FOR AGENDA

0450

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March 3, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Overview of Policy Experiences and Issues in the Baltic Countries, Russia, and Other FSU States

Attached for consideration by the Executive Directors is the paper on the overview of policy experiences and issues in the Baltic countries, Russia, and other countries of the former Soviet Union. Concluding remarks appear on pages 32 and 33.

This subject, together with the paper on the revenue decline in the Baltic countries, Russia, and the other countries of the former Soviet Union (SM/95/27, 2/3/95), is now tentatively scheduled for discussion on Monday, March 20, 1995.

Mr. Citrin (ext. 38982) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Overview of Policy Experiences and Issues in the Baltic Countries, Russia and Other FSU States

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(In consultation with other departments)

Approved by John Odling-Smee

March 3, 1995

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The Baltics, Russia and Other FSU States: Experiences and Key Issues

I. Introduction

The emergence in late 1991 of fifteen independent states on the territory of the U.S.S.R. presented policymakers in these countries, as well as the international financial community, with unprecedented economic challenges. Although there were some differences, these countries faced a number of comparable problems at the start of their transformation to market economies. Nevertheless, the period since the break-up of the U.S.S.R. has seen wide divergences in progress in making this transformation. This paper begins by briefly reviewing the key challenges these countries faced at the beginning of the transition process and assesses the progress made to date.

During the initial years of transition, a number of common developments and issues of concern have emerged across a wide range of the countries in the region. Among these, five issues have presented particular difficulties in the design and implementation of Fund-supported financial programs for these countries: (i) the extensive decline in output; (ii) the persistence of inflation, which in many cases occurred for some time despite a deceleration in the rate of monetary expansion; (iii) the emergence of overdue payments amongst enterprises, or interenterprise arrears; (iv) the sharp decline in fiscal revenues; and (v) questions regarding the appropriate exchange rate strategy that might be employed in the stabilization process. The paper reviews developments in each of these areas, with a view to drawing lessons for stabilization and reform in the period ahead. 1/ Part III of this paper discusses each of these issues and suggests main conclusions and policy lessons. Many other issues, such as financial sector reform, privatization and enterprise restructuring, the functioning of labor markets, and the structure of government expenditures are also critical to the stabilization and reform process, but a detailed analysis of these is beyond the scope of this paper.

II. The Experience since 1991

1. Key Challenges at the Start of Transition

a. Common challenges

After the breakup of the U.S.S.R., the Baltics, Russia, and the other FSU states all faced the immediate need for macroeconomic stabilization measures, both to address existing financial imbalances and to contain price pressures in the wake of price liberalization. In conducting monetary

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1/ A detailed analysis of the decline in revenue is contained in an accompanying staff paper (SM/95/27), and the Supplement to this paper contains detailed studies of each of the other issues.

policy, an immediate issue was whether some or all states would use a common currency as part of a ruble area, or whether separate national currencies would be established. On the one hand, the relatively limited institutional and administrative capacity for conducting independent monetary policies in the newly-formed states pointed to the maintenance of the ruble area as the means of achieving effective monetary control. On the other hand, however, the ruble area suffered from an inherent inflationary bias caused by the "free rider" problem, whereby each state with its own central bank had an incentive to expand credit at a rate faster than the average. Thus, the attainment of monetary stability in the context of the ruble area depended on the ability to effectively implement a coordinated monetary policy for the area as a whole.

During 1992, the Baltic countries and Ukraine moved to establish independent currencies, not only because of a desire to achieve better monetary control, but also to overcome shortages of ruble banknotes, to capture income from seignorage, and also to strengthen their national political and economic identities. Other non-Russian states, however, indicated a preference for staying in the ruble area. This preference appears to have been motivated by the objective of maintaining intra-FSU trade and payments relations, and an expectation that remaining in the ruble area would result in access to more financing and cheaper energy from Russia. 1/ It became increasingly clear, however, that the prospects for obtaining assistance from Russia were not necessarily linked with the ruble area issue. At the same time, many policy makers realized that the level of policy coordination among member states required for the effective functioning of a common currency area might not be consistent with their desire to maintain political and economic independence. In the event, an effective common monetary policy could not be put in place, initiatives to establish a common currency area were abandoned within a few months after the Russian currency reform in July 1993 that demonetized pre-1993 ruble notes, and monetary policy has been conducted on the basis of independent

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1/ On its part, the Fund staff made it clear to newly independent states that the decision as to whether or not to introduce a national currency was a sovereign prerogative. However, it stressed (i) that monetary union would entail certain economic consequences, particularly the loss of independence in financial policy making; and (ii) that the introduction of a national currency would not improve macroeconomic performance unless it was backed by appropriately prudent fiscal and monetary policies.

currencies in all countries since late 1993 with the exception of Tajikistan. 1/

The early move to establish monetary independence allowed the early achievement of price stabilization in the Baltic countries, first in Estonia and Latvia and later in Lithuania. In Ukraine, the introduction of an independent currency was followed by extremely high inflation and a sharply depreciating exchange rate because of a lack of appropriate supporting financial policies. In the Kyrgyz Republic--the other state that introduced its own currency prior to the Russian monetary reform in July 1993--its new currency was also initially accompanied by excessive inflation and a weak exchange rate, but stabilization was subsequently achieved and the currency strengthened as financial policies were tightened appropriately. That said, remaining in the ruble area was not an attractive option either. Expansionary policies in Russia, and the failure to implement a coordinated monetary policy among those states continuing to use the ruble, led to a lack of financial stability in the ruble area prior to its demise as well.

It was recognized by the authorities in many states that far-reaching structural changes were needed to establish the framework for a market-oriented economy. In moving successfully to a market-based system, comprehensive decontrol of prices was essential to guide the efficient allocation of resources, and in addition as a tool to help absorb excess liquidity at the outset of reform (i.e. the "monetary overhang"). For the net energy-importing economies, this meant confronting a large terms-of-trade shock that would imply a substantial and permanent reduction in real income, as energy prices rose markedly toward world-market levels. An end to the system of allocation of production through state orders was also necessary.

In addition to the provision of market incentives to economic agents, successful transformation would require that corporate decisions be taken on the basis of such signals. With the privately-owned firm as the basic element of a market economy, this would entail privatization of existing state enterprises as well as fostering the creation of new private firms. At the same time, recognizing that privatization of large enterprises in particular would take time, enterprise restructuring was needed to ensure that state enterprises would be run on a commercial footing--i.e. on the basis of "hard" budget constraints. Specific measures to facilitate

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1/ Developments and issues related to monetary arrangements are reviewed in IMF, Common Issues and Interrepublic Relations in the Former U.S.S.R., IMF Economic Review, April 1992; Hernández-Catá, Ernesto, "The Introduction of the National Currencies in the former Soviet Union: Options, Policy Requirements and Early Experiences", The Economics of New Currencies, Centre for Economic Policy Research, 1993; and Wolf, Thomas, et al, Financial Relations Among Countries in the Former Soviet Union, IMF Economic Review, February 1994. Tajikistan has announced its intention to introduce its national currency in the spring of 1995.

restructuring would include the reduction of state subsidies and elimination of the system of "directed credits" at below-market interest rates targeted at specific enterprises and sectors.

A key requirement for establishing an efficient and competitive productive sector, as well as to provide consumer choice, was the liberalization of external trade, services and capital transactions. This would include the reduction of tariff and non-tariff restrictions, securing the rights of foreign direct investors, and establishing freedom of access to foreign exchange.

Other structural policies to support transformation include institutional and legal reform to provide the appropriate framework for the operation of a market economy, such as the establishment of a well-functioning (two-tier) banking system that is sufficiently capitalized and well supervised, of effective treasury operations and tax administration, of a legal framework providing for bankruptcy and the enforcement of contractual obligations, and of statistical systems capable of meeting the information requirements of monitoring and operating the economy. And, given the inevitable short-term contraction of output facing these states from the dramatic changes in the old structure of incentives and trading relationships, it was important to introduce a well-targeted social safety net.

b. Special factors

To some extent, significant differences in the situation facing these states at the start of the transition process have also influenced the response of individual states in the transition process. First, geographical proximity and historical links may have made it easier for some states so inclined, such as the Baltics, to establish new trading relations with market economies, and vice-versa. Second, factor endowments varied widely. For example, significant energy and other natural resources exist in Russia, Turkmenistan, Uzbekistan, Kazakhstan and Azerbaijan, which, all else equal, could ease the shock of transition in these states.

Finally, and critically, the political commitment to a market economy varied from state to state. To an important extent, this reflected differences in the relative powers of various interest groups, such as the agricultural sector and the military-industrial complex. These differences were reflected in disparities in popular support for and political commitment to reforms, which, in turn, had a key impact on the strength and credibility of the reforms across the region.

2. The response thus far

Overall, progress in achieving success in stabilization and structural reform has been mixed. Five out of the fifteen countries--the Baltic states, the Kyrgyz Republic, and Moldova--have gone a long way toward macroeconomic stabilization (Table 1). Elsewhere, however, inflation has

Table 1. The Baltic States, Russia and Other FSU Countries: Consumer Price Inflation 1/

(In Percent)

	1992	1993	1994 (Proj.)	1994:QIV (Annual rate) 2/
Estonia	1,069	89	48	18
Latvia	951	109	36	24
Lithuania	1,020	410	72	49
Moldova	1,157	689	245	51
Kyrgyz Republic	855	1,209	277	59
Tajikistan	1,157	2,195	1,500	158
Armenia	825	3,732	5,169	240
Russia	1,353	896	302	388
Kazakhstan	1,516	1,662	1,880	422
Uzbekistan	645	534	723	454
Turkmenistan	493	2,102	2,397	2,062
Azerbaijan	1,747	1,047	1,493	2,262
Belarus	969	1,188	2,220	2,791
Ukraine	1,210	4,735	891	5,312
Georgia	913	3,126	18,264	8,479

Source: Data provided by authorities; and staff estimates

1/ Average year-on-year percentage increase.
2/ Annualized rate of inflation during the fourth quarter of 1994 except for Armenia, Azerbaijan, and Georgia, which are based on data for the three months through November, 1994.

remained excessively high. In the structural area, the Baltic countries, and to a somewhat lesser extent the Kyrgyz Republic and Russia, have made significant strides (Table 2). In many of the others, however, structural transformation has advanced little.

The process of stabilization and transformation has been accompanied by substantial declines in output in all countries. There is little to suggest, however, that delays in fighting inflation have been associated with a more favorable output performance--if anything, cross-country data for 1992-94 show an inverse relationship between inflation and output growth (Chart 1). And in several countries where inflation has been reduced--i.e. the Baltic states--there are now clear indications of economic recovery (Table 3). In most others, however, economic activity has continued to weaken.

Turning to a brief review of country-specific progress, the <u>Baltic states</u> are clearly furthest along in the transition. 1/ These states have benefitted from proximity and past economic relations with market economies, particularly in Scandinavia, and previous experience as independent market economies. Nevertheless, the data clearly bear out the effects of sustained stabilization efforts in the Baltic states, with inflation having been reduced to relatively low levels and positive growth resuming. In addition to adopting tight fiscal and monetary policies, these countries, which even before the dissolution of the Soviet Union, had begun to deregulate prices, fully liberalized prices and absorbed the total terms of trade impact of a rise in energy prices to world market levels with little delay. 2/ 3/ These countries have also increasingly altered their direction of trade toward western Europe.

On the structural side, the three Baltic states have made good progress with privatization, including that of large scale enterprises, 4/ although land restitution is proceeding slowly and looks likely to be a lengthy process. With regard to enterprise restructuring, budget subsidies and directed credits have largely been eliminated, but the implementation of a legal structure for bankruptcies and enforcement of contracts is far-advanced only in Estonia, with less progress in Latvia and Lithuania. Trade regimes in all three Baltic states have been liberalized to a large degree, 5/ and both current and capital account transactions are virtually

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1/ Of course, it should be recognized that judgements on overall progress amongst the fifteen countries in the region are difficult and perhaps unavoidably subjective.

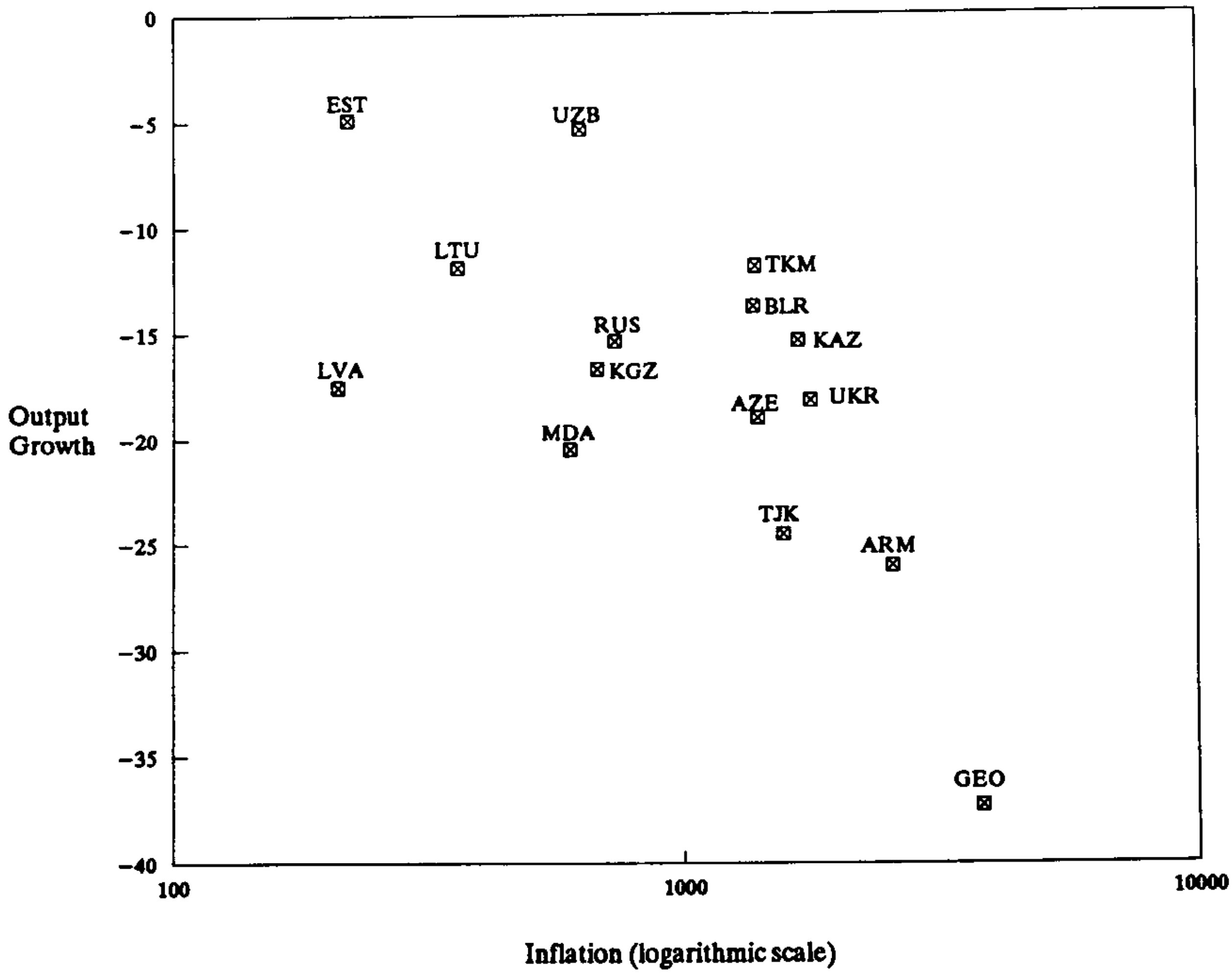
2/ Lithuania lagged Estonia and Latvia somewhat in this respect.

3/ In all three, incomes policy was used as a transitory measure, with a view to absorbing the permanent effects of the energy price rise without undue inflationary effects.

4/ Latvia is lagging somewhat with regard to large-scale privatization.

5/ The reduction of agricultural import tariffs in Latvia and Lithuania has posed problems.

Chart 1. The Baltics, Russia, and Other FSU Countries:
Inflation and Output Growth, 1992–1994 1/



Sources: Data provided by authorities; and staff estimates.

1/ Average annual percent changes in retail prices and real GDP.

Table 2. Selected Indicators of Reform (as of end-1994) 1/

	Fiscal Consolidation 2/	Privatization/ Land Restitution	Govt./ Institutional Reform 3/	Legal Framework 4/	Social Safty Net	Trade Liberalization
Estonia	S	S	S	M/S	M	S
Latvia	S	M	S	M/S	M	M/S
Lithuania	S	S	M	M/S	M	S
Kyrgyz Republic	M	S	M/S	M	L	S
Russia	L/M	S	M	L/M	L	M/S
Kazakhstan	M	M	M	M	L	M
Moldova	M	M	L/M	L	M	M
Armenia	L	S	L	L	L	L/M
Azerbaijan	L	L/M	L	L	L	
Belarus	L/M	L	M	L	L	M
Georgia	L	L/M	L	L	L	L
Tajikistan	L	L	L	L	L	L
Turkmenistan	L	L	L	L	L	L
Ukraine	L/M	L	L	L	L	S
Uzbekistan	L/M	L	L	L	L	L

Source: Staff estimates.

1/ L, M, and S stand for little, moderate and substantial progress, respectively.
2/ Judgement based on a comprehensive view of fiscal and quasi-fiscal developments.
3/ Banking system, Treasury, Tax Administration, foreign exchange control, statistics.
4/ Bankruptcy law, contract law, stock exchange, commercial banking law.

Table 3. The Baltics, Russia, and other FSU Countries:
Changes in Real Gross Domestic Product, 1991-1994

(In percent)

	1991	1992	1993	Est. 1994	Cumulative 1991-94
I. Countries afflicted by armed conflicts:					
Armenia	-10.8	-52.4	-14.8	--	-63.8
Azerbaijan	-0.7	-22.1	-11.5	-23.1	-47.3
Georgia	-20.6	-45.6	-30.0	-35.2	-80.4
Moldova	-18.0	-29.1	-8.8	-22.3	-58.8
Tajikistan	-8.7	-30.0	-27.6	-15.1	-60.7
II. Countries with a large share of natural resource exports:					
Turkmenistan	-4.8	-5.0	-9.9	-20.0	-34.8
Uzbekistan	-0.9	-11.0	-2.4	-2.6	-16.1
III. Others:					
A. (Baltics)					
Estonia	-7.9	-17.0	-2.1	6.0	-20.7
Latvia	-11.1	-35.2	-14.8	1.8	-50.0
Lithuania	-13.1	-20.1	-16.1	2.0	-40.6
B. (Moderate reformers)					
Kazakhstan	-13.0	-14.0	-12.0	-20.1	-47.4
Kyrgyz Republic	-5.2	-19.1	-16.0	-15.1	-45.3
Russia	-13.0	-19.0	-12.1	-15.0	-47.3
C. (Slow reformers)					
Belarus	-1.2	-9.6	-9.5	-21.5	-36.6
Ukraine	-11.9	-17.0	-14.2	-23.0	-51.7
Average (unweighted)	**-9.0**	**-22.8**	**-14.1**	**-17.7**	**-49.2**

Sources: Data provided by authorities; and staff estimates.

fully convertible (all three countries have accepted the obligations of Article VIII, sections 2, 3 and 4). The establishment of a well-functioning banking sector has proven to be difficult, however, with supervision remaining weak and insolvency problems surfacing in some of the banks. Also, while moderate progress in the planning of social safety nets 1/ administered and funded through government (rather than enterprises) has been made, the Baltic states are in general still not fully prepared to cope with a significant rise in open unemployment if it were to occur.

The Russian Federation has made significant headway, although its reform process started later and less decisively than the Baltic states. Efforts at achieving macroeconomic stability have, however, not succeeded. The monthly rate of inflation fell to single-digit levels in mid-1994, reflecting a sharp tightening of monetary and fiscal policies during 1993 and early 1994, but credit expansion began to accelerate in mid-year, and monthly inflation rose back to a double-digit rate by end-1994. Indeed, by the end of 1994, it became clear that performance on the stabilization front had deteriorated. The fiscal deficit had risen significantly over 1993, and inflation was on a rising--rather than falling--trend. Accordingly, reducing the fiscal deficit remains a key challenge, not only because of continuing sectoral pressures to increase expenditure, but also because of a collapse in revenue owing to a decline in traditional tax bases, numerous exemptions, and problems in tax administration and compliance.

Russia has made important progress on the structural front. In particular, privatization has been rapid, with over half of output and employment now in the private sector. However, progress in enterprise restructuring has been slow, in part reflecting lack of effective corporate governance, and banking supervision remains weak. Prices have been largely freed of controls at the federal level, 2/ and imports are also relatively free of restrictions. A wide range of controls remain, however, on the export side. Russia, like many other countries in the region, has received technical assistance from the Fund for improvements to its social safety net, but there has been little reform in this area thus far.

Another country where significant progress towards stabilization and reform has been made is the Kyrgyz Republic. Fiscal and monetary polices have been kept tight, notwithstanding a sharp contraction in revenue collections, and monthly inflation has averaged just 3 percent since April 1994. The (som) exchange rate has appreciated considerably against the U.S. dollar since that time, and remonetization of the economy is underway. On the structural front, progress has been most notable in the areas of privatization, deregulation of domestic prices, and liberalization of the exchange and trade system. Indeed, the Kyrgyz Republic has maintained full current and capital account convertibility since mid-1993. Key areas where

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1/ Mainly the provision of public housing, the structure of unemployment benefits, and reform of the pension system.

2/ Some restrictions remain at local levels.

a strengthening of efforts is needed are enterprise restructuring and banking reform; indeed, interenterprise arrears are a significant problem and the financial situation of the banking sector is weak.

In Moldova, inflation has been dramatically reduced to low single-digit levels (monthly rate) since April 1994, the exchange rate has stabilized, and private capital has flowed back into the country. The progress in stabilization has not been matched, however, in the structural area. Particular problems are the poor financial situation of state enterprises (which threatens to undermine price stability), relatively little progress in privatization, and banking sector weakness.

In Kazakhstan, a tightening of financial policies in mid-1994 brought about a marked reduction in the inflation rate, but inflation remains too high, and a weak revenue performance along with enterprise losses are, inter alia, exerting considerable inflationary pressures. Prices have been largely decontrolled and there has been progress toward trade liberalization. However, the implementation of privatization plans has lagged, the state enterprise sector has not been subject to financial discipline, and important legislation--e.g. in the bankruptcy and antimonopoly areas--remains to be introduced.

Elsewhere, there was generally little progress toward stability or transformation during the 1992-94 period as a whole. However, at the end of 1994, stabilization and reform programs were initiated in Ukraine, Armenia, Georgia, and Uzbekistan, and there are indications of further significant efforts in 1995. In Belarus, there was only partial implementation of a Fund-supported program in 1993, followed by policy setbacks, particularly in the structural area. The commitment to market-oriented reforms was strengthened in the second half of 1994, and a number of reform and stabilization measures were adopted. In Azerbaijan, Tajikistan and Turkmenistan, there has been very little movement to stabilize the price level or initiate reforms, although in Azerbaijan reform efforts are now under active consideration.

III. Key common issues in the transition process

1. The decline in output

a. Experience and possible causes

The significant fall in recorded output throughout the region since the dissolution of the U.S.S.R. has raised concerns about the design of the stabilization and reform strategy being, or to be, pursued. Indeed, real GDP in these states declined by one-third on average in 1992-93 and further in 1994, although the extent of deterioration has varied markedly across countries. Even though part of the fall may be attributed to well-known measurement problems--e.g. the overstatement of production under the planned system followed by incomplete coverage under the new--the actual decline is likely to have been large as well. 1/

The output performance has varied significantly amongst the fifteen countries. These differences in part reflect the influence of two special factors. First, five countries--Armenia, Azerbaijan, Georgia, Moldova and Tajikistan--were adversely affected by armed conflicts and in some cases accompanying economic blockades, and thus experienced relatively large output declines (Table 3 and Chart 2). Second, Uzbekistan and Turkmenistan were buoyed by relatively stable demand and favorable price movements for natural resource exports, which accounted for a large share of total output in those economies.

Apart from these differences, the weakening in growth in the region stemmed from the influence of a common set of forces. While data limitations prevent a precise quantitative analysis for most states in the region, the available literature and information point to the importance of two types of factors: (i) developments related to the desirable systemic transformation; and (ii) problems arising from the disintegration of the U.S.S.R. 2/

With regard to the first, the reduction in government coordination of economic activity led to transitional disruptions in input supplies, and marketing difficulties for enterprises. In addition, domestic price liberalization, modifications in the structure of taxes and subsidies, and the end of central planning all led to substantial changes in relative prices and the structure of demand, with a rise in demand for goods and services previously in "shortage" and a fall in demand for output in traditional sectors. Output in some traditionally favored sectors fell because of reductions in governmental demand. For example, the drop in defence spending in Russia contributed an estimated 3-4 percentage points to the overall drop in GDP in 1992 in that country. Similarly, for some of the central Asian republics, from 1992 the cessation of grants from the U.S.S.R. budget, and from 1993 onwards substantial reductions in official financing from Russia amounting to 15 to 20 percent of their combined GDP, exacerbated output losses in these states by constraining their ability to pay for imported inputs.

While a large part of the stock of physical and human capital in traditional sectors quickly became obsolete, productive capacity in new activities has been slow to develop because of unavoidable time lags. Meanwhile, the liberalization of external transactions has led prices of

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1/ It should be kept in mind that to the extent that part of the lost output may have been unsalable or undesired by consumers and the public, the decline in output does not necessarily translate one-for-one into a fall in living standards or consumer welfare.

2/ References to the literature in this area may be found in Chapter I of the Supplement.

tradeables (especially energy products) to rise markedly from previously low and subsidized levels toward those prevailing on world markets, and has also released previously pent-up demand for foreign goods. Together with the loss of traditional CMEA export markets, these developments constituted a large external shock that had adverse implications on output and income, particularly in many net energy importing countries of the region. For the fourteen states apart from Russia, the move in prices of tradeables towards world levels is estimated to have entailed a terms of trade deterioration of some 30 percent in 1992-94. 1/ This worsening in the terms of trade is estimated to have had a direct negative impact on GDP on average in these fourteen states amounting to about 13 percentage points. 2/ 3/

As presented in Chapter 1 of the Supplement, available data are broadly consistent with the thesis that the output decline in large part reflects the systemic change. In particular, there is a distinct relationship between the timing of reforms and the time path of output. Those states (the Baltics) that reformed and stabilized rapidly recorded larger contractions in activity initially, but are now experiencing a renewal of growth, as well as a recovery in investment. In the meantime, countries that have moved more slowly have registered continued declines in output, albeit smaller ones early on (see Chart 2, Groups IIIB and IIIC countries). Moreover, and consistent with the increasing evidence for eastern Europe, it does not appear that the countries in this region that have postponed action have been able to reduce the cumulative size of the output decline.

Political changes and disruptions associated with the demise of the U.S.S.R. have also been important. In addition to armed conflicts, states were affected by disruptions to exchange and payments arrangements for trade with the other states in the region and with the rest of the world, and by a reduction in financial transfers from Russia. All these developments contributed to inefficiencies and interruptions in trade flows and, thereby, to declines in output. That said, it should be emphasized that the decline in interstate trade must be viewed in the context of systemic change and the needed reorientation of trade onto a market basis; thus, it should not be attributed solely to the break-up of the U.S.S.R.

There is little evidence that the output decline has been exacerbated by unduly contractionary monetary and credit policies. Indeed, in addition

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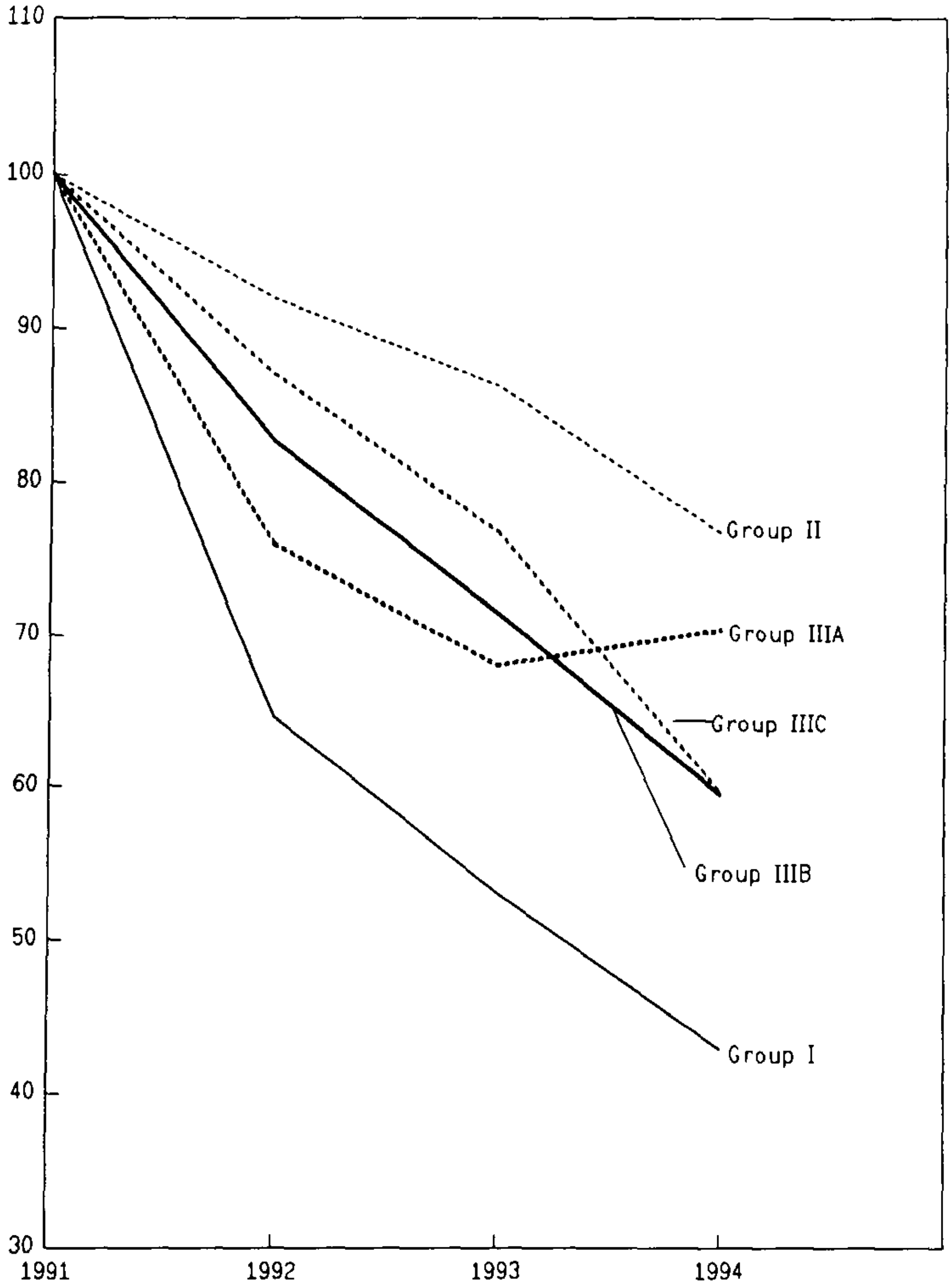
1/ See IMF (1994b).
2/ This calculation is based on 1990 trade intensities estimated by Tarr (1994).
3/ On the other hand, the countries in the region in general, and Russia in particular, could not benefit from the terms of trade gain following the abolition of the Council for Mutual Economic Assistance (CMEA) because of the collapse of CMEA trade. For example, from around 60 percent of the U.S.S.R.'s total trade in the second half of 1980's, the former CMEA's share dropped to less than 20 percent of Russia's trade with the area outside the Baltic states and other FSU countries in 1992.

CHART 2

The Baltics, Russia and other FSU Countries:

Real Gross Domestic Product, 1991-1994

(1991=100)



Group I: (Conflict states) Armenia, Azerbjn., Georgia, Moldova, Tajikstn.
Group II: (Natural resuource exporters) Turkmenistan and Uzbekistan.
Group IIIA: (Fast reformers) Estonia, Latvia, and Lithuania.
Group IIIB: (Moderate reformers) Kazakhstan, Kyrgyz Republic, and Russia.
Group IIIC: (Slow reformers) Belarus and Ukraine.
Source: WEO data and staff estimates.

to the inverse relationship between inflation and growth shown in Chart 1, the correlation across countries between output growth and money growth is also negative during 1992-94 (see Chart 3). That said, there is a positive correlation in a number of countries between the cumulative decline in the real money stock and that in output. 1/ However, this does not constitute convincing evidence in favor of the hypothesis that tight money has exacerbated the cumulative output decline, as the decline in real liquidity has not necessarily reflected tight credit policies. First, a good portion of the decline in real balances in 1992 reflects the elimination through price liberalization of the monetary "overhang" accumulated in previous years. 2/ Second, lower real balances are likely to have partly reflected lower money demand due to the output decline (and high inflation). Third, substantial declines in real balances were reported both in countries which undertook monetary tightening and those which did not.

Moreover, there is little correlation between the decline in output and the observed level of real interest rates: while high positive real rates of return were associated with declining output in Ukraine, the achievement of positive real interest rates was accompanied by a recovery in output in Armenia, the Baltics, Kazakhstan and Moldova. Meanwhile, strongly negative real rates did not prevent an acceleration in the rate of decline in output in Azerbaijan, Georgia, Tajikistan and Turkmenistan. While a tightening of credit policies may have posed a problem for new private firms as well as for those in traditional sectors, its impact is likely to have been quite different for new and traditional activities because enterprises that did well in the new market environment could use internal cash flows to finance investment. In addition to stabilizing prices, the primary effect of tighter credit has likely been to accelerate structural change, reducing rather than increasing the total output loss associated with transition, as misallocated resources were freed up more quickly and became available for use in new activities, and managers were found to develop new products and seek new markets.

b. The period ahead

Looking ahead, the resolution of political disruptions could lead to some recovery in activity, including in traditional sectors. More importantly, however, the initiation of sustainable growth oriented towards a new structure of production will depend positively on the pace of structural change and investment in new activities. Indeed, looking at several central and eastern European countries, as well as the Baltics: (i) all but one country first brought down inflation before beginning to recover, and (ii) the recovery has generally been accompanied by a strengthening in real fixed investment, enhancing possibilities for longer term growth. This implies that prospects for a resumption of growth will be

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1/ See Supplement, Chapter 1, pp. 18-20.
2/ The real money stock in the U.S.S.R. was 35 percent higher in 1990 than it had been in 1988.

better the more decisive are stabilization efforts as well as other actions that impact positively on confidence and the investment climate, i.e., bold liberalization and reform measures, and the development of a stable legal and financial infrastructure.

2. Inflation developments and velocity behavior

a. The experience

An important concern in the transition process has been the extremely high and variable rates of inflation observed for most economies in the region. The growth of prices has been due primarily to rapid monetary expansion--indeed, average inflation and money growth rates have been highly correlated during the 1992-94 period as a whole for every country. However, there have also been intervals of striking divergence between rates of inflation and money growth, reflected in most cases in declining domestic real money balances and increases in the level of velocity.

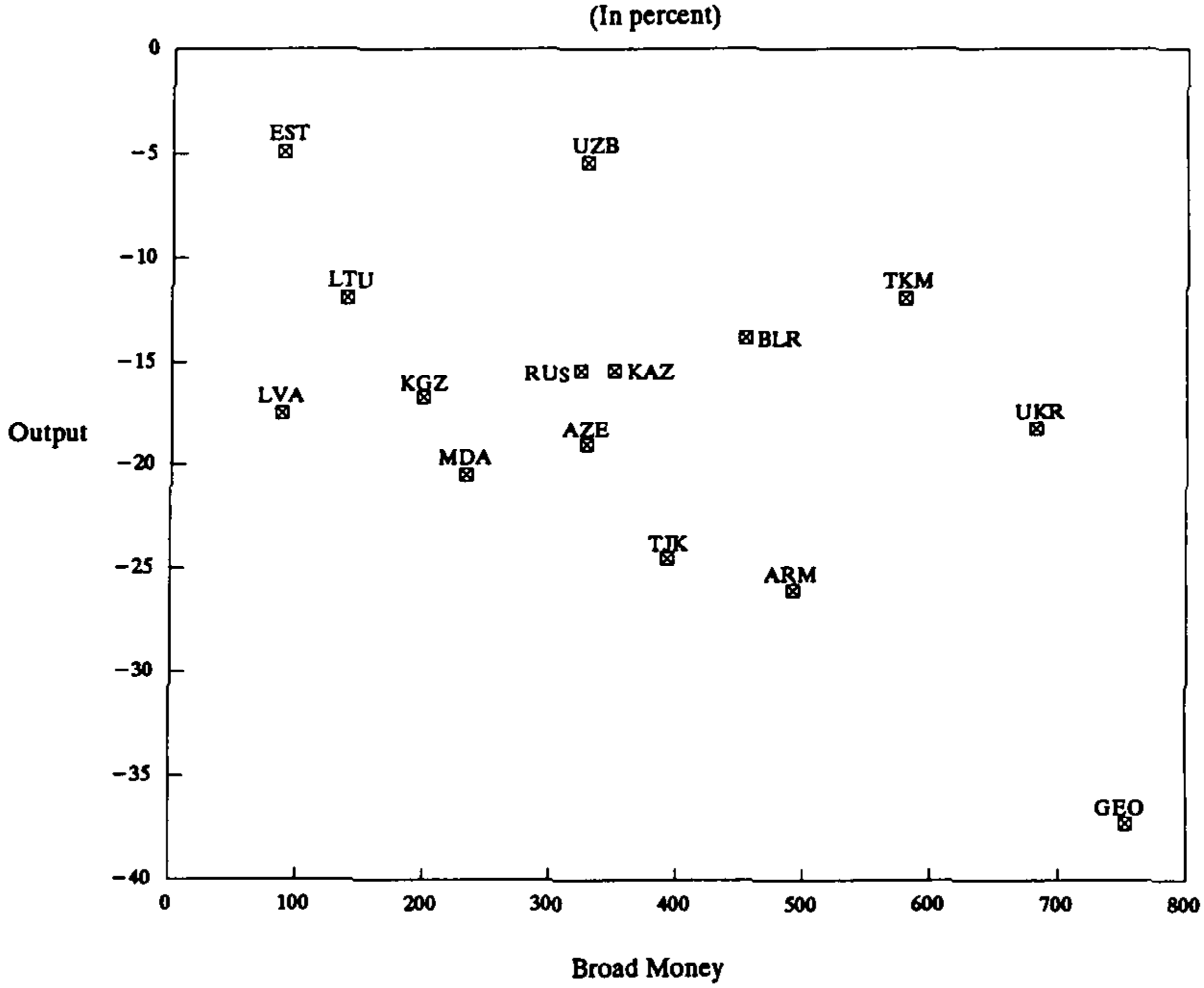
Velocity movements in the Baltics, Russia and other FSU states have tended to display the following characteristics (Chart 4). First, increases have generally occurred not in smooth trends, but rather in large discrete shifts--in extreme cases such as in Armenia, Georgia and Turkmenistan in late 1993, velocity rose threefold or more in the space of one quarter. Second, an acceleration in inflation accompanied by a rise in velocity occurred virtually simultaneously across a number of countries. During late 1993 and early 1994, velocity rose substantially in every country in the region except for the Baltic states, Russia and Uzbekistan. Finally, increases in velocity have tended to be protracted. In some cases, velocity has declined only slowly following the initial increase, while in others velocity has remained at its new, higher level.

A review of Fund-supported program experience, where many of the initial stabilization efforts saw inflation outcomes exceed program targets by wide margins, also highlights the ability of money growth and inflation paths to diverge substantially in the short term. Contrary to initial expectations, inflation substantially exceeded contemporaneous broad money growth rates for two quarters or more in five of the seven programs where price objectives were not attained--Belarus, Kazakhstan (1993), Kyrgyz Republic (1993), Lithuania (1992), and Moldova (September, 1993)--and were reflected in marked and unanticipated increases in velocity (see Table 4 and also Chart 5). Only in one case--Russia (1993)--was the poor inflation outturn explained first and foremost by excessive monetary expansion.

Four factors appear to have played important roles in these observed inflation and velocity movements. First, inflation has generally responded with a lag to changes in monetary conditions, especially in countries where there has been high volatility in the rate of monetary expansion. Most stabilization efforts, for example, have only been rewarded with a decline in inflation one or two quarters subsequent to decline in money growth. Chart 6 presents developments in inflation and lagged money growth for the

Chart 3. The Baltics, Russia, and Other FSU Countries:
Growth in Output and Broad Money, 1992–1994 1/

(In percent)

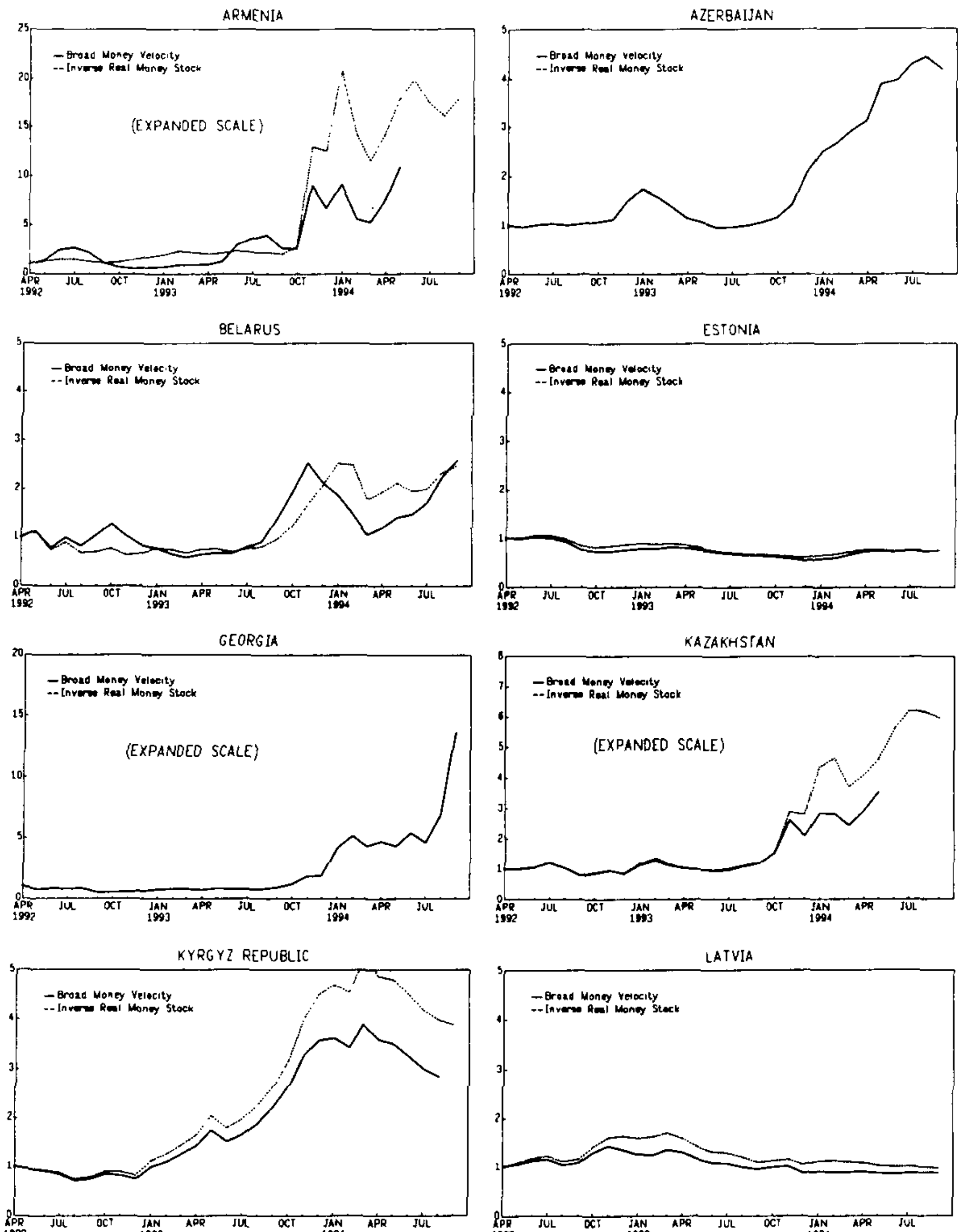


Sources: Data provided by authorities; and staff estimates.

1/ Average annual percent changes in domestic broad money and real GDP.

CHART No 4

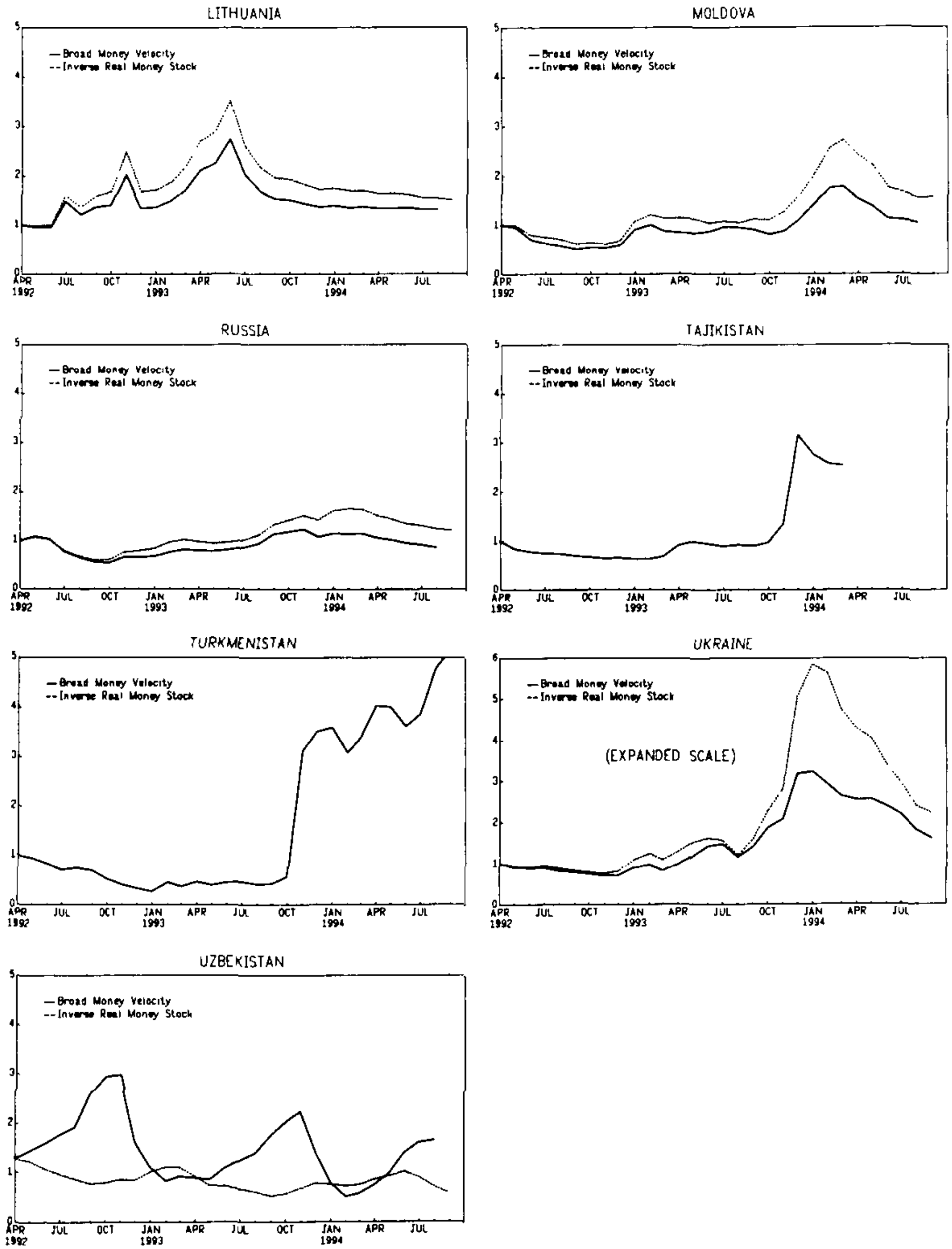
Baltics, Russia and Other FSU States: Money Velocity and Inverse Real Money Balances, 1992-1994



Definitions:
Money Velocity -- Domestic broad money velocity, index (April 1992 = 1)
Real Money Stock -- Real stock of domestic broad money, index (April 1992 = 1)

CHART No 4, continued

Baltics, Russia and Other FSU States: Money Velocity and Inverse Real Money Balances, 1992-1994

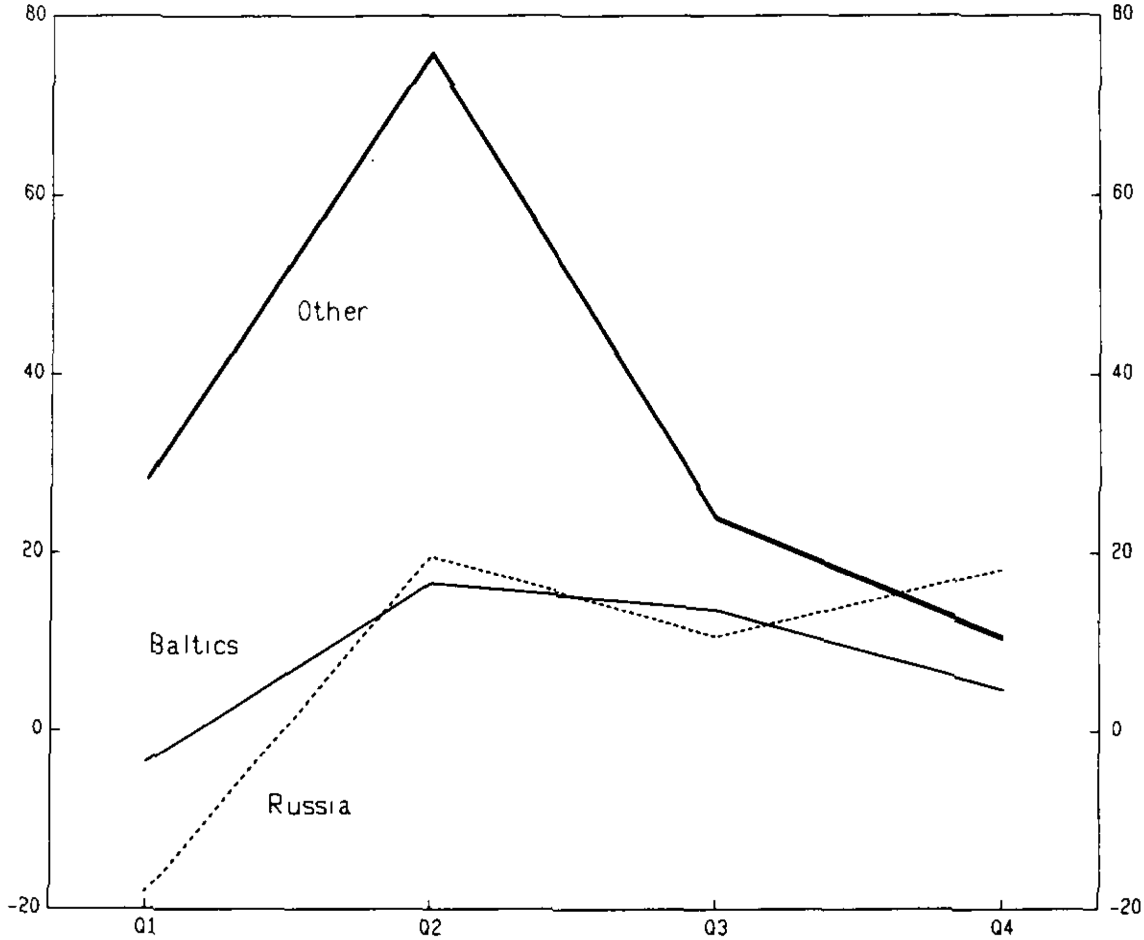


Definitions:
Money Velocity -- Domestic broad money velocity, index (April 1992 = 1)
Real Money Stock -- Real stock of domestic broad money, index (April 1992 = 1)

CHART No 5

Difference Between Inflation and Money Growth Rates in Selected Fund-Supported Programs, 1992-94 1/

(in percentage points)

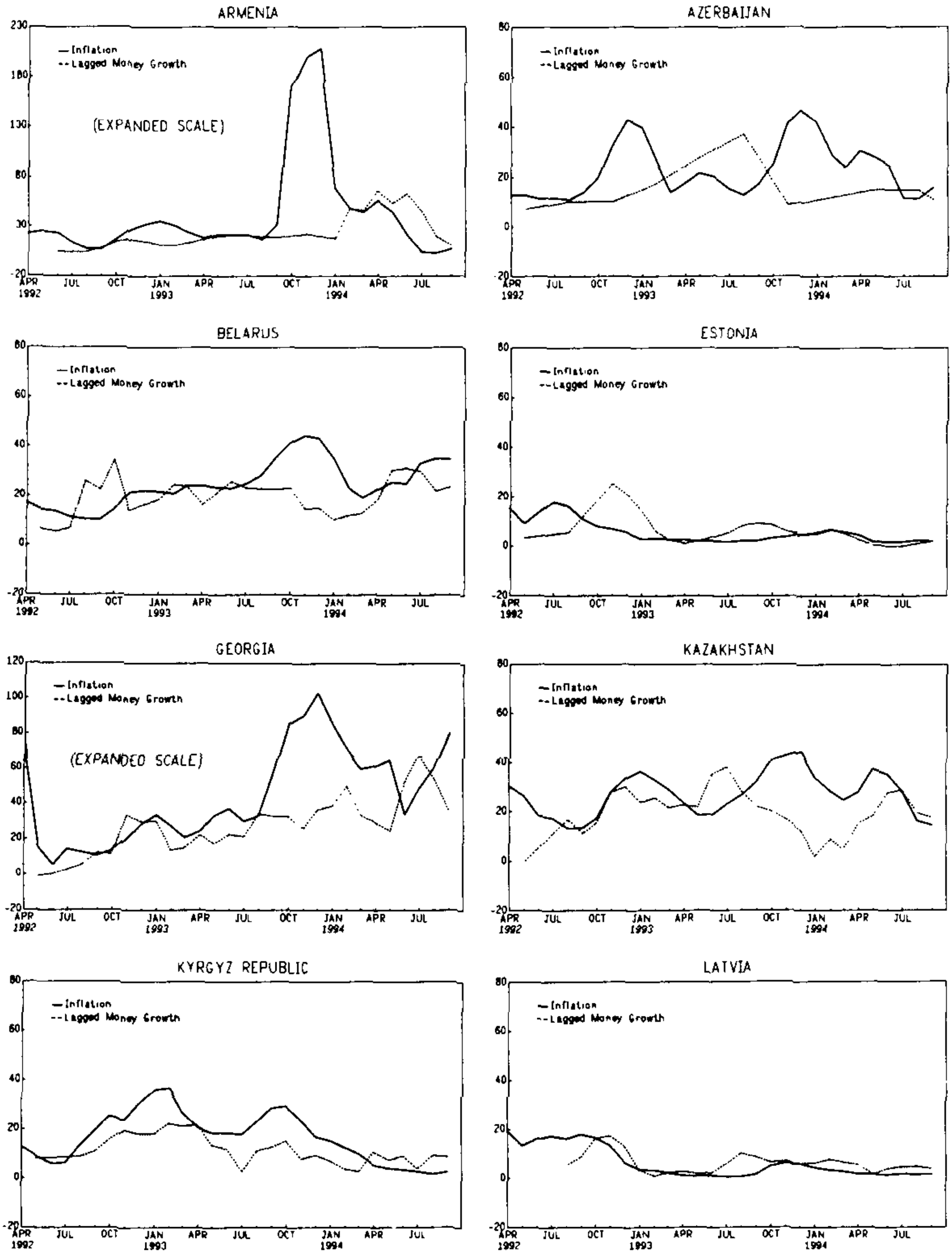


1/ Defined as the within-period quarterly growth rate of retail prices less the within-period quarterly growth rate of broad money. The monetary aggregates used are defined in Table 4.
'Q1' refers to the first program quarter for each arrangement.

Baltics: Estonia SBA (8/92), Latvia SBA (8/92), Lithuania SBA (8/92)
Russia: Russia STF (6/93), Russia STF (4/94)
Other: Belarus STF (7/93), Kazakhstan STF (7/93), Kazakhstan SBA (1/94), Kyrgyz SBA (4/93), Kyrgyz ESAF (6/94), Moldova STF (9/93), Moldova SBA (11/93)

CHART No 6

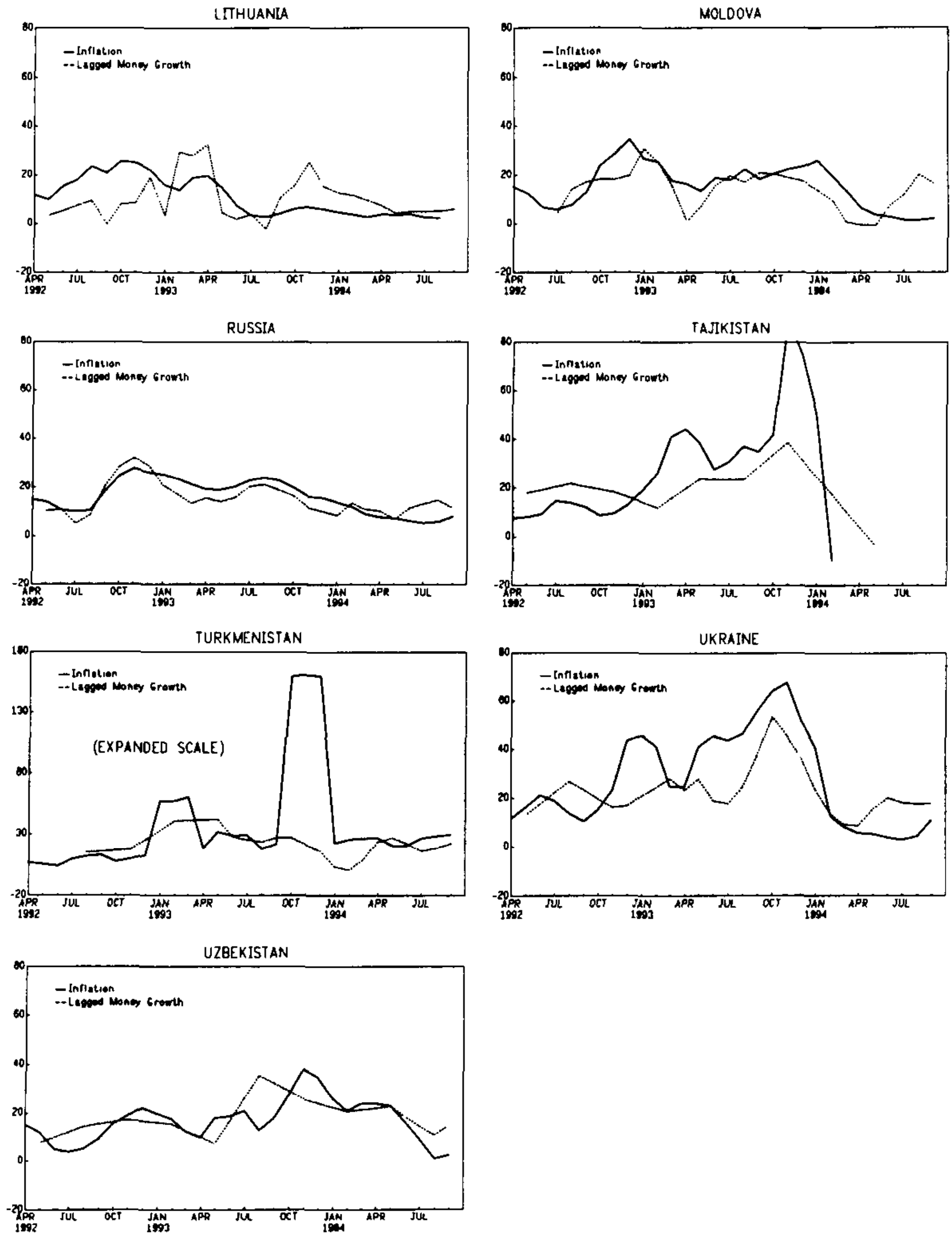
Baltics, Russia and Other FSU States: Inflation and Lagged Money Growth, 1992-1994



Definitions:
Inflation -- 3-month moving average retail price inflation
Money Growth -- 3-month moving average growth rate of domestic broad money, lagged one quarter

CHART No 6, continued

Baltics, Russia and Other FSU States: Inflation and Lagged Money Growth, 1992-1994



Definitions:
Inflation -- 3-month moving average retail price inflation
Money Growth -- 3-month moving average growth rate of domestic broad money, lagged one quarter

Table 4. The Baltics, Russia, and other FSU Countries: Inflation and Money Growth, Program Performance, 1992–1994 1/ 2/

(Percent changes)

	1992		1993	
	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.
The Baltics				
Estonia (SBA, 8/92)				
Consumer prices				
Program	18.3	13.2	4.0	1.8
Actual	55.8	21.8	9.0	5.4
Broad money 3/				
Program	...	...	...	...
Actual	96.1	18.1	6.1	26.7
Velocity				
Program	...	...	...	...
Actual	−28.5	1.7	4.7	−7.0
Latvia (SBA, 8/92) 4/				
Consumer prices				
Program	31.0	22.0	10.0	5.0
Actual	55.9	43.7	9.8	2.3
Broad money				
Program	26.0	28.0	29.0	14.0
Actual	57.9	14.6	6.7	25.2
Velocity				
Program	0.0	−2.0	−12.0	2.0
Actual	−16.0	3.9	−11.9	−10.6
Lithuania (SBA, 10/92) 5/				
Consumer prices				
Program	121.0	30.0	8.0	9.0
Actual	88.0	95.9	46.5	49.7
Broad money				
Program	65.0	25.0	10.0	10.0
Actual	56.5	79.1	11.7	−8.3
Velocity				
Program	0.0	33.0	−6.0	−2.0
Actual	−0.6	−21.4	25.4	80.9

	1993			1994		
	2nd qtr.	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.	3rd qtr.
Lithuania (SBA, 10/93)						
Consumer prices						
Program		8	5.5	4.5	4	
Actual		8.2	21.7	11.4	10.8	
Broad money						
Program		38.7	16.1	10.4	...	
Actual		54.4	29	13.5	15.3	
Velocity						
Program		−21.3	−4.1	−1.5	...	
Actual		−26.5	−7.7	3.1	−2.6	
Russia (STF, 6/93)						
Consumer prices						
Program	60.2	36.8	26.0			
Actual	68.2	89.7	56.6			
Broad money 3/						
Program	45.1	32.5	23.7			
Actual	81.1	41.4	44.7			
Velocity						
Program	4.9	14.1	−12.3			
Actual	−5.3	32.9	6.6			
Russia (STF, 4/94)						
Consumer prices						
Program					48.2	36.8
Actual					22.9	18.1
Broad money 3/						
Program					39.0	43.7
Actual					50.7	27.5
Velocity						
Program					2.2	3.5
Actual					−23.4	6.3

Sources: Data provided by authorities; and staff estimates.

1/ Inflation reflects within–period quarterly rate.
2/ Broad money includes foreign currency deposits, unless otherwise noted: program figure derived using accounting exchange rate; actual figure reflects actual exchange rate.
3/ Reflects domestic broad money.
4/ First two quarters are for August SBA, next two quarters are revised March SBA.
5/ First three quarters are for October SBA, last one is revised March.

Table 4 (concluded). The Baltics, Russia, and other FSU Countries: Inflation and Money Growth, Program Performance, 1992–1994 1/ 2/
(Percent changes)

	1993 2nd qtr.	1993 3rd qtr.	1993 4th qtr.	1994 1st qtr.	1994 2nd qtr.	1994 3rd qtr.
Other FSU Countries						
Belarus (STF, 7/93)						
Consumer prices						
Program		57.0	25.0			
Actual		109.6	201.3			
Broad money						
Program		51.0	70.0			
Actual		71.3	61.7			
Velocity						
Program		23.0	−7.0			
Actual		4.0	30.0			
Kyrgyz Republic (SBA, 4/93)						
Consumer prices						
Program	33.0	20.0	14.0			
Actual	65.8	85.0	87.7			
Broad money						
Program	10.0	15.0	19.0			
Actual	48.1	51.4	−7.0			
Velocity						
Program	19.0	−5.0	−2.0			
Actual	12.0	11.0	100.2			
Kyrgyz Republic (ESAF, 6/94)						
Consumer prices						
STF/SBA					15.0	15.0
Actual					12.4	4.8
Broad money						
STF/SBA					20.0	10.0
Actual					27.3	19.6
Velocity						
STF/SBA					...	7.0
Actual					−3.6	−12.2
Moldova (STF, 9/93)						
Consumer prices						
Program		43.0	28.0	9.0	7.0	
Actual		81.0	81.9	67.6	10.7	
Broad money						
Program		90.0	20.0	−13.0	3.0	
Actual		66.4	34.8	−3.0	65.5	
Velocity						
Program		24.0	0.0	0.0	0.0	
Actual		21.5	8.9	107.3	−32.5	

	1993 3rd qtr.	1993 4th qtr.	1994 1st qtr.	1994 2nd qtr.	1994 3rd qtr.
Moldova (SBA, 11/93)					
Consumer prices					
Program		57.0	14.0	10.0	6.0
Actual		81.9	67.6	10.7	3.7
Broad money					
Program		23.0	3.0	9.0	19.0
Actual		34.8	−3.0	65.5	15.7
Velocity					
Program		63.0	−61.0	10.0	131.0
Actual		8.9	107.3	−32.5	−1.6
Kazakhstan (STF, 7/93)					
Consumer prices					
Program	48.0	31.0			
Actual	102.8	188.8			
Broad money					
Program	26.0	17.0			
Actual	59.7	22.4			
Velocity					
Program	37.0	13.0			
Actual	10.7	90.3			
Kazakhstan (SBA, 1/94)					
Consumer prices					
Program			57.0	20.0	7.0
Actual			107.9	157.3	55.9
Broad money					
Program			56.0	15.0	7.0
Actual			56.3	69.9	46.6
Velocity					
Program			−1.0	24.0	8.0
Actual			1.6	66.5	...

1/ Inflation reflects within–period quarterly rate.
2/ Broad money includes foreign currency deposits, unless otherwise noted: program figure derived using accounting exchange rate; actual figure reflects actual exchange rate.

countries in the region during 1992-94. For several countries--Latvia, Moldova and Russia--inflation appears to have closely followed broad money growth with a lag of roughly one quarter. Most countries, however, experienced intervals of strong divergence in the growth rates of money and prices even after accounting for such lags.

Second, in some countries, e.g. Armenia, Georgia, Kazakhstan, and Turkmenistan, inflationary expectations and uncertainty about macroeconomic policies appear to have led to flight from domestic monetary assets, particularly during the dismantling of the ruble area and the often ad-hoc introduction of national currencies. Third, exogenous price pressures have given rise to periods of high inflation not accompanied by corresponding increases in money growth. In particular, exogenous increases in import prices (energy prices and Russian non-energy export prices) appear to have had a large impact on inflation in many states in late 1993; discrete increases in domestic administered prices have also played a role at various times.

Finally, there are strong indications that increases in informal trade credits and arrears have contributed to the rise in velocity. In several countries--including Azerbaijan, Belarus, the Kyrgyz Republic, and Ukraine--a tightening of monetary conditions or exogenous price pressures appear to have been "offset" by the creation of such credits, reducing the need, at least for a time, to reduce nominal expenditures.

b. Lessons

Beyond the short term, inflation has been closely linked to money growth in these countries over the medium term. Nevertheless, the divergence between the two over shorter intervals, especially the sharp rise in inflation relative to money growth in many countries in late 1993, suggests the following lessons. Regardless of the factors underlying the initial deviations in inflation and money growth and the associated increases in money velocity, countries which have achieved a subsequent reduction in velocity levels have been those that established and maintained positive rates of return on domestic monetary assets, as well as other conditions that instilled confidence in the currency. Looking at the experience of Fund-supported programs, the successful anti-inflation cases achieved not only low rates of monetary and credit expansion but also positive real interest rates, which contributed to a stable or appreciating exchange rate and a recovery in the demand for money. 1/ On the other hand, stabilization efforts in which real rates of return remained significantly negative, or have only recently turned positive, have had greater difficulty in controlling inflation, and have yet to bring about a reversal of velocity increases. To the extent that inflationary inertia has played a role, moderating wage pressures can also be important--in fact, those program countries (Estonia, Latvia, Lithuania, and Moldova) which were

1/ See Supplement Chapter II, section 4.a.

most successful in achieving sustained reductions in inflation and velocity did so during periods of successful wage restraint.

Thus, while the steady and substantial reduction in monetary expansion--supported by fiscal restraint--is both a necessary and sufficient condition for bringing down inflation over the medium-term, the achievement of positive real interest rates can facilitate a more rapid response of prices and minimize the effects of exogenous shocks. The desirability of quickly establishing confidence in the currency and favorably affecting inflationary expectations would argue for mechanisms that clearly signal policy intentions; under appropriate conditions, this could entail a commitment to an exchange rate peg. 1/ Finally, the ability of enterprises to offset monetary restraint with increases in interenterprise credits suggests that policies to discourage an undue rise in such credits--in particular those which signal the refusal of the government to "bail out" indebted enterprises--would make stabilization policy more effective.

3. The emergence of interenterprise arrears

a. Developments and main causes

As in many other transition economies, the process of adjustment from central planning to a market-oriented system in the Baltics, Russia and other FSU states has been accompanied by an increase in interenterprise trade credits and overruns on the maturity of such credits. Interenterprise trade credits and overdue obligations (or arrears) are common features in all market economies, and some increase in their volumes--from very low initial amounts--was to be expected in transition economies. However, it is important to distinguish between the natural adaptation to markets and the special factors present in a transition economy that drive the accumulation of arrears during the process of transition. Interenterprise arrears signal a lack of financial discipline, can retard investment and the process of privatization, and can complicate the conduct of stabilization policies.

In almost every country of the region, interenterprise arrears grew rapidly following the dissolution of the U.S.S.R. (see Table 5). In Russia, for example, interenterprise arrears amounted to 21 percent of GDP in gross terms in mid-1992. In an attempt to deal with the problem of mounting arrears, all the countries in the region, except the Baltics, carried out netting operations in the second half of 1992 and early 1993. The netting operations, however, were accompanied by bail-outs of the net debtors. With such action leading to expectations of further bail-outs, interenterprise arrears re-emerged quickly.

1/ The issue of appropriate exchange rate strategies is discussed in Section 5 below.

Table 5. The Baltics, Russia and Other FSU Countries:
Interenterprise Arrears 1/

(End of period)

	1992	1993				1994		
		1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.	3rd qtr.
				(As percent of GDP) 2/				
Azerbaijan	...	1.8	9.1	12.6	15.0	13.5	14.6	...
Kazakhstan	1.7	1.9	1.9	3.4	5.0	4.0	3.7	7.1
Kyrgyz Republic	...	9.1	8.7	9.0	7.9	...	...	...
Lithuania	...	6.8	8.3	11.5	8.8	5.4	...	...
Russia	...	...	...	...	3.0	4.0	2.6	...
Of which: industry and construction	...	2.6	2.3	2.2	2.7	3.6	2.3	...
Turkmenistan	...	...	...	...	...	2.9	...	...
Ukraine	...	...	0.8	0.7	1.8	4.6	...	...
				(As percent of broad money) 3/				
Azerbaijan	34.2	5.8	19.7	44.9	42.8	57.8	56.7	...
Kazakhstan	9.2	12.8	12.8	28.4	81.1	35.3	...	214.2
Kyrgyz Republic	107.8	105.0	129.1	160.5	250.7	248.1	256.4	227.8
Lithuania	52.2	74.6	181.1	119.7	50.2	43.8	45.5	...
Russia	...	...	...	26.5	33.1	49.5	48.0	54.7
Of which: industry and construction	19.3	19.9	17.1	24.1	29.6	44.6	42.9	45.5
Turkmenistan	...	...	...	...	63.1	66.2	81.4	100.8
Ukraine	...	1.5	6.9	6.7	33.2	70.3	...	...
Memorandum Items:								
				(Interenterprise payables as percent of GDP) 2/				
Belarus	...	...	3.9	3.5	8.1	15.6	13.9	...
Latvia	23.8	...	...	...	16.2	...	...	...
				(Interenterprise payables as percent of broad money) 3/				
Belarus	...	38.5	36.5	36.2	185.8	114.8	141.2	...
Latvia	204.0	...	...	...	79.5	...	...	...

Sources: Data provided by the authorities; and staff estimates.

1/ Defined as overdue payables for every country except Turkmenistan, for which the data refer to overdue receivables.

2/ Defined as average during the quarter as a percent of annualized quarterly GDP.

3/ Defined as the ratio of the end-of-period stock of broad money.

While interenterprise arrears rose to high levels at various times during 1992 and the first half of 1993, 1/ it should be noted that, when measured in relation to GDP, they remained generally low by both the standards of established market economies and by the levels observed in some central and eastern European countries in similar stages of transition. 2/

Subsequently, i.e. from mid-1993 to late-1994, it appears that the experience has been rather varied. During this period, the arrears problem has declined in Latvia, Lithuania and the Kyrgyz Republic. 3/ At the same time, arrears increased rather modestly in both Russia and Turkmenistan, although nonpayment for energy deliveries by enterprises in these countries to those in other states have been a significant problem. These arrears, which rose sharply after the increase in energy prices toward world market levels, have impeded stabilization efforts by leading to added pressures for credits and subsidies to energy enterprises, and complicated interstate relations with energy-importing states in the region.

In contrast, interenterprise arrears increased dramatically in Azerbaijan, Kazakhstan, and Ukraine during this period, and on the basis of data on interenterprise credits, in Belarus as well. In Kazakhstan, a sharp rise in late 1993 was followed by another jump in mid-1994, even though the Government attempted to solve the arrears problem in early 1994 by undertaking a netting operation, extending credit to all net debtor enterprises, and initiating an enterprise restructuring plan. In the event, financial discipline was not established and a new stock of interenterprise arrears emerged that exceeded by a wide margin the previous amount.

In the initial stages of transition, managers of state-owned enterprises have little experience with the market, and institutional arrangements and incentive structures do not change dramatically. The high level of uncertainty regarding relative prices, the prospective stance of macroeconomic policies, and the future ownership and management structure compound the problem of inadequate incentives for efficient management. In such circumstances, managers seek to avoid conflicts with the workforce on employment and wage issues, often buying raw materials and inputs on credit

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1/ Data on either arrears or total credits are available only for 9 of 15 states in the region. The underlying payments situation of enterprises during this period is obscured by the impact of the netting operations. Also, any cross-country comparison of the arrears problem is subject to the caveat that the data is not strictly comparable across countries because of differences in definition as well as coverage (see Chapter 3 of the Supplement).

2/ Interenterprise arrears as proportions of GDP were 16 percent and 22 percent in 1991 in the former Czechoslovakia and Poland, respectively. The corresponding ratios to broad money were 22 and 69 percent in the two countries.

3/ For Latvia, this judgement is based on the decline in total interenterprise credits.

and maintaining a level of production even if there is insufficient demand. Such behavior also may lead to delivering output in exchange for future promises to pay to buyers with questionable prospects. Of course, when the promises to pay are not honored in time, arrears build up. The absence of a sound banking and payments system, macroeconomic stability and suitable laws and institutions, perpetuate a management culture inappropriate for a market economy and financial discipline.

b. Policies to deal with arrears

Policies to address interenterprise arrears must focus on encouraging enterprises in adjusting to market signals and on promoting financial discipline. The experience with the exceptional measures such as netting taken in a number of countries clearly demonstrates the temporary nature of relief to the arrears problem provided by such measures. Netting and bail-out exercises merely address symptoms rather than underlying causes, and indeed perpetuate and compound the problem by strengthening expectations of future bail-outs of debtor enterprises by the government.

In the short-term, the authorities could promote a solution to the "stock" problem of existing interenterprise arrears by promoting a secondary market where such claims could be traded. Such a solution could lead to a netting out of interenterprise arrears without any extension of government or central bank credit, and send a strong signal to enterprises and banks that the authorities will no longer bail out firms with arrears or bad debts. 1/ The involvement of governments and central banks should be limited to providing an adequate regulatory and institutional framework to prevent abuses such as insider trading and manipulative practices.

In addition to avoiding any bail-out component in the measures designed to deal with existing arrears, a few other specific steps could be helpful to prevent the emergence of new arrears, i.e. the flow problem.

First, bankruptcy criteria and judicial procedures should be streamlined with a view to providing for the closing of insolvent enterprises, but also for their reorganization in an attempt to avoid future liquidation and closing. It is unrealistic, however, to expect a bankruptcy system to emerge rapidly just with the enactment of the appropriate laws. 2/ Until bankruptcy procedures are working smoothly, in providing

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1/ This approach played a part in the restructuring of enterprise debt in Poland.

2/ Given the relative inexperience of judicial courts in bankruptcy cases and the limited availability of trained liquidators, and hence the uncertainty of the judicial awards, creditors tend to fight shy of becoming "pioneers" and incurring large start-up costs in bankruptcy proceedings. This slow start-up is illustrated by the experience of the Czech Republic, where the number of declared bankruptcies went up from 5 in 1992 to 60 in 1993 and further to 254 in 1994.

enterprises with the incentive to alter their behavior and be financially responsible, it will be essential for governments to clearly demonstrate their willingness to allow enterprises to close. The government should identify a narrow set of enterprises with large arrears problems. If any of these enterprises are deemed to be not viable, bankruptcy proceedings should be initiated by the government. 1/ 2/

Second, to ensure that managers are accountable for all payments obligations of their enterprises (including taxes and wages), governments could impose financial and administrative penalties on managers of state enterprises, including termination of service. Moreover, since a significant part of the blame for arrears can be placed on the inappropriate behavior of managers of creditor enterprises, penalties could be applied to them as well. 3/ Third, for customers with arrears in excess of agreed limits, state-owned enterprises could be required to ship products only on the basis of preshipment payment or on the basis of promissory notes of the receiver of goods and services, duly guaranteed by commercial banks. 4/ Finally, the timely monitoring of the underlying financial position of enterprises as well as their arrears to both domestic and foreign banks and enterprises should be ensured through appropriate reporting requirements.

Interstate interenterprise arrears related to energy deliveries are largely of a quasi-governmental nature, with volumes, prices, and means of payment determined on the basis of intergovernmental agreements. While governments should take responsibility for regularizing such arrears through the negotiation of rescheduling agreements, they should move towards removing themselves from involvement in interstate trading activities in the future.

1/ In exceptional circumstances, if bankruptcy is not a viable option for a particular enterprise because of strategic considerations, the flow problem should be dealt with by a restructuring of the enterprise and identifying budgetary support over the medium-term. Furthermore, it is important to make the provision of budgetary support conditional on, inter alia, the clearance of existing arrears and their avoidance in the future.

2/ In Poland more than 1200 enterprises have been liquidated by the government because of their financial non-viability. In late 1992, the Government of Estonia initiated bankruptcy proceedings against a small number of state enterprises because of tax arrears and insolvency.

3/ In Hungary, for example, the 1991 law on bankruptcy made the failure on the part of managers to declare bankruptcy, when payments were overdue for more than 90 days, punishable according to the provision of the Civil Code.

4/ In the former Yugoslavia in the 1980s, promissory notes with a maturity up to 90 days, which were the most important category of interenterprise credits, had to be guaranteed by a bank and backed by a physical transaction.

4. The revenue decline 1/

a. Developments and main contributing factors

Another key concern is the significant deterioration in government revenue that has occurred in the countries in the region since 1991. With the contraction in economic activity, revenues declined in real terms in all states except for Uzbekistan. Of even greater concern, however, has been a drop in revenues in relation to GDP. For a number of countries, the cessation of grants from the Union government following the dissolution of the U.S.S.R. played a significant role. Even excluding such grants, however, the revenue to GDP ratio is estimated to have deteriorated in at least twelve of the fifteen countries (Table 6). Excluding Russia, revenues for this group of states fell by an average of 8 percent of GDP in 1992-93, and a further sharp fall of around 4 percent of GDP is estimated for 1994. In Russia, the revenue to GDP ratio is estimated to have fallen by 5 percent of GDP in 1993-94. 2/

It should be stressed at the outset that revenue levels and the nature of the fiscal problem differ considerably across countries. The revenue declines may be viewed in part as a consequence of market-oriented fiscal reforms and a reduction in the role of government, and in and of themselves are not necessarily a cause for concern. Indeed, the fastest reformers--the Baltic states--are among those countries where revenues are now significantly lower than prior to reforms. Moreover, to the extent that the drop in revenues has contributed to a widening in fiscal imbalances in many countries, the problem may be inadequate efforts to reduce government spending rather than a need to enhance receipts. Nevertheless, in a number of cases, sharp declines in revenues may have exceeded the scope for spending cuts, and thus efforts to address them should be central to correcting the fiscal problem.

The decline in revenues in relation to GDP has its roots in a number of factors. First is the collapse in activity in the traditional sectors of the economy. The main tax bases in the Baltics, Russia and other FSU countries have been state enterprise surpluses, wages and salaries paid through enterprises, and retail sales primarily through state stores. Accordingly, a disproportionate decline in output in the traditional sectors of these economies help explain the declining relative yield from major sources of taxes--i.e. enterprise profit taxes, taxes on wages and salaries, and VAT and other indirect taxes.

1/ The decline in revenues is analyzed in depth in the accompanying report, "The Revenue Decline in the Baltic Countries, Russia and Other Countries of the Former Soviet Union" (SM/95/27).

2/ Due to problems associated with the succession of the Russian Federation to the Soviet Union, reliable 1991 data for Russia are not available.

Table 6. The Baltics, Russia, and other FSU Countries: Evolution of Revenue, excluding Union Grants, 1991-1994

(*In percent of GDP*)

	1991	1992	1993	Est. 1994
Countries with an increase in revenue to GDP ratio				
Tajikistan	20.2	26.6	26.9	...
Ukraine	36.5	41.5	41.1	42.8
Uzbekistan	30.6	31.3	41.0	...
Average	29.1	33.1	36.3	42.8
Countries with a decrease in revenues to GDP ratio				
Armenia	25.6	26.7	23.5	18.8
Azerbaijan	37.5	49.0	36.9	...
Belarus	43.9	42.2	43.6	39.2
Estonia	41.0	35.1	36.6	34.7
Georgia	33.8	15.3	2.9	...
Kazakhstan	20.5	22.9	22.3	15.7
Kyrgyz Republic	22.4	16.5	13.6	13.3
Latvia	37.4	28.1	35.8	36.7
Lithuania	44.0	33.7	27.6	24.1
Moldova	31.6	27.0	22.9	18.5
Russia	...	37.6	36.7	32.9
Turkmenistan	38.2	42.2	19.2	6.2
Average 1/	34.2	31.4	26.8	24.0
Average for all countries	33.1	31.7	28.7	25.7

Sources: Data provided by the authorities; and staff estimates.

1/ The calculation of the average for 1991 excludes Russia.

Meanwhile, private and informal activities, which now account for a significant share of output in most countries of the region, have not contributed significantly to tax receipts. 1/ Some firms in these sectors may not be profitable in the initial years of operation, while others have received substantial start-up and other exemptions from paying taxes. More generally, many of these entities have not been captured in the tax net because of weaknesses in tax policy and administration.

Shortcomings in the design of tax systems have also led to an erosion in revenue. The switch from turnover taxes to broad based VATs and excise taxes entailed an unexpected net loss in revenues, in part because VAT liabilities were allowed to be determined on a cash basis while VAT credits for inputs could be claimed on an accrual basis. The effects of trade liberalization and ineffective custom administration at newly established borders reduced collections from trade taxes.

Numerous exemptions from all major taxes have been a critical factor. Throughout the region, exemptions have proliferated as Governments have not had the will to impose hard budget constraints and have sought to earn the political support of powerful interest groups--sectoral lobbies, regional elites, foreign investors, and vulnerable segments of the population. Governments have not fully appreciated the importance of level playing fields in market economies and also have sought to use such exemptions as an alternative to a social safety net.

Problems in tax administration in general have played a significant role, by not allowing lost revenues to be replaced through the more effective taxation of emerging (as well as traditional) sectors. In planned economies, tax administration had only a limited function, with assessment essentially determined by the plan and collection taking place through the state-owned banking sector. With reforms, the introduction of a modern tax administration became critical. However, the countries of the region have had serious problems in coping with the basic functions of tax administration--taxpayer identification, filing and payment procedures, organization of tax administration, and taxpayer education. The lack of an effective tax administration has led to poor compliance, and together with the low wages of tax officers has created an environment of corruption. Barter arrangements and multiple exchange rate regimes have also contributed to tax evasion.

The weak legitimacy of new governments has also hindered tax collection. In some countries, uneasy relations with local regions led to disputes over revenue-sharing arrangements and delayed or insufficient payments by local governments to the federal authorities. In addition,

1/ While coverage is incomplete, private and informal activities are at least partly covered in the national accounts data for most countries. To the extent that they are not fully captured, the revenue decline relative to GDP would be even larger than indicated above.

political instability and the lack of a coherent and committed reform strategy has led to a culture of misappropriation and withholding of revenues by ministries, local governments and state enterprises.

b. Lessons

Addressing the revenue problem will be a complex and formidable task. In the immediate period ahead, the most effective reforms will be those that improve the collection of taxes from those sectors of the economy that are already theoretically in the tax net. This would involve, first and foremost, the removal or severe restriction of exemptions on all types of taxes. Second, every effort should be made to capture the emerging private sector. In the short term, when there are difficulties in assessing tax liability on new taxpayers, some presumptive elements of taxation could be considered. Third, the agricultural sector, which is the largest untaxed sector in the region, should be brought into the tax net--initially through the removal of exemptions on major taxes but also through the introduction of a land tax. Fourth, trade taxes might be enhanced, for example through the application of broad-based and uniform tariffs. Fifth, an increase in petroleum and other energy taxes should be considered. Indeed, for the region as a whole, energy-related excise taxes are significantly lower than in major OECD countries; and for the energy producers in the region, relatively little is earned from these sectors compared with international norms. Finally, the establishment of good governance, and a taxpaying culture will be critical. To this end, Governments should establish and commit themselves to a coherent tax system that is based on objective and transparent criteria and not subject to ad hoc adjustments. At the same time, they should establish on their part, realistic budgets and observe their own spending commitments and obligations so as to eliminate precautionary and retaliatory withholding by taxpayers.

Over the medium term, although with little delay, improvements in the design of the tax system and tax administration will be important. In the design area, the two main accounting reforms should be the introduction of accrual accounting to the enterprise profit tax, and the replacement of the mark-up method with the invoice method for calculating VAT liability. Desirable reforms to tax administration include: improvements to taxpayer registration and identification procedures, taxpayer education, and the introduction of effective audit procedures and adequate penalties.

5. The Role of the Exchange Rate

a. General considerations and experience

The question of whether a fixed exchange rate strategy may be more effective in bringing down inflation in transition economies than a strategy based on monetary targets with a flexible exchange rate has received considerable attention in the past year in both the public debate and discussions within the Fund.

There are a number of reasons for looking favorably at fixed exchange rate approached, including: money-based approaches with exchange rate flexibility may be less effective in the face of unstable money demand; an exchange rate anchor may both signal and help secure the end of an inflationary spiral, thereby enhancing confidence and helping in the re-monetization of transition economies; and an exchange rate peg may induce a greater commitment to fiscal adjustment than would otherwise be the case.

However, the adoption of a fixed exchange rate as a stabilization tool also has a few potential problems. In addition to instability in money demand, countries in the region have been and continue to be exposed to large real and external shocks--e.g. changes in the terms of trade--which are better absorbed under a flexible exchange rate regime. Second, while an exchange rate anchor may *induce* greater fiscal discipline, it also may *require* greater fiscal adjustment, since it will require a low inflation target. The degree of fiscal adjustment needed to sustain a fixed exchange rate may exceed the added discipline that is likely to arise with such an arrangement. Third, the failure of an exchange rate peg will entail significant costs, not only losses in foreign reserves associated with an attempt to save the peg, but also typically higher inflation than before the program started, mainly because of the loss of credibility of the government. By contrast, departure from a monetary target may be reversible, or the program may be adjusted without visibly signalling failure.

The experience with alternative stabilization strategies outside the Baltics, Russia and the other FSU area--both in transition economies and market economies--indicates that exchange rate anchors are an effective and possibly superior approach to stabilization if supporting adjustment measures are adequate. However, the inadequacy of accompanying adjustment policies--in particular, fiscal restraint--has ultimately led to failures of such stabilization attempts in many cases. On the other hand, money based stabilizations have had a mixed record as well. With regard to central European transition economies, all three attempts to use exchange rate anchors in stabilization were effective in bringing down inflation fast (Table 7); however, one of the three (Yugoslavia) subsequently failed, and inflation returned to very high levels. At the same time, four out of six money based stabilization attempts in central Europe were successful, with quarterly inflation reduced to single-digit levels within one year. 1/

In light of the general arguments and experience, the staff has taken a case-by-case approach in the FSU region, with the choice of stabilization strategy guided by judgements regarding the specific fiscal situation, the underlying commitment to stabilize, the adequacy of official reserves, and the nature and size of shocks likely to prevail in the country in question.

1/ The October 1993 Croatian stabilization is included as a money based approach here. For further discussion, see Supplement, Chapter IV, footnote 1, p. 8.

Table 7. Countries in Transition: Stabilization and Inflation Performance

(Average quarterly percent changes)

	Quarter of Stabilization Attempt (Q0)	Q−1	Q0	Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8
Money−based stabilization:											
Albania *	III/92	30.5	51.6	33.3	12.4	1.6	10.2	5.7	3.8	12.0	−3.0
Bulgaria	I/91			48.0	17.7	11.6	13.8	18.7	12.7	15.7	18.2
Croatia *	IV/93	109.9	77.4	−1.3	−2.7	0.6	0.4				
FYRM *	I/94	36.5	44.6	8.2	2.5	6.0					
Romania	I/91		40.6	40.3	24.2	34.3	50.3	26.7	16.3	34.5	36.7
Slovenia *	IV/91	31.8	63.7	48.5	24.1	10.1	8.1	7.0	3.9	4.0	6.3
Belarus	II/93	78.6	90.0	98.4	181.1	127.1	84.1	127.0	130.6		
Kazakhstan	II/93	139.6	84.6	86.8	170.2	137.4	122.8	92.6	50.4		
Kyrgyz Republic *	II/93	143.7	78.2	72.4	102.7	50.1	19.5	7.6	...		
Latvia *	II/92	222.5	69.5	57.4	53.8	12.9	3.4	1.7	12.7	13.3	5.8
Lithuania *	III/92	47.7	69.0	91.1	57.6	61.6	13.5	18.0	14.8	10.1	8.3
Moldova *	IV/93	70.5	74.2	82.7	23.3	5.1	9.1				
Russia	II/93	94.2	70.9	83.6	69.0	46.6	25.4	18.0	37.4		
Exchange rate−based stabilization:											
Czechoslovakia *	I/91	3.8	34.4	9.3	1.7	1.5	2.6	1.7	2.6	5.1	...
Poland *	I/90	48.9	49.2	23.0	10.4	15.4	26.1	11.7	6.1	9.7	12.9
Yugoslavia	IV/89	135.8	225.4	117.7	12.5	5.2	20.4	17	22.9	23.9	58.5
Estonia *	II/92	279.0	61.2	55.0	27.0	11.3	7.0	5.6	9.2	17.0	11.9

Sources: Data provided by authorities; and staff estimates.

* Successful stabilizations.

Thus, the case of Estonia entailed an exchange-rate based stabilization approach, while in all other cases stabilization attempts under Fund supported programs involved flexible exchange rates. 1/ The main factor militating against an exchange rate peg was an insufficient commitment to strong restraint in fiscal policies.

The inflation record of cases in the region where sufficient time has passed to allow an assessment of the stabilization attempt is shown in Table 7. An exchange-rate anchor was associated with a reduction in inflation in the only case in which it was attempted during the main stabilization phase (Estonia), while four out of seven money based stabilizations can also be considered successes (Latvia, Lithuania, Moldova and the Kyrgyz Republic).

The experience with flexible exchange rate arrangements in Fund-supported stabilization programs outside the Baltics, which will be taken up separately below (Belarus, Kazakhstan, Kyrgyz Republic, Moldova and Russia) does not indicate that an exchange rate peg would have been more appropriate in these countries. In some of these programs, the intended disinflation, as reflected in program targets, was not sufficient to sustain a fixed exchange rate. While most of these economies experienced large swings in velocity that partly undermined the short-term effectiveness of the monetary anchor, they also experienced large and unforeseen real disruptions, which were probably better dealt with under flexible rates.

Finally, these countries all failed, by a wide margin in some cases, to meet fiscal targets. In the absence of a counterfactual, it is impossible to say with certainty whether these fiscal slippages would also have occurred under an exchange rate anchor; however, the extent and nature of the slippages suggest that the even greater fiscal restraint that would have been needed under an exchange rate peg could not have been delivered. In the case of Kazakhstan, the main source of fiscal slippage under the program supported by a stand-by arrangement in 1994 related to an ill-designed and large bail-out of interenterprise arrears, which served as a clear indication of the magnitude of underlying financial imbalances and lack of commitment to financial discipline. In the case of the 1993 program supported by a stand-by arrangement for the Kyrgyz Republic, the slippage resulted from excessive credits to agriculture that were seen as necessary to ensure oil and gas imports under bilateral barter agreements; the size of the problem and the authorities' policy response strongly suggests that a peg would not have been sustained. In the case of Moldova, the slippages on the domestic front were related to external financial shortfalls and a severe drought that were outside the control of the authorities. The money-based approach permitted the program to be modified as needed without

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1/ Subsequent to the main price stabilization phase, Lithuania switched to a currency board arrangement in March 1994, while Latvia has maintained a de-facto peg to the SDR (without formal commitment) since February 1994, also after the main stabilization phase.

creating the perception that the authorities had failed, and thus did little damage to confidence and the authorities' credibility. Finally, for Belarus and Russia, the political consensus to undertake the major adjustments required to support an exchange rate peg was clearly not present, as was reflected in failures to take necessary budgetary measures as well as to restrict credit to enterprises and sectors under several Fund-supported programs in 1992-94.

The cases of Estonia and Latvia permit a comparison of the relative merits of the two approaches in circumstances of similarly appropriate fiscal and institutional preconditions. Estonia and Latvia both successfully stabilized in 1992-93, Estonia under a currency board and Latvia under a flexible exchange rate regime. While the degree of fiscal restraint was comparable, deposit interest rates were substantially lower in Estonia than in Latvia up until early 1994, suggesting that the Estonian currency board arrangement commanded greater credibility than the Latvian approach. In addition, for a similar decline in inflation, Estonia's recorded output loss during 1992-94 appears to have been smaller than in Latvia.

It is not clear, however, to what extent the difference in recorded output performance is due to the exchange rate arrangements. Estonia's closer ties to the Nordic countries may have contributed to higher foreign direct investment inflows in that country, and Latvia was slower to privatize. Moreover, the output figures may be misleading since they attempt to account for the new private activities in the case of Estonia, but not Latvia. On the whole, the experience in the Baltic countries supports the view suggested by the central European stabilization experiences, namely that pegging the exchange rate may be a useful element in stabilization if the fiscal conditions are right, but that pegging is not necessary for stabilizing rapidly and successfully.

b. Conclusions for the period ahead

Recent developments in a number of countries in the region appear to have strengthened the case for rapid disinflation supported by a fixed exchange rate. With progress in price and trade liberalization, a large portion of the real shocks associated with transition may lie in the past, and the underlying recognition of the need for fiscal adjustment and the taming of inflation has strengthened in many countries. Several countries (including Russia, Kazakhstan, Ukraine, Armenia and Georgia) may soon be at a point where an exchange rate anchor could be a useful complement to appropriate financial policies in the stabilization effort. Second, three countries, Latvia, Moldova and the Kyrgyz Republic, where money based programs were successful and exposure to external shocks (particularly in the case of Moldova) persists, may do better to continue with the prevailing exchange rate arrangements. Similarly, there is no case for Estonia or Lithuania to change their currency board arrangements. Finally, there is a group of countries whose stage in the transition process--and thus the magnitude of prospective real shocks--and whose underlying fiscal and creating the perception that the authorities had failed, and thus did little damage to confidence and the authorities' credibility. Finally, for Belarus and Russia, the political consensus to undertake the major adjustments required to support an exchange rate peg was clearly not present, as was reflected in failures to take necessary budgetary measures as well as to restrict credit to enterprises and sectors under several Fund-supported programs in 1992-94.

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III. Concluding remarks

Success in stabilization and reform has been mixed. The widespread hopes of a quick turnaround in the countries of the region have been replaced with the recognition that systemic transformation will take time. That said, the evidence distinctly points to the benefits from an immediate attack on inflation accompanied by the introduction of a comprehensive and coherent structural reform strategy. The cross-country pattern of output developments and the experience with efforts to reduce inflation and to deal with the problem of interenterprise arrears, all strongly support such an approach. All the economies of the region where activity has begun to recover had already achieved a reasonable degree of price stability, and there is nothing to suggest that output levels can be preserved through more expansionary financial policies.

The task of reducing inflation from extremely high levels is not easy, not least since monetary management is complicated by unexpected fluctuations in velocity, or the demand for money. The experience has confirmed the essential importance of steadfast monetary and credit restraint, and of resisting pressure for additional credits to accommodate higher price increases. However, the problem of unstable money demand also argues for timely reviews of intermediate money and credit targets, so that needed adjustments can be made in light of actual inflation developments, taking due account of the normal lags between previous changes in the monetary stance and price developments. Given the underlying uncertainties, monetary policy formulation in the short term may also be facilitated by the use of a market exchange rate and/or market-related interest rates as intermediate indicators. Under appropriate conditions, credit policies could be governed by a fixed exchange rate as the formal nominal anchor. Finally, supporting policy measures that clearly signal the Government's policy course, ensure financial discipline amongst enterprises, and promote wage restraint, would facilitate the disinflation process by enhancing credibility and the flexibility of goods and labor markets. In this vein, it is important that measures to deal with interenterprise arrears by ensuring that enterprises are financially responsible for their own actions be implemented without delay.

While a fixed exchange rate may be helpful in the disinflation process. The failure of an exchange rate peg does entail costs, and the experience of several countries has shown that such an approach is not necessary for the achievement of stabilization objectives. Decisions on the choice of approach in this area must continue to be guided by case-by-case judgements regarding the fiscal position, the political commitment to adjustment, and other relevant factors.

Finally, the discussion of the problem of revenue performance also confirms the importance of strong commitment to reform and stabilization. Indeed, the lack of a well-designed and credible Government policies toward taxation have contributed importantly to the deterioration in revenue performance that has made the stabilization process even more difficult.