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Supporting Transition in Central and Eastern Europe:
An Assessment and Lessons from the IMF's Five Years' Experience

Second Annual Francisco Fernández Ordóñez Address
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It was a great honor for me to be invited to give this Second Annual Address in memory of a man beloved in Spain, in Europe, and throughout the world, Paco Fernández Ordóñez. Paco devoted his working life to public service in Spain, and his country was fortunate to have an individual of his caliber participating directly in its most important political and economic developments over the past 20 years. The strength of his character is known to all, as is his disregard for personal honors and material trappings; we are also fully aware of the delight he took in serving the public and the contribution he made to the process of restoring democracy in Spain.

As Minister of Finance he was responsible for important reforms of the tax system, and subsequently as Minister of Justice he was the driving force behind important legal and social reforms that have been of no less vital importance in the lives of the Spanish people. When he relinquished his post as Minister of Justice, his work took on a more pronounced international dimension, first as Chairman of Banco Exterior de España, and then of course as Foreign Minister beginning in 1985. All of us, whether Spaniards or persons honored to be friends of Spain, bore witness to his successes in integrating Spain, this "España necesaria" as he put it, into the European and international communities of nations, and in raising his country's standing in the world to the first rank. Paco Fernández Ordóñez skillfully guided Spain to membership in the European Communities and was one of the driving forces behind the Maastricht Treaty on European Union.

Paco's contribution to Spanish democracy and to the political and economic development of his country--and of Europe at large--stands as a clear example for all of us devoted to serving the common good of our own countries and of the world. His Majesty the King described him as an exemplary minister and one of Spain's finest statesmen. What could I add to such an assessment of our friend Paco Fernández Ordóñez?

As the Deputy Prime Minister has just observed, the first stages of the transition process in central and eastern Europe were among the last historical challenges to which Paco Fernández Ordóñez, as a great European minister, was called upon to respond. It was, if I recall correctly, at one of the first meetings of the founders of the G-24, which was established in Brussels specifically to support this transition, that I first had occasion to meet with him. How interested he would have been in the progress made since those initial stages, and how strongly he would have continued to support the contribution of the international community to the process! Bearing this in mind, I think it is fitting for me to discuss with you today, as we remember him, where we stand in this transition process in the countries of central and eastern Europe, some five years later. Let us, then, examine the following questions. What has been our approach? What has been achieved? What has been learned? And what are the challenges ahead? First let me review the IMF's approach to the transition process.

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The IMF has 25 member countries in transition in central and eastern Europe and the remainder of the former Soviet Union. All except Hungary, Poland, and Romania have joined the Fund within the past five years. Helping these countries to reorient their economies toward market based systems and to integrate themselves into the global market economy has been one of the Fund's greatest challenges in its 50-year history.

In the large majority of these countries, it was well recognized that this reorientation offered the only option for achieving economic progress. Although there were large differences from country to country, after decades of central planning these economies suffered in common from massive problems with which you are all familiar; and furthermore, the old structures of planning and control were disintegrating, creating conditions of economic and political crisis. From such starting conditions, the transition to a market economy required extraordinary resolution to pursue a policy strategy having three essential and interdependent components.

The <u>first</u> requirement is to <u>liberalize the economy</u>, decentralize decision making, and allow economic agents to assume responsibility for their actions. This means, in particular, bringing price controls to an end, and liberalizing the exchange and trade system to ensure that the domestic economy is subject to the discipline of international competition.

The <u>second</u> requirement is to <u>stabilize the economy</u>: to ensure, essentially through appropriately tight fiscal and monetary policies, that decisive progress is made toward low inflation, together with sustainable external and budgetary balances. Early macroeconomic stabilization is particularly important, for several reasons. One is that price liberalization inevitably brings a large jump in prices, which should not be allowed to develop into sustained inflation. Another is that the bad effects of inflation--arbitrary variations in relative prices, increased uncertainty, loss of confidence in the domestic currency, capital flight, and the added burden on the poor--can be especially destructive during the transition process, when the direction of change needs to be clear, and when maintaining public confidence is crucial.

The __third__ essential component of the strategy is the restructuring, and creation where necessary, of the institutions and markets that are needed for a competitive market economy to function effectively. Here I include a whole range of structural reforms, including:

- changes required for the effective implementation of fiscal and monetary policies, such as new tax collection systems, and strong and sufficiently independent central banks;

- changes required to ensure that enterprises are responsive to market forces, including bankruptcy legislation, the commercialization and privatization of state-owned enterprises, and the break-up or regulation of monopolies;

- and last but not least, social safety nets that are cost-effective and well targeted at the poor and most vulnerable.

Here, however, another problem arises. Many of these structural reforms necessarily take time, especially those entailing deep institutional changes. This implies a need to proceed with restructuring as quickly as possible, even though we know full well that for a number of years the process will have to proceed within a decidedly imperfect framework: the market economy must, as it were, move into a house that is still under construction.

So it is in terms of these three essential and interdependent components--liberalization, stabilization, and restructuring--that the IMF has viewed the policy strategy needed for a successful transition. This leaves many strategic aspects of economic policy to be tailored to national circumstances, and I shall return to some of the pragmatic elements of the Fund's approach. But as far as broad strategy is concerned, we have recommended that all three courses of action be pursued simultaneously with all reasonable speed.

The Fund has also held throughout that these countries' efforts must be supported by __international cooperation__--by open markets abroad, especially in the industrial countries; by substantial external financial resources; and by technical assistance. And commensurate with the leadership role it has been given by its membership, the IMF itself has undertaken a major reorientation of its activities so that it could make its contribution. Fund staff have been engaged in intensive and virtually continuous dialogue with practically all the countries in transition since, and often before, they joined the Fund. The Fund is providing financial support for policy programs in 20 of the 25 countries I mentioned earlier, with commitments amounting to about US$20 billion since 1990. Sixteen of these countries have utilized the systemic transformation facility (STF), which the Fund introduced last year specially to assist countries in transition to shift to multilateral, market-based trade. The Fund has also been playing its usual catalytic role in mobilizing financial support from other creditors and donors for the programs it has supported with its own resources. In addition, the Fund has been making a major technical assistance effort in a range of areas that fall within its expertise, in cooperation with other international organizations and our member governments. 1/

Speaking of our cooperation with other institutions in these tasks, permit me to single out the decisive contribution made by Europe, particularly within the framework of the G-24 to which I referred earlier, which the European Commission has led with professionalism, commitment, and vision. Spain is to be thanked for its important contribution to all of this.

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What has been achieved with this approach? You will not be surprised when I say that progress has been mixed. At the present time, we can roughly distinguish three groups of countries.

First, there are about ten countries--and I am pleased to say the number has been growing--where most of the work of freeing prices and the exchange and trade system has been done, where significant progress has been made toward macroeconomic stabilization, and where substantial structural reforms have been implemented in a number of areas. I include here Albania --prodigious efforts and remarkable results have been seen in this small country, the poorest in Europe, as it has emerged from its years of complete isolation--Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia. With regard to the liberalization of trade and payments systems, all these countries have taken major strides to integrate themselves into the global market economy. But the progress made by the three Baltic countries has been outstanding given their circumstances: each has eliminated all exchange restrictions, and accepted the obligations of Article VIII of the Fund's Articles of Agreement relating to the current account convertibility of their currencies. I am also delighted to say that Poland surprised me by accepting the obligations of Article VIII when I was in Warsaw last weekend. In the macroeconomic area, although inflation in all these countries has been brought down substantially from rates that once bordered on hyperinflation, it still ranges up to about 30 percent a year in Poland; and in all the countries except the Czech Republic and the Baltics, severe fiscal pressures remain. There are also wide variations in what has been achieved in structural reforms. Regarding privatization, in almost all of these countries more than half of GDP now originates in the private sector; the Czech Republic has been the leader, with the private sector now producing roughly two-

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1/ In the past two years alone, there have been more than 800 technical assistance missions by Fund staff or long-term assignments of experts to these countries, involving 1,800 person-months spent in the field. We have also attached great importance to helping with the training of economic policy officials, to many of whom the workings of a market economy were, of course, quite foreign.

thirds of output. In spite of these variations, however, all these countries may be said to have put the essential foundations of a market economy securely in place.

And look at the results, in terms of growth! All the countries in transition of course initially suffered severe output declines, related to the collapse of the old systems of centrally planned output and trade. In 1992, Poland, the pioneer in radical transformation, was the first and only country among the 25 economies in transition to see positive growth. In 1993, it was joined by Albania and Slovenia: indeed in 1993, Albania and Poland were the fastest growing economies in Europe. And in 1994, all ten countries in this first group are expected to register positive growth, led to a large extent by exports and investment. Not only have they established the foundations for a market economy, but they have begun to grow. The Deputy Prime Minister cited the words that Vaclav Klaus applied to his own country, in saying that these countries have come "out of the operating theater and into the recovery room." In fact, I would say that they are well along in their convalescence!

A <u>second</u> group of countries have made considerable progress with liberalization, and some progress toward stabilization, but have as yet failed to achieve a sustained reduction in inflation to moderate rates (of, say, below 50 percent a year) because of lack of consistent fiscal and monetary discipline. At the present time, I would put seven countries in this group, namely Bulgaria, Kazakhstan, the Kyrgyz Republic, the former Yugoslav Republic of Macedonia, Moldova, Romania, and Russia. I would add, however, that the Kyrgyz Republic and Moldova have made impressive progress toward stabilization in the second half of this year. Let me also say a word about Russia. Russia's monthly rate of inflation declined from above 20 percent in mid-1993 to around 7 percent last summer, in response to a tightening of financial conditions under a program supported by two drawings from the Fund under the STF. But since September, inflation has picked up again to about 15 percent a month following a relaxation of financial policies, and as you know there has been an associated rapid decline of the ruble. The control of inflation in Russia has still not been secured. This is clearly a matter of the highest concern and priority. Accordingly, we have been working closely with the authorities; in recent weeks a team from the Fund has been continuing discussions in Moscow on a program that could bring about rapid disinflation and that would be strong enough to be supported by a stand-by arrangement.

The countries in this second group have achieved various degrees of progress with structural reform. In the area of privatization, for example, Russia is the clear leader. About half of its GDP now originates in the private sector, higher than in any other country in this group. In the other countries, the proportion is typically closer to one third.

In none of these countries have adjustment and reform efforts been pursued as consistently or in such a sustained way as in the first group, and I am afraid that one of the results has been continuing stagnation or decline. Most are likely to show another year of declining output and incomes in 1994.

The remaining, third group of about eight countries have not, at least until recent months, made much progress toward macroeconomic stabilization, and all are likely to register inflation of around 1,000 percent or higher in 1994. Ukraine must for now be included in this group; but two months ago it embarked on its first Fund-supported program, and it is now taking its first substantial steps toward comprehensive adjustment and reform. Also in this group are Armenia and Georgia--countries where until recently warfare made it virtually impossible to launch a coherent stabilization program. I am delighted to say that improved conditions in these two countries enabled the Fund only last week to provide support for programs adopted in both of them. I have also very recently been able to recommend to our Executive Board programs formulated with the help of the Fund in Belarus and Uzbekistan, two countries where the desire for stabilization and reform appears recently to have strengthened. Recently, therefore, there have been signs of progress in a number of the countries in this group. But apart from in one or two countries where output has stabilized during 1994 for special reasons, economic decline has continued; and all the countries in this group have much still to do to establish the conditions for sustainable growth.

So you can see what I meant when I said that there has been progress, but mixed progress. A year ago, my first group would have been much smaller than it is today, and my third group considerably larger: this is progress. And in 1995, I am confident that we shall see more progress with policies, and that more countries will have begun their convalescence.

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Let us now turn to my third question: what lessons have been learned? The enterprise of transformation in which these countries have been engaged is unprecedented in many ways, and we have all learned a great deal; but there are three particular lessons I would like to highlight.

First, and most important, the most appropriate course of action is to adopt a bold strategy. Many countries, including countries of the former Soviet Union, have by now proven the feasibility of implementing policies of rapid--and I stress rapid--liberalization, stabilization, and structural reform; and such policies have indeed been shown to provide the key to successful transition and economic recovery--more so than a country's starting conditions, natural resources, or external assistance. The countries that have moved farthest on all three policy fronts have come out best.

- Liberalizing the economy works, and markets and the private sector do respond. Both queues and the uneconomic production of unwanted goods can be eliminated quickly, and if macroeconomic and structural conditions are right, economic recovery will begin.

- Macroeconomic discipline works. Allowing rapid inflation to persist provides no help in sustaining output beyond the short term: in fact, it is a hindrance.

- And structural reform is essential. Let me just mention here, as one among many examples, the difficulties that have been caused for macroeconomic policy in a number of countries by the failure to pursue enterprise reform and ensure that enterprises squarely face hard budget constraints.

What can be said about "gradualism"? The fact of the matter is that gradualism has not been found to be an effective prescription in any of the three major policy areas. At first glance, of course, it may appear to be the prudent approach. In practice, however, it carries considerable risks, because it makes it possible for mechanisms and methods of the old system to remain in place and because it can impede the working of the new forces of the market economy. I think that a better principle is to seize every opportunity to make progress. Such bold pragmatism is what leads most rapidly to success, thereby shortening the period of greatest suffering for the people. Moreover, it is the best way to transmit clear signals about the long-term course of policy, and the best way to build confidence. This is why gradual adjustment can turn out to be more difficult, apart from being more risky.

The <u>second</u> lesson is the need for--I can scarcely utter the word, as it is so far-removed from our traditional image, but I shall do so nevertheless--flexibility! Yes, flexibility! Within the overall framework to which I have referred, policies may indeed need to be adjusted pragmatically in light of circumstances and developments.

One example has been in the area of fiscal policy. No one foresaw the scale of the collapse in output that occurred in these economies, or the extent of the erosion of fiscal revenues that stemmed partly from it. In many cases, after careful assessments, the Fund has agreed in these circumstances to the temporary relaxation of fiscal deficit targets in programs it has supported, while of course continuing to focus on the requirements of lowering inflation and achieving medium-term fiscal sustainability.

Pragmatism is also required in the choice of exchange rate arrangement. The Fund has always recognized the helpful role that can be played by a fixed exchange rate as a nominal anchor in stabilization. And the Fund has supported programs with fixed exchange rates in a number of countries--for instance, the Czech Republic, Estonia, Lithuania, Poland, and Slovakia --programs that have had very positive results. However, fixed exchange rate arrangements have been supported only when there has been a reasonable assurance that adequate policies would be in place to ensure low inflation and maintain international competitiveness, and hence to sustain the peg for a reasonable period of time. And a fixed exchange rate arrangement also makes sense only if the country concerned has sufficient resources to defend the rate. When these conditions have not held, or when some degree of exchange flexibility has been called for by the country's economic circumstances, pegging has not made sense. Accordingly, the Fund has supported programs with flexible exchange rates in Albania, Latvia, Russia, and several other FSU states. As Albania and Latvia have shown particularly clearly, a flexible exchange rate does not imply any complacency about stabilization. And all these countries have shown that monetary and fiscal discipline is the key to stabilization, whatever the exchange arrangement.

The third lesson relates to external assistance and financing. While all the forms of international cooperation to which I referred at the beginning have proved essential, I would emphasize how external financing has followed the commitment to and implementation of appropriate policies. In one way, this is clearly shown by the large inflows of private capital that have recently been seen in the successful transition economies of central Europe and the Baltics, indicating the establishment of confidence and a diminishing need for exceptional balance of payments financing. Indeed, the Czech Republic has not needed to draw from the Fund since early this year, and Poland could follow suit in the year ahead. And in the three Baltic countries, private capital inflows in 1994 have amounted to about a tenth of their export earnings, with foreign direct investment making a particularly important contribution to the recovery of output.

Of course it has also been shown how official financial assistance can help speed up the transition process. It has played an important role in almost all the successful transition economies. But such assistance cannot be a substitute for stabilization and reform policies. Indeed, without adequate policies in place, the availability of external financing may actually encourage the postponement of adjustment, end up in capital flight, and add to the country's debt burden with no benefit to the country. This is one of the reasons why the conditionality attached to the IMF's lending is so necessary and important. And of course it is this conditionality that underlies the catalytic role the Fund is able to play in mobilizing assistance from other sources. I believe that the official assistance provided and catalyzed by the Fund has been the most beneficial and constructive that the transition economies have received. And that indicates how important it is for our conditionality to be maintained. But the effectiveness of our catalytic role also depends on the readiness of other creditors and donors to commit adequate amounts and to disburse promptly in support of our programs.

These, then, are some of the more important lessons that are in the forefront of our minds as we continue our efforts in these countries. And we could not do otherwise in view of the challenges these countries continue to face. What are the challenges for today and tomorrow?

It is clear that the old world order is dead and buried. Even where former communist parties return to power, a return to communism is the last thing they seek, and I can assure you that their cooperation with our institutions is no more problematic than in other countries in transition, or indeed than in all countries where the old order has been cast aside. However, immense problems remain unresolved and call for our concerted efforts: these problems are our problems as well.

Immense problems, I said. These problems are undeniably different from the problems of yesterday, but they are no less difficult, especially given that they must be addressed in an environment that has changed beyond all recognition. The celebrations are over; the enthusiasm with which the initial steps were taken has in many cases turned to bitterness; and the consensus in support of building a future based on freedom has given way to disputes among political factions looking to the next elections. Beyond a doubt, these countries have taken a leaf out of our book! What, then, are the challenges of today? Limiting myself to the essentials, I will mention just three:

- further progress toward stability and reform;
- progress toward rebuilding the state and toward a new approach to citizenship;
- in addition--and this challenge is a challenge for ourselves--to strengthen our solidarity with these countries.

<u>The countries must make further progress toward stability and reform</u>. Why? Because this is the quickest way they can achieve economic efficiency and economic growth, and reach a position where they will at last be fully equal to the immense tasks that lie before them in the areas of investment in human capital and infrastructure and social progress. The more these crucial efforts have been delayed (entailing further hardship for the citizens of the countries involved), the more urgent the task has become, and the higher the price that will have to be paid for any pause along the way.

<u>The countries must make progress toward rebuilding the state and toward a new approach to citizenship</u>. This, too, is clear. The "invisible hand" of the market is not sufficient to ensure economic growth that truly serves human needs. The state does have a role to play, and assigning it is no small task at a time when efforts must be made to dismantle all kinds of suffocating controls and indeed the entire outdated apparatus of government intervention in the economy. This has especially significant implications for the countries in transition, but not for them alone. The Fund is supporting similar efforts to restructure the state in a great many countries: in Latin America, in Africa, and even in Asia, in the midst of its dramatic economic upsurge. The Vice President of Bolivia is visiting Madrid today. Its President, who was an extremely successful Minister of Finance, told me a few days before taking his current office that "As Minister of Finance it was my job to fight hyperinflation. As President it will be my job to fight hypercorruption. To do that, I will have to rebuild the state." That is, of course, easier said than done. Everywhere we are seeking to promote market-based economies, this effort to ensure that

government is efficient, leaner, and yet also better equipped to carry out its core functions will be crucial to the success of the transition process. If this good governance is not achieved, if the benefits of economic growth are monopolized by a handful of individuals, and unless a state is established based on the rule of law which is uniformly and transparently applied, then we have been building on sand. However, the reconstruction of the state makes no sense unless it is placed in the service of a meaningful form of citizenship that in turn is intimately bound up with the capacity of the government to foster a dialogue concerning the major policy options, to decentralize power, and to show scrupulous respect for the principle of subsidiarity. And this brings me to the challenge that concerns us most directly, namely the call for our solidarity.

<u>We must intensify our solidarity</u>. "Adjustment fatigue" in countries in transition often goes hand in hand with "solidarity fatigue" in our countries. This is understandable enough at a time when our countries are engaged in what are in some cases rather belated efforts at fiscal consolidation. Nevertheless, I am convinced that we must resist the temptation to throw up our hands too soon. Perseverance in our efforts will be crucial to the success of transition in all these countries, and furthermore these efforts really do represent the most profitable investment opportunity that the old industrial countries have to enhance their own chances of achieving sustainable economic growth. Successful transition in these 25 countries will serve as a wellspring of economic growth for Europe--it is an unquestionable source of exports, growth, and jobs!

This solidarity currently comes in many forms for those of you who are citizens of the European Union. I will mention three issues: the opening of markets, accession to the EU, and financing. I need not dwell on the first of these issues at this time. The EU is constantly faced with difficult decisions. I would simply venture to suggest to you that when in doubt, you must go with economic openness: it represents the most effective means of supporting these countries.

On the question of their accession to the EU, suffice it to say, upon my return from Warsaw, how important the prospect of accession is to these countries in this stage of their transition, and how welcome are the new opportunities provided by the Essen summit. In this connection, it is my hope that constructive formulas will be provided for those countries endeavoring to catch up with the six that are in the lead.

With respect to financing, I must confess to a degree of anxiety in this area, since we are experiencing increasing difficulty in arranging financing for these countries, even when the countries in question are prepared to make major adjustment and reform efforts. Permit me to be frank: all indications are that the major countries are becoming more and more inclined to unload their responsibilities for this kind of financing on to the international financial institutions, when everyone knows that we cannot be expected to deal with it all ourselves. I must emphasize this.

Reform strategies are in progress throughout the former Soviet Union, but for some years to come their needs will be enormous, and bilateral donors--individual countries as well as the European Union--must be urged not to abandon their efforts prematurely. As for ourselves at the IMF, we have decided to forge ahead, and to accept large risks as long as we are dealing with sound programs that we can recommend to the rest of the world for support. We have increased the limits on access to our credit facilities by 50 percent, and we are currently examining the possibility of creating a new financing instrument in the form of "currency stabilization funds." The purpose of this instrument would be to increase confidence in the exchange rate, and thus boost the credibility of anti-inflationary monetary and fiscal policies, by making sizable resources potentially available in the context of vigorous stabilization programs, for the purpose of intervention in the foreign exchange markets to the extent required to help counter short-term destabilizing pressures.

Another proposal, still on the table after the failure to reach agreement in Madrid, is to supplement global reserves through a moderate allocation of the Fund's special drawing rights (SDRs). This would be of particular benefit to the countries in transition, both because of the low levels of reserves from which many of them suffer, and because almost all of them have never received an SDR allocation because they have joined the Fund since the last allocation in 1981. I did not make this proposal merely to make the Madrid meetings so exceptionally lively, but because I believe that never in history has an SDR allocation been so fully justified. We trust that the consultations on this issue, which are continuing under the aegis of the Chairman of the Interim Committee, will lead to a positive outcome in the coming months.

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So this is where we stand: not at the end of history, nor at the end of the transition period, but with the transition now well under way in many cases. We have witnessed extraordinary efforts. Something irreversible has been accomplished, to the extent that this can be said about any development in human affairs. We have had the good fortune, each in our own way, to be associated with this transition, unquestionably a watershed in the history of our time.

I have noted in passing that the magnitude of the task facing us has required greater collaboration among the international financial institutions, between the international financial institutions and governments, and with the European Union. Let us not abandon our efforts prematurely. The stakes are too high; and above all, it is essential to contribute to the building of a united Europe, a Europe that is strong and capable of achieving its true potential.