FOR AGENDA

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SM/95/46
Correction 1

March 15, 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

The following corrections have been made in SM/95/46 (3/3/95):

Page i, Section IV.: Concluding remarks now appear on page 31.

Page 12, footnote 1: Revised to read "See Wolf, et al (1994) cited on page 7, footnote 1."

Page 27, footnote 1, lines 2 and 3: for "Chapter IV, footnote 1, p. 8"
read "Chapter IV, page 80, footnote 3."

Original page 31 deleted and pages 32 and 33 renumbered pages 31 and 32.

Corrected pages are attached.

Att: (4)

Other Distribution:
Department Heads

SM/95/46
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INTERNATIONAL MONETARY FUND

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

Prepared by the European II Department
(In consultation with other departments)

Approved by John Odling-Smee

March 3, 1995

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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

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 Wolf, et al (1994) cited on page 7, footnote 1.

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.

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, page 80, footnote 3.

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.

political conditions suggest that a fixed exchange rate strategy would still entail an unduly high degree of risk. In all this, it should be emphasized that political and economic uncertainties remain unusually high in this region, warranting a continual reassessment of the appropriate policy approach.

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.