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Concluding Remarks by the Chairman
Review of Policy Experiences and Issues in the
Baltic Countries, Russia and Other FSU States
Executive Board Meeting 95/26 - March 20, 1995

I would like to thank my colleagues for their participation in this discussion and for their suggestions on how the reform and stabilization process can be accelerated to promote the resumption of growth in the Baltic countries, the Russian Federation, and other FSU states. From the staff paper and the comments of Directors, it is clear that there is finally an encouraging degree of consensus between the FSU states and the Baltic countries and the Fund on the appropriate policy approach.

There was a strong consensus on the need for accelerating structural reform as well as for rapid stabilization to improve the output performance in these economies. Success in stabilization and reform across the 15 countries had been mixed, and widespread hopes of a quick turnaround have been replaced by recognition that systemic transformation will take time. Nevertheless, significant progress had been made in a number of countries, and perhaps because of the successful example of those that have pursued a bold, comprehensive, and coherent reform strategy, the prospects for an acceleration of stabilization and reform in other countries have improved over recent months. There is thus a clear consensus that credible commitment to stabilization and reform policies is essential for the success of these policies, and that gradualism is not a viable alternative. Let me also emphasize--as several of you have done--the critical importance of institution building, in its broad sense, in the stabilization and reform efforts.

The decline in output in the 15 states since the dissolution of the U.S.S.R. has raised concerns about the design of policies in these states. In that context, it probably needs to be observed, first of all, that the database is flawed and that the output decline may well have been a good deal smaller than the official statistics suggest. Directors noted that, while there appeared to be a direct correlation between the speed of output decline and that of systemic change in the first two years of transition, the rewards, in terms of positive output response, accrue with a lag and the evidence does not suggest that a gradual approach helps to contain the cumulative decline in output. In fact, Directors observed a positive correlation between lower inflation and smaller output decline. They emphasized that the experience in the Baltic countries clearly shows the beneficial effects of sustained stabilization combined with structural reform: inflation has fallen to relatively low levels, and growth has resumed. Directors found little evidence that the output declines in these countries were exacerbated by unduly contractionary monetary and fiscal policies. At the same time, the need to contain the fiscal deficit to avoid crowding out the emerging private sector under tight monetary conditions was underscored by a number of Directors.

All Directors recognized that the rate of money growth remained the single most important determinant of the inflation rate over the medium run. We must not lose sight of the fact that in the group of countries we are discussing here, the role of money in a modern economy was not fully understood. We must also keep in mind that the introduction of national currencies--versus the maintenance of the ruble area--was a complex, time-consuming political issue. Thus, time was inevitably lost; with hindsight, it is clear that a number of these countries would have done better if they had introduced their national currency earlier, and supported them with a tight monetary policy.

Several countries had experienced difficulties in controlling inflation, at least in the short run, owing in part to large swings in velocity--especially in late 1993 and early 1994. Directors noted that a number of factors, including declines in confidence and thus in the underlying demand for money, exogenous increases in import prices and administered prices, and the creation of informal credits between enterprises, had contributed to these velocity swings. Some Directors noted, however, that many of these problems might themselves have resulted from--or at least been aggravated by--inadequate policies. For instance, capital flight could have been stemmed and confidence increased by ensuring positive real interest rates and, in some cases, by committing to exchange rate stability. Mr. Tulin has drawn our attention to currency substitution as a rational reaction of the public to protect its savings. We need to reflect further on this.

Also, Directors agreed that inflation control had been frustrated by the problem of interenterprise arrears. Directors expressed concern that increases in interenterprise arrears signalled a lack of financial discipline in many of the countries, and endorsed the staff's analysis and policy recommendations in this area.

Directors recognized that the revenue decline was to an important extent an inevitable consequence of the transition to a market economy. This decline, however, complicated the task of stabilization and needed to be reversed. Directors were also in broad agreement with the strategy put forward in the staff paper for enhancing revenue, and emphasized the critical role of Fund technical assistance in this area.

Directors noted that pegging the exchange rate had been a successful stabilization tool in Estonia and in some Central European countries. They observed that an exchange rate peg had the advantages of anchoring the price level in conditions of unstable money demand and of constituting a public commitment of the government to stabilization policies, particularly when embedded in a currency board-like arrangement. However, they also recognized that the costs of failure were high under an exchange rate peg, and the chances of failure could be substantial--especially in an environment of large real and external shocks and questionable political support for large fiscal adjustment. Most Directors concluded that, under such circumstances, a cautious approach should be taken in choosing to adopt an exchange rate-based approach to stabilization. Indeed, while anchors had proven useful in several countries, the experience in a number of others showed that exchange rate anchors were not necessary for successful stabilization from high levels of inflation. As has been noted in today's discussion, the choice of an exchange rate regime is probably secondary to the importance of strong monetary and fiscal restraint. In view of the fact that many of the external and real shocks associated with liberalization had already been experienced, and political support for reform had grown in many countries, the view was expressed that there was increased scope for the use of exchange rate anchors in the future. Most Directors observed that, in the case of countries such as Russia and Ukraine, more progress in stabilization and the establishment of a proper track record would be required before a fixed exchange rate could usefully be considered. Directors generally agreed that a case-by-case approach to the appropriate external regime during stabilization remained warranted.

We will continue our work and learn from our experience, which is growing over time. I have noted the calls of several of you for more work in several areas, and I can assure Directors that we will examine these requests, see how and when we can satisfy them, and critically assess the record of our policy advice. The learning curve of our policy experience continues.