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Progress in the Economies in Transition in Central and Eastern Europe: The Roles of Policies and External Assistance

Address by Michel Camdessus
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Madame Grapin, your Excellency, distinguished guests: it is my pleasure to welcome you to the IMF, and to participate once again in a Forum organized by the European Institute. You are discussing some of the most momentous challenges of our time--the transformation of the economies of Central and Eastern Europe and their integration into the global economy. Let me contribute modestly by telling you what we, at the IMF, have learned from the early history of this process, and also by indicating what remains to be done, especially now in Russia, where many of our concerns are focused. What we have learned, and what has been confirmed for us, go to the basics of our activities in the Fund: policies and financing.

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First, it is the policies of the countries that provide the key to their success. The transition to a market economy entails inescapable challenges for policy--prices have to be freed; the economy has to be opened to the rest of the world; macroeconomic stability has to be established; laws and institutions have to be reformed; enterprises have to be commercialized and privatized; and the poor and vulnerable have to be protected. What challenges these are! But where they have been faced with determination and consistency, in a number of cases by people present here today, observe the results:

- In Poland, growth in 1993 was the second fastest in Europe, and similar growth is expected this year. Inflation, at more than 30 percent a year, is still certainly too high; but it has been brought down from an average monthly rate of 18 percent in 1989--not very different from the rates of inflation we are seeing now in Russia and many other countries of the former Soviet Union. The transition in Poland is not complete, and indeed important challenges are currently being faced. But we can say, four years after the transformation began, that a growing market economy has been established.

- In the Czech Republic we see another emerging success story. Important structural reforms still lie ahead, but inflation has almost been reduced to single digits at an annual rate, and growth is resuming. This country was even able to stop borrowing from the Fund during 1993, and has in fact been receiving large private capital inflows.

- Albania, whose situation less than two years ago seemed especially dire, was in 1993 the fastest growing economy in Europe by far, with a growth rate close to 10 percent; and its inflation was similar to that of Poland. Its recovery is expected to continue this year... Who would have expected that in 1991?

Also in Central Europe, I would mention the progress made in Hungary, Slovakia, and Slovenia.

In the countries of the former Soviet Union, the transition began later than in Central Europe, the initial macroeconomic imbalances and distortions were worse, and more institution-building needed to be done. But it has been shown that these obstacles are not insuperable, for observe:

- the progress made in Estonia, Latvia, and Lithuania. In each of these three Baltic republics, inflation is being brought decisively under control. Output turned up during 1993, and continued recovery is expected this year.

The progress made by these countries in Central Europe and the Baltics has not been fortuitous. <u>Nor--and I emphasize this--can it be attributed mainly to external assistance</u>. In each case, what underlies it is the resolute implementation of comprehensive and rigorous policies of macroeconomic stabilization and structural reform. As those of you from the countries I have mentioned know from first hand, this road is not easy. But is there any other road that can provide an easier or safer passage? So far we have not seen it. Just as strong policy programs have brought progress in the countries I have mentioned, the attempt in some other countries--including, I regret to say, Russia and Ukraine--to protect existing patterns of output and employment through subsidies and credits has not brought stabilization or growth. This so-called more gradualist approach has instead prolonged the transition and made it more painful.

It is clear what the countries that have not yet been successful need to do to establish the conditions for sustained growth: they need to strengthen their stabilization efforts and speed up their reforms. To those who say that the IMF is advocating shock therapy, I would ask: who will have suffered the more severe and prolonged shocks--the peoples of Poland, the Czech Republic, and the Baltics, where growth has resumed and inflation is being brought under control, or the people of those countries where indiscipline and gradualism have brought hyperinflation or the threat of it? There is no shock more cruel than prolonged recession, hyperinflation, and economic disorder. In fact, if there are shocks anywhere they are there, and in the legacy that the countries in transition have inherited, not in the policy strategies supported by the Fund.

Let me say a special word about Russia. A great deal has been accomplished by the Russian authorities in the past two years--notably in the liberalization of prices and the exchange rate system, the setting of key interest rates close to positive real levels, and substantial progress with privatization. The private sector has begun to respond to these important measures. But as a result of a lack of consistent fiscal and monetary discipline, inflation has remained far too high, and has indeed risen again recently, to around 20 percent in January. Such rapid inflation undermines the working--indeed the virtue--of a market economy. It deters foreign and domestic investment, promotes capital flight, and undermines reform and the transition process itself. And it hurts the poor most. The *highest priority for Russia today is the establishment of macroeconomic* stability through disciplined fiscal and credit policies. At the same time, structural reforms need to be advanced more vigorously in a number of areas: I refer in particular to the need for budget constraints to be imposed on public sector enterprises, the closure of non-viable plants, reforms of the agricultural sector, financial sector reform, adaptation of the social safety net, and further liberalization of the trade system.

Most other countries of the former Soviet Union face similar tasks, and in all of them the historic challenge facing the leadership is to build the consensus required to sustain policies of the kind that have been shown to provide the key to success.

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But the transition process in the countries of Central and Eastern Europe also presents the rest of the world with a challenge, and this brings me to the second of my two basic points. This is that external assistance and cooperation for the economies in transition are essential, but they should be seen as complementary to, not substitutes for, good domestic policies.

The countries in transition need and deserve assistance from the rest of the world in a variety of forms. First, access to markets: at a time when they are endeavoring to establish viable economies, it is essential that these countries be allowed to compete in markets where they have a comparative advantage. Another field of cooperative action is technical assistance, an essential vehicle by which the international institutions, governments, private organizations and particularly private enterprises can facilitate these countries' transformation efforts, and indeed lay the groundwork for fruitful cooperation in the future.

There is also, of course, financial assistance. Let me tell you here that contrary to what has recently been said by some, with more eloquence than respect for truth, the money made available by the so-called West in support of Russia has not been so negligible! It amounted to at least

US$58 billion over the two years 1992-93. But the IMF, in particular, has been criticized for not disbursing enough. As far as the IMF is concerned, the financial assistance it can provide is necessarily tied to countries' policies. This is part of the rules by which the Fund is governed--rules agreed by the entire membership, but sometimes forgotten in the capitals. The conditionality of the Fund's lending is designed to ensure the restoration of equilibrium and growth in the economies of member countries. In fact, the need for Fund conditionality is understood nowhere more clearly than among those who have been striving to implement policies of stabilization and reform, because--as they continually tell us--they have been materially helped by it.

The Fund has been actively providing financial support for programs of stabilization and reform in the countries of Central and Eastern Europe, and we are hoping soon to enter into new arrangements with Bulgaria and Romania to help put their programs back on track. In the countries of the former Soviet Union, the Fund has provided financial support for programs not only in the three Baltic republics, but also in Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, and, of course, Russia. Except in the Baltics, there is still a long way to go in all these countries to establish macroeconomic stability and to secure the transition to market-based economic systems, but determined efforts are underway in Kazakhstan and Moldova. In some other countries (Armenia, Azerbaijan, Georgia, and Tajikistan) situations of armed conflict have not allowed the adoption of programs we could support. Elsewhere (in Ukraine and Uzbekistan) the governments have not yet been ready to adopt policies that could be supported, but some hopeful signs of change are emerging.

In all these countries, the Fund has been very active in providing policy advice and technical assistance, including through the continuous presence of our resident representatives, and stands ready to provide financial assistance as appropriate, in support of creditworthy programs.

But let me again be more specific about Russia. The Fund has provided financial assistance to Russia twice, in 1992 and 1993--last year using our new Systemic Transformation Facility, which was introduced specially to assist the economies in transition in dealing with the disruptions caused by the shift to multilateral, market-based trade. On both occasions, important policy undertakings in the crucial fiscal and monetary areas were not fully implemented, with the result that inflation was not brought under effective control. We are now again actively discussing with the Russian authorities the policies needed to promote stabilization and reform, and we fervently hope to reach agreement on a program that the Fund could support with the disbursement of the second tranche of the STF, and subsequently with a stand-by arrangement. But this will depend on the Russian authorities' ability to commit themselves to, and to start implementing, credible policies to speed up the stabilization and reform process. Impatient as we are to provide effective financial assistance to Russia, it would be a breach of our duties to ask for less. Quite apart from the rules by which the Fund is governed, it would be wasteful and counter-productive to draw on the Fund's resources and on the credibility of its catalytic role to finance further capital flight, prolonged monetary instability, and continuing stagnation of living standards. We are working closely with the Russian authorities in the hope of a successful outcome to these negotiations.

But the complementarity between policies and financing goes much further than Fund conditionality or the Fund's catalytic role. To see how the international community responds to strong and sustained policies of adjustment and reform, consider the recent experience of Latin America, where a number of countries that were at the center of the debt crisis a decade ago have been receiving large private capital inflows. Or consider the recent strong inflows of private capital into the Czech Republic and Hungary. Moreover, strong policies promote domestic saving. Therefore, the finance available to the economies in transition is very much a function of the strength of their policy programs. This is naturally the case, because sound policies provide the basis for profitable investment opportunities, and thereby help any country to realize its potential for economic growth. If we seem to insist ad nauseam on these very basic observations it is because we believe that they are essential, particularly in a case such as Russia where there is so much at stake, for a great people and for the prosperity of the world--so much at stake that we cannot take the risk of making a wrong decision through impatience or misguided good intentions.

Look at what is at stake: look at the great potential to be released by successful transition in Russia and the other countries of the former Soviet Union. For purely illustrative purposes, let us assume that the difference in growth rates between a successful transition scenario and one of stalled reform in these countries would be 5 percent annually. This assumption implies that after a decade of successful reform, output in these countries would be almost $1 trillion higher (in 1993 dollars) than otherwise. Even after allowing for full reimbursement of external assistance, almost all of this output gain would directly benefit the peoples of Russia and the other former Soviet Republics, by more than $3,000 a year per head if population is unchanged. At the same time, the rest of the world would benefit enormously from the associated expansion of trade, 1/ from the huge investment opportunities, and from the environmental cleaning that the prosperity of these countries would allow. And as far as the political and social implications are concerned, the importance of success is immeasurable.

Success is achievable, I am convinced. It is mainly dependent on the countries in transition themselves: it is mainly their job. But they cannot do it alone. Success must be promoted by the assistance and cooperation of the international community, including timely financial

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1/ On this scenario, trade between the rest of the world and the FSU could be raised by roughly $100 billion a decade from now; cumulatively, $400 to $500 billion more trade with the FSU would be conducted over the next ten years taken together.

support once good policies are in place. As Chancellor Kohl noted recently in Davos, the prosperity of the rest of the world is linked to the success of Russian political and economic reform. Knowing what is at stake--knowing what we all stand to gain from success--the rest of the world would be crazy, once the process of comprehensive adjustment and reform is in place, to shilly-shally with its contribution.