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Minutes of Executive Board Seminar 91/4

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M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

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	A. Al-Tuwaijri
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	J. Prader
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J.-P. Landau	J.-F. Cirelli
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L. B. Monyake	
D. Peretz	
G. A. Posthumus	G. P. J. Hogeweg
	A. R. Ismael, Temporary
A. Torres	
A. Végh	A. G. Zoccali
K. Yamazaki	

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present

African Department: P. Marciniak. Asian Department: M. J. Fetherston, R. P. Kronenberg. European Department: M. Russo, Director; B. Banerjee, K. Bartholdy, G. Belanger, A. R. Boote, D. G. Demekas, M. C. Deppler, E. B. Maciejewski, J. Odling-Smee, H. O. Schmitt, A. Singh, T. van der Willigen, J. F. van Houten, N. E. Weerasinghe, E. J. Zervoudakis. Exchange and Trade Relations Department: J. T. Boorman, Director; E. D. Brau, Deputy Director; D. Burton, B. Christensen, M. G. Gilman, S. Kanesa-Thasan. External Relations Department: A. Mountford, J. Starrels. Fiscal Affairs Department: V. Tanzi, Director; S. K. Chand, H. R. Lorie, M. S. Lutz, D. Mihaljek. IMF Institute: W. G. L. Evers. Legal Department: T. M. C. Asser. Research Department: B. B. Aghevli, G. Calvo, M. S. Khan. Secretary's Department: C. Brachet, Deputy Secretary; A. Tahari. Western Hemisphere Department: S. T. Beza, Counsellor and Director; E. V. Clifton. Office of the Managing Director: J. Grieco, Visiting Scholar. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. M. Abbott, J. O. Aderibigbe, L. E. Breuer, M. B. Chatah, M. Galán, A. Gronn, Z. Iqbal, A. Napky, D. Powell, A. Raza, B. Szombati, A. M. Tanase. Assistants to Executive Directors: T. S. Allouba, J. R. N. Almeida, J. A. Costa, S. B. Creane, A. Fanna, S. K. Fayyad, B. R. Fuleihan, J. Gold, S. Gurumuthi, M. E. Hansen, J. Jonas, P. K. Kafle, P. Kapetanović, V. Kural, G. Lindsay-Nanton, R. Meron, M. Mrakovcic, M. Nakagawa, L. Rodriguez, Z. Shao, D. Sparkes, N. Sulaiman, Tin Win, S. von Stenglin, J. C. Westerweel.

1. CENTRAL AND EASTERN EUROPE - INTERIM ASSESSMENT OF 1990 PROGRAMS

The Executive Directors considered a staff paper on the interim assessment of 1990 programs in Central and Eastern Europe (SM/91/55, 3/6/91 and Sup. 1, 3/8/91), together with a staff paper on the role of the Fund in assisting East European countries (SM/91/46, 2/28/91).

Mr. Peretz made the following statement:

I believe this has been a useful exercise, and I am not repentant about suggesting that the paper be written. I hope that the staff has found it useful too. I rather suspect it has, given the signs in the paper of a number of healthy debates and differences of view. I think it was a wise move to appoint an editor unconnected with any of the programs under discussion. I believe the analysis has already helped to inform the design of programs for Romania and Bulgaria.

I will try to follow broadly the structure of issues suggested for discussion on page 17 of the main paper, though I think there are one or two points worth discussion that are not directly mentioned there. All the issues are in one way or another to do with how macroeconomic stabilization policy interacts with a process of radical structural reform.

The first issue raised on page 17 of the paper is the need for a social safety net during a period of massive structural reform. I do not disagree with this, though I do not think that it has been a serious problem in most of the countries under discussion. If anything, the problem has been to target more effectively the existing systems of welfare provision.

The much more interesting question is one implicit in question 2 on page 17, although not addressed as squarely as it might have been in the paper. Obviously structural reform should be implemented as fast as possible. But there is a huge task to be carried out which will inevitably take many years. What about sequencing?

One question is whether a full macroeconomic stabilization program should be implemented at all right at the beginning of the process, or whether it might not be better to wait--say, for a year--until the initial structural reforms have begun to take effect. There are arguments both ways.

Another question is--given everything cannot be done at once--what is the optimal sequencing of structural reform? It has become fashionable to dismiss the concept of sequencing in favor of progress on a broad range of policies at the same time. I have some sympathy with this view but doubt its realism. This means that it is essential to focus on priorities, and to accept second best solutions in some areas.

Obviously, a substantial degree of price liberalization and trade liberalization need to come first. After that, I think experience in Poland, Hungary, and Yugoslavia suggests that, given the limits to the authorities' capacity to implement a great many reforms at once, the urgent priority should be those structural reforms which do most to bolster financial disciplines at the enterprise level. I have in mind two main areas.

First, the restructuring and reform of the banking sector. This is needed if there is to be any semblance of a hard budget constraint on enterprises. It is also needed for effective transmission of monetary policy, a problem that crops up time and again in the paper. For if enterprises know they can always borrow what they need from banks, then the level of interest rates may have little impact on their behavior. So it is important to do as much as possible as soon as possible to increase competition in the banking sector. This will involve reduced market segmentation and an expansion in retail networks. The easiest and quickest way may well be to encourage foreign participation. The World Bank also has an important role in this sector. Alongside this, it may be necessary to recapitalize domestic banks, probably by issuing government paper in place of the non-performing assets. Without this, the temptation to widen spreads between lending and borrowing rates--which has, I believe, greatly complicated the operation of monetary policy in Poland--may be too great. I agree with the paper that until these reforms are in place, there is a good case for retaining administrative controls, such as ceilings on credit and interest rate spreads.

The second priority area for action is, I believe, public enterprise reform. Privatization, even in an industrial country, is a lengthy process. In the end it is the only satisfactory answer. But in the short run it is important to put in place quasi-market disciplines for enterprises remaining in the public sector. By this I mean the sort of controls on wages, prices, and borrowing by which any industrialized country regulates its public sector enterprises. I think that it could also help if non-economic financing of loss-making enterprises were transferred from the banks to the national budget.

This leads me to the third of the issues identified for discussion: the extent to which multiple anchors and administrative controls are needed to keep non-competitive forces--and hence inflation--in check during the transition to a full market economy. I am inclined to agree with the paper's conclusion (and this took some thought) on the need for multiple anchors and for administrative controls in some areas.

I have already mentioned the possible role for some forms of administrative controls in banking and public enterprises. I think there is a question--to which the answer is not necessarily no--of whether this applies also to trade liberalization. Freeing trade is a quick way of opening up the economy to competition, before monolithic state enterprises have been split up and sold. And, needless to say, for trade liberalization to be fully effective, it needs to be accompanied by a considerable degree of current account convertibility. But I can see that there may be a case for administrative controls to ease the initial impact of international competition on domestic producers, provided these measures go with the grain of reform. Protective tariffs should in general be lowered. But there may be a case in some instances for lowering them more slowly for consumer imports than capital goods and intermediate products. The retention of such measures, if strictly temporary, can have advantages over a lower exchange rate.

As to multiple anchors, I will come back in a minute to the role of the exchange rate. I have noted that interest rates may not be a very powerful transmission mechanism for monetary policy at the early stages of structural reform. There is the risk too that higher borrowing rates for companies will be passed through directly in higher prices to consumers, in the absence of sufficient competitive forces to keep this in check. This supports the case for credit ceilings during this interim period, and also supports the case for some reliance on the exchange rate as a more effective transmission mechanism. The best control on non-competitive behavior by domestic firms may well be foreign competition--but this will not work as a discipline if domestic firms are bailed out by devaluation.

This leads me to my answer to the question posed in item 4 on the list: is it a lesson from the Polish experience that policy was set too tight? That is not the lesson I would draw. First, I suspect that a loss of measured output on the scale recorded was probably an inevitable result of the beginning of the process of structural change. The actual loss of output will have been less: some of the measured output lost probably had little or no real added value; and output will have risen (as the paper notes) in the unmeasured sectors of the economy. Second, I would question how much impact high interest rates will have had on output anyway, given the points I have already made. But obviously they have some impact, perhaps as much on saving as on borrowing. And here it seems to me doubly unfortunate that Polish banks were allowed to open up such a wide margin between deposit and lending rates.

The main lesson of the Polish experience, to my mind--with the undoubted benefit of hindsight--was not that the program was too tight, as the paper suggests, but that the exchange rate peg was set too low. This not only had a direct effect on the price level but accommodated emerging inflationary pressures. When it came to mid-course adjustment, should the authorities not have considered revaluing the peg upward? Then the reduction in interest rates that was made might, in that case, have been appropriate.

Let me now turn to the last issue, the use of an exchange rate anchor. My own starting point is that economies undergoing this kind of revolutionary structural change have an inbuilt tendency to slip into hyperinflation. Yugoslavia demonstrated this. The only really effective way that has been found in modern times to stem this tendency to hyperinflation, which is a manifestation of a complete loss of confidence in the currency, is to enhance credibility by going for a fixed exchange rate.

Both the Polish and Yugoslav experiences reinforce this message. But they also demonstrate that it is absolutely essential to reinforce the exchange rate anchor with the right policies, and that in practice countries may have to be prepared when the time comes to consider adjustments in the rate--up as well as down. On the first point, there is a question of whether some degree of capital account convertibility would not help to bring the signals through more quickly of when policy action is needed. On the second, there is the delicate question of how to handle realignments. To the extent that counter-inflationary policy is not fully effective, pressures will at some stage emerge to adjust the peg downward. The worst thing that the authorities could do in these circumstances is to abandon the commitment to exchange rate stability. The second worst is to try to shore up the existing parity by reintroducing controls. This would undermine the exchange rate's usefulness as a guide for domestic policy. The opportunity has to be found to devalue to a new peg at a sustainable rate, ensuring that financial policy is tight enough to contain the effect on the price level.

Finally, I would like to make a general suggestion. I think we have all learned a good deal from this evaluation of a category of Fund programs. As I said at the beginning, I suspect that the exercise has been as useful for the staff as it has been for the Board. I can think of several other parts of the world where we could usefully compare the strengths and weaknesses of Fund programs in similar neighboring countries. If today's discussion is a success, I hope that the staff will be encouraged to produce further papers in future of a similar nature.

Mr. Dawson made the following statement:

I welcome this paper and the opportunity to draw some preliminary insights from the 1990 programs in Central and Eastern Europe before considering new programs for Bulgaria, Poland, and Romania in the coming days and weeks. I recognize that the differing initial circumstances of the three countries under consideration--Hungary, Poland, and Yugoslavia--and the somewhat different policy prescriptions applied to them, preclude making too many sweeping generalizations. I agree with Mr. Peretz that this need not become an inquiry into the theory of exchange rates. However, a few conclusions seem clear.

First, the choice of exchange rate regime is not a decisive factor in determining the success or failure of the program, or even in determining inflation performance. Rather, it is the strength or weakness of the underlying policies that makes or breaks program performance. As the paper itself states, "...exchange rate anchors are not a panacea--they are no stronger than the underlying wage, fiscal, and monetary anchors." The paper also notes that an anchor approach requires that the "...anchors be maintained if the exchange rate is to be sustained into a period where inflationary expectations have fully adjusted." While I believe that the Board agrees on these principles when stated on a general level, it seems that agreement on these points tends to break down when they are applied to specific country cases.

The paper notes that in all three country cases, the choice of exchange rate regime was made in light of the primary stabilization objective. Where combatting inflation was the primary objective--that is, in Poland and Yugoslavia--a fixed exchange rate was chosen; where protecting the external position was the primary objective--in Hungary--a flexible system was adopted.

In the event, all three countries had higher inflation than expected. However, Hungary's performance seemed to come the closest to fulfilling program expectations in 1990, notwithstanding its lack of exchange rate anchor. Although average inflation was 50 percent higher than programmed, at least half of the excess rise in the domestic price level was due to higher than programmed increases in administered prices adopted in the second half as part of an effort to tighten fiscal policy. Here, I would add parenthetically that Hungary deserves credit for adjusting policies in midcourse to keep the program on track.

The case of Poland, which is probably the next best of the three, shows that picking the right fixed rate is hard and seems to argue for ability to adjust the wrong rate. Would the staff comment on whether this reading is correct and whether it is possible?

A second message that comes across particularly clearly is the importance of structural and institutional reform if stabilization policies are to succeed. The section on Poland in the background paper contains an interesting discussion of the proper sequencing of stabilization and structural reform measures. In actuality, there has not been much alternative to proceeding with both at once, however imperfect a solution that may be.

Be that as it may, all three cases demonstrate the perils for the stabilization effort of allowing structural and institutional reform to lag behind. In Poland and Hungary, the failure to break the power of monopolies is seen as a factor in the higher-than-programmed inflation. In Yugoslavia, the failure to resolve the issue of property rights or to carry out banking reform permitted excessive wage settlements, leading to excessive monetary creation and, eventually, the collapse of the entire program.

Experience to date also confirms the general expectation that there would unfortunately be severe dislocations in the transformation from a centrally planned economy to a market system. These dislocations confirm the importance of providing adequate safety nets, both to reduce the misery of the more vulnerable segments of society and to avoid excessive popular disaffectation with reform. At the same time, I concur with the staff's judgment that in the face of uncertainty, it is important not to err excessively on the side of overadjustment, as this may not contribute to the lasting success of the program.

In this connection, one of the most difficult aspects of these adjustment programs, especially in Poland, has been the size of the price shock and the decline in real wages used to extinguish excess liquidity. A footnote in the main paper (page 7) notes that alternative approaches--such as the sale of public assets--exist, but discounts their practicality. This strikes us as a counsel of despair. Such solutions may not be easy or work at all in some cases, but they are certainly an avenue worth exploring, both as a means of sopping up excess liquidity and expediting the privatization process which will have other beneficial effects on the economy.

Another point that comes through clearly is just how treacherous are conventional calculations of the impact of policy actions when the entire economic system is in flux. Our standard economic models assume stability of the underlying structural relations. Experience now confirms that such stability cannot be relied on, at least in the early stages of a shift away from a centrally planned to a market-based system. This analytical problem is compounded when available statistics mismeasure the concepts we are interested in. The staff post mortem on the Polish experience is particularly instructive--and fascinating--in this regard.

The lesson we should draw from this is that a considerable amount of pragmatism will be necessary in designing and implementing economic programs in these countries. We need not retreat to situational economics, but it should be recognized that we will have to rely heavily on sound analysis and basic principles rather than precise calibration. We should continue to stress the importance of sound public sector finance, of stable monetary policies, of external viability, of appropriate incentive structures, of clarity in property rights, of effective competition, and of meaningful accounting systems. But the experience of the last two years demonstrates there is no basis for dogmatism in the dosage of the medicine we prescribe.

The candid--but still inconclusive--staff analysis of whether the Polish program was or was not too tight establishes this point with particular force.

Mr. Prader made the following statement:

I wish to address the following issues: the Fund's extraordinary role in the transition of centrally planned economies to market economies; the projections of the financing requirements and prospects of Eastern Europe; and the evaluation of Fund supported adjustment and reform programs, in particular, the issues of decline in output and trade, causes of higher than expected inflation, inflation, and monetary overhang.

The studies prepared by the staff on the Central and East European countries provide a valuable summary of the macroeconomic situation and the unfolding of the reform processes in this group of countries, and of the Fund's contribution in terms of both technical advice and financial support. It is perhaps also the first serious systematic effort at a comparative analysis of the regional impact of the Fund's policy recommendations. While these studies understandably could not deal with the role of the

U.S.S.R. in the region, this omission has perhaps produced an assessment more optimistic than it would otherwise have been.

The analysis clearly shows how enormous are the tasks undertaken by the Central and East European countries, since they cannot set the modern market economies they wish to create for themselves into motion until they have completely dismantled the previous economic systems, which have been in operation for almost half a century. Moreover, recent developments indicate that the collapse of the centrally planned economies may have been only the first step, and that the countries of the region have completed neither their economic nor their political restructuring, which may have major repercussions for the economic and financial situation of the region.

In these uncertain circumstances, the importance of the Fund's role can hardly be overestimated. The Fund's mandate commits it to assist and encourage the full integration of these countries into the international trade and payments system. The Fund's involvement in this process makes it responsible for assisting in the design of macroeconomic and structural programs, not for a country, but for a whole region where an economic and political transformation, unprecedented as to both kind and magnitude, is under way. Undoubtedly, the Fund has reacted to the daunting challenge of assisting Eastern Europe's transformation in a rapid, flexible, and comprehensive manner. In particular, its contribution clearly goes beyond its usual role of providing only token amounts of money. In fact, together with other international financial institutions and official creditors, the Fund has provided the bulk of the financing for these countries.

I agree with the call for patience implicitly embodied in the staff's conclusion that the deeply rooted inefficiencies of these economies will take a good bit of time--perhaps extending beyond the medium term--to correct. Their warning of future setbacks should not be misunderstood as an acceptance of less conditionality, but only invokes the need for realism with respect to policy outcomes. This warning against undue optimism stops short of the financing issue. However, Eastern Europe's deteriorating financing prospects indicate that the exceptional financing role of the Fund will need to be continued longer than was earlier anticipated. On this particular point, the analysis itself is reticent. Despite a description of the difficulties of raising money through the EC/G-24 process, and the sobering statement that so far, the appropriate amounts have been forthcoming only on behalf of Czechoslovakia, the staff's assumptions about the magnitude of future needs for assistance from the Fund and other official creditors are inclined toward optimism and are based on best-case scenarios.

There are four factors that seem likely to give rise to higher and more prolonged demands for official financing from Eastern Europe. The first is the negative shift in the markets' assessment of Eastern Europe. Private inflows have now fallen off substantially, and are now much lower than flows to the old, centrally planned economies. To a great extent, this shortfall in private financing has had to be offset by official financing. The recent G-10 communiqué also expresses an awareness of the risk of reduced financial flows. However, it seems doubtful that their conclusion that the East European countries should use their own resources contains any promise of quick and substantial success. The foreseeable decision to grant debt relief to Poland is certain to elicit similar requests from other countries of the region, and could possibly decrease the willingness of private lenders to extend funds to any East European country. To this extent, the presentation made in the staff's paper glosses over the fact that debt reduction for one country cannot be viewed independently of its effects on the resumption of spontaneous capital flows for all, or in isolation from the reactions of neighboring countries who may feel they have a stronger economic justification for seeking debt reduction.

The second reason for greater financing demands is the contraction of CMEA trade. During 1990, it appeared that this contraction stemmed mainly from a steep decline in Soviet oil exports to the other countries of the region, and to a certain extent also from those countries' reduction of their exports to the U.S.S.R. as they attempted to avoid accumulating non-marketable claims on one another's output. Now, in 1991, the problem has begun to look more like one of export market loss for all the other countries of the region, stemming from the U.S.S.R.'s lack of solvent demand caused by its own internal economic crisis. The potential output losses from this cause could substantially exceed the levels assumed in the design of the programs for certain Central and East European countries. According to present projections, Hungary, for example, is facing a possible 50 percent reduction below 1990 levels in its exports to the Soviet Union, rather than the some 30 percent assumed in the program. Czechoslovakia has also seen its trade with the CMEA region shrink during the first months of this year to a level far below the original assumptions of the program.

The third reason is the decline in exports to Western Europe. It can be assumed that the slowdown of economic activity in Western Europe, and particularly in the wake of a more restrictive than expected fiscal tightening in Germany, the economic engine of Europe and the principal Western export market for Eastern Europe, will hurt the export prospects of the East European countries.

The fourth reason for higher than expected demands for financing stems from infrastructure investment. Empirical studies of East Germany have demonstrated that the absence of adequate infrastructure is perhaps the greatest obstacle to foreign investment. Even if one accepts that East Germany is a special case, the inadequacy of infrastructure is generally recognized as a major problem of the region, but probably has not been sufficiently incorporated into estimates of the financing needs of these countries.

In short, I am more skeptical than the Fund about the resumption of appropriate private capital flows and the size of official financing. On the specific result of Fund supported programs, I should like to make the following observations.

It is quite correct to assume that the improvement of economic efficiency is the focal objective of economic programs in former centrally planned economies. All reforms and programs are plainly intended to ensure financial stability, increase efficiency, and produce sustained high real output growth. The ultimate objective is to improve the standard of living of the people.

But not all these goals can be achieved simply and solely by liberalizing prices and foreign trade. The centrally planned economies were characterized by two kinds of inefficiencies: allocative and internal. The first, allocative inefficiency, arose from the distorted pricing system which prevented scarce resources from being allocated in accordance with marginal utility and marginal costs. Price liberalization does make substantial progress in this direction possible, though in certain exceptional cases, as when monopolies are involved, it does not work. The second type of inefficiency, internal inefficiency, characterizes the behavior of internal economic agents, primarily producers. Under the existing property rights structure, the underlying goals of producers generally resulted in substitutive loss of efficiency in the use of resources. In this case, price liberalization alone cannot directly solve the inefficiency problem. The best correctives for internal inefficiencies are privatization and increased competitiveness in the markets.

One of the most significant features of the 1990 programs was the improvement of the external and internal imbalances of the economies in the face of steeper than expected declines in output and higher than expected inflation rates. Underlying this outcome was the relative ease of achieving demand management targets, by comparison with the difficulty of stimulating a supply response. In all three countries under Fund programs, the rate of inflation has risen higher than was foreseen at the start of their programs. If one accepts a causal relationship between the growth rate of the money supply and the inflation rate, it is clear why this occurred. In all three countries, the growth rate of broad money was significantly higher than the original estimates. Any evaluation of significant declines of real output in economies undergoing the reform process must be conducted very carefully. In normally functioning market economies, real output decline is considered unfavorable because it usually results in a decline or slowing of growth in the standard of living. But in economies where really innovative changes are under way, the connection between output decline and the decline of living standards is less clear.

Experience with the use of a pegged exchange rate as a nominal anchor for an economy where without it, prices would rise at a faster rate, suggests that the level of the pegged rate may possess some importance, as shown by the case of Poland. Nonetheless one must bear in mind the limitations of the pegged rate approach for resisting inflation. The choice of a pegged exchange rate as a nominal anchor assumes the existence of a casual relationship between devaluation and inflation which is still far from being proven. Generally, if conditions affecting hard currency supply and demand are fluctuating significantly, it will be very difficult to avoid serious external imbalances without resorting to the administrative allocation of foreign exchange. Such a situation may arise from insufficiently restrictive monetary and incomes policies, as in the case of Yugoslavia.

In all these economies, the behavior of economic agents was more or less identical, and the various attempts at macroeconomic regulation of this behavior, for example the approach to foreign indebtedness, may have changed it only slightly and most often in the direction of making it worse. When economic reform commences with the liberalization of prices, there is always the risk that the savings and the cash holdings of households, and to a lesser extent of enterprises, not finding enough goods, will destabilize the market. It is impossible to judge, from the absolute level of cash holdings, whether a monetary overhang does or does not exist. Under certain circumstances, even relatively low levels of cash holdings and savings may prove destabilizing to an economy. A very important factor in determining the outcome is the public's expectations with respect to the economy's long-term financial stability.

Credit ceilings like those applied to the Polish economy, and now to the Czechoslovak economy, may actually pose a greater danger for the economy, but only in the narrow sense that not all existing enterprises, still mostly state owned, will be able to maintain their accustomed level of activity. Such a limitation is not necessarily bad for an economy as a whole, however. Indeed, if credit is allocated according to the criterion of economic efficiency, it is probably unavoidable that a temporary decline in aggregate supply will result.

A serious problem accompanying the tightening of credit policy is the effect on debt between enterprises. In Czechoslovakia, for example, the price liberalization which began in January led to a price jump of 30 percent in that month. The originally planned 2 percent increase in credit represented a significant contraction in real terms. This was reflected in a strong surge in interenterprise debt, which rose by Kcs 24.6 billion in a month, from Kcs 53 billion at the end of December 1990 to Kcs 77.6 billion at the end of January 1991, while the latest data show that total domestic debt has increased by KCS 46 billion so far in 1991. Tight credit policy was loosened a bit to accommodate the price level developments and prevent serious disruptions in the real economy. No general solution to this problem will be found without the enactment, acceptance, and enforcement of a bankruptcy law.

The traditional monopolistic economic structure common to all of the former centrally planned economies poses serious, potentially damaging economic and social problems for these countries. A tempting way of limiting the damage could be the reintroduction of administrative controls. This could take the form of controlling the spreads between borrowing and lending rates in the banking system, controlling the trade margins of trading organizations, and so on. The basic defect of this solution is its temporary character: administrative control cannot in and of itself diminish the power of monopoly, and in many cases, this cure may be worse than the disease. Branches of the economy under administrative control furnish poor soil for encouraging the seeds of competition.

Mr. Filosa made the following statement:

Let me start by commending the staff for the high quality of the work done in assessing the approach followed by the Fund in helping Central and East European countries in their transition toward market economies. I particularly appreciate the distillate of the economic reasoning that the staff has been able to extract from the experience accumulated so far concerning the policy design and the implementation of Fund programs in countries characterized by very different economic circumstances. Because of the high quality of the papers and in light of the valuable and unique work of the Fund in these countries, I believe that we should consider the possibility of publishing a paper, or a set of papers, drawing from the material prepared for this seminar as well as from the various working papers already issued, to offer to the general public a comprehensive overview of our approach to the transition to market economies of the Central and Eastern European countries. If this suggestion is agreeable, I would also suggest two main additions to the work already done.

First, I think it would be necessary to include a fairly comprehensive summary of the philosophy underlying the programs that are not included in the present survey, namely the programs with Bulgaria, Czechoslovakia, and Romania.

Second, I would like to see more empirical evidence to substantiate the different conclusions theoretically drawn by various authors on the issues discussed in the paper, for example, on the issue of monetary overhang hypothesis, on the conclusions that some programs have been judged too tight, and so on. We need some extra empirical work to be done in order to dismiss or to accept one explanation or an alternative one. In what follows I will try to suggest in what areas we might attempt to have more work done.

Coming now to the issues for discussion, let me start with that of policy design. The first question concerns the existence of a monetary overhang at the outset of programs that led to a price increase greater than expected in Poland, as well as in other countries.

I tend to share the staff's view that the initial surge of inflation should not be associated with excess demand inflation generated by the existence of a monetary overhang, because there is no evidence of excess demand. The fall in output, the even greater fall in consumption, the initial increase in stocks, and the fall in imports are all indications that, if anything, the excess demand was reduced at the outset of the programs. However, I also believe that this tentative conclusion concerning the monetary overhang should be better tested both at the empirical level.

Concerning the empirical evidence, changes in the composition of financial assets of households and enterprises, both in national and foreign currencies, could help in shedding a better light on the issue. The idea is that an excess consumption owing to the mobilization of the idle monetary resources should be accompanied by a significant increase of the share of financial assets of the enterprises over the total financial wealth matched by a corresponding fall of the household's share of the financial wealth. Is there any evidence of that? Could the staff comment on this issue?

Concerning the issue of the appropriate degree of tightness of financial policy, and in particular, the hypothesis of a credit crunch in the Polish case, I share the staff views that there are important counterarguments to the "too tight" thesis, as explained on pages 25 and 26 of the paper on the review of the 1990 programs. Therefore, I tend to believe that no significant credit crunch occurred and that the output drop has been mainly induced by the fall in demand. However, the dismissal of the credit crunch thesis or, conversely, its acceptance, is too important to be left at the level to qualitative reasoning as it has been done in the papers we are discussing today. I think that an appropriate empirical verification is required not only to better tune the financial policies in the future, but also to pass a judgement on whether, in other programs, the gradual approach is too loose. In our discussion on the budgetary outlook, (EBM/91/33, and 91/34, 3/8/91) I supported the idea of having evaluation work done. I believe that a precise assessment of our policies in Central and East European countries should be given very high priority in these evaluation efforts if we want to minimize the social costs in these countries of a trial and error approach to the policy design.

Still concerning the issue of policy design, I do not share the conclusion drawn on page 7 of the main paper when it is said that if the greater than expected price increase at the outset of the program was due to "the liberalization of previously repressed monopoly elements," then the monopoly element explaining the unexpected acceleration of price is consistent with the "too tight" hypothesis.

It is my view that the monopoly element of the high price increase might well be consistent with a program characterized by the "right" degree of tightness of financial policy. If the monopoly power is great enough, nothing prevents enterprises from raising prices at their will in the attempt to regain a soft budget constraint once excessive credit is brought to normal levels and once subsidies are eliminated. The fact that profits in Poland have increased in the presence of a dramatic fall in output (which is absurd in industrial countries) might well be ascribed to the fact that external competitiveness is not yet working effectively to limit inflation. More generally, I do not think that this fact is specific to Poland and I would like to ask the staff for its views on the monopoly element's effect on price throughout the Central and East European countries in general.

The importance of the monopoly element reinforces my endorsement of the staff's view that the use of multiple anchors can prove very effective in containing output losses and inflation.

I am on record regarding the appropriateness of using the exchange rate as an anchor against inflation and I do not want to repeat the argument that I have made in previous occasions. Instead, I would like to raise two questions that have not been dealt with in the papers. The first one is conceptual and concerns the choice of the anchor: is it better to select a specific currency as an anchor or a basket of currencies? The second is empirical in nature and concerns the issue of what the development of competitiveness and inflation in different countries suggests as far as the appropriateness of shifting from one exchange rate regime to another or to change the level of the peg.

The staff does not discuss the pros and cons of pegging the exchange rate to a specific currency or, alternatively, to a basket of currencies. I recognize that at the outset of a program in countries where open inflation is high it is preferable to peg the exchange rate to one specific currency (the U.S. dollar in the case of Poland and the deutsche mark in the case of Yugoslavia) because of the visibility of the authorities' determination to follow a hard currency option. On the other hand, the case for shifting to a pegging the national money to a trade-weighted basket of currencies at an appropriate time seems to me also desirable in a medium-term perspective because it avoids linking the national currency to the policy stance of one particular country. The case of the pegging of the Yugoslavian dinar to the deutsche mark is a particularly pertinent example of what I mean by that. The pegging to a basket would allow a greater flexibility in the exchange rate policy while at the same time ensuring that the hard currency option is not abandoned. It is quite obvious, however, that before shifting to the pegging of a basket of currency or to an adjustable peg, full credibility of the authorities and control over inflation need to be unambiguously established.

In the opposite case, the shift from an adjustable peg regime to a fixed exchange rate is justified when progress on inflation is slow or uncertain. In this case, the gain in credibility is self-evident in the shift of the exchange rate policy. I would like to hear other opinions on this issue.

Concerning the choice of exchange rate regime, the level of the pegging, and the decision to shift from one regime to another, one cannot judge in abstract. It seems to me that a detailed presentation of indexes of competitiveness is required. Here, I know that some indicators are already available and have been used to this end. But my opinion is that indicators of relative inflation based on consumer prices are not appropriate to reflect external competitiveness (because of the presence of administered and service prices). Relative wage inflation behavior is, in turn, a partial indicator because it excludes a great deal of imported inflation. I wonder why export prices are not used to complement the other indicators. A staff reply on this issue would be appreciated.

Concerning the issue of policy implementation, I have little to add to the considerations made by the staff concerning monetary and fiscal policy. In both policy areas, I believe that Fund approach and efforts are commendable and deserve support, in particular, the strict integration between policy advice and technical assistance.

Finally, some brief remarks on the role of structural factors and reforms. So far, the contribution made by the Fund to reduce macroeconomic imbalances is to be positively judged. The Fund has developed a successful strategy thanks to the innovative ingenuity, the dedication and the hard work of the staff. The overall success of the strategy rests, however, on the speed and the appropriateness of the solution that the new democratic institution will give to the many structural reforms that the Central and East European countries need to implement. In these areas, the progress has not been satisfactory and sufficiently rapid. This might well reflect the reluctance to carry through with reforms on the part of the authorities. I am not sure, however, that the international community has done its part to concretely show the same cooperative spirit and the same coordination with which it has dealt with macroeconomic stability issues.

While I realize that structural issues are not within the specific mandate of the Fund, the fact remains that a strategy to solve systemic issues is not in place, and I clearly detect a lack of leadership in this field. This gap needs to be filled. A Fund initiative to clarify with the World Bank what role can be played by the Bretton Woods institution as well as other international bodies to more decisively tackle these problems seems to me urgent. So far, official financing has been forthcoming, but it would be contrary to the market orientation of the economic policies of these countries to expect that in the future the main source of financing would continue to come from official sources. Private financing, however, is not likely to be abundant until systemic reforms are successfully carried out. Therefore, at this point, the Fund and the Bank's efforts in helping these countries's economic transitions should also focus on determining the most suitable reform strategy for each country. Without a major initiative of this type, it is unlikely that enough progress will be made. I hope that the Chairman will be able to convince me that I am overly pessimistic, but that would be difficult.

The Chairman remarked that despite the quality of the cooperation between the Fund and the Bank in dealing with the Central and East European countries, the institutions had not been able to prevent a flood of conflicting advice to those countries. The Fund and the Bank were actively involved in pressing for properly sequenced structural reforms. The two institutions had distinct mandates, but had made clear efforts to produce common papers in a medium-term perspective precisely so as to integrate as well as possible the actions of the Fund and of the Bank. The extended Fund arrangement for Poland, which the Board would soon be considering, as well as that for Hungary, were cases in point.

The Director of the European Department recalled Mr. Peretz's question on why the exchange rate had not been adjusted upward once data became available that raised questions about the level of the exchange rate selected to act as an anchor for the Polish economy. In fact, that possibility had been discussed, but was in the end rejected because of the information then becoming available on inflation. In the case of Poland, information on the strength of the balance of payments, on the response to the exchange rate, and on the program as a whole was only beginning to become available toward the end of February. Therefore, exchange rate action could only have taken place in March/April. By then, however, the staff knew that inflation had been much higher than anticipated and that, therefore, the real exchange rate appreciation in terms of consumer price inflation had been much higher than assumed in the scenario underlying the program. The staff felt that that was likely to continue, and concluded therefore that while a modest appreciation could have strengthened credibility, it would have had little impact on inflation, whereas a larger appreciation would have implied too many risks for both credibility and competitiveness.

The initial decision on the exchange rate had been very difficult, the Director confirmed. The budget proposed by the authorities had been based on an exchange rate of Zl 14,000 per dollar. Indeed, when the staff began to discuss figures around Zl 10,000 and below, some officials had been very surprised and indicated that they thought they would have difficulty maintaining such a rate. The exchange rate in the free market had already reached Zl 12,000 in October, although it fell subsequently as the authorities tightened policies. In the end, a rate of Zl 9,500 had been chosen, but the staff had expected significant pressure on reserves during the first three months of the program.

While selecting the correct exchange rate was clearly difficult, it was important that the rate selected remain viable for a significant period of time if it was to serve as an anchor, the Director stressed. The anchor had held well so far in the case of Poland, but it had done so partly because wage behavior had been very different from consumer price behavior: at the end of 1990, the real exchange rate in terms of unit labor costs was still more competitive than it had been at the end of 1989. That was not the case for the real exchange rate in terms of consumer prices, but that was largely because relative prices were fully distorted in Poland and needed to change.

The choice in favor of an exchange rate anchor approach reflected in large part the presence of a very high rate of inflation, the Director indicated. Both Yugoslavia and Poland had been in a situation of hyperinflation during 1989, with Poland experiencing a serious balance of payments crisis as well. He was not aware of any cases in which hyperinflation had been arrested without making use of the exchange rate as an anchor.

The question of whether one should peg to a single currency or a basket of currencies had also been addressed by the staff in the various documents, the Director noted. In theory, if one pegged to a currency, one should pick a currency whose exchange rate was relatively stable in terms of the currencies of the other partners so that, in fact, the resulting effective exchange rate also did not move too much as a result of the movement in the currency to which one was pegged. In the case of Poland and Yugoslavia, however, those decisions had reflected more pragmatic considerations. In Poland, the dollar was the most widely used currency in the financial market and the one in which most savings were held. It was thus felt that the most vivid representation of a peg would be to maintain the exchange rate vis-à-vis the currency that was most widely held and known in the country. It so happened that the dollar subsequently depreciated, resulting in a nominal effective depreciation of the zloty. However, the effect of movements in the dollar vis-à-vis third currencies was minor compared with the appreciation that resulted from Poland's higher than expected inflation. In the case of Yugoslavia, the deutsche mark was the most familiar currency, because the many Yugoslavs who worked in Germany tended to send home their savings in deutsche marks. The peg for the deutsche mark also reinforced the idea of a strong anti-inflation policy, which was also very important to the Yugoslav authorities.

Turning to the question of capital account convertibility, the Director commented that, in a sense, Poland and Yugoslavia had more freedom of capital transactions than many other European countries. In particular, the household sector was allowed to hold foreign exchange deposits. However, the staff had felt that given the number of changes that were already taking place, it would be going too far to seek capital account convertibility at that early stage in the reform process. Moreover, the authorities were concerned that convertibility would be abused, particularly by enterprises. Nevertheless, if capital convertibility were to become an important element in the decision to invest in East European countries, the staff would have to study the issue more carefully.

The decision of how to move from one exchange rate regime to another was very difficult, the Director remarked. By definition, it was much easier to move from a flexible to a fixed rate system and to try to maintain that rate with the correct policies than to change a peg and then try to convince people that that was the last time one would do so. However, the new peg could be credible if inflation were successfully reduced to the targeted level. That was not yet the situation in Poland or Yugoslavia. The experience with the more flexible approach to the exchange rate in

Hungary had been positive, but Hungary had not had the inflation rates that Poland and Yugoslavia had known. The current rate of inflation in Hungary was of concern, and the staff was considering how to give more weight to the problem of inflation in the determination of exchange rate policy. But that could only be done once the external situation had improved sufficiently and the uncertainties regarding Hungary's ability to borrow from abroad were removed or became less serious.

Several questions had been raised on monetary policy, and on the link between monetary policy and the sequencing of structural reforms, the Director recalled. He fully agreed that in the sequencing of structural reforms, the reform of the financial system, the banking system, the financial market, and the money market were very important and needed to be carried out at an early stage. However, while experience showed that progress in those areas would take a long time, there really was no choice; one could not wait for the reforms to take place before putting in place the stabilization programs.

The suggestion had been made that the staff had been too accepting of the view that the stabilization policies combined with the choice of exchange rate had brought about a significant part of the fall in output in Poland, the Director recalled. That was a judgment for the Board to make, but the staff had wanted to put the issue before the Board for discussion. He personally considered that the high level of the interest rates had perhaps been partly responsible for the unintendedly sharp fall in enterprise production; an interest rate of 50 percent per month meant that enterprises would have doubled their indebtedness in two months. It was therefore perhaps not surprising that enterprises preferred not to borrow. Not only was the credit ceiling not reached, but credit actually fell.

The specification of stabilization policies in those countries was further complicated by the possibility of a monetary overhang, the Director continued. There was no problem of an overhang in Yugoslavia or Hungary. In Poland, the situation was less clear. Ex ante, staff econometric estimates had pointed to the absence of an overhang, but the margin of error in such calculations was high. Ex post, he considered that there might have been some residual overhang element at the outset of the program because the increase in nominal prices had been larger than the fall in production would justify, so that nominal demand had risen faster than planned. The overhang could have resulted from the fact that people had used up their savings when faced with the prospect of high prices and nonavailability of goods. The degree of monopolization in the Polish economy was very large, the Director indicated. Individual enterprises had supplied very large markets, often the whole country, and even neighboring countries because of the CMEA arrangements. An anti-monopoly law had been introduced during the month before the program was adopted, but it would take a good deal of time to change the behavior of the enterprises. That made the liberalization of trade all the more important.

However, in doing so, one had to be careful not to expose the country suddenly to excessive competition from abroad, the Director cautioned. Some form of tariff protection was necessary. The irony of the situation was that since the East European countries had relied so heavily on quantitative restriction, their tariffs were very low, and had to be restructured upward. In Czechoslovakia the solution had been an import surcharge on consumer goods, which was presented to and approved by the GATT. The extreme case of sudden exposure to external competition was east Germany, where companies had been exposed to the full brunt of competition from abroad without the protection of compensating adjustments in the exchange rate. In the case of Poland, a large devaluation had provided the necessary protection. Nevertheless, entire consumer product sectors were becoming extraneous, as consumers who were finally being given the choice were choosing foreign goods. Accordingly, large production falls had to be expected.

Regarding the suggestion that there was a need for more institutional leadership on issues regarding funding for, and structural reform in the East European countries, the Director said that the staff would of course like to see much more of the funding come from the development institutions, in particular, from the EBRD and the IBRD. However, the staff knew from experience that there was a long lag between commitments and disbursements. For example, the IBRD was providing quick disbursement funding for structural adjustment, but that institution always waited for the conclusion of the Fund's programs before beginning its own negotiations. However, he assured the Board that such activity was extremely well coordinated between the institutions.

The authorities of the various East European countries had begun to exchange views and share experiences, the Director remarked. For example, the Bulgarian authorities had analyzed the experience with the Polish program in considerable detail, and had come to the same conclusion as the staff regarding the lessons to be learned from that experience.

Mr. Landau made the following statement:

> At this stage I will concentrate on one specific issue, namely, the unexpected resilience of inflation in countries experiencing transitions toward a market economy and what should be done about it.
>
> As is made very clear in the staff paper, a temporary surge in inflation was unavoidable, at least as a second best solution for dealing with monetary overhang, when such an overhang could be identified; it was also a consequence of price and financial liberalization. But it is one thing to accept and manage a one-step inflationary shock, and quite another to tolerate the development and acceleration of the persistent inflationary process. This, as experience shows in other parts of the world, would lead to very damaging consequences.

An inflation rate of 20 percent to 60 percent is, by nature, unstable. It is bound to accelerate very quickly if not brought back into control. So we should not underestimate the risk of hyperinflation developing in some of the East European countries in the future. Mr. Dawson made the point that in Hungary, inflation was higher than expected for two or three very specific reasons. The real issue is how to prevent these unexpected shocks from becoming permanent features of the economy, which is a real risk in the case of Hungary.

Inflation at such a high level, and with some persistence, would undoubtedly both prevent structural reform and deter foreign direct investment. It would instead trigger capital outflows, the disorganization of financial markets, and the reappearance of parallel exchange rates. Experience shows that capital will not flow into countries that have not achieved a significant degree of price stability.

The population of East European countries has been asked to take a big drop in real output and real incomes. If no significant result appeared on the inflation front after two years of adjustment, this would weaken social consensus, give rise to distributional problems and conflicts, and make the whole process of adjustment and transition very difficult.

Given these points, my only--slight--disagreement with the staff paper, is that such a large part of it has been devoted to asking whether or not the Polish program was set too tight. In my view, the real issue is what could have been done to prevent the resumption at the end of the year of some inflationary acceleration at the present level. Mr. Peretz mentioned the possibility of a real appreciation of the exchange rate. With hindsight, I would say that perhaps the relaxation in fiscal policy could have been avoided in the second part of 1990.

This is where the question of the appropriate exchange rate policy for the future comes in. Obviously, the exchange rate cannot be the only tool against inflation. But too pragmatic an exchange rate policy would certainly not do the job either. So we have to ask ourselves how exchange rates can usefully serve as an efficient anti-inflationary tool for countries undergoing a transition toward market oriented economies. Some doubts might be warranted in that regard. The main purpose of exchange rate stability is to influence inflationary expectations. But we do not really know how expectations are formed in a non-market and non-financial economy. This is clearly a matter of great uncertainty. And this is why, in my view, the staff is right in stating that any exchange rate policy should be strongly supported, during the transition period, by a direct income policy.

On the other hand, it is clear that the usual channels for transmission of monetary policy--such as monetary aggregates or interest rates--might not be working as efficiently in a non-market economy as they are in a fully fledged and financially developed industrialized economy. This is why both credit ceilings and interest rate flexibility have been necessary in the case of Poland. In this framework, any stable nominal anchor would go a great way toward contributing to price stability. I would say that it is all the more important to try and influence expectations in countries where demand management policies cannot do the job alone. As shown clearly in the staff paper, the price/output split of the demand management has been less favorable than expected, thus pointing to a serious supply rigidity.

Furthermore, the exchange rate is the only visible and clearly identifiable target for monetary policy and, more generally, nominal income management in those countries. This is why I fear that building up Fund programs on too fuzzy and pragmatic exchange rate policies would convey the impression that the Fund is indeed prepared to live with some high and persistent inflation in those countries.

There is no guarantee whatsoever that a fixed exchange rate would by itself lead to price and financial stability, but there is a strong assumption that programs built on too flexible an exchange rate policy would fuel inflationary expectations, and contribute to entrenching the inflationary process during the transition phase toward a market oriented economy. Therefore, the Fund should err on the side of caution on this issue, and favor the development of nominal anchors in these countries.

I think we can be proud of the reaction of this institution to the important systemic changes that occurred last year in Eastern Europe. This reaction has been bold, quick, and comprehensive. We have built up a broad range of programs, brought a significant amount of technical assistance, and, last but not least, committed huge amounts of resources. Large financial gaps will remain in the future, and the Fund might not be in a position to commit on a permanent basis such resources. Someone else will therefore have to take on the burden. It is not clear that foreign capital inflows will come in a sufficient amount. At the very least, this situation makes a strong case for bringing down inflation to more internationally accepted levels.

> Indispensable structural reforms are not being implemented with sufficient speediness in the East European countries, thus creating prolonged uncertainty and preventing the resumption of growth. This is obviously a matter for the authorities themselves to tackle. But the Fund should not miss any opportunity to both encourage them and help them in this regard. The World Bank also has a major role to play, and I would strongly favor a deeper, quicker, and wider involvement of that institution in this area.

Mr. Goos said that he shared the concerns expressed by the staff and other speakers about the unexpectedly large losses in production as well as the inflationary slippages that occurred in a number of the program countries. But he wondered whether those unfortunate developments were sufficient reason to reconsider the basic philosophy of the adjustment approach used by the Fund so far. In that regard, he had noted with some concern an inclination in the staff papers to emphasize somewhat more than before the potential benefits of a more gradual approach as opposed to the big bang approach. Had the staff intended to convey that impression?

He also had some doubts about the relevance of comparing the experience of countries in such diverse economic situations as the ones dealt with in the papers, Mr. Goos continued. One important distinguishing feature was that Hungary and Yugoslavia had a long history of economic and structural reforms, which Poland and East Germany did not. He therefore considered that the relatively small losses in production in Hungary and Yugoslavia did not reveal much about the appropriateness of the Fund's policy advice, including the appropriateness of its exchange rate policy advice.

With respect to the question of gradualism versus a big bang approach to reform, Mr. Goos stressed the potential negative welfare effects of undue gradualism. Such negative effects had been witnessed in Yugoslavia in particular, where there had been only partial liberalization and hyperinflation had resulted. The gradual approach might also exacerbate the problem of insufficient entrepreneurial talent and spirit often encountered in these countries, because gradualism might not convey a sense of irreversibility of the reforms.

He was interested in the staff assessment of the economic and financial prospects of the reforming countries in the Central and East European countries, Mr. Goos continued, including in particular their prospects for balance of payments financing and the medium-term role that the Fund would be expected to play. He would welcome staff response to Mr. Prader's comments in that regard.

The economic decline in Eastern Germany was very substantial and was taking place notwithstanding the massive financial support provided by the Federal Government, Mr. Goos stated. The main reason for that was probably that the former German Democratic Republic, without any transition period and virtually overnight, had become one of the most open economies in the world. It did not enjoy any protection from tariffs or exchange rate policies. Second, it appeared that monetary and political union had created wage and income expectations that clearly exceed productivity. Third, after so many years of forced savings, East German consumers had developed a strong preference for Western products. That was not to deny the relevance of other problems surrounding, in particular, the operations of the German Trust Fund. However, he would note that just a few days previously the German Government had decided to ease the transfer of property rights by no longer insisting on the principle that restitution of such rights to the former owners should always come before compensation. It remained to be seen to what extent that would moderate the problems.

He hoped that all those issues would be discussed in a thorough and more detailed manner in the forthcoming Article IV consultations with Germany, Mr. Goos said, perhaps with a more comprehensive and more political perspective than usual. For the time being, while a smoother transformation in East Germany clearly would have been desirable, it was unclear how things could have been handled more effectively than had been done.

On the issue of the possible monetary overhang and how to deal with it, Mr. Goos noted that in the footnote to page 7 of the main paper, the staff referred to the reluctance of the newly democratic Government to employ authoritarian practices such as monetary reform. Apart from the risks of fueling a permanent rise in the inflation rate, he was concerned that the alternative approach of an inflation tax--in particular at the rates observed in Poland--would create highly adverse and inequitable effects on income distribution and thereby might erode public support for the authorities' reform efforts. Monetary reform was less risky than an inflation tax, and should perhaps be given more emphasis in the staff's policy advice, although there were only a few countries left to which to apply that advice.

Mr. Ismael made the following statement:

I welcome the opportunity to review the recent experience of the Central and East European countries with reform programs. It should pave the way for further improvement in the Fund's daunting task of rendering advice to these countries' future reform agenda.

Our limited experience seems to show that despite the application of shock therapy through dramatic tightening of fiscal, monetary and income policies, and a significant exchange rate reform, stabilization programs have not successfully ensured lasting stable conditions. In fact, it appears that stabilization measures by themselves may have imparted a negative impact on real growth and employment, further injecting instability into the system. This indicates that an adequate macroeconomic framework, consistent with a viable balance of payments and price stability in the short run, is a necessary but not sufficient condition for growth and stability over the longer run. Stability requires not only durable and efficient demand management policies, but also efficient structural policies which elicit adequate supply response.

I will first touch on the question of the appropriateness of the design and implementation of stabilization policies. For the policies to be effective, the economic, social, and political realities of the country must be taken into consideration. The experience seems to confirm that response uncertainties to price and trade liberalization during the adjustment program can undermine stabilization measures. It is therefore vital that these uncertainties be adequately incorporated into the program. Otherwise, the result might be a program design that is either unduly tight or too weak, resulting in ineffectiveness of the program's implementation. Second, the design of growth-oriented stabilization programs should incorporate a package of structural components from the outset. Moreover, in my opinion, definite sequencing of reform implementation is as important as the content of the reform itself. Experience has shown that, although fiscal and monetary tightening can attain a dramatic and immediate reduction in inflation, it cannot be sustained on its own for more than a short period. In the absence of competition and since both inflation and efficiency are affected by enterprise subsidies--through direct operational support and access to credit at negative interest rates--enterprises have been able to increase wages, and thereby fuel inflation. In this connection, I agree that more competitive and financially disciplined market structures are a sine qua non for the functioning of an efficient market economy and effective macroeconomic policies.

In this connection, financial reform, particularly in regard to exchange and interest rate policies, must effectively underpin macroeconomic stability in order to support parallel reforms in other sectors. In the absence of macroeconomic stability, the sustainability of a fixed exchange rate regime will be undermined and it may be desirable to adjust the exchange rate with a certain degree of flexibility through gradual depreciations in line with the growth in inflation rate. Weak enterprises can only be restructured if their demand for credit is made sufficiently sensitive to interest rates. This implies the need for a realistic structure of relative prices and interest rates. Absence of parallel reforms and the uncertainties associated with implementation lags will incur additional risks. I therefore believe that structural reforms on a broad front are essential to reduce the risks and facilitate the success of appropriate macroeconomic policies. I also agree with the staff that the pace of the reforms should be speeded up where possible.

In an economy marked by severe rigidities, where production is dominated by monopolistic state enterprises and where limited capital and labor mobility are prevalent, the question of social resilience and adaptation is crucial, especially given the political dimension of the issue. Therefore, I share the staff's view that one should not be overconfident about the likely success of the program and that safety net provisions are essential. In order to lend it credibility, the program ought to provide for a reasonable economic performance in the transition period. In most cases this will require certainty of inflows of external financing. This is one area where the Fund has an important catalytic as well as actual role to play. The challenging task ahead, as I see it, is on the one hand to strike a balance between setting the demanding pace for market-oriented measures to revive and sustain growth, and on the other to ensure that this effort is not undermined by political pressures.

Mr. Spencer made the following statement:

I have comments and questions on three general areas. These are: supply responses, the sequencing of reforms, and the use of nominal anchors.

Looking first at supply responses, the clear message from the papers is that the supply response has been worse than expected, causing steep output declines and higher than expected inflation rates. A host of factors have apparently contributed to this outturn, but the main factor identified is the lack of progress in restructuring enterprises and establishing property rights so that both enterprises and individuals have incentives to respond to emerging profit opportunities. In other words, the lack of what Mr Prader refers to as internal efficiency.

After reading the papers, I did not get a feel for the seriousness of this problem as a constraint to future growth in the program countries. On the one hand, we are told there is a measurement bias with official statistics not capturing output of the new emerging small enterprises and that, at least in the cases of Poland and Hungary, we have observed good export growth performance. But the overriding message in the papers suggests that structural rigidities and the noncompetitive traditions in Eastern Europe will take a long time to change and that therefore, we should not expect too much in the way of results too soon.

I would be interested to hear the staff expand on how the supply side lessons have altered its view of the future. Are we now to expect a much longer period of negative growth and low investment before we start to see the benefits of the liberalization process or are there cases where greater optimism is justified? Clearly, if weak supply persists beyond 1991 then some major revisions to existing programs will have to take place.

The second area I would like to comment on is the sequencing issue. The general approach that has been taken is a very pragmatic one. As the staff says in the paper on Poland, for example, what could be done first was done first and what could be done later was done later. Having been involved in a liberalization program in my own country, I would support this approach. I also support the concluding comment in the overview paper that reforms should generally be stepped up where possible to more rapidly establish an integrated market structure.

But we also have the situation in many of these programs that direct administrative controls are recommended on the basis that monopoly elements persist in some markets, notably in the labor market and in markets dominated by large public enterprises. That is to say, the judgment has been made, in some areas, that no liberalization is better than partial liberalization below some level of critical mass. While I see the rationale for continued controls in some areas, there would appear to be a risk here that the development of free markets may actually be inhibited by these direct controls. My concern is simply that we should not wait for perfect free market solutions before freeing up some of these direct interventions. I would be interested in any comments staff might have on this issue.

On the third area of nominal anchors, I would like to touch on two aspects. The first is the idea of using multiple nominal anchors in the absence of effective market mechanisms, especially in the financial sector. This might be called a "belt and braces" approach to monetary policy. While the textbooks tell us that we can only fix one of the exchange rate, the interest rate, and the quality of money and credit, in the Polish case, for example, we attempt to control all three. I understand the argument for this--which is that in the absence of effective market linkages, we need to try and set these variables within a consistent analytic framework. But in the turmoil of transition to a market economy, there is clearly a risk of setting inconsistent targets. It is apparent from the discussion in the staff papers that inconsistent settings of wages, interest rates, credit ceilings, and the exchange rate in some cases may have contributed to the poorer than expected output performance.

In order to get away from this multiple anchor approach, the key is, of course, to establish financial discipline and hard budget constraints, especially in the financial sector. In this context, the staff mentions the promotion of private and foreign ownership and the restructuring of banks. But it does not mention a relaxation of external capital controls, which I would have thought might be an effective way of establishing greater discipline in domestic financial markets, without imposing multiple nominal anchors. Perhaps the staff could comment on what scope it sees for more freedom in international capital movements, either in the near or long term, as an additional weapon for enforcing market discipline.

The second aspect of nominal anchors that I would comment on is the perennial question of whether to peg the exchange rate. As the staff paper says, an exchange rate peg can be a clear and transparent anchor for price stability, but it can be no stronger than the underlying monetary, fiscal, and incomes policies. As I expressed during the recent discussion on Yugoslavia (EBM/91/35, 3/11/91), an exchange rate peg will only make a positive contribution if it is credible, that is, if it is expected to be sustained. If the peg is not credible, the prospect of large and uncertain changes in the exchange rate may well be more disruptive than a predictable but flexible adjustment mechanism.

I would not agree with Mr Filosa that a peg will in itself boost credibility. In order to be credible, a peg must be supported by a track record of sound underlying financial policies and be set at a level that is not likely to put untenable pressure on the traded goods sector. At least in the case of Yugoslavia, it is apparent that neither of these requirements are met, suggesting that the present peg is not credible and therefore not an appropriate policy approach at the present time. The Polish peg is less obviously out of line, but continued high monetary growth and inflation represent ominous signs for the sustainability of the Polish peg. I am not as optimistic as the staff or Mr. Landau in this respect.

The success of an exchange rate peg cannot be judged by inflation performance over the first few months or even over the first year of a program. It is always possible to get inflation down temporarily by holding fixed a large segment of the CPI, but that is a bit like claiming to have lost weight by holding in your stomach. The true test, of course, is whether low inflation can be sustained when relative prices and the real exchange rate in particular return to normal levels--in other words, when the economy is breathing normally again.

Certainly the benefits of low inflation will not be delivered in terms of lower real interest rates and reduced pressure on the real economy until inflation has been held down for a sustained period. This has been clearly demonstrated in a number of the ERM (exchange rate mechanism) countries. I would therefore sound a note of caution about claiming premature success for a pegged exchange rate strategy.

Mr. Monyake made the following statement:

The task of transforming the centrally planned economies of Eastern Europe from the socialist to a western-style market system is enormous, not only for the countries undertaking the adjustment, but also for the international community providing support for their adjustment efforts. The Fund is assisting these countries in the design of appropriate macroeconomic policies in addition to providing them with financial and technical assistance. Considering that macroeconomic stability is an important prerequisite for successful liberalization and structural reform efforts, the role of the Fund becomes especially important in the transformation process. Our discussion today, based on the review of the programs for Hungary, Poland, and Yugoslavia, should bring out ideas that can provide useful guidance to the staff in designing future programs for other economies in transition in that region and other developing countries outside the region with similar problems.

I note with concern that while the primary objectives of the economic programs and the needs of Eastern European countries appear to require medium-term financing, the Fund's financing facilities for these countries are largely of a short-term nature provided under stand-by arrangements. As revealed in one of the background papers, of all the countries undertaking radical economic reforms in the region, only Hungary and Poland are being considered for extended arrangements. The Fund should exercise some flexibility in its financing arrangements with countries of that region as well as the so-called middle-income developing countries in other regions that do not qualify for the SAF and ESAF arrangements but have limited or no access to international capital markets. As some of these countries have established good track records of policy implementation under successive stand-by arrangements, their structural problems could be more appropriately addressed under extended arrangements. There is also a need to reduce the length of time it takes to put country economic programs in place. The fact that only three of the East European countries had programs in place in 1990 points to this need.

In very general terms, the primary objective of the ongoing reforms in the region is to improve economic efficiency in the individual countries. In the specific cases of Hungary, Poland, and Yugoslavia, their economic programs are designed to achieve durable growth, price stability and viable balance of payments position. Performance during 1990 could, therefore, best be evaluated in terms of the achievement of these objectives against the background of the prescribed policy strategies.

I note that the overall performance was not a total success as substantial slippages in policy implementation occurred and, in fact, the programs for Poland and Yugoslavia went off track during the second half of the year. Although external sector performance showed substantial improvement in all the three countries, inflation performance was poor for Hungary and mixed for Poland and Yugoslavia. Output contracted substantially in the three economies.

I agree with the staff that policy implementations were, to a considerable extent, constrained by existing structural rigidities, price distortions, as well as the absence of necessary legal framework and institutional infrastructure for a free market operation. The adverse impact of these limitations was particularly significant in the areas of monetary and income policy implementation. As a result, the objectives of reducing inflation and stimulating output growth were not attained. I am encouraged that the staff recognizes the constraints imposed by these factors on policy implementation and appears to show a more liberal attitude. Realizing that these deficiencies would not be removed overnight, the staff has been cautious in pressing for acceleration in the pace of reforms in those countries. The staff has even suggested that a selective use of administrative controls could be tolerated in the monetary policy area to keep non-competitive forces in check during the transition. I would like to see this flexibility extended to other developing countries facing similar problems in their program implementation.

Nonetheless, the need to remove existing obstacles as well as establish necessary institutional infrastructures to enhance the effectiveness of reform policies remains and must be addressed by the authorities of these countries. The fear, however, is that this may take a considerable time to accomplish. It has been suggested that, meanwhile, stabilization should be brought up-front in the transition process as a strategy for moderating the impact of these distortions and, more importantly, to establish a stable macroeconomic environment considered necessary for more radical reforms. It is anticipated that the implementation of stabilization policies could even lead to the achievement of certain structural reforms. For example, the elimination of government deficits would invariably involve the reform of public enterprises as the removal of subsidies would impose discipline in their financial operations.

Finally, the use of fixed exchange rate policy as an anchor for inflation has proved successful in both Poland and Yugoslavia. Poland has used exchange rate policy to achieve both the objectives of reducing inflation and achieving an improved external current account position. However, the sustainability of a fixed exchange rate policy would require the maintenance of a healthy external reserve position.

The adoption of a flexible exchange rate policy by Hungary, on the other hand, also achieved the desired improvement in the external position but was accompanied by a significant acceleration in inflation. I would like to underline the fact that the improvement in the external sector performance in Hungary was facilitated by the positive supply response of the industrial sector to currency depreciation. Recent experience has shown that the pursuit of flexible exchange rate policy in most of the primary export producing developing countries would only result in high inflation, without the expected gains in the external current account balance. Overall, it does appear that where emphasis is on inflation control, the shift toward a fixed exchange rate policy is advisable. Whichever of these two approaches is followed, however, the pursuit of non-accommodating monetary and fiscal policy is critical to the achievement credibility of exchange rate policy.

Mr. Clark made the following statement:

Before I begin with comments of substance, I wish to first commend the staff for an excellent paper. The paper identifies in a concise manner the main issues that need to be addressed in the transformation process of the centrally planned economies and also points to the many uncertainties involved in the process. In this regard, I appreciate the staff's candidness in acknowledging that there remain considerable gaps in our knowledge in this area and that as a result there continues to be some ambiguity in the choice of the optimal policy strategy.

It is clear from this review that the centrally planned economies are only at the beginning of what will undoubtedly be a very lengthy process, and that a great deal remains to be learned. Given the novel nature of these programs, I believe relatively frequent reviews of progress in the transformation processes supported by Fund resources would be useful. Consequently, I would suggest that another assessment paper be prepared within one year's time.

I am in broad agreement with the conclusions of the staff paper, and in particular with the conclusion that one should not be too sanguine about the performance likely to be achieved under adjustment programs. This chair has expressed a similar view in a number of Board discussions on East European countries and cautioned staff that programs should not be based on overly optimistic assumptions. Our concern is that setting unattainable objectives could lead to adjustment fatigue and loss of public support. I believe that these countries are best served if expectations are not set too high to begin with, which could lead to disappointment and discouragement when economic developments fall short of these expectations. This could be particularly detrimental in new democracies where broad acceptance by the public is necessary to ensure that the adjustment effort is sustained.

The paper notes that there is considerable uncertainty with regard to the degree of financial restraint that is necessary in the initial stages following price and trade liberalization, and points to Poland as one example where policies may have been overly restrictive. Although the evidence in the case of Poland suggests that indeed this may have been the case, I would agree with the view that there are reasons to believe that a more accommodating policy stance would not have been appropriate.

In my view, quite a large degree of output and employment loss will inevitably be part of the process of transformation and restructuring. Nonetheless, I suspect that the actual declines in economic activity, although large, may nevertheless, be smaller than that implied by official data. Most of these countries have an informal economy, whose activities are not reflected in the official data. With current efforts toward liberalization and deregulation, the activities of the informal sector are surely expanding at a rapid pace, yet it will take some time before this activity is incorporated in the official statistics. A recent article in The Economist quotes a Hungarian economist as saying that the private, "mostly black," economy may be equivalent to 25-30 percent of GDP, and when this is taken into account, national output of Hungary remained stable in 1990 rather than declining by over 5 percent. I would be interested as to whether the staff has made any rough estimates of the size of the informal economy in the countries that were reviewed in the paper, and whether this activity can be seen to offset the decline in the official sector.

Another factor affecting one's views of the substantial declines in output in these countries is the issue of whether the cessation of production should be seen as leading to an equivalent loss of welfare. The staff paper implies that one should be very careful in such a judgment, by stating that the declines in output in centrally planned economies do not have their usual economic connotations since no one wished to consume the outputs at cost-covering prices. I would be interested whether the staff has any estimates on the magnitude of what could be considered as redundant output.

The discussion on east Germany in the appendix of the accompanying staff paper concludes that other countries embarking on a reform program should probably adjust at a slower pace than was the case in east Germany. In the latter, output fell by 50 percent but the country was able to cushion the adjustment cost with the enormous resource transfers from west Germany. The paper notes that since such financing is not available to the other countries, they cannot afford to proceed with a similarly rapid adjustment, which would lead to large output losses, substantial increase in the cost of the social safety net, and possibly political strife.

However, the large output loss experienced in east Germany is due not only to the rapid pace of reforms, or as the staff put it, the speed at which the country was exposed to external competition, but also to the very high and, one could argue, inappropriate exchange rate adopted by the country. The highly appreciated exchange rate necessarily led to many more enterprises becoming nonviable than would have been the case had the exchange rate been more competitive. However, the pace of adjustment itself, in terms of exposure to foreign competition, price liberalization, introduction to hard budget constraints, and other such reforms, was not the main cause for the large loss of output and employment. I would therefore argue that in the long term there is no trade-off between the pace of transformation and loss of output and employment, but that it is essential to ensure that the basic parameters, such as the exchange rate, are appropriately set. Consequently, I do not believe that countries should attempt to pace their transformation in an effort to reduce the output and employment losses, but rather that they must move as quickly as possible on all fronts to maximize their chances of success.

The paper describes the risk that attend fiscal planning in the process of transformation and restructuring. Although these are difficult to guard against, certain guidelines could perhaps improve the overall fiscal performance of these countries. For example, there is considerable risk associated with the revenue forecast, but most of the expenditures, save those that arise from the safety net, can be estimated with considerably more confidence. Consequently, in addition to targeting the overall public sector deficit, programs could also enforce certain expenditure limits, for example, on wages and transfers to enterprises. The latter is particularly important as it would provide one way to ensure that enterprises would be subject to hard-budget constraints.

I of course agree on the need for frequent reviews, but would caution against too much fine-tuning. Even in industrial countries such fine-tuning is often poorly timed because of the lags in data and difficulty in discerning the main factors behind certain developments. Given the rapid changes ongoing in the centrally planned economies, one would expect problems with data collection and interpretation to be considerably more pronounced.

Mr. Vegh made the following statement:

We can all agree that the role of the Fund in assisting East European countries should be the same role that the Fund plays in relation to any other country in need of financial or technical assistance. What makes this a special case, however, is that these countries are undergoing a process of transition from centrally planned economies to market economies, a process for which there is no previous experience on which to rely. The first conclusion we can draw, therefore, is that policy implementation in these countries should be closely monitored. Moreover, the Fund's policy advice should be subject to constant scrutiny.

One important aspect is the uncertainty surrounding the amount of financial assistance that these countries need. We all know the variables that should be taken into account to arrive at these figures, but we barely know the values those variables will show in the actual working of the reform process. Trade relations between CMEA countries are so disturbed that any estimation of trade results in this area are mere guesses. Private capital flows, and in particular foreign direct investment, are also very difficult to estimate.

There is also a problem in measuring the performance of the program because the figures that we have under the preceding economic organization of these countries are not comparable with those for the present economic organization. The budget deficits as percentages of GDP before and after prices are liberalized and public enterprises privatized do not mean the same thing. Even trade figures with CMEA countries will show very different results when measured in world prices rather than in convertible rubles as in the past.

Another area of very uncertain results is the so-called social safety net. We all agree that the proper way to proceed is a speedy process of reforms, or the "big bang" theory. The fact is, however, that a speedy process of reforms will certainly bring about huge costs in terms of unemployment and reallocation of factors of production, which will increase the budgetary needs to finance a most necessary social safety net.

The need to create a social safety net will increase fiscal expenditures significantly. The elimination of consumption or production subsidies, therefore, may be more than compensated for by other type of expenditures, which will complicate fiscal results. Furthermore, as the working paper on tax reform in economies in transition (WP/91/23) indicates, the efficiency of the tax system to procure resources in an economy in transition will be impaired by the lack of proper fiscal institutions. All in all, the fiscal performance of these economies will be poor.

Another crucial aspect of the transition process is how to contain inflationary pressures in a situation of price liberalization, partial privatization of the economy and recurring budget deficits. We know that in a situation like that it is very important to tighten the financial constraint of public enterprises, to expose the economy to the competition of foreign prices, and to reduce inflationary financing of the budget. This is easier said than done. Take for example the financial constraint of public enterprises. Given the industrial organization of these countries, whereby the core of the productive process is a few monopolies, the tightening of financing for one such enterprise may have such spillover effects to the rest of the economy that the decision to restrict financing could be softened. The central question in these cases is to assess whether the extra financial need is due to inefficiencies attributed to a given enterprise or to external factors. I doubt the authorities have the capability to produce that assessment. In the end, there can always be an excuse to relax the financial constraint.

In relation to the liberalization of foreign trade so as to contain inflationary pressures, we have to consider that to the extent that the policy recommendation is successful, the problem of unemployment and its budgetary impact will worsen. The fact is, however, that the influence of trade liberalization on price restraint will very much depend on the degree of openness of the economy. So there will always be a wide range of goods and services--the nontradable ones--for which there will not be external controls.

The latter bring us to another related problem. The central planning system as a guide to economic decisions is supposed to be replaced by market-determined prices--international market prices for tradeable goods, and locally determined market prices for the non-tradeable ones. To the extent that the local market system is not yet fully in place, there will be a need for some type of guidance during the transitional period. The fact is that this guidance will not exist because the central planning system is falling apart. There will be, therefore, a large set of prices that are free but not fully subject to market discipline.

Another crucial characteristic of the economic structure of East European countries is the lack of a financial system that is able to channel financial resources from surplus to deficit units according to the principles of economic efficiency. The importance to economic growth of this function goes without saying. As the working paper points out, centrally planned economies were very efficient in capturing savings from the economy but very inefficient in channelling those savings to productive uses. There is here an institutional building need that will take time to be met.

A final characteristic I would like to mention is the power conflict represented by all those managers of monopolistic state enterprises who are unwilling to accept new ways of doing business. Until these companies are privatized, these people will have a significant amount of power, which could be used to disrupt the process of transition to a market economy. This problem goes beyond the scope of the Fund's competence but its importance should not be understated.

Having reviewed the main characteristics of these economies in transition, it seems that the Fund will have a very special role indeed to play in their process of transformation to market economies. I am thinking of the technical assistance that the Fund can provide to meet the institutional building need, particularly in the fiscal and monetary fields. Moreover, given the high uncertainty that besets the financing programming for these economies, it will be extremely important that an almost continuous monitoring process be undertaken so that the authorities may be prepared, with timely guidance, to face unforeseen developments. The main contribution of the Fund should be based, therefore, more on human resources than on financial ones.

The latter does not mean that I am underplaying the need for financial assistance. We all know about the important financing already committed by the Fund, and that which is forthcoming to support the process of transformation of East European countries. We also know that the actual need of financial assistance is a variable amount, which depends, to a considerable extent, on the successful implementation of a myriad of technical decisions. It is here that the Fund has an irreplaceable role.

It would not be advisable that the Fund's share of total financial assistance to Eastern Europe be too large. Otherwise, the catalytic role of the Fund would be undermined. Moreover, it is important not to lose sight of the fact that the transformation of these countries into market economies is not only a technical or economic problem but also a political one. Bilateral assistance should play, therefore, an important role in this endeavor.

As somebody has said, western countries spent millions fighting communism; it is now time to shift spending to help its victims rebuild their countries.

Mr. Finaish made the following statement:

I join other speakers in welcoming this seminar. I believe that a frank program assessment such as the one contained in the staff papers can be quite useful in articulating lessons that might be learnt and hopefully applied in the future. This is obviously true in general and is not limited to the particular experience with Eastern Europe. I would therefore encourage the staff to apply the same critical approach in evaluating other program experiences, for example, in the context of conditionality reviews. Of course, I realize that reform in Eastern Europe is, in certain ways, different because of the type of economic transformation that is involved. But one can argue that it is all a matter of degree. There are certainly countries outside Eastern Europe where a systemic change was also involved; and the experience of such countries may also be worthy of assessment.

Beyond this, let me offer five specific comments. First, one thing that was known in advance was that economic transformation in Eastern Europe would inevitably involve some pain. The experience so far has confirmed this expectation all too well. In fact, the costs of transition are proving on the whole to be higher than many had expected. This raises an interesting question: to what extent can these higher than expected costs be attributed to uncontrollable factors--such as exogenous developments and unexpected patterns of behavior on the part of economic agents, and how much can be attributed to problem of sequencing of reforms. I do not know whether this question can be answered in a precise manner. But it seems to me that the problem of sequencing has been an important factor in the higher than expected losses of output and employment. If this is the case, could one then say, at least in retrospect, that the reform strategy could have been somewhat different?

One thing that was, more or less, known in advance was that the existence of an adequate institutional and legal framework was necessary to enable market forces to operate once liberalization policies, especially pricing policies, are put in place. We know that this is not exactly what happened, and to some extent one can argue that, in practice, sequencing was dictated by political and practical considerations. But I also get the feeling that an important underlying consideration was the notion that by pushing ahead at once in those areas where it was possible to push ahead, somehow the pain can be squeezed in time and thus limited to the period where political support for reform is still present. The question that arises, however, is whether in retrospect this reasoning might have overlooked the possibility that a more or less ad hoc sequencing could on balance mean higher and more prolonged costs of transition than otherwise would have been the case.

My second point relates to macroeconomic stabilization and, more specifically, monetary policy in the case of Poland. I believe the staff is to some extent correct in casting the issue of whether monetary policy was too restrictive as one of foresight and hindsight. But this is correct only up to a point because when one adopts, a priori, a very skewed balance of error, chances are the outcome will itself be skewed. The staff draws from the Polish experience the lesson that "one should take care not to err unduly on the side of extra adjustment in the face of extra uncertainty." I would certainly not disagree with this principle, but I am not sure one needed the Polish program to confirm its validity.

A related, and more specific issue, is whether the adjustment of interest rate policy should not have taken place earlier in the program. It seems to me that by the time of the first program review, there were indications that the extremely high interest rates, and the setting of the refinancing rate on the basis of monthly movements in the price index, were not fully justified. There is a question therefore as to whether a reconsideration of this policy should not have taken place earlier than it has.

A third issue relates to the level of inventories. Economic systems that prevent enterprises from having direct access to important inputs, while applying no restraints on credit availability, inevitably result in the holding of very large inventories of essential raw materials and other intermediate inputs. A "hard" budget constraint through severe restraints on the availability of credit can be circumvented through running down such inventories once enterprises are assured that a liberal trade regime guarantees the availability of such inputs from abroad. It may thus be possible for existing publicly owned firms to manage for long periods in the face of severe credit restraint while new enterprises are starved of credit. This is particularly unfortunate since success of the economic transformation depends critically on the emergence of "grassroots entrepreneurship."

My fourth comment is about the use of the exchange rate as a nominal anchor. It is probably too much to expect the limited experience so far in some of the East European countries to provide us with lessons of general applicability. I would not disagree with the staff's conclusion on this matter in the bottom of page 17. But in describing the experience of the three countries in question the staff appears to be setting a general principle regarding the use of the exchange rate as an anchor versus its use to strengthen the external position through periodic depreciation, depending on whether the priority objective is the strengthening of the external position or the containment of inflation. It is stated on page 3 that "...in Yugoslavia, where inflation was the paramount problem, the program emphasized the use of the exchange rate as an anchor; in Hungary, where the priority objective was strengthening the external position, exchange rate policy was used primarily to secure a real depreciation; and in Poland, where both inflation and the external position were in need of correction, the program combined an initial depreciation with use of the exchange rate as an anchor at its new level." This may well be true, although I am not fully clear about what is implied here. For example, in a country where the strengthening of the external position is the priority objective, is it implied that a nominal anchor would not be advisable? Could not a nominal anchor help preempt inflationary policy? It seems to me that the external position may determine the magnitude of the initial depreciation but not whether a nominal anchor is advisable or not. The answer to the latter question probably lies elsewhere, as paragraph 5 on page 17 seems to recognize.

My fifth point relates to the longer run political risks confronting the programs of transformation currently under way. It is indeed remarkable that the reforms enjoy a high degree of support, despite the substantial cuts in the standard of living that the populations have had to endure. For this support to be maintained, the process must be perceived as a positive sum game, and even those who are losers in the transition phase, are protected by adequate social safety nets. It is commendable that a great attention has been given to the establishment and financing of such safety nets.

Against the background of these complexities, the contribution that Fund assistance can make to the eventual outcome remains uncertain. The Fund has moved quickly to help with macro economic management issues. It has become patently clear, however, that for the reform process to succeed, many changes at the micro and institutional levels will be required. Many of these issues lie outside the Fund's expertise. It is essential therefore that the Fund move in concert with other international and national agencies and assure itself, through a continuous review of developments, that its action does not get too far ahead of the capacity of the East European societies to implement what is after all one of the most daring experiments in social engineering in recent times.

To conclude, I wish to once again welcome this assessment of the recent experience in Eastern Europe. Fortunately or unfortunately there are not many centrally planned economies left to which to apply the wisdom we are accumulating from this experience, but I suppose Albania should feel safe when it comes to the Fund.

Mr. Yamazaki made the following statement:

At the outset, I would like to commend the authorities of the East European countries and the Fund staff for their strenuous efforts in formulating these programs. Although the outcome of the first year of the program has not been as successful as initially envisaged, I highly appreciate the authorities' efforts to implement the various reform measures in the Fund's programs in spite of the severe economic and political circumstances they were faced with.

Taking into account the substantial contraction of CMEA trading, the oil price hikes associated with the crisis in the Middle East, and the slowing down of economic activity in the industrial countries, nobody can deny the fact that as a result of unavoidable factors, these programs went off track. As the transitional period for these East European countries has been one of uncertainty and trial and error, I agree with the staff that a frequent review of the programs is very important. Therefore, this seminar provides a useful opportunity to evaluate the policy implementation and the results of the programs.

The transitional period has been difficult; however, the size of the projected financing needs of these countries in the coming five years is surprisingly large, as seen in Appendix II of the paper on the Fund's role in assisting East European countries. However, the medium-term scenarios for these countries in the same Appendix seem to be rather ambitious. At the initial stage of the reforms, I support shock therapy rather than a gradualist approach. Nevertheless, after the initial, intense reform, a gradual stabilization period will be needed in view of the limited resources. Therefore, a much more conservative picture of these countries in the coming five years than presently envisaged may be warranted.

Let me here briefly touch upon some of Japan's experiences with reform in the late 1940s and 1950s. After the Second World War, Japan experienced hyperinflation caused by price decontrol, balance of payments difficulties, supply constraints, fiscal deficits, and monetary expansion in the period of transformation from a highly regulated and military-oriented economy to a market economy. The authorities implemented a fixed exchange rate, severe fiscal consolidation, and tight monetary policies, including credit rationing on the energy and iron and steel industries. The implementation of these policies, together with a substantial decline in the real wage of the household sector, finally proved to be successful in bringing about the goal of a stable economy in the late 1950s. These experiences of ours would suggest that a period of approximately 10-15 years of perseverance would be needed to achieve successful economic reform.

After the period of euphoria about the abolition of the centrally planned economies in Eastern Europe, we have come to realize that the problems of a high rate of inflation, large fiscal deficits, inefficient state enterprises, ill-defined assets in the banking sector, and increasing unemployment are left unresolved.

In these circumstances, I agree with the staff that the Fund's programs should continue to provide the social safety net necessary to help these countries. However, I wonder what level of living standards the Fund and the authorities of these countries wish to attain, and what is the time span in which they expect the goal to be reached? Do the tables in Appendix II of SM/91/46 not indicate that the staff and the authorities are aiming at a rather high rate growth? The export volumes of Bulgaria, Czechoslovakia, and Hungary are projected to increase at an annual rate of 8 percent, 10 percent, and 7 percent, respectively, in the coming five years, while the import volume of the industrial countries is estimated to be 5-6 percent. This means that the elasticities of export are assumed to be 1.5-2.0 in these East European countries. According to the staff, there is not breakdown by industry, but the staff nevertheless assumes extremely high elasticities. If export volume does not increase as much as expected and real growth rate is high, the external balance will deteriorate, and the already huge financing needs will increase further.

In this context, I do not think it appropriate to try to attain too ambitious a goal in the next five years. In a period of limited savings, it would be risky to try to pursue too high a growth and rely too heavily on other countries' savings. The critical point is that the abolition of a centrally planned economy does not automatically lead to a stable and high-income society. As I mentioned earlier, more likely than not it will take approximately 10-15 years, or even more.

As for economic anchors during the reform period, the use of multiple anchors seems reasonable. Reforms in the East European countries are being implemented on almost every front of the economy, while inter-market arbitrage is not necessarily working. In this context, not only exchange rates but also interest rates and wages might be useful anchors.

When the authorities use a fixed or pegged exchange rate as a nominal anchor, fiscal consolidation and tight monetary and incomes policies become indispensable. In the case of Poland in the second half of 1990, for example, if wages had not been raised, inflation and inflationary expectations would not have accelerated.

For those countries in which monetary and fiscal discipline are not necessarily so easily forthcoming, flexible exchange rates may be a useful tool in encouraging the authorities to pursue tight macroeconomic policies. However, a flexible exchange rate system with a relatively inflationary and weak production base is more likely to provoke subsequent expectations of depreciation of the exchange rate.

All in all, the determined way in which the authorities handle the fiscal, monetary and structural policies is a prerequisite for whichever path the country takes with respect to the exchange rate regime.

Mr. Arora made the following statement:

I welcome this discussion, as it gives the Board an opportunity to have an overview of the reform process in Central and Eastern Europe. Like my fellow Directors, I would like to compliment the staff on the very high quality of papers produced for this discussion. In particular, the staff paper on the interim assessment of 1990 programs was a treat to read. I also found the discussion of the Polish program in Supplement 1 very illuminating. These papers are a valuable addition to the growing literature on the economics of transition.

It is time that we looked at what was attempted and what was achieved in order to draw some tentative conclusions about the design of programs to be worked out in the future and about the respective roles of different entities in the international monetary system.

I would endorse the judgment of the staff that the stabilization programs implemented in the course of 1990 were a mixture of success and disappointment. This does not imply that the Fund adopted a wrong strategy. In fact, the program design varied according to the circumstances prevalent in countries undergoing the reform process. While a very comprehensive strategy was tried out in Poland and to a certain extent in Yugoslavia, the Hungarian program had a somewhat different orientation. I would say that despite the setbacks in terms of higher inflation and steeper decline in output than envisaged in the programs, basically the strategic thrust was right. It has become clearer with the passage of time that stabilization policies in the erstwhile centrally planned economies do not have much prospect of enduring without wide-ranging structural and institutional reforms. This lesson was clearly driven home in the staff report for the 1990 Article IV consultation for Yugoslavia. On page 13 of SM/91/38 it is stated that "the experience in 1988-90 in combating inflation has underscored the close interrelationship between stabilization and structural and institutional reform."

I suppose, therefore, that the debate on whether the stabilization should precede liberalization may be regarded, in a manner of speaking, as having been closed by evidence coming out of Eastern Europe, although I think that such evidence has not yet closed the debate on the speed with which a comprehensive program should be attempted. Here the experience of East Germany, with some of the most favorable starting conditions, throws sufficient doubt, in particular with respect to the pace at which domestic industry should be exposed to external competition.

I would therefore wholeheartedly support the staff assessment that we should refrain from entertaining high expectations about the results to be achieved within a shorter time horizon. The process of transition to market-oriented economies is going to be much longer than what many people anticipated in the heady days of October-November 1989. It is also going to be much more painful than was expected at one time. The data on unemployment in East European economies clearly point to the need for tempering optimism in regard to the time likely to be taken for achieving a viable degree of transformation.

There are two points that would perhaps deserve more attention in analytical work to be carried out in future. The first relates to the establishment of new patterns of trade among East European economies making the transition to market economy and between these economies and the rest of the world. While the staff papers have rightly drawn attention to the disruptive effects of the new trading arrangements governing the erstwhile intra-CMEA trade, it is not clear how East European economies are going to adjust to this new pattern and what effects the new pattern will have on their structure of output and income. It should not be forgotten that however inefficient the CMEA trade pattern may have been, it involved a degree of product specialization within countries constituting the socialist bloc in a regional perspective. Now this regional perspective may be disappearing and is being replaced by a closer integration with the European Community. What this shift will mean in terms of structure of output and trade for East European economies has to be analyzed carefully in a somewhat longer time frame.

The benefits of a fully developed market economy will be evident only when the process of integration with the European Community has brought into being production and trade patterns that can sustain reasonable growth over time. Given the relatively small domestic markets in individual countries of Central and Eastern Europe, development of modern manufacturing and services sectors, while being shaped by specific circumstances and endowments of each country, would also have to take into account the wider perspective of the European Community. Market forces will undoubtedly play an important part, but if I understand the underlying philosophy of the European Community right, it was a vision not only of competition engendered by market forces but also of cooperation that consisted of resource transfers to the relatively less developed members of the community.

Without such a larger framework of cooperation, is it not conceivable that competition may not lead to optimal strategies of development in Central and East European economies, especially as the much larger domestic market in the Soviet Union may within a short period be in a position to take much greater advantage of economies of scale offered by technologically modern manufacturing industries? This is not a plea for reversion to central planning but a modest suggestion to introduce regional perspectives into economic thinking about the future of Eastern Europe. Without such a perspective, we may be hitting against barriers that impede growth sooner than later. This argument presupposes that industrial countries in the European Community and outside will maintain a liberal trade regime which will not discriminate against exports from Central and Eastern Europe. It also presupposes that both official creditors and capital markets will play respective roles in meeting the financing needs of East European economies confronting the daunting tasks of modernization and adjustment at the same time. Even after these assumptions are made, which could be large ones in the context of the present stalemate on the Uruguay Round and the persisting coyness of financial markets, the need for analyzing the evolution of trade relationships over the medium term remains.

My second point concerns incomes policy. The staff papers have given a good deal of attention to the significance of incomes policy in the context of anti-inflation strategy. This is good as far as it goes. The fact that incomes policy did not perform well in Yugoslavia, Hungary and to some extent in Poland is not an argument for not emphasizing its key role, especially if liberal trade and payments systems have to be maintained and repeated disruptive devaluations avoided.

In a recent book, David Worswick has made a strong case against the generally accepted view that the high and rising unemployment is a sad but necessary by-product of the need to reduce inflation. He has argued that inflationary wage pressures can be contained through an incomes policy which should be seen as an alternative to policy-induced recession. Of course, Worswick's discussion relates to the British economy, but in a different context East European economies are faced with a similar problem. It is a social and political problem of great consequence.

The failure to fashion and thereafter to implement an appropriate incomes policy may block prospects for steady growth in a non-inflationary environment. Of course, it would be difficult to construct a social consensus in favor of incomes policy given the strong demonstration effects emanating from Western Europe. But this is a political challenge that has to be faced.

Arguably, the incomes policy practiced in South Korea, Japan, and Taiwan during the earlier stages of their development may have owed something to relative isolation, although I believe it was more a question of how political leadership was able to communicate to the population the need for wage restraint. The notion that the changeover from a centrally planned economy, which was bad, to the market, which is good, will by itself produce high living standards with rising personal incomes and consumption, belongs to the category of fairy tales. But this is what the people are led to believe.

The British experience in controlling inflation suggests that for countries starting with a relatively small and insufficient industrial base, an exchange rate anchor without supporting incomes policy will only deliver higher inflation and lower output. Competition is not always an unmixed blessing as may be seen from the case of Britain. In Britain, the share of manufacturing in gross domestic product fell from 26.8 percent in 1980 to 22 percent in 1989. Britain had the services sector to make up this deficiency and consequently maintain high standards of life for its people. East European economies will simply not have this room to maneuver. Their only hope would seem to lie in a strategy of rapid modernization of industry underpinned by relatively low wage levels to enhance external competitiveness. Unless this message were to go through to the people at large, it would be difficult indeed to look forward with any degree of confidence to scenarios of medium-term viability. The alternative will be deindustrialization and migration in large numbers to Western Europe.

In this context I would like strongly to endorse the leadership role that the Fund has played in assisting Eastern European economies in their transition to the market system. In spite of uncertainties regarding financing assurances, about which much anxiety has been expressed, I believe that the Fund should continue to play its important role. External financing in sufficient quantities will have to be organized and the Fund can also help in this.

In the report on German unification, (Occasional Paper 75) it is stated that in the ultimate analysis what will help build East European economies is domestic entrepreneurship. I hope we shall see a more thorough discussion of domestic entrepreneurship in future reviews.

I wonder whether the East European economies now making a transition to the market system can affect life styles of western economies. The reason for this is that these life styles are based upon energy intensive industry and agriculture, a condition which these economies may not be able to observe on account of high prices. Even though energy prices may come down now, it would seem that energy shortage is a phenomenon we will have to live with. It is just a thought that facing energy intensive life styles may bring sadness and disappointment.

Mr. Al-Tuwaijri made the following statement:

I share the views expressed by previous speakers. Though interim, the staff report is candid in its assessment of programs with Hungary, Poland, and Yugoslavia. Obviously, it is too soon to have a conclusive view of these countries' experience. However, it is clear that the task has turned out to be more challenging than envisaged. Irrespective of whether the programs followed the so-called big bang approach or a more gradual approach, the mixed results call for caution in the future.

One important conclusion that could be derived from the experience of the three countries under review is that the domestic adjustment lagged behind exchange and trade liberalization. Thus, there were difficulties in forcing the desired supply response. It seems that the domestic price adjustments, though necessary, may have unintentionally increased the monopoly power of state enterprises rather than enhanced efficiency. On the other hand, tight financial policies and depreciation appear to have generated accumulation of foreign assets, but at the expense of economic recovery. Subsequent attempts to ease domestic economic hardships have led to inflation, which highlights the inherent dilemma of simultaneously achieving internal and external objectives in the special circumstances of Eastern Europe. As always with hindsight, the design and sequencing of policies could have been different.

It is apparent that the underlying structural constraints are too pervasive to be corrected in a short period and without a comprehensive, minimum critical effort. Such an effort is needed so that a dynamic, market-based, supply response can be ensured. While I agree with the staff that progress on this front may have to be slower, I would like to emphasize the importance of avoiding a weaker performance on inflation. For any program to succeed, the inflationary tendencies have to be fundamentally eliminated. Hence the need for an appropriate design of the program and sequencing of policy actions. There should be no compromise on tight stabilization programs including strict incomes policies. These policies should spearhead the adjustment effort and facilitate reforms aimed at eliminating state monopolies and the establishment of effective market structures. However, should it prove difficult to proceed on all structural fronts simultaneously, preference should be accorded to the privatization of banking institutions and the establishment of a well-functioning financial market with positive real interest rates. Such a banking system, combined with a "hard" budget constraint, would help in forcing corrective cost-cutting steps by the state enterprises, while they are undergoing privatization.

The most contentious issue has been the use of the exchange rate in the adjustment process. At the outset, I wish to emphasize that we cannot be doctrinaire about exchange rate policies. There is much to be said for an exchange rate anchor at an appropriate level, especially because it can instill the much-needed credibility to the program and force corrections in the rest of the economy. However, an anchor, though advantageous from the point of view of establishing credibility, can only be successful if domestic financial policies are effective in containing inflationary pressures and in establishing financial stability. It goes without saying that an inappropriate anchor could call for unacceptably tight financial policies with attendant destabilizing speculation. Therefore, I see merit in the staff assessment that the exchange rate anchor is not a panacea. As a matter of fact, it can easily turn into an Achilles' heal if not supported by effective incomes, fiscal and monetary targets, and associated policies. Hence, greater focus should be on ensuring appropriateness of domestic policies.

So far, the experience in Eastern Europe shows that more concerted internal adjustment will be called for. Naturally, any additional debt-creating financing should be viewed as a complement rather than a substitute for adjustment.

Mr. Posthumus remarked that monetary overhang was another term for savings in the hands of the people. While there were many interesting policies to do away with the monetary overhang, for the people concerned such policies all essentially meant a loss of savings. The Fund could explain all it liked that those savings were not real savings, but it would probably not be very convincing.

It was not clear to him, Mr. Posthumus commented, what was behind the unsustainable process of production dropping and exports increasing, as had been seen in Poland and to a lesser extent in Yugoslavia.

The first conclusion in the main staff paper suggested that one should not be too sanguine about the performance likely to be achieved under programs, Mr. Posthumus recalled. He would point out in that context that the papers under discussion dealt with transition economies, which were in very different situations than, for example, Japan immediately after the Second World War, or Australia a few years previously. The East European countries were undergoing a complete systemic change that could not be compared to previous cases. He therefore read into that first conclusion a message--that the estimates on which the policies were based were not very firm, because the economies were unknown. For example, the unexpectedly large drop in production was unexpected partly because there was no model for countries in transition to market economies. Models were usually based on estimates, and estimates were based on past experience, which was not available in those cases.

Turning to the role of the Fund, Mr. Posthumus remarked that while the transition process might well be prolonged, the Fund's role in that process should not be. As soon as it was possible for the countries concerned to have a reasonably stable macroeconomic environment, the Fund's role should be reduced. That would be a difficult step to take, because a number of countries and other financial institutions were satisfied with the current important role of the Fund. It would be necessary for the Fund to discuss that issue further and carefully prepare its future policies in that respect. One result might well be that the rest of Europe would have to take up a larger role than it currently intended to do.

On the question of whether the pace of reform should be speeded up, Mr. Posthumus noted that the Fund's general experience had been that the faster the adjustment process, the faster the recovery. However, he wondered whether that general conclusion applied to the specific cases of the countries in transition.

Mr. Kabbaj made the following statement:

> The Fund's involvement in the stabilization of the centrally planned economies of Eastern Europe and their transformation into market-based economies has been recently well documented in the paper on the Fund's role in assisting East European countries.

This report shows the extent of Fund's financial and technical support provided to these countries, as well as the extensive collaboration achieved between the Fund and other international organizations to assist East European countries in the transformation of their economies.

For today's discussions, the staff paper on the assessment of the programs concluded with these countries in 1990 indicates that "these programs were reasonably successful in their basic objective of establishing a stable macroeconomic framework." I welcome this conclusion.

I note the staff proviso that "the focus of the report is on the implications of the 1990 experience for stabilization policies rather than for the process of structural reform." However, in assessing the performances of these programs, what is really significant, apart from the short-term achievements, is the ability of these economies to sustain growth in the context of a stable financial environment over the medium term. I make this point because the experience under other programs suggests that short-term stabilization is a relatively achievable task, particularly where a strategy of shock treatment is applied, compared with the ambitious objective of sustaining a process of adjustment policies and reforms over a period of three to four years.

Second, when reviewing and taking stock of the experience under these programs, we should keep in perspective not only the particular characteristics of these economies and the circumstances under which these programs were initiated, but also the interest expressed by the international community in the success of these programs, as reflected in particular in the creation of the EBRD, the provision of financial support from the Fund and the World Bank, the mobilization of a wide ranging expertise for technical assistance, and the early introduction of adequate safety nets.

Third, the 1990 experience in Central and Eastern Europe reinforces the view expressed by the staff that "one should not be too sanguine about the performance likely to be achieved under programs." It is becoming evident that the implementation of structural reforms, including the rehabilitation of market forces, the restructuring of enterprises, trade liberalization, and price reform, constitutes a time-consuming process that is also costly in view of its impact on growth and employment. Therefore, a delicate balance should always be achieved between the need to speed up the process of reforms and to assign ambitious objectives to the program on the one hand, and the necessity to accept in some cases a schedule of reforms in the context of more realistic timetables, particularly for those countries where the administrative capacities of the authorities are insufficient. In all cases, it is evident that an early design of safety nets to protect the poor and the unemployed is an essential feature of any medium-term adjustment program. Comprehensiveness and adequate sequencing of reforms are also important features that could reinforce the chances of success of programs.

Fourth and finally, it is not surprising to note from the staff paper that one of the major problems encountered in East European countries is the lack of financial markets. This experience suggests that financial sector reform should play a leading role in the adjustment process. It is clear that without a viable financial system, it will be difficult for many countries, and not only those in Central and Eastern Europe, to promote higher levels of domestic saving and better allocation of resources as well as enhance competition. On this latter point, and as demonstrated by the programs under reviews, the acceptance of direct controls in the conduct of monetary policy could be a second best solution for a period of time until adequate competition in financial markets is achieved.

I would welcome the extension of such regional reviews as this one to other groupings of member countries.

Mr. Dai made the following statement:

I welcome the opportunity to discuss the recent experience in Central and East European countries. This seminar will surely provide us with more insight and a broader view on the reform experiences of these countries.

The Central and East European countries have embarked on an unprecedented transition of economic life. Recent overall performance of these countries' economic stabilization and reform programs has been mixed. On the positive side, many inefficient features of central planning are being corrected; on the other hand, however, serious economic problems emanating from the reform process--such as inflationary pressures and a continuous decline in growth--threaten the environment for further reform. While it is true that it is hard to avoid some of these setbacks during the reform process, it is equally true that they could hamper the whole process unless handled cautiously.

I endorse the pragmatic views presented by the staff in the paper, which are drawn from experiences and lessons of more than a year of arduous work in dealing with these countries' economic transformation. Although these economies all originated from a central planning system and are embarking on the same strategy of transforming into a market-oriented economy, the economic structural features, macroeconomic situations, and social backgrounds vary from country to country. In this connection, I agree with the views that the Fund programs to these countries should be designed and implemented on a case-by-case basis. No simplistic and unified approach would apply to all. I also agree that, given the complexity and sheer magnitude of redressing the structural inadequacies, it should be recognized that they will take time to correct. I also support the idea that administrative controls may also be necessary in certain instances.

All countries in this region have shown their determination and commitment to a rapid transformation. However, without political consensus and wider social support, no economic reform will be successful. If the public is not prepared to accept the drastic changes in economic life, any well-designed program could be disrupted by slippages or setbacks. We have seen previous examples of such slippages in the countries under discussion. Therefore, considerations in this respect must be fully taken into account in program formulation and implementation, though it is sometimes difficult for the Fund staff to ascertain the political implications.

It is obvious that in the present circumstances, adequate and substantial external financing is indispensable for economic reform in these countries. The Fund's financial involvement in these countries is also large and expected to remain so for a considerable time. Without strong international financial support, it would be extremely difficult, if not impossible, for the countries to pursue their economic programs. Nevertheless, financial assurances are generally not so certain. What would be the impact on their economic reform programs if there were a shortfall in foreign financial assistance? Could these countries continue their transformation programs mainly on their own? From a longer-term perspective, domestic resources should play the primary role in economic transformation and development since the whole process could be relatively long and take time to accomplish. I would like to hear from the staff what are the prospects of mobilizing domestic savings in these countries.

The staff paper indicates that every country under discussion experienced large declines in output. It also explains that five major forces contributed to the decline, and concludes that such a decline is unavoidable during transition. I wonder whether the decline in output is absolutely unavoidable. Is it not possible to avoid this fate? Will there be another alternative if we can find some other outlets as we gain more experience?

Mr. Fogelholm made the following statement:

I very much welcome this opportunity to discuss Fund programs in Central and Eastern Europe, which is an area of increasing importance to the Fund. Like other Directors, I believe that this review is and has already been useful, not least for the staff in its work on the upcoming programs for Bulgaria and Romania. I also agree with Mr. Peretz and Mr. Finaish that similar reviews should be undertaken for other countries. However, I am not as sure as Mr. Monyake appears to be that the conclusion to be drawn from similar studies--for instance regarding the speed of adjustment in some African countries--will be that the pace has been too rapid, suggesting that a more gradualistic approach would have been called for.

Turning now to the paper in front of us, my authorities agree with the staff that it is difficult and perhaps also too early to draw definitive conclusions from experience to date with the three programs in force during 1990. Nevertheless, some general observations can be made.

There is no doubt that designing a stabilization program for an economy undergoing radical restructuring has been more difficult than anticipated. The results achieved so far underscore the importance of a rapid implementation of necessary structural reforms, particularly to improve the competitive economic environment.

The fact that the trade-off between production and prices has been less encouraging than expected should not cause the Fund to relax its emphasis on price stability in future programs. The dismantling of inefficient production is both necessary and desirable, as it will release resources that can be directed toward the manufacture of profitable and marketable goods. The need for such changes is undeniable, but the speed at which they should take place will result in high unemployment during the transitional period. Therefore, temporary and targeted safety net measures are definitely required. From the employment aspect, it is obviously important that the transitional period, during which resources are not fully utilized, be as brief as possible.

Needless to say, it is most important that the programs be comprehensive. Application of several anchors will facilitate the management of and adjustment to the new situation by both the authorities and private economic agents. As the staff points out, the exchange rate has proved to be a very clear and useful anchor in circumstances where formulation of an appropriate monetary policy stance would have been rather problematic.

Experience in the cases of Poland and Yugoslavia has shown that the exchange rate can be effectively used as an anchor to ameliorate an acute situation in the short term. At the same time, the risks for program derailment will grow over the medium term unless the exchange rate policy is supported by monetary and wage policies--which did not happen in the Yugoslav case. The Polish experiment of using the exchange rate in the combined role of anchor and instrument to enhance competitiveness through an initial devaluation is given a fairly positive assessment in the staff paper. However, the applicability of this model is limited, as the method requires a strong reserve position at the outset of the program. In connection with the discussion of the exchange rate, it would have been interesting if the question of convertibility had been dealt with, particularly as the countries under review have chosen different approaches in this regard.

Even though there have been difficulties associated with fiscal planning in the Central and East European countries during the restructuring phase--and these are clearly depicted in the staff document--fiscal policies must also be geared toward stabilization. The Fund's approach, which couples frequent reviews of fiscal policy with the preparedness of the authorities to introduce necessary supplementary measures, must therefore be regarded as appropriate.

The liberalization of prices and foreign trade occurred so rapidly in 1990 that there was insufficient time to provide the institutional and economic framework necessary to support an efficient market system, which, in turn, would have laid the foundation for a rapid restructuring. To ensure success in the transformation process, it is highly important to establish a competitive environment with appropriate relative prices as soon as possible. This holds true in the institutional and property rights area; in the factor inputs area, including labor; in the financial sphere, including interest and exchange rates; and in the product markets area.

To ensure that economic agents are responding to the right signals, all prices should, of course, in principle reflect the relative scarcity of resources, or to put it differently, the relative efficiency of factor inputs. An appropriate market response by privatized and demonopolized enterprises facing tough budget constraints is also crucial to the success of stabilization policies. A competitive economic environment should greatly facilitate, and, indeed, is necessary for, a rapid reallocation of resources to productive and profitable activities. Also, the role of viable financial institutions must not be underestimated in this context.

Price distortions, even in the name of well-meaning distributional considerations, will undoubtedly hamper the necessary reallocation of resources. Even though specific safety nets are needed, efficiency in the production and economic areas should have precedence over distributional considerations, so as to avoid the confusion that would be caused by efforts to attain distributional targets by influencing the markets. This should have clear implications, inter alia, for the level of government subsidies influencing prices. Distributional concerns would have to be taken care of through income transfers over the fiscal budget, based, of course, on an overall assessment of their feasibility in light of the general macroeconomic situation.

This being said, I acknowledge that in practice one may have to compromise on first choice solutions, and that before smoothly functioning markets become established, it is necessary temporarily to administer certain prices.

In the labor market, therefore, income regulation is probably unavoidable for an interim period. The same is true of the financial sector, as one cannot expect that the exchange and interest rates will immediately find appropriate levels on their own. In these instances also, it would seem that one has initially to set the rates administratively.

Thus, the difficult policy choice is to find the levels of administered prices that as accurately as possible reflect the requirements imposed by, on the one hand, the need to attain a reasonable level of competitiveness, and on the other hand, the prevailing balance of payments situation. The staff papers show that this has indeed been a most difficult task and that success has been varied; consequently, every effort should be made to keep this period of administrative price setting as short as possible.

In sum, I agree with the staff that, in most instances, one has to take a pragmatic approach, and do what is feasible in the various areas. These economies simply do not have the time--or the luxury--to wait for all the relevant elements to be perfectly in place before introducing the various policies and reforms.

Extending his remarks, Mr. Fogelholm said that he supported the conducting of similar reviews for other regions. However, he was not so sure that the other reviews would come to the conclusion that Mr. Monyake was evidently looking for--that the Fund's advice had resulted in too quick an adjustment. It could well be that the opposite was the case in many instances. Indeed, adjustment experience in different parts of the world, including China, indicated that the gradualistic approach had not been extremely encouraging to date. With respect to the countries currently under discussion, Hungary had started off with the gradualistic approach and had had to desert that approach in favor of more rapid adjustment, which had probably led to the results that were currently evident.

On the contraction of production, Mr. Fogelholm considered that the countries under consideration had done extremely well. The Fund had perhaps been expecting unrealistic levels of adjustment. There was certainly significant redundant and inefficient production in the countries concerned, and the subsidized enterprises had to be allowed to close.

He felt that the Fund should be cautious in its approach to the transition in Eastern Europe, Mr. Fogelholm said. He hoped that the Fund's involvement would be long, not in a financial sense, but in terms of offering advice and technical assistance. The Fund's financial role needed to be reviewed, but one could do that on a future occasion.

The Director of the European Department said that the output and inflation costs of adjustment, particularly in Poland, were considered by the staff to be unexpectedly large compared with the Fund's experiences with other programs. However, Poland's experience was not that different from that of other countries in Eastern Europe, such as Romania and Bulgaria, which did not have a program in 1990 but nevertheless had also suffered a large fall in production in 1990. Such costs were unavoidable by-products of the shift from ill-planned to market economies. In certain sectors, output needed to be adjusted, either by cutting production or by producing different goods. There was also an enormous amount of underemployment and overstaffing, even in the industries that were potentially viable. Therefore, it was crucial that the exchange rate be used to make at least some of the industries competitive, so that they could export enough to pay for necessary imports. In fact, in the countries with programs, the exchange rate and production had both dropped initially, and production was now gradually beginning to pick up. That explained why some projections of growth rates in Eastern Europe were currently relatively high. Reforms would in time be successful in making the system more efficient, and market shares could be gained if exports remained competitive and markets abroad were open to those exports.

On sequencing, the Director said that it would clearly have been preferable if one could have put in place all the institutional structure before adopting the necessary policies, but that had not been a realistic option. For example, the process of reform in Hungary had initially been very slow, and that had lead to much dissatisfaction within the country. A clear signal was needed for a real change of regime. The Polish Government had also been very concerned about the issue of appropriate sequencing. They understood that the costs of adjustment would be smaller if they had had the necessary institutions to conduct monetary policy, channel savings, and eliminate segmentation in place before hand. But neither they nor the public had been prepared to wait for all those institutional changes to take place before addressing the transformation of the economy. Some Executive

Directors had thought that the costs of adjustment would induce the staff to change its approach to reform. However, and without wishing to fuel the debate on the relative merits of a big bang versus gradualism, the Director thought two points were insufficiently appreciated. First, the change of regime had to be sufficiently comprehensive to make it credible that a new system--with new rules of the game--was being adopted. Second, these choices were choices made by the governments themselves. The staff had not forced the big bang approach on any government; the governments had chosen it independently. Even the government of Hungary, which had long ago begun its process of reform, had turned to the big bang approach out of dissatisfaction with the stagflation that was resulting from the initial very slow approach to reform.

The case of China was different in two respects, the Director remarked. First, China did not share the same goals as the East European countries; it was not aiming at divesting itself of all state ownership of production and establishing a market economy with private ownership of the means of production. Second, in China, the agriculture sector was much more important than in Eastern Europe, and the response of agriculture to some of the reforms had been much faster, which reduced the importance of the issues of unemployment and output. By contrast, Czechoslovakia, for example, was very industrialized. Moreover, industry and the division of labor had been established administratively, with only limited knowledge about the country's comparative advantages.

Regarding Hungary, the staff was concerned about the inflation rate, the Director said. Moreover, the external situation was very precarious. The authorities were trying to maintain access to capital markets, but in a context where creditors were becoming increasingly reserved about lending to Eastern Europe in general. It was disappointing to note that, while commercial banks had been willing to finance the previous regime, they seemed less willing to finance these countries once they began implementing market-oriented policies. He hoped that that would change as the reforms proceeded, but it was a fact for the time being. The Fund therefore needed to be cautious about the risks it was prepared to take in the case of Hungary, in particular vis-à-vis the balance of payments and the use of the exchange rate as an anchor.

It had been suggested by Mr. Spencer that the use of multiple anchors risked the establishment of inconsistent targets, the Director recalled. He did not agree. If there had been problems, these had been problems of implementation rather than of consistency. In the case of Poland, in particular, he did not consider that the use of multiple instruments had proven to be inconsistent, ex post. The staff had set the exchange rate and the interest rate, but it had hoped that the interest rate could be moved much more quickly than had turned out to be possible de facto because of the institutional rigidities. The interest rate had moved in response to the market, although not promptly and not sufficiently. A first problem was that the financial markets were not providing the information required to adjust the interest rate in full awareness of market conditions--e.g., regarding the spreads between the parallel market rate and the official rate, and between the increase in reserves and the increase in credit. Second, the staff initially set the interest rate, hoping that that would be sustained for no more than a week or ten days, until information began to come from the exchange market. What the staff had found, instead, was that to change the rate in a way that would also be reflected in market rates was much more difficult and took much more time than expected. In fact, to date, it can only be changed as often as once a month.

The important issue in the case of Germany was what wage differential between east and west was comparable with containing migration from east to west, the Director remarked. The exchange rate could have fixed a larger differential to start with, but that differential would have been closed very quickly by an increase in wages in eastern Germany, as illustrated by the latest A.G. Metal wage settlements. By the same token, the wage differential was particularly important to the valuation of bank portfolios and claims on enterprises, which were exchanged at a different exchange rate than that used for demand deposits, wages, and salaries.

The Chairman remarked that it would be interesting to analyze what was the acceptable rate of unemployment that was implicit in the adopted wage settlement. It was conceivable that if productivity had not grown significantly after three years, either unemployment or transfer of population would result.

The Director of the European Department remarked that in Italy, for example, experience had shown that the population became mobile if production did not pick up. Particularly in the case of the unified Germany, one could not set the exchange rate without also addressing the issue of wages, since the mobility of laborers within the country was relatively high.

Mr. Goos agreed that selecting the appropriate exchange rate was important for the conversion of financial balances, and therefore for the viability of enterprises and banks. However, prices would immediately adjust to the west German price level. The basic problem was that east Germans continued to migrate to west Germany because of the wage gap between the two areas. The unions had responded that the only way to stop that flow of manpower was to close the wage gap. That would, of course, have serious implications for employment. But on the other hand, those people who left east Germany were those with the initiative and energy that was needed to rebuild the east German economy.

Mr. Clark commented that the exchange rate did impose an adjustment cost to economic activity, be it through wages, productivity, or movement of labor. There was an additional adjustment cost imposed by the pace of reform, and it was difficult to distinguish which costs were due to the appreciation of the exchange rate and which were due to the pace of reform.

His point had been that one should not conclude, on the size of the adjustment, that the country should proceed with a slower pace of reform.

The Director of the European Department indicated that in the countries other than Germany, the depreciation of the exchange rate and the resultant export growth had reduced the impact on employment.

The staff paper did not suggest that incomes policies should not be adopted, as had been implied by one Executive Director, the Director said. In fact, the staff had been disappointed that incomes policies had not been applied in some countries, such as Yugoslavia, and considered that such policies were crucial until the labor market became fully functional.

On the question of whether greater use of monetary reform rather than inflation should be used to eliminate monetary overhangs in these countries, the Director noted that all the East European countries under discussion had tried monetary reform, including the confiscation of savings, at least once under the previous regime. It was understandable, therefore, that the new democratically-elected governments did not want to make such a step their first action on monetary policy. In addition, the staff had come to the conclusion that the postwar German monetary reform had taken place under ideal administrative conditions that could not be duplicated in present-day East European countries.

The staff's medium-term forecasts were not overoptimistic, the Director said; it was aware of the difficulties ahead, in particular regarding some elements of domestic adjustment. However, it was crucial that the countries be given the room to capture the export markets they needed to implement their reforms. For example, Hungary had managed to do well in the face of CMEA export declines because its new exchange rate had made its exports more profitable, so that the value of exports had increased despite the fall in production. One had to aim at policies that would produce a similar growth of exports in the other East European countries.

Fund's financing would continue to take place according to the standard procedures currently in place, the Director of the European Department indicated. The staff hoped that as the economies moved from stabilization to reform and as commitments and disbursements were made by the other development institutions, the attitude of the commercial banks and the rest of the private sector would change. In addition, in two very important cases--Poland and Bulgaria--there was the question of debt rescheduling and eventually debt reduction, which would ease the financing requirement. As for policy advice and technical assistance, the Fund's presence in Eastern Europe would certainly continue for quite some time.

Mr. Posthumus remarked that while it was easy enough to measure the successes of stabilization, it was not so easy to measure progress in the transformation process from a centrally planned economy to a market economy.

The Chairman commented that it was hard to determine what was an appropriate price for the international community to pay for an orderly, democratic transition by a country to a market economy.

The regional surveillance evaluation just conducted deserved to be broadened to include the other East European countries, which were just beginning the transformation process, the Chairman continued. Such evaluations would also be useful in the context of other regions and issues, such as the reconstruction of the Middle East.

While the current seminar's discussion had rightly concentrated on the design of programs, the Chairman said that he would welcome a more in-depth discussion of the Fund's involvement in those cases. He agreed that the sooner the Fund could remove itself from the process of adjustment, the more successful the policies would have been. Certainly it was desirable that the Fund's financing role diminish over time, with the other international financial institutions taking over that responsibility, and the Fund remaining involved in terms of technical assistance and policy advice. The Fund should insist more firmly on strengthened structural adjustment, since the interrelationship between, for example, slow financial reform and inefficient monetary policy was clear. In that context, it was appropriate that countries graduate from a stand-by arrangement to an extended arrangement.

The Executive Directors then concluded their discussion on the interim assessment of the 1990 programs in Central and Eastern Europe.

LEO VAN HOUTVEN
Secretary