a not being particularly monetarist in his previous job as Minister of Industry. Szabó actually proved much less of a disaster than feared by many because his amended version of the Kupa Budget for 1993 was credible. He also ran a Ministry of Finance able to submit to Parliament a budget draft that could be approved before the calendar year started. The volume and the structure of spending, however, leave much less room for satisfaction, and the planned 12% general government deficit forecast for 1994 speaks for itself.

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[7] A new, this time operational, Committee on the Reform of Public Finances started its activities only in February 1995 with first measures envisaged for 1996.

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One wonders what led Hungarian government officials to believe for all of 1993 that they could satisfy the IMF by meeting some of the basic formal requirements while avoiding most of the substance of fiscal and social security reforms. As late as mid-July, anonymous sources informed the most influential Hungarian economic weekly that, although the government had avoided funding cuts to the newly created social security directorates and thus could not agree with the IMF in June, on the basis of the amended Budget, it still viewed a new understanding as realistic (cf. Kádár, 1993).[8] Later, in autumn, the then Secretary of State reiterated much the same story as had led to the downfall of Kupa the previous year. Requirements and financing targets agreed with the IMF and the ones derived from legislation passed by the Hungarian Parliament on the initiatives of the governing parties, such as the law on civil servants, on social security, on retirement age, on supports for medicine, and on bank consolidation, were again inconsistent (Nagy, 1993). Still, the hope for an agreement with the IMF was cherished.

With the approaching elections, a certain sobering took place. This led to the first open confrontation between the Hungarian authorities and the IMF. Explaining the economic policies and the Budget for 1994, the Minister of Finance spelled out in no uncertain terms, and with reference to the election defeat of Polish radical reformers, that growth and social consensus were more important than fiscal cuts and anti-inflationary concerns (Szabó, 1994). He noted, with reference to the IMF, that after 40 years of socialist dogmatism, Hungary does not need antisocialist, free marketeer dogmatism.

The Hungarian government refrained from launching new government programs and not increased government expenditures rapidly. It followed a generally pragmatist overall line. Still, it could not avoid a clash with the IMF due to the rise of fiscal deficit. In part, the structural deficit inevitable in transforming economies (Bruno, 1992) have surfaced, but this explains less than half of the general government deficit that occurred. The other half is explained by delays in social security and fiscal reforms and the related explosion of the domestic debt servicing burden on the Treasury, as well as by the costly bank recapitalization and industrial loan consolidation programs.

As far as social security is concerned, the need for reform had been known for sometime. When the Antall government took office, a leading figure in the central bank called it an issue that had been put off for about a decade (Riecke, 1991). As documented in detail in this reference as well as in Kopits (1993), by the late 1980s a fairly detailed and far-reaching reform project had been elaborated with the technical assistance of the Fund. This would have separated services into those provided to citizen as entitlements and those to be paid for. Privatization of many public establishments figured high on the agenda. In reality, with the accession to power of the new government, these ideas were rejected out of hand. A confused idea,

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[8] These directorates were equivalent to pension funds and health insurance agencies. The concept creating them and their way of functioning is described below. The point here is that an election contest was underway in June 1993 when drastic fiscal cuts, especially of transfers, would have become economically necessarry. This was indeed experted by the Fund and rejected openly by the Hungarian government.

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originating with the Free Democrats but later taken over and cultivated by the governing Christian Democrats, prevailed. This rejected the concept of focusing on financing health care services. Instead, it sought to endow social security directorates with wealth and thus to enable them to conduct economic activity like a large bank or pension fund in the United States.

Knowing the level of financial intermediation, as well as the demographic structure of the Hungarian population, aggravated by extremely generous retirement benefits, sickness and unemployment schemes, this idea had absolutely no relation to Hungarian realities. Furthermore, when the average yield of public assets is between 3-5% even in the best of circumstances social security directorates could not earn enough from their assets to be able to finance already-existing schemes. Actually, these organs were endowed with less than 10 billion Ft of assets instead of the decreed 300 billion. This proved to be fortunate because they were already making sizable losses on even this small amount of capital, disproving the belief that it is the state that is always the worst entrepreneur. Meanwhile, the Ministry of Public Welfare (MPW) sabotaged any meaningful reforms. In a survey, conducted by the independent Hungarian-International Blue Ribbon Commission, a number of social security reforms were proposed (KSZB, 1993). Social policy should be targeted to the poorest rather than distributed as a general right. Except for basic services, health care should require some payment by the patient. Tuiton fees should be introduced in higher education combined with a British-style credit system. The system of unemployment benefits should be reformed because two-sevenths of the unemployed were receiving 85-100% of their previous wage, and a further two-thirds over 70%. Consequently, the incentive to readjust to changes in the labor market were minimal. Rents should be raised to levels at least covering maintenance. Special programs to deal with the problems of special underprivileged groups, e.g., gypsies and drug addicts, need to be elaborated.

This was more or less a replication of the 1988 propositions. Meanwhile, the MPW was proud of allegedly defending the poor by sabotaging any change.

As far as fiscal reforms are concerned, as the current resident of the IMF for Hungary, George Kopits (1993), explains, it is lack of transparency, insufficient controls, and a duplication of tasks that plague Hungarian public finances. First attempts to produce a consolidated general government balance were made only quite late (Borbély and Neményi, 1993), and even then without taking due account of the need to apply international standards in accounting for individual items.

It is important to note, that these much overdue technical corrections do not take account of some further facton that aggravated the situation. A large number of new offices were created. New entitlements, such as early retirement schemes and restitution and compensations of various sorts were created. The act on civil servants envisaged salaries absolutely out of line with the economic performance of Hungary in 1990-1994. When GDP declines by 20% it is not feasible to raise wages across the board in the public sector. Last, but not at all least, territorial decentralization created 3200 new municipalities, with obvious financing needs for the longer run. As many of the vested interests were defended and new entitlements created in the sphere of social security, with the new legitimacy and revoutionary euphoria gone, it will be increasingly difficult to get even elementary cuts through. Owing to

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the type of legitimation earned by the first coalition government and to the type of political self interpretation practiced in the first Hungarian Parliament, it is not only the traditional left who are against such cuts. Most of the middle-of the-road and center-right parties also declared a crusade against such reforms, with the extreme right employing social demagoguery anyway. This means that most precious years 1990-1994 have been wasted. It will be both more costly and politically more difficult to institute such cuts when the pressure to do so comes in 1995 at the latest.

The government of Hungary has chosen forms of reorganization of banks and companies where political, employment, and strategic considerations play a much larger role than the resident of the IBRD sees as understandable (Rogerson, 1994). This is not a fully independent development but is intimately related to the economic policy turn of late 1991 discussed above. Pressed hard by the disciplinary force of the IMF, by private financial markets, by social resistance, and by the dramatized fears of the implications of a collapsing CMEA, in 1990 and the first half of 1991, the conservative government of Hungary managed to distance itself from the economic platforms of its constituent parties and to apply a fair degree of common sense. With the immediate danger gone, and with the radical populist voices in the governing parties, especially the MDF, gathering momentum in August 1991 and August 1992, this situation changed. Policy-making became more responsive to what it perceived as social needs, which were basically its own election rhetoric and the feedback from its handful of faithful. Whatever our political tastes and priorities are, the fact remains that the educational operation of the IMF 3-year standby program failed. The commitment of the Hungarian government to market principles was much less than had been assumed, and its vulnerability to various pressure groups much greater. Therefore, developments in Hungary, increasingly resemble a typical third-world scenario, with the Fund and Bank preaching macroeconomic common sense, and the national authorities making their customary references to their national peculiarity and the need to behave in a socially sensitive manner.

It is an important feature of continuity that the government in general has refrained from publicly contesting the wisdom of the Washington twins either in general or in particular cases. However, its way of thinking was clearly reflected in its outburst against the National Bank when the Bank increased its prime rate in September 1993. At this time, the Treasury was still hoping to depress the real rate of interest and avoid the burden of debt servicing, without any technical or institutional or structural fiscal reform. In a week, the professional number one of the Bank, First Vice-Governor Imre Tarafás, an internationally highly esteemed and strictly nonpartisan long-serving official, who could have been a model civil servant in any democracy, was relieved of his post by the Acting Prime Minister, Péter Boross, without explanation. Since Tarafás was only 47 and Boross was about to run against populist-rightist contenders for the Chairmanship of the largest government party the connection seems fairly straightforward. Likewise, another professional known for his skill and opposition to *dirigiste* industrial policies, Péter Balázs, was relieved of his post as Secretary of State for Industry just at the time his boss became the frontrunner of the Christian Democrats, the staunchest adherents

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of statist policies. In sum, social sensitivities and dislike for IMF-type policies were emerging hand-in-hand.

But not only the, probably inevitable, politicking of the election campaign played a role. From late 1991, i.e., ever since Hungary's survival of the economic crisis seemed assured, an overall softening of economic policies could be observed. First, monetary policy became expansive from October 1991 to September 1993 when it returned to the neutral stance of 1989-1990. In the summer of 1992, fiscal deficits increased. In 1992 and 1993, costly and government-run reorganization programs were launched and several new transfer entitlements legislated. The tough bankruptcy legislation was relaxed in June 1993, leading to a threefold decrease in new cases initiated since then. And, as could only have expected, calls for protecting the domestic market and reversing trade liberalization started to gain the ears of decision makers. In 1994, for the first time since 1988, the degree of foreign trade liberalization in Hungary has decreased, even though only by 2%.[9]

The bottom line is that a replication of all that could be observed in 1985-1987 occurred. While the government of the day was responding to politico-ideological and power aspirations rather than to economic challenges, the central bank of the country was diligently hoarding hard currency reserves. This stockpiling paid off insofar as direct clashes with the Fund and the Bank were averted due to the satisfactory level of reserves. Having raised over 4.5 billion dollars in fresh money, the National Bank was awarded the borrower of the year title by *Euromoney* magazine. Indeed, comments by the Bank's chief money manager, Frigyes Hárshegyi (1994), were directly supportive of the above-mentioned claims of Finance Minister Iván Szabó that Hungary could survive 1994 not only without resorting to the IMF facility, but even under a worst-case scenario of not a penny of fresh money being injected into the country.[10]

Much as in 1985-1987, narrower banking considerations and success indicators were in conflict with broader economic policy and especially systemic priorities. Successes and the predominance of the former considerations led to distortions of the latter. At times of real need, when grave mistakes were being made, the IMF could, and did, send its warning signals, make its position clear, and try and persuade the authorities, but it did not impose anything upon an unwilling partner. In many ways, it is a story that could take place in any corner of the globe; still it is also a unique story.

If there is a difference between the two periods, it is the domestic scene in Hungary. The filter mechanism of the early period did not exist in 1991-1994. On the other hand, no central economic policy-making could emerge in Hungary. Formally, the Hungarian party conducting talks with the Fund and the economic cabinet were legitimately representative and could take action. In reality, neither of them were in a position to transform the understandings into actual policy measures. The economic cabinet is a formal organ, not the least because Antall con-

[9] This a crude measure of what percentage of total imports consists of commodities that are actually not liable to licensing or any other form of administrative protection.

[10] Actually, according to several interviews given by Hárshegyi, Hungary's 1994 financing needs could be covered by July by issuing bonds.

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sistently resisted the creation of a top government agency. Mr. Horn seems to be following this path. When Antall passed away, the election campaign was already in progress, with cabinet ministers playing their party roles. In the new center-left government, most departments are headed by people publicly portraying themselves as protagonists of particular vested interests or sectoral concerns, be that industry, farming, social policy, or defense. This makes the continuation of the trends described above probable. By the time the Fund has regained its leverage over the Hungarian government, the latter will have shown early signs of being worn down by being in office and being unable to deliver on its election promises, most particularly with regard to improvements in living standards. Thus, the situation will probably be a replication of 1989-1991, and domestic weaknesses will prevent the government from performing according to the expectations of the Washington twins. The latter will probably force some of the measures needed to achieve a degree of fiscal equilibrium, but they will surely fall short of getting those wide-ranging measures that their philosophy suggests would make major improvements in the Hungarian economy. Thus, we are back to the much-too-familiar situation of the majority of Third-World members of the Fund and the Bank.

IV. Concluding Remarks

The objective of this paper is much more modest than that of a detailed overview. In reviewing Hungary's pre- and posttransformation experience a fair degree of continuity is evident. This is remarkable *per se*, given the widely divergent philosophy and target setting of the respective regimes. A more detailed examination shows the recurring conflicts between systemic and narrower banking considerations. Inherent limits to the IMFs and the World Bank's power to impose policy are evident since they lacked the means to discourage Hungarian governments from adopting populist measures and socially motivated growth-promoting policies at those times when systemic and other, broader conditions for the sustainability of growth were clearly nonexistent. The repetition of the story indicates how little the Fund and the Bank let themselves and their operations be influenced by the considerations of transformation. This is a value-free descriptive statement.

Thus, reasons for the discord between the IMF and the Hungarian government of the day are quite similar to those in other countries. The Hungarian governments, too, tended to resort to the IMFs advice much too late, only when things had deteriorated to the utmost. Moreover, the IMF's advice was taken only temporarily, as a digression and only as long as accepting it was inevitable. Whenever macro performance was acceptable and immediate pressures receded, institutional reforms tended to be avoided. For its pan, the IMF tended to close its eyes benignly as long as the current account seemed to be in reasonable shape. Reasons for the cordiality of relations are several. First, nobody who came close to rule in Hungary seriously contemplated a debt rescheduling or moratorium, even at times when countries from Mexico to Bulgaria were resorting to such options. Those who publicly aired such ideas kept them to themselves whenever they came close to having a say in

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actual decision making. These include József Torgyán, Imre Pozsgay, and István Csurka.[11]

Second, Hungary has never had a government during its IMF membership that would have declared an all-out assault on the principles of the market economy on which the Fund is built. This is quite unlike many member-states, probably Russia included. Third, the Fund has always treated Hungary with care and assistance. At times of real difficulty, such as in 1982 and 1990, a hand was given. Differences on both sides were played down. Fund positions on systemic change were hardly more radical than those of Hungarian specialists. Fourth, Hungarian governments never blamed the Fund for their own policies or for the need to respond to exigencies. The Fund never sought to make policies in place of the Hungarian authorities, whereas the latter never contested the philosophy, or the final wisdom of Fund proposals, although they often declared these untimely or avoided their substance out of fear of social resistance.

One wonders whether or not the Fund and the Bank could have delivered more in terms of market reforms. And indeed, when it first became possible to discuss the vices and virtues of Hungary's Fund membership, this criticism was immediately made (Csikós-Nagy, 1990, pp.157-158), faulting the Fund's one-sided insistence on equilibrium considerations and its neglect of restructuring. Our reading of the events does not support this claim, reiterated by several other authors ever since. We join Szalkai (1991, pp.178-180) in seeing the standby programs and radical measures to implement institutional reform as mutually supportive in each of the cases. The only exception was 1982-1984, but then an unprecedented improvement in fiscal and external balances took place. Moreover, the requirement of even-handedness would hardly have allowed the Fund to apply more pressure on Hungary, where radical reforms were already endorsed by governmental expert committees, than on Ceauşescu's Romania, which was also a member. Like in other countries, the Fund had rather bad experiences with medium-term standby agreements in Hungary.

While being constantly dissatisfied with what the government of the day delivered, and rightly so, the IMF never lost its sense of reality. Resisting the constantly changing tides of sympathy in the international press, the Washington professionals never forgot the Hungarian lead in systemic reform. In many ways, Hungary was a training ground for them to study strains and difficulties that surface sooner or later in transforming countries. To note but a few, bankruptcy legislation, the problem of bad debts in banking reform, the insufficiency of subsidy cuts alone to attain fiscal equilibrium, revenue losses due to privatization, and many other problems making a sizable imprint on IMF thinking could be studied in Hungary first. Thus, it is hardly by chance that it was the then-resident of the IMF to Hungary who concluded about transformation that there is no cookbook to go by (Szapáry,

[11] József Torgyán is Chairman of the Smallholders' Party, a right-wing populist Party taking about 8% of the seats in the 1994-1998 Hungarian Parliament. Imre Pozsgay used to be a leading figure of the reformist wing of the Communist Party. Having quit the Socialists in 1991, he has sunk into oblivion. Csurka's Hungarian Life and Justice Party earned 1% of the 1994 election votes.

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1993). He, too, drew attention to the large number of unexpected behavioral characteristics of both firms and households that made actual transformation quite unlike the early visions. Last but not least, he and Kopits (1993) underlined the large number of factors making fiscal and social security reform a much longer process than most of us would have thought a few years ago. When one-fifth of GDP is lost, and living standards have not improved over a decade, it is hard to initiate drastic cuts, provided sustainability is also a policy consideration.[12] In the end, it is sincerity, criticism, and empathy that are the foundations of any lastingly cordial relationship.

Is there a general lesson from the IMF-Hungarian encounter? I would suggest only preliminary findings. First, radicality of the original reform projects did not prove to be a sound indicator of success, since sustainability matters more once stabilization is mastered and institutional reforms come to the fore. Second, being a watchdog of balance of payments disequilibria, the Fund is ill-suited to enforce structural reforms. When Fund assistance is needed, immediate, often administrative, steps to improve the balance of payments are necessary. When improvement occurs and reserves are built up, only enlightenment and persuasion remain and the Fund has no leverage over an unwilling government. Third, combining the above two, one is reminded of a political triviality, often forgotten by technical economists and system designers. In order to enable institutional reforms to last, preferably beyond a single election cycle, one needs to build up a constituency in favor of these reforms primarily within the country concerned. Unless there is a degree of consensus, the stability of policies required by the nature of the exercise cannot be secured. Poland and Russia already show warning signs. Membership in the Bank and the Fund can hardly substitute, only supplement, other, more important conditions for a sustainable and committed domestic reform policy.

[12] Interestingly, it was one of the most radical critiques of the conservative government (Antall, 1994, pp. 88-90), that echoed this assessment in explaining the delays in fiscal reform.

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BEA SZOMBATI

The IMF's Role in the Hungarian Reform Process

Hungary became a member of the International Monetary Fund in 1982 as first among the Central European satellite countries of the Soviet Block. The step had a great political importance since it was taken in a period when these economies still operated in a rigid centralized system of economic management and under close political and economic control from Moscow. Hungary's joining the Fund was also a clear expression of intentions and efforts having already existed in several Central and European countries since the middle of 1970s to open up their economies to the West and, to launch economic management reform.

Hungary has become member at record speed, in six months, of the IMF and, three months later of the Worldbank. It could be attributed to three factors. First, it was most welcome, that during the previous two-three years a marked shift from the stimulation of growth to the improvement of the external balance has taken place in Hungary's economic policy. Second, the Fund management greatly appreciated that since 1968 when Hungary introduced a broad market oriented reform, elements of market mechanism and a moderate scope for private initiatives have existed in the economy and provided basis for further development of the economic reform. Last, but not least, Hungary had got the support of the international financial community and enjoyed its confidence, as a reliable borrower with low political risk at the international capital markets. During the twelve years of cooperation with the IMF these very factors of Hungary's policies have constituted a sound basis to close and fruitful relationship. Namely, undertaking of adjustment when needed, promoting reform process and maintaining good relations with the financial community, became fundamental in Hungary's economic policy. Hungary benefited from Fund support in different forms, like policy advice to design adjustment and reform programs, technical assistance and provision of substantial financial resources.

Fund Support and Reform Steps in the Period of 1982-1989

The international financial institutions have strongly urged market reforms even before the political changes in 1990, and have played a major role in making the economy more flexible and adaptable to external environment. A first and a second standby arrangement, concluded in 1982 and 1984, respectively, represented the first steps of cooperation between Hungary and the IMF. Both arrangements supported strong macroeconomic stabilization programs, to overcome the difficulties in the balance of payments, Hungary experienced due to the serious deterioration in terms of trade. Adjustment programs of that period put a strong emphasis on steps to check domestic demand and included a tightening of credit, a freeze of government expenditure, higher interest rates and curbs on real wages and investments.

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Introduction of heavy import restrictions was also needed to achieve a desirable improvement in external payments. In lack of market intruments, policies of these programs were implemented with the help of administrative controls through direct state intervention. The early reform steps, like a price liberalization in 1980, the liberal policy toward small private production in agriculture and the attempt to increase enterprise autonomy, left intact most of the traditional institutional system of economic management. The government still did not foresee the enhanced role for such economic policy instruments as the exchange rate and interest rates. Although the Hungarian economic management system was not characterized by pervasive direct administrative controls any more, the authorities remained able to control enterprise activity and enterprise financial results. Moreover, the economic development strategy has also remained fundamentally unchanged. Macroeconomic policies were not sufficiently tight to avoid the subordination of price and wage liberalization to political objectives and a renewal of imbalances and growing indebtedness *vis-á-vis* the convertible currency area.

The IMF management made it clear in its policy recommendation for the 1984 program that more fundamental measures needed to improve the responsiveness of the economy to market stimuli and to improve the efficiency of resource allocation. They proposed further price and wage liberalization, increased financial responsibility of enterprises and the establishment of an efficiently working financial intermediation system. However, most of those steps proved to be too ambitious objectives for the Hungarian authorities and policymakers to achieve even in mediumterm. Reform efforts as a whole had been scaled down during 1985-86, reflecting the primaly of political objectives and the intention of maintaining the prevailing economic system.

Political consideration has resulted in a stop-go pattern for demand management policies, too, during most of the 1980s, whereas the supply response of the economy also remained inadequate due to the inconsistent and incomplete measures of economic reform. The stagnating pattern of reform process has changed only from 1987 on, when the government adopted a comprehensive medium term stabilization and a structural adjustment program to overcome the balance of payments difficulties experienced again in 1985-87. The program, which was supported by a new IMF standby agreement in 1988, gave a new impetus to structural reforms affecting important areas of economic policies. Supported by IMF advice and technical assistance, a two-tier banking system has been established, personal income tax and value added tax system have been introduced in the frame of a tax and budget reform, and further progress has been made with price and import liberalization.

Measures to substantially reduce subsidises to inefficient enterprises and preparation of a comprehensive reform of the social security system were also on the medium-term agenda. As an important move toward institutional reform, a new Corporate Association Law was adopted in 1889 establishing uniform conditions for business activities across the economy and faciliting the Conversion of state enterprises to joint stock companies. These reform steps were supported and encouraged by extensive technical assistance of the IMF. Staff analyses and recommendations were especially focused on the area of banking reform, the development of more effective monetary policy instruments and on the tax- reform.

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The adoption of a new Association Law and other connected corporate acts in 1988 represented the first steps to reform the institutional system in the area of microeconomic decision making. This measure was strongly urged by the IMF and the implementation of the key features of the Corporate Association Law constituted a perfomance criterion under the 1988 standby arrangement. The urgent need to make price system responsive to relative scarcities in order to ensure efficient resource allocation was also emphasized by the Fund. Accordingly, a criterion on pricing system, too, was set to raise the share of consumer prices not subject to controls.

These reform steps and their implementation, however, were inadequate to deal with the structural rigidities reflected in the renewal of macroeconomic imbalances. In particular, price liberalization was too gradual to promote the required adjustment of the economy to world market conditions. Exchange rate policy and wage measures have reflected competing and inconsistent objectives. Only the first stage of a desirable budgetary reform has been reached, and the creation of the two-tier banking system represented only an initial move toward financial sector reform which did not change the operation of the state controlled resource allocation.

The Fund staff clearly spelled out that the main reason for inconsistencies in the Hungarian reforms was the lack of effective representation of ownership interests in the enterprise sector which limited the financial responsibility of corporate management and undermined financial discipline. This situation also complicated the enforcement of tight fiscal and monetary policies, which in turn limited the scope of further liberalization of the price and wage systems.

During this period, the scope and effectiveness of economic reform, as well as the ability and willingness of the Hungarian policy makers to follow Fund advices on further essential reform steps were severely limited by the prevailing social-political system. The dominant role of the party in all political and economic activities and the dominance of state ownership allowed only halfway implementation of economic reforms. A political reform was necessary to achieve a sound and consistent progress with market reform process and to start a successful transformation of the economic system.

IMF Support to Reforms Since 1990

By 1990 Hungary has already made substantial progress with economic reforms compared with most of the countries in economic and political transition. Nevertheless, the tasks ahead represented a major challenge for policy makers, not least because of the need to establish many of the economic and legal institutions of market economy wich were still missing

The first freely elected government of Hungary that assumed office in May, 1990 after the fundamental political changes, has formulated a comprehensive program of economic reform aimed at moving to a market economy based on private ownership. The government faced the enormous challenge to proceed without delay to restructure the economy and accelerate the building of market institutions in many important areas, while dealing with the serious macroeconomic imbalances experi-

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enced during 1989 and 1990. The IMF management welcomed the government's medium-term "Economic Program of National Renewal" and supported it by a three-year extended arrangement for Hungary. Fund experts provided extensive assistance in formulating the policy content of the program, taking account of the need to address, in a comprehensive fashion, many well-known weaknesses of the economy hampering productive potential and leading to periodic external imbalances. The list of structural policies included:

- privatization and deregulation to promote an effective supply response and also to increase the responsiveness of inflation to demand management policies,

- measures to reduce the share of resources absorbed and distributed by the public sector,

- measures to promote market based reallocation of resources toward efficient production and investment, including the completion of price and import liberalization, improvement and development of the financial system, the break-up of monopolies, the restructuring or closing down of loss-making enterprises, and,

- measures to develop an adequate social safety net.

Performance criteria for the arrangement included a detailed time schedule for progress in various areas of structural reform, including the adoption of legislation and implementation of the envisaged reforms for social security, banking and the budget. To monitor progress with structural reforms, quantitative and other benchmarks were also established for the period of the arrangement. As immediate tasks, the program for 1991 included significant steps in all these areas and a strong macroeconomic stabilization program.

The Fund has been closely involved in the design of both macroeconomic adjustment policies and structural measures. Pace and sequence of different steps in the areas of privatization, enterprise restructuring and legislation for the financial sector have been extensively discussed during consultations between Fund staff and the Hungarian authorities. Fund and Worldbank staffs' collaboration have also been intensified during this period with close coordination of conditionality of the IMF program and the Bank's SAL loan. The Fund and Bank staff have jointly assisted the authorities in preparing program documents for the medium-term macroeconomic and structural adjustment.

Technical Assistance

As an important channel of IMF support, technical assistance has also been provided to promote institution building in the areas of banking, monetary policy and the exchange system. In accordance with the objective to reduce the state's role in the economy, technical assistance focused on the fiscal system during 1990 and 1991. A major technical assistance program, covering VAT, personal income tax,

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review of corporate taxation, reorganization of tax administration, the budget and treasury system has been completed by 1991. The comprehensive review of the social security system started in 1989 by Fund experts, has been continued with the aim of promoting creation of a less expensive and more efficient social safety net. Technical assistance was provided to advise the authorities on the development of a foreign interbank market, too. The IMF's role in the design and implementation of the Hungarian transformation process has been strengthened by the direct assistance of a senior resident representative of the Fund who has been staying in Budapest since 1990.

Financial Assistance

The viability of the Hungarian stabilization efforts and the whole program, in general, heavily depended on sufficient external financial assistance. At the first half of 1991 Hungary was on the edge of losing access to capital markets due to political uncertainties and financial difficulties which have threatened the economical and political transformation process that had been initiated. Hungary was one of the countries benefiting from the concerted financial support for the transforming Eastern and Central European countries that was launched in July 1989 by the G-24 and the international financial institutions. During 1991, in addition to Fund financial support, as of US $ 1 billion under the first year of the EAF and a separate compensatory financing, further assistance, amounted to US $ 1.3 billion, were disbursed to Hungary from Worldbank and parallel financing, and from the G-24 and the EC, in the form of exceptional balance of payments support.

Tasks Still Ahead

During the years since 1990, Hungary has made a significant progress with structural transformation in all main areas of the economy. Privatization has progressed, the remaining consumer price controls have been eliminated, liberalization of external transactions has continued, actions have been taken to reduce government spending, to reform taxes and, new laws on banking, accounting and bankruptcies have been introduced. While appreciating the successful implementation of these structural measures, the Fund stressed the need for further progress in many areas. In particular, they consider the pace of privatization too slow, especially for larger state enterprises. The Fund staff emphasizes the need for setting clear and consistent objectives at this difficult area of privatization while recognizing that the determination of the appropriate size of government involvement in the reallocation of resources represents a main challenge of the transition process. Further areas where Fund management urges more concerted and accelerated actions, are the consolidation of the banking sector, and improvements in the bankruptcy process.

Fund advices on these areas and on many other important structural issues as well, was set forth in the program for a recent standby arrangement, approved for Hungary in September last year. In addition to the difficult issue of privatization,

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consultations with the Fund staff were focused on the problems and aspects of the government's bank consolidation program. Both IMF and Worldbank staff has collaborated in the preparation of an appropriate scheme for a comprehensive recapitalization operation. The program aims at reinforcing Hungarian commercial banks and addresses the problems of bad loans. Parallel projects with the Worldbank to strenghten bank supervision and restructure of specific enterprises will also support the consolidation program.

A further improvement of the fiscal system is also on the list of fund structural policy advices. They are of the opinion that despite stuructural improvements which represented the 1992 Act on Public Finances, significant weaknesses still exist in the system, hindering effective financial management in central and local governments. A technical assistance mission of the Fund has completed its findings on this issue and submitted recommendations to the government just a few weeks ago. It includes proposals to develop a comprehensive system for public debt management, a rationalization and streamlining of the structure of the government sector.

Hungary is also confronted - like most of the transforming countries - with the even more difficult and burdensome task of implementing severe macroeconomic stabilization policies in the face of substantial and prolonged output loss. Although the implying contraction of income, the widening fiscal deficit and the recently experienced substantial external imbalance represent a major challenge to the fundamental restructuring of the productive sector, the government agrees with the Fund that the way out of stagnation lies in with further intensification of structural tansformation rather than slowing down the process.

The transition to a market economy has proved to be a much more costly and difficult task for the peoples in Eastern and Central European countries than it had been expected. This is the case for Hungary, too, and there had been periods when Western assistance and policy advice had been criticised because it proved insufficient in the face of the severe income loss Hungary suffered. Disappointment had been felt by the public and by many experts and politicians because of the limited access to western markets and especially because of the unfulfilled expectations on a much larger financial assistance from the advanced countries and the international financial institutions. Nevertheless, during all these years there was no major disagreement between the IMF's and the Hungarian authorities' views regarding the policy issues of the reform. IMF assistance and policy advice has played a catalystic role in the acceleration of Hungarian market reforms and the government continues to rely on this assistance in implementing the numerous tasks still remaining.

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HUNGARY'S FINANCIAL RELATIONS WITH IMF
(As of December 31, 1993)

	SDR Million	**Percent of Quota**
Quota	754.8	100.0
Fund Holdings of Currency	1595.0	211.3
Outstanding Purchases and Loans	896.3	118.7

FINANCIAL ARRANGEMENTS

	Approval date	**Expiration date**	**Amount Approved** (SDR million)	**Amount Drawn** (SDR million)
Standby	December 8, 1982	January 8, 1983	475.00	475.00
Standby	January 13, 1984	January 13, 1985	425.00	425.00
Standby	May 16, 1988	June 30, 1989	265.35	215.35
Standby	March 14, 1990	February 20, 1991	159.21	127.37
Extended	February 20, 1991	February 19, 1994	1114.00	557.24
Standby	September 15, 1993	December 14, 1994	340.00	56.70

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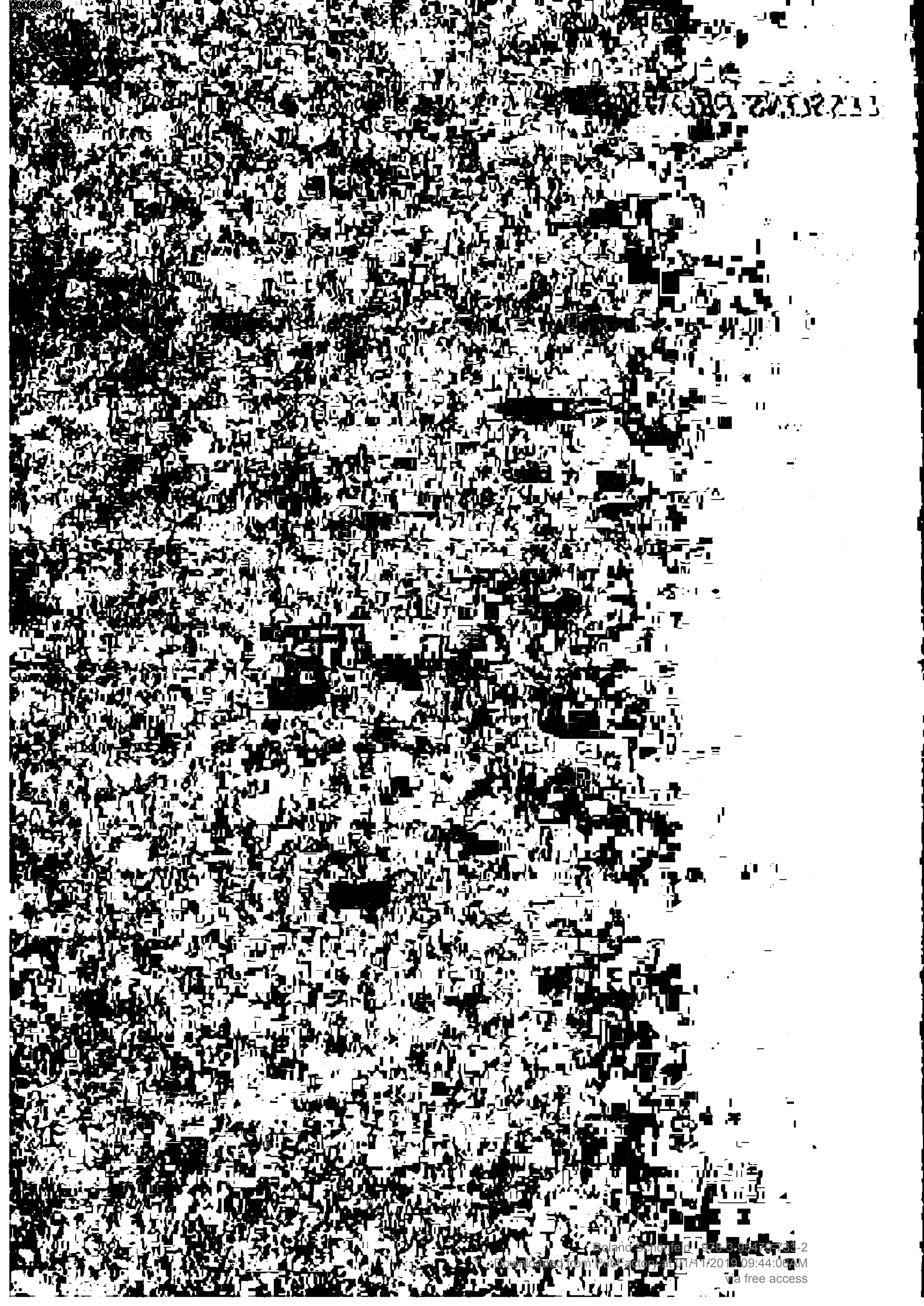

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MARVIN JACKSON

Transition of Bulgaria and the International Financial Institutions

I. Introduction

Although this impression is still subject to verification (some of which may come from this conference), Bulgaria does appear to have had especially difficult relations with the international financial institutions. This is said on the basis of much patient observation of the Sofia scene, but still as one outside of the inner circles of both the international fnancial institutions (IFIs) and the Bulgarian government officials and politicians who deal with these issues. I have learned one thing. All parties in these relations, no matter how much one might be counted as a beer drinking friend, do not welcome curious outsiders about their bureaucratic business and do not like to air dirty laundry. Good civil servants, anywhere, avoid discussing bureaucratic business with friends. In any case, I have learned some important things by trying to collect information myself. This lends more truth than listening to the often uninformed voices of those who make politics about and against the international financial institutions and those who try to work with them to bring reforms swiftly in the transition countries.

Before turning to a review of the bits of public evidence that I have been able to collect on Bulgarian-IFI relations since 1980, I would like to suggest some of the reasons why some transition countries, like Bulgaria, might have more difficulties in their relations with the IFI than other countries.

II. Possible Sources of Transition Country Problems with the IFI

There are at least three general problems that would be expected to contribute to difficult relations between a transition country and the IFIs.

1) The extent of political instability in a transition country and, related to this, the amount of time in office of regimes that are unfriendly to transition.
2) The extent of structural and institutional distortions at the time of initiating transition, the extent of exogenous shocks after transition, and the degree of negative economic impact of transition on the country.
3) The amount of international debt at the initiation of transition and the difficulties of servicing and reducing the debt after transition is initiated.

I shall now turn to a review of Bulgaria in these terms, which also allows me to provide a good introduction before I consider Bulgaria's record with the IFIs (at least that part that I have uncovered).

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III. Bulgaria's Transition Politics

The special features of Bulgaria's political life since the beginning of transition have been a sequence, each lasting approximately one year, of (1) a former communist government that won the first election and then resigned in the face of popular protests, (2) an interim "non-political" government of technocrats, (3) an elected government of the non-communist (non-socialist) opposition, and finally (4) another "non-political" govornment of technocrats. During this whole period, the Bulgarian Socialists (former BCP) have remained the single strongest party but since the second elections unable to achieve a governing majority without the help of a third political group representing the Turkish minority. This same minority party formed a government with the non-communist opposition coalition (UDF) and played a critical role in supporting, with the Socialists and some elements of the UDF the present "non-political" government of Berov.

Bulgaria's long ruling communist leader, Tudor Zhikov, was removed from office by his own associates in November 1989. Early in 1990 the BCP changed its name to the BSP and successfully campaigned to win the election in June 1990 by 211 seats of 400. Andre Lukanov, head of the BSP, became Bulgaria's first elected head of government, while the presidency was won by an opposition leader, Zhelu Zhelev. The BSP did not win a two-thirds constitutional majority and in the face of a political stalemate, growing economic confusion, and popular strikes and rallies against him, Lukanov resigned in November 1990. A technocratic caretaker government was formed by Dimitar Popov, a former judge, to see the country through the new constitution, adopted in July 1991, and elections following its adoption.

The first elections under the new constitution in October 1991 were won by a coalition of non-socialist parties, the Union of Democratic Forces (UDF), and a coalition party representing Bulgaria's Turkish minority (the Movement for Rights and Freedoms). The new UDF Prime Minister, Filip Dimitrov, remained in office until October 1992 and then resigned in the face of a non-confidence vote.

On December 30, 1992, a new government was formed under Liuben Berov, the economic adviser of President Zhelev. This government was seriously reshuffled in June 1993 and now has lasted beyond most expectations. After the IMF agreements (see below) and with a seeming crisis of confidence in the Bulgaria *Lev*, Berov came under growing political pressure and the opposition of the trade unions. On March 8 he was rushed to the hospital with a heart attack and then underwent quadruple by-pass surgery. His deputy announced on 23 March that Berov would be back at work on 28 March. Indeed, even on 25 March he appeared on TV with attacks on the trade unions and the opponents to his economic reform program.

It has been said that the Berov government continues because neither the BSP nor the now disunited UDF want to assume responsibility for the difficult situation of the country. It is remarkable that Berov survives without organized political backing and perhaps even more remarkable that he apparently has managed rather large concessions from Bulgaria's private creditors and to get Parliament to accept tough measures to earn IMF support again.

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Political instability of the Bulgarian sort makes it especially hard to carry out complex reform projects. I choose privatization as an illustrative case because it is also an important condition in the programs of the IFIs.

In Bulgaria's case it is also important for the Berov government. Berov himself came into office "as a government of privatization". Also, privatization has been and still is one of the key issues dividing all political groups and factions, even within the non-socialist UDF where every politician seems to have become his own expert on the subject and on which program should be followed in Bulgaria.

Although a one-man privatization office was set up under the BSP, the first serious steps were the Privatization Law adopted in April 1992. Among other features, it included possibilities for debt-equity swaps as a way of privatization. Actually in spite of much work organizing and then reorganizing privatization agencies under the Dimitrov and Berov governments, no large scale privatization took place until mid-1993. This record provoked the Financial Times (5 May 1993) to describe Bulgaria as "the laggard in east European privatization".

Since 1988, preceding the fall of the communists, real privatization has taken the form of managerial and nomenclatural asset stripping. Usually this has been done by setting up related new private companies with friends or family and then doing business through the new company and stripping funds by the pricing arrangements and financial flows. While this was going on, the politicians and the experts were quarrelling and struggling over the methods of privatization.

Programs finally took form, although with much debate over which enterprises to privatize, and 49 cases were initiated and 13 sale transactions conducted before the end of 1993. Also, in August plans were announced to study and to undertake a form of mass privatization, using vouchers. Details of the plan are still debated and may not be high on the list of an otherwise hard pressed government.

IV. Initial Distortions, Exogenous Shocks, and the Economic Impact of Transition in Bulgaria

Bulgaria entered the transition already facing a foreign debt crisis (see below) as a result of mismanagement of the communists (and possibly even theft of assets by leading communist officials). To the debt crisis was added further external shocks from the collapse of the CMEA trading and payments system, and the Gulf War. Recently, Bulgarian officials have claimed that the country is owed a total of USD 3.0 billion by the former Soviet Union and Third World countries.

The terms of trade losses alone from the collapse of CMEA were estimated by Bulgarian authorities to be USD 2.5 billion, or 12.8% of 1989 GDP. Also, between 1980 and 1990, it is estimated that Bulgaria granted USD 2.4 billion in Third World credits, including large loans to Libya and Iraq. Only in mid-1990 a deal had been made with the latter for annual oil imports of USD 120 million for 5 years. As will be seen below, the first funds to Bulgaria from the World Bank went to finance oil imports in order to avoid a crisis from the losses of both Soviet and Iraqi sources.

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The data in Table 1 may be compared to other transition countries. The fall in Bulgaria's GDP of 30 per cent from the end of 1989 to the end of 1993 is much less than the experiences of Romania (-38%), Albania (41%), Russia (41%) and the Baltic States. On the other hand, Bulgarian industry is badly hit by the loss of connections and its declines are more like those in the other countries. Compared to Romania, Bulgaria has had the specific disadvantage of not being able to run a large trade deficit for either consumer goods or industrial supplies.

These factors may account for Bulgaria having the highest unemployment rate in the region. It also has one of the highest ratios of deficit to GDP for 1993, especially if deferred foreign debt service is included in the deficit.

The economy until the end of 1993 was also suffering from a relative revaluation of the *lev* because its nominal depreciation against the dollar lagged behind the increase in domestic prices. According to PlanEcon's calculations of ratios of official exchange rates to estimated purchasing power exchange rates, the *lev* (at 2.42) in July 1993 had become stronger than the Czech, Romanian and Slovak currencies. That relationship rose sharply when the *lev* fell to 36.8/USD on 18 February 1994 and further to 50/USD in March.

TABLE I

MAIN STATISTICAL INDICATORS

	1989	1990	1991	1992	1993
Real GDP (%)	-0.3	-9.1	-11.7	-7.7	-4.0
Industrial output	-1.5	-17	-22	-18	-10
Consumer prices (%)	6.2	21.6	333.5	82.6	72.9
Unemployment (%)	1.5	10	15	18	
CC exports ($bn)	3.1	2.5	3.7	5.1	4.5
CC imports ($bn)	4.3	3.3	3.8	4.6	4.8
Current account ($bn)	-1.3	-1.2	-0.9	-0.3	-1.0
Gross CC debt ($bn)	10.1	10.9	12.0	12.1	13.0
BIS bank assets ($bn)	1.2	0.6	1.0	1.4	1.2
BIS bank liabilities	7.8	8.7	8.2	7.4	7.0
Exchange rate (Lv/$)	0.9	2.2	21.8	23.3	27.5

Sources: *PlanEcon Report*,12 October 1993; Economist Intelligence Unit, *Country Report*, 1st quarter 1994; EBRD, *Economic Review: Annual Economic Outlook*. September 1993; National Statistical Institute, *Statistical News*, 3:1993 and *Statisticheski spravochnik*, 1993; Agency for Economic Coordination and Development, *Business Survey Series*, 1993 annual.

Foreign Investments

In mid-1991 a Foreign Investment Law was passed with relatively liberal provisions. It was revised in January 1992 to provide an even more liberal framework. In 1990, only USD 100,000 of foreign investments were reported and in 1991 still a

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modest USD 700,000-800,000. Bulgaria has remained the least attractive transition country.

Data on foreign investment are rather uncertain. One report said that from 1991 to August 1993 only USD 216 million had come in, including USD 120-150 million in shares, bonds, and deposits in Bulgarian banks (*PlanEcon Business Report*, 3:24).

If the transition started with an external shock, it seems to be continuing with another one. According to a government commission, losses on account of sanctions against Yugoslavia amounted to USD 3826 million by July 22, 1993, a monthly average of USD 212.6 million. It was pointed out that this would be a large percentage of Bulgaria's foreign debt.

V. Bulgaria's International Debt Problems

The Bulgarian government announced a moratorium on principal payments on 29 March 1990. Subsequently the moratorium was extended to interest payments, as well.

Negotiations with the Paris Club led to an agreement in May 1991 for rescheduling the official debt over 10 years, with a six year grace. More good news has resulted from President Mitterand's visit to Bulgaria in January, 1993, the result of which new meetings with the Paris Club (official creditors) started in March. It is hoped that the USD 1.6 billion official debt can be reduced and rescheduled.

Negotiations started with a consultative committee of the London Club in April 1992. Pending an agreement, Bulgaria's commercial creditors granted a succession of three-month roll overs of maturities of principal and interest. The negotiations with the London Club proved very difficult. The UDF government under Dimitrov had paid 20% of the current interest as a gesture of good will, but this was stopped by the Berov government in March 1993. In June the Prime Minister suspended the discussions, saying that an agreement was impossible when "we suggest a write-off of 50% and the banks offer us 8%." He went on to suggest following Poland's strategy of suspending discussions for a year (reported in the *Bulgarian Economic Outlook*, August 6-12, 1993). Parliament and the government then agreed to limit commitments on restructuring to a fixed payment of USD 700 million and up to USD 200 million in annual debt service until the year 2000.

In November 1993 an outline agreement was reached which indicated a 50% reduction in the USD 9.3 billion debt, covering principal of about USD 7.0 billion and interest of about USD 2.0 billion, with technical discussions to follow and negotiations to be concluded by June 1994.[1] A practical problem is that separate bilateral agreements have to be signed with more than 300 commercial bank creditors.

[1] It was also announced on 20 January 1994 that the Bulgarian government had accepted in principle some Russian offers for settlement of the TR 670 million and the "clearing dollar" 500 million that Russia owes Bulgaria from TR trade in 1990 and "clearing dollar" trade in 1991. The offers envisage payment in commodities.

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The agreement stipulated an initial downpayment of not less than USD 865 million and annual payments of less than USD 300 million for the first seven years, altogether making payments of USD 4.5 billion by the year 2030. Bulgaria is required to recommence interest payments and partial payments for three quarters of 1993, starting 1 April 1994, to the amount of 5% (instead of 20% as was agreed back in 1992).

At least three means of settlement have been discussed. One would involve Bulgaria buying USD 300 million "zero coupon" US Treasury bonds to serve as collateral for two types of Bulgarian bonds: (a) discount bonds at 50% and (b) bonds with below market interest rates. A second approach mentioned is debt-for-equity swaps, involving the privatization program.

A third approach is a debt by-back. In March the government offered 25% on the dollar and some creditors appeared to be ready to take it up. This may appear attractive to the USD 2 billion that had been purchased in the secondary markets by non-banking investors at discounts as low as 10-18% of par.[2]

VI. Selected Review of Bulgaria's Relations with the IFI

VI.A. The IMF

Bulgaria joined the IMF/World Bank in September 1990. By February 1991 the first stand-by loan of SDR 279 million was approved, which was subject to the following conditions:

- interest rate increases and tightened credit conditions;
- wage controls;
- price liberalization, except for electricity, heating, and essential foods;
- a unified floating exchange rate based on an inter-bank foreign exchange market;
- demonopolization, introduction of commercial practices, and privatization;
- abolishment of import-export quotas and reduction of subsidies to exports;
- commencement of negotiations with official and private creditors concerning the debt moratorium.

In 1991 the IMF disbursed about USD 400 million (disbursements were lower than expected by SDR 32.6 or USD 45 million).

Following the adoption of an austerity budget with a deficit target of 4.3 per cent of GDP, in April 1992 the IMF approved another stand-by credit for 12 months of USD 212 million (SDR 155 million) with the purpose of supporting the balance of payments deficit, the economic stabilization program, and structural reform. Funds were to be provided in 5 tranches. By the end of January 1993 Bulgaria had received 4 tranches. Total credits from the IMF had reached USD 632 million (SDR

[2] On March 16 the secondary market was closed for dealings in debt when the Bulgarian Foreign Trade Bank stopped registering such transactions. This was done in order to help establish who the creditors are.

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459.9 million), while Bulgaria had paid interest charges of USD 51.1 million (SDR 37.2 million). Payments of principal were to begin in 1994 and last until 2000.

At the end of 1992 net budget crediting by banks exceeded the upper limit of the SBA, partly due to unpaid interest on internal debt. As a result, the fifth tranche was not taken up and the second SBA expired on March 31,1993.

In addition to the funds, the IMF had provided significant technical assistance in setting up a modern banking system. The Bulgarian National Bank, in particular, received help in nearly every area.

The IMF argued that Bulgaria had not achieved the projected progress in structural adjustment and passing necessary financial legislation. It also refused to negotiate a new SBA before adoption of the national budget act and minimum budget deficit targets. In July 1993 a new IMF negotiator arrived in Sofia without agreements being achieved. Then the Bulgarian group to the IMF meetings in September returned, saying that in spite of large increases in the budget deficit, a new sympathy for losses connected to the Yugoslav embargo would lead to an agreement within months.

A draft agreement was finally announced by the IMF and Bulgarian government negotiators in December 1993. The conditions were recognized in a letter of intent to the IMF as:

- a maximum deficit of 6.2% of GDP;
- an inflation target of 30%;
- positive interest rates by the first month;
- new budget revenues from taxes and cut backs of price subsidies (including higher energy prices);
- a restrictive incomes policy;
- a floating rate for the USD to be maintained without National Bank intervention in currency markets;
- encouragement of secondary markets by the Ministry of Finance;
- the bad debts of state owned enterprises to be settled in late 1993 and early 1994;
- overall bank lending to be reduced.

It was said that if these negotiations are a success, Bulgaria should expect some USD 1.0 billion new funds from official creditors in 1994. This would include a new standby credit of USD 70 million and USD 300 million Systemic Transformation Facility (STF) loan from the IMF, plus a new SAL from the World Bank.

It was not until 28 February 1994 that the Parliament, in an extra-ordinary session approved a budget with the necessary deficit limit of 6.7 per cent of GDP. The budget includes USD 246 million interest payments to London and Paris Club creditors (6.8% of total expenditures).

The IMF Sofia representative then said that this would pave the way for new funds of USD 400 million by mid-year to make initial repayments to the London Club under the rescheduling agreement.

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VI.B. The World Bank and the IFC

After the IMF approved the first stand-by loan in February 1991, the World Bank opened in August 1991 a USD 250 million credit line. USD 150 million were used for the purchase of crude and fuel oil. Then delays in structural reform and the requirements of the Structural Adjustment loan caused the second tranche of USD 100 million to be postponed. Among the specific problems were the lack of privatization and land reform, and need to adopt international standards of bank supervision.[3] A new Financial and Enterprise Sectoral Adjustment Loan (FESAL) was offered in 1992, with the private investment and export finance (PIEF) project as a bridge in negotiations. In March 1992 a consulting company initiated a study of structural issues in the banking system.

The World Bank established an office in Sofia. By the summer of 1993, World Bank commitments reached a total of USD 445 million for 5 projects covering (a) structural adjustment, (b) technical assistance, (c) energy (USD 93 million: an earlier commitment of USD 75 million loan for the energy sector was to be disbursed March 1993), (d) telecommunications (USD 30 million), and (e) credit for private investment and exporting (USD 55 million).

The head of the Sofia office "... the Bulgarian reform program has been slower than we expected and that has delayed the extension of our full support." (BEO,13-19 August 1993).

The loan for telecom services was only approved December 4, 1993, when the first tranche of USD 135,000 was released. Release of funds for private investment and exporting was arranged earlier, in September 1993.

The conditions of the latter loan provide a useful review of the terms that the Bank demanded and the Bulgarian government was willing to accept. The technical conditions were:

- a loan of USD 55 million for 20 years including a 5 year grace period, of which USD 52 million would go to private entrepreneurs (through financial intermediaries) and USD 3 million to the participating financial intermediaries (PFI);
- the proceeds to be lent out to PFI at prevailing six-month market spreads;
- loans to be repaid in the currencies which were lent;
- private exporters to receive funds for a maximum of 180 days and funds for investment financing for loans of 10 years and 3 years grace period.

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[3] According to an undated World Bank report, "The Bank's Activities in Eastern Europe & Central Asia", lending in 1990/91 was USD 17 million and in 1991/92 amounted to USD 250 million (the SAL). As of 15/3/93 some USD 1055 million were in the pipeline, including agricultural development (USD 50 million), debt and debt service reduction (USD 215 million), education (100), energy I (USD 75 million), financial and enterprise sector adjustment (USD 150 million), health development (USD 50 million), employment promotion and social protection (USD 65 million), private investment and export finance (USD 70 million), SAL II/private sector development (USD 150), telecommunications (USD 30 million) and water-sanitation (USD 100 million).

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The macroeconomic conditions were that:

- the Government should advance privatization in 1993;
- the Government should declare its decision on the State Fund for Reconstruction and Development to the effect that funds would no longer be distributed at non-market prices through a centralized loan mechanism;
- the National Bank should approve a new bank control system which would be obligatory for all banks in order to receive funds from Structural Adjustment Loans;
- the Government should meet its commitment and implement a market-oriented mechanism for money lending in all sectors of the economy;
- by September 30, 1993, the National Bank should circulate instructions imposing international accounting standards on all banks and the banks should be audited by independent CPAs for 1993 and after;
- the Government should sign the Structural Adjustment Loan, acceptable to the Bank, with at least two participating financial intermediaries (PFI);
- the PFI boards of directors should pursue financial policies and a corporate strategy acceptable to the World Bank.

Another World Bank funding of USD 100 million for water treatment and water supply has been arranged. Also, by the end of February 1994 funds of USD 50 million were agreed to for private sector farm lending (the project had been delayed due to difficulty in screening and selecting 3 commercial lending banks).

Finally, the Bulgarian government has asked the Bank for new loans of USD 400 million to cover construction of a new unit at the Maritsa Istok power station. In addition, the Bank has taken up the issue of providing extra financing for the London Club private debt settlements (see above). The conditions are said to include strong specific targets for large-scale privatizations, including at least 70 projects and 5 liquidations. It is hoped that the Bank will make its decisions by mid-June 1994.

IFC

Bulgaria is eligible for equity financing from the International Finance Corporation (IFC), which can take up to 30 per cent minority shares in projects. The IFC annual report for 1992 listed no projects for either Bulgaria or Romania, while the report for 1993 lists one technical assistance project for Bulgaria, preparing the financial sector section of the financial and enterprise adjustment loan.

VI.C. The EU PHARE Program

After Bulgaria joined the IMF/World Bank, the EU (then EC) granted ECU 290 million for restructuring the economy and boosting hard currency reserves as part of its commitments with the G-24.

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In the period, 1990-1992, the only PHARE country treated better in terms of commitments than Bulgaria according to size of population was Albania.[4] In 1991 and 1992, a total of ECU 197.5 million had been appropriated by the PHARE program (including a project of ECU 11.5 million aimed at improving safety at Kozlodui nuclear power station), but in October 1993 there remained to negotiate ECU 131 million of these funds. This included some small funds for technical assistance to the banking sector. Also included were grants for environmental projects, beginning with ECU 3.5 million in 1990, ECU 7.5 million in 1991 and 1992, and ECU 7 million in 1993. New environmental projects have been set up for 1994, as well, including USD 20 million for a network of regional environmental inspectorates and laboratories, which was to be in place by the end of 1994.[5]

Among the projects for 1993 is a planned ECU 4 million for the tourist industry. This project has been delayed because of opposition of Bulgarian interests to the possible sale of prime tourist locations to foreign investors.

The PHARE program for 1993-1995 is to total ECU 300 million, of which ECU 90 million was set for 1993 (covering the private sector (ECU 20.5 million), updating and restructuring of the power industry (ECU 29.5 million), human resources (ECU 27.5 million), institutional reform (ECU 8 million), miscellaneous (ECU 4 million)). The EU Commission also announced that another ECU 62 million could have been given for privatization and agriculture if there had not been such slow progress in utilizing funds already granted for these areas.

One of the problem areas has been a rather small sum of ECU 7 million allocated for agriculture back in 1991. The purpose had been to enable emerging private farms and agro-industrial organizations to purchase imported inputs from EU countries through credit lines set up in commercial banks. Also involved were counterpart funds of Leva 300 million. The funds were still unused at the end of 1993 and were transferred to separate funds under the Council of Ministers. Recently it was announced the funds would be used for privatization in the agricultural sector (ECU 2 million), land reform (over ECU 3 million) and developing farm produce markets (over ECU 2 million). Use of the funds have been art of controversies with the Minister of Agriculture, who complains that too much of PHARE money in agriculture (he claims 65%) goes to pay foreign consultants.

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[4] According to PHARE data in the period 1990-1992 the following commitments (including food and humanitarian aid) were made (in ECU million): Poland 578, Hungary 306, CSFR 233, Romania 302, Bulgaria 219, Albania 120, Estonia 10, Latvia 15, and Lithuania 20.

[5] Programs listed in *The Compendium* of PHARE 1991 Operational Programmes are: Integrated SME/Regional Reconversion and Development Programme - 2.5 years (ECU 22.5 million); Telecommunications II -18 months (ECU 3 million); Agriculture - 2 years (ECU 10 million); Health - 4 years (ECU 10.5 million); Environment - 3 years (1991-ECU 7.5 million; 1992-ECU 7.5 million); Energy - 3 years (1991-ECU 2 million; 1992-ECU 8 million); Energy II - winter 1992/93 (ECU 10 million); Nuclear safety-no date (ECU 3.5 million).

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Most of the rest has been spent on technical equipment, such as computers and fax machines.[6]

VI.D. The EU Association Agreement

Negotiations began with the EU for associate membership in May 1992. An agreement for Association was signed in Brussels on 8 May 1993 with the Interim agreement expected to come into force in July 1993. The EU Council then unexpectedly become involved in internal issues, iucluding how to set safeguards. After the EU Council settled its internal issues, an agreement announced that the Interim Agreement would finally come into force on 1 January 1994. In the meantime, the Bulgarian government claims to have suffered losses of over USD 200 million in lost trade.

VI.E. The EBRD and the EIB

No EBRD and EIB financing took place in 1991. The EBRD entered Bulgaria in at the end of 1991. On 24 March 1992 a loan of ECU 114 million was approved for technical modernization of Maritsa Istok II electric power station in which the EBRD provided ECU 40 million, the EIB ECU 45 million and the rest by the Bulgarian National Electric Company.

A second project was taken up for reconstruction and expansion of the Bulgarian telecommunications system. The EBRD participation was ECU 32 million and the EIB extended ECU 70 million (World Bank participation was also envisaged). Other projects studied in 1992 were for improving the road system, on providing a credit line for SMEs, and participation in bank consolidation as well as capitalization of some banks. By the end of 1992 EBRD approved loans amounted to USD 131.56 million, covering the Maritsa Istok II power station (USD 49.2 million), posts and telecommunications (USD 39.36 million), and roadworks (USD 43 million).

A Bulgarian report then complained that not only were loans smaller than granted to neigbors, they also were restricted to public projects unlike other countries (*Bulgarian Economic Outlook*, Jan 8-15, 1993).

Studies taken up in 1993 included reconstruction of the railways, a Trans-European highway, ecological sewerage systems, wholesale agricultural markets in 6 cities, and an improved layout of the Varna seaport.

In January 1994 the first equity stake by the EBRD was announced, 35 per cent in a new Bulgarian Investment Bank (having a capital base of USD 5 million). Another ECU 85 million were committed with the EIB for the new unit at the Maritsa Istok power plant (see above World Bank).

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[6] Reported in *Finance East Europe*, 4 February 1994. Also, see the minister's interview in the Bulgarian language newspaper, *Pari*, on 29 November 1993.

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Commitments of ECU 200 million for modernization of the railroad in 1993-98 and USD 43 million for road rehabilitation in 1993-94 have been reported (the latter is in conjunction with a EIB loan). The EBRD is also expected to support a project of USD 85 million for reconstruction of the Sofia airport.

EIB

The EIB began in 1992 its Bulgarian financing with a feasibility study of credits to Bulgarian commercial banks for investment in small- and medium-sized enterprises, with a credit agreement signed in mid-1993 for ECU 30 million.

Under its co-financing facilities, EIB joined the Bulgarian National Electricity Company in the EBRD supported coal power project in 1992 for ECU 115 million. Bulgaria had more support from the EIB in terms of its size than did Poland, Romania, and the Czech and Slovak Republics.[7]

For 1993 it committed ECU 60 million for installation of a new air traffic control system. As mentioned above (see World Bank), the EIB joined the EBRD and the World Bank in supporting a USD 300 million project for digitalisation of the telephone system over 4 years.

At the end of 1993, a loan of ECU 21 million was agreed to for road modernization (together with the EBRD loan) which would be repaid between 1997 and 2009 (partly through toll charges).

VI.F. The Other IFI (G-24, UN agencies. etc.)

The G-24

After conclusion of the stand-by agreement with the IMF, the G-24 promised much funding that subsequently did not materialize. Bulgaria had requested USD 800 million of which USD 600 million was pledged and only USD 200 million disbursed in 1991. Disbursement of the rest of the pledged USD 400 million was expected in 1992, but how much was actually forthcoming is unclear.

Some USD 290 million were provided according to an agreement with the EU in August 1991 with the first tranche of USD 150 million disbursed then, and the second disbursed on 12 March 1992.

In 1992 bilateral agreements were signed with Norway, Finland, Sweden and Austria for credits to support balance of payments needs (USD 23 million, ECU 14.5 million, and ATS 210 million).

[7] For the period 1990-1992, the following amounts, in ECU million, were committed: Hungary 305, Poland 290, Czech and Slovak Republics 85, Romania 25 and Bulgaria 115.

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Remaining IFIs

After the IMF stand-by, UNIDO, FAO, and UNDP unblocked funds for specific technical assistance projects. No information has been collected on their activities in Bulgaria. Also, no information has been gathered on bilateral assistance, for example from the US AID, or on export financing lines with country agencies.

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OLGA TENEVA

International Financial Organizations - A Bulgarian Viewpoint

We are experiencing a unique historical epoch, the transition from a command and administrative system to a market economy in a large number of countries. In view of their increasing participation in the world economy, this is an event of great concern for policy makers and researchers both in the East and in the West. In this complex situation, there are no ready formulae or models for attaining the preset goal of transformation. Problems are complicated by the need to simultaneously advance both in the process of political democratization and in the progress of the economy. While in terms of political democracy, based on the principles adopted by the world's developed democracies, Bulgaria can boast of quite a few positive results, we have to admit we face enormous difficulties in the economic sphere.

All the international financial institutions and organizations are analyzing the situation and discussing ways and means for our economy's transformation. The goal is clear, but how to attain it is a problem difficult to solve. Indisputably, the main benchmarks of transformation are: structural reform, privatization, improvement of the legislative framework, of the fiscal policy, and of banking.

No matter how similar the conditions inherited from the former artificial social and economic structural framework developed under socialism, might be, in each Eastern European country, they have specific characteristics ranging from economic and natural to psychological ones. Presently, the Bulgarian economy is in an intense crisis. The reform started early in 1991 by introducing a restrictive monetary policy, but GDP has been falling in recent years – by 11.7 per cent in 1991, by 5.7 per cent in 1992, by 5.0 per cent in 1993. Even though we managed to avoid hyperinflation, inflation is high – 79 per cent in 1992, 63 per cent in 1993. Unemployment is increasing and now includes approximately 16 per cent of the active population.

The space for manoeuvering between the dangerous social and economic restrictions is severely limited. Measures targeted at one problem have negative impacts on others - we often simultaneously step on the accelerator and on the brake, and it is only natural that the car moves ahead only with difficulty. In such circumstances, structural policy faces many obstacles in its implementation. Privatization is difficult to effect and is going on at very unsatisfactory rate. Nevertheless, the official statistical data show that, at present, 18.5 per cent of the economy is controlled by the private sector. The strict anti-inflationary policy requires cutting budget expenditures and grants and maintaining a high interest rate. This has, however, a negative impact on investment. At the same time, Bulgaria lacks capital markets.

The improvement of the organization of tax administration is under way, and the tax reform has been set in motion. The VAT, applied in all European countries, was introduced on April 1, 1994.

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The consolidation of the banking sector is almost complete. In 1993, 53 banks with state participation were consolidated into 5 universal bank groups. In 1994 their number will increase to 6. The share of private banks in the Bulgarian banking system is increasing. The Central bank has licensed over 15 private banks, which are open to foreign capital. Austrian, Greek and American banks participate as shareholders or have opened branches in the Republic of Bulgaria. The South Korean concern DAEWOO has bought 49 per cent of the First Private Bank Ltd., and the EBRD has offered to acquire 11% of the Bulgarian Investment Bank.

Foreign exchange policy has been relatively successful. The major objective is to achieve convertibility of the national currency for all types of payments. A freely-floating exchange rate and a liberal foreign exchange regime, probably the most liberal among all Eastern European countries, e.g., exporters are not required to sell foreign exchange acquired through exports to the Central Bank, were adopted. Gold reserves have increased up to 38 t, i.e., 1,229,312 troy ounces in August, 1994. In less than two years, foreign exchange reserves increased 20 fold, but since the autumn of 1993 they fell by one-half. The exchange rate has remained stable for almost three years at 22-25 levs to the USD, but at the end of 1993 and the beginning of 1994 the national currency was strongly devaluated owing to great extensive speculation.

The external debt is considerable for the country's size, USD 10.5 billion. Following the moratorium on servicing the debt, announced by the Government in the spring of 1990, Bulgaria's access to capital markets was, in practice, terminated. Negotiations were held and framework agreement concluded with the Paris Club, thus rescheduling our debt to the official creditors, who hold about 20% of the total amount of the Bulgarian foreign debt as of April, 1994. An agreement with the London Club reducing Bulgaria's foreign commercial debt by USD 8,124,933,263 was signed in Sofia on June 29 1994.

After three-years of hard bargaining, Bulgaria achieved an unprecedented debt reduction, and Bulgaria's foreign commercial debt was slashed to USD 4,300 million. According to Mr. Peter Tils, the Chairman of Bulgaria's Bank Advisory Committee, serving on behalf of Deutsche Bank AG in its capacity as closing agent for the transaction, these are the most favourable terms that a debtor has ever received in a Brady plan transaction. The banks agreed to a buyback of 12% of the outstanding debt at a 75% discount on both principal and past due interest. This option is the deepest reduction not only in the package of Bulgaria but also the cheapest price ever negotiated in a Brady deal. Sixty per cent of the debt is set aside for settlment by collateralized discount bonds. The 50% discount on this option also results in an unprecedented amount of global debt reduction.

The front-loaded interest reduction bonds further facilitate the servicing of the transaction. The redemtion of these securities, going far into the next century, will help assure the viability of the package in the medium and long term. In this form, the deal allows the creditors to keep a reasonable portion of their due receivables.

The Bulgarian Government chose Citibank NA of the United States to act as fiscal agent for Bulgaria's foreign debt agreement with its London Club creditors. Citibank's offer was considerated best because it is a leading United States bank in capital size, standard of service, and experience in dealing with debtors of the same

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type. The bank does not require any special charges for its agency exept the fees for registration of the bonds on the Luxembourg Stock Exchange.

Bulgaria has thus been readmitted to the international financial community. In practical terms, this new chapter in our economic relations will bring, we hope, fresh bank financing and investments.

Our foreign trade regime has been liberalized completely. Last year's balance of trade was negative, unlike in the previous three years of the reform. The commodity and geographic structure of foreign trade changed drastically. The collapse of the market in the former socialist countries, the CMEA (Council for Mutual Economic Assistance), had a strong negative effect on the economy because decades it had been adapted to the specific requirements of that market. There was a natural striving to redirect the foreign trade flows to the industrial countries of the OECD. Their trade barriers, however, are difficult to overcome in spite of the agreement for association with the European Community signed in December, 1992. In the last three years, the Bulgarian trade balance was affected negatively by the Middle East crisis and by the United Nations embargos on Iraq, Libya and Serbia-Montenegro, which we strictly observe.

The last embargo imposed by the United Nations cut off our basic trade routes to Europe, including the Danube and placed us in real commercial isolation. A special Sanctions Commission founded to the Council of Ministers estimated Bulgaria's losses at over $ 2 billion. At the initiative of the UN, the International Monetary Fund estimated them at over $ 1 billion. This amount exceeds the gap in the state budget of our country.

Other Eastern European countries have similar problems with their real incorporation into the world economy. So far the assistance rendered by the industrialized countries for the reforms in Central and Eastern Europe has not come up to their expectations. This period coincided with the cyclic recession in western economies. The fall in production, the rising unemployment and the shrinking market, though not to the extent of the mid 70-es and early 80-es, increased insecurity in international financial markets. Therefore, the difficulties that the reforms in the Eastern European countries face have been conditioned by the unfavorable combination of simultaneously accumulated external and internal reasons.

The Republic of Bulgaria is developing good relations with the international financial institutions, the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development, the European Investment Bank, G-24, etc. The objective is to attract financial resources for the needs of the reforms, for the stabilization economic program, the structural reform, for support of the private sector development and technical assistance for various other sectors. It is in the overcoming of all difficulties in the inter-related world economy outlined above that I see the still growing role of those institutions, in supporting and coordinating the efforts of politicians and scientists from the West and the East to solve the global problems of today's world economy. The past can give examples for successful and unsuccessful solutions that have to be reconsidered in the light of specific modern conditions.

For instance, the countries that after World War II became democratic market economies were at the very beginning even more ruined than the new democracies

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in Central and Eastern Europe. Of course, there the market economy traditions were still alive. The process of revival, with a significant role for the state sector, was based on a system of regulatory and control measures to hold inflation and wages at a low level, to maintain the exchange rate and to regulate interest rates. Some elements were gradually dropping out of the system and at the same time there was an increasing trust in the capabilities of the market forces to cope with the problems almost by themselves, but this constructive process would have been impossible without the help of the United States through the Marshall Plan.

Jacques Delor, as President of the Commission of the European Communities, made a proposal to the European Parliament in Strasbourg in early 1990 that considered the possibility of giving a similar assistance to Eastern Europe. The Marshall Aid Program provided 16 West countries with some $ 12.4 billion over four years or $ 3.1 billion a year. In 1989 prices that are equivalent to $ 65.4 billion or $ 16.4 billion a year. In terms of Western GDP these are not very large numbers: $ 16.4 billion is about 0.3 per cent of the US GNP or the European Communities' GDP. For the United States, the EC and Japan combined it would be just over 0.1 per cent. Mr. Delor's proposal is for $23 billion. It would amount to some 0.45 per cent of the Community's GDP in 1989[1].

Actually, the important question for the Economic Commission for Europe in the UN is not so much whether West European countries could provide a Marshall Plan but rather whether Eastern European countries would be able to absorb and use it. The presumption is that, after the war, the ruined West European countries did not have to reconstruct their market economies from first principles. However, the absence of some preconditions in East Europe is compensated by the presence of others. For instance, the greatest wealth of our country is its human potential, the highly qualified, for its greater part up to the world standards, labor force which is still underpaid. Apart from the fertile land we have modern infrastructure and good traditional relations with the vast market of the former Soviet Union and other Eastern European countries. The Law on Foreign Investment Protection, adopted by the Bulgarian Parliament on January 16, 1992, provides sweeping rights and guarantees for foreign investments. Those who see the future benefits and promptly make their investments will have an advantage in the following periods of inevitable economic revival.

On the other hand, there exists the negative example of the mass assistance given for the recovery of the so-called third world in the last two or three decades. We should not be compared to these countries. The basic features and conditions differ. We can easily become an adequate economic partner and in this way assist with the development of the optimum currency area that is so necessary for the industrialized countries. Essential is the fact that in the Republic of Bulgaria both the population and the political forces are convinced of the necessary development of a real market economy.

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[1] Economic Reform in the East: a framework for western support. "Economic Survey of Europe in 1989-1990", ECE, UN, April 1990, pp.1-14.

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PETRA PISSULA

Financial Sector Development in Romania

Financial sector developments in Romania are a rather complicated subject for somebody from the outside, the more so as it seems to be a rather complicated subject for the Romanian government as well. In hardly any other sector is the conflict between economic needs and social considerations felt more, i.e., the conflict between the need for a restrictive monetary and fiscal policy in order to restructure and stabilize the economy versus the wish to avoid social unrest among the population. This dilemma has certainly led to various policy inconsistencies, and the reform process has often suffered from bureaucratic interventions and corrections by the government during the past four years.

1. The Romanian Economy in the Beginning of 1994: A Brief Overview

Romania today seems to be the country in the former socialist block where reforms and the macroeconomic stabilization process have been making the slowest progress and where the government is still suspected of not being convincingly devoted to reforms. But Romania, with its deeply rooted structural problems, is certainly also the country that was economically and politically the worst equipped and prepared for comprehensive reforms.

Instead of trying to find a balance between liberalization, stabilization, and institutional change, vital for a country in transition, the Romanian government, after the revolution of December, 1989, started "reforms" with a number of highly populistic measures in order to calm down the population. Although this is understandable, since the Romanian population had the lowest living standard within the former CMEA, the reduction of the weekly working hours and the considerable increase in consumer goods imports, financed by drawing down foreign exchange reserves, certainly did not contribute to the necessary macroeconomic stabilization.

Only in 1991/1992 did the government slowly start an economic reform program, which, for the first time, focussed more on macroeconomic stabilization, including financial and monetary sector reforms.

However, until now the Romanian reform process has been characterized by a highly inconsequential gradualism, which often meant the method "two steps forward - one to three steps backward". One example of this kind of behavior was the reestablishment, in October 1993, of price controls for food products. Such controls had been abolished only three months previously.

Thus the economic results of this reform process have been disappointing. Romanian GDP started to shrink in real terms in 1988 with accelerating rates of decline

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in each of the following four years.[1] Compared to 1989, in 1992 the GDP had decreased by almost one-third. Industrial production decreased to one-half of 1989 production, thereby reducing its real share in GDP from some 53% in 1989 to 40% in 1992.

Although preliminary official statistics, contrary to most forecasts, surprisingly showed a halt to the continuous GDP decline in 1993, there seems to be some doubt about the truthfulness of the reported growth figures according to which the overall GDP increased by 1%, industrial output by 1.3% and agricultural output by more than 12%. These doubts exist not only among OECD experts, who consider a negative growth of 4% more likely, but also among some Romanian economists, who think it possible that the positive growth rates are intended to draw a more positive picture of the country in order to attract foreign investors. However, this is reported with all caution since there is no reliable confirmation for this opinion.

Annual inflation rates kept accelerating also in 1993; they rose from 5.1% in 1990 to some 256% last year (295% on a December 1993 to December 1992 basis), instead of only 70 - 80% as was forecast.[2] Inflation in 1993, however, was particularly influenced by certain measures strongly recommended by the IMF and the World Bank. Those being the elimination of consumer price subsidies in May, the introduction of an 18% VAT in July and the elimination of ceilings on retail margins for consumer goods also in July, the latter, as already said, having been meanwhile reimposed. Inflation was, of course, fueled by a considerable depreciation of the leu *vis-à-vis* the dollar even though the government policies aimed at a real revaluation of the leu in order to avoid an additional inflationary impact.

The official exchange rate, i.e., the rate that resulted from the official foreign exchange auctions under supervision of the National Bank, more than doubled from the end of 1992, when it was 460 Lei/$, to 1,074 Lei/$ in November 1993. Much higher was the exchange rate on the so-called grey market, i.e., hard currency transactions directly carried out between enterprises, and at the private exchange offices, which also settle a larger part of hard currency transactions than the National Bank. The private offices exchanged the Dollar for some 1,600 Lei in December 1993. The official rate quickly decreased quickly when the introduction of full convertibility by April, 1994 was announced. By the end of January, 1994, it had depreciated to 1,480 Lei/$, thereby eliminating the temporary real appreciation; by the beginning of April, it had been brought in line, if not with black then with grey market rates, i.e., approx. 1,700 Lei/$.[3]

Real wages declined by an additional 15% in 1993, finishing at 50% of their 1989 level. The unemployment rate reached 10.2% of the workforce at the end of 1993. Although only some 25% of these lost their jobs due to the closing down of non-viable enterprises, further massive increases in unemployment figures will have to be expected if the government is to refrain from further subsidization of

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[1] Cf. P. Pissulla, G. Hunya: Romania - Macroeconomics, in: The World Bank *et al.*: Romania - A Strategy for the Transition in Agriculture, *Working Papers*, Vol 1 of 5, Washington, D.C. 1993, p. 33.

[2] Cf. *Neue Zürcher Zeitung* (NZZ), No. 29, February 5, 1994.

[3] Cf. *NZZ*, No. 29, February 5, 1994 and Rompres, Press Release of April 11, 1994.

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these state enterprises. By March, 1994, the unemployment rate had already increased to 11.3%, which was still below the East European average.[4]

What can be regarded as last year's success is the development of foreign trade with increasing exports and a shrinking trade deficit: exports increased by 5.6% to 4,527 mill. $, imports decreased by 4% to 5,676 mill. $ (cif); the deficit reached 1,149 mill. $, i.e., a decline of almost 30%.[5] The current account deficit declined from 1.5 bill. $ in 1992 to 0.9 bill. $ last year. Nevertheless the foreign exchange situation remained precarious until very recently, i.e., the beginning of April, 1994, although foreign exchange reserves covered almost two months of imports at the end of 1993. On the interbank foreign exchange market, demand regularly exceeded supply, and the private sector, which had almost no access to the interbank auctions, had to rely on its own foreign exchange earnings or on the above mentioned private exchange offices.

No exact data are available on Romania's foreign debts, which were zero at the end of 1989, since Ceauşescu, in an attempt to get rid of the influence of Western banks and financial organizations, had completely repaid all credits. Medium and long term credit lines in mid-1993 were $4.3 bill., one-third of which were government guaranteed credit lines to enterprises.

Of these $4.3 bill., $2.8 bill. were actually drawn by mid-1993. By the end of 1993, outstanding gross foreign debts are estimated at $3.3 bill.[6] No IMF credits had been disbursed in 1993, after the standby arrangement had been suspended in early 1993, due to the non-fulfillment of credit performance criteria.

At the end of 1993, Romania had outstanding IMF credits of 750.9 mill. SDR, which is almost 100% of the Romanian quota (754.1 mill. SDR). Only in December after nine months of negotiations did Romania reach a new agreement with the Fund. The IMF memorandum generally demands a speed-up in the reforms and an implementation of a strict austerity policy, which will include the fight against inflation by tight monetary and wage policies, and the restructuring and reorganization of state enterprises, of the banking sector, and of state finances. The deficit of the central state budget may not be higher than 3.5 to 4% of GDP. By a complete liberalization of the exchange rate, exports are to be promoted.

Romania hopes that the new credit arrangement with the Fund will free up additional financial sources from the World Bank and commercial banks up to the amount of $1 bill.. The World Bank, after having also suspended the last tranche of a $400 mill. structural adjustment loan in 1993 until agreement with the IMF had been reached, in fact reacted by releasing a $175 mill. credit for the modernization of Romania's oil and gas industry in April 1994.

The domestic debts of the Romanian government reached 734 bill. Lei in Dec., 1993 (4.4% of GDP) of which the biggest parts originated from credits for the redemption of government-guaranteed bad assets in the accounts of the four big state-

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[4] Cf. *NZZ*, No. 77, April 3/4, 1994.

[5] Cf. G. Hunya: The Romanian Economy in 1993: Economic Growth and Price Surge, Paper presented at the Hanns-Seidel-Stiftung, Wildbad Kreuth, March 1994, p. 7.

[6] Cf. ECE: Economic Survey of Europe in 1993 - 1994, p. 112.

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owned banks, and from credits for the financing of the 1992 budget deficit.[7] Domestic debts increased by almost 30% in March, 1994, when the government transferred an additional 210 bill. Lei of non-performing credits from commercial banks' portfolios to the public debt.[8]

These are some of the basic features and problems of the recent development of the Romanian economy with which monetary and fiscal policy has had to deal. Monetary and fiscal reforms were introduced rather late, i.e., not before 1991/92. From the beginning, monetary policy in particular suffered from a continuous struggle between soft and tight policy.

2. Monetary Policy

Since in socialist Romania the role of financial planning was absolutely secondary to that of physical planning, the lack of a functioning financial system made an active monetary policy at the initial stage of transition impossible. A two-tier banking system was established, though far from functioning, in fall 1990; the law on the central bank (National Bank of Romania, NBR) was passed in April 1991. The banking sector is still rather monopolized, dominated by four big state banks and the Romanian Savings Bank (CEC). The total number of legally-constituted banks was no higher than 20 by the end of 1993, of which four were private banks. Until today the banking sector cannot offer well-operating banking services.

Although monetary policy, together with budgetary and wage policies, has always had the task of keeping down the inflation that followed price and exchange rate liberalizations, it could fulfill its task only to a limited extent due to such factors as the underdeveloped financial sector, government interventions into NBR's credit policy, imprudent relations between banks and enterprises, and extremely bad payment discipline among enterprises.[9]

While the National Bank's first attempts to influence overall economic developments via monetary policy started in the second half of 1991 with an extremely soft policy, which was characterized by highly negative real interest rates and a real domestic credit expansion of some 20%, the policy changed in early 1992. In order to fight inflation, a tight monetary policy was introduced during the first six months of year. This policy, however, was contravened in August 1992 when government interventions led to a selective relaxation of credit policy.

Although the National Bank raised its refinancing rate almost constantly, to 80% in May 1992, in order to reach a positive real interest rate, this goal was achieved only temporarily, while producer prices were frozen for several months in 1992. The basic NBR refinancing rate, which was decreased in December 1992 to 70 % and valid through 1993, was far from being a positive real rate in 1993.

One of the National Bank's major problems through 1992 and 1993 was that the refinancing rate did not determine the overall structure of interest rates in the bank-

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[7] Cf. National Commission for Statistics: *Monthly Statistical Bulletin*; No. 1, January 1994.

[8] Cf. Romanian Business News, March 1994, *Banking-Financial News*.

[9] Cf. P. Pissulla, G. Hunya, op.cit., p. 21.

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ing sector, i.e., that the refinancing rate of the National Bank was for most of time the highest interest rate in the economy as a whole especially in 1992. The central bank lacked control over interest rates in the commercial banking sector for two reasons:

1. The Romanian Savings Bank, which was "saved" from the old times of communism, is so far not subject to the banking law and issued its own refinancing credits to state-owned banks at much lower interest rates than the National Bank. Its financial sources were the savings accounts of the population, for which the interest rates through 1992/1993 were extremely low if compared to the annual inflation. In 1992, for example, CEC interest rates for household sight deposits were 27%, for deposits over one year 50%, while consumer prices rose by 210%.[10] Since CEC had considerable savings accounts, being the only savings bank in the country that people knew and trusted, CEC became an important refinancing institute for the commercial banks. Only by the beginning of 1994 did CEC start to lose importance through increasing competition from commercial banks which offered much higher interest rates on deposits.

2. In 1992/1993 the government forced the National Bank to give preferential credits to certain priority sectors such as agriculture, transport, and later also production for exports, the refinancing rate of which was 13.5%, meaning a 15% interest rate on lendings by commercial banks.

Only in the course of 1993 did deposit and lending rates of commercial banks slowly start to increase. Deposit rates of the banking sector were in the range of 10 - 85% with a weighted average of 41.4% per year in November 1993. Short term lending rates to the non-banking sector ranged from 15 - 176% (weighted average 84%).[11] However, even these rates were still highly negative. Recently are there also credit auctions organized by the National Bank, where commercial banks compete for short term refinancing central bank credits. Interest rates increased up to 187% per year at these auctions.

Not only did the National Bank lack control over interest rates during the last two years, it also lacked control over credit and money supply for two additional reasons.

1. The financing of the national budget deficits so far have remained outside the scope of general credit policy. The deficits of the national budget have largely been financed by interest-free credits granted by the National Bank.

2. A considerable amount of uncontrolled credit emission occured through inter-enterprise arrears, which was the reaction of state enterprises to increasing liquidity shortages, thereby, of course, sharpening the problem. Since these arrears were interest-free through 1993, they were an extremely cheap source of financing.

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[10] Cf. P. Pissulla, G. Hunya, op.cit. p. 23.

[11] Cf. *Romanian Business News*, March 1994, p. 12.

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Also after the second global compensation of inter-enterprise arrears, i.e., the complete clearing of net arrears by the government - under law 80 in December 1991, these arrears very quickly started to rebuild in the course of the particulary tight monetary policy during the first six months of 1992 above-mentioned. By October, 1992 gross inter-enterprise arrears amounted to 1,600 bill. Lei (= 30% of the GDP).[12] By the end of 1993, payment arrears reached 4,200 bill. Lei,[13] which, however, was a reduction in relation to GDP (25%).

The government is only now undertaking first, although insufficient, steps in order to increase the financial discipline on enterprises. Since recent studies have shown that roughly 100 big state enterprises are responsible for most of the arrears, some 25 of these enterprises have been put under a surveillance regime of financial discipline, which is coordinated by the National Commission of Restructuring and which is part of the restructuring process. Furthermore, a new regulation scheme was introduced, which specifies that invoices unpaid within ten days will incur an interest rate of 0.15% per day (= some 55% per year). However, it is easily seen that this interest rate will be negative, even if inflation is no higher than 70 - 80% in 1994, and will hardly hinder enterprises from accumulating additional arrears unless the government is willing to strictly apply the bankruptcy procedure of the old Commercial Code, which has recently been reactivated as an interim regulation until a new and more efficient bankruptcy law can be put into force. However, so far, the Romanian Government has not applied this Code.

To sum up, it can be said that the major characteristic and problem of the Romanian credit market in 1993 was its segmented nature and the National Bank's lack of control over money and credit supply. Market-clearing rates functioned together with highly subsidized interest rates and involuntary interenterprise crediting.

But despite these unfavorable developments, the renewed restrictive monetary policy of the National Bank, which started last Fall and which went along with rising interest rates, seems to have yielded fruit by the beginning of 1994.

It obviously contributed to a decline in real credit to the non-governmental sector (156% in current terms; December 1993/December 1992) as well as to the government sector (59%),[14] and brought down monthly inflation rates from two-digit numbers in the Fall of 1993 to 7.4.% in December, 4.9% in January 1994 and 5.9% in February. For the entire year of 1994, an inflation rate of 70 - 80% is envisaged, which had been the forecast also for 1993. At these monthly rates, current real interest rates are finally positive.

High interest rates on domestic currency deposits, part of the increase of which can be attributed to an increasingly noticeable shortage of broad money in the economy,[15] obviously persuaded enterprises and the population to cease hoarding foreign exchange outside the banking system. For the first time, the exchange rate

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[12] Cf. P. Pissulla, G. Hunya. op.cit., p. 23.

[13] Cf. *Romanian Business News*, March 1994, p. 4.

[14] Cf. National Commission for Statistics, op.cit., p. 11.

[15] Due to an insufficient supply of broad money, its share in GDP continuously decreased from 61% in 1990 to 27% at the end of 1993. The shortage became noticeable by the beginning of 1994 and became acute by the end of March 1994. Cf. ibid.

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was under less pressure in April, 1994, and for the first time the supply of hard currency at NBR's auctions exceeded the demand by $2 mill. on April 8.[16] However, the almost triumphant cry of M. Cosea, Vice Prime Minister and President of the Council for Economic Reforms: "The Leu is convertible!" seems to be a little too optimistic.[17] Too many still existing constraints hinder free access to convertible currencies for private enterprises and private citizens, but if the National Bank maintains this form of tight monetary policy and if positive real interest rates on domestic currency accounts remain as incentives to move out of the dollar, then a significant further depreciation of the Leu might be avoidable. The exchange rate can then become an anchor, contributing to greater price stability

3. Fiscal and Budgetary Policy

Increasing strains on government expenditures led to rising budget deficits in the years 1990 through 1992. In 1992, the central government's official budget had a deficit of 263 bill. Lei, or 4.8% of GDP.[18]

Very often, a considerably lower figure (1%) was mentioned by the Romanian government, which liked to present the so-called consolidated budget, including central and local budgets and extra budgetary funds, because there are research, health, education, unemployment, supplementary pension, and social security funds. Extra budgetary surpluses, mainly from the unemployment, social insurance and supplementary pension funds, were used to provide temporary means to finance the central budget deficit. On the other hand, additional off-budget funds with an overall deficit, mainly from the foreign asset revaluation fund, which are not included in the consolidated budget, had to be balanced by the central budget. Were these deficits included, the total consolidated deficit in 1992 would increase to 5% of GDP. This exclusion of off-budgetary spendings certainly makes the overall budget obligations very non-transparent.

Looking at these figures, it should be noted that revenues and expenditures of the 1992 consolidated budget were accomplished under accounting conditions, which were rather favorable for the government. The enterprise accounting system, for example, overstated profits by understating production costs as well as the costs of depreciation of fixed assets, the latter having been highly underestimated by the lack of revaluation of assets in the course of inflation and by extremely long depreciation periods of 32 years. Both factors led to rather high revenues from profit taxes (23% of overall revenues) but also to a considerable decapitalization of enterprises.[19] On the other hand, extrabudgetary expenditures for social purposes like unemployment allowances were far from reflecting the realistic number of unemployed that would have burdened the consolidated budget if non-viable enterprises had not been subsidized but had been closed down.

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[16] Cf. Rompres, Press Release of April 11, 1994 (Currency Market in the April 4-8 week).

[17] Cf. Adevarul, April 11, 1994.

[18] Cf. P. Pissulla, G. Hunya, op.cit., p. 40.

[19] Cf. Banca Nationala a Romania: *Buletin al Statistic de Informare Publica* Nr. 1/1993.

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Since these, from the view of the state budget, rather favorable conditions were also true for 1993, it was not necessarily a surprise that the outcome of the 1993 budget was better than drafted in April 1992. While the central budget deficit was targeted at 4% of GDP, the actual deficit reached only 336 bill. Lei or 2% of GDP due to revenues 9% higher and expenditures 1.6% lower than anticipated.[20] The consolidated budget reportedly was balanced. Profit taxes were 22% higher than forecast, however, there seems to have been a downward adjustment for the expected profit tax incomes during 1993; their share in overall revenues decreased to some 20%.[21] Wage taxes, on the other hand, increased their share in budget revenues from 26% in 1992 to almost 35% in 1993, which seems to be surprising in so far as real wages declined while the number of unemployed increased. Both should have reduced the taxable income base.

Very likely the central budget suffered from the mentioned inter-enterprise arrears although they declined in relation to GDP in 1993. However, there were two main sources of loss caused by payment arrears:

1. Delayed payments in a highly inflationary environment necessarily led to lower real profit taxes, since there was no indexation for receivables in 1993.

2. Payment arrears also caused arrears in payments of turnover taxes, which are collected on an accrual basis.

It is not quite clear how far changes in the accounting system, introduced in January 1994, will eliminate these peculiarities. At least, an intended full inflation correction of the tax base will remove inflation-induced losses. On the other hand, there are legitimate apprehensions that enterprise profits could be more or less eliminated if the former accounting methods that used to overestimate profits are abolished. In the case of an economy that will most likely be stagnating at best if austerity policy is strictly pursued, the 1994 budget could very well suffer from serious tax losses. A budget deficit higher than the 3.5 - 4% of GDP allowed by the IMF could therefore be possible.

In order to protect the goal of fiscal policy over the next years, the government intends to increase the VAT, profit tax and excise tax rates, and to reduce expenditures from social funds without affecting the most vulnerable groups of the population.

These measures, however, most likely will have only very limited effects in the short and medium run. The VAT rate increase, for example, would affect low income groups of the population most, i.e., that greater direct income transfers to the vulnerable groups would be required. The present profit taxation already has contributed to a serious decapitalization of enterprises; further taxation would sharpen the problem until the envisaged reform of the accounting system reduced or even

[20] Cf. National Commission for Statistics: *Monthly Statistical Bulletin*, No. 1/1994, p. 3.
[21] Cf. National Commission for Statistics: *Monthly Statistical Bulletin*, No. 12/1993, p. 23.

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eliminated taxable profits. In this case, higher profit tax rates hardly would lead to noticeable revenue increases. Expenditures, on the other hand, could easily be higher than expected due to rising social and unemployment allowances in the course of almost inevitable closures of state enterprises.

Latest estimates on the growth of bad assets in the banking sector and the burden of the state budget by direct and hidden subsidies indicate that the government will have no other choice than to allow bankruptcies. No financial room seems to be left to resort to further subsidies for large state enterprises. According to estimates, direct and, via government guaranteed bank credits, indirect subsidies to non-viable state enterprises amounted to some 25% of GDP alone in 1993.[22] Although the latter do not burden the official national budget, the burden is high; subsidies are estimated to have accounted for up to 40% of total budget expenditures last year.[23] Bank credits to non-viable state enterprises at negative real interest rates, on the other hand, have already accumulated a huge amount of bad assets in the banking sector; it is assumed that they currently account for roughly 50% of GDP. Since a large share of these bad assets are government guaranteed, they will most likely raise public debts very shortly.

For the first time, in February, 1994 the Ministry of Finance together with the National Bank decided to issue treasury bills in order to finance at least part of the expected state deficit. The government hopes that one-third of the deficit can be covered; the rest will be financed from foreign credits, i.e., that foreign credits will be used for unproductive consumptive purposes. The public issue, amounting to 100 bill. Lei, will have a negotiable interest rate and will be redeemed in 3 to 6 months.

The issuance of these bonds, which had originally been envisaged for 1993, follows two test bond issues placed in 1992, which had an interest rate of 49% and were sold to the population exclusively by CEC. CEC, however, at the same time wanted to sell its own bonds at an even less attractive interest rate. Since this conflict, apart of the rather low interest rate was one reason for the undersubscription of those issues, the new bonds will be offered to banks, insurance companies, and the Private Ownership Trust Funds. The Romanian government obviously intends not to rely on interest-free credits of the National Bank in order to finance its budget deficits any longer. One source of uncontrolled and unrestricted credit expansion will thereby be eliminated.

4. Outlook

Romania is certainly in an extremely difficult situation. While financial and budgetary strains will most likely increase in the near future, in recent months major

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[22] Cf. Frankfurter Allgemeine Zeitung, No. 290, December 14, 1993.

[23] Cf. *Die Tageszeitung*; No. 4239, February 14, 1994.

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strikes indicate that the population will hardly be willing to bear additional burdens that are almost inevitably connected to an austerity policy as demanded by the IMF.

The official Romanian forecasts for industrial growth (2%) in 1994 which disregarded the impact of austerity policies were made in November, 1993. If this policy is strictly pursued, production will decrease. Most companies, in the wake of increasing interest rates, are much less optimistic today about their production possibilities than they were in the middle of last year.

On the other hand, if the austerity policy is not pursued, the IMF and other creditors will hold back credits, which will have negative impact on imports, thereby also curtailing industrial production. In any case under the condition of further GDP decline or only modest future increases fiscal constraints, the macroeconomic strategy of the government will predominate.

Monetary policy, therefore, must become a reliable anchor for economic policy while brought into harmony with fiscal and structural policies. However, the scope for an active monetary policy, which, in the past, had been restricted seriously by setbacks in the liberalization process, particularly with regard to prices, exchange rates, interest rates and subsidies, has been widened. We can only wait and see and hope that this policy can be more consequently implemented in the next future.

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